MARKET UPDATE

Economic Market Update – First Quarter, 2025

April, 2025

- Q1 of 2025 saw a softening of equity performance with small cap stock hit particularly hard
- The economic outlook for the remainder of 2025 will be buffeted by uncertainty
- Economic policy laid out in early April launched expansive tariffs that drove markets lower and renewed concerns about recession
- Diversification of assets, as always, can be a key ingredient to a path forward

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In investing, as in life, we often assume that the future will resemble the past. But sometimes, the future glances at the past, shrugs its shoulders, and charts its own course. That's what seems to be unfolding in the global economy right now.

For the last decade, markets operated under a quiet but near omnipresent assumption: that investing in companies in the United States was an exceptional opportunity – not just in story, but in substance. Growth was more substantial, innovation was faster, and crises, when they arrived, were met with policy responses swift enough to dull the pain. If the global economy were a stage, the U.S. would be both the star and the spotlight. But these prevailing market perceptions have begun to shift this year.

U.S. growth expectations have quietly taken a step down, not because of a natural slowdown that inevitably occurs during economic cycles, but because we're entering an era where policy decisions, not just economic fundamentals, may shape the path forward. The main culprit as of this writing? Tariffs. Over the past six weeks, the administration has announced a series of tariffs culminating in a wave of blanket reciprocal tariffs[1] on April 2 that have raised the average U.S. tariff rate to 22% and could shave nearly an entire percentage point off GDP growth if left in place unaltered for an extended period of time.

Markets have stood up and taken notice. The S&P 500 just fell nearly 10% in the two days following the announcement of the tariffs. Volatility has spiked and appears, at least in the near-term, like it is here to stay. Much of this volatility stems from policy uncertainty. The administration is pursuing a path that includes higher tariffs coupled with aggressive spending cuts and has signaled negative market reactions will not derail the implementation of their policy vision – a far cry from the reassuring "policy put" markets had come to rely on and expect. Suddenly, for many investors the floor under risk assets doesn't feel as solid. The probability of a recession isn't just a footnote anymore; the whispers of concern are getting louder. "Hard" economic data continues to be solid, but "soft" data has been steadily deteriorating during the first three months of the year. Inflation expectations have been rising. Consumer and business confidence has been falling. After two years of strong growth and high returns, the environment has noticeably shifted in 2025.

Investing in a time of high political polarization and dramatic change is a challenging endeavor. It is important in times like these that investors work extra hard to manage biases in an effort to prevent political preferences from infecting economic and market analysis, no matter which side of the aisle we find ourselves on. While the near-term effects of the tariffs has led to market turbulence, those who believe that the tariffs are a misguided policy should also remember that the dust will eventually settle. When we look ahead three, five, and ten years from now, the opportunities remain exceptional. Over time companies will invest, innovate, and once again take advantage of all the themes that were the focus just a few weeks ago – artificial intelligence, an energy revolution, and dramatic advances in healthcare. It is natural at a moment of economic change to worry about what is to come, but when we look further out into the future after the current dust has settled, we continue to believe that patient, diversified investors who stick with their long-term plan will be rewarded.

[1]The administration has called the tariffs announced on April 2 "reciprocal tariffs", but what they announced is not quite what most readers would think of when reading the phrase "reciprocal tariffs." The tariffs imposed on each country by the administration did not simply match tariffs imposed by those countries on US exporters. Instead, the administration aimed to incorporate a wide range of tariff barriers, ultimately measured by the trade deficit in goods (but not services) with that country divided by the level of imports from that country, a methodology that has proved to be controversial.

U.S. Equity

After two consecutive years of equity returns above 20%, the U.S. stock market began 2025 on a dour note. The Magnificent Seven continue to drive returns – though in the first three months of the year, the direction was down – leading the S&P 500, the bellwether for US stock returns, to finish down -4.3% for Q1, and that was before the further market declines after the announcement of the new reciprocal tariffs in the first week of April. Small-cap stocks were hit even harder, with the Russell 2000 finishing down -9.5%. Most of the nine Russell and S&P style boxes finished the quarter in the red. U.S. equity performance varied widely by style, however, with large cap value stocks finishing the quarter well in the black. The Russell 1000 Value Index finished Q1 up 4.5% as investors flocked to defensive names, significantly outpacing the -10.0% return of the Russell 1000 Growth Index. As can be expected when the style returns diverge so significantly, performance also varied widely across sectors and industries. Seven of the eleven sectors in the S&P 500 were up during the quarter, but the concentration of technology and communications stocks in the index left the overall index return deeply in the red. Consumer Discretionary stocks fell the most, down -14.0% over the first three months of the year. Information Technology and Communications stocks, the biggest winners in 2024, were among the hardest hit to start 2025, with the Communications sector down -6.4% on the quarter and the Tech sector down -12.8%. The Industrials sector, down -0.5%, was the only other sector in the red in Q1. Energy stocks were the best performers, up 9.3%, followed by Health Care (6.1%) and Consumer Staples (4.6%).

International Equity

International stock markets helped demonstrate the value of diversification in Q1 2025, with international stocks outperforming their U.S. counterparts by the largest quarterly margin since 2002. The MSCI EAFE Index, which tracks developed international markets, finished the quarter up 6.9%. Value also outperformed internationally, with the MSCI EAFE Value Index up 11.6% for Q1 compared to the MSCI EAFE Growth's 2.1% return. Emerging markets were also positive on the quarter, with stocks in developing countries up 2.9% to start the year. Digging beneath the surface, however, reveals significant return dispersion across countries. Chinese stocks were up 15.0% in Q1, posting further gains after a strong 2024. Though the weight of Chinese firms in the MSCI Emerging Markets Index has fallen from around 45% to around 24.5% today, the performance of the Chinese market still significantly impacts the return of the overall index. India, which has the second highest weight in the index after China, has struggled in 2025, down 3.0% to start the year. Closer to home, stock markets in Mexico and Brazil also posted strong returns, up 8.6% and 14.0%, respectively. **Summing up the global stock market in Q1, the MSCI All Country World Index, which tracks the global stock market, was down -1.3%, highlighting the impact of negative returns in U.S. markets.**

Fixed Income

The fixed-income market started the year positively, benefiting from stabilizing interest rate expectations and heightened equity market volatility. The Bloomberg U.S. Aggregate Bond Index, a broad measure of the performance of investment-grade fixed-income markets in the U.S., was up 2.8% for Q1, with long-duration bonds particularly strong as the Bloomberg U.S. Treasury 20+ Year Index gained 4.6%. Investment-grade credit, as measured by the Bloomberg U.S. Credit Index, was up 2.4% on the quarter. Riskier areas of the fixed income market lagged to start the year, with the Bloomberg U.S. Corporate High Yield Index up 1.0% and the S&P UBS Leveraged Loan Index up 0.6%. International bonds also provided modest positive returns; the Bloomberg Global Aggregate Bond ex-USD Index rose 2.5%. Municipal bonds lagged slightly, with the Bloomberg Municipal Index dipping -0.2%, although high-yield municipals managed a small gain of 0.8%. **Summing up global fixed income markets in Q1, the Bloomberg Global Aggregate Index was up 2.6% for the quarter.**

The Economy

It's remarkable how quickly we swing from economic optimism to fear of a recession. Early this year, America's economy was the envy of the world—strong, resilient, seemingly unstoppable. However, economic narratives can shift more rapidly than we think, and here we are again, discussing potential downturns. Currently, uncertainty seems to be coming from all directions: an escalating trade war, dramatic cuts to government programs, a looming immigration crackdown, and ongoing debates over taxes and debt ceilings.

While this level of rapid change and controversy is certainly disconcerting to many investors, it's important to distinguish between an economic slowdown and a collapse. Policies from the Trump administration are likely to diminish economic growth in the near-term but are unlikely to derail it entirely and push the U.S. into recession. History suggests that when economic pain becomes obvious – such as falling stock prices and rising layoff rates – politicians tend to pivot. This exact thing happened in Trump's first term; when tariffs began hurting farmers and manufacturing jobs, the president changed course, securing trade deals with Canada, Mexico, and China. Despite public protestations to the contrary from the administration, we continue to expect a similar pattern this time eventually, though the current tariff battle is deeper and more painful than the first go around.

Tariffs act like a tax, subtly raising prices, unsettling investors, and dampening consumer spirits. The cumulative impact is initially tiny but becomes meaningful over time. If tariffs continue rising unchecked, they'll begin to weigh on growth. Yet markets, being the nervous creatures they are, expect – and perhaps will demand – a policy retreat when things get shaky enough.

Two significant categories of tariffs dominate the new outlook. First, targeted product-specific tariffs – most strikingly, a sweeping 25% levy on global auto imports introduced in a late March announcement and a 10% tariff imposed on essential goods like pharmaceuticals, semiconductors, electronics, and energy resources. Second, reciprocal tariffs aim to reduce or even eliminate trade imbalances, which will profoundly affect global trade dynamics.

The effective tariff rate for the U.S. economy, already elevated by existing policies, is now set to climb sharply – from an increase of about 3 percentage points based on early Trump administration actions to around 20 percentage points following the reciprocal tariffs announced on April 2. The announced tariffs were far more aggressive than initially anticipated, with most firms expecting an increase of around 10 percentage points as a baseline and 15 points on the more aggressive end. It's the economic equivalent of stepping harder on the brake pedal while driving uphill.

The Federal Reserve is caught in a delicate balancing act. Despite stalled progress on inflation, we expect the Fed to deliver two rate cuts in 2025, followed by another in 2026, ultimately anchoring rates between 3.5% and 3.75%. These won't be the previously expected rate cuts aimed at normalizing interest rates as inflation returned to target; instead, they'll be defensive moves – insurance cuts reminiscent of the Fed's cautious stance in 2019, intended to shield the economy from worsening tariff impacts. Elevated inflation expectations, however, raise the bar for these moves, making policy navigation increasingly complex.

This doesn't mean a recession is inevitable. It simply means that uncertainty is now a major player in the economic narrative. Consumers are the main characters in this story – they drive roughly 70% of economic activity. And consumer confidence, once lost, is difficult to restore. As we begin the second quarter of 2025, confidence is shaky, but not yet shattered. If that changes – if confidence tumbles by, say, 20 points within three months – then spending drops, layoffs begin, and recession can follow swiftly. However, additional expected government policies, like deregulation, new incentives for businesses, and an extension of the 2017 tax cuts, may partially mitigate the effects of tariffs and help restore some of that lost confidence.

A quiet but telling indicator comes from housing, particularly mortgages insured by the FHA. FHA borrowers frequently have lower credit scores than borrowers with standard mortgages backed by Fannie Mae and Freddie Mac – the program allows for borrowers with a credit score of 580 to make a down payment of 3.5% and borrowers with scores between 500 and 579 to make down payments of 10% – and are often younger and less affluent, with a median household income of $75,000, making them more vulnerable to economic shifts. These families were stretched thin as they entered a housing market with high prices and soaring interest rates, with many hoping for a chance to refinance at lower rates later. But the Fed's higher-for-longer path has closed that door – at least in the short-term. When economic storms gather, vulnerable borrowers feel it first, like birds sensing an approaching storm. Their current financial stress suggests broader risks may lie ahead.

The real-time barometer? Layoffs. Companies haven't yet started aggressively shedding workers. They're nervous but holding steady, cautious but still hiring. However, if initial unemployment claims rise above 250,000 per week for several weeks, businesses are signaling they've lost faith. Around 300,000 claims per week? We're likely already slipping into recession.

Economies thrive on faith – faith in jobs, faith in markets, faith in stability. When faith erodes, recessions follow. Right now, faith remains – but it's fragile. We will be watching carefully to see if that changes over the coming weeks and months.

Market Outlook

For nearly fifteen years following the financial crisis of 2008, investing in the United States felt like a guaranteed win. America's equity markets have consistently outperformed the rest of the world, driven by robust earnings growth, particularly in the booming technology sector. It seemed as though betting on U.S. tech giants was less speculation and more like a sure thing – a narrative so compelling that few investors questioned it.

Yet narratives, like markets, evolve. This year, cracks in the story have started to appear. The S&P 500 slipped by 4.3% in Q1, and the tech-heavy Nasdaq, once the symbol of American market dominance, tumbled 10.3%. Meanwhile, markets abroad, long overshadowed, have found their footing: Europe was up 10.5%, and China surged 15% in the quarter.

What's changed? Three primary factors are reshaping the global landscape. First, America's economic engine is cooling. The remarkable growth rates that propelled the U.S. ahead of its peers are tapering off, just as prospects brighten in regions previously lagging – specifically, Europe and China. Markets thrive not only on strong growth but also on growth that surpasses expectations. Currently, America's economic momentum is decelerating more sharply than anticipated.

Second, policy uncertainty, particularly around tariffs, has clouded the U.S. outlook. Tariff worries have soured investor sentiment, elevating risk perceptions in the U.S. market. The advantage America once held, especially following Europe's uncertainty in the aftermath of the Russian invasion of Ukraine, is now reversing. Higher tariffs on key sectors – such as autos, pharmaceuticals, electronics, and minerals – are increasingly baked into expectations, further weighing on sentiment.

Third, the intense concentration in U.S. markets – once a strength – is becoming a liability. The Magnificent 7 have seen their shine diminish somewhat over the first three months of 2025. Despite massive investments in artificial intelligence, incremental earnings growth advantages have faded amid rising competition from Chinese tech firms. Year-to-date, these seven stocks are down 16%, while China's tech sector has leaped forward, up over 30%.

