March 2025 Capital Markets Commentary

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"With a good perspective on history, we can have a better understanding of the past and the present, and thus a clear vision of the Future."

Carlos Slim Helu

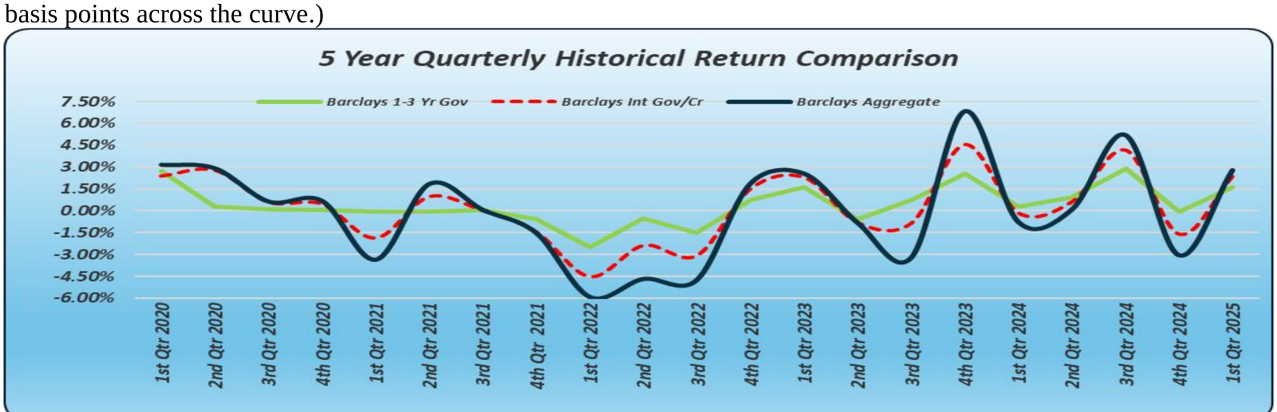
Fixed Income

The 1st quarter of 2025 brought increased volatility within the fixed income markets. That doesn't mean it was bad; it just means that returns must be tempered with some hesitation. With a return of +2.78% for the quarter (On the Barclays U.S. Aggregate), this proved to be a relatively good quarter for the bond markets. Considering the -3.06% return that ended the 4th quarter.

The yield on the benchmark U.S. 10-year Treasury note closed the quarter at 4.23%. For the quarter, the 10-year note's yield fell 35 basis points seemingly due to the current Administration's stated policies and movement out of the equity market and into fixed income. Spreads in the Corporate bond market remained tight to U.S. Treasuries during the quarter.

During the quarter, the FOMC held the current target Fed Funds to the range of 4.25% to 4.50%. Inflation is still higher than the Fed's target, and lately moving higher, but most Fed governors are still leaning towards lowering rates in 2025.

As mentioned, returns were positive across all parts of the curve during the quarter. The Barclays U.S. Aggregate posted a +2.78% return for the quarter, and the Barclays Intermediate Index was at +2.42%. The short end of the yield curve also saw a positive returns, with the 1-3 Year Government Index at +1.62%. On the truly short end of the yield curve, you also saw positive returns. The 1 Year T-Bill returned +1.0% for the quarter. As for yields, the 10-year Treasury yield ended the quarter at 4.23%, the 5-year Treasury yield ended at 3.96%, and the 2-year Treasury yield ended at 3.89%. (As of the end of December, yields were higher by 30 40 basis points across the curve.)



Fixed Income Markets - Looking Ahead

At the two most recent FOMC meetings, there was no change in policy and the FOMC stayed the course. The markets were looking for more direction.

As the quarter ended U.S. Treasury yields were volatile and corporate bond spreads broadly widened. However, a surge in economic policy uncertainty has traditionally heralded a material widening if it persists long enough and results in an actual economic slowdown.

The tariff-induced combination of weaker sentiment, slower activity and higher prices have combined for an indecisive effect on long-end yields, and front-end yields are pricing in more aggressive U.S. Federal Reserve rate cuts as we move forward into 2025. The fixed income markets are forecasting downward rate cuts, which are priced into the market currently. The markets continue to believe that there will probably be additional Fed cuts in 2025; however, any easing may be muted due to tariff implications.

