STATE STREET GLOBAL ADVISORS

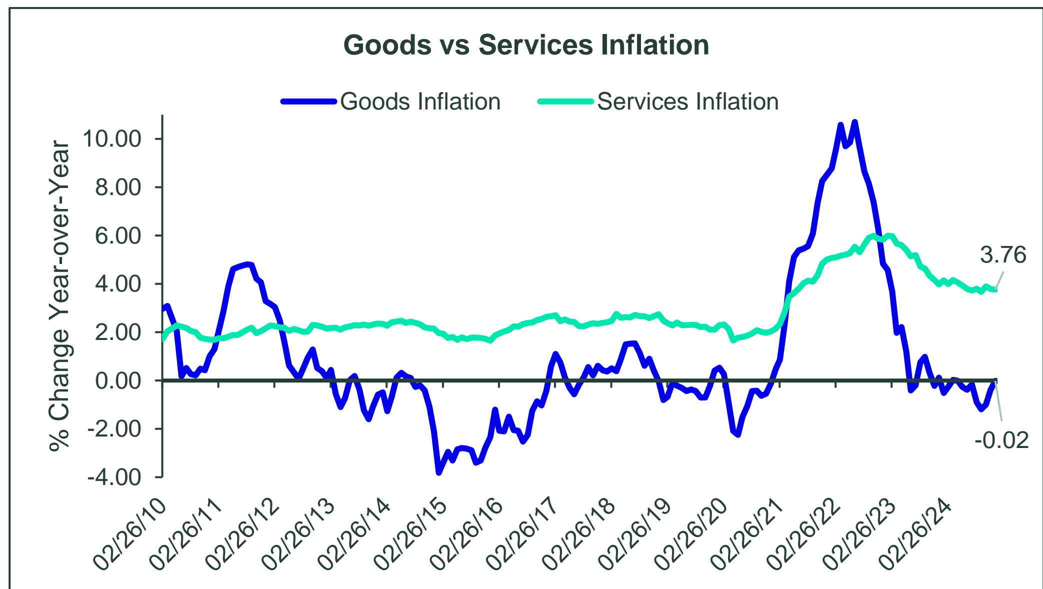
February 27, 2025
Commentary

Weekly Market Update

Insight of the Week

U.S. Inflation Trends: Goods vs. Services

Inflation played out as a tale of two sides in 2024. Services inflation remained sticky around 4% and continues to be above levels seen in the 2010's. Goods inflation however fell below 0%, acting as a disinflationary force in the total inflation equation. As a result, the U.S. was able to see some progress towards lower overall inflation.



Source: FactSet, US Bureau of Economic Analysis. Data as of 12/31/2024.

Recent tariffs introduced by Donald Trump have threatened to disrupt the fragile inflationary equilibrium that's emerged between goods and services. Impacts from tariffs will have more of an impact on goods inflation, more so than services. With goods no longer acting as an anchor, investors are concerned that overall inflation could rise. All this matters as we try and determine the Fed's reaction function to these policies.

Markets continue to react to all the moving pieces of the new administration. What's interesting is that despite all the inflation anxiety, the market is currently pricing in more 2025 rate cuts than what was priced prior to Trump taking office on January 20th. Seemingly, growth concerns appear to be temporarily putting downward pressure on rates, overwhelming the upward pressure from inflation.

Source: S&P, FactSet, US BEA. Past performance is not a reliable indicator of future performance. Index returns are unmanaged and do not reflect the deduction of any fees or expenses.

Equities

Equity Market Focused on the Future

The US equity market has exhibited more volatility as of late as the market digests tariffs and new policies. Over the past five days, the S&P 500 has fallen 2.6% and the CBOE VIX has risen 24% to a level of 19.4. Not only has tariff talk put the market on edge, but the latest consumer confidence print showed the sharpest decline in consumer confidence since August of 2021. Yields have fallen and the market is now pricing in 2 rate cuts this year.

Although this market volatility is based upon future prospects, the latest earnings data for Q4 does not seem to be bringing any cause for concern. For Q4, ~94% of index constituents have reported earnings. Surprising to the upside, the index is reporting 18% YoY earnings growth compared to the estimated figure of 14% back in September. Earnings across sectors have broadened out as anticipated and we've seen impressive earnings growth especially from the Financials, Communication Services, and Consumer Staples sectors. The only sector with negative YoY Q4 earnings growth was Energy.

Arguably, the most anticipated earnings report for the quarter comes from Nvidia. Post the DeepSeek debacle, investors are curious how the AI posterchild has held up. With Nvidia now occupying 6.1% of the S&P 500, the performance and earnings results are quite important for the overall index and market sentiment towards tech in general.

