Quarterly Market Commentary

First Quarter 2025

Escalate to Escalate

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"I told my plebes – stay focused. Take the jabs. They're an annoyance intended to distract you from the real danger; punches."

- Eric Peters, CIO One River Asset Management

Muhammad Ali is widely considered the greatest boxer of all time. He not only fought with athleticism, but also with style and wit. Ali famously employed the "rope-a-dope" strategy, where he hunched against the ropes allowing his opponents to swing at will. Bobbing and weaving, his adversaries would tire themselves out as Ali waited for his chance to go on offense. While difficult to endure, his fifty-six wins, three heavyweight championships, and one gold medal speak for themselves.

Through the first months of 2025, US equity investors have absorbed several blows. The "US Exceptionalism" narrative, taken as fact in January, came under direct fire in February and March when the new administration unexpectedly announced aggressive trade policies, including significant and widespread tariffs on long-time US allies. Heightened policy uncertainty collided with crowded investor positioning in US stocks, as investors were allocated to US equities near all-time high levels.

Accordingly, the S&P 500 experienced its fifth fastest correction (a drawdown of 10% or more) in over 50 years. Unlike the past few years, the US stock market is now competing for capital with international equities, real estate, and fixed income. This stands in stark contrast to 2023 and 2024, when the US stock market appeared to be the only game in town. For long-term oriented asset allocators and investors, it has been a not-unexpected regime shift, where diversification across asset classes, geographies, sectors, and market capitalizations is being rewarded once again.

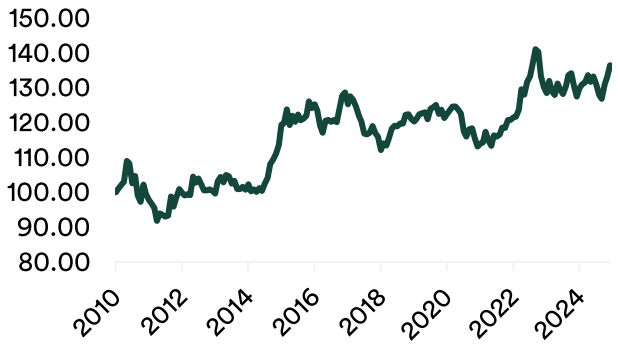
The Mar-a-Lago Accord?

There are, of course, many opinions on the administration's proposed economic policies. However, one unequivocal end goal is a reordering of the world's current economic system.

The US dollar, the world's reserve currency, has appreciated steadily for decades as US markets attracted investor capital from across the globe. International investors have been drawn to the US because of its dynamic economy, stable rule of law, and geopolitical position. From 2010 – 2024, the US Dollar Index, which is a measure of the value of the US dollar relative to a basket of foreign currencies, such as the Japanese yen, the Euro, and the British pound, appreciated by nearly 40%.

ICE US Dollar Index[1]

January 1, 2010 – December 31, 2024 (Indexed to 100)



[1] FactSet

With significant upward pressure over the past 15 years, the administration has been explicit about its intentions to reduce the dollar's value. A weaker dollar, according to economic theory, would stimulate demand for US exports (as US goods become cheaper for foreign purchasers), US manufacturing (as cheaper prices create more demand for US goods), and ultimately US employment (as higher demand for US goods requires more US labor).

There is speculation on Wall Street that an international summit is in the works to transform this theory into policy. A so-called "Mar-a-Lago Accord", like the Plaza Accord of 1985, would require collaboration from G7 allies, and from countries in the Middle East and Latin America, to agree to raise the value of their currencies, and thus reduce the relative value of the dollar.

Mechanically, it would look something like this:

- The US would provide participating countries security and access to its markets.
- In return, the participating countries would agree to weaken the dollar (increase the values of their currencies) and swap existing US Treasury holdings with longer term US government debt, thus growing the size of the US manufacturing sector and providing low cost, long term funding for the US government, respectively.[2]

It remains to be seen whether such a meeting, let alone an agreement, will take place. So far, however, the blunt instrument to bring countries to the negotiating table has been tariffs.

