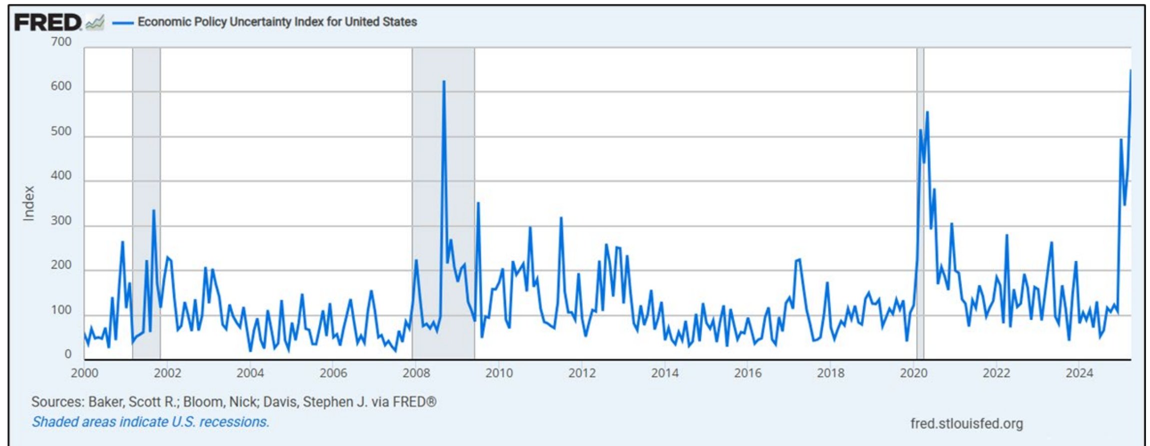
Quarterly Market REPORT

REVIEW AND OUTLOOK

1st QUARTER 2025 REVIEW AND OUTLOOK

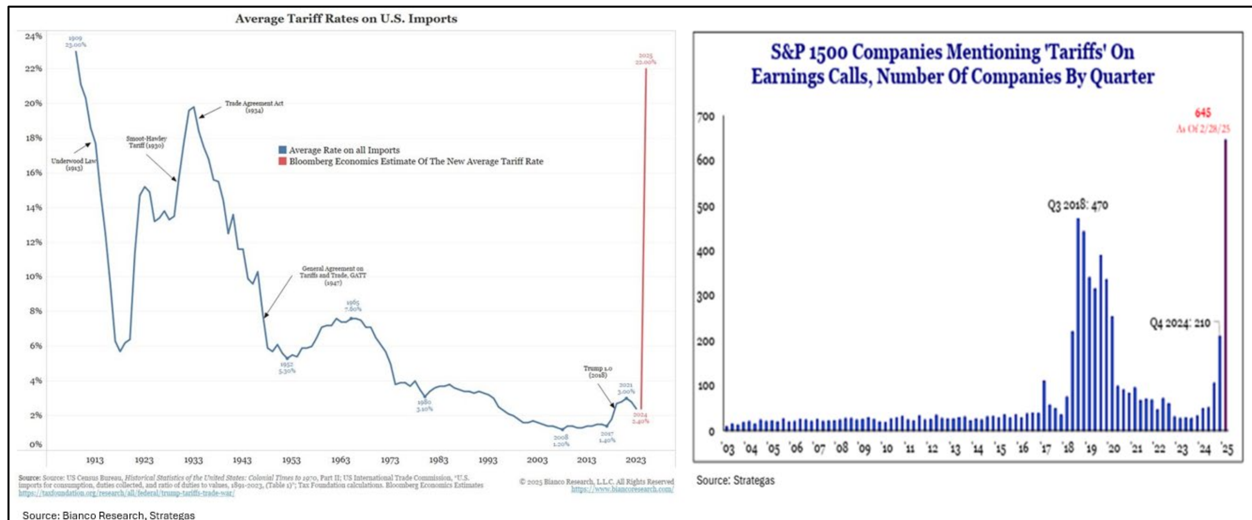
TARRIFYING SHOCKS

Overview



The first quarter presented investors with a range of mixed signals as tariff concerns and rapid government downsizing introduced new uncertainty regarding the fiscal outlook. Early in the quarter, Chinese AI startup DeepSeek released its cost-effective DeepSeek V3 model, prompting a sharp sell-off in U.S. technology stocks due to its competitive positioning despite lower development costs. Broader market conditions reflected ongoing weakness with persistent inflation, a sluggish housing market, declining consumer spending, lower household savings, and falling manufacturing output alongside rising input costs. Volatility increased throughout the quarter, driven by growing concerns about the economic impact of tariff policy.

