Market Commentary

First Quarter 2025

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The first quarter of 2025 saw a continuation of the volatility that began in late 2024. The benchmark S&P 500 index declined by 4.3% in the three-month period. The volatility was primarily caused by a seeming never-ending discussion of tariffs along with rising concerns about the slowing US economy. While we believe the tariff situation will play out over the next several months, recessionary fears may take longer to subside. The constant news flow gave investors an added concern following the 50% rise in stock prices over the prior two years.

After cutting interest rates by one full percentage point during their final three meetings of 2024, the Federal Reserve met twice during the recent quarter and held rates steady at both meetings. Importantly, the Fed stuck to its prediction of two rate cuts during the year even though they meaningfully raised their expectations for core PCE inflation from 2.5% to 2.8% for 2025. We believe the Fed is looking more at the labor side of its dual mandate in sticking to two rate cuts in their forecast. They reduced their 2025 GDP forecast from 2.1% growth down to 1.7% and modestly increased their unemployment prediction to 4.4%. The Fed does not see inflation declining to its 2% target until 2027.

Interest rates across most of the maturity spectrum declined modestly during the quarter as the hopes for Fed rate cuts along with softening economic data combined to move rates lower. The 1-year Treasury bill yield declined to 4.04% from 4.16% on December 31. The 2-year Treasury note began the quarter yielding 4.24% and declined to 3.92% at the end of March. The benchmark 10-year US Treasury note ended the quarter with a yield of 4.21%, meaningfully down from the 4.57% yield on December 31.

Economic and Market Outlook

The biggest concern facing consumers and business leaders currently is the ambiguity over what tariffs will be put into place and for how long. Until some more certainty is gained, businesses will be reluctant to make major purchases or move ahead with expansion plans, adding to economic indecision. If we remove tariffs from the equation, we note there have been several economic data points over the past few months that show the US economy slowing. Consumers have spent far more than they earned for over three years now. In the past 12 months, consumers have outspent their personal income by an estimated 30% or more. This is partly due to drawing down excess savings and partly from increased debt. Clearly, this cannot continue without further borrowing. With credit card debt already showing signs of strain and increased delinquencies, the preferred path is for consumer spending to slow. While the probability of a recession in 2025 is low, it has increased over the past three months.

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Earnings for the S&P 500 in 2024 are approximately $240. Current estimates for 2025 are $270, down from a range of $275-280 three months ago. We remain dubious about a 13% increase in earnings while numerous cost uncertainties remain along with a consumer that is getting tapped out from inflationary pressures on core goods. Although the decline in equities during the first quarter slightly reduced the forward P/E multiple, estimated earnings also declined so the US market is only fractionally cheaper than it was at the start of 2025. Many sell-side strategists have begun to factor in some of the concerns we have been discussing for most of the past year. This has caused a reduction in forecasts for market growth during the remainder of the year. However, the current median forecast for the S&P 500 index is 6430 at year-end. This implies a multiple of 23.8x for the current year estimated earnings and 21.4x 2026 estimates. We remain concerned that a blend of declining earnings growth along with weak consumer sentiment could combine to move stock prices lower in the coming months.

Portfolio Positioning

With the market pullback in the first quarter, equities have reduced their overvaluation a bit. While still not cheap, we believe some of the froth has been taken off the high-flying stocks of the past two years. The "Magnificent 7" stocks are down an average of 23% from their peaks. This has reduced the overall valuation of the market modestly. We have been cautious about US equities for most of the past year due to valuations and concerns about interest rates remaining higher than most expect. Elevated interest rates position fixed income as an alternative to equities. We wrote last quarter, "*we remain cautious about the potential for further meaningful advances in equity prices. We understand the motivation to buy stocks when prices are rising, but as your risk manager, we are responsible for telling you when markets are showing signs of froth.*" We continue to view bonds and cash equivalents as key components of overall portfolios. Earning 4%+ with limited risk while equities are volatile helps overall portfolio returns. When equities are rising 25% in a year, nobody wants to discuss safe 4% returns, but that tends to be the best time to begin shifting your asset allocation into safer holdings.

Conclusion

Clearly the level of uncertainty has increased since the start of the year. There is uncertainty in the economy, uncertainty for business leaders, and uncertainty for consumers. This ambiguity is causing volatility in financial markets as investors abhor uncertainty. While nobody likes to see their portfolio decline in value over the short-term, we remind you that investing is a long-term endeavor, and periodic pullbacks are expected and healthy. They help to weed out speculators in certain assets and prevent valuation distortions from persisting for the long-term. We have not been selling equities but rather continuing the process we started last summer of focusing on more defensive stock holdings that should better withstand a downturn. We believe the "noise" of tariffs will decline as we progress through the year. More important to investors will be the shape of tax policy that should become clearer as we move through Spring and Summer. A ten-year extension of current tax rates should do far more to cheer businesses and investors than the negative overtones of tariffs and trade wars.

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The US economy is navigating a period of transition. Interest rates, which had been raised aggressively in response to high inflation, have begun to stabilize as inflation has receded from its 2022 levels. Extremely high levels of government spending are subsiding, and as businesses, states and municipalities adjust to this, there will be disruptions throughout the economy. If the result is a lower level of government spending, and thus lower deficits, this will be a net positive. The economy faces several challenges, including the risk of a slowdown, stubborn inflationary pressures in specific sectors, and the uncertainty of tariffs and their effects. As the Federal Reserve evaluates its next moves, the trajectory of inflation, interest rates, and global economic conditions will play a critical role in determining the future course of the US economy. Ultimately, the ability to both reduce inflation and sustain economic growth will be key to shaping the economic outlook in the years ahead. The stock market has been volatile but relatively resilient.

We remind you to review your portfolio asset allocation and contact us if there are any significant changes in your financial situation or if you have any specific questions or concerns about your investments.

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