

Investment Strategy Outlook

MARCH 2025

THE ECONOMY

Mounting Downside Risks Amid Heightened Uncertainty

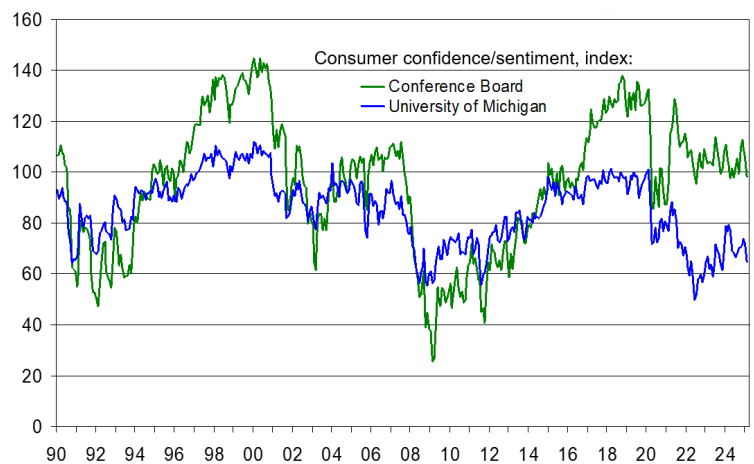
Over the past few months we've cautioned that an uncertain and rapidly changing policy environment could weigh on economic activity and lead to heightened volatility in the financial markets. The past few weeks have been a prime example of what we had in mind when we first began raising those concerns. To be sure, the U.S. economy continues to push forward, but the path forward has become much rockier and far less clear. While at present our base case is that the economy will continue to expand, we now anticipate slower real GDP growth and higher inflation than we expected coming into 2025, and we consider the risks to our baseline forecast to be weighted to the downside. That is, we think, also the signal being sent in the financial markets, with sharp declines in yields on U.S. Treasury securities and significant declines in equity prices signaling more concern over the prospect of flagging growth outlook than the prospect of higher inflation amid wavering consumer and business confidence.

Consumers' moods have meaningfully soured thus far in 2025, which is visible in both the Conference Board and the University of Michigan survey data. On top of the stress being caused by cumulative price increases over the past few years, consumers are now increasingly worried that higher tariffs will lead to further price increases. Uncertainty over tariffs, particularly given the on/off nature seen over the past several weeks, is impacting business decisions on purchases of raw materials and intermediate goods, capital spending, and hiring. To that point, the Institute for Supply Management's (ISM) February survey of the manufacturing sector shows some firms putting off placing orders due to uncertainty over tariffs, while others report input prices already rising in anticipation of tariffs. Moreover, the speed and scope of cuts in federal government employment and spending are contributing to a sense of unease amongst both consumers and businesses, particularly given the potential spillover into the private sector in areas such as education and health care. The ISM's February survey of the services sector conveys concerns along these lines.

Many are quick to dismiss confidence surveys and the ISM surveys as "soft" data which does not necessarily impact the "hard" data, such as consumer spending, business investment, and nonfarm job growth. Market participants may have been inclined to do the same with the most recent batch of survey data had that survey data not coincided with a run of hard data coming in below expectations. For instance, we noted last month that January's gain in nonfarm employment came in handily below expectations, sparking concern over the labor market and the broader economy despite the details of the January employment report being stronger than implied by the headline job growth print. The January employment report, however, was followed by reports showing sharp declines in retail sales and residential construction in January, while at the same time January's 0.5 percent increase in the Consumer Price Index (CPI) – with no help from tariff-related price increases – triggered fears that inflation was reigniting.

While we'll admit to having been somewhat flustered by the wave of disappointing data, our task is, as always, to dig beneath the headline numbers and decipher the message in the details of the data. Along those lines, we think the following points are worth making. First, atypically harsh winter weather

Either Way, Consumers Just Aren't Feeling It...



