

QUARTERLY REVIEW

March 31, 2025

Q1 Economic and Market Commentary

In the first quarter of 2025 uncertainty reigned supreme. The market experienced a correction as the confluence of worries over an impending trade war, a slowing economy, the Deep Seek announcement on Chinese advancements in AI, and more volatility than we have seen in some time combined to bring the market lower. **The S&P hit a record high early in the quarter, rising 4.4% for the new year as of February 19th. From there the market dropped 10.1% reaching its low and officially entering correction territory on March 13th.** The VIX index, which is a measure of stock volatility, had been averaging in the 16 – 18 range over the past few years (relatively calm). However, the index spiked to almost 28 on March 10th as President Trump and several cabinet members made comments on weekend news shows refusing to rule out that their aggressive trade policies might cause a recession. This further unsettled the markets leading to a 2.7% drop in the market on March 10th and solidified in investors' minds that Trump 2.0 was not just using tariffs as a negotiating tactic but was serious about broad based implementation. The market partially recovered into the end of the quarter but then fell again as tariffs of 25% were announced on auto imports, ultimately ending the quarter down 4.3%. **This was the worst quarterly performance for the S&P since the third quarter of 2022.** The “Mag 7” stocks have borne a great deal of the recent pullback declining 16% in the quarter, while the broader Nasdaq index was off 10.3%. The small cap indices were also hit hard in Q1, falling 9.5%, and registering its worst Q1 since 1982. International markets became the bright spot YTD 2025 with the MSCI EAFE (Europe, Australia, Far East) gaining 7.6%. The Fed finds themselves in a tight box as recent inflation data and tariff policy effectively keeps them sidelined on rate cuts until there is more clarity, or until weaker hard data emerge that would justify a cut. **If inflation persists and growth slows then we could be faced with “stagflation” which creates a real dilemma for the Fed, as raising rates to slow inflation would add to unemployment, and cutting rates to aid growth would likely be inflationary.** The recent downgrades to expected GDP growth have seen the markets price in an expected three rate cuts for 2025, but this is highly subject to change. Markets have reacted negatively to tariff news but have yet to benefit from positives that should come later this year in the form of renewed tax cuts, deregulation, and some degree of cost cutting. These were the “animal spirits” that caused the market to rise post-election but have been lost with the tariff rollout. Now that the rules of engagement on tariffs have been clarified, we would expect to see policy makers work to implement the pro-growth policy initiatives soon to offset the negative impact of tariffs.

The Economy

The Economy: US GDP rose at a rate of 2.4% in Q4 and 2.8% for the full year, down just slightly from 2.9% in 2023. **But the level of economic uncertainty is causing estimates for 2025 to move lower as the Blue-Chip survey now expects growth of 2.1% in 2025, and this compares to the Federal Reserve which recently lowered their 2025 estimate from 2.1% to 1.7%.** It is common now to see forecasts for 1% or lower GDP growth in 2025, and risks of recession have risen. Evidence of concerns are more abundant in the “soft data” as surveys show consumer confidence falling for the fourth straight month, and consumers expectations for the next 6 months outlook falling to a 12-year low. The University of Michigan consumer confidence index fell from 64.7 in February to 57 in March and is now at the lowest level since November 2022. **Two thirds of consumers expect unemployment to rise in 2025, and inflation expectations for the year ahead are now 5%, and long-term inflation expectations rose to 4.2%.** On the corporate side, small business capital expenditure plans have plummeted, after rising strongly just after the election. So, it’s safe to say at present that policy uncertainty is exceeding animal spirits. The “hard data” is telling a slightly different story at least for now. Initial Jobless Claims have stayed relatively contained in the 224,000 range, unemployment is at 4.1%, and the ADP employment report for March showed the private sector adding 155,000 jobs. Unemployment will move higher as government layoffs hit the numbers, and Challenger layoffs numbers have spiked. However, job openings have stabilized at just over 7.7 million after declining from their peak in 2022. Real Personal Spending, while tepid at +0.1% in February, was a nice rebound from -0.6% in January. Retail sales were up 0.2% in February, but this was weaker than forecasted. **Wage growth has now exceeded inflation for 26 consecutive months, so while everyone remembers the lower price level, wages have kept consumers from falling behind.** Inflation worries have increased due to tariffs, and the most recent Core PCE reading of 2.8% was slightly higher than expected. **We remain concerned about inflation as Producer Prices are up 3.4% year over year and potentially move higher from tariffs.** Producer prices are a leading indicator for consumer inflation and bears close monitoring. The positives for inflation are that higher unemployment numbers should cap wage inflation, and the moderation in home prices will also help the shelter component of CPI. Other indicators that the consumer is pulling back are an increase in the Personal Savings Rate which has moved up to 4.6%, and the Visa “Spending Momentum Index” (tracks whether consumer spending is strengthening or weakening relative to the previous year) is currently at 96.1 in February, down from 98.2 in January. **A worrying statistic is that the top 10% of wage earners account for almost 50% of consumer spending. A prolonged drop in the stock market and lower real estate prices could cause this cohort to rein in spending which would have an outsized impact on GDP and growth.** So, while the data is troublesome and anxiety levels are high, our opinion is that we have entered a growth slowdown, with rising recession risk, but we do not expect an imminent recession. It’s too early to know if tariff reaction is retaliatory or moves toward negotiation, and the answer to that question will better inform our economic view. Stay tuned.

Market Review

First Quarter Market Recap:

Sectors that performed better in the first quarter were the sectors that had significantly lagged the market in 2024. **Energy was the best sector in the quarter at +10.2%, followed by Healthcare at +6.5% and Consumer Staples at +5.2%.** It's logical that Healthcare and Staples being defensive in nature would have performed better, but Energy is highly cyclical and certainly subject to a weakening global economy. Possibly stiffer sanctions on both Russian and Iranian crude account for crude oil prices staying near \$70 despite concerns on the economy. The two best performing sectors of 2024, Communications Services and Technology, were the second and third worst performers in Q1, with Communications Services at -6.2% (Google -18.2%), and Technology at -12.7% (Nvidia -19.2%). Even stocks that are not within the technology sector but had some ancillary association with AI such as utility and electrical supply companies also declined. **The worst performing sector was Consumer Discretionary, losing 13.8%, as its top two holdings, Amazon and Tesla, were down 13% and 35% respectively.** We also saw profit warnings from retailers such as Wal-Mart and Target as they saw consumer behavior change in the quarter. The Mag 7 saw substantial P/E multiple compression in Q1 going from a 45X valuation prior to the Deep Seek news, to a still lofty 35X. High valuation names were hit the hardest in Q1 as the stocks with the highest price/sales multiples suffered the largest decline (-14.3%). The equal weighted S&P 500 returned a much better -0.67% for Q1 as the technology component (by definition) is much smaller than the pure index. The quarter also saw a significant differential in the performance of value stocks versus growth stocks. Growth swamped Value in 2024 by 19%, but in Q1 Value returned +2% versus Growth at -9.9%.

Stock Market Indexes

Market/Index	2024 Close	03/31 Close	Mthly Change Total Return	Qtrly Change Total Return
DJIA	42544.22	42001.76	-4.06%	-0.87%
Nasdaq	19310.79	17299.29	-8.14%	-10.26%
S&P 500	5881.63	5611.85	-5.63%	-4.28%
Russell 2000	2230.16	2011.91	-6.81%	-9.48%
IEFA	70.28	75.65	0.36%	7.64%

What to Expect Going Forward:

The US tariff rate has gone from roughly 2.5% to 20%, and its possible that this could reduce US GDP by 1 – 1.5% and potentially add a similar amount to inflation. **It's important to note that the current market pullback is a non-financial event versus a financial event (a bank failure, major bankruptcy, etc..).** The anxiety and pain are the same, but financial events tend to be more problematic and long lasting. As a result of tariffs, we should see the deficit fall this year by roughly \$500 billion. While the Fed will likely be late in cutting rates (they will wait for more data), we expect they will cut rates again this year as financial conditions are too tight. Fiscal policy is also restrictive as government cutbacks loom, and lawmakers should now feel more urgency to extend tax cuts and perhaps add additional pro-growth initiatives. Corporate earnings are always important, but perhaps more so now. As of March 28th, the consensus is for earnings to grow 11.5% in 2025. This is down from 14.2% forecasted at year end. I suspect that earnings are being revised lower even as I write, but to avoid recession it's critical that earnings remain positive. **There are currently several estimates for just mid-single digit eps growth for 2025.** This is critical because the US typically does not go into recession when earnings grow. Over the past 40 years the next 12-month earnings at the start of a recession have averaged just 2.3%, and we are above that number at present. To put this in some context, since 1950 the median earnings decline in a recession is 22%. **And while we are certainly in the midst of a correction, most market corrections do not turn into bear markets unless accompanied by a recession.** In fact, it has only happened three times without a recession and that was in 1962, 1987, and 2022. Some upheaval is also common in the first year of the new presidential term as historically we have seen market pullbacks that average dropping 12.3%. As of today, we are very close to that number. From a valuation perspective, the market is selling at 20X forward earnings, down from 22X, but remains elevated relative to the 10-year average of 18.3X, but is now in line with the 5-year average of 19.9X. The top 10 stocks in the market sell at an average multiple of 24.4X, but if you strip them out the remaining S&P constituents sell at a more reasonable 18.2X. **The US Policy Uncertainty Index has now spiked to about 300 but is still below the level reached during Covid.** Interestingly, forward 6 months and 12-month returns have averaged 10.9% and 21.5% respectively after uncertainty readings above 180. It's only natural to ask why this would occur. Perhaps the reasons are that the market prices in a scenario that ultimately is not as bad as anticipated, policy makers implement changes to soften the cause of the uncertainty, and then the natural market rebound that occurs from a low. We don't know if we are at the maximum point of uncertainty yet for markets, but we should be close. Caution is warranted for the near term, but we will also be looking for opportunities in the sell off.

Fixed Income Recap and Outlook

Market Overview: Over the past several years, quarterly returns in the bond market have reflected significant volatility, resembling a Yo-Yo as the market struggles to establish certainty or conviction regarding the path of growth and inflation. Market opinions remain widely diverse, with some investors fearing stagflation while others anticipate a new economic era driven by deregulation and reaccelerated growth.

Corporate credit spreads began 2025 at historically tight levels, and the first quarter witnessed a broad repricing of risk, not only in the stock market but also in corporate bonds. The market remains fixated on the potential implications of the Trump tariffs, with uncertainty surrounding future economic outcomes. Additionally, JPMorgan and Goldman Sachs have both revised their inflation expectations for 2025 upwards while simultaneously lowering growth projections for the remainder of the year.

Federal Reserve Policy and Market Reaction: The Federal Open Market Committee (FOMC) left policy rates unchanged, as widely expected, maintaining the federal funds rate at 4.25-4.50%. The dot plot continued to indicate 50 basis points (bp) of rate cuts in 2025, in line with market expectations. However, the Committee's language shifted, replacing its previous stance of a "roughly balanced" economic outlook with the acknowledgment that "uncertainty around the economic outlook has increased." The FOMC reiterated its commitment to monitoring risks on both sides of its dual mandate.

One notable development was the dissent of Fed Governor Christopher Waller, who voted against the decision to slow the pace of the Fed's balance sheet runoff. Beginning in April, the Committee will taper its balance sheet reduction by lowering the monthly cap on Treasury security redemptions from \$25 billion to \$5 billion while maintaining the cap on agency debt and mortgage-backed securities at \$35 billion per month.

Despite an unchanged median forecast for the fed funds rate path, the underlying distribution of projections shifted hawkishly. Only two policymakers' projections separated the median expectation of 50 bp in cuts from a more conservative 25 bp projection. A closer look reveals that 17 of 19 policymakers anticipate two or fewer rate cuts this year, with eight expecting just one or no cuts and four advocating for no cuts at all.

Economic Projections and Outlook: The Summary of Economic Projections (SEP) revealed the following key takeaways:

- The median fed funds rate projection remained unchanged, forecasting two cuts in 2025 (to 3.875%), two more in 2026 (to 3.375%), and one additional cut in 2027 (to a terminal rate of 3.125%).
- Inflation expectations increased, with core PCE inflation projected at 2.8% in 2025 (+0.3 percentage points from December) and headline PCE inflation raised to 2.7% in 2025 (+0.2 percentage points).
- The unemployment rate forecast edged higher to 4.4% in 2025 (+0.1 percentage points), while GDP growth forecasts were revised downward across the projection horizon (1.7% in 2025, 1.8% in 2026, and 1.8% in 2027).

Market Implications: Following the FOMC's decision and projections, the Treasury market initially rallied but ultimately settled within its prior range, leaving rates largely unchanged on the day. Investors remain focused on Chair Powell's commentary and any additional insights that may emerge from future Fed communications.

The primary overhang in the market continues to be the uncertainty surrounding trade policies and inflation trends. With corporate credit spreads starting the year at historically rich levels, any further repricing in credit markets will depend on evolving macroeconomic conditions and monetary policy adjustments.

Looking ahead, the market will closely watch for signs of sustained inflationary pressure, shifts in Fed policy, and potential fiscal developments that may influence economic growth. While uncertainty remains elevated, disciplined fixed income portfolio management will be essential in navigating the evolving landscape of rates, credit, and liquidity dynamics.

Conclusion: The bond market continues to grapple with an environment of heightened uncertainty, oscillating between fears of stagflation and the potential for renewed economic acceleration. With monetary policy largely in line with expectations but economic forecasts shifting, vigilance and adaptability remain critical. As the Fed's balance sheet reduction slows and inflation remains a key focus, investors should prepare for continued volatility in fixed income markets throughout the remainder of 2025.

As always are here to assist you in any way and to answer your questions. We appreciate the opportunity to serve you and value the trust and confidence that you have placed in us.