Market Update: Q1 2025

The first quarter of 2025 was marked by significant economic, geopolitical, and market turmoil in the United States. While initial economic data from the prior quarter was strong, sentiment turned negative during Q1 2025, leading to increased market volatility, a correction in U.S. equity markets, and falling Treasury yields. The so-called "Trump trade" unwound in the face of rising global tensions and policy uncertainty.

Notably, the "Magnificent 7*" stocks, which had previously led market gains, significantly underperformed and pulled the U.S. stock market lower. Aggressive trade policy and a Federal Reserve stuck in neutral have fueled near-term volatility and negative earnings revisions.

Key Takeaways

- Policy uncertainty and rising global tensions soured sentiment and sparked volatility
- "Magnificent 7" underperformance weighed on the U.S. stock market
- Economic outlook remains clouded by tariff uncertainty, underscoring the importance of not trying to time the market

INDEX	YTD	1-YEAR	3-YEAR ANNUALIZED
S&P 500	-4.3%	8.3%	9.1%
Russell 2000 Small Cap	-9.5%	-4.0%	0.5%
MSCI EAFE - International	7.0%	5.4%	6.6%
MSCI Emerging Markets	3.0%	8.6%	1.9%
Bloomberg US Agg Bond	2.8%	4.9%	0.5%

SOURCE: BLOOMBERG

March: In like a Lamb, Out like a Lion

The first quarter began with strong backward-looking data. The fourth quarter earnings data was exceptional with year-over-year earnings growth at 18%, the highest since Q4 2021. Revenue growth and profitability exceeded market expectations, pushing the S&P 500 to a new all-time high on February 19th. Economic data was also favorable with stable inflation and employment data.

The backward-looking hard data was solid, but sentiment deteriorated rapidly during the quarter. The 'soft data' reversal was highlighted by falling consumer confidence and small business optimism, while the St. Louis Fed's Economic Policy Uncertainty index spiked. Housing inventories rose to pre-covid levels with mortgage rates remaining stubbornly high, threatening momentum in home values and construction. The growing concern is that a shift in 'soft data' will translate into slowing economic growth and a deterioration in the 'hard data'.

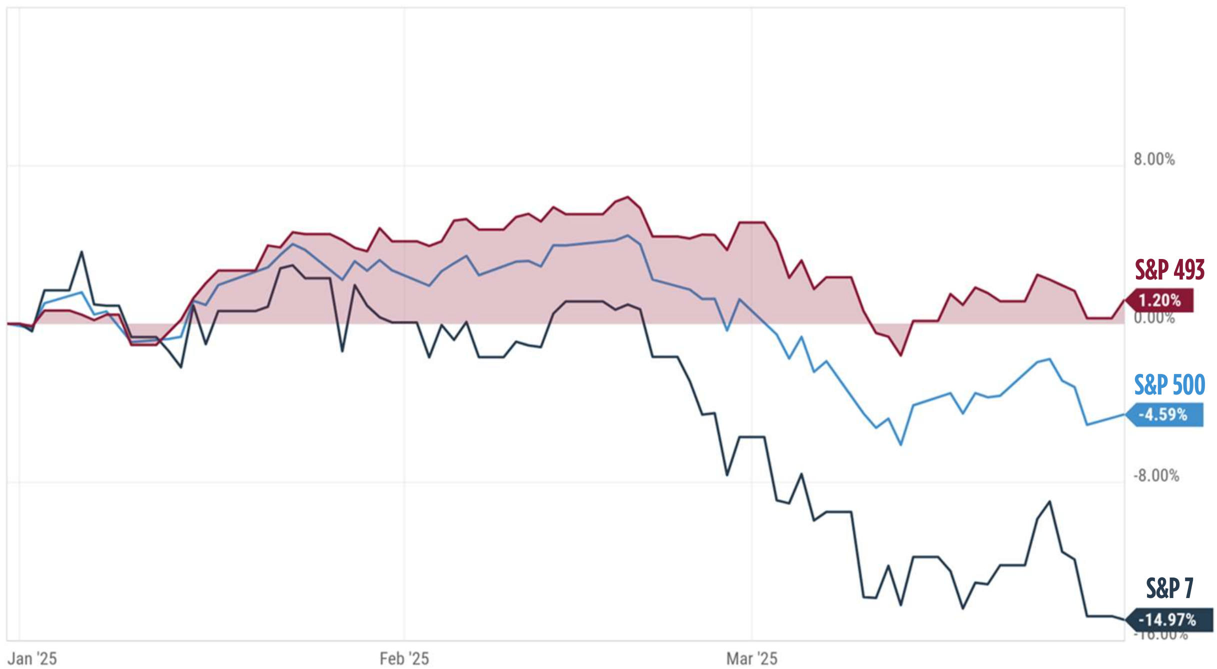
Mr. Market Speaks

Economic indicators and consensus estimates are great fodder for market pundits on CNBC,

*Apple, Microsoft, Alphabet, Amazon, Nvidia, Meta Platforms, and Tesla

S&P 500 VS. S&P 493 VS. S&P 7

LEVEL % CHANGE, Q1 2025



SOURCE: YCHARTS

but the market has a voice of its own and it is always forward looking. Most notably, the S&P 500 experienced a correction in the latter half of Q1, falling more than 10% before recovering to finish the quarter down -4.3%. The tech-heavy Nasdaq index and U.S. mid-cap and small-cap indexes fell into correction territory and continue to trade well below 52-week highs.

Market leadership shifted away from growth sectors with Communications, Information Technology, and Consumer Discretionary stocks trailing the value-oriented Energy, Healthcare and Consumer Staples sectors. However, seven out of eleven S&P 500 sectors were positive year-to-date at the end of Q1, suggesting some underlying strength despite the overall correction.

The "Magnificent 7" underperformed the broad S&P 500 significantly in the first quarter. On a cap-weighted basis, the Mag7 fell -15.0% while the rest of the S&P 500 posted a modest 1.2% gain. After two years of extraordinary returns, valuations among the mega-cap technology stocks were stretched and a selloff was not a complete surprise. However, the rising global tensions and policy uncertainty contributed to the stock market decline as selling accelerated in the lead up to the Trump administration's April 2nd announcement of broad tariffs.

In the aggregate, analysts still project positive earnings growth for the S&P 500 in 2025. But the number of companies reducing profit guidance is growing and analyst estimates are steadily declining. Analysts' forecasts for 2025 revenue and earnings growth for all 11 sectors in the S&P 500 had fallen during the first quarter.

The bond market is also sending mixed messages. Treasury yields fluctuated wildly before settling lower. Falling bond yields suggest slowing economic growth, but yields remain above the 2024 lows. In addition, the yield spread on corporate bonds remain largely unchanged, which suggests broad confidence in corporate liquidity and credit availability.

Outside of the US, International stock markets moved higher, helped by an increase in fiscal stimulus in Europe and a drop in the US dollar. The big winner for the quarter was commodities. Gold surged over 18%, closing above $3000/oz for the first time as investors looked for a hedge against geopolitical uncertainty and resurgent inflation. The prices on other commodities like copper rose as buyers stockpiled inventories ahead of higher tariffs.

A Little Help From the Fed?

The Federal Reserve left interest rates unchanged at the March meeting, with Chair Powell stating the Fed is in "no hurry" to cut rates. The Fed is expecting lower growth and higher inflation for 2025 while holding the Federal Funds Rate guidance relatively constant. Fears of "stagflation," or rising inflation alongside slowing economic growth, have the Fed in a bind. Uncertainty around trade policy and tariffs, as well as the international response to higher tariffs, will make it difficult for the Fed to calibrate monetary policy. Despite the Fed signaling, the bond market is betting on 3 rate cuts in 2025, up from 1.5 at year end. This tension between the market, the policy goals of the Trump administration, and the Fed is likely to be a source of added uncertainty and market volatility in the months ahead.

The Fog of a Trade War

Investing is a data driven discipline. We rely heavily on ratios, indicators and indexes that guide decision making. But there are no metrics or historical guideposts for evaluating the impacts of the broad, sweeping tariffs proposed by the Trump administration. It is nearly impossible to estimate the economic and psychological impact on markets, as well as the retaliatory measures from other countries. Targeted tariffs and strategic trade agreements play a useful role in the global economy. Importantly, the source of recent volatility is not a systemic economic crisis, but rather the consequence of policy actions that can be amended and refined.

US companies have demonstrated an ability to adapt and navigate change. The response to the COVID pandemic is the most recent example. Periods of volatility can offer opportunities to reposition and improve the quality of companies in portfolios. Being focused on the bottom-up stock selection has always driven long-term results at HM Payson. Change is the only constant in investing and economics. Each market presents challenges, and the best way to meet those challenges is to analyze one company at a time.

The Liquidity Moat

At HM Payson we consistently (some may say incessantly) recommend building a liquidity reserve that will fund 3-5 years of expected spending. The underlying objective is to avoid selling equities to fund spending needs in times of elevated volatility. It is difficult to maintain discipline as equity markets struggle, particularly if the source of the volatility is unpredictable and external to the markets.

TIME HORIZON	ASSET TYPE
0-1 Year	Money Market, T-Bills
1-5 Years	High-Quality Corporate/Treasury Bonds
5+ Years	Equities

Investing can be an emotional process. Some argue markets need to be emotional. The simplest examples are fear and greed. Without these countervailing forces guiding investor behavior, asset values would be unchallenged and arbitrary. Clearly there are periods where the pendulum swings too far in one direction. Knowing there is a full range of emotions that can distort investor perception, we have adopted a common-sense, time-tested approach to impose discipline on the asset allocation decision. Otherwise, the temptation to abandon stocks in times of volatility can be overwhelming.

Dangers of Market Timing

Trying to 'time the market' is a dangerous pursuit. It is beyond heroic to claim the ability to profitably jump in and out of stocks. After all, it is not just about knowing when to 'get out', it's also about knowing when to 'get back in' as well. There are two decisions that need to be perfect. The hard fact is this: the best days often follow very near the worst days in the market and missing the best days can be catastrophic. Investing in the S&P 500 from January 1998 – December 2024 and missing the 10 best days would reduce ending wealth by more than 50%. This 26-year period includes the dot.com bust, the 9/11 attacks, the global financial crisis and great recession, and the COVID pandemic, in addition to countless natural disasters, military conflicts, and social unrest. This period also includes smart phones, social media, the block chain, video streaming, electric cars, gene editing and artificial intelligence.

S&P 500 ANNUALIZED RETURNS, JAN. 1, 1998-DEC. 31, 2024

	ANNUALIZED RETURN	$10K INVESTED
All days during period	8.0%	$74,411
Missed: 10 best days	4.8%	$34,090
Missed: 20 best days	2.8%	$20,293
Missed: 30 best days	1.0%	$12,826

SOURCE: MORNINGSTAR, STANDARD & POOR'S

Warren Buffett famously once said, "The stock market is a mechanism for transferring wealth from the impatient to the patient." It is very difficult to be patient when the global economic order is disrupted. The current market volatility highlights the value of a clear, cash-flow-driven, high quality stock selection approach. Combined with a disciplined asset allocation process that aligns clients' specific spending needs - protecting liquidity for short-term needs - we endeavor to avoid emotional, reactionary decisions during uncertain times. Change is constant and comes in many forms. Our mission is unwavering: helping clients stay on course and build long-term wealth, while protecting short-term spending needs from unexpected volatility.