Source: The Conference Board (Consumer Confidence Index); University of Michigan (Consumer Sentiment Index); Regions Economics Division

across much of the U.S. in January clearly had an impact on the economy. Yes, there is a winter every year and, sure, it's always cold in the winter, but the key words in the above sentence were "atypically harsh," as evidenced by significant snowfall across much of the South. The impact of January's atypically harsh winter weather is clear in the data on nonfarm employment and hours worked, residential construction, industrial production, and consumer spending.

We'll also note that, for many data series, seasonal adjustment was much less generous this January than has been the case over the past several years, which to some extent could reflect seasonal adjustment catching up to the pandemic having triggered significant disruptions in what for many years had been stable seasonal patterns. For instance, the not seasonally adjusted data show this January's declines in nonfarm employment and control retail sales to be right in line with typical January declines, but in each case less favorable seasonal adjustment contributed to a softer headline print than would have been shown had last January's seasonal factors been applied. In other words, less generous seasonal adjustment impacted perceptions of much of the January data.

Finally, recall that consumer spending, particularly on consumer durable goods, was notably strong over the final few months of 2024. There is evidence, including from the University of Michigan's surveys, that consumers were pulling purchases of big-ticket items, including motor vehicles, forward into 2024 to avoid tariff-related price increases in 2025. Additionally, late-2024/early-2025 data on inventory accumulation, factory orders, and trade flows have been impacted by firms attempting to front-run higher tariffs. To the extent consumers and businesses were engaging in such behavior, there will naturally be payback, and we think we're starting to see some of that in the recent data releases.

To be clear, this is not us trying to explain away a run of subpar economic data and make a case that all is well with the U.S. economy but is instead simply our usual attempt to put the data into proper context. After all, how one feels about the economy should be determined by what is actually happening in the economy and not by, say, the size of a seasonal adjustment factor. Be that as it may, while we did not find anything particularly amiss in the unadjusted January data, we are nonetheless increasingly concerned over what we perceive to be mounting downside risks. Some of these downside risks were ones we had flagged coming into this year but which now seem more threatening, while others have emerged more recently.

As an example of the former, coming into this year we highlighted the risk that, should they perceive that demand for their goods/services is eroding, firms may be more inclined to let workers go, particularly to the extent that softening labor market conditions lessen the rationale for firms to engage in the labor hoarding behavior that we and many others have argued has been practiced in the post-pandemic years. Though we remain concerned over the prospect of an adverse labor supply shock stemming from immigration reform, we now see weakening demand for labor to be the more pressing downside risk to the labor market. This is one reason to not dismiss reports of flagging business confidence out of hand.

As for newly emerging downside risks, sharp cutbacks in federal government employment and, potentially, research and grant funding are hitting, rather abruptly, at a time when

the economy is already slowing, and we do not yet have a way to gauge the potential spillover into private sector activity. But, the prospect of a few hundred thousand workers being displaced in an already cooling labor market could easily push the unemployment rate higher than we had been anticipating. Additionally, recent sharp declines in equity prices and what in many markets are softening house prices raise the potential of negative wealth effects leading to cuts in discretionary consumer spending, which could be significant given the degree to which higher income/net worth consumers have been driving overall consumer spending.

The path ahead for the U.S. economy looks much rockier than it did coming into this year. Yet another round of atypically harsh winter weather left a mark on the February employment report and will likely do the same with the data on residential construction and retail sales. Another round of disappointing data won't make anyone feel any better about the growth outlook and, looking ahead, the March employment report will be the first to show meaningful impacts from cuts in the federal government workforce. It is not difficult to envision a negative feedback loop in which disappointing "hard" data further depresses business and consumer confidence which, in turn, blows back on consumer spending and business investment/hiring. These conditions could prevail until there is more clarity on the policy front.

