FOCUS PARTNERS | WEALTH

MARKET PERSPECTIVES

QUARTER ONE 2025

Investors entered 2025 generally optimistic as a presumably market-friendly President was poised to take office. January's performance followed this script. At the end of January, Chinese firm DeepSeek announced the creation of a new artificial intelligence (AI) model that rivaled ChatGPT only at a much cheaper cost. This certainly put investors on edge over the amount of growth that AI will drive. It wasn't until mid-February that the prevailing optimism did an about-face once President Trump began implementing parts of his agenda. Investors grew concerned that the administration's early emphasis on immigration, government cost cutting, and tariffs were a headwind to economic growth and, thus, the direction of the markets.

A subtle change in Federal Reserve (Fed) Chairman Jerome Powell's rhetoric has compounded the market pain. As recently as last fall, some economists were forecasting the Fed would continue its rate cutting campaign, pricing in an additional three to five cuts in 2025. Inflation, however, continues to hover above the Fed's 2% target, and so the Fed has, for the time being, paused rate cuts. The yield on the 10-year Treasury Bond, which started the year at 4.57%, moved up to a high of 4.80% before the previously mentioned growth concerns pushed them down to finish the quarter at 4.21%. Lower yields drove higher returns for fixed income investors, with the Bloomberg U.S. Aggregate Bond Index returning +2.8% for the first quarter.

The U.S. stock market, as measured by the S&P 500 Index, returned -4.3% for the quarter, trailing its international counterparts to a degree not seen since the 1980s. Indeed, the MSCI ACWI ex USA Index increased +5.2%, reminding us that international stock markets can move higher without support from the U.S. markets. It is too early to predict that this trend will stay in place; however, as we pointed out in our previous letter, the winds of change are blowing harder today.

Tariffs have become a focal point for investors and that will likely remain the case over the coming months. In the first section below, we look at the history of tariffs and provide some color on how this game of chicken may progress.

In addition, we analyze the length of bull markets compared to bear markets. The abruptness and duration of most bear markets makes it hard to invest around them and supports the need for diversification.

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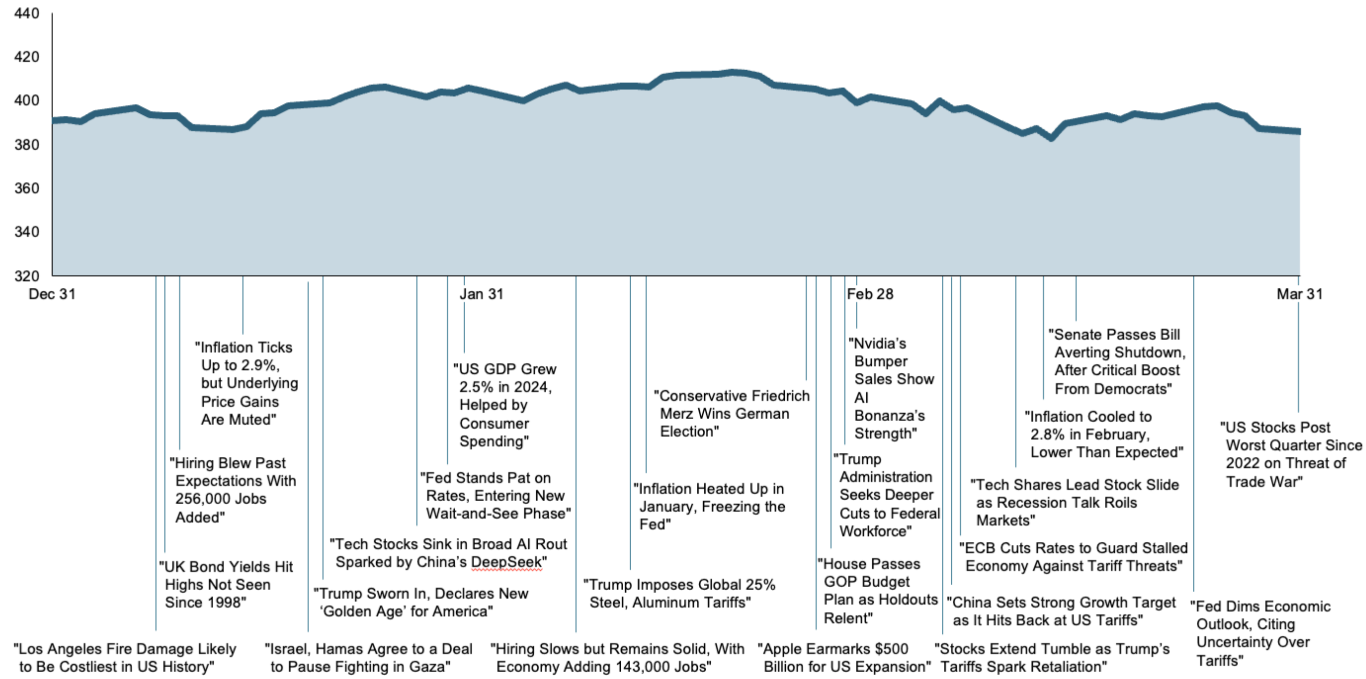
MSCI ALL COUNTRY WORLD INDEX WITH SELECTED HEADLINES FROM Q1 2025



