

Punching Waves

“If you’re pushing the edge, eventually you find the edge.”

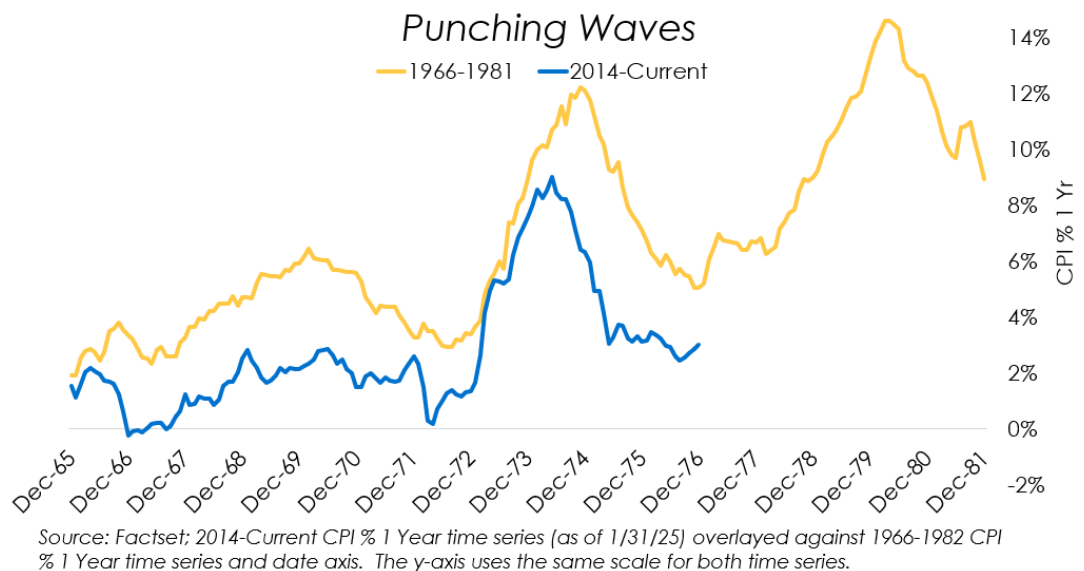
– Jimmy Chin (*Free Solo* 2018)

Mother Nature has a way of helping us define our limits. Whether we’re trying to catch the metaphorical edge of some hand hold or the curl of some surf, the edge is that testing of the boundary line.

In much the same way, it would seem that boundaries are being tested for investors as well. 2025 has brought with it a degree of heightened uncertainty across almost every dimension. From the AI revolution to the political climate, the geopolitical backdrop to the policy of the Fed; it feels as if a new world order is being shaped and, at the same time, one that is still unknown and yet to be determined.

Last month, we chronicled that the third year of an equity bull market has historically led to more challenging market conditions –

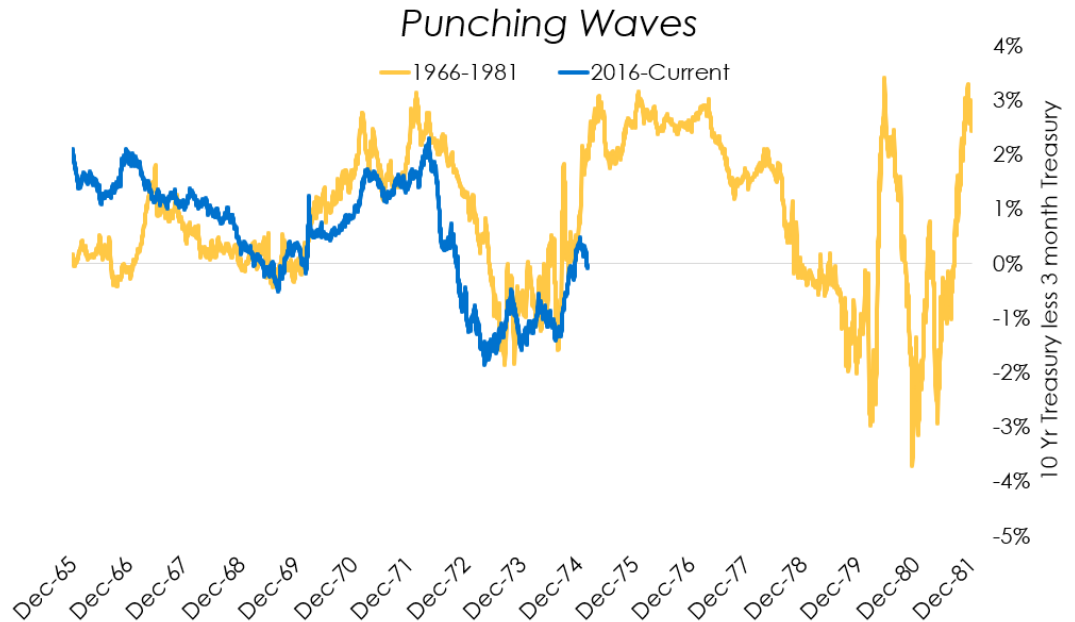
presumably as boundaries get tested. Right on cue, this year has had a completely different tone than the way things ended last year (with some of the most comfortable trades getting pushed to extremes).



