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Investors should stay disciplined as markets adjust to tariffs, inflation, AI trends, and more. Stock market volatility is a normal part of investing. Those who can stay balanced and focused have historically been in a better position to achieve financial success.

Key Market and Economic Drivers

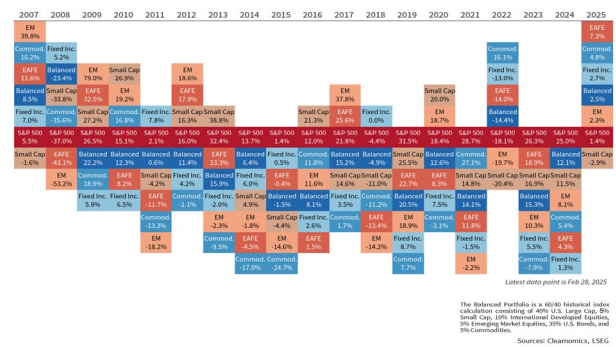
- The S&P 500 fell 1.4% in February, the Nasdaq fell 4.0%, and the Dow Jones Industrial Average fell 1.6%. Year-to-date, the S&P 500 is up 1.2%, while the Nasdaq is down 2.4%, giving up its year-to-date gains during the month.
- The Aggregate Bond index gained 2.2%. The 10-year Treasury yield ended the month at 4.2%, but reached as high as 4.6% mid-month.
- The Consumer Price Index increased 3.0% year-over-year, higher than expected and faster than the 2.9% reading in December.

- Retail sales fell 0.9%, including a 1.9% decline in nonstore retail sales. The household savings rate rose slightly to 4.6% but is still below the historical average of 6.2%.
- Bitcoin declined from over \$102,000 at the beginning of the month to around \$84,000 at month end.

In February, a flurry of policy headlines and inflation concerns rattled markets and consumer sentiment. While major market indices ended weaker, the S&P 500 also reached new all-time highs during the month. These back-and-forth swings in the stock market may be uncomfortable, but they are a normal part of investing. In addition, the stock market pullback was partially offset by bond market gains, demonstrating the importance of portfolio balance. For long-term investors, it's more important than ever to stay focused on financial goals.

Chart: Many asset classes beyond U.S. stocks are positive this year

Asset Classes Relative to U.S. Stocks



Perhaps the biggest market moves that captured investor attention had to do with the largest technology stocks. The group of stocks known as the Magnificent 7 struggled to find its footing, even as plans for significant artificial intelligence spending were confirmed by several large technology companies and Nvidia reported solid earnings results. Investors continue to worry about the growth potential for some of the largest beneficiaries of the AI trade, especially if tariffs worsen production constraints.

While the recent selloff has improved valuations for many parts of the market, the Information Technology and Communication Services sectors remain priced at premiums compared to their historical averages. In fact, all but two S&P 500 sectors still have positive year-to-date returns. The top sectors, including Healthcare, Financials, and Consumer Staples, have tended to be more defensive.

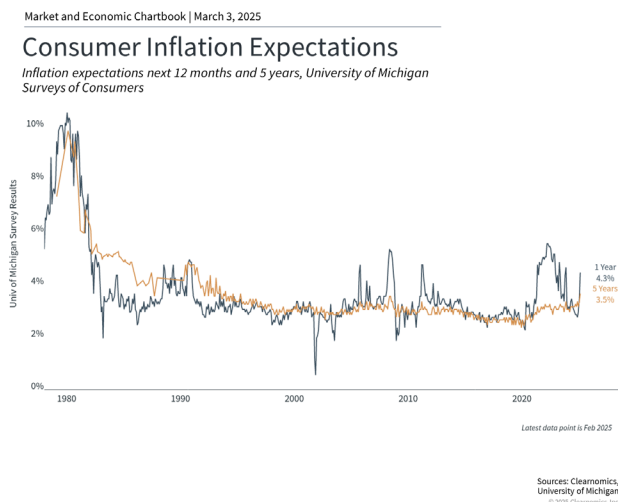
Bonds have also played a positive role in this environment. The 10-year yield ended the month at 4.2%, more than one-third of a percentage point below where it began the month. When interest rates fall, the prices on existing bonds rise since their higher yields become more attractive. Thus, when interest rates decline alongside the stock market, bonds can help provide balance to portfolios.

As seen in the chart on the previous page, both fixed income and international markets have outperformed the S&P 500 year-to-date. While the stock market, and technology stocks in particular, have performed well over the past few years, February underscores the importance of being balanced across different parts of the market to help manage risk across different market conditions.

Investors and consumers continue to be focused on inflation

It's not surprising that one of the main drivers of market volatility in February was inflation. According to the Consumer Price Index, inflation is back at 3% for the first time since last summer. Other inflation readings also showed that prices across many categories are stickier than many economists had anticipated

Chart: Consumers are worried about higher inflation



Consumer expectations of future inflation have also risen. The combination of still-rising food and shelter prices and the anticipated impact of tariffs is driving consumers to prepare for even higher prices. As seen in the accompanying chart, inflation expectations for the next 12 months jumped to 4.3% from 3.3% in January. Over the next five years, these same consumers expect average inflation as high as 3.5%.

The fear of a resurgence in inflation has rattled some investors. In addition to their economic and financial market impacts, higher prices increase uncertainty around Fed policy. If inflation remains stubborn, the Fed may need to keep rates higher for longer.

Corporate earnings are a bright spot

Amid these market and economic concerns, corporate earnings continue to be strong. Earnings-per-share growth of 18.2% year-over-year is the highest since 2021, according to FactSet. This earnings season was characterized by broad participation in growth across sectors and growing profit margins, which are indicators of a healthy economy. Notably, 75% of companies have exceeded consensus earnings estimates, in-line with the 10-year average. However, the size of the earnings beats was greater than the 10-year average.

Chart: The stock market follows earnings in the long run

Market and Economic Chartbook | March 3, 2025

The Stock Market and Earnings

S&P 500 Index price and trailing earnings-per-share since 1990



In the long run, growing corporate earnings are what drive financial markets higher, in spite of day-to-day headlines and investor fears. Current Wall Street estimates suggest that the S&P 500 earnings-per-share could reach \$266 this year, representing a 12% growth rate. At Avalan we estimate S&P 500 earnings will rise 15.6% this year to \$285 per share and a forward P/E of 21.9, unchanged from year end 2024. This corresponds to an S&P target of 7,000. While much could change in the coming months, we are focusing on cash flow investments this year, rather than purely AI-related growth.

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