These headlines are not offered to explain market returns. Instead, they serve as a reminder that investors should view daily events from a long-term perspective and avoid making investment decisions based solely on the news.

Graph Source: MSCI ACWI Index (net dividends). MSCI data © MSCI 2025, all rights reserved. Index level based at 100 starting January 2000.It is not possible to invest directly in an index. Performance does not reflect the expenses associated with management of an actual portfolio. Past performance is not a guarantee of future results.

A Brief History Lesson on Tariffs

Looking back through history at the role of tariffs in global trade, we see wide variations in their use. During the 1800s, tariffs were the primary form of revenue for the federal government. According to JP Morgan, tariffs accounted for 50 – 90% of U.S. government income during that time. This compares to approximately 2% at the start of 2025.

Tariffs started to decline in use during the first two decades of the 1900s. The ill-fated Tariff Act of 1930 (a/k/a Smoot-Hawley Tariff Act) was put in place by President Herbert Hoover at the start of the Great Depression to protect American industry from outside competitors. Instead, these tariffs helped to deepen the depression when foreign countries retaliated with tariffs of their own.

Since Smoot-Hawley, tariffs have been on the decline again globally. The General Agreement on Tariffs and Trade (GATT) and its replacement, the World Trade Organization (WTO), worked to liberalize trade and lower tariffs. The fall of the Berlin Wall gave another shot in the arm to trade along with China's admittance into the WTO. As a result, global trade exploded, although the benefits were not spread equally.

President Trump is largely responsible for bringing the word tariff back into our everyday vocabulary. Following the end of the quarter, the administration announced one of the largest tariff increases in history, citing an unbalanced global trade market.

We agree that trade with select countries has become unfair and should be revisited. China is notorious for its one-sided trade arrangements. The country has a long history of trade abuse, including intellectual property theft, state subsidies, forced technology transfers, and restrictions on the operations of foreign companies. Even our allies in Europe are not the best trade partners. They subsidize their agriculture industry and levy strict regulatory restrictions on U.S. companies.

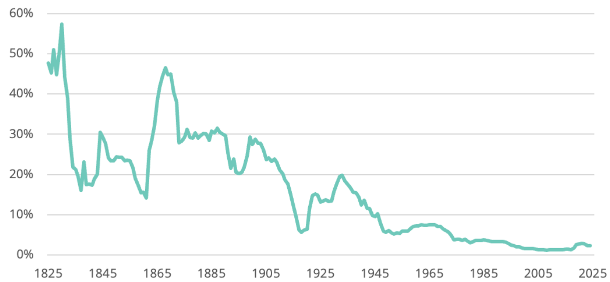
Most of our trade agreements were struck decades ago. They were likely made with the understanding that a developing economy could not compete with American industry due to significantly stronger productivity growth and innovation. They could only compete in lower value-add products by exploiting their cheap labor. The U.S. was likely willing to make this sacrifice because its companies were gaining access to a new market, though it is now evident that these agreements need to be revisited.

WHAT DOES THIS MEAN?

