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Capital Markets Commentary – April 2025

For every action, there's an equal and opposite reaction. We mentioned this, Newton's Third Law of Physics, in last month's letter. The law can apply to economics as well. Low interest rates, for example, can fill an economy's gas tank with high test fuel, allowing companies to innovate and grow or helping individuals purchase homes via cheap mortgages. Low rates can also spur inflation, punish savers in favor of risk takers, and create so much demand for housing that the cost of buying a new home becomes prohibitive, regardless of how cheap the mortgage is. Another example might be the stimulus that spewed from government coffers during COVID. Sure, it kept the economy on the rails, but we were paying consumers to stay home, and all those consumers wanted to buy stuff, but that stuff wasn't being made in sufficient quantities (because the people who made the stuff were also at home), so what we ended up with was a sticky inflation problem.

Because redirecting an economy as large as ours can be slow and unwieldy, like turning a cruise ship in a cow pond, five years on we're *STILL* dealing with that inflation problem. Economists sometimes refer to this as the "knock-on effect," and the Fed has suddenly found itself in the unenviable position of trying to ascertain what the knock-on effect of tariffs might be. Inflation? Deflation? Stagflation? None of the above? Nobody knows. Last month we looked at past tariffs for clues. This month we'll take a look at where market participants think we're heading from here. We'll get to that in a moment, but before we do, let's look at the numbers for March (and this might be an apt moment to gird your loins).

We're in no position to complain. Since the COVID era began in March 2020, we've enjoyed 37 months of positive performance from the S&P 500 versus only 23 down months,[i] and for the trailing 12-months, the index is still solidly positive.[ii] It's been a great run, but while March's performance was far from tragic, neither was it any fun at all. Markets, like children, do not thrive amidst chaos, and the chaotic ebb and flow of tariff talk took its toll.

For the month, the NASDAQ took it on the chin, giving up 8.1% while the more diversified S&P 500 lost 5.6% and the Dow lost just 4.1%. It was a different story in Europe where all major bourses were either flat for the month or slightly to the good. Returns out of Asia were mixed. While Japan's Nikkei 225 lost 3.1%, Hong Kong's Hang Seng was narrowly positive.[iii] Bonds, as measured by the US ten-year didn't move much, but the ten-year wasn't the big story. Municipal bonds sold off rather precipitously as investors grew increasingly concerned that cuts to Federal funding programs would negatively impact issuers, while short Treasuries gained in value on fears of a contracting economy.[iv]

As widely expected, the Fed left their March meeting with the Fed fund rate unchanged. One would think that if they were *confident* tariffs would cause the economy to contract, they would have cut, right? The thing is, at the moment, *confidence* is elusive. Tellingly, during his presser following the announcement Powell used the words "uncertain" or "uncertainty" 18 times. The Fed's conundrum is that their actions can take months to filter through the economy. If they cut (aka stimulate) now and then see alarming signs of surging inflation, they may have only made matters worse. Stimulus, in part, caused inflation. To stimulate now when nobody knows how tariffs and other policy changes will unfold, would be like shooting frogs in the dark.

> *"LOOKING AHEAD, THE NEW ADMINISTRATION IS IN THE PROCESS OF IMPLEMENTING SIGNIFICANT POLICY CHANGES IN FOUR DISTINCT AREAS: TRADE, IMMIGRATION, FISCAL POLICY, AND REGULATION. IT IS THE NET EFFECT OF THESE POLICY CHANGES THAT WILL MATTER FOR THE ECONOMY AND FOR THE PATH OF MONETARY POLICY."*
>
> *JAY POWELL, 03/19/2025*

In our opinion, anyone who says they know what's coming next is flipping coins, but we can find value in checking out what professional investors say when they aren't mugging for the camera on CNBC. Alpine Macro, an investment research firm that conducts regular surveys of professional investors, may be able to give us an idea of what professional investors are thinking, even if they aren't saying it out loud. While these surveys aren't necessarily scientific, they are useful in gauging the general sentiment of market participants. The surveys typically ask respondents to name, in their opinion, the things most likely to drive equity markets higher or lower. Alpine's most recent survey pointed to trade wars as by far the biggest threat to the downside, but at the same time named trade deals (i.e. the cessation of trade wars), as the biggest potential upside catalyst.