In March, the Federal Reserve held the federal funds rate steady at 4.25%–4.50% for the second consecutive meeting, following three rate cuts that began in September. The Fed's updated projections indicate expectations for slower economic growth and higher core inflation by year-end, partly due to the anticipated effects of new U.S. tariffs and retaliatory measures. The NY Fed GDP growth forecast was lowered to 2.6%, and the year-end unemployment rate was revised up to 4.4% from 4.3%.



Protectionist trade policy made a forceful return in the first quarter, contributing to elevated market volatility. The renegotiation of trade agreements with key European and Asian partners raised concerns about higher business costs, global supply chain disruptions, and potential retaliatory actions. Markets reacted sharply to each development, with trade-sensitive sectors such as technology and industrials experiencing frequent daily moves of 2–3%.

The rationale behind the administration's tariff proposal remains uncertain, which has implications for the duration and magnitude of its impact. If the intent is structural—such as reshaping global trade, boosting domestic manufacturing, or protecting key industries—the effects are likely to be long-term. If the proposal is primarily political, aimed at securing concessions, supporting tax policies, or reinforcing campaign messaging, the impact may be more limited and short-term. The chart at the upper left illustrates effective U.S. tariff rates since the late 1800s. While a temporary increase occurred in 2018 under the first Trump administration, it is modest compared to the broader tariff agenda currently being proposed.

OUTLOOK

Constructive Observations

- Oversold conditions in U.S. equity markets present a potential "buy the dip" opportunity.
- Despite expectations, a material slowdown in growth has not yet occurred—corporate fundamentals, labor markets, and consumer spending remain relatively healthy.
- Stagflationary tariff policies are unlikely to persist long term; potential exists for renewed fiscal stimulus (e.g., tax cuts) and deregulation to reassert a bullish narrative.
- AI-driven efficiencies are just beginning to influence productivity, inflation, and growth.

Cautious Observations

- A stalled stock market could result in a fading wealth effect, lowering consumption.
- Aggregate job growth could slow down as DOGE layoffs begin to gather momentum.
- Flip-flopping policy maneuvers leads to uncertainty and potentially slower growth.
- Struggling U.S. housing market could portend broader economic softening.
- Recession odds are climbing as policy uncertainty remains elevated.

Markets began to exhibit signs of policy fatigue during the first quarter, driven by inconsistent tariff developments and shifting geopolitical dynamics, particularly regarding NATO and traditional U.S. alliances. The equity bull market appears to be entering a more precarious phase as initial pro-growth policies—such as tax cuts and deregulation—are increasingly overshadowed by trade tensions and global realignments.

Looking ahead, growth and inflation will be influenced by a combination of trade, fiscal, monetary, and regulatory policies, as well as trends in employment, wages, and capital investment. Although trade policy is currently a dominant concern, we believe its effects will be short-term in nature and unlikely to trigger a recession over the intermediate to long term.

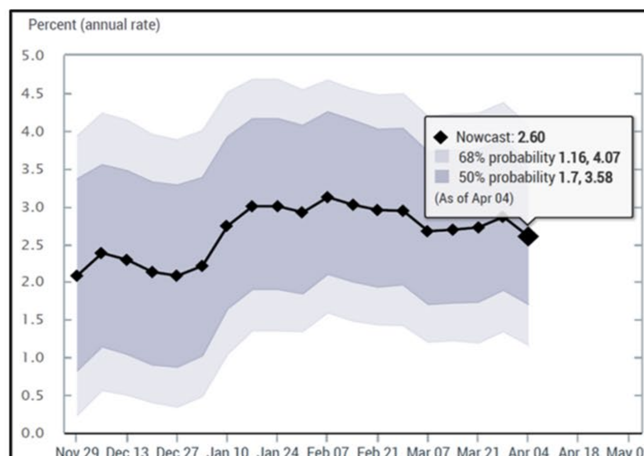
We are maintaining a modestly constructive view on equity markets over the next 12–24 months. Our positioning favors value stocks over growth stocks and a preference for U.S. and emerging markets over developed international equities. From a fixed income perspective, we are holding a neutral duration stance given the potential for continued trade and geopolitical disruptions.

