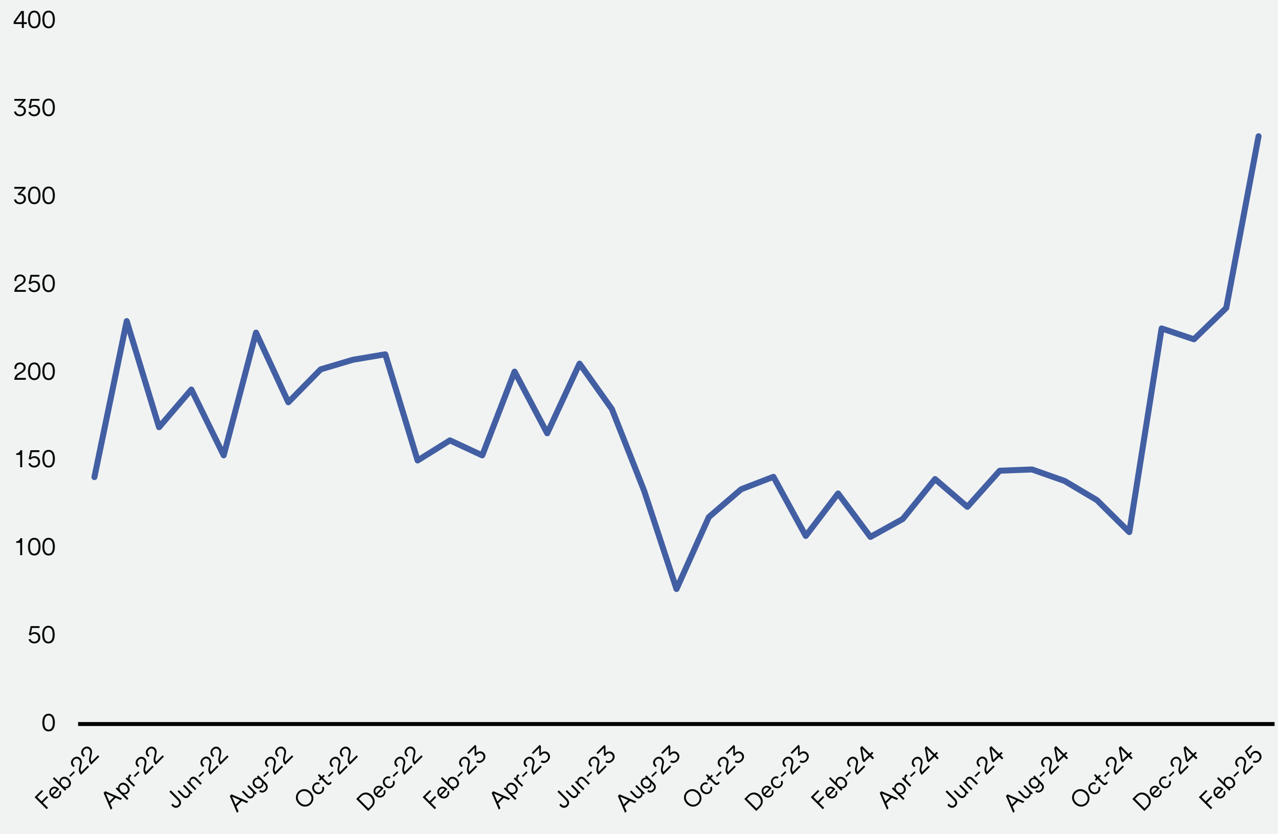
Special Report March 2025

Equity Market Volatility Rises on Uncertainty

After two consecutive years of 25% returns for the S&P 500 in 2023 and 2024, it should perhaps be expected that the sluggish start to 2025 for domestic equities has unnerved investors. While macroeconomic conditions and the corporate earnings environment continue to look decent, there have been two catalysts behind the relatively weak start to the year for domestic equities and the increase in market volatility we have been observing:

- A shift in market focus and attention from the risks of a potentially overheating economy and reaccelerating inflation to economic growth risks
- A notable increase in public policy uncertainty, particularly as it relates to tariff threats

U.S. Economic Policy Uncertainty Index



Source: Bloomberg. https://www.policyuncertainty.com/us_monthly.html

Our Observations

Increased investor uncertainty is often reflected in higher market volatility and frequently accompanied by a rotation in key market leadership. Uncertainty tied to increased risks to economic growth and the path of trade policy has resulted in several notable market developments in the last couple of months:

- Long-term interest rates have rallied since mid-January, with the 10-year Treasury yield dropping more than 50 basis points (bps) and the market increasing expectations for Federal Reserve (Fed) rate cuts over the last few weeks even as the Fed has transitioned to a “wait and see” position on policy.
- The yield curve between 3 months and 10 years has re-inverted, a potential sign of slower economic growth ahead.
- Bonds, particularly long-duration Treasuries, are outperforming domestic equities year-to-date as rates across the yield curve have dropped.
- Value-oriented stocks are outperforming growth-oriented stocks in 2025, driven by defensive sectors of the market such as staples, utilities and healthcare, which are outperforming cyclical sectors such consumer discretionary and financials.
- Investor exuberance over the Magnificent Seven (MAG-7) stocks has abated as developments tied to Chinese Artificial Intelligence (AI) company DeepSeek have introduced caution around aggressive earnings growth expectations and the high valuations of these companies.
- The Nasdaq 100 and Russell 2000 are both down more than 10% from their 52-week highs placing both in market correction territory.
- After consecutive years of underperforming domestic equities, international equities are outperforming so far in 2025 reflecting investor movement away from “priced-for-perfection” U.S. stocks in a higher growth risk environment and due to the aforementioned pullback in MAG-7 stocks.

Our Interpretation

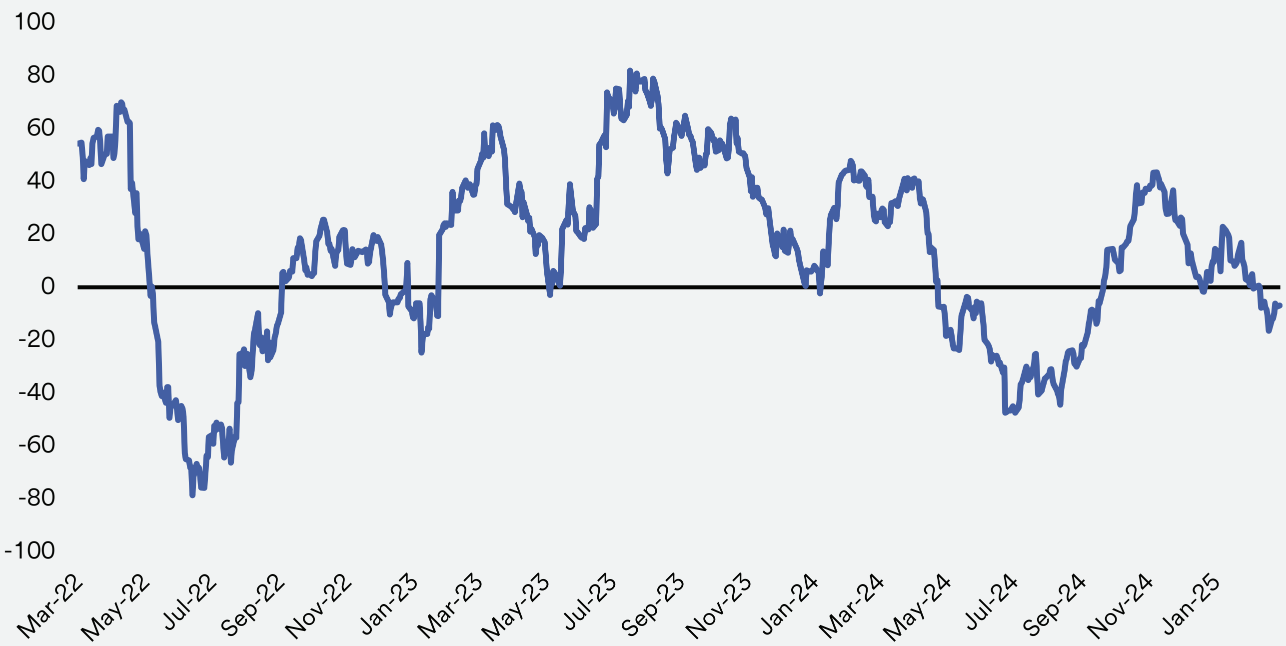
The S&P 500 index hit an all-time high of 6,144 on February 19 and as of March 10 the index is down 8% from this peak, placing this pullback just short of what is considered a market “correction” of -10%. At the same time, average earnings growth estimates for 2025 remain greater than 10% pointing to positive corporate fundamentals. In some sense, the unprecedented back-to-back calendar year returns of ~25% for the S&P 500 in 2023 and 2024 may be making negative year-to-date

returns feel more painful than is reality. However, the underlying changes in market leadership driven by market-perceived economic growth risks and policy uncertainty today are notable and deserve further discussion.

