Monthly Market Update

March 2025

Madison INVESTMENTS

Highlights:

- The S&P 500 dipped -1.3% in February, reflecting the stock market's sensitivity to uncertainty, with concerns over tariffs, inflation, and a weakening consumer sentiment.
- The "Magnificent 7" tech stocks, which had been market leaders, faced a downturn due to concerns over AI investments and competition from China's AI breakthrough.
- The Atlanta Fed's GDPNow forecast projected a -1.5% contraction in Q1, driven by slowing consumer spending and exports, along with potential ripple effects from government layoffs.
- The Federal Reserve faces a dilemma between cutting rates to counteract a slowing economy or holding rates to control inflation.

A well-worn phrase states that the stock market hates uncertainty. February was a case in point, as the S&P 500 Index dipped -1.3%. This brought the year-to-date index return to 1.4%, though the gain feels increasingly fragile. While there appear to be no deep cracks in what remains a fundamentally strong domestic economy, there were reasons for concern. As tariffs moved from negotiating strategy towards implementation, economists and corporate leaders scrambled to ascertain the complex impacts. Some of this concern percolated to the consumer level as sentiment faltered. Public projections for future inflation spiked, no doubt fueled in part by the skyrocketing price of eggs. While the culprit was mostly bird flu, consumers likely remembered the 2024 election campaign which encouraged voters to use egg prices as a barometer of inflation. The awareness that tariffs can have a ripple effect on prices further fuels concerns about reigniting the steep inflation which peaked in 2022.

Then there was the Magnificent 7. For much of the trailing two years, the leading technology companies lumped under the term carried much of the market, reaching close to 35% of the S&P 500's cap-weighted valuation mid-2024. Such a top-heavy index is bound to be volatile, and so far this year the direction of that movement has been decidedly downward, as six of the seven leading stocks dipped. The downturn was sparked by China's allegedly low-cost AI breakthrough, DeepSeek, but compounded by broad concerns over the return on investment from the huge infrastructure spending underway to support AI.

The latest GDPNow forecast from the Atlanta Fed hinted at broader economic troubles extending far beyond the price of eggs. A preliminary finding showed that the national economy was on pace to shrink -1.5% in the first quarter, with consumer spending and exports both slowing. Consumer spending, which constitutes two-thirds of the U.S. economy, has supported GDP through otherwise challenging periods. However, the bulk of this spending was clearly in the hands of the affluent, powered by the wealth effect of rising equity valuations. A drop off in January when the market was solidly positive bodes concern since any future market drops, including February's, could accelerate this trend. Another factor with difficult-to-measure implications is the wave of government layoffs. These jobs are actually not concentrated in Washington and will have direct impacts across the county. They also have a chilling effect on sentiment via the indirect effect on friends, family, and neighbors.

All of these uncertainties will likely weigh heavy on the Federal Reserve, which may find itself in a bind between cutting rates to counteract a slowing economy and holding rates to dampen inflation. It's also a challenge for investment managers. Our own prejudice keeps us leery of the more speculative edges of the market and concentrated on the best domestic companies with solid moats around their businesses. While all stocks are potentially subject to market volatility, we hold a deep conviction in the long-term success of these companies.

Portfolio Manager Q&A - Bill Ford

What has been driving the movement in rates this year and what is the bond market telling you about the state of the economy?

So far this year, we've seen a partial pullback following the sharp rise in rates at the end of 2024. We're also seeing a lot of volatility day to day, where rates markets are responding strongly to incoming data points—employment reports, inflation, GDP, and so on. So, while the underlying trend is lower rates, markets are continually repricing their expectations for the economy and Fed policy, unsure as to the path of Fed rates, where the term premia will be, and what factors will ultimately drive inflation and the economy one way or another. We think rates will continue to bounce around within a range until we see either a breakout of inflation expectations to the upside or growth and employment expectations to the downside.

Bill Ford, CFA
Co-Head of Reinhart Fixed Income, Portfolio Manager

What is the team's outlook on spread sectors, and what impact will tariffs and other policies from this new administration have?

Credit spreads remain exceptionally tight (low single-digit percentiles over the past 25 years). This tells us that the credit market sees no recession or negative impact from the administration's trade, immigration, fiscal or regulatory policies. While the rates market reflects tremendous uncertainty, the credit market has become somewhat complacent, with spreads growing tighter. The administration's policies will likely have conflicting effects on inflation, growth, and employment. Tariffs tend to be inflationary, at least in the short run. Immigration policy has the potential to be inflationary if it pushes up labor costs. Fiscal policies will have an impact on term premia and the yield curve. Deregulatory efforts will have the potential to promote growth and act against inflation. This situation is a bit incongruous, with all these interrelated factors having potentially conflicting effects and credit market pricing reflecting no disruptions. So, we're carefully watching if the market reprices this risk at some point.

How do you and your team approach sector allocations, and more specifically, how does it relate to the contribution to overall duration?

We tend to believe in mean reversion when it comes to spreads and market pricing of risk. Generally, we will take more risk when the reward for taking risk is higher. We'll take less risk when the reward for taking risk is lower. Currently, the market isn't offering much reward for taking credit risk. Unless we have a strong thesis that agrees with the market's risk pricing, we will maintain our discipline and pull back from exposure to these risks.

In our experience, when markets grow complacent and credit spreads tighten to current levels, any widening tends to happen suddenly and unexpectedly.

Where we do take credit risk, we look at our contribution to duration, or the share of duration of our portfolios coming from credit. Our contribution to duration from a credit or a spread sector is at a fairly historic low. We're always skewed towards higher quality within the credit market, but even more so now.

Over the past few months, we've seen a massive move in rates both up and down. Can you explain why fixed income remains a key component in a portfolio?

As much as we've seen volatility and rates move down, rates were up significantly at the end of 2024. Looking back a few years, rates remain substantially higher than in late 2021 and early 2022 when the Fed began its tightening cycle and throughout much of the post-financial crisis period. In an intermediate portfolio with a 4.5%-5% yield, that yield now represents a significant portion of the portfolio's expected return. It also offers greater protection against negative price movements—whether from rising rates or widening spreads—than was the case in the post-financial crisis era.

In a portfolio, these higher yields allow fixed income to fulfill its historical role of dampening volatility, providing diversification from equities, and offering reliable returns that are not dependent on price movements.

U.S. Equities (%)

	Feb	YTD	1 Year	3 Year	5 Year	10 Year
DJ Industrial Average	-1.4	3.3	14.4	11.2	13.8	11.7
S&P 500	-1.3	1.4	18.4	12.6	16.9	13.0
Russell 1000	-1.7	1.4	18.1	12.1	16.5	12.7
Russell 1000 Value	0.4	5.1	15.8	8.7	12.5	9.0
Russell 1000 Growth	-3.6	-1.7	19.7	14.8	19.7	16.0
Russell Midcap	-2.8	1.3	12.2	7.2	12.4	9.3
Russell 2000	-5.3	-2.9	6.7	3.3	9.4	7.2

U.S. Equity Sectors - S&P 500 (%)

	Feb	YTD	Weight
Communication Services	-6.3	2.3	9.5
Consumer Discretionary	-9.4	-5.4	10.5
Consumer Staples	5.7	7.9	5.9
Energy	4.0	6.1	3.3
Financials	1.4	8.1	14.5
Health Care	1.5	8.4	10.8
Industrials	-1.4	3.5	8.3
Information Technology	-1.3	-4.2	30.7
Materials	0.0	5.6	2.0
Real Estate	4.2	6.1	2.2
Utilities	1.7	4.7	2.4

U.S. Equity Characteristics - S&P 500

	Feb	2024
Price/Earnings Ratio (NTM)	21.6	21.6
Weighted Avg. Market Cap ($B)	1,023.2	1,117.1
Dividend Yield (%)	1.3	1.3

International Equities (%)

	Feb	YTD	1 Year	3 Year	5 Year	10 Year
ACWI	-0.6	2.7	15.1	9.1	12.8	9.1
ACWI ex USA	1.4	5.5	9.7	4.6	7.6	4.8
MSCI EAFE	1.9	7.3	8.8	6.4	8.7	5.3
Emerging Markets	0.5	2.3	10.1	0.5	4.3	3.5
China	11.8	12.8	39.0	0.0	-0.3	2.6
Japan	-1.4	0.2	0.7	5.1	7.2	5.4
Germany	3.9	13.6	21.5	10.1	9.8	4.7
United Kingdom	3.5	8.9	18.7	7.7	9.8	4.2
India	-8.0	-11.3	-6.2	5.0	11.7	6.4

Key Asset Prices

	Feb	2024
EUR/USD	1.04	1.04
USD/CAD	1.44	1.44
USD/JPY	150.64	157.37
GBP/USD	1.26	1.25
Bitcoin ($)	84,373.0	93,429.2
Gold ($/oz)	2,859.0	2,608.0
Crude Oil (WTI) ($/bbl)	70.0	72.4

Fixed Income (%)

	Feb	YTD	1 Year	3 Year	5 Year	10 Year
Government Bond	2.1	2.7	5.0	-1.1	-1.1	1.0
Municipal	1.0	1.5	3.0	1.0	0.7	2.3
U.S. Aggregate Bond	2.2	2.7	5.8	-0.4	-0.5	1.5
Investment Grade Corporate	2.0	2.6	6.4	0.4	0.0	2.4
High Yield	0.7	2.0	10.1	4.9	4.9	5.1

U.S. Treasury Yields (%)

	Feb	2024
3-Month	4.3	4.4
6-Month	4.3	4.2
2-Year	4.0	4.3
5-Year	4.0	4.4
10-Year	4.2	4.6
30-Year	4.5	4.8

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In addition to the ongoing market risk applicable to portfolio securities, bonds are subject to interest rate risk, credit risk and inflation risk. When interest rates rise, bond prices fall; generally, the longer a bond's maturity, the more sensitive it is to this risk. Credit risk is the possibility that the issuer of a security will be unable to make interest payments and repay the principal on its debt. Bonds may also be subject to call risk, which allows the issuer to retain the right to redeem the debt, fully or partially, before the scheduled maturity date. Proceeds from sales prior to maturity may be more or less than originally invested due to changes in market conditions or changes in the credit quality of the issuer.