MACRO OVERVIEW

GDP components

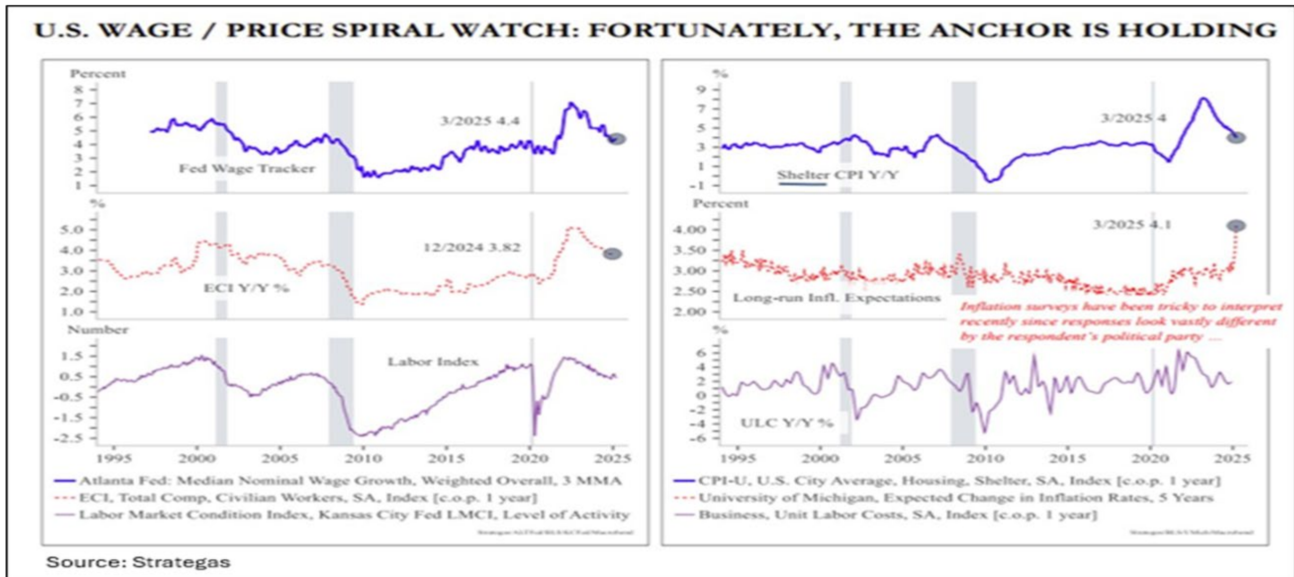
	% of GDP	4Q24	3Q24	2Q24	1Q24
• Consumer spending	69.1%	4.0%	3.7%	2.8%	1.9%
• Government spending	17.0%	3.1%	5.1%	3.1%	1.8%
Federal: 6.5%		4.0%	8.9%	4.3%	-0.4%
State/local: 10.5%		2.5%	2.9%	2.3%	3.1%
• Net exports of goods and services*	-4.5%	0.3	-0.4	-0.9	-0.6
Exports: 11.2%		-0.2%	9.6%	1.0%	1.9%
Imports: -15.7%		-1.9%	10.7%	7.6%	6.1%
• Fixed investment	18.1%	-1.1%	2.1%	2.3%	6.5%
Nonresidential: 14.9%		-3.0%	4.0%	3.9%	4.5%
Residential: 3.4%		5.5%	-4.3%	-2.8%	13.7%
• Change in private inventories*	--	-0.8	-0.2	1.1	-0.5
	Real GDP	**2.4%**	**3.1%**	**3.0%**	**1.6%**

Source: Charles Schwab, Bloomberg, Bureau of Economic Analysis, as of 4Q2024. Components based on real GDP annualized q/q % change. *Contribution to percent change in real GDP. Numbers may not add up to 100% due to rounding.