Heading into 2025, the U.S. economy was already exhibiting some pockets of slowing. But consumer activity was unusually robust in Q4, 2024 and was perhaps foreshadowing some giveback in January. Retail sales for January were unexpectedly negative, contracting -0.9% for the month. Recent surveys showing deterioration in consumer confidence and expectations suggests the January pullback was likely driven by more than just a giveback effect, however. While the housing sector has been a weak spot in the economy for some time, housing activity as measured by existing and new home sales has slowed even further in early 2025 as lower housing affordability continues to lock buyers out of the market and limit household-related consumption activity.

While manufacturing has exhibited signs of recent acceleration, as evidenced by the ISM manufacturing index moving into expansion territory (>50.0) in January for the first time in two years, underlying details within the February ISM index revealed softening in new orders, production and employment. The Citi Economic Surprise Index, which measures economic data surprises relative to market expectations has been reflecting some of these decelerating growth trends compared to expectations and aligns with the timing of the financial markets adjusting to higher growth risks.

Citi Economic Surprise Index (U.S.)

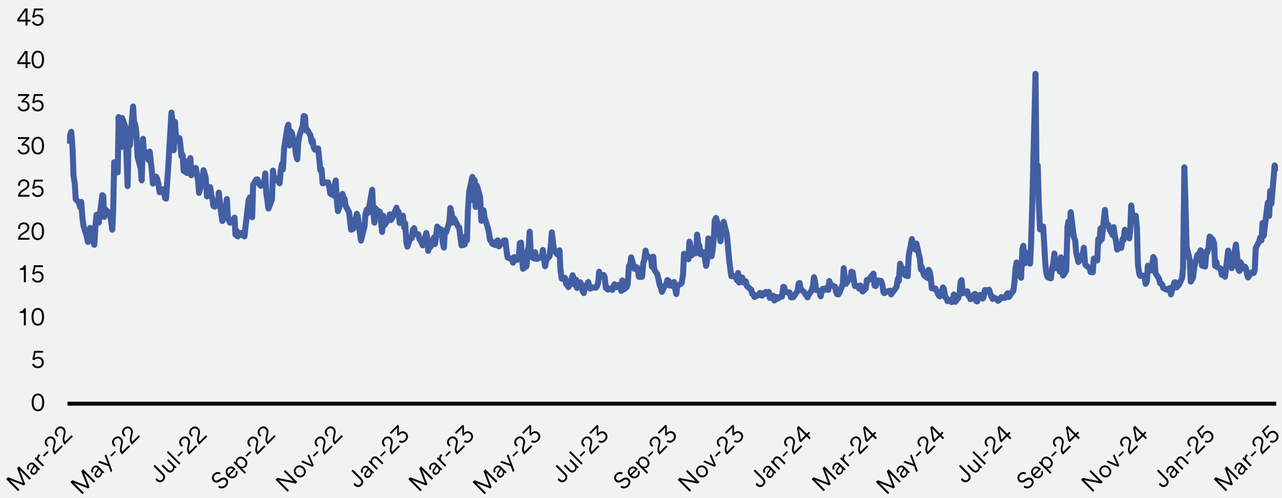


Source: Bloomberg.

Public policy uncertainty, primarily related to trade and tariff policy, has also introduced a higher level of market volatility this year. Anecdotally, in discussions with our corporate clients as well as in business surveys and the Fed's quarterly beige book report, the wide range of potential public policy outcomes and mixed messaging from the Trump administration seems to have frozen many companies from making significant new investment and hiring decisions.

