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Doll's Deliberations®

Quarterly Investment Commentary

Bob Doll, CFA
PM/CIO/CEO

(Note: This piece was written before Trump announced the tariffs and the market melted down.)

Introduction

Just six weeks ago, the S&P 500 traded at an all-time high, with enthusiasm among consumers, businesses, and investors. While the initial reaction to President-elect Trump's victory in November was certainly pro-risk (stocks rose, the U.S. dollar strengthened, and bond yields fell), the markets settled back into an uneasy holding period, acknowledging the challenges that await the new administration, and corrected 10%. The policy uncertainty stemming from the on-again, off-again tariff announcements has done little to restore confidence, and the biggest risk now is that the market has entered a negative feedback loop, contributing to a sentiment-induced slowdown. As a result, recession probabilities have moved up from 20% at year-end to 35-40% now. Earnings estimates are only beginning to fall and multiples, while down a bit, are still high.

1Q market action

U.S. equities fell in Q1 (S&P 500 -4.59%, DJIA -1.28%, NASDAQ -10.42%, and Russell 2000 -9.79%), the worst quarterly returns since the middle of January 2022. All but the DJIA achieved corrective territory during Q1 (falling more than 10%). Mega cap tech was a notable laggard, with the Magnificent Seven in bear market territory (falling more than 20%). U.S. Treasuries rallied sharply, with the 10-year yield falling more than 35 basis points (bps) to 4.2%. The dollar and oil fell, while gold soared 19.3%.

Causes of the correction include:

1. **Uncertainty.** Risk assets despise uncertainty. There was (and remains) plenty of uncertainty—tariffs, taxes, inflation, consumer spending, jobs, DOGE, etc. Some of this can be relieved by the administration, but most will take the passing of time.

2. **Tariffs.** Perhaps the main cause of the uncertainty is the tariffs—Who? What? When? How much? These questions need answers for businesses to properly plan and for markets to settle. (Inherently, we believe that in the short run, tariffs are not market-friendly, as they are viewed as a tax and are inflationary. Longer term, there could be positives.)

3. **Overvaluation.** If you regularly read our weekly Doll's Deliberations or digested our 10 Predictions, you know we have been waving a red flag on valuations for some time. We also acknowledged that valuation is a very poor short-term timing tool and that markets need a catalyst for valuations to matter. Numbers 1 and 2 above were the catalysts.

Stocks started the quarter with strong momentum, as the S&P 500 hit a new all-time high on Feb. 19. Weakness then set in as growth fears followed uncertainty around tariffs and the broader Trump policy agenda. Other related catalysts for the decline included softer economic reports, sticky inflation, and some uncertainty related to AI. Growth fears and tariff uncertainty spread beyond big tech as strategists began cutting their S&P year-end targets. The 2025 consensus earnings estimates started the year at +14%. That number is now +10%, with 1Q and 2Q estimates reduced by 6% and 3%, respectively, with hardly any changes to the back half of the year. We expect further reductions in earnings estimates due to economic weakness.

The Magnificent Seven, which had driven equity market returns over the past two years, have fallen significantly as investors begin to reconsider stretched valuations and excessive positioning. The outperformance of the S&P Equal-Weighted Index vs. the Cap-Weighted Index should continue to benefit active managers. Ironically, international shares have been significant beneficiaries in the early days of the Trump administration, as both fiscal and monetary policy now appear more robust abroad than at home. Additionally, more value-oriented sectors like financials and energy seem to be better insulated from the tariff discussions. If (or hopefully when) attention shifts away from tariffs to deregulation or tax relief, investors may be encouraged to take on risk once again.

Tariffs, tariffs, tariffs

Given the elevated uncertainty around trade policy, and the administration's recent rhetoric indicating a tolerance for some near-term economic weakness to achieve trade goals and other objectives, concerns about meaningful downside risks to growth are valid. We expect volatility to remain elevated (see Prediction 5) as uncertain crosscurrents continue.

In contrast with Trump 1.0, the President has led with isolationism and escalating trade tariffs, which has heightened economic uncertainty at home and abroad. We came into 2025 with a mild pro-growth stance, but warned that successful investment strategy would likely require periodic tactical shifts. It is premature to bet on a recession (outside of Canada), and recent turmoil may create a good buying opportunity in equities. However, for such an outcome to develop there will have to be a pivot in the U.S. to significantly lower trade uncertainty and a switch to pro-growth policies. Toward the end of the quarter, the President stepped up tariff threats, declaring April 2 "Liberation Day," when sweeping reciprocal tariffs are to be announced. Because of the uncertainty, consumer sentiment measures fell significantly during the quarter as economic growth expectations were lowered and inflation estimates were raised (not a happy combination).