Meanwhile, Europe finds itself in an unexpectedly favorable position. Germany's bold fiscal plans – encompassing major investments in defense and infrastructure – have significantly improved Europe's growth outlook in the years ahead. Positive macroeconomic surprises are stacking up, reinforcing investor confidence. The result is a valuation-driven rotation toward European equities. Europe's markets, which have historically been discounted compared to their U.S. counterparts, are finally reaping the benefits of a narrowing valuation gap.

Additionally, rising interest rates abroad, particularly German bund yields, which are projected to reach 3% by year-end 2025, have reignited the appeal of value investing. European banks, emblematic of this shift, have seen a 27.5% surge this year alone. After more than a decade of growth dominance, value-oriented strategies are reclaiming investor attention.

Amid these shifts, market correlations have dropped to their lowest since the 1990s, highlighting the renewed power of diversification. The message for investors is clear: The era of unquestioned U.S. outperformance is no longer assured. Global diversification isn't just prudent – it's essential as the geopolitical environment continues shifting towards a multipolar world order.

Yet, caution remains warranted. International equities, while outperforming the U.S. so far this year, are no longer cheap compared to historical norms because the 2025 rally has largely come in the form of multiple expansion. Global markets remain vulnerable to corrections, particularly given the low equity risk premiums worldwide. What investors may be facing today is not simply a standard market rotation but a fundamental rewriting of the narrative. The certainty once felt about U.S. dominance has given way to a nuanced, globally diversified story where risk and opportunity span borders, sectors, and styles. Recognizing – and adapting to – this new reality will define investment success in the years ahead.

While the short-term outlook may make attempting to time the market appealing, history shows that this is a loser's game. The biggest up days in the market have historically been clustered with the biggest down days. To successfully time the market, you must be right twice; you have to successfully get out of the market at the right time, but just as importantly, you need to get back in at the right time. The market doesn't reward brilliance nearly as much as it rewards patience. Trying to outguess it is like trying to catch lightning in a bottle – you might get lucky once, but odds are you'll just get burned. A prudent plan, held for a long time, beats perfect timing, because compounding doesn't ask how smart you are. It just asks how long you're willing to wait.

For portfolios, the lesson is less about prediction and more about preparation. We're in a world that's becoming more balanced, more complex, and more scenario-dependent. Diversification isn't just a strategy – it's an admission of humility. In a world where policy can swing sentiment faster than fundamentals and where growth leadership is up for grabs, owning a little bit of everything might be the only thing that still makes sense. In the end, we're reminded of a timeless truth: no one knows precisely what's next. But those who prepare for a range of outcomes – who diversify not just their portfolios but their perspectives – tend to survive the storm and thrive in the calm that follows.

The Path Forward

Every investor, at some point, stares at a screen filled with red and wonders: What should I do now? It's a natural question. Uncertainty spikes, markets react violently, and suddenly the temptation to act – do something, anything – feels overwhelming.

But here's the thing: this moment isn't a surprise. Not really. Because while we never know exactly when turbulence will hit, we know it will. That's not cynicism; it's just how markets work. The price of admission to long-term growth is occasional market stress.

Think back to March 2020. COVID shut the world down. Uncertainty was off the charts. Markets fell hard. But then, almost as quickly, they started recovering. By April and May, stocks were sprinting back. And yet, many investors who sold in March couldn't bring themselves to buy back in. The news was still bleak. Valuations were higher. Confidence was low. So they waited. And missed out.

That's the hard part about market stress. It doesn't just challenge your portfolio – it challenges your resolve. Your belief in your plan.

But the investors who stuck with their long-term plans through 2020? They've done very well. Not because they had perfect timing. But because they trusted the process, even when it felt uncomfortable. This moment is no different.

We don't pretend to know exactly how this chapter plays out. But we do know this chapter was always part of the story. It's why we build portfolios with resilience in mind. It's why we plan with the long-term in focus. Because moments like this – while uncomfortable – are not new. They're just the latest version of an old, familiar pattern.

That doesn't mean we sit still. Rebalancing, adjusting to new information, and taking advantage of opportunities as they emerge – those are all part of the plan too. And we'll be doing that in the days and weeks ahead. But the core message doesn't change: Take a breath. Stick to the plan. Ride out the storm. Because while we didn't plan for this exact moment, we planned for moments like this. And that makes all the difference.

We'll continue to share updates as the picture becomes clearer. In the meantime, if you're feeling anxious or just want to talk through what's going on – we're here. Always.

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