Diversification does not assure a profit or protect against loss in a declining market.

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The Dow Jones Industrial Average® (The Dow®), is a price-weighted measure of 30 U.S. blue-chip companies. The index covers all industries except transportation and utilities.

The S&P 500® Index is a large-cap market index which measures the performance of a representative sample of 500 leading companies in leading industries in the U.S.

The Russell 1000® Index measures the performance of the 1,000 largest companies in the Russell 3000® Index, which represents approximately 89% of the total market capitalization of the Russell 3000 Index.

The Russell 1000® Growth Index is designed to track those securities within the broader Russell 1000 Index that FTSE Russell has determined exhibit growth characteristics.

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Russell 2000® Index is a small-cap market index which measures the performance of the smallest 2,000 companies in the Russell 3000® Index.

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The MSCI ACWI ex USA Index captures large and mid cap representation across 22 of 23 Developed Markets countries (excluding the US) and 23 Emerging Markets countries. With 1,843 constituents, the index covers approximately 85% of the global equity opportunity set outside the US.

The MSCI EAFE (Europe, Australasia & Far East) Index is a free-float adjusted market capitalization index that is designed to measure developed market equity performance, excluding the U.S. and Canada.

Emerging Markets - MSCI Emerging Market Index captures large and mid cap representation across 24 Emerging Markets (EM) countries. With 1,138 constituents, the index covers approximately 85% of the free float-adjusted market capitalization in each country.

China - MSCI China Index captures large and mid cap representation across China A shares, H shares, B shares, Red chips, P chips and foreign listings (e.g. ADRs).

Japan - MSCI Japan Index is designed to measure the performance of the large and mid cap segments of the Japanese market.

Germany - MSCI Germany Index is designed to measure the performance of the large and mid cap segments of the German market.

United Kingdom - MSCI United Kingdom Index is designed to measure the performance of the large and mid cap segments of the UK market.

India - MSCI India Index is designed to measure the performance of the large and mid cap segments of the Indian market.

Government Bond - Bloomberg US Government Index measures the performance of the U.S. Treasury and US Agency Indices, including Treasuries and US agency debentures. It is a component of the US Government/ Credit Index and the US Aggregate Index.

Municipal - Bloomberg US Municipal Index covers the USD-denominated long-term tax exempt bond market. The index has four main sectors: state and local general obligation bonds, revenue bonds, insured bonds and prerefunded bonds.

U.S. Aggregate Bond - Bloomberg US Aggregate Bond Index is a broad-based flagship benchmark that measures the investment grade, USD-denominated, fixed-rate taxable bond market. The index includes Treasuries, government-related and corporate securities, mortgage backed securities, asset-backed securities and corporate securities, with maturities greater than one year.

Investment Grade Corporate - Bloomberg US Credit Index measures the investment grade, USD-denominated, fixed-rate, taxable corporate and government related bond markets. It is composed of the US Corporate Index and a non-corporate component that includes foreign agencies, sovereigns, supranationals and local authorities.

High Yield - Bloomberg US Corporate High Yield Bond Index measures the USD-denominated, high yield, fixed-rate corporate bond market. Securities are classified as high yield if the middle rating of Moody's, Fitch and S&P is Ba1/BB+/BB+ or below. Bonds from issuers with an emerging markets country of risk, based on Bloomberg EM country definition, are excluded.

Weighted Avg. Market Cap: measures the size of the companies in which the portfolio invests. Market capitalization is calculated by multiplying the number of a company's shares outstanding by its price per share.

Price-to-Earnings (P/E) Ratio: measures how expensive a stock is. It is calculated by the weighted average of a stock's current price divided by the company's earnings per share of stock in a portfolio.

Dividend Yield: the portfolio's weighted average of the underlying portfolio holdings and not the yield of the portfolio.

Bond Spread is the difference between yields on differing debt instruments of varying maturities, credit ratings, and risk, calculated by deducting the yield of one instrument from another.

A basis point is one hundredth of a percent.

Yield Curve: a line that plots yields (interest rates) of bonds having equal credit quality but differing maturity dates. The slope of the yield curve gives an idea of future interest rate changes and economic activity. There are three main types of yield curve shapes: normal (upward-sloping curve), inverted (downward-sloping curve), and flat.

The Magnificent Seven stocks are a group of high-performing and influential companies in the U.S. stock market: Alphabet, Amazon, Apple, Meta Platforms, Microsoft, NVIDIA, and Tesla.

The federal funds rate is the target interest rate range set by the Federal Open Market Committee (FOMC) for banks to lend or borrow excess reserves overnight. It influences monetary and financial conditions, short-term interest rates, and the stock market.

Duration is a measure of the sensitivity of the price of a bond or other debt instrument to a change in interest rates. Duration measures how long it takes, in years, for an investor to be repaid the bond's price by the bond's total cash flows.

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