Sources: Bureau of Economic Analysis; Bureau of Labor Statistics; U.S. Census Bureau; Conference Board; University of Michigan Survey of Consumers; Institute for Supply Management

STOCKS

More Bricks In The Wall Of Worry

The S&P 500 and small-cap Russell 2000 index closed out February with monthly losses of 1.3% and 5.3%, respectively, as sagging consumer confidence contributed to fears of a 'growth scare', or perhaps something worse, lying in wait. It became apparent as February ended that consumers, corporations, and investors were growing increasingly skittish and taking on a more defensive posture by building up savings/cash while reducing spending/investment in the face of rising geopolitical angst, government layoffs, and ongoing trade uncertainty. With consumer spending accounting for roughly two-thirds of GDP, households tightening purse strings in preparation of higher prices from tariffs would likely tamp down earnings growth in the coming quarters. And with corporations unwilling to invest or engage in mergers and acquisitions due to a lack of clarity on the trade and regulatory fronts, business spending can't be relied upon to pick up the slack for a more cautious U.S. consumer. At the same time, rapid-fire cutbacks in federal government employment and spending added another layer of uncertainty for households and businesses to contend with, in part because the effects of these cutbacks will spill over into the private sector.

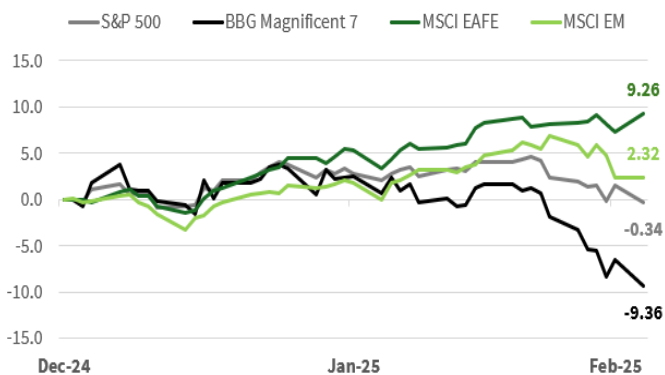
Shaky investor sentiment was evident in the American Association of Individual Investors (AAII) weekly investor survey. Pessimism ruled the day, with 60.6% of respondents 'bearish' on stocks over the next six months in the February 26 poll. The percentage of 'bearish' respondents is almost twice the historical average of 31% and was last higher on September 29, 2022. Interestingly, that level of bearishness in the September 2022 survey proved to be an opportune time to buy as the S&P 500 rallied 5.5% in the three months to follow and 17.7% in the next year. While we would love it if history repeated and the S&P 500 turned out similar returns in the next 3- and 12- months, other guideposts, specifically the muted response out of the CBOE Volatility Index (VIX) and defensive leadership profile, lead us to believe that 'peak pessimism' and additional downside in U.S. stocks may still lie ahead.

VIX measures 30-day implied S&P 500 volatility and is calculated based on demand for 10% out-of-the-money puts, or

options that rise in price as stock prices fall, relative to 10% out-of-the-money calls, or bets that stocks will move higher. A VIX reading of 20 or less is indicative of limited demand for hedges against a market drawdown and has been quite common in recent years as pullbacks have been shallow and short-lived. A spike in the VIX tends to coincide with a selling crescendo or sentiment 'flush' which can correspond with market bottoms. VIX entered March below 20, a potential sign of complacency surrounding whether tariffs would be levied or not. A VIX spike to 30 or above, a level last seen in August 2024, would be more indicative of peak pessimism and give us comfort that a market bottom is close, if not in place. VIX was hovering in the mid-20's in early March as tariffs went into effect on Canada, China, and Mexico, so we are likely closer to a level where those needing to sell to de-risk have already done so. That said, it would be unusual to see the market bottom with so few S&P 500 constituents trading below their short-term moving averages.

Market breadth didn't signal a rush to the exits at month-end as over 50% of S&P 500 constituents remained above their 10, 50, and 200-day moving averages. But the Index still pulled back despite decent participation, shining a light on concentration risk as the 'Magnificent 7' is still dictating the direction of travel for the S&P 500. An equally weighted basket of this anointed group of stocks fell 8.5% in February, making it a tough ask for the remaining 493 names to offset such a sizable drop. As of early March, six of the Mag 7 - with Apple the lone exception - were down 10% or more from their all-time high and most were trading in oversold territory based on relative strength indicators (RSI). This backdrop could bring about a near-term bounce, but near-term upside could be limited as prior support levels may now become upside resistance. The S&P 500 was testing support at its 200-day moving average around 5,730 in early March and if this level holds buyers could be emboldened to step back in, and the 100-day moving average at 5,950 is the first upside target worth watching as seasonals become more supportive.

