WHIRLWIND

In just one month since Inauguration Day, President Trump has spun up norms and expectations as dramatically as the tornado that lifted Dorothy out of Kansas.

It is not yet clear where policies will land. But, in both the US and overseas, the speed and scope of change have been enormous. Markets have mostly taken the flurry of announcements and actions in stride, although this week saw US equities come off recent highs with continued policy uncertainty. Although much of the US Administration's action has been directed against allies, including in Europe, equities there have also rallied – admittedly from a low base.

On February 20, a month into President Trump's new term, US markets closed 2.1% and 1.8% higher than their levels before Inauguration Day, as measured by the S&P 500 and Nasdaq. In Europe, where the shock of potential abandonment by the US is leaving many reeling, major stock indices, nevertheless, climbed by 7.5% over the same time period. China has not been at the center of attention for the White House so far. It is ready to negotiate, preparing retaliatory trade measures aimed at hurting constituencies that support Trump to strengthen its position. The 16.5% jump in equities came largely from enthusiasm over DeepSeek (more below). Most long term foreign investors remain reluctant to risk the political – and financial – uncertainty of China, despite signs that the government may allow space for private business as President Xi sat down this week with business leaders including Jack Ma of Alibaba. Traders still look for short term opportunities.

There are reasons for the relative market calm in the early days of the new US Administration.

One is that President Trump's dramatic reversals from previous policies – not just of President Biden but of many earlier governments – have come so quickly that observers appear to have been stunned. Foreign governments – especially allies in Europe – are fearful of an apparent new world order. But they are unsure how best to mitigate harm to their interests, recognizing that the US is still the most important and powerful nation in the world. And Democrats, as much as they may dislike what they see from the White House, are wary of running afoul of President Trump's formidable strength with voters. Many Americans may be cheering on sweeping changes to the bureaucracy and established order, or at least more interested in what is happening in their own lives than in the upheavals in Washington, DC.

While markets have tested new highs since President Trump took office, there are more recent signals of potential weakness amid uncertainty. It is simply too soon for businesses and investors to know which new policies will become permanent, given both legal challenges and shifting declarations from the White House, notably on tariffs. Meanwhile, some of the President's plans, including for tax cuts and deregulation, are favored by investors and likely to boost growth and corporate profits.

At RockCreek, we are watching three economic themes as the new Administration's policies play out:

1. **TAXES AND SPENDING – AND THE DEFICIT**
2. **TRADE AND TARIFFS**
3. **INFLATION AND INTEREST RATES**

Uncertainty is starting to impact some businesses and consumer spending. While certain sectors including energy, space and defense are expected to be beneficiaries of the new Administration, uncertainty can impact others. Early indications are for US growth to continue in Q1 at a similar pace to the 2.3% annual rate confirmed for Q4. But prolonged uncertainty would be troubling. Optimism in the short term is likely warranted. But some businesses, and many economists, fear that the longer-term US outlook may be weakened by trade wars that could trigger more inflation and reduce productivity growth, by labor shortages and by demand shortfalls, particularly in communities with large immigrant populations where people have stopped spending outside their homes.

Optimists point out that recession predictions after the pandemic recovery were wrong. The US economy is still strong. And the President will likely be careful to avoid – or undo – policies that could shake markets or business or – most importantly – prove to be unpopular with American voters.

TAXES AND SPENDING

The Administration has focused in its first month on executive orders that assume an expansion of presidential power, in particular, to enforce political control over the federal government, including previously independent federal agencies.

But changes to taxes and a reordering of spending priorities will require legislation. So far, the White House has given mixed signals on how it would like Congress to proceed. The President this week sided with House leadership on combining into "one beautiful bill" both tax cuts and border measures. The Senate prefers two bills, fearing long delays in negotiations on taxes and the budget would hold up any quick wins from border measures. With control of both House and Senate, Republicans and some Democrats reluctant to obstruct President Trump, he has important sway. But the room for maneuver is limited, given the narrow majority in the House and ardent opposition by some Republicans to blowing out the deficit.

