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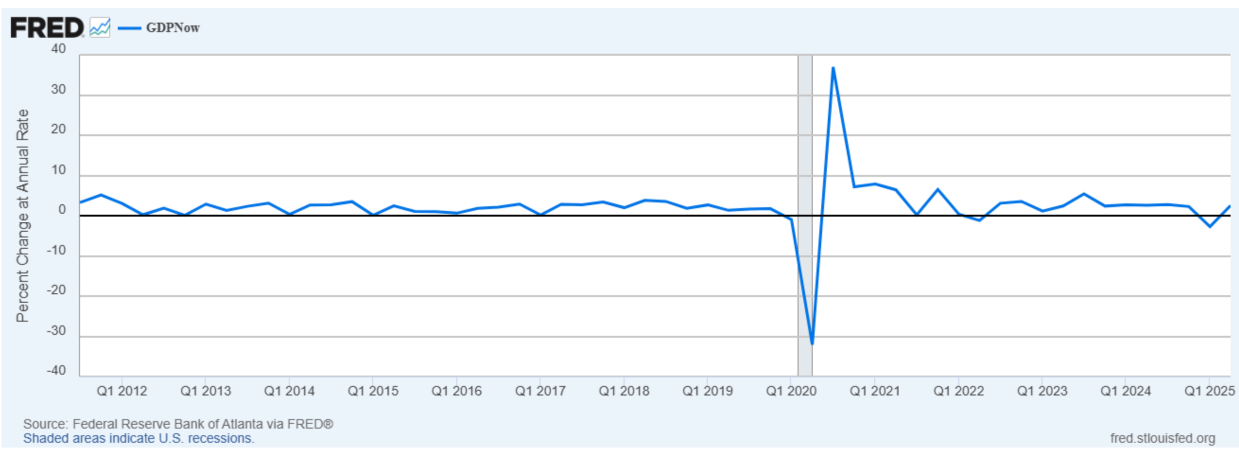
2025 Q1 Market and Economic Update

Economic Update

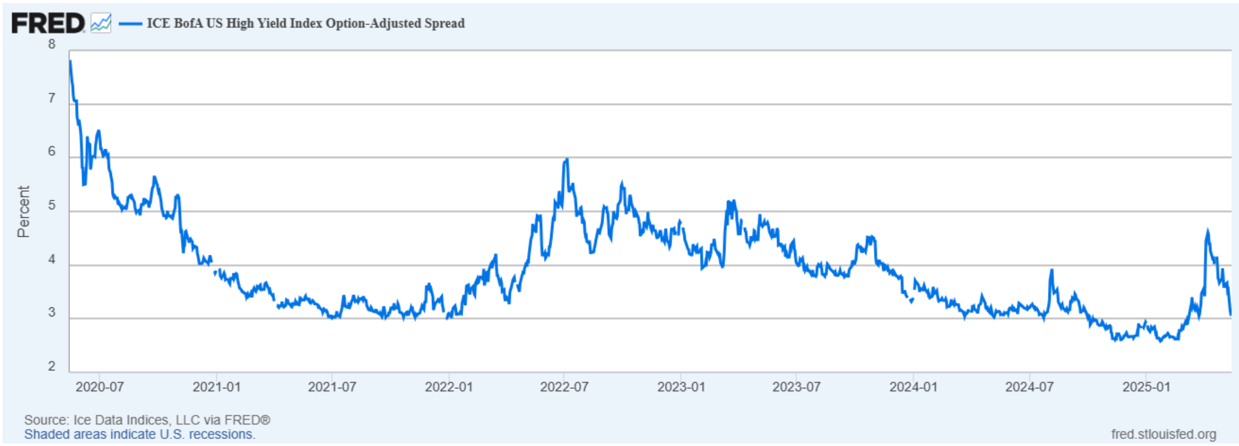
The big topic this year has been international trade, and specifically tariffs. On "Liberation Day" when Trump rolled out tariffs on America's trading partners, the US stock market initially crashed, expecting devastating economic contraction and inflation. I initially commented that it was too early to determine what would happen. I still think it's too early. I don't want to get into a political discussion, but I do believe that taxes and barriers to trade (both domestically and internationally) reduce wealth creation. This massive tax that was rolled out on the American consumer does threaten to raise prices domestically while slowing global economic growth, or even causing contraction. This is the logical outcome to large tariffs, but it doesn't have to turn out that way. I'm still confused on the point of the tariffs. Are they to stop illegal Fentanyl imports, to raise taxes or to compel trade partners to reduce their unfair trade practices toward the US? Trump famously likes to negotiate. Sometimes misdirection and being unclear about what you are willing to settle with are effective tactics. It is too early to judge what the final outcome of the negotiations will be. The situation could still resolve favorably if negotiations end with trade partners giving the US more favorable treatment in exchange for the US dropping its new tariffs. It could also turn out poorly if both sides dig in and maintain or escalate protective trade policies that ultimately impoverish everyone by reducing comparative advantage trade. For instance, imagine the impossible example of California and Iowa engaging in a trade war. Iowa slaps a large tariff on California wine, so California retaliates by taxing Iowa corn. If this were enforceable, California would have to tear up vineyards to plant corn, while Iowa would repurpose cornfields toward homegrown wine. Iowa is perhaps the best place in the world to grow corn, and California is one of the best places to produce wine, but trade barriers would have each reducing what they do best to do what someone else does better. Practically, if the goal is to reduce trade deficits by taxing imports, the actual mechanics of how this works is the final price to the customer rises to a point that the either the customer doesn't buy or a domestic producer makes the product for a higher price than the non-taxed import but a lower price than the all-in cost with tariffs. The point is, US consumers get less for their money, and stocks suffer. We do know that Trump is very concerned with the stock market, so he is likely to have limited patience with a strategy that is hurting stocks. We also know that elections happen every two years, while stock valuations are based on decades of future earnings. If the current plan doesn't work, Trump is likely to change course, and if he doesn't the next person will.