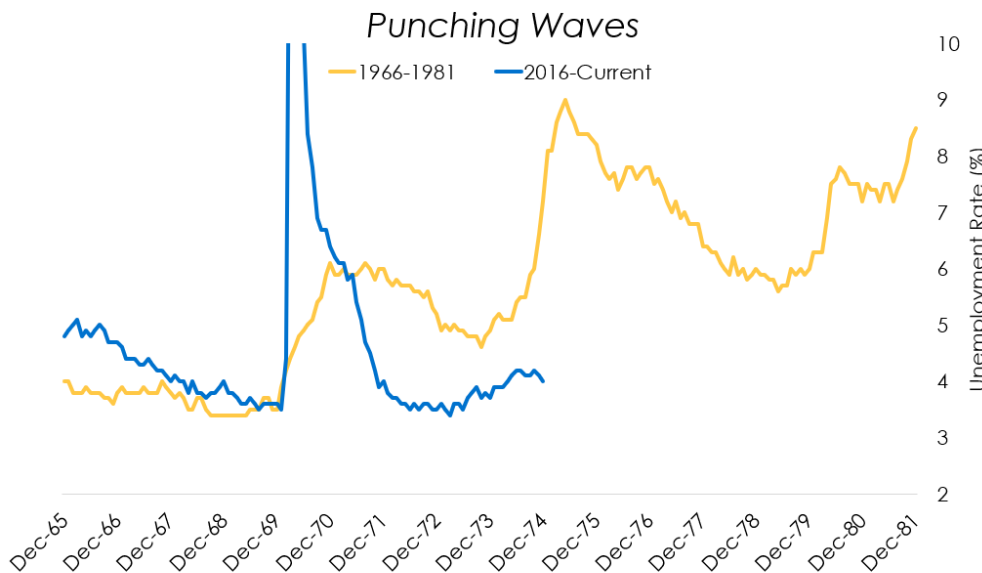
To help with the uncertainty, we look to history for clues and patterns. And while we’d be the first to argue about the imperfections of this corollary, the inflationary waves of the ‘60’s and ‘70’s do yield some similarities with the pattern we’ve seen thus far over the last decade. Notable bouts of inflation have historically come in waves as the initial push higher on price levels brings with it renewed pressure on wages to keep up. As companies appear to be quicker to raise prices than raise wages, the wave dynamic takes shape.



In overlaying changes in the Rate market via the yield curve (10 Year Treasury Yield less the 3 Month Treasury Yield), a similar wave pattern emerges though with a nuanced difference. The comparison with today's backdrop comes with a two year advancement suggesting that this Fed was slower to react to the inflation dynamic than in the late '60's. Of course, to be fair, inflation was an order of magnitude higher back then and likely more uncomfortable for policymakers necessitating a quicker reponse.