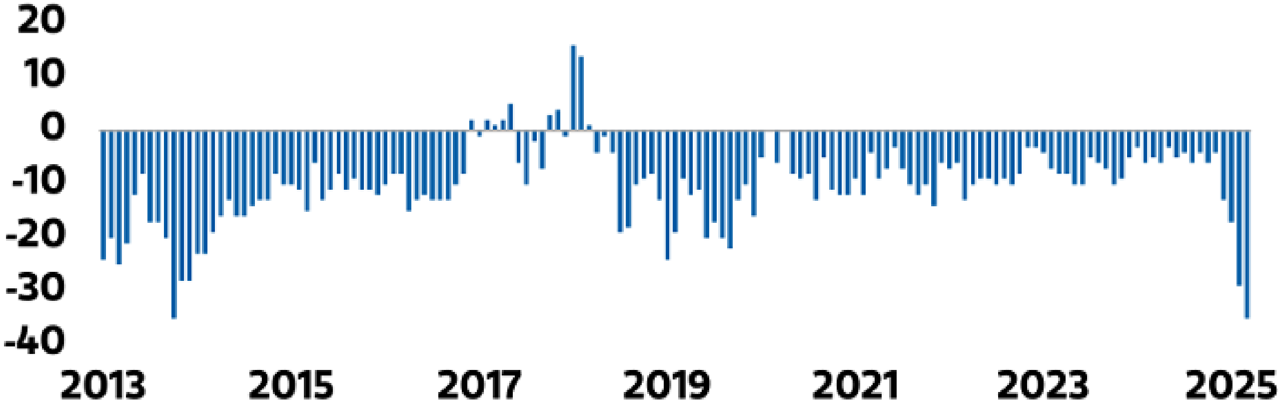
Unfortunately, fewer than 2% of respondents predict freer trade and lower tariffs, while a plurality predicted increased regionalization (i.e. less global trade) as well as permanently higher tariffs.[v] According to Alpine, "Clients do not believe President Trump's tariffs are short-term negotiation tactics." Should that prove true, we could be looking at both slower growth *AND* higher inflation, a concern also expressed by Jay Powell.

Those of you old enough to have been around in the 1970's, will remember that we call this phenomenon "stagflation," a portmanteau of stagnation + inflation. Stagflation <u>should</u> be an anomaly since low growth and inflation would seem to be mutually exclusive things. To create stagflation, there needs to be a shock to the economic system that suddenly increases the cost of production and goods. In the '70's, that catalyst was, at least in part, the Arab Oil Embargo. The difference here is that the tariff threat could be withdrawn at the drop of a hat (at least in theory) whereas the Arab Oil Embargo dragged on for most of two, long years. It's the *potentially* transient nature of tariffs that makes them extremely difficult to trade around.

So professional investors are kinda sorta squeamish, but what about the average American consumer? Markets may be allergic to tariffs, but the consumer doesn't appear to like them very much, either. It's been nigh on twelve years since the US consumer held such a negative outlook for the economy, a sentiment that appears to be reflected in retail sales data. In February, seven of thirteen retail sales categories posted month-over-month declines.[vi] Since the US consumer generates roughly 68% of GDP[vii], sentiment can be as important (or more) than reality. If Jane Smith *feels* like times are, or will be tough, she is likely to pull back her spending. If Jane pulls back on spending, GDP contracts. It can become a self-fulfilling prophesy.