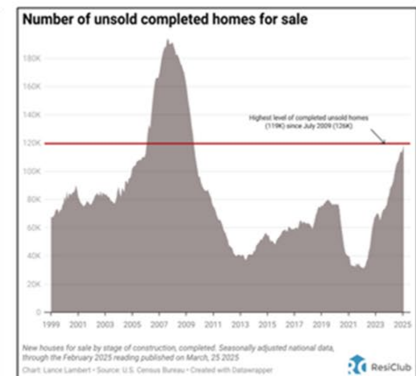


Source: Charles Schwab, NY Fed

- U.S. Real GDP grew by 2.4% in Q4 2024, down from 3.1% in Q3. Growth was driven by strong consumer and government spending, along with a rebound in residential investment. However, the overall pace moderated due to declines in business investment and inventories.
- The New York Fed projects U.S. Q1 2025 GDP growth at 2.6%. Growth expectations have eased slightly since mid-February, but the outlook remains consistent with moderate economic expansion.



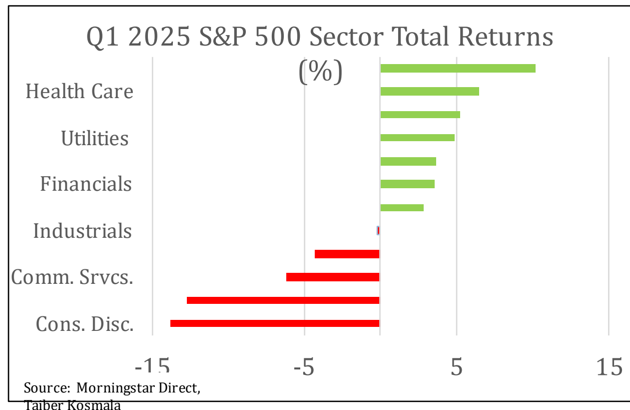
- Inflation pressures continue to ease across key indicators. Wage growth has moderated, with the Fed Wage Growth Tracker down to 4.4% in March, the Employment Cost Index showing continued deceleration, and labor market conditions gradually loosening. The shelter component of CPI (a large weight in the Core and Headline readings) is also declining, albeit slowly. However, longer-term inflation expectations have ticked higher, reflecting uncertainty around tariff-driven price pressures.

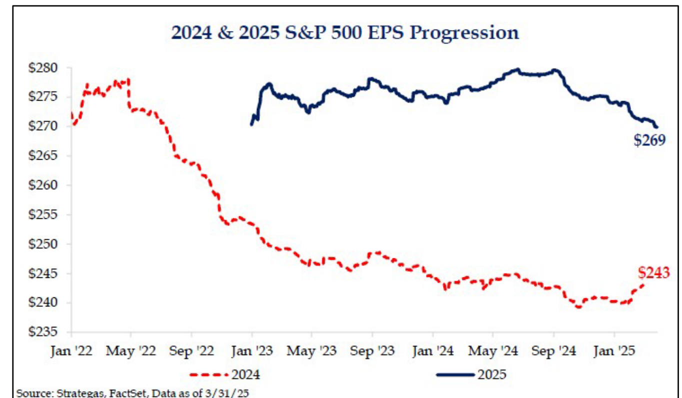


Source: St. Louis Fed, Resiclub

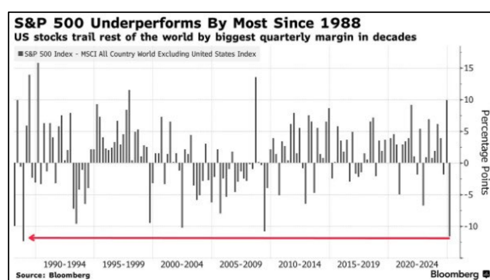
- As of February 2025, the median U.S. home price was $415,000, up from approximately $300,000 in 2019—a 38.3% increase over six years. This rise underscores growing affordability challenges for prospective buyers. Recent surveys show a decline in homeownership aspirations among renters, driven by the lowest housing affordability levels in decades.
- U.S. homebuilders are carrying elevated levels of unsold finished inventory, contributing to price declines in previously high-growth housing markets. The number of completed but unsold single-family homes has reached its highest level since July 2009 (see chart above right).
- Mortgage applications remain weak, the number of housing units under construction continues to decline, and construction job openings have dropped sharply.