While I want to take a wait and see approach on tariffs, I do acknowledge that uncertainty is bad for business. This is one of the problems with public, high-stakes negotiations such as are happening now. The situation is very challenging for businesses – they don't know what their inputs will cost. Even businesses that manufacture in the US usually have some components that are being imported. An environment where the rules are changing daily is not conducive to investing in growing one's business. This is why some people are saying that even if the tariffs are removed, the damage has been done.

GDP growth in the first quarter was negative, but this was before severity of the tariffs was known. The Fed's real-time estimate showed the economy has already bounced back. This could be people accelerating their purchases to get ahead of tariffs. It's complicated.



One good indicator of stress in the economy is the high yield spread, which is the extra yield investors demand to hold junk bonds. When the spread is low, it indicates investors are comfortable that riskier companies will be able to make their debt payments. This spread was spiking earlier this year, and then quickly reversed course. This implies that investors are confident that the trade deals will get worked out without major damage to the economy… for now.



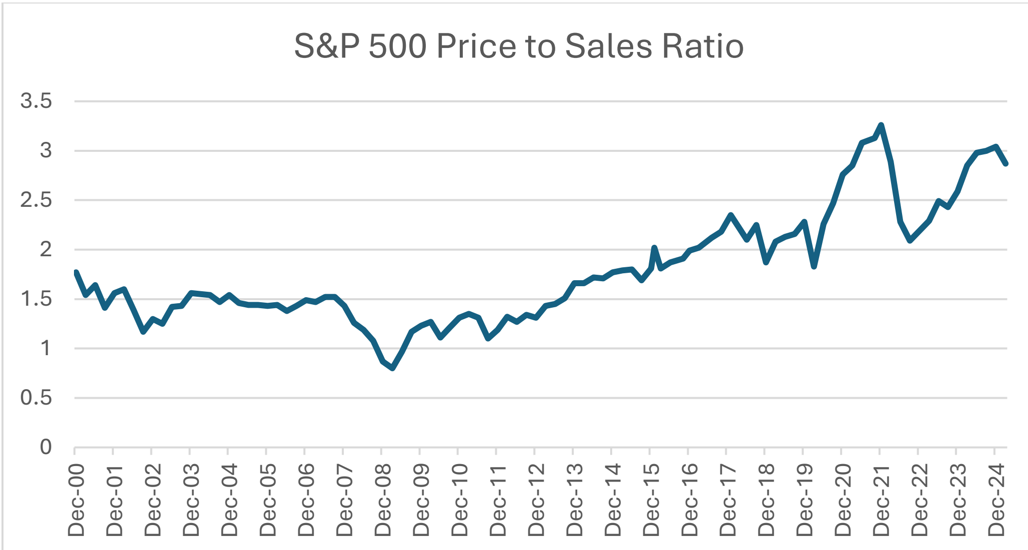
Predicting the economy is hard, and clearly views can change quickly. Whether you agree with what the current administration is doing or not, it is engaging in an aggressive campaign to make some substantive changes. This is a messy process. Communication based on posturing for negotiations or gaining political support makes the situation even harder to read. Rather than predicting which direction the lines on the charts will go next, investors should be ready for anything, with a good plan in place that balances all of the future possibilities.

Market Update

While economic cycles come and go, it is important to remember that as investors we own real companies. The value of the company is based on its future cash flows over the very long-term. The two determinants of return are the future performance of the company and the price we pay today. The first is unknown, but can be estimated. When expectations get too high, the current price rises to a level that demands perfection for way off into the future to generate a good return. Looking at the price of stocks based on today's earnings is a short-cut way of understanding embedded expectations. Even with all the turmoil around recent headlines, embedded expectations are very high.