A Pronounced Leadership Shift To Start The Year



Source: Bloomberg

Sector leadership struck a ‘risk-off’ tone in February due to economic and policy uncertainty, with consumer staples (+5.7%), health care (+1.3%), and utilities (+1.1%) each outperforming the S&P 500 during the month. But the energy (+3.2%), financial services (+1.2%), and real estate (+4.1%) sectors - all economically sensitive to some degree- outperformed the S&P 500 as well, confounding investors positioning for an economic slowdown. The sector leadership profile has shifted in a decidedly defensive direction in March as energy and financial services succumbed to selling pressure and have given back February’s gains plus some. With quarterly earnings season behind us, the path taken by U.S. stocks will be beholden to headlines and the macro backdrop, a potentially disconcerting combination. With few positive catalysts to speak of outside of an unlikely about-face on tariffs, economic surprises are likely to skew to the downside. However, the seasonal backdrop has historically turned more supportive for U.S. stocks in mid-March through May, and with the S&P 500 now oversold, a bounce should be expected, it’s just a matter of whether that bounce happens now, or from a lower level.

Earnings Growth Estimates Likely To Follow Economic Surprises Lower



Source: Bloomberg

Developed Markets Abroad Outperform As Accommodative Monetary Policy And The Prospect Of Fiscal Support Drive Capital Inflows.

The MSCI Europe Index advanced 3.2% in February, outpacing both the S&P 500 and MSCI EAFE by a sizable margin, and strength out of euro area country indices continued into early March as investors sought relative safety as U.S. tariffs on Canada, China, and Mexico went into effect. Accommodative monetary policies have buoyed economic growth estimates for the EU and U.K. early in the new year, and the European Central Bank (ECB) again cut key policy rates in early February, while leading market participants to believe that additional support was possible, if not likely, in the coming quarters. Hopes for easier monetary policy pulled capital into euro area stocks in January/February, but the most impactful and unexpected shift spurring economic optimism across the pond could come on the fiscal front.

In early March, in a surprising move, Germany voiced a willingness to step up spending on manufacturing and military capabilities, possibly signaling the beginning of the end for a nearly century-long period of fiscal austerity. This could be a watershed moment for euro area economic growth, but skepticism remains warranted as there have been no actions taken yet and when the rubber meets the road some euro area countries could balk at what is proposed, limiting the size and impact of any fiscal support. Sovereign bond yields across the euro area rose on the prospect of more debt needing to be issued, and the euro currency rallied versus the U.S. dollar, touching 1.08€ to \$1, a level last seen in November prior to the U.S. presidential election, and a sign of capital being repatriated and moving out of the U.S in favor of Europe.

The German DAX garnered headlines after touching all-time highs on its way to a 21.9% return in the first two months of 2025, overshadowing peripheral European country indices such as Italy, Greece, and Spain which have all rallied 18% or more in U.S. dollar terms year-to-date. Over the trailing three years, Italy, Greece, and Spain have quietly bested the S&P 500 – who had that on their bingo card? From a valuation perspective, developed markets abroad remain relatively attractive, with the MSCI EAFE trading at 15 times estimated next twelve months earnings, which compares favorably to the S&P 500’s loftier valuation of 21.5. Perhaps most notably, even amid signs the U.S. economy is slowing, there is little hope for less restrictive monetary policy in the near-term, but policymakers in Europe appear willing to ease policy to support economic growth despite sticky inflation, and movement on the fiscal front would be the cherry on top for investors in the euro area.