The Fed's top priority of inflation reduction and containment remains. Inflation is the wild card. Many believe inflation will continue to fall, providing the backdrop for the Federal Reserve (Fed) to continue its rate-cutting cycle. However, others believe that inflation will remain sticky while wreaking havoc on consumers, interest rates, and the housing market. Unfortunately, no matter what camp you're in, it might be a while (maybe years) before we see data to support either camp.

Equity

The equity market, as measured by the S&P 500 Index, fell -4.27% in the 1st quarter.

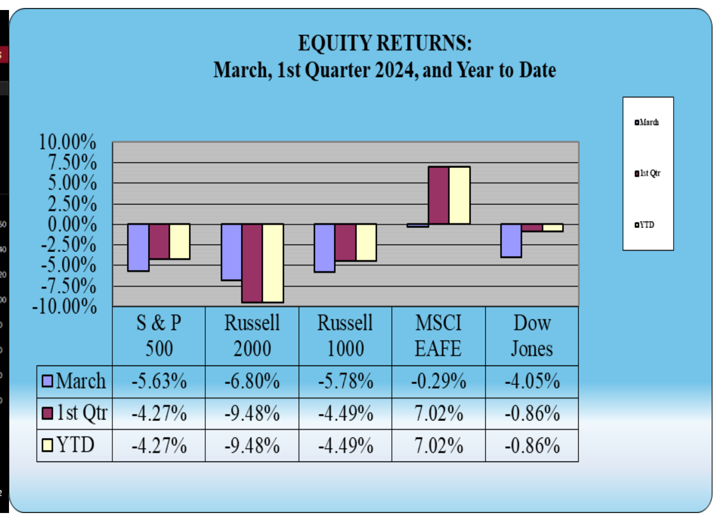
It was a chaotic quarter for the equity markets, with U.S. stocks falling more than 4% amidst uncertainty around tariffs and the current administration's policies. But amid the chaos, fixed income markets posted positive results.

With policy uncertainty leading to a correction in the equity market, stocks fell sharply in the last six weeks of the quarter, with U.S. markets leading the way down. After having positive results in January and early February, uncertainty about Trump's policies began to bear on markets. The S&P 500 briefly fell more than 10% from its February 19 high, which meets the technical definition of a "correction," before rebounding in late March.

As was happening with most of 2024, the "Magnificent 7" stocks were much of the driving force in the negative returns of the 1st quarter of 2025. The 7 largest stocks in the index accounted for -4.8% of the negative return in the quarter. All other stocks had a positive 0.5% return.

It was a mixed quarter for value, small cap, and high profitability stocks. Value stocks, or those with low relative prices, outperformed growth stocks for the quarter through late March. Over the same period, the stocks of small cap companies lagged large caps. High profitability stocks were outpaced by low profitability stocks in both developed and emerging markets as of the end of February, and as the quarter ended.

Overall, indexes were negative for the quarter, with the exception of the EAFE Index. On the U.S. side, the Russell 1000 Index ended with negative -9.48% return for the quarter, and the S & P 500 Index returned -4.27%. The other indices also had negative returns. The Russell 1000 index returned a negative -4.49%, and the Dow returned -0.9%. The international markets posted not only a positive return, but a strong +7.02% on the EAFE for the quarter.



	S & P 500	Russell 2000	Russell 1000	MSCI EAFE	Dow Jones
March	-5.63%	-6.80%	-5.78%	-0.29%	-4.05%
1st Qtr	-4.27%	-9.48%	-4.49%	7.02%	-0.86%
YTD	-4.27%	-9.48%	-4.49%	7.02%	-0.86%

Equity Markets - Looking Ahead

2025. I will ask the same question. Will we have a roller coaster year in stocks?

As we move further into 2025, conditions still remain good for U.S. equities. However, the Fed could very well be the key player that will alter the outcome of the markets.

