Market analysis | February 18, 2025

At a glance

Equity markets edged higher last week despite elevated U.S. inflation and weak retail sales. Attention remains focused on inflation expectations and corporate spending on artificial intelligence.

Number of the week

3%

The increase in consumer prices in January compared to a year earlier.

Term of the week

Real estate investment trust (REIT) – A company that owns, operates or finances income-generating real estate. Like mutual funds, REITs pool the capital of numerous investors, allowing individual investors to earn dividends from real estate investments without having to buy, manage or finance any properties themselves.

U.S. retail sales fell 0.9% in January for the first monthly decline since August. Soft auto sales and weakness in sporting goods and building materials were primary detractors. Winter storms and California wildfires may have dampened consumer spending. Resilience in consumer activity has been a hallmark of the current economic expansion, and while this slowdown is concerning, the solid labor market should support a rebound in consumer activity.

***Robert Haworth,** CFA, Senior Vice President, Senior Investment Strategy Director, U.S. Bank*

Global economy

Quick take: U.S. inflation remains stubbornly higher to start 2025, though growth in shelter costs is easing. Weak retail sales will put the focus on the labor market to set the forward trend. Growth in major developed economies saw improvement in the fourth quarter.

Our view: The U.S. economy appears likely to achieve a soft landing in 2025, aided by slowing inflation and solid domestic demand growth. Tariffs pose some risks to slow but improving growth in developed markets, including the eurozone, the United Kingdom and Japan. Emerging markets remain diverse as trade policies take center stage while China struggles to rekindle consumer demand.

- **U.S. inflation remained stubbornly strong to start the year** for both the Consumer and Producer Price Indexes. Year-over-year consumer prices gained 3% in January, up from 2.9% in December, while producer prices increased 3.5%. A rebound in energy prices, reflecting a cold winter, spurred the gains. Core consumer prices, which exclude food and energy, remain elevated, rising 3.3% compared to January 2024. However, shelter inflation moderated, gaining just 4.4% year-over-year, the slowest pace in two years.
- **U.S. retail sales fell 0.9% in January** for the first monthly decline since August. December was revised higher to a 0.7% gain. Soft auto sales and weakness in sporting goods and building materials were primary detractors. Winter storms and California wildfires may have dampened consumer spending. Resilience in consumer activity has been a hallmark of the current economic expansion, and while this slowdown is concerning, the solid labor market should support a rebound in consumer activity.
- **The National Federation of Independent Business Small Business Optimism Index fell by 2.3 points to 102.8 in January**, retreating from a six-year high. The Uncertainty Index, a component of the survey, rose 14 points to 100, the third-highest reading on record but below pre-election levels. The report flagged continued hiring challenges, with owners struggling to find qualified workers to fill their many open positions.
- **Growth in developed foreign markets improved in the fourth quarter.** Gross domestic product data improved in Japan, the United Kingdom (UK) and the eurozone. Service business activity was a strength in the UK and Spanish growth was a bright spot for the eurozone, while Germany and France saw modest contractions. Japan was helped by rising export demand, softer imports and consumption spending.

Equity markets

Quick take: U.S. equities continue to inch higher amid fourth quarter earnings releases with potential headwinds approaching.

Our view: Inflation, interest rates and earnings are directionally consistent with advancing equity prices. Conversely, valuations are elevated, company guidance is measured, inflation is elevated, government policy is evolving, tariff talk is ongoing and global tensions are elevated.

- **U.S. equity performance reflects underlying economic strength.** As of Friday's close, the popular broad-based U.S. indices are up between 2.3% and 4.9% for the year, with all 11 S&P 500 sectors in positive territory. Communication Services (8.9%) and Financials (7.2%) are the best-performing sectors so far. Information Technology is positive once again, up 1.6% after posting negative returns for much of 2025. Additionally, performance is broadening out beyond the largest stocks. The 20 largest S&P 500 companies by market capitalization, representing 47% of S&P 500 market cap, are performing in line with the index, both advancing roughly 4.0% year-to-date.
- **Consensus earnings projections for 2025 are stable with downside bias; valuations are elevated.** At present, analysts forecast S&P 500 earnings of approximately $270 per share in 2025, according to Bloomberg, FactSet and S&P Cap IQ, reflecting 11.0% year-over-year growth. We anticipate modest downward revision to the 2025 estimate as the year progresses and as more becomes known about government policy changes. As of Friday's close, the S&P 500 traded at roughly 23 times consensus 2025 earnings estimates, above the 35-year historical average on next 12-month estimates of 16.6 times.
- **Fourth quarter results are trending largely in line with expectations.** As of Monday, 77% of S&P 500 companies have released results. Sales are up 5.1% year-over-year, modestly above expectations of 4.5%. Earnings are up 10.4% versus expectations of 11.6%. Another 9% of S&P 500 companies plan to release results this week.
- **Resilient consumer and business spending are takeaways from company reports.** Hyperscaler (large cloud service providers) capital expenditures remain strong, despite mounting concerns over China's DeepSeek and its reportedly hyper-efficient artificial intelligence (AI) model that could disrupt the industry's cost structure. Upcoming reports from the big box retailers will provide insight into the pace of spending on discretionary items, as well as spending differences among income groups. AI-bellwether NVIDIA is slated to release results on February 26.