BONDS

Near-Term Economic Pain Likely To Keep A Bid Under Treasuries

Core investment-grade bonds have performed quite well up to this point in 2025, with the Bloomberg Aggregate Bond Index higher by 2.7% year-to-date through February, followed closely by the Bloomberg U.S. Corporate Index which has rallied a respectable 2.6%. Fears of an economic slowdown have put a bid under high quality bonds, and Treasury yields across the curve have fallen to start the year, retracing much of the upward move made throughout the fourth quarter of 2024.

In President Trump’s first term, he consistently cited and

tied his ‘wins’ to the stock market’s gains. However, both the President and Treasury Secretary Scott Bessent were noticeably silent as stock prices fell in the back-half of February and into March, and the administration appears to be more focused on the Treasury market this time around. The pair have repeatedly voiced their willingness to see Treasury yields, specifically the 10-year yield, fall to unlock or thaw the housing market where a combination of high prices and higher interest rates have effectively shut out new buyers. Some near-term economic pain

is perhaps the only path to achieving this aim as it would lower consumption/demand and force investors into safe-haven U.S. Treasuries, pushing yields/rates lower and weakening the U.S. dollar. February's softer economic data could be viewed by the administration as a means to an end, and if some degree of economic pain is going to be tolerated, then economic surprises are more likely to be to the downside in the coming quarters. Thus, we see little reason to reduce exposure to Treasuries with this backdrop in place. Investment-grade corporates, on the other hand, which have also benefited from falling Treasury yields, hold less appeal as credit spreads are still tight by historical standards and potentially fail to adequately compensate investors for taking credit risk into an economic slowdown.

Some Signs Of Caution Coming From Credit. Credit spreads widened in the back-half of February as tariff rhetoric ramped up, consumer confidence flagged, and investors were presented with more signs of cooling in the labor market. However, while valuations for investment-grade (IG) corporate bonds have cheapened only modestly up to this point, the drawdown in riskier higher yielding corporate bonds (HY) has been deeper with the spread over the U.S. Treasury curve for the Bloomberg U.S. Corporate High Yield Index now 50-basis points above its mid-February low. Higher yields appeared to initially draw investor capital back into these bonds in early March, reversing some of the widening in spreads last month, but the selloff appeared to pick up steam mid-month as the S&P 500 approached a nearly 10% peak-to-trough decline. Fears of a U.S. economic slowdown could persist and weigh on consumer spending, business investment, and hiring in the coming months, potentially leading to downward revisions to earnings estimates. This backdrop would likely force credit spreads wider and weigh on valuations for lower quality corporate bonds, but active managers could be best positioned to sift through the wreckage and take advantage of further weakness in this segment of the bond market.

Elevated Volatility Forcing Credit Spreads Wider- More To Come?



CBOE VIX (left), Bloomberg HY OAS (right)
Source: Bloomberg

Opportune Time To Lower Exposure To Emerging Market Debt In Favor Of Developed Market Sovereigns. At the end of February, the Bloomberg EM USD Aggregate Bond Index had turned out a 9.6% total return over the trailing year, lagging only the Bloomberg U.S. Corporate High Yield Index's 10% return among the major fixed income segments we track. However, trade/tariff uncertainty will likely weigh on global growth for quarters to come. With lofty valuations and upside from tighter credit spreads likely limited from here, this appears to be an opportune time to reduce, but not eliminate exposure to U.S. dollar denominated emerging market debt in favor of developed market sovereigns abroad.

U.S. dollar-hedged developed market sovereign bonds currently offer U.S. investors a higher yield relative to U.S. Treasuries, broadly speaking, and the credit profile is similar to that of many domestic investment grade issues. We have been under-allocated to developed market sovereigns in recent years as yields were unappealing on both an absolute or relative basis versus U.S. Treasuries, and the U.S. dollar's strength versus the euro, yen, and British pound in the post-COVID environment has been a headwind for upside from exposure to foreign bonds. But this dynamic has shifted in recent quarters and yields on developed market sovereigns are more attractive and should the U.S. dollar continue to slide on economic growth concerns, U.S.-based investors would benefit from diversification via exposure to assets tied to foreign markets and currencies.



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