Composition Wealth

From The CIO's Desk

Market Commentary | Q2 2025

Quarterly Market Perspective

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The U.S. economy began 2025 in favorable shape with conditions fueled by stimulative fiscal spending and strength in consumer expenditures. This evolved in a stark and swift manner during the first quarter as the incoming Trump Administration made immediate and significant announcements and decisions that altered the momentum of the economy. These policies, alongside the publication of DeepSeek's artificial intelligence (AI) capabilities, led investors to reframe their expectations for the momentum of the equity market.

The most notable change in the investment landscape was a transition in market leadership. Whereas investment returns during 2023 and 2024 were dominated by large, U.S. technology stocks, the first quarter of 2025 rewarded parts of the equity market that had been left behind over the last two years. The segment that stood out the most in this regard was international stocks, which gained 5.6% in the first quarter versus a decline of 4.6% for the S&P 500[1].

The dominant contributor of market volatility, which ultimately powered a retrenchment in stock prices, was rhetoric and policy action around tariffs. To explain our interpretation of the Trump administration's tactics, we start by identifying an overarching economic objective to extend the tax breaks enacted through the Tax Cuts and Jobs Act (TCJA) in 2017. To accomplish this in a manner that does not materially disrupt the borrowing costs on U.S. Treasuries, the White House needs to find measures to fund its tax policy. The dominant approaches being pursued are identifying alternative revenue streams, such as tariffs, and extracting spending cuts. Our perception of this playbook is that the first stage is to establish the revenue and expense drivers to justify the financial support for the intended tax policies when they are presented in 2025. This approach creates a dynamic where near-term expectations and economic data may be less desirable. We witnessed this during the first quarter as market participants reacted less favorably to tariffs, with growing concerns that they could constrain economic growth and risk higher inflation. As we get into the back half of 2025, we expect the emphasis will pivot with tax policy taking center stage. This could set the tone for a more constructive market environment with expectations of stimulative tax policies encouraging a more favorable economic backdrop.

In our view, the proposed trade policies most likely constrain economic growth and lead to a resurgence in inflation. The average tariff on U.S. imports is currently 3%. If we consider the tariffs proposed to date, the average tariff rate would rise to closer to 9%[2], which we estimate would reduce GDP by 0.5-1.0%, and have a similar, 0.5% to 1% impact on inflation. The effect on inflation is likely to be a one-time price adjustment, which will play out by exaggerating near-term metrics but taper off quickly. While not optimal in and of themselves, these impacts are not enough to completely derail the economy. The prospective benefits from tariff policies, such as increased investment spending in infrastructure and manufacturing capacity, will take time (years) to prove out.

In his book, *The Yellow Pad: Making Better Decisions in an Uncertain World*, former Treasury Secretary Robert Rubin discusses the importance of not reacting but rather responding to new information. Reacting is immediate while responding allows you time to consider your options before acting. Given the nearly daily rhetoric around tariffs, we believe it's important to be patient and respond rather than react. For example, a 25% tariff has been proposed on goods imported from Canada and Mexico. Given the significance of our trading relationship with both countries, a tariff of this magnitude would be felt across the economy. We don't believe one should react to this announcement, especially since the administration has openly discussed that the proposed tariffs are in response to policy desires to restrict the trafficking of fentanyl across the U.S. border. As such, we will be patient in responding to this policy proposal, given that we see a low likelihood of a 25% tariff being imposed in perpetuity.

We are paying more attention to the potential follow-on impacts of tariffs. For example, the direction of the U.S. dollar will influence the significance of tariff impacts. During the first Trump administration, the increase in tariffs on goods coming from China was largely offset by a stronger dollar and depreciation in the Chinese renminbi. We don't expect a stronger dollar this time around. In fact, during the first quarter, the U.S. dollar depreciated by 3.9%[3]. Second, companies reliant on importing goods may elect to sacrifice profit margins and not pass on the full amount of the tariffs in order to maintain the demand for their product. Companies comprising the S&P 500 are sitting at record levels of profit margins and have room, if they so choose, to accept a higher input cost. This would be a short-term negative for stocks but would be a positive for overall economic conditions.

We saw signs of slowing economic growth as the first quarter played out. Some indicators, such as durable goods orders, housing permits, as well as consumer and business sentiment, soured. Alternatively, several real-time indicators like credit and debit card transactions, manufacturing activity, and employment levels pointed to stability. As we piece these elements together, it appears that individuals and companies have paused large purchases and investment plans, while daily consumption patterns remain within the range of recent trends.

We believe what is currently occurring in the economy is just a pause in activity, particularly with large economic decisions. The longer the uncertainty drags on, however, the more we will begin to worry that the pause in activity may ultimately turn into a cancellation in spending. An additional consideration we are closely watching is spending among higher-income consumers. Over the last two years, higher equity prices and rising home values have resulted in affluent households saving less and spending more. Should markets continue to weaken, we fret that consumer spending may also slow as these households switch to saving more and spending less.

This uncertainty around the evolving economic landscape has driven the pullback in U.S. stock prices during the first quarter. Going into the year, sentiment among investors was stretched as both individual and institutional investors had bullish views and outsized equity positions, especially to U.S. markets. However, as ambiguity sets in, sentiment is shifting and investors are paring back their overallocation to U.S. equities. Putting on a long-term lens, we view the reset in equity prices as healthy given that U.S. stocks had begun the year at above-average valuations. We believe the shift in sentiment is only starting and expect more compelling relative returns out of international equities over the intermediate term. Given this expectation, we added to international allocations where appropriate.

As international stocks have gained momentum, the benefits of diversification have been revalidated. In 2024 the S&P 500 appreciated by 25%, while international stocks rose by just 4%, and taxable bonds up a mere 1%[4]. As the calendar year turned, large-cap U.S. stocks (as exemplified by the S&P 500) lost their luster and finished the first quarter down 4.6%, with international stocks up 5.6% and taxable bonds up 2.1%[5]. While the need for diversification may have been questioned during 2023 and 2024, it has paid off handsomely thus far in 2025, with global portfolios holding up and U.S. centric portfolios experiencing a modest retrenchment.

What transpired in the equity market during the first quarter was part of the natural cycle of the market. From its record high, the S&P 500 experienced a 10.5% correction between February 19th and March 13th[6]. This is not atypical. Research by J.P. Morgan Asset Management points to, on average, equity markets experiencing an intra-year correction of 14.1%[7]. While equity prices have been and likely will continue to have some volatility around them, we take comfort that diversified portfolios are working as expected. The performance of international stocks has decoupled from that of the U.S. stocks. Today, bonds offer reasonable yields and have served as a buffer to returns on days when market sentiment turns negative on the economy. Now is the time to ensure you talk with your advisