

On Our Radar – March 2025

Over the past few months, market sentiment has shifted from optimism to heightened uncertainty, driven by concerns over tariffs, government spending cuts, rising prices, and a sharp decline in consumer spending. In February, the S&P 500 fell 1.4 percent, accompanied by increased volatility across financial markets.

Interest rates on the 10-year U.S. Treasury Note dropped from 4.58 percent at the end of January to 4.24 percent, reflecting growing worries about a slowing economy. Meanwhile, oil prices declined by approximately \$5 per barrel over the past month, settling at \$70.

Adding to market turbulence, President Trump announced plans to impose 25 percent tariffs on Canadian and Mexican imports beginning March 4, 2025, along with an additional 10 percent tariff on Chinese goods — on top of the 10 percent already implemented in February. This has fueled volatility, particularly as China and other affected nations have vowed to retaliate.

TJT Capital Group's InVEST Risk Model® has helped our clients participate in bull markets and protect capital from the devastation of bear markets by focusing on 5 indicators that really matter when it comes to determining the health and direction of markets. The following is the most recent update.

Interest Rates (Monetary Policy)

At the end of 2024, U.S. government debt stood at approximately 124 percent of Gross Domestic Product (GDP), down from its COVID-era peak of 130.4 percent in March 2021 but up from 118.5 percent in March 2023. For perspective, in early 2020, federal debt was around \$20 trillion, with GDP at roughly \$21 trillion. In just five years, federal debt has surged to approximately \$36.2 trillion — an increase of more than 80 percent — an unsustainable trajectory.

Adding to fiscal concerns, the U.S. government ran a budget deficit of \$838.3 billion in the first four months of the 2025 fiscal year. That's about \$306 billion higher than the same period last year. If this trend continues, the annual deficit could reach an alarming \$2.5 trillion.

Meanwhile, inflation remains a key challenge. The Federal Reserve's preferred inflation measure—Core Personal Consumption Expenditures (PCE), which excludes food and energy—rose 2.6 percent yearover-year. In recent Congressional testimony, Fed Chairman Jerome Powell reaffirmed that interest rates will remain restrictive until inflation returns to the central bank's 2 percent target.

The next Federal Open Market Committee (FOMC) meeting is scheduled for March 18-19, 2025, where policymakers will assess the evolving economic landscape and determine the path forward.

Valuation

S&P 500 operating profits are projected to reach approximately \$268 in 2025, implying a Price/Earnings (P/E) ratio of about 22.4. While this valuation is far from cheap, the “earnings yield” – the inverse of the P/E ratio – stands at around 4.5 percent, exceeding the current yield



on the 10-year Treasury Note. This suggests that equities may offer a more attractive investment opportunity than bonds.