The details showed a beat on both revenue and earnings per share as the market anticipated, however the magnitude of the earnings beat was smaller than we've seen over the past few quarters. For the quarter earnings rose 71% from a year ago, against September estimates of 53%. The figures were followed up with positive, but not overwhelmingly positive, guidance. According to FactSet, Nvidia's AI processors, coined Blackwell, and Hopper AI chips now account for 91% of total revenue, and executives described demand for the chips as "extraordinary". One flaw in the report was an update on declining gross margins with guidance for Q1 being lower than expected. Overall, the report likely didn't do much to derail the secular growth theme of artificial intelligence, however market reaction was negative following the less extreme beat.

The S&P 500 as a whole has seen strong earnings from constituents over the quarter, differing from some of the more bearish sentiment we've seen from investors surveying the economy. Looking forward to next quarter earnings, forecasts call for 7% YoY earnings growth for the index.

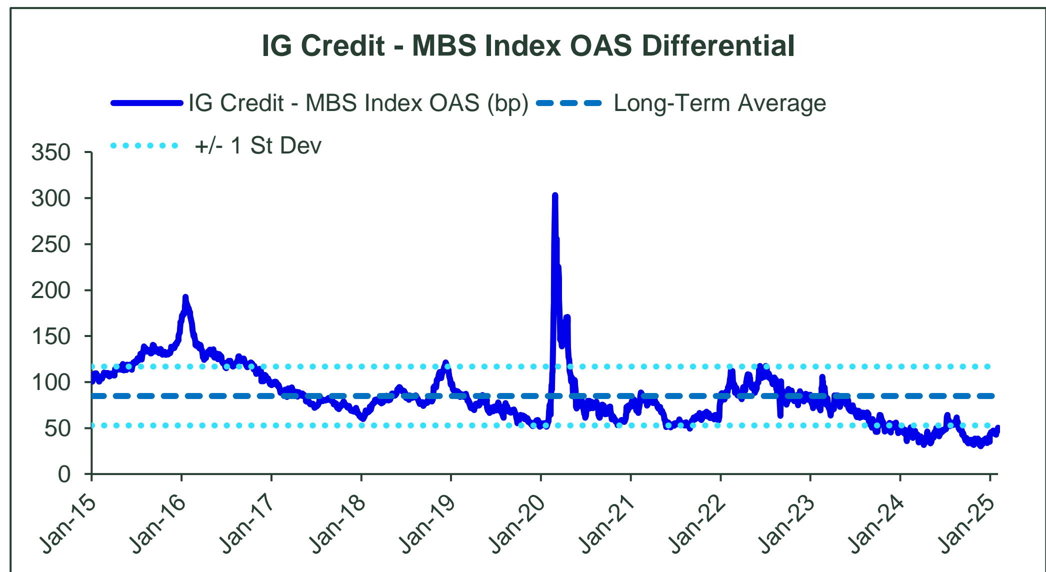
Source: FactSet. Data as of 2/26/2025 unless otherwise stated. Past performance is not a reliable indicator of future performance. Index returns are unmanaged and do not reflect the deduction of any fees or expenses.

Fixed Income

MBS Offers an Attractive Alternative to IG Credit

Driven by attractive relative value, strong fundamentals, and favorable market dynamics, the Mortgage-Backed Securities (MBS) sector offers a compelling alternative to investment grade (IG) corporates where valuations remain rich.

IG credit typically trades at a yield premium to MBS due to the fact that IG credit spreads are subject to idiosyncratic risks such as downgrades and defaults. MBS securities on the other hand are comprised of a pool of liquid, high-quality, diversified loans. As such they have different risk drivers, and most agency loans enjoy the additional benefit of implicit government backing. IG Corporate valuations, as indicated by option-adjusted spreads (OAS), are currently at multi-decade lows (approximately 80 basis points) due to strong corporate fundamentals and high demand. In contrast, mortgage-backed securities (MBS) spreads are aligned with their long-term fair value at around 35 basis points. Comparing these metrics, MBS presents an appealing value, as index OAS spreads are one standard deviation cheap compared to investment-grade credit.