The last chart shows the overlay of the labor market using the unemployment rate – loosely matching the 2020 COVID induced recession with the one occurring in 1970. It would seem that we're at another fork in the road in determining if there's another wave in the unemployment rate like that seen in the 1974-75 period. Such a backdrop facilitated notable Fed rate cuts and a steepening of the curve only to usher in another upsurge of inflation in the late '70's as policymakers continued to punch waves. Of course, today's corollary is yet to be written but with high uncertainty and change seemingly afoot, history can sometimes be the wisest of teachers.



Source: Factset; 2016-Current Unemployment Rate time series (as of 1/31/25) overlayed against 1966-1982 Unemployment Rate time series and date axis. The y-axis uses the same scale for both time series. April 2020 - July 2020 is truncated due to COVID spike.



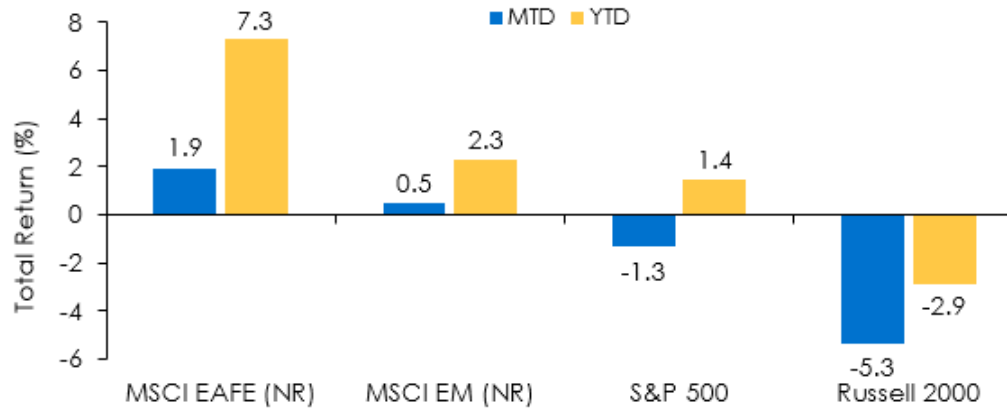
Bonds, Commodities, and REITs all posted positive returns in February. Equities were mixed with domestic stocks down on growth, tariff, and inflation concerns while international stocks continued to rally. Returns were led by REITs and Bonds as interest rates continued to fall after peaking in mid January. Commodities were also positive, led by energy and industrial metals.

Stocks

International Developed Markets (MSCI EAFE) were up in February, after very strong returns in January, and lead all asset classes for the year. Emerging Markets (MSCI EM) also

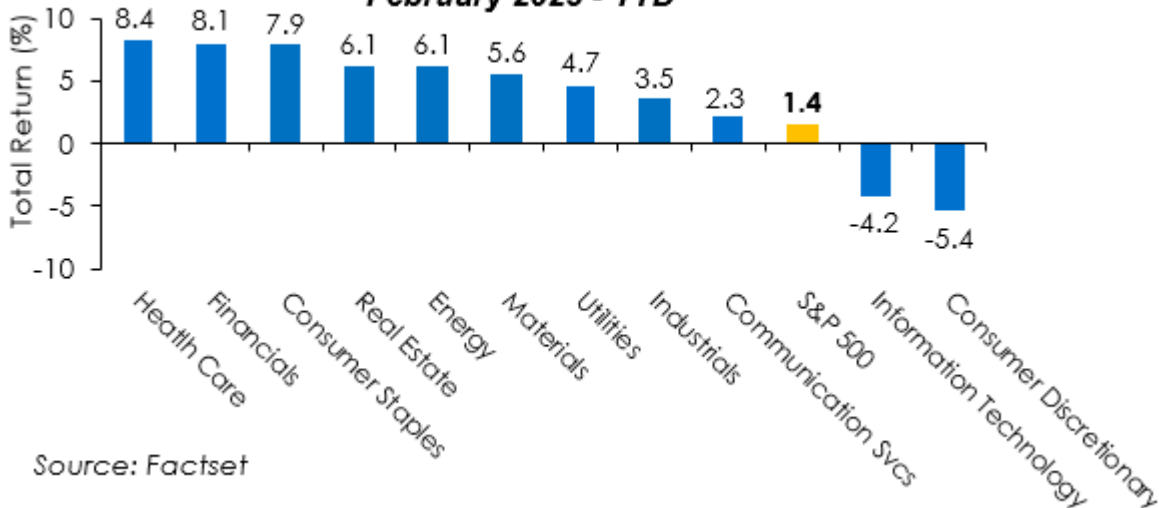
outperformed for the month and year-to-date as speculation of AI democratization breathed new life into China's tech stocks. Meanwhile, domestic stocks posted negative returns in February, with U.S. Large Caps (S&P 500) and Small Caps (Russell 2000) down low to mid single digits on growth, tariff, and inflation concerns. From a sector perspective, strength was much broader with the notable exception of Information Technology and Consumer Discretionary – both having lagged significantly year to date.

**Global Equity Returns
February 2025**



Source: Factset

**S&P 500 Sector Returns
February 2025 - YTD**



Source: Factset

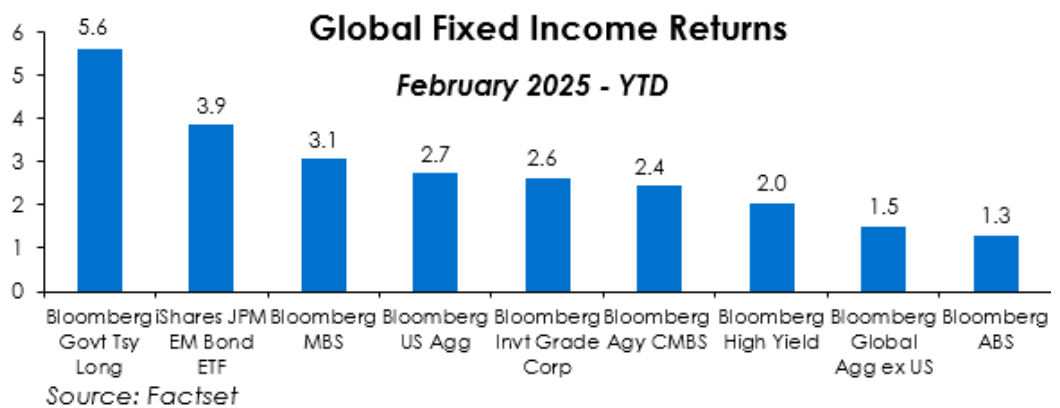


Bonds

Despite ongoing balance sheet reduction – policymakers pivoted to an easing bias by reducing the Fed Funds rate by 50 basis points at their September meeting and another 25 basis points each at their November and December meetings (Fed Funds at 4.25-4.50%). While this easing bias is the first in over four years, policymakers left rates unchanged in January and recently reduced the number of expected 2025 rate cuts from four to two (25 basis points per) as inflation remains sticky and labor markets solid. Bond returns were positive in February

as interest rates peaked mid January and have steadily declined since. Long duration Treasuries (Bloomberg Govt Tsy Long) and Emerging Markets (iShares JPM EM Bond ETF) were among the best

performing areas in February and year-to-date. Conversely, Asset Backed Securities (Bloomberg ABS), Global Agg ex US (Bloomberg Global Agg ex US), and High Yield (Bloomberg High Yield) lagged.

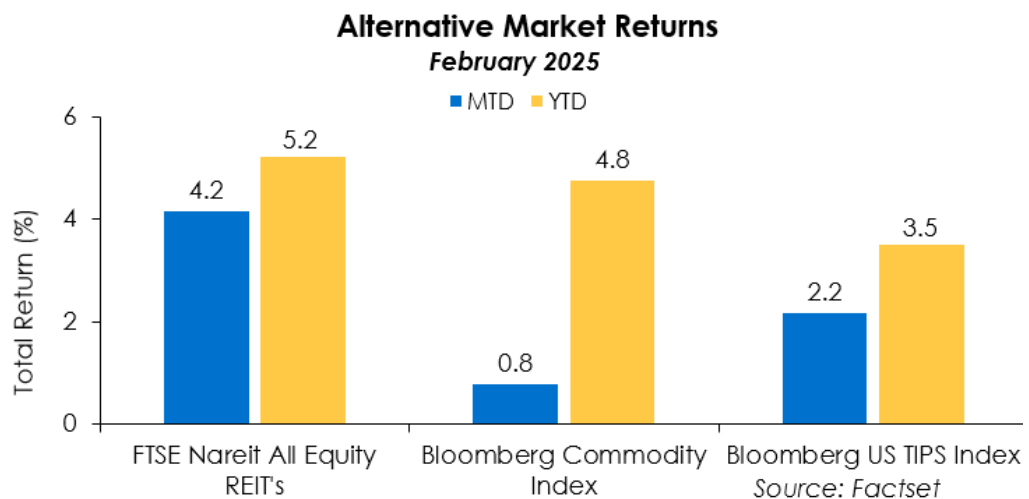


Alternatives

Commodities were positive for the month, after a strong January, with leadership shifting to energy and industrial metals from precious metals and agriculture.

Meanwhile, publicly traded Real Estate

(REITs) posted strong returns as interest rates declined during February. Finally, year-to-date returns on Treasury inflation protected securities (TIPs) outperformed nominal Treasuries amid rising short to intermediate term inflation expectations.



Market Outlook

***“It’s Tricky to rock a rhyme, to rock a rhyme that’s right on time.
It’s Tricky.”***

– Run DMC, *It’s Tricky* (1986)

As the page turns to 2025, we’re focused on the incongruencies that exist within the “Tri-Cycle” – the “three cycle” framework we’re using to assess the landscape. A de-synchronous orientation – one later (Economic Cycle), one earlier (Profit Cycle) and one that runs counter to history (Fed Cycle) – makes for the continuation of a Tricky backdrop that requires investors to keep their proverbial eyes up and “Head on a Swivel”. Let’s explain.

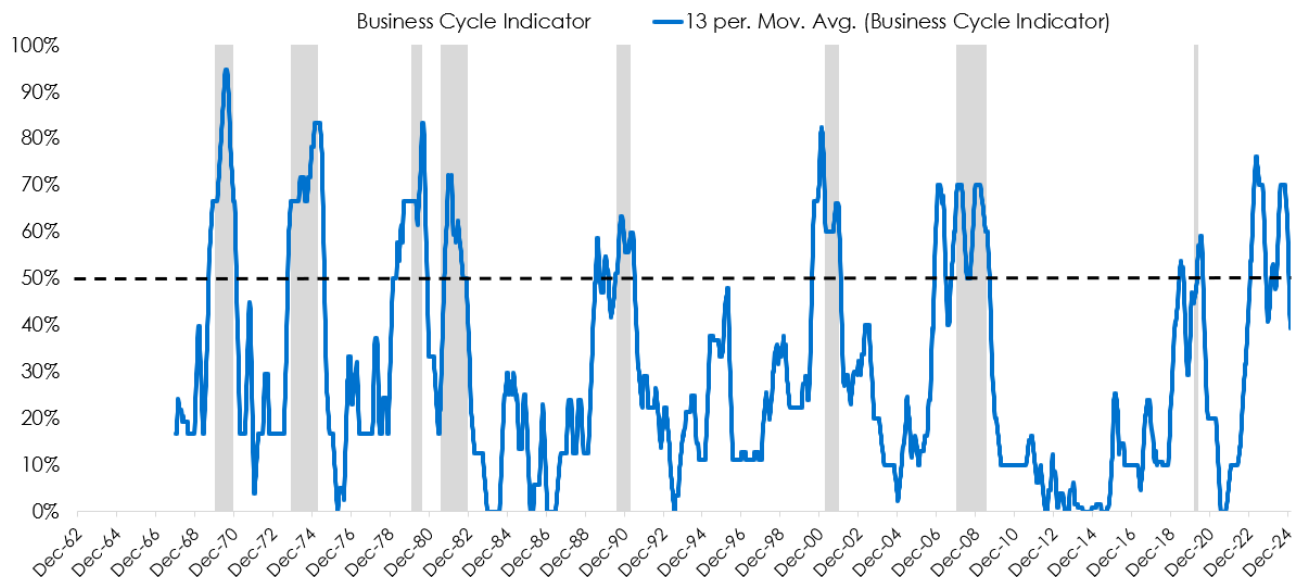
It's Tricky

Cycle	Stage
Economic Cycle	Later
Profit Cycle	Earlier
Fed Cycle	Counter

While only five years removed from the (short) COVID induced recession, we’re more than fifteen years removed from the more economically oriented one prior to that. But it’s not just the duration that suggests we’re on the later side of

the economic cycle. Several fundamental data points including the yield curve, leading economic indicator composites, certain survey relationships and especially labor market measures suggest a similar conclusion. As can be seen below in our business cycle indicator, an increased percentage of measures being triggered

Business Cycle Indicator



Source: Yellow Cardinal Research; the Business Cycle Indicator is a proprietary dashboard of financial conditions that historically have provided some context of business cycle duration and lead time on recessionary events. When more than half of the weighted average signals were triggered, this often preceded a recession. The Business Cycle Indicator is a weekly signal with the 13 week moving average smoothing the volatility.

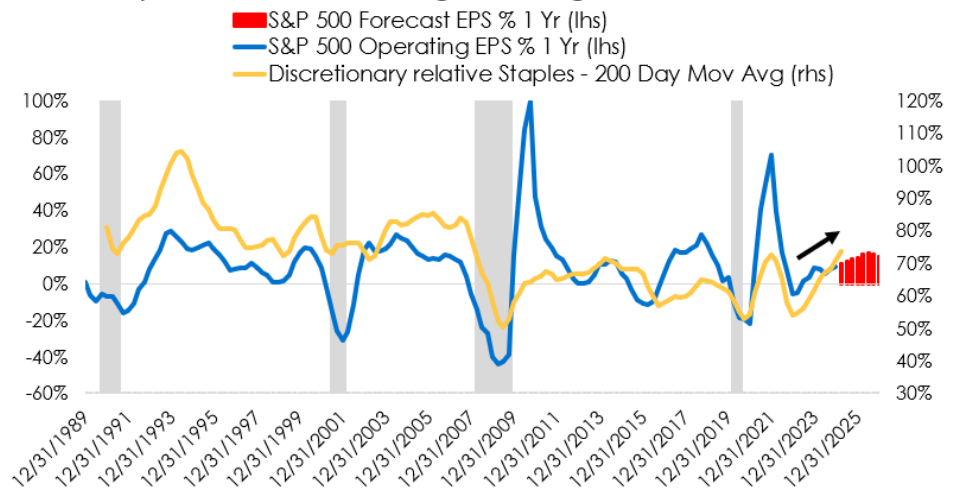


is additional confirmation that we remain at comparable late cycle levels in the economy (with recessions designated by shaded regions).

And yet from a profit cycle perspective, we don't look as late. In fact – as can be seen in the chart below – profit growth (blue line) continues to ramp off of the earnings recession trough in 2022 with the consensus forecast (red bars) not suggesting a peak in growth until 2Q26.

While we certainly wouldn't call it early, we do think this suggests an earlier setup in the profit cycle. For now, the price action in the equity market seems to be confirming the cyclical improvement in corporate profits. When comparing the Consumer Discretionary sector against the Consumer Staples sector (both on an equal weighted basis using the relative 200 day moving average – yellow line), the pro-Discretionary tilt implies a cyclical bias that tends to coincide with an acceleration in earnings growth. The caveat here is that using the 200 day moving average – while smoothing out the noise – can also dampen any signal change. The chart at left shows the daily price change against that 200 day moving average measure. The recent weakening isn't material enough to signal a change just yet but it is worth watching