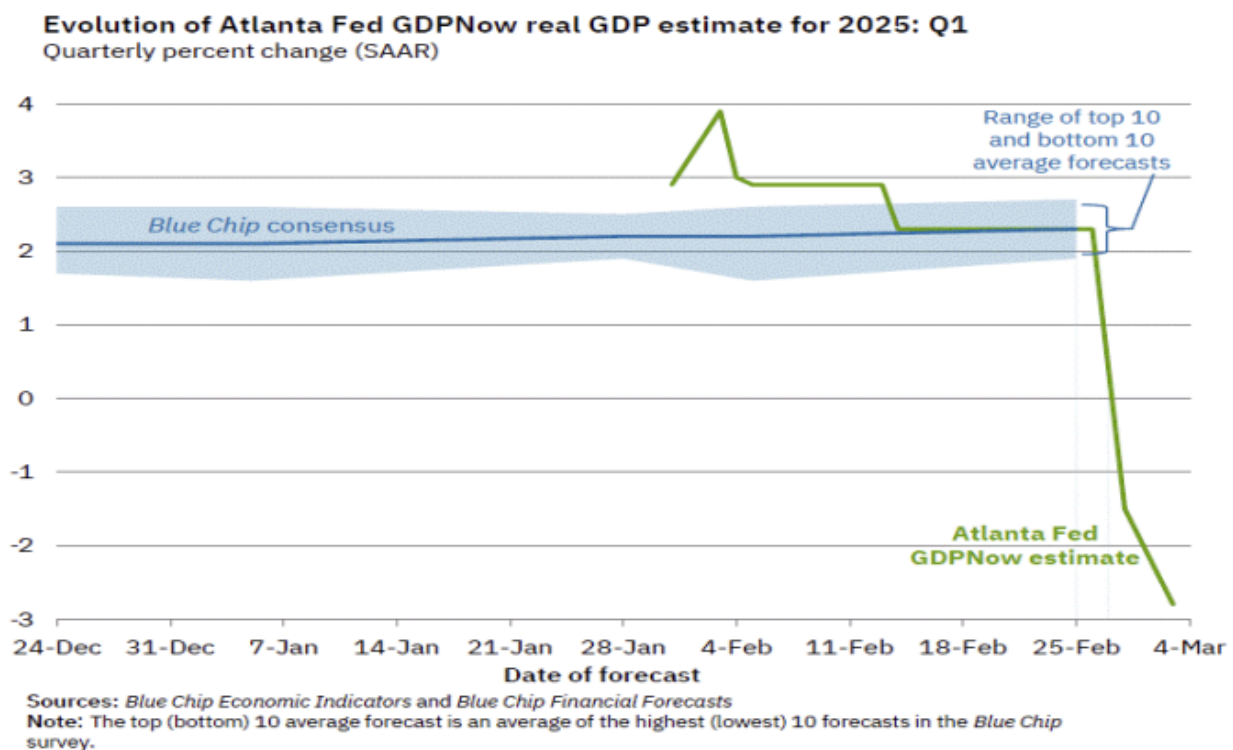
However, ongoing shifts in tariff policies could be fueling concerns in the bond market about the likelihood of the \$268 earnings estimate materializing.

Economic Cycle

Economic data suggests a cooling economy. U.S. Gross Domestic Product (GDP) grew at an annualized rate of 2.3 percent in the fourth quarter of 2024, down from 3.1 percent in the previous quarter. The Institute for Supply Management (ISM) Manufacturing Index slipped to 50.3, barely above the 50-threshold that separates expansion from contraction. New Orders dropped to 48.6, while the Prices Paid Index surged by 7.5 points to 62.4.

Consumer sentiment has also weakened. The University of Michigan’s Consumer Sentiment Index declined by more than three points, while long-term inflation expectations recorded their largest month-over-month increase since May 2021. Job market data painted a similarly concerning picture, with unemployment claims rising and continuing claims hovering near a three-year high, making it increasingly difficult for job seekers to find new employment. As a result, inflation-adjusted consumer spending fell by 0.5 percent in January—the largest monthly decline in nearly four years.

This uncertainty is reflected in the GDPNow model, which, while not an official Federal Reserve Bank of Atlanta forecast, serves as an indicator of shifting economic conditions. As shown by the green line in the accompanying chart, first-quarter growth estimates have plunged from nearly 4 percent in late January to -2.8 percent recently.



Sentiment

As market volatility has increased, with significant price swings in both directions, bullish sentiment has declined from around 59 percent in late December to the mid-40s by late February.

Although the S&P 500 reached a new closing high in late February, the drop in bullish sentiment was unusual, as it typically moves in tandem with the market. This divergence suggests that investors are increasingly wary of the potential impact of tariffs.

Technical Factors

Over the past few months, we have noted that while the major indices have remained resilient, significant movement has been occurring beneath the surface. One example is the small-cap Russell 2000 index, which peaked at 2,433 in late November but ended February at 2,163—an 11 percent decline—even as larger-cap indices continued to advance.

From a technical perspective, this divergence suggests that small companies may be more vulnerable to the effects of tariffs and government cutbacks than their larger counterparts.