Early executive orders gave sweeping powers to Elon Musk's new DOGE (Department of Government Efficiency) to attack "waste, fraud and abuse" in the federal government. This was supposed to contribute to significant savings in the budget that would open up room for tax cuts. So far, the scale of saving has been insignificant.

Many of DOGE's highly visible actions are now being challenged in court. These include the firing of thousands of federal workers and the virtual shuttering of agencies previously established by Congress, including USAID (the Agency for International Development) and the Consumer Financial Protection Bureau (CFPB). DOGE teams have also had presidential clearance to access payment systems in the Treasury and financial records in the IRS and Social Security Administration. But the changes announced so far are unlikely to make much of a dent in the $7 trillion federal spending bill, more than half of which goes on health and Social Security spending with the bulk of the rest on other entitlements, interest payments and defense. Cuts to Medicaid and other social programs could occur. But these would impact many lower income Trump voters in rural areas and poorer states and may be strongly resisted.

TRADE AND TARIFFS

On trade and tariffs, the picture is also unclear. The President has spoken of tariffs against Canada and Mexico and across-the-board tariffs against all countries and, more recently, "reciprocal" tariffs to be calculated for imports from different countries according to their treatment of American goods.

While simple in concept, reciprocal tariffs would be difficult to implement in practice, as laid out in the Brookings paper above. More fundamentally, variable tariffs would be inimical to a stable set of rules that would allow companies to make long-term decisions about where to invest and how to build and maintain supply chains.

The President has shown that he is open to negotiation on tariffs – both with trading partners, including China, and with American companies that fear harm, for example from higher costs for steel and aluminum.

INFLATION AND INTEREST RATES

Federal Reserve policymakers – together with most Americans – are still focused on inflation and the risk that recent progress may be undone, whether by unexpected events like a more rapid spread of bird flu, or by policy mistakes. Minutes of the Fed's January meeting released this week showed that the central bankers were concerned that higher tariffs could stall disinflation. If Administration trade actions trigger higher prices, the scope for further interest rate cuts will be limited. That will not please President Trump.

So far, the President and his Treasury Secretary Scott Bessent have indicated that monetary policy independence will not be challenged. That will be critical for markets. This week, the White House called for financial regulatory agencies, such as the SEC and CFTC, that have operated until now with a bipartisan consensus of independence, to be brought under direct Presidential oversight, effectively to be subject to the Office of Management and Budget (OMB) in the White House. A carve-out for the monetary role of the Fed was written into the executive order. Defining a clear line between supervisory and monetary policy will be important for Fed independence. Rule of law remains an important underpinning of the US capital markets, and its preservation will ensure continued investment in the US.

EQUITIES

2025 has gotten off to a noisy start with the pace of executive orders and unpredictable trade moves and with the DeepSeek bombshell in late January. It has been a lot for investors to make heads or tails out of. Some areas like financials and energy have performed well as expected. However, small-caps have been hindered by stubborn inflation and the lack of an M&A return as CEOs remain cautious. President Trump's 'America First' policies were widely expected to reinforce the American exceptionalism we've seen within the equity market in recent years. They still might, but it's interesting to note how Europe has significantly outperformed the US thus far.

Part of the story is diverging central bank policies with Europe expected to cut rates and the Fed holding steady. Never fight the central banks. We're also seeing investors interested in diversifying into less expensive markets that may offer better valuation support in the event of a market shock. According to the latest data from Citi, European equity funds saw a $2 billion inflow over the past week, the largest weekly inflow in just over two years. Though US earnings have remained strong, revision trends have looked more impressive in Europe, which has helped induce investors to diversify.

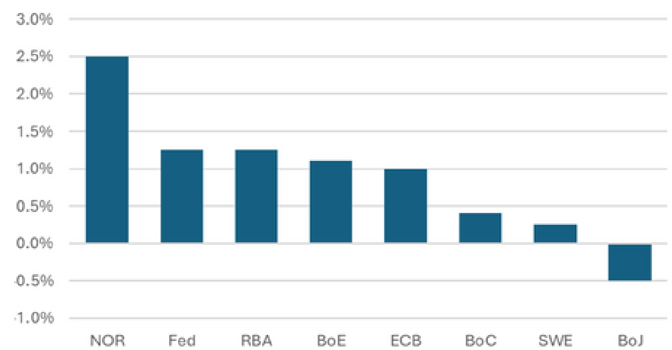
Chinese AI startup DeepSeek's claims of developing sophisticated AI models at a small fraction of the cost as that of major US-based companies led to a panic across the US technology sector, contributing to the US's relative underperformance. The headline cost of $6 million cited by DeepSeek was startling yet vague on details, which allowed knowledgeable investors to potentially acquire additional AI exposure at a discount. We saw indications of some notable buying though Nvidia, Microsoft, and other companies with foundational AI exposure have not yet fully recovered. It's become apparent that DeepSeek was citing the cost of its final stage

inference models and excluding much of the research and development costs being absorbed by US companies in the earlier stages. Progress on foundational reasoning models will still be needed, and as such, the consensus view remains that demand for AI computing resources will remain strong in the years ahead. What the DeepSeek news made abundantly clear, however, was that the cost of developing inference models is falling rapidly. This has major implications for AI adoption trends to the benefit of software, advertising, content creation and numerous other areas.

FIXED INCOME

Fixed income and currency markets have been whipsawed in the past several weeks by both current economic data and policy expectations. Recent inflation data in the US was hotter than expected, causing a repricing in front-end rates. Markets are now pricing in only one interest cut by the Fed for 2025, down from two at the beginning of this year. Throughout 2024, markets priced in more easing. The recent inflationary surprise, coupled with tariff expectations, actions, and reactions have sent treasury yields at the 10-30yr points 20 basis points higher, lower, then essentially back again – all within the first few weeks of the year. Currently, the yield curve has shifted such that front-end rates are above where they started the year, while longer-dated tenors are lower or flat. This flattening of the curve could be an early indication that rate traders are worried that above-trend inflation may be countered by higher interest rates that could foment a recession in a few years' time. To be sure, the pricing is not particularly severe currently, but the dynamics warrant further monitoring.

This volatility is underlined by the growing divergence in monetary policy expectations across the globe. Even when looking at a few major developed market central banks the divergence is clear. In Europe and Canada, for example, markets are pricing in four additional cuts this year, on top of cycle-to-date policy rate reductions in-line or more aggressive than those enacted by the Fed here in the U.S. Meanwhile, Japan is going the other way entirely. The Bank of Japan (BOJ) raised interest rates again (following a pause since July 2024) last month to 0.5%. Markets have reacted in a more orderly and predictable way after this rate increase, with the yen strengthening and Japanese government bond (JGB) yields rising. Strong growth and above-trend inflation should pave the way for the BOJ to continue raising interest rates, absent any unforeseen hiccups.



One part of the fixed income market that does not seem concerned about recession any time soon is the credit markets. Investment grade and high yield credit performance continue to exceed expectations. Credit spreads in both cash markets and credit derivatives are approaching, or already at, multi-decade lows. This has been driven by increased demand from a range of investors looking to pick up excess yield. Investment grade credit has proven popular as a way to both extend the duration of fixed income portfolios and earn higher yields with very little risk of default given the strength of corporate balance sheets. Further down in credit quality, high yield credit, specifically the lowest-quality CCC-rated names, have performed exceptionally well in recent months, again owing to few defaults on a par-weighted basis and the impact that growth in private credit has had on removing the most-risky credits from major indices.

CURRENCIES

In currency markets, dollar strength has been a resounding theme since the election. Indeed, the

dollar is at its strongest level since the end of 2022 but the lack of serious bite from tariff policy thus far has caused the greenback to trade off its January peak – despite a persistent growth and monetary policy advantage. Since just prior to the inauguration – emerging market currencies have broadly gained 1.5% vs. the dollar with the CNH performing in line with that broader basket. The Mexican Peso has rebounded 2.3% over the same period. In developed markets, the Canadian Dollar strengthened 2.1% during that time, while the Euro and Pound are up 2.2% and 4.1%, respectively. The Yen is also stronger, driven by the BOJ's outlier monetary policy detailed above. In the current environment it seems hard to call for an outright weakening of the dollar, but evolving tariff and monetary policy, as well as their impact on inflation, will be key to monitor going forward.