Beacon Trust
INNOVATING WEALTH STRATEGY

Market Outlook 1Q 2025 Review **April 4, 2025**

First Quarter Summary *

Roughly one hundred years ago Frank Knight, a well-known economist from the University of Chicago, made the distinction between risk and uncertainty. Risk may be quantified with probabilities, such as the one in six odds of correctly predicting the roll of a fair die. In contrast, uncertainty is unable to be quantified with any degree of precision. In our view, stocks fell over the first quarter primarily due to the high level of uncertainty around tariffs and other geopolitical issues. Specifically, the S&P 500 fell 4.3% in Q1, its worst performance since the third quarter of 2022. Growth stocks, such as those that comprise the "Magnificent 7" performed even worse. For example, the Russell 1000 Growth Index fell 9.5% in Q1 and recent market favorites, such as NVIDIA, Tesla, and Broadcom fell roughly 20% or more in Q1. Small cap stocks fared poorly as well, also falling 9.5% in Q1.

There is a silver lining in the market wreckage of Q1. Several areas of the financial markets that have previously lagged significantly, such as value stocks, international stocks, and bonds, all generated positive returns over the quarter. For example, the MSCI EAFE Index of international stocks increased 8.0% in Q1, and the Russell 1000 Value Index returned 2.1% in Q1. The Bloomberg Barclays Aggregate Bond Index increased 2.8% in Q1, amidst a backdrop of a slowing economy with the Federal Reserve on hold. Gold continued its glittering performance, rising 19% in Q1 on top of its more than 25% increase in 2024. In short, the recently maligned principle of diversification worked well in Q1, mitigating the drawdown from an all-equity portfolio, especially one tilted towards previously high-flying U.S. growth stocks.

Earnings reports from the fourth quarter were largely reported in Q1. Approximately 75% of firms exceeded consensus estimates according to FactSet. However, the somewhat cloudy outlook, due in no small part to tariff uncertainty, resulted in more subdued forecasts by many firms, including Walmart, Target, UPS, FedEx, and Nike. Gross Domestic Product (GDP) for Q4 increased 2.5% according to the Bureau of Economic Analysis. However, Q1 estimates are much more modest, with the Atlanta Fed forecasting a small drop in GDP, potentially placing the U.S. economy on the precipice of a recession.

As we write this report, the Trump Administration has proposed large tariffs that are expected to go into effect this month. The higher than expected tariffs resulted in a sharp further deterioration in stock prices, with the S&P 500 falling 4.8% on April 3rd, its worst day since the early days of the COVID-19 pandemic in March, 2020. High tariffs are viewed by most economists as a significant negative for the global economy, which we discuss further in our Market Outlook section below. Tariffs are not the only government action creating anxiety for many workers and market participants. The Department of Government Efficiency (DOGE), led by Elon Musk, has proposed sharp budget and payroll cuts across many areas of the federal government. In some cases, entire departments, such as the Department of Education, have been slated for elimination. DOGE has limited authority to implement its recommendations, so many of its proposed changes are being challenged in federal courts.

Furthermore, geopolitical events may also move the markets. The U.S. is trying to broker an end to the Russia-Ukraine War, but several hurdles remain to a lasting diplomatic solution. American meetings with Russia, which currently exclude leaders from Europe, have exacerbated tensions between the U.S. and European Union (EU), in addition to the newly announced tariffs. In parallel, war continues to wage in Israel and the U.S. undertook military action against the Iranian supported Houthi rebels in Yemen.

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We expect continued volatility in asset prices, since the tariffs may upend the way many firms conduct their business. Despite the sharp drop in U.S. stock prices which are now firmly in correction territory, we believe equities will find their footing once there is further clarity on the tariffs. The statement published by the White House on April 2nd noted

"Today's IEEPA Order also contains modification authority, allowing President Trump to increase the tariff if trading partners retaliate or decrease the tariffs if trading partners take significant steps to remedy non-reciprocal trade." In other words, the aggressive tariffs are partially designed to bring global trade representatives to the negotiating table. The likelihood is that at least some of the proposed tariffs will be reduced or eliminated.

American firms proved somewhat resilient in the face of significant supply chain challenges during the COVID-19 pandemic, and we expect them to be similarly adroit in light of the new expected tariffs. Nevertheless, we do expect the tariffs to result in some additional inflationary pressures. For example, it is unlikely that Nike sneakers produced by a factory in America will be less expensive than a similar pair of sneakers produced by an existing factory in Vietnam. Furthermore, there may be a substantial time lag in order to get new American factories up and running smoothly. Earnings are still expected to increase in 2025, according to FactSet, inclusive of the cautious outlook by the bellwether firms alluded to earlier in this report.

Importantly, we expect the Federal Reserve will begin its interest rate easing cycle sometime during the second quarter. Futures markets are expecting the first rate cut of 0.25% to begin in June and are attaching the highest probability of four cuts of 0.25% each to occur by the end of the calendar year. If economic conditions rapidly deteriorate, the Fed may also institute an "emergency" rate cut. Lower short-term interest rates usually reduce financing costs for businesses and consumers. They also tend to improve the net interest margins and lending activities of banks, which are the main conduits of credit in the economy.

We remain optimistic on the ability of AI to improve business productivity, and the current administration's rollback of business regulations appears to be the most aggressive since at least the Reagan Administration. It is not our base case, but we cannot rule out the possibility of a "peace dividend" similar to the Perestroika and Glasnost period of the Soviet Union in the late 1980s if the conflicts in Russia-Ukraine and Israel are resolved in a timely manner. We are not in the bear market or recession camp, although the sizeable tariffs and correction in stock prices have notably increased the odds. A sharply rising unemployment rate or abruptly declining purchasing manager index (PMI) reports may result in a change to our outlook. The recent PMI reports suggest modest expansion and, somewhat paradoxically, there may be a brief surge in Q2 GDP as consumers aim to get ahead of the looming tariffs.

Risks are an inherent part of investing and are managed in part at Beacon through portfolio and time diversification. Stagflation, which results in a declining economy with rising inflation, cannot be ruled out amidst the tariff implementation and uncertainty. A further contraction in the valuation multiple of stocks due to continued declines in consumer confidence is also within the realm of reasonable possibilities. A worsening of the wars in the Middle East and Russia-Ukraine and a further decline in the U.S.-China relationship provide the backdrop for geopolitical risks negatively impacting the financial markets. The long-term problems of the federal debt and deficit will eventually have to be faced in the form of higher taxes and less spending, notwithstanding DOGE's efforts, placing a drag on economic growth. Beacon's entire team of financial professionals remain at your disposal, especially during times of market distress.

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** The source of the investment performance figures is Morningstar.*

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