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Economic & Market Update

First Quarter 2025 Review & Outlook

First Quarter Review

- During the first quarter, global markets and economies were focused on Washington, D.C. President Trump's chaotic first few months in the White House saw an erratic slew of announcements imposing (or threatening) aggressive tariffs on economic allies and rivals alike. The protectionist agenda is meant to tilt the scales back toward a stagnant American industrial base while raising revenue for the federal government. However, uncertainty over which of the many proposals would stick (and of those, which would endure) cast a dark cloud over consumers' mood. On April 2nd, Trump released plans for reciprocal and sectoral tariffs, dubbing it "Liberation Day." However, details are still lacking, and consumers and business owners, who have been the resilient engine of economic growth, still lack clarity. (Read, Is It Time to Panic? (Spoiler Alert: No, It Is Not) to learn about the potential impacts of these tariffs.) All in all, three months into the Trump 2.0 presidency, just one thing is obvious: The only certainty will be uncertainty.
- Despite the efforts of Elon Musk and the Department of Government Efficiency (DOGE) to cull the herd at one of the nation's largest employers, labor markets remain in balance: no longer strong enough to supercharge wage-induced inflation but not weak enough to push consumption off a cliff. Economic growth appears to be slowing from its brisk pace in 2024, yet uncertainty about price impacts of tariffs is keeping the Federal Reserve (Fed) from moving forward with its plan to continue easing monetary policy.
- A combination of question marks on fiscal, monetary, immigration, and trade policy drove increasing volatility in financial markets. Despite inflation fears, U.S. Treasury yields peaked in early January before rolling over and ultimately settling near the middle of a multiyear trading range. Investors also began to question the indomitable status of the Magnificent 7 companies and their lofty growth expectations. A re-rating of valuations for this handful of stocks dragged concentrated large cap indexes down into correction territory after reaching all-time highs in February. The pain was mostly limited to the tech giants' respective sectors, while seven of the other 11 S&P sectors were up in the quarter. Money that flowed out of the Magnificent 7 began to find a curious new home in international equities. Despite the growing threat of tariffs looming over their highly trade-dependent economies, enthusiasm about supportive fiscal and monetary policy as well as cheap valuations drove a wave of inflows into the previously unloved markets. With a strong reversal of recent U.S. dollar strength as an added tailwind, the MSCI EAFE Index's gain of 6.9% in the first quarter was its best relative quarter against the S&P 500 in over 20 years.

Our Outlook for the Second Quarter

GLOBAL ECONOMY

- Led by above-trend growth in the United States, the global economy entered 2025 with positive momentum. Prospective monetary policy ease by most central banks around the world helped maintain that momentum. The major wild card and market unknown was the cadence and impact of the incoming U.S. administration and the turn toward deglobalization. As it was legislatively easier to govern through executive order over the first 100 days of the Trump presidency, orders around tariffs, government efficiency, and mass deportation of undocumented immigrants dominated the airwaves and drove market action, both domestically and in the rest of the world. The more market-friendly fiscal policy proposals, those centered on corporate and individual tax cuts, require congressional approval. These proposals will be introduced and debated over the coming months and are not likely to have an offsetting impact on the economy and markets until closer to year-end.
- Throughout the first quarter of 2025, economists and market participants seemed to spend most of their time reacting to and analyzing the almost-daily administration announcements around future tariffs. The April 2nd tariff announcement was an apparent worst-case scenario for the markets, sparking a global sell-off. The magnitude of the tariffs on some countries is so onerous that it appears the administration is begging them to come to the negotiating table. So, although some of the tariffs may ultimately prove transactional, we have no choice now but to take them at face value. The counter argument is that the tariffs—at least on paper—raise so much in revenue that they provide room for more tax cuts in the current budget negotiations with Congress.
- The U.S. economy would likely hold up best in the looming trade war environment, but it would be difficult to find any true "winners" over the near term, as the first consequence would be an increase in inflation with businesses attempting to pass along the cost increases to the consumer. Beyond that initial reaction, a more sinister economic contraction could develop as tariffs act more like tax increases, which pinch corporate profitability through squeezed margins and/or declining sales of the affected products. As the first quarter ended, the term "stagflation"—coined in the 1970s to describe an economy with high inflation rates and weak growth—was being invoked more frequently to describe the ultimate outcome. Having little experience with tariffs and their effects, investors may look to defend their portfolios until some of the smoke clears.
- The U.S. economy entered 2025 with strong economic momentum after having grown at a healthy and above-trend rate of 2.8% in 2024. One of the perhaps unintended consequences of announcing prospective tariffs at the beginning of the second quarter was the incentive it gave to businesses and individuals to accelerate purchases ahead of the announced tariff implementation dates. This caused a significant increase in imports, which will detract from first quarter gross domestic product (GDP) when it is announced at the end of April. The threats of significant government layoffs and mass deportation are leading to additional expected contraction in first quarter estimates.
- Cracks have begun to form in the legend of the indomitable U.S. consumer, but they were generally in the confidence surveys, which appear to be politically skewed in this intensely partisan environment. Actual data around incomes, retail sales, and job and wage growth have been more indicative of a less confident, but generally still-positive, American consumer. Businesses are likely to be more discerning around capital expenditures, as the impact of tariffs and a diminished supply of cheap labor challenge margins. However, the need to boost labor force productivity should lead to continued spending in the technology space.
- A somewhat surprising implication of the U.S. administration's threats to reduce its commitment to defending Europe was the willingness of Germany to adjust its long-held reputation for fiscal austerity and to embrace greater deficit spending.

The incremental spending will be allocated to defense and infrastructure. When combined with continued monetary policy ease, these expansionary policies should help offset some of the impact of tariffs in the largest European economy—which is expected to show anemic growth for the full year.