The first year of any presidency is typically strong, with returns of +11.8% on average over the past 12 elections. However, the first months are often rocky as campaign promises collide with the messy process of policy change. In 2025, changes enacted by the current administration have been rapid in some areas, with Executive Orders being used extensively. However, the usual challenges such as the debt ceiling and extension of tax cuts seem to unfold in a typical, back-and-forth manner.

The current weakness in equities can be attributed to a dip in valuations, which entered the year at unusually high levels. They have cooled in response to the rapid pace of change and high levels of uncertainty over the future path of policy, combined with persistent inflation. Economic growth is the most significant question for 2025. It will affect everything, especially the equity markets.

As we move forward, there are risks for markets and investors. Inflation seems to be rising again and remains above Fed targets. The timing and amount of future interest rate cuts (or maybe hikes) by the U.S. Federal Reserve is murky for the markets, and with that, everyone needs to be wary. 2025 still looks to be a positive year for equities. But as we mentioned last quarter, the winds can also change direction.

The Economy

<u>The Economy. Where is it going?</u>

After a strong end to 2024 U.S. economy ended the 1st quarter of 2025 in a weakened state.

The economy kicked off 2025 on the wrong foot, with early indicators pointing to an ugly GDP report for the first quarter when the advance estimate is published at the end of April. However, a lot of the quarter's headwinds look temporary. The economic hit due to the LA wildfires, disruptions from winter storms, and the surge of imports as businesses were front-running higher tariffs, could fade quickly.

<u>Change is not only in the air but on the ground</u>. The dominant economic story of the quarter has been tariffs imposed and threatened. Unfortunately, the major tariff action is yet to come, scheduled for the second quarter and with economic impact anticipated later in the second quarter and throughout the year. However, steel and aluminum tariffs imposed in late February have already had an impact on business operations, increasing costs and slowing business activity in some sectors. By the end of the first quarter, the average tariff rate in the United States, estimated at a modest 2.3-2.5%, had risen to 8%. Although the Federal Reserve remains watchful for the impact of tariffs on inflation, the longer-term concern is the negative impact on consumer spending and employment.

The FOMC had no changes in policy or rates during the quarter.

The Economy - Looking Ahead

<u>Economic Growth? Inflation? Recession? Global problems? Stagflation? Everything is on the table.</u>

As we enter the second quarter of 2025, it is with a constructive but less optimistic economic outlook for the US. While indicators for the US economy point to continued growth(albeit slower), the outlook is increasingly shadowed by high levels of uncertainty around economic policy and geopolitics.

The current economic forecast for 2025 shows growth, but at a slower pace. Inflation will remain above the Federal Reserve's target, with President Trump's policies limiting production while stimulating spending. The greatest risk going forword, in light of recent statistical data, is that we may be heading towards Stagflation. <u>I don't like to be technical, but an explanation is necessary.</u> Stagflation occurs when the economy cools but inflation rises.

Stagflation is relatively rare because inflation and economic stagnation don't typically occur at the same time. Falling prices usually accompany economic slowdowns, as lower demand puts downward pressure on inflation. Usually, when that happens, policymakers often turn to stimulative fiscal and monetary measures such as increased government spending or lower interest rates to help jump-start growth.

During periods of stagflation, slowing economic growth and rising consumer prices occur simultaneously. This typically results from supply-side shocks, restrictive trade policies, or poor government decisions that drive prices higher while hurting economic activity.

As we move forward, the broad economic picture is murky. While some companies in the manufacturing sector continue to show signs of strength, other economic indicators show a more pessimistic picture. A worrying outcome, is the possible slowing of labor market expansion. Which means that the Fed must be ready to respond if labor market conditions weaken. At the same time, the Fed must retain the credibility it has re-earned in working inflation back to a more normal level. Since inflation could increase via tariff action and labor expansion could slow via policy uncertainty, constant signals and communication from the Fed will be vital.

Despite the early declines in inflation, we have seen inflation tick upwards due to new tariff policies and their effects. Fed officials want to see more sustained progress in the inflation data before making additional rate cuts., but they have the worry of slower economic growth if they ease too soon. The expectations are that the Fed will more likely watch and wait to see the actual impact of real and proposed policy changes before moving one way or another with interest rates.