Consumers Hold Their Most Negative Views on US Economic Policy Since 2013

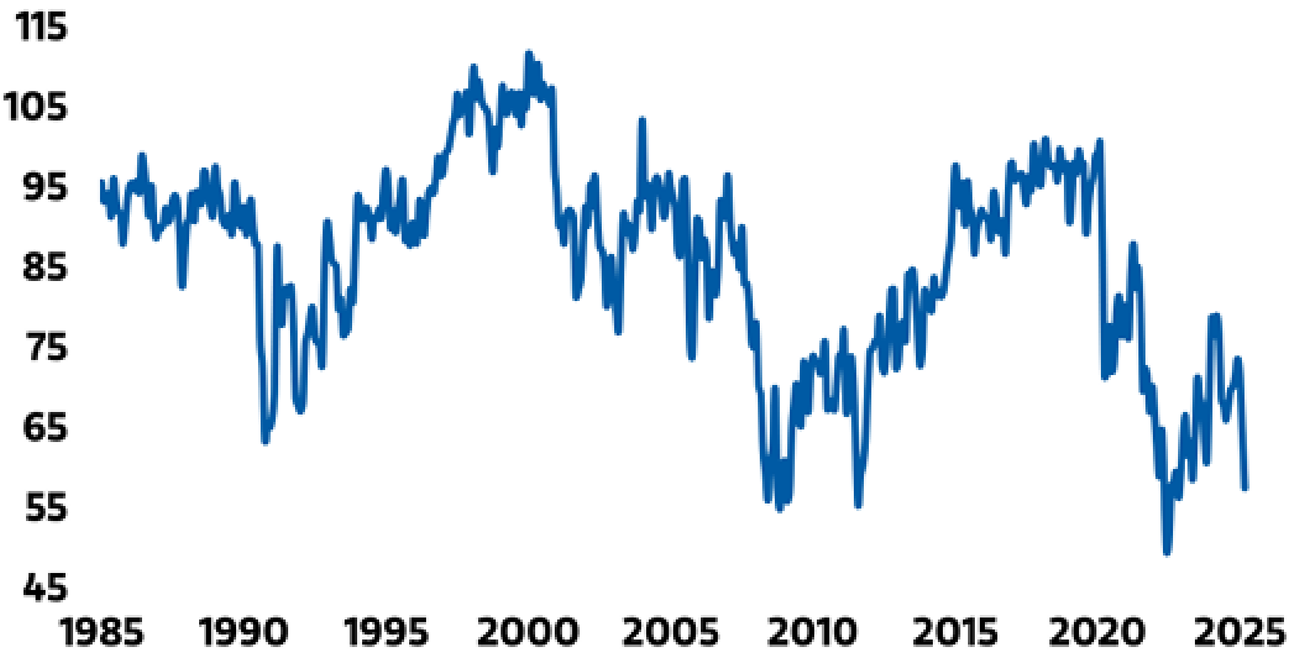
University of Michigan Unfavorable News Heard: Government Economic Policies



Source: Bloomberg, Morgan Stanley Wealth Management GIO. Data as of March 14, 2025.

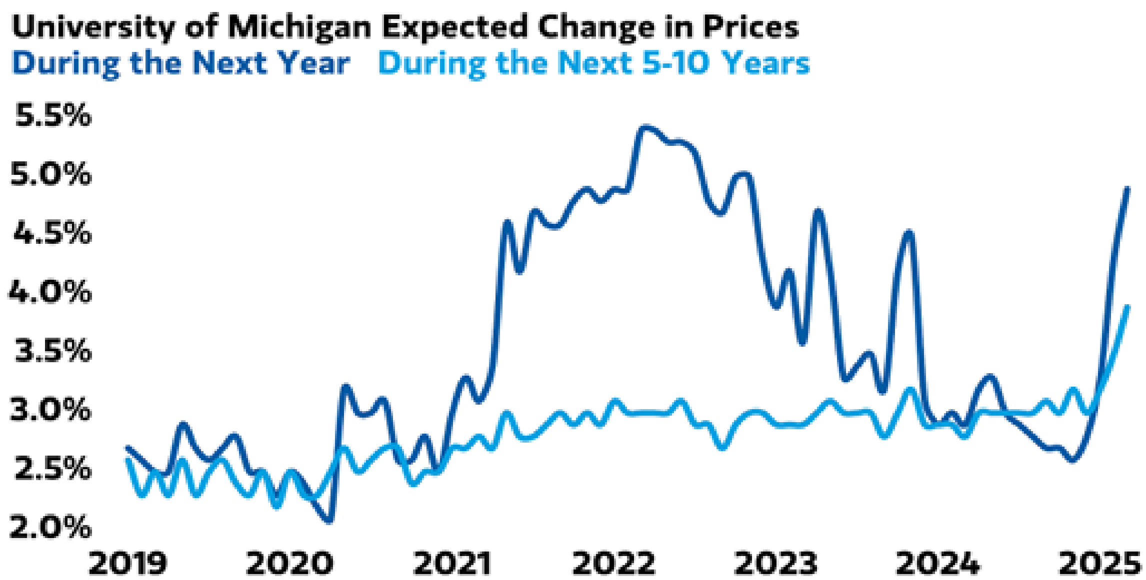
This negativity would seem to flow directly into consumer sentiment (But of course. Yes, we hear all of you collectively saying "duh."):