While I usually share an earnings-based chart, this time I want to look at price to sales. Ultimately, earnings are what investors get to keep, but looking at price/sales is interesting for an entire market because it removes profit margin, which is very cyclical.[1]

[1] Simplistically, Earnings = Sales * Net Profit Margin. When net profit margin surges higher for various reasons, earnings rise faster than sales



Source: multpl.com

The chart above only goes back to 2000, during the tech bubble. The rise in the multiple over the last sixteen years can be explained by a rising earnings multiple (probably unsustainable) and a rising net profit margin (also probably unsustainable.) As I've written before, the profit margin has increased on lower interest expense, primarily. With rates up from their lows, as debt matures, companies will have to roll it over at higher rates, which will impact the interest expense. As of the end of the first quarter of this year, US stocks trade at a significant premium to their average over the last quarter-century based on revenue.

We follow four equity risk factors (stock selection criteria that have historically been indicative of higher returns) – value, momentum, quality and size. The last several years have been a very challenging time for factor-based investing. This year has been a little better, but still unfavorable. Value and quality have more or less kept up with the S&P 500, while momentum and size have lagged significantly.[2] Smaller companies are more at risk to tariffs, as they tend to be more domestic and don't have the benefit of international diversification. They also have a harder time adjusting supply chains because they lack the scope of a bigger company. Momentum is challenged when headlines whipsaw markets. Momentum investing holds companies that have been experiencing the best stock performance over the recent history. When headlines suddenly change what investors hold, trends are more likely to be broken. We expect times when these strategies fail to keep up with the broader market and are invested for the long-term, trying to always keep

[2] These are general comments and not an evaluation of funds held in client portfolios. There are different ways of constructing portfolios with exposure to these factors and some have done better than others in the recent environment.

the odds in our favor, and fully realizing we won't win every day. We also diversify across strategies.

The reason factor-based investing or almost any sort of strategy that attempts to add value through stock selection has struggled in recent years is that the biggest stocks have done the best. The S&P 500, the most-used proxy for the US Large Capitalization stock market, weights each company based on its market value. Bigger companies have greater representation. Size is measured not by earnings, but by market value, so a relatively small company with a very high earnings multiple (e.g. Tesla) will carry a much higher weighting than a larger company with a small multiple (e.g. Ford and GM). A recent article noted that the top ten stocks make up 37% of the S&P 500, but only 28% of earnings.[3] This is noteworthy for a few reasons. First, the authors point out that concentration of the top ten is roughly the highest it's been since the 1960's. They tested 60 years of data using an equal-weighted portfolio and found that when the share of the biggest ten stocks was high, 88% of the time the bottom 490 outperformed the top 10 over the next five years, compared to 69% of the time in general.[4] (This corroborates other studies that have shown that recent history notwithstanding, owning the ten biggest stocks is usually a losing strategy.) Second, the valuation gap between the top ten stocks and the rest of the market (equal weighted) is in the top 10% of what it has been historically, at over 50%. The authors found that when the gap was in the top decile historically, the top stocks went on to underperform their smaller peers by 7% per year for the next five years. Third, contrary to their reputation as safe "blue chips" the top ten stocks have been more volatile than the rest of the market. Investors can draw a couple of conclusions from this study. First, since the market is so heavily weighted to stocks that are positioned for lower returns and higher volatility than the rest of the market, we can expect lower returns and higher volatility in general based on their outsized contribution to index performance. In fact, the authors show two prior "lost decades" where the S&P 500 earned almost zero return for ten years. In both cases, the bottom 490 stocks (again equally weighted) showed positive, albeit low returns while the largest stocks had a decade of negative returns. Second, while factor-based investing, particularly value and size, has underperformed relative to an index driven by a small number of expensive high-fliers, history suggests this will reverse going forward. Now is not the time to capitulate and chase the crowd.

Index investors have enjoyed a lucrative time of exceptionally high returns with mostly low volatility for about sixteen years. Even sharp market pullbacks have been

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[3] (Pauley, 2025)

[4] The authors divided the data sets into thirds. Periods with the highest tercile of market concentration were "high concentration" while the lowest tercile was "low concentration" and saw the biggest ten outperforming the bottom 490 61% of the time.

quickly reversed, teaching a generation of investors to buy the biggest and best companies, buy the dip, and buy what everyone is talking about. These may have been the wrong lessons to learn, because historically, none of these strategies have worked well.

Works Cited

Pauley, B. S. (2025, April 2). *Market Concentration and Lost Decades*. Retrieved from Enterprising Investor: https://blogs.cfainstitute.org/investor/2025/04/02/market-concentration-and-lost-decades/?utm_source=theideafarm.com&utm_medium=newsletter&utm_campaign=trade-walls-global-risk-recalculated&_bhlid=1f947521b39f473c8617a617643845e217048600&mc_cid=b379359d99&