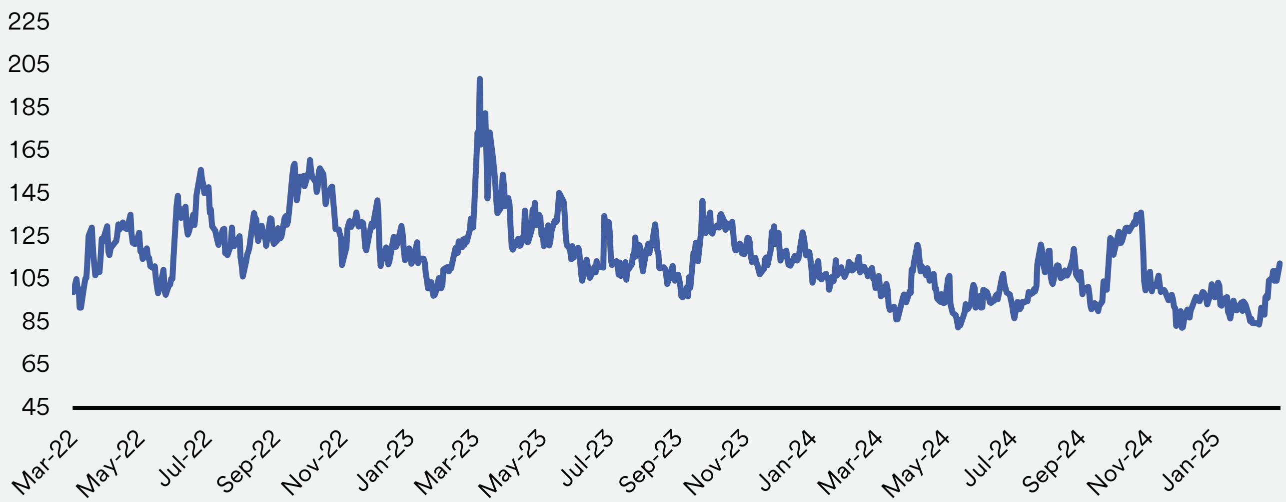
Post-election business sentiment has shifted meaningfully from very positive and optimistic about the prospects for a more business friendly administration, deregulation and lower taxes to sentiment best characterized as uncertain, confused, and frozen in place. This sentiment shift from optimism to high levels of uncertainty explains much of the market volatility we are observing so far in 2025. It will require greater clarity and consistency on policy issues such as trade, the debt ceiling and federal government funding to lift policy risk as a significant market overhang.

VIX Index



Source: Bloomberg. VIX Index measures the expected volatility of S&P 500 Index.

MOVE Index



Source: Bloomberg. MOVE Index measures U.S. bond market volatility.

Concluding Thoughts

While greater volatility and negative domestic equity returns so far in 2025 represent a departure from the investor experience of the prior two years, the significant increase in public policy uncertainty may be making current market conditions appear more dire than they actually are.

According to J.P.Morgan's "Guide to the Markets," over last 45 years, average intra-year declines for S&P 500 (peak to trough, price only) was 14.1%, while annual returns averaged 10.6% over this period. Our modestly positive 2025 outlook for the economy and corporate earnings remains intact, though we acknowledge that growth risks have increased measurably in the last couple of months. Currently, U.S. Bank's Economics Group forecasts economic growth slowing this year but remaining positive with an estimate of 1.8% gross domestic product (GDP) growth for 2025.

The positive growth outlook is supported by:

- Household finances remain generally healthy, and the labor market appears to remain in good shape today, which should continue to support consumption activity that accounts for nearly 70% of annual economic output
- Manufacturing activity has started to reaccelerate, and the onshoring trend in production could lend further support to this important sector of the economy
- Corporate fundamentals continue to look very good with healthy balance sheets, recent strong quarterly sales and earnings growth, and historically high margins with credit spreads remaining relatively tight
- Though recent policy headlines have entailed a negative growth skew, the prospects for favorable policy developments later in the year including in areas of deregulation and further tax cuts remain on the table with potential economic and corporate earnings tailwinds in the near future.

A risk to our positive outlook for some time has been the relatively narrow cohort of upper income households fueling a disproportionate amount of consumer activity in part through wealth-effect spending. The sustainability of strong wealth-effect spending, and consumption patterns across lower- and middle-income households under the strains of stubborn inflation represent key risk factors to our outlook. Additionally, public policy remains very fluid and difficult to predict today. Policy risk — both fiscal and monetary — represents risk to inflation and a positive outlook that is very difficult to handicap at the moment. However, we are monitoring this daily and stand ready to act if necessary.

We are positioned today as risk neutral in portfolios, neither over nor underweighting risk assets relative to client strategic asset allocation targets. As economic and market conditions evolve, and as the public policy landscape changes, we will remain agile and ready to adjust portfolios as we deem prudent.

In the interim, please reach out to your PFMAM relationship manager with any questions.

Sources

https://am.jpmorgan.com/us/en/asset-management/adv/insights/market-insights/guide-to-the-markets/