EQUITY OVERVIEW





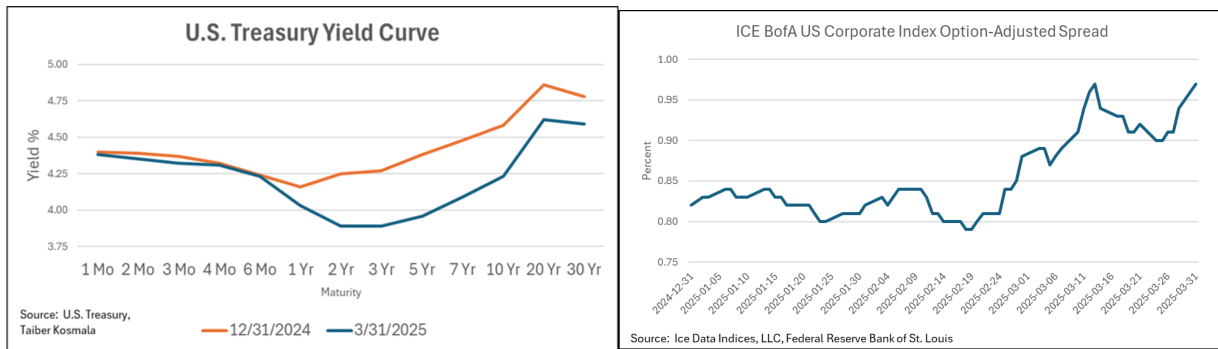
- After two consecutive years of 20%+ gains and reaching record highs in February, the S&P 500 declined 5.6% in March, bringing its year-to-date return to -4.3%. The downturn was driven by concerns over the administration's policies and their potential impact on growth. In response to rising uncertainty, investors rotated out of cyclical sectors—such as Materials, Technology, and Industrials—and into defensive sectors like Healthcare, Utilities, and Consumer Staples, which typically offer more stable earnings. Financials and Energy stocks, perceived as less exposed to tariff impacts, also held up relatively well.
- Value stocks gained 0.3% during the quarter, outperforming growth stocks, which fell 8.5%. Small caps underperformed, with the Russell 2000 Index declining 9.5%.
- Performance from the "Magnificent 7" mega-cap technology stocks weakened, creating a drag on market-cap-weighted indices. In contrast, the average stock, as measured by the Equal-Weighted S&P 500, declined only 0.6% for the quarter.
- Wall Street analysts have begun revising earnings expectations downward. Goldman Sachs recently lowered its 2025 S&P 500 earnings forecast to $253, implying year-over-year growth of 3% (see chart above right).



- International equity markets outperformed U.S. indices in the first quarter. The MSCI EAFE Index rose nearly 7%, while emerging market equities gained 3%. The gap between the S&P 500 and the MSCI All Country World Index ex-U.S. was the widest for any quarter since 1988, according to Bloomberg data (see chart above left).
- European markets were notably strong. Although Europe has long traded at a valuation discount, it has struggled with limited organic growth. In the first quarter, German equities rose over 15%, supported by plans to increase defense spending, while British stocks gained nearly 10%. Ongoing fiscal stimulus and solid economic fundamentals are expected to support continued growth in European equities.