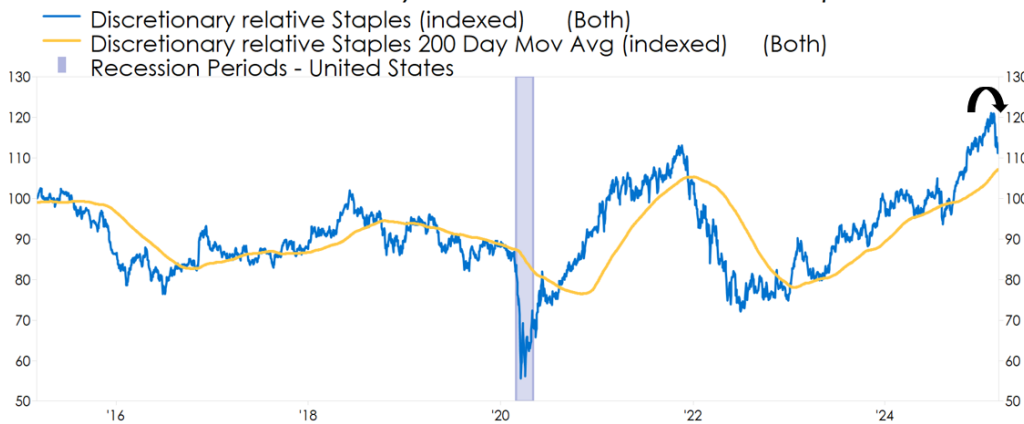
Cyclicals Confirming Earnings Acceleration



Source: Factset; S&P Dow Jones Indices with operating EPS defined on a trailing twelve month basis. Discretionary relative Staples is defined as the relative 200 day moving average using the S&P 500 equal weighted sectors indexed back to inception through 2/28/25.

and suggests that we may be nearing the peak in the forward earnings growth rate faster than the consensus expects. Such a change would suggest a downshifting in the profit cycle that has historically come with some

Consumer Discretionary relative to Consumer Staples



Source: Factset

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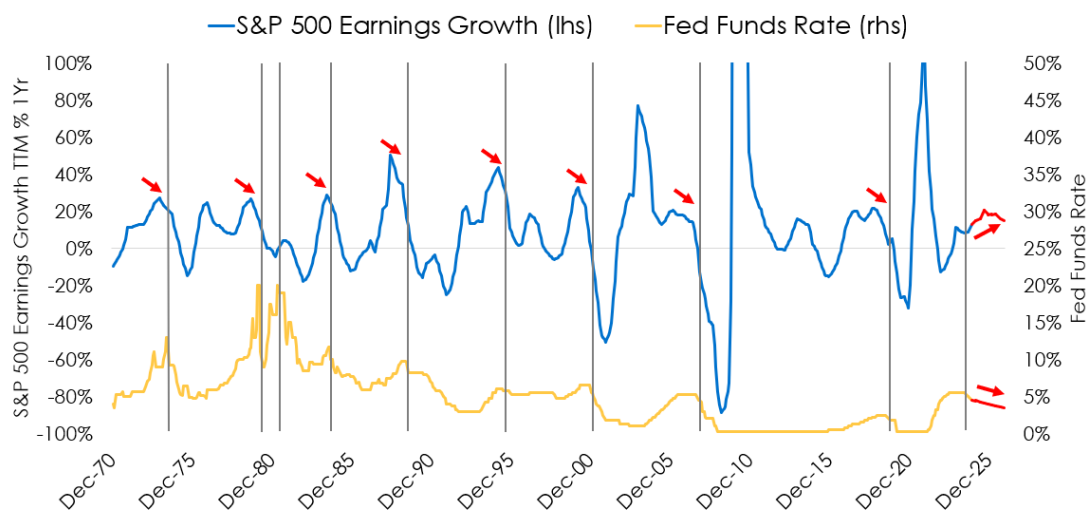
rotational leadership changes. Of course this is also happening at a time when economic and trade policy is exceptionally uncertain which adds another layer of complexity in deciphering signal from noise.