» The Chinese government is also using a combination of expansionary fiscal and monetary policies to offset tariffs and support a naturally slowing economy. Demographic challenges will continue to slow China's growth in the longer term, but greater government spending, combined with tax breaks, will only partially offset the high tariff rate the US placed on China making it difficult to reach the 5% growth goal for 2025. Japan, a leading global exporter, will be looking more inward to its consumers to partially offset tariffs and achieve 1.0%–1.5% 2025 GDP growth. Healthy job and wage growth should provide fuel for robust consumer spending growth.

MONETARY POLICY

» Stalled progress on the inflation rate moving down to the Fed's 2% target has temporarily delayed the planned reduction in the federal funds rate to a more neutral level. Markets expect the Fed to resume its policy rate easing moves following the June meeting, but the initial inflationary impact of tariffs may lead to further pause. Fed Chair Jerome Powell's characterization of tariff-driven inflation as "transitory" has reaffirmed the current dovish bias as has the reduction in balance sheet runoff announced after the March meeting. Two cuts of 25 basis points in the federal funds rate by year-end continue to be the forecast.

» The European Central Bank (ECB) remains resolute in its easing campaign, as inflation has moved closer to the 2% target in a weak economic growth environment. Any impact of greater fiscal spending on inflationary progress will be closely watched, but achievement of the single price stability mandate will provide continued flexibility for the ECB to gradually bring rates down through the remainder of the year.

» Despite having apparently achieved its 2% inflation target, the Bank of Japan has surprised investors by leaving its key policy rate at a very low 0.5%. With exports being such a large contributor to Japanese GDP growth, the central bank is waiting to better assess the impact of tariffs on its economy. Holding off on any tightening measures will also help prevent a sharp increase in the Japanese yen, which would be another impediment to exports.

» The People's Bank of China (PBOC) likely welcomes greater government fiscal support to offset the effect of tariffs . The Chinese central bank is somewhat limited in its ability to ease policy aggressively, as rate cuts tend to cause an acceleration of capital flight out of the country. Gradual and milder rate decreases is the preferred strategy for the PBOC.

BOND MARKET

» Except for very short maturities, the government yield curve is again back to its more usual upward slope. Short-term rates should decline when the Fed resumes its easing campaign mid-year. With the forecast for continued economic growth, albeit at a slower rate, we anticipate intermediate- and longer-term yields will remain around current levels for the rest of the year. Greater issuance of Treasury notes to fund larger budget deficits should apply some incremental upward pressure on yields.

» Spreads on high-yield bonds widened slightly in the first quarter as fears of an impending recession increased. The asset class remains historically expensive with not-enough yield spread to adequately compensate investors should a recession ensue in this highly uncertain economic environment.

EQUITY MARKETS

» Beginning in the middle of the first quarter, U.S. equity markets experienced the first correction in over two years. Growing uncertainty around the magnitude and effect of proposed tariffs on U.S. trading partners led to a 10%+ downturn. The promise of lower-cost alternatives in the artificial intelligence space, which took some of the luster off the Magnificent 7 stocks that had been the major drivers of the 2023–2024 bull market, put further pressure on U.S. markets.

- At the current level of interest rates, it is difficult to make a valuation case for a rebound and continuation of the bull market. A more likely driver of further price appreciation would be earnings growth. While the growth rate of earnings going into the year may have been too high given the difficulty of incorporating tariffs, consensus 2025 earnings growth expectations are currently at roughly 10% in an economy that is slowing but not receding. We expect earnings estimates to come down because of tariffs but still show positive growth for 2025.
- Greater market breadth and a move away from reliance on the top seven holdings would likely signal a healthier market. The S&P 500 Equal Weight Index outperformed the capitalization-weighted S&P 500 Index in the first quarter, but that was merely indicative of the more defensive nature of the equal-weighted index in a market downturn. Investors will be looking for continued outperformance when equities rebound off correction lows.
- Developed market equities, led by Europe and Japan, posted strong outperformance of U.S. equities in the first quarter. Most European bourses achieved directional outperformance as prices rose compared to the 5% pullback in prices seen in the United States. Relative valuation in these markets has always been an advantage, but a catalyst was needed to provide a spark. That catalyst occurred when European countries finally realized they would have to begin bearing the costs of defending themselves. A stronger commitment to defense spending and the willingness to run greater fiscal deficits should help drive previously anemic top-line growth in these countries. However, the uncertain impact of tariffs on economic and earnings growth suggests a more cautious approach to the equity markets.
- A somewhat surprising government commitment to expand both fiscal and monetary policy has helped lead Chinese equities out of their decade-long slump. Long-term secular issues around population growth and the hesitancy to fully embrace an entrepreneurial capitalist model may eventually serve to impede the advance, but a near-term headwind would be the ultimate effect of tariffs on the export sector.

COMMODITIES & CURRENCIES

- Some easing of tensions in the Middle East toward the end of the quarter combined with less demand from China due to its growth slowdown have put downward pressure on the price of crude oil. As the state of Middle East politics remains tenuous, there may be some additional production cutbacks, putting upward pressure on prices.
- Lower real (or inflation-adjusted) interest rates engineered by central banks around the world should further enhance the attractiveness of gold. Central bank diversification efforts away from the U.S. dollar should be another incremental source of demand pushing prices higher.
- Weaker-than-expected first quarter economic growth as well as uncertainty around tariffs have pressured the U.S. dollar at the beginning of the year. We believe higher relative interest rates and a Fed more hesitant to ease rates should lead to some element of rebound this quarter and a return to a narrow trading range through the rest of the year.

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