Many countries will likely react to the tariffs by retaliating. If the administration's warnings are to be believed, any retaliation will be met with escalation from the U.S. Our hope is that this ultimately brings about negotiations. This process of retaliation, escalation, and negotiation likely means we should brace ourselves for more volatility over the near term.

According to the World Bank, the U.S. has the most closed economy of all developed countries. U.S. exported a little more than 11% of GDP in 2023, indicating its citizens consume most of what is produced. On the other side of the spectrum is the European Union (EU), which exports more than 51% of its GDP. Admittedly, most of that is trade between EU member countries. Nevertheless, the U.S. exports less than half of what the average country does.

Effective US Tariff Rate On All Imports



Source: Tax Foundation

President Trump is likely betting that the rest of the world will relent first since they have greater exposure to trade and will therefore incur more pain. How much pain the President and our trade partners are willing to endure is uncertain. One silver lining is that there will be mid-term elections in two years, and the Republicans' thin majority in Congress may mean less aggressive posturing on trade.

Escalator Up; Elevator Down

A well-known saying in the investment industry is that "markets take the escalator up and the elevator down." This axiom highlights the swiftness of bear markets compared to bull markets. Bull markets are generally longer-lasting, typically measured in years not months, and develop slowly and methodically. On the other hand, bear markets are often sudden and unexpected. For example, history shows that bear markets last on average 1.3 years with a range from as little as three months to as much as 2.8 years. Bull markets, by comparison, last an average of 6.6 years with the longest running for nearly 15 years.

Investors are living this phenomenon right now. From February 19, this year's market high, through April 4, the S&P 500 fell nearly 17%. Most of that decline occurred during the two days following "Liberation Day," the term the administration uses for its tariff announcement.

This phenomenon corroborates why we prefer diversification over concentration. The recurring pattern of market cycles, which mostly includes a slow march higher followed by a quick and often severe decline, can aggravate investors' emotions. Humans prefer the comfort of crowds in the face of uncertainty, and nothing draws a crowd like an upward move in stock prices. As more investors feel compelled to join the party, pushing up prices often beyond what the fundamentals support, the probability of a sharp move lower increases. Being overly concentrated in the market's recent winners can exacerbate an investor's pain if or when a correction occurs. Year-to-date, more diversified portfolios that include fixed income, international equities, and alternatives, have held up much better.

WHAT DOES THIS MEAN?

Investors are generally risk averse. Research from the field of behavioral finance has established that investors' aversion to losses supersedes the happiness they derive from gains. This often leads to behavioral anomalies not conducive to successful investing, such as holding onto losers too long, selling winners too quickly, finding comfort investing alongside the crowd, and putting too much weight on recent market action when making decisions.

Bear markets are usually associated with pervasive fear amongst participants. This aggravates some of the behavioral anomalies listed above. Diversification helps to mitigate the risk of overconcentrating in recent winners. While bear markets are harrowing and unwelcome, the process of purging market excesses and normalizing valuation is an important part of the cycle.

Conclusion

When large market dislocations occur, as we've seen in this year's first quarter, investors become frightened. Most investors fall into one of three categories during a market crisis. The first group of investors are unperturbed. They don't watch their portfolios daily because they trust their financial plan. The second group looks at each selloff as an opportunity. They know that investment markets have always moved higher after bottoming and are willing to accept the short-term volatility that may come from purchasing oversold, cheap assets. The final cohort abhors uncertainty and seeks to derisk their portfolios by selling during significant declines.

Each of these investor types has its drawbacks. The opportunistic investor must consider each market decline individually. The market timers, who sell out of the market on weakness, must decide when to get back in. The long-term investor demeanor is probably best suited to meet long-term goals. Nevertheless, even they need to be concerned with sequencing risk, or the risk of a sharp market decline just before funds are needed for retirement.

We are not certain when the market will find support and recover from this year's losses. We are certain it will happen, however, as markets have recovered from every bear market in history, no matter what the cause. Staying calm and resolute in the knowledge that markets have always found a bottom is the best path forward, regardless of which type of investor you are.

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Sources: Statista, World Bank, Axios, and First Trust

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