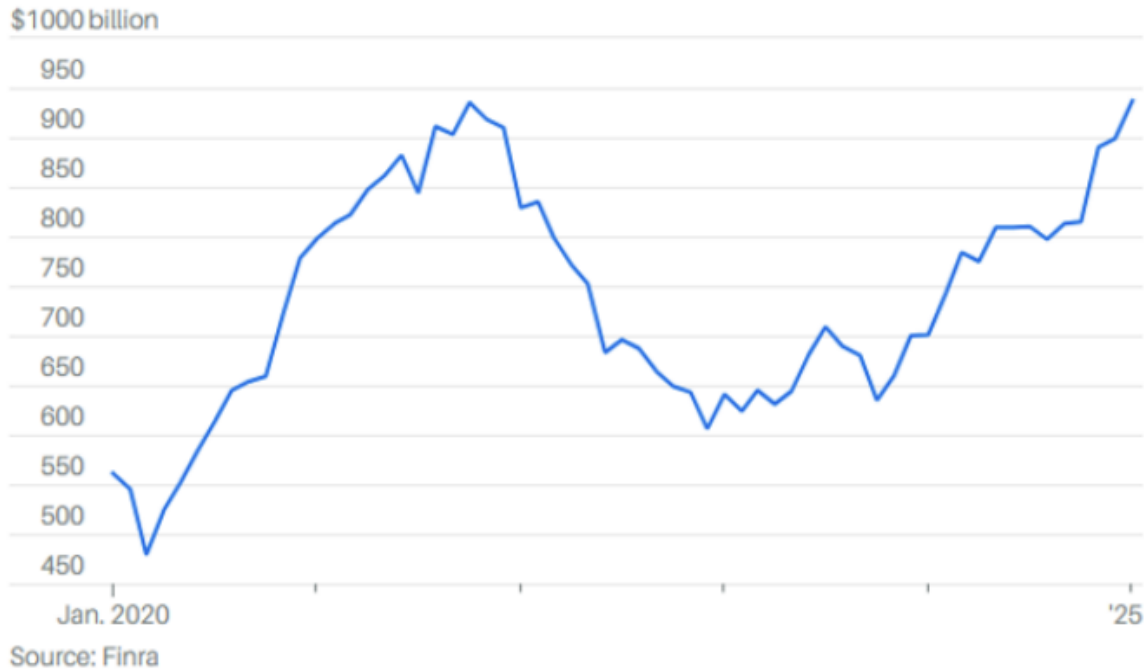
Outlook

The ongoing back-and-forth over tariffs and federal government cutbacks has added uncertainty to the economic landscape, prompting businesses and consumers to become more cautious with their spending. As a result, the term "stagflation"—a combination of sluggish growth and persistent inflation—is increasingly being discussed among economists.

When major policy shifts occur in an environment of rich market valuations, any unexpected developments could have significant implications for investment portfolios. Currently, valuations remain elevated, with the S&P 500 trading at more than 22 times projected 2025 earnings.

At the same time, investor enthusiasm has been evident in early 2025. Over the first six weeks of the year, more than \$130 billion flowed into exchange-traded funds (ETFs) — more than double last year's pace and surpassing the previous record of \$120 billion set in 2021.

Amid this surge in inflows, margin debt — the amount borrowed to purchase securities — hit an all-time high of \$937 billion in January, according to FINRA (the Financial Industry Regulatory Authority). The increase in leveraged investing suggests heightened risk exposure in the markets.



Adding another layer of uncertainty, the December 20, 2024, Continuing Resolution that temporarily funded the U.S. government is set to expire on March 14, 2025. With federal spending at approximately \$7 trillion and revenues at \$5 trillion, the resulting \$2 trillion deficit has played a crucial role in supporting economic growth. If the Department of Government Efficiency (DOGE) continues efforts to eliminate wasteful spending, reduce fraud, and cut the number of federal employees and contractors, the economic ripple effects could be more substantial than currently priced in.

With U.S. stocks near all-time highs, credit spreads at their narrowest in nearly 30 years, record margin debt, and an unprecedented surge into ETFs, the market appears to have little room for error. While tariffs could be delayed or reversed at any moment, investors should prepare for sustained volatility and a broader range of potential market outcomes. (3.4.25)

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