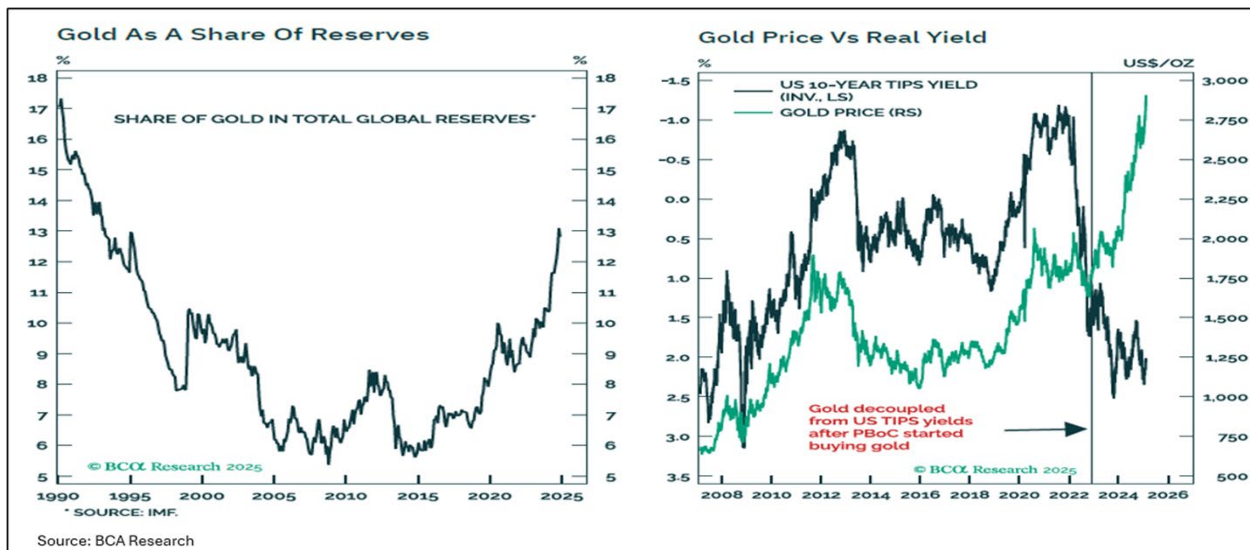
- China's large-scale stimulus programs over the past six months have supported both its domestic market and emerging markets more broadly. Chinese equities rose 15% for the quarter, driven by a rebound in consumer activity. However, long-term returns from Chinese equities remain poor. As shown in the chart above right, $1 invested in the MSCI China Index in 1993 would be worth about $0.80 today (excluding dividends). China's economic growth peaked around 2010 and has since slowed, with the stock market now roughly flat compared to levels seen in 2010. Structural challenges remain, including demographic decline, state intervention risk, a weak property sector, and deteriorating relations with Western countries. Fiscal stimulus in 2025 is projected to approach levels seen during the peak of the COVID-19 pandemic.

FIXED INCOME OVERVIEW



- Bond market returns were positive as interest rates fell and Treasuries served as a safe haven from tariff-related turmoil. The 10-year Treasury yield declined from 4.58% at the end of 2024 to 4.23%. Short-term Treasury rates (<1 year) were largely unchanged, while longer-term rates fell 20–40 bps depending on maturity.
- This led to a modest steepening of the yield curve, particularly on the long end. Investors interpreted falling yields as a sign the market is more concerned with downside growth risks than inflation or fiscal deficits.
- Tariff uncertainty and softer economic data supported flows into high-quality fixed income, particularly Treasuries and investment-grade corporates. Credit spreads remained range-bound, but demand for higher-quality issuers increased as risk appetite faded late in the quarter.
- Fixed income returns reflected these dynamics, with short-term Treasuries up 1.56%, intermediate-term Treasuries gaining 3.79%, and long-duration Treasuries returning 4.93%. The broad-based Aggregate Bond Index rose 2.74%, while TIPS returned 2.46%. High yield bonds delivered a more modest 1.40% as investor risk appetite declined. Bank loans and investment-grade floating rate debt posted gains of 1.34% and 1.63%, respectively. Emerging market debt also rallied, with sovereign bonds up 2.67% and local currency debt gaining 3.70%, supported by favorable currency dynamics and easing policies in select markets.

REAL ASSETS OVERVIEW



Source: BCA Research

- Gold gained 18% for the quarter, driven largely by increased central bank demand—particularly from emerging markets. This sustained accumulation has coincided with a notable divergence from gold's traditional inverse relationship with real yields. Despite rising U.S. real yields, gold prices have continued to climb, suggesting a shift in market dynamics.

IMPORTANT DISCLOSURES

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