Bond markets

Quick take: Surprisingly hot inflation data for January caused a brief increase in Treasury yields Wednesday that reversed later in the week. Bonds have delivered steady returns so far this year with investor expectations for one to two additional Federal Reserve (Fed) rate cuts in 2025 stabilizing Treasury yields and strong demand and fundamentals supporting riskier bond prices.

Our view: While inflation can erode the value of the steady interest generated from fixed income investments, bond yields are sufficiently high enough to support meaningful returns. Non-taxable investors can find opportunities to improve income returns with exposures to non-agency mortgages and reinsurance, while the extra yield on longer-term and high yield municipal bonds can benefit taxable investors.

- **Higher-than-expected inflation should keep the Fed cutting cycle on pause for now.** Core consumer inflation (excluding volatile food and energy price changes) in January marked the eighth consecutive month of prices rising at a steady 3.2%-3.3% annual rate. Bond yields reflect expectations that the Fed will keep interest rates steady for at least its next couple meetings. Testifying before Congress last week, Fed Chairman Jerome Powell emphasized the Fed is in no hurry to adjust interest rates, saying, "We want to keep policy restrictive for now." Notably, interest rate hikes also appear off the table considering Powell said Fed members don't want to overreact to any single inflation report.
- **The U.S. Treasury began reducing Treasury bill issuance to abide by the federal debt ceiling.** Treasury bills have maturities of one year or less. The Treasury is relying on extraordinary measures to fund the government without breaching the debt limit. Congress has yet to raise the debt ceiling, so the Treasury reduced bill auction sizes by $12 billion last week. The government can limit net new Treasury issuance and rely on its cash balance and tax revenues to sustain spending likely into the summer. Temporarily limiting Treasury issuance can favorably reduce supply headwinds for bond buyers until Congress lifts the debt ceiling.
- **Strong fixed income investments support bond prices.** Over the past four weeks, funds that invest in core aggregate bond exposures, municipal bonds, corporate bonds and bank loans have all received strong inflows of investor capital. This indicates investor demand remains healthy despite elevated valuations in parts of the bond market, like corporate bonds. Bond valuations can remain high while favorable yields continue to draw in investors for opportunities to generate meaningful income.

Real assets

Quick take: Publicly traded real estate returns were slightly positive last week, with gains in the largest real estate segments like retail, health care and industrial. Commodities also extended their run of solid performance, which coincides with higher inflation expectations.

Our view: Publicly traded real estate investment trusts (REITs) remain an important source of income for portfolios that grows alongside broader economic growth and inflation. Diversifying portfolios with real asset exposure can provide important protection against inflation risks.

- **REITs delivered 0.1% returns last week with help from stable Treasury yields.** REIT prices moved in opposite directions to Treasury yields recently since higher yields raise borrowing costs for developers and income opportunities in bonds can draw investors away from real estate. The modest decrease in Treasury yields this year helped REIT prices advance. Last week, three of the largest four real estate segments delivered positive returns. Retail companies generated 0.4% returns, industrial rose 2.3% and health care 3.4%. Weakness in smaller REIT categories like office, which returned -3.2% but is less than 4% of broad REIT exposures, partially offset these gains.
- **Natural gas prices led commodity prices higher last week**. Forecasts for another bout of cold temperatures across the U.S. prompted price gains in natural gas used to heat homes. Weather changes often drive short-lived spikes in natural gas prices, but most other major commodities also gained last week. Gold prices rose 0.4% and continue to capture investors' attention, with some firms flying physical gold bars into the U.S. to sell at higher prices than available in Europe ahead of potential tariffs. Silver, copper and agriculture commodity prices also rose, culminating in broad commodity exposures generating 1.8% returns. The increase in commodity prices was consistent with inflation expectations rising last week, demonstrating the inflation protection commodities can provide portfolios.