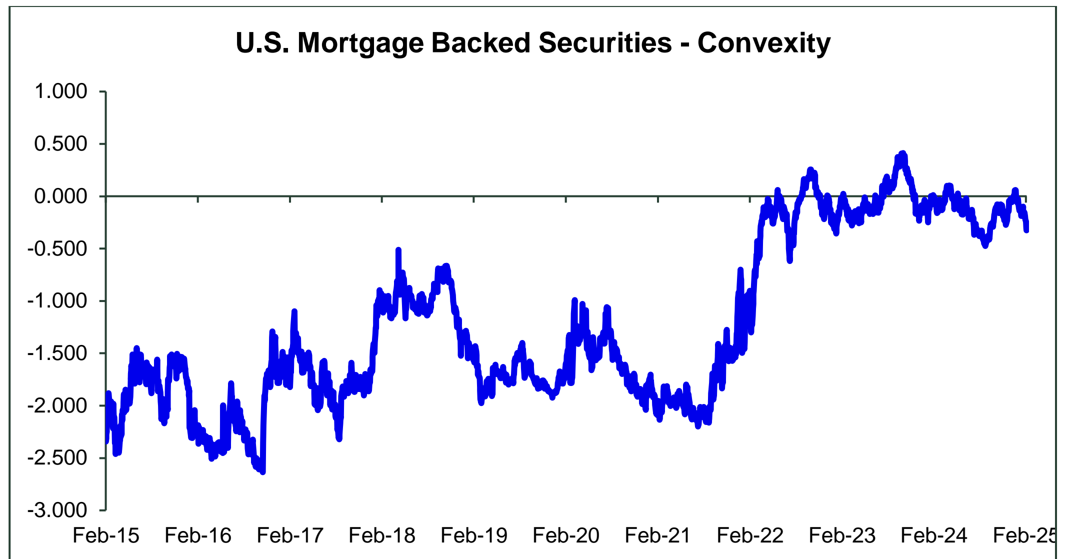


Source: Barclays Live. Data as of 2/26/25.

One nuance of investing in MBS is their convexity, which measures the rate of change in duration as interest rates shift. Higher convexity is good (duration increases as rates fall), whereas lower/negative convexity is bad (duration falls as rates fall). Typically, MBS have negative convexity – that is, as interest rates fall, MBS duration falls. This is because lower rates incentivize homeowners to refinance, paying off their higher cost loans in favor of new, lower rate mortgages.

Today, the MBS index is largely comprised of loans that were issued during the Covid-19 pandemic. These loans were characterized by low rates ranging from approximately 3% to 4%. Following the commencement of the Federal Reserve's rate hiking cycle in 2022, both treasury yields and mortgage rates rose. Given this, homeowners have had less incentive to move or refinance their existing low-rate loans. This reduces prepayment risk within MBS, which in turn lessens the typical negative convexity.

The relative value signal (informed by the OAS), favorable fundamentals (higher quality), and market dynamics stemming from the index's improving convexity, may make the case for an increased allocation to MBS in comparison to investment-grade credit.



Source: Barclay's Live. Data as of 2/26/25.

In the event of a deteriorating economic conditions, both IG Corporate and MBS are likely to experience underperformance. However, higher quality and low correlation with other fixed income sectors may allow the MBS sector to better absorb economic shocks. During periods of financial distress, investment-grade securities may face increased credit risks and wider spreads. In contrast, the liquid, high quality diverse universe found within MBS offers a flight to safety during times of economic uncertainty, enabling MBS to endure economic shocks more effectively than investment-grade securities.

Source: Bloomberg, Bureau of Economic Analysis, Federal Reserve Bank of St. Louis. Past performance is not a reliable indicator of future performance. Index returns are unmanaged and do not reflect the deduction of any fees or expenses.

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*Pensions & Investments Research Center, as of 12/31/23.
†This figure is presented as of December 31, 2024 and includes ETF AUM of $1,577.74 billion USD of which approximately $82.19 billion USD in gold assets with respect to SPDR products for which State Street Global Advisors Funds Distributors, LLC (SSGA FD) acts solely as the marketing agent. SSGA FD and State Street Global Advisors are affiliated. Please note all AUM is unaudited.

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Marketing Communication

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Equity securities may fluctuate in value and can decline significantly in response to the activities of individual companies and general market and economic conditions.

Bonds generally present less short-term risk and volatility than stocks, but contain interest rate risk (as interest rates raise, bond prices usually fall); issuer default risk; issuer credit risk; liquidity risk; and inflation risk. These effects are usually pronounced for longer-term securities. Any fixed income security sold or redeemed prior to maturity may be subject to a substantial gain or loss.

Currency Risk is a form of risk that arises from the change in price of one currency against another. Whenever investors or companies have assets or business operations across national borders, they face currency risk if their positions are not hedged.

Generally, among asset classes, stocks are more volatile than bonds or short-term instruments. Government bonds and corporate bonds generally have more moderate short-term price fluctuations than stocks, but provide lower potential long-term returns. U.S. Treasury Bills maintain a stable value if held to maturity, but returns are generally only slightly above the inflation rate.

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