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William Rutherford

February's calm conceals a changing of the guard

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Readers of my column last month will recall that January was described as calm above a storm raging below. The major indexes posted modest gains, while one of the most violent rotations in recent memory ripped through individual stocks and sectors. Did February bring calmer seas? It did not. The S&P 500 slipped less than 1 percent for the month, closing at 6,879. The Dow eked out a small gain, finishing at 48,978. The Nasdaq took the worst of it, falling 3.3 percent to close at 22,668. Once again, the surface told you almost nothing about what really occurred.

The sector rotation that began in January intensified. Money continued pouring out of the mega-cap technology stocks that had dominated the last two years into cyclical sectors: energy, materials, industrials. Wall Street dubbed it the HALO rotation: Heavy Assets, Light Other. Energy stocks surged over 14 percent in January and kept climbing. Materials gained nearly 9 percent. The equal-weight S&P 500, which gives every company the same importance regardless of market value, outperformed the capitalization-weighted index by its widest margin since March 2025. Nine of 11 sectors moved higher. The headline number looked flat only because the mega-cap tech names carrying so much weight were dragging it lower. As noted last month, money is not leaving the market. It is moving to different neighborhoods. In February, those neighborhoods got even more crowded.

What was happening to those technology stocks? Two words: AI panic. Nvidia CEO Jensen Huang proclaimed that February marked the inflection point for agentic AI – the arrival of autonomously reasoning AI that plans, decides and executes multistep tasks. The software sector experienced what the market dubbed the “SaaS-pocalypse.” AI tools capable of performing enterprise-level tasks autonomously sent investors fleeing from traditional software companies. The fear is straightforward: if an AI agent can do the work of a \$50,000-per-year software subscription, why keep paying? The software index fell roughly 18 percent year to date, erasing more than \$300 billion in market value. It was indiscriminate selling with little regard for individual company fundamentals.

Is the threat real? Markets tend to overshoot in both directions when they encounter a genuinely new force. AI will reshape the software industry, but the notion that decades of embedded

enterprise data and complex workflows can be replaced overnight seems premature. Companies with deep vertical expertise and real switching costs will adapt. The ones selling thin wrappers over commodity tools will not. This is how creative destruction has always worked.

The crypto market offered its own drama. On Feb. 5, Bitcoin plunged 18 percent in a single day, crashing below \$60,000 and erasing nearly \$500 billion from the total crypto market. The catalyst was partly the nomination of Kevin Warsh as the next Federal Reserve chair, a signal that tighter monetary policy may lie ahead. Coinbase lost over \$13 billion in market value in four sessions. MicroStrategy reported a \$17.4 billion operating loss on its Bitcoin holdings. The much-hyped notion of crypto as the new store of value, versus the dollar and gold, did not meet the test.

The Fed held rates steady at 3.50 to 3.75 percent at its January meeting, with two dissenters favoring a cut. Chairman Jerome Powell maintained his data-dependent posture, and the Warsh nomination added another layer of uncertainty. Here is where the bond market tells an interesting story. Since the Fed began cutting in September 2024, it has lowered the federal funds rate by 175 basis points. Yet the 10-year Treasury yield has risen about 60 basis points over the same period. That divergence has not occurred since 1989. The bond market is signaling concern about the deficit, which is at 6.5 to 7 percent of GDP, and about whether inflation is truly beaten. Services inflation remains stubbornly elevated, even as headline CPI dropped to 2.4 percent.

On the economic front, the picture is one of surprising resilience. The economy added 130,000 jobs in January, beating expectations, though previous months were revised sharply downward. The ISM manufacturing index surged to 52.6, signaling that the long manufacturing recession may finally be ending. Corporate earnings showed strength, with S&P 500 fourth-quarter growth tracking 12.1 percent year over year, well ahead of estimates. Importantly, the earnings gap between the mega-cap giants and the rest of the market is narrowing. Excluding the Magnificent Seven, growth was a solid 7.8 percent.

February also brought a landmark legal decision. The Supreme Court ruled 6 to 3 that the president cannot unilaterally impose burdensome tariffs, invalidating the sweeping tariff regime in place for much of the past year. The administration quickly imposed new tariffs under the Trade Act of 1974, starting at 10 percent and increasing to 15 percent within a day. The tariff landscape remains in flux, and the market hates uncertainty. But the potential for refunds on previously collected tariffs, estimated at over \$140 billion, could provide a meaningful tailwind for importers and consumers.

As if all of that were not enough, the month ended with a geopolitical shock. The United States and Israel launched major military strikes against Iran, resulting in the death of Supreme Leader Ayatollah Khamenei. Iran retaliated with missile strikes across the Middle East, targeting military and civilians in Israel, the UAE, Qatar and Bahrain, disrupting airports and causing a mass exodus from Dubai and other business and tourist hubs. The Strait of Hormuz, through which roughly a

third of the world's seaborne crude flows, was "closed" by Iran, although subsequently the U.S. initiated use of military forces to ensure safe passage of ships. Oil prices jumped sharply. Noteworthy is that the 25 most significant geopolitical crises since World War II produced an average S&P decline of 4 percent, a bottom in 15 days, and a recovery in 33. The pattern does not always hold, but it is worth remembering before making rash decisions.

In a market defined by disruption, rotation and geopolitical risk, the temptation is to sell and wait on the sidelines. Resist it. As Gene Fama, the Nobel laureate, once said, "Your money is like soap: the more you handle it, the less you'll have." Earnings are growing and broadening. The labor market appears to be resilient. Manufacturing is recovering. The fundamentals remain sound.

What January started and February confirmed is that the era of buying an index and riding the mega-cap wave may be giving way to something more rewarding for those willing to do their homework. The broadening of the market is not a threat. It is an opportunity for disciplined stock picking. Two months into the year, the message is clear: this is a market that rewards selectivity, not passivity. Act accordingly.

William Rutherford is the founder and portfolio manager of Portland-based Rutherford Investment Management. Contact him at 888-755-6546 or wrutherford@rutherfordinvestment.com. Information herein is from sources believed to be reliable, but accuracy and completeness cannot be guaranteed. Investment involves risk and may result in losses.

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