January produced excellent returns in both stock and bond markets – though the relative winners and losers switched as we predicted in our year-ahead note in early January . For the month, the Dow Jones, S&P 500, and Nasdaq rose 4.8 percent, 2.8 percent, and 1.7 percent respectively. Value outperformed growth for the month with the Russell 1000 Value gaining 4.6 percent and the Russell 1000 Growth gaining 2.0 percent. Mid cap stocks and small caps also performed well, with the Russell Mid-cap gaining 4.3 percent and the Russell 2000 (small caps) increasing 2.6 percent. International stocks also had a good month with the MSCI All-Cap world ex-us rising 5.0 percent, the MSCI EAFE gaining 5.3 percent, and the MSCI Emerging Markets gaining 1.8 percent. Bonds rallied modestly as well – the Bloomberg US Aggregate index increased by 0.5 percent . Somewhat counterintuitively, longer duration bonds performed well despite the Fed pausing its rate reductions. More on that below.

The focus of the media attention since Trump's inauguration has largely been tariff and government-spending related (Department of Government Efficiency). We understand these two issues now reside at the forefront of our clients' minds and want to convey our views on what's transpiring.

From a purely economic viewpoint, tariffs differ from any other corporate tax increase only in what they subsidize – domestic companies and workers at the expense of foreign. If you excise any judgment about the merits of the subsidy, the mathematics are identical to increasing the corporate tax rate to fund green energy subsidies. At the end of the analysis, consumers pay all taxes levied against corporations; and the government uses the collected funds to engender social goals because the free-market would have naturally produced a different outcome. The words used to describe the tax and the targeted beneficiary differ, but the economic analysis remains the same.

Reductions in government spending, which we refer to as fiscal impulse, likewise have economic consequences. Even eliminating the most objectionable and wasteful things imaginable; even extinguishing expenses that could only harm the country is an exercise that will likely reduce short-term economic growth and inflation, and possibly stock prices. As the new administration's Department of Government Efficiency works to cut spending, if the cuts grow to sufficient magnitude, we would expect markets to react.

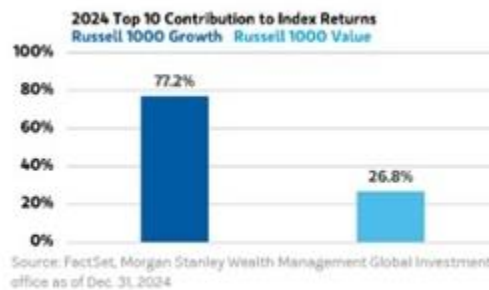
Professionally, we endeavor to not to pass judgment on political issues: instead, we focus solely on growing and preserving your wealth. What's on our minds right now is not whether the tariffs and spending cuts are good or bad for the country (that's where the news focuses to draw emotional response and viewership) – but rather how these changes will affect your portfolio. Should we alter portfolio allocations and if so, how much and in what way? The short answer is this: now we like

bonds/duration more and mega-cap multinational stocks (Magnificent 7) even a little less than we did at the start of the year. As we often have pointed out, and Richard Bernstein highlighted again this month in his note, the narrow markets of the last couple years are the exception not the rule. Concentration and narrowness in the large cap space has become so severe that Morgan Stanley's Peter Winkler and Amy Tomkin, two of our large cap growth fund analysts, pointed out in this month's On the Markets that the literal rules that govern mutual funds prevent investment advisors that manage those funds from owning the market weight of the Magnificent 7, causing just about every fund to underperform its benchmark.

Short Takes

Growth Versus Value: It's Complicated

Over the past three years, only 11% of actively managed large-cap growth funds have outperformed their benchmarks, versus 59% for large-cap value. Why the gap? One reason is that most officially diversified large-cap growth strategies have been more severely impacted relative to benchmarks and passive strategies by Investment Company Act of 1940 concentration limits. Given that the Russell 1000 Growth Index's top ten holdings account for more than 55% of the index weight and 77% of 2024's return, matching or beating the index, which is not subject to 1940 Act rules, has been especially challenging. The Russell 1000 Value Index's top ten holdings account for only approximately 17% of the index weight and 27% of last year's return.—*Peter Winkler and Amy Tonkin*



Source: FactSet, Morgan Stanley Wealth Management Global Investment Office as of Dec. 31, 2024

At this point, we will not be surprised if 2025 proves to be a year in which value stocks outperform growth and bond returns are robust. We remain optimistic overall but anticipate different sources of return this year.

Getting back to what's dominating the financial news: ultimately, we think the tariffs won't be large and trade wars will be avoided (the market also seems to be pricing in those eventualities.) Therefore, we think the inflation concerns with regard to tariffs make good politics but are unlikely to endure as issues that we need to hedge in portfolio construction. Barring a full-fledged trade war with successive rounds of increasing tariffs, we simply don't view tariffs as inherently inflationary over time – the trouble is that the word "inflation" is both used to describe a one-time increase in prices and also a persistent change in the rate of increases in prices over time. As Seth Carpenter, our chief economist puts it: "For tariffs, I regularly hear more focus on higher inflation and relatively little about weaker growth. Both matter, and judging from Fed transcripts from 2018, the Fed sees things our way. Inflation seems to rise about 2 or 3 months after tariffs are enacted. We and the Fed expect the rise to be temporary, but with the recent bout of inflation,

the Fed will not be confident, so they will stop cutting and simply wait. Only if tariff-driven inflation unanchors inflation expectations and we get very little slowing in the economy would tariffs result in a hike. The Fed knows the growth slowdown will take a couple of quarters, so they will simply wait." Here, Seth uses the term "inflation expectations" to distinguish the two things.

In other words, while immediate price increases will occur in some goods and regions as a direct consequence of tariffs, a single step up in prices is not the same as a prolonged change in the expected-average rate of inflation. Furthermore, tariffs will likely also decrease growth expectations which could even prove disinflationary over time in the longer-term sense of what the word inflation means. Morgan Stanley wrote an [excellent piece](#) over the weekend of February 2nd detailing what might happen if the 25% tariffs on Mexico and Canada are actually implemented. The following table outlines what we see as the consequences of three different scenarios. In a nutshell, all else held equal, in any of the three scenarios we see likely to unfold, US treasuries become relatively more attractive to other asset classes and multinational companies (the Mag 7) have more risk than more domestically-focused enterprises.

	Tariff Implementation Avoided and/or Delayed	Limited Scope and/or Temporary Duration	Broad-Based and/or Durable Tariffs
Economics			
US	• No change to baseline	• Firmer inflation, slower growth, on-hold Fed	• 25% on MX/Canada and 10% on China boost headline PCE by 0.3-0.6pp & weigh on real GDP by 0.7-1.1pp
Asia/China	• No change to baseline	• No change to baseline	• Similar or larger growth drag than the 100bps hit to Asia and China's growth in 2018-19
Canada	• No change to baseline	• Targeted measures imply slightly lower growth & higher inflation	• Prolonged tariffs & reciprocal action shave off ~2.3-2.8ppt from GDP growth & spur near-term inflationary pressures
Mexico	• No change to baseline; uncertainty remains elevated	• If no reciprocation, modest impact on growth & inflation • If MX retaliates, expect a larger impact on inflation	• MX economy enters recession, the depth of which depends on reciprocation from MX authorities (100-150bp increase in inflation if MX responds in kind)
Strategy			
Rates	• Buy US Treasuries • Mexican Rates to fully price in 50bp February cut, but limited room to outperform	• Buy US Treasuries as tariffs create downside risk to nominal GDP • Mexico/US spreads in the 1y+ sector to widen on more uncertainty	• Buy US Treasuries as tariffs drive investment to the US Treasury market as a deep, liquid, risk-free alternative • Mexican rates to price out most cuts (8.40% terminal)
Mexico	• Positive for MX equities, Mexbol rises 2-3%	• Mexbol likely remains flat	• Mexican equities suffer across the board, Mexbol likely to drop ~5-10%
FX	• Weaker USD (EUR/USD 1.08, GBP/USD 1.27, USD/JPY 145) • USD/CAD declines toward low 1.40s • MXN mildly positive reaction • Buy dip in USDCNH as strategic tariff risks linger	• USD: similar outcome to scenario 1, weaker but limited • USD/CAD peaks on tariff risk premium • MXN could depreciate ~5%, FX intervention possible • Buy dip in USDCNH as strategic tariff risks linger	• Broad USD index rises ~3.5 - 4.0% short-term. DXY falls late; JPY outperforms • USD/CAD rises to 1.50 • MXN could depreciate ~10%. FX intervention likely • Maintain 7.6 USDCNY target
MX Sov. Credit	• Positive for USD bonds	• Smaller rebound due to existing cheapness	• Underperformance continues
Equities			
US	• Best case scenario for US equities • Consumer Discretionary Goods stocks/cyclicals lead	• Baseline market assumption at the index level • Could be a clearing event for certain Consumer Discretionary Goods stocks that have been weighed down by tariff risk	• Long services over consumer goods (autos, retailers, brands, durables) • Markets adopt a more defensive posture
Cross-Asset			
Global	• OW equities & spread products	• OW equities & spread products, but look for vol dislocations to add hedges	• Macro correlations to spike, but 'stocks down/yields lower' correlation prevails, i.e. buying bonds as diversifier works

Source: Morgan Stanley Research

Over the weekend of February 2nd we also observed the Trump Administration cutting expenses aggressively with regard to USAID. The Department of Government Efficiency also gained access to the treasury payments system and began auditing individual payments. While cutting wasteful spending is a laudable goal and it's still hard to say how things will eventually play out as any cuts are likely to face numerous procedural and legal challenges (and the Trump administration may also increase government spending in other areas), relative to our thinking on January 1st, our view is spending cuts may prove to be larger and more impactful than we or markets previously assumed. The whisper number on the number of government employees who have already accepted a severance package is about 40,000 individuals. It's difficult to know how many of those folks might have resigned this year anyway or if that is a marginal number. At the end of the analysis, the larger the aggregate spending cuts (irrespective of type, cause or merit) the more we would expect GDP growth to decrease, inflation to decelerate, and interest rates to fall. As with the tariff analysis above, bonds and value stocks now seem relatively more attractive to us than they did before Trump took office. In our view, slower growth and less inflation than markets currently expect will be very likely to produce lower interest rates. Bonds and value stocks are simply more rate sensitive (they have more duration) than growth stocks. This is also true for small and mid-cap stocks. The bond market seems to have already taken note of this and rallied during the first week of February.

As always, if you have any questions or concerns, please don't hesitate to reach out to any member of our team.

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