Quarter To Date as of March 31, 2025[3]	
S&P 500 Total Return Index	-4.3%
Dow Jones Industrial Average	-0.9%
Nasdaq Composite Index	-10.4%
Russell 2000 Index	-9.5%
MSCI EAFE Index	7.0%
MSCI Emerging Markets Index	5.2%
Bloomberg Aggregate Bond Index	2.8%

Tariffs and US Exceptionalism

The consequence of fluctuating tariff policy has been a substantial loss of business, consumer, and investor confidence. In March, the University of Michigan's US Consumer Sentiment Index fell to 57.9, the lowest level since the inflationary and geopolitical episodes of 2022.

Tariffs have also challenged business sentiment, as executives scramble to reconstruct supply chains (for the second time in five years) and pause investment spending. As a result, JP Morgan recently downgraded their 1Q2025 GDP forecast from 1.5% to 1.0%, in response to a likely slowdown in activity. Now, many investors are wondering whether we are seeing not only the end of US Exceptionalism, but also the beginning of a recession.

Recession? Not Yet…

In our view, the potential for slowing growth to manifest into recession this year is unlikely for three reasons. First, markets are responding to the policy induced slowdown by lowering borrowing rates, oil prices, and the US dollar – all of which should be supportive of future activity. Short term interest rates are now

[2] Torsten Slok, Apollo Global Management Chief Economist

[3] Black Diamond

below 4%, which should unleash some pent up demand for housing, autos and retail spending. Secondly, corporations and individuals remain in relatively strong position to absorb any short-term shocks, as earnings growth and jobs gains continue to be on track and balance sheets remain healthy. Credit markets are also not signaling significant stress, as credit spreads (a proxy for investor perception of credit risk) remain near historical averages. Lastly, recent headlines regarding capital investment into the US, new infrastructure and defense spending in Europe, ongoing stimulus in China, and pro-growth policies in Japan should all serve as tailwinds to the global economy.

Recession, or not, we continue to expect heightened volatility in US equity markets due to increasing competition for capital and relatively high current valuations following abnormally strong returns (in excess of 20%) over the past two years.

Diversification: The Only Free Lunch

Harry Markowitz, creator of Modern Portfolio Theory, once said "Diversification is the only free lunch in investing." In other words, a diversified portfolio should generate an equivalent, or higher, return with lower risk relative to a highly concentrated portfolio.

For many months, our team has fielded questions from clients about the value of diversification, broadly speaking – such as the rationale for owning international stocks and income producing assets such as fixed income and real estate. These questions are warranted given the exceptional US equity returns over the past several years. However, the value of diversification was clear in the first quarter, as it typically is during periods of volatility. During the quarter, international equities, fixed income, and real estate all advanced and provided a ballast for diversified portfolios during the US stock market pullback. In other words, owning a diversified portfolio increased return and reduced risk (volatility) relative to owning a concentrated portfolio of US equities alone.

Of course, an investor's long-term portfolio goals are rarely achieved in one quarter. Further, we have maintained, and continue to maintain, a bias for US equities. However, the value of diversification to provide strong risk-adjusted returns should be evaluated, and we contend will deliver, across years and decades and across cycles.

As we look to the rest of the year, we are more optimistic about the US economy than most. US businesses are well capitalized, nimble, and dynamic, and many will be able to manage their way through the policy uncertainty out of Washington. While soft data such as sentiment is gloomy, hard data such as credit card spending and retail sales suggests that consumption remains on solid footing. Furthermore, investor positioning suggests that much of the reallocation away from US stocks has already taken place. The allocation to US equities is currently the lowest since June 2023, and cash positions have risen to 4.1% from 3.5% in December.

The shuffle in investor positioning, while painful in the short term for headline US stock indices, has benefitted broadly diversified investors. Patient and thoughtfully allocated investors own a portfolio of assets not only for their return characteristics, but also for their diversifying role in the context of the total portfolio.

While the "rope-a-dope" flurry of political headlines may just be jabs, we continue to be aware of the punches and prepared for surprises. As always, we appreciate your

continued trust. Please don't hesitate to reach out to us with any questions or concerns.

Respectfully,

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