Add to that, the third leg of the stool – a Fed Cycle that looks counter to history. The chart below highlights the nine other Fed easing cycles (i.e. cutting rates) over the last half century. Acting as a countercyclical body,

the Fed has almost always started its rate cutting cycle after earnings growth has peaked.

Should earnings growth continue to ramp into 2025, such would not be the case in this current Fed cycle. We remain mindful of how such an occurrence might impact both growth and inflation.

Fed Easing Cycles vs Earnings Growth



Source: Factset; historical monthly earnings data smoothed over each quarter from Robert J Shiller; www.shillerdata.com. Earnings growth is calculated based on trailing twelve month reported earnings figures. Next twelve month forecast for earnings based on bottom up analyst estimates for S&P 500 reported earnings using the S&P Dow Jones Indices datasets; www.wpglobal.com. Next twelve month forecast for Fed Funds rate based on FOMC projection from the December dot plot and forecast exhibits; www.federalreserve.gov.

So what do we make of this de-synchronous setup?

If earnings growth continues to accelerate and broadens, this could unlock a recalibration of valuations in companies that might be more economically sensitive and smaller in size. According to Factset data, consider that since the end of 2009, the “average” stock (as defined by the equal weighted S&P 500) is trading at over a 20% discount to the market (as defined by the cap weighted S&P 500 index) versus its historical discount of about 6%. Similarly, the valuation difference between the S&P 500 Growth and Value indices are still rather extreme – not too far off from their disparate readings witnessed back in late 2021 and before that, the Tech Bubble peak. It remains noteworthy that the highest valuations still remain in the hands of the largest and growthier weights in the index. A key takeaway for us is that this kind of market action has conditioned investors to become accustomed to succeeding with increased concentrations – and with a disregard of building valuation (and mean reversion) risk – at a time when growth might be becoming more balanced.

At the same time, we want to remain on guard for additional scenarios that could lead to a faster peak in earnings growth translating into a change in market conditions. Such a development might occur due to the



de-synchronous setup referenced earlier and could play out – for example – with labor markets weakening quicker than anticipated and/or a stickier inflation backdrop that causes the Fed to pivot to more restrictive policy. Of course, changes in economic and trade policy should also be considerations. With what seems like an increasingly large number of potential scenarios, it's no wonder that the only certainty might be a high degree of uncertainty.

So what are the implications and key takeaways for portfolios?

From a portfolio positioning perspective, we continue to emphasize the importance of diversification and balance as a way to mitigate the high uncertainty as referenced above. While diversification has previously been an uncontroversial concept, the concentration present in portfolios today – by virtue of the price action over the last couple of years – suggests this notion remains a relic of the past. We respectfully disagree and earlier in the month took the opportunity to rebalance portfolios to maintain that degree of balance. In so doing, we trimmed our OW in stocks by taking some profits in US Large Caps and reduced our UW to bonds by adding to US Core Fixed Income. We remain UW the most expensive and concentrated areas where the long-term risk reward is especially skewed.

Within equities, our positioning incorporates balance geographically and within our US Large Cap exposure especially. Our bias has generally been to have more exposure to less expensive areas (down market cap vs top). As such, we've maintained a larger OW in Cyclical Value and a lesser OW in Defensive sectors combined with a smaller sized cap bias. We remain UW the most concentrated and expensive Cyclical Growth areas.

Within fixed income, we remain biased toward the higher quality US Core Fixed Income segment – where we are longer in duration and have previously repositioned our Treasury exposure in acknowledging the steepening yield curve. This exposure remains OW in portfolios for diversification purposes though we've also added to International Fixed Income (EW), where the end of negative interest rate conditions has led to more attractive opportunities. Maintaining a higher quality bias means that we still remain UW the most expensive part of the bond market (High Yield) where spreads remain tight relative to what the potential risks might be.

Within alternatives, we remain fairly balanced across the board with neutral positions in Diversified Alternatives, Real Estate and Commodities.



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