University of Michigan Consumer Sentiment



Source: Bloomberg, Morgan Stanley Wealth Management GIO. Data as of March 14, 2025.

And, it appears the consumer thinks stuff is going to get way more expensive (Note: Because tariffs can be withdrawn as quickly as they can be imposed, we can't know that the consumer will be right about this in the end):



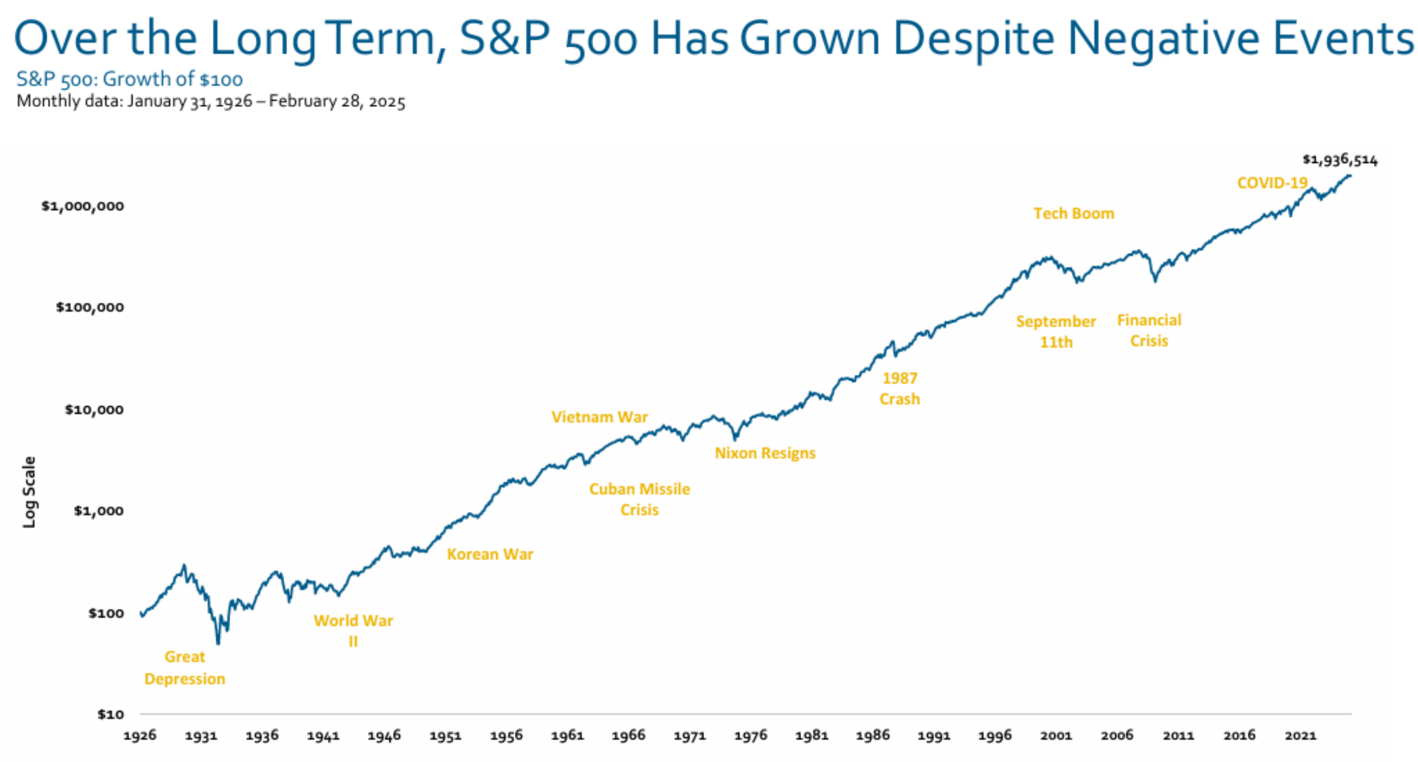
Source: Bloomberg, MS & Co. Research, Morgan Stanley Wealth Management GIO. Data as of March 14, 2025.

So, what's a long-term investor to do? We didn't see tariffs of this magnitude coming– we're not fortune tellers – but we did think that valuations in growth had gotten unpalatably frothy. We've been advising clients, where appropriate, to reduce exposure to growth in favor of value. We've raised cash and added to fixed income, because in our view, valuations matter more than momentum. Folks might give us the side eye when they hear us preach value even though growth is running like a scalded cat, but valuations can find their level eventually. For the year so far, the tech heavy NASDAQ is down over 10%, but the dull-as-dirt, less tech dependent Dow Jones Industrial Average has lost just 0.9%. For the trailing twelve months, the Dow is up 8.5%, handily beating the NASDAQ which is up just 6.3%.[viii] We get that the techy-growthy stuff is more exciting, but sometimes, in a tortoise vs. hare match-up, the tortoise wins. We believe this is one of those times.

Let's talk briefly about what a "correction" is. Technically, a correction is defined at a pullback of greater than 10%. It doesn't mean that markets are down 10% for the year or down 10% for the trailing twelve months. Instead it means a market that has retreated 10% from its most recent ***high***. We get that it can be unnerving. Even those of us who are gray-haired pros with decades of experience aren't immune, but let's look at the big picture and close with the most relevant (we think) chart of all the charts we pop into this letter every month.

For the past five years the S&P has annualized 19.72%. For the past ten years, the S&P has annualized 12.52%. For the past twenty years, the S&P has annualized 10.24%. Since its debut trade in 1923, the S&P has annualized 10.61%.[ix] This despite all of the awful, gut-wrenching, terrifying challenges the country, and indeed the world have encountered over time. Some of those events are noted, in the unlikely event anyone needs reminding. We may not be in a bear market yet, but eventually, one will likely rear its ugly head. When that day comes, cut this chart out and tack it to the fridge as a reminder that over time, the trend line has always been up.

Of course, please don't hesitate to call on us with your specific questions or concerns. We always look forward to hearing from you.



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[i] Source: 2020 https://www.statmuse.com/money/ask/sandp500-monthly-returns-2020, 2021-2025 https://ycharts.com/indicators/sp_500_monthly_return

[ii] Source: Bloomberg, FactSet, Morgan Stanley Wealth Management GIO
[iii] Source: Bloomberg, FactSet, Morgan Stanley Wealth Management GIO
[iv] Source: Bloomberg.com/markets/rates-bonds/government-bonds/us
[v] Source: Alpine Macro Investment Survey March 25, 2025
[vi] Source: Federal Reserve Bank of St. Louis
[vii] Source: Federal Reserve Bank of St. Louis / FRED
[viii] Source: Bloomberg, FactSet, Morgan Stanley Wealth Management GIO

[ix] Source: Refinitiv Eikon through 04/01/2025

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