Inflation remains sticky

Central banks may verbalize a return to a 2% inflation target, but we do not expect them to succeed. The surge in inflation over the past few years represents a clear break with the past four decades, when globalization and other forces kept consistent downward pressure on goods prices. Goods price inflation will generally be higher as companies build greater buffers into supply chains and selectively re-shore manufacturing. We expect the recent acceleration in wage costs to be sticky compared with recent decades, in part reflecting aging populations. Central banks may not formally abandon their current inflation targets, but they will not sacrifice growth to achieve them. We expect inflation in the U.S. to average approximately 3% this year and over the next decade.

A silver lining?

We expect President Trump to ultimately pivot before the U.S. economy is dragged into a recession, but the administration's initial comments/actions have not been supportive of this view. A silver lining for the global economy arising from the trade war is that some laggard economies, particularly the euro area, are now planning on meaningful fiscal stimulus. And, for better or worse, defense spending (especially in Europe) is in a long-term bull market.

Conclusions/observations

1. A resolution of the heightened uncertainty (largely, but not exclusively tariff driven) is necessary to avoid a recession.
2. Inflation will remain sticky (and may even rise some due to tariffs).
3. As the 10-year yield approaches 4%, bonds become less interesting.
4. The expiration of the "liquidity bazooka" may cause a rise in rates and the dollar.
5. Earnings expectations remain too high.
6. While down some, valuation of U.S. stocks remains high.
7. We expect a choppy year for stocks, with above normal volatility.
8. The Magnificent 7 are lagging as their earnings and, more importantly, cash flow growth, slows.
9. International stocks are under owned in most U.S. portfolios.
10. The administration is attempting to front load the "pain" (tariffs) and then move to the "gain" (tax cuts and deregulation).

10 Predictions for 2025: Review and update (2Q 2025)

Introduction (written December 2024)

Investors continue to enjoy the bull market, but remain somewhat nervous about valuation. Policy uncertainty is higher than usual, in part because there are so many policy changes at the same time. Donald Trump campaigned on a mix of policies that are both economy-supportive (tax cuts and deregulation) and economy-disruptive or negative (tariffs and deportation). As a result, the election outcome has created fatter tails for the U.S. economy. It is possible that a mix of pro-growth and disruption policies will occur simultaneously and/or the administration will toggle back and forth, thereby heightening uncertainty as well as economic and financial market volatility. The main policy downside risks are related to trade and immigration policies. This could be negative for growth and push up inflation. That could lead to the Fed ceasing the cutting cycle and potentially even restarting rate increases, putting upward pressure on bond yields and negative pressure on stock valuation. Trump 2.0 may drive higher uncertainty around inflation and deficit risks. Immigration and tariffs may be inflationary, but corporate tax cuts are disinflationary as benefits get passed onto the consumer. Lower oil prices from increased energy production could also help. Lighter regulations will be positive for financials (especially banks), which now have relatively strong balance sheets and are focused on cash returns and potential loan growth. A pickup in merger-and-acquisition activity may occur with lessened regulatory scrutiny.

Key: Heading in the right direction Heading in the wrong direction Too soon or too close to call

1

Economic growth slows as the unemployment rate rises past 4.5%.
The economic slowdown is (sadly) happening. The tentative signs we saw at the start of the year have only increased at the consumer, jobs, and sentiment levels. In our view, the primary cause of economic slowdown has come from the massive policy uncertainty created by the Trump Administration over tariffs and other issues. Lower- and now middle-income consumers are struggling, as evidenced by the slowdown in spending, the rise in consumer credit, and some 401(k) withdrawals. The excess savings at all levels post-pandemic has finally been exhausted. The unemployment rate has ticked up to 4.2% and could reach over 4.5% by mid-year.

2

Inflation remains sticky, fails to reach the Fed's 2% target, and causes Fed funds rate to fall less than expected again.
The now long-hoped-for 2% inflation rate remains elusive. In fact, the threat of tariffs could mean a further rise in the inflation rate (to over 3%) before any chance of a decline. We have argued for some time that, absent a recession, a 2% inflation rate is very unlikely. Some inflation pressure is coming in both goods and services. This stickiness is creating a massive headache for the Fed as they simultaneously attempt to fight both a rising inflation rate and an economic slowdown that threatens jobs. Our guess is if pressured on both sides, the Fed will fight economic weakness and a rise in unemployment before it fights the inflation.

3

Treasury 10-year yields trade primarily between 4% and 5% as credit spreads widen.
Anticipating a 4–5% 10-year Treasury yield trading-range, the recent move downward in yields toward 4% is causing us to think about lightening up in fixed income positioning and/or shortening duration. Of course, if the economy rolls over into a recession, a 4% yield for a 10-year Treasury bond may look attractive. Upward pressure on inflation is a function of goods prices, service prices, and wage rates. Credit spreads have widened somewhat in recent days from very tight levels. Our assumption of an economic slowdown leads us to believe that more spread-widening is likely.

4

Earnings fail to achieve consensus a) 14% growth and b) every sector has up earnings.
Earnings estimates have just begun to fall in earnest. Year-to-date, earnings estimates for Q1 have fallen by 6-7% and 3-4% for Q2, without much change in second-half estimates. The uncertainty-driven economic weakness will likely become evident as companies release their 1Q earnings and discuss the outlook for the balance of the year. Profit-margin growth expectations seemed unachievable to us even before the year started and the slowdown became more evident. Interestingly, profit growth is most at risk in the Magnificent Seven, with pockets of the other 493 improving.

5

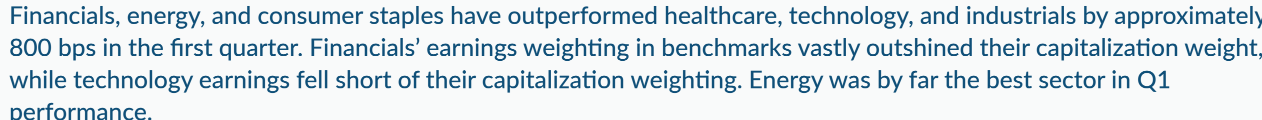
Equity volatility rises (VIX average approaches 20 for only the third year in 14).
The VIX averaged 18.5 in Q1, a significant increase from the 15.5 average for 2024. Confusion and uncertainty have created an environment (even intraday) where investors have moments of "sell now, and ask questions later." We are experiencing a period where growth estimates are being cut while inflation expectations are moving higher, hardly an environment for calm and constructive markets. Hopefully, the administration can take us past the short term "pain" (tariffs) and move us to long term "gain" (tax cuts and deregulation), but our hunch is that tariff uncertainty and pain will be with us for at least a few more months.

Stocks experience a 10% correction as stocks fail to keep up with earnings (i.e., P/Es contract).
Well, it happened fast! After recording a new all-time high Feb. 17, slightly more than a month later, the S&P 500 fell more than 10%. We have commented ad nauseum about the decline and its causes. While the market P/E fell from 22.5 to 20.5, stocks still remain expensive and are vulnerable to further valuation decline. This was the fifth-fastest 10% decline since WWII. Following the decline, the market rallied 5%, but then fell back to retest the lows. Our expectation is that we will experience a lower low (5200-5500). At that point, the economy and earnings will likely determine what's next. Should the economy and earnings hold well, that could be the low for the year (even though we do not expect a new high). Should a recession unfold, we think stocks are vulnerable to a "4" handle on the S&P 500.

7

Equal-weighted portfolios beat cap-weighted portfolios (average manager beats index), and value beats growth.
In the last decade or so, big cap stocks have outperformed the benchmarks, which generally means active managers (who tend to have more equally weighted portfolios) underperform. As the mega cap stocks (think Magnificent Seven) have fallen more than the averages, the average active manager has beaten benchmarks (60% outperformed in Q1). Value outperformed growth by nearly 10%. We expect these patterns to continue, but acknowledge it won't be a straight line.

8

Financials, energy, and consumer staples outperform healthcare, technology, and industrials.

Financials, energy, and consumer staples have outperformed healthcare, technology, and industrials by approximately 800 bps in the first quarter. Financials' earnings weighting in benchmarks vastly outshined their capitalization weight, while technology earnings fell short of their capitalization weighting. Energy was by far the best sector in Q1 performance.

9

Congress passes the Trump tax cut extension, reduces regulation, but tariffs and deportation are less than expected.
This prediction leaves something to be desired. We continue to expect the Trump tax cut extension to be passed this year and for regulation to be lessened (to especially benefit the financials). But of course, tariffs have "stolen the show." Our expectation (and hope) is that the headwinds tariffs cause will lessen as the year progresses and the good news of tax cuts and deregulation will dominate in the second half of the year.

10

DOGE efforts make progress but fall woefully short of $2 trillion per year of savings.
Elon Musk and team are creating quite a stir in their DOGE efforts. They are focusing on waste, fraud, and abuse, and finding it in many places, while at the same time attempting to eliminate departments. While slimming down government is a great idea, many tests (e.g., court challenges) will get in the way of this process. We continue to expect progress, but reiterate that DOGE will fall short of initial goals.

Final Tally: 5 0 5

In summary (written December 2024)

U.S. equities should remain supported by continued economic expansion and earnings growth, ongoing easing by global central banks and a likely 1Q wind down of the Fed's quantitative tightening. Consumers are largely flush with cash and record wealth, although there is evidence of fraying at the low end and some mid-level consumers. The Fed is in easing mode, but will likely dial its dovish intent down in 2025 due to sticky inflation, with potential upside risks due to continued economic growth and trade/tariff issues. The stock market is already pricing in an optimistic backdrop and carries high valuations creating risks as we enter 2025. An early-in-the-new-year 5-10% pullback is possible (if not probable) given the sharp gains, froth in sentiment, and stretched valuations, leaving the market vulnerable to bad news or simply in need of consolidation. Note that stocks tend to be strong in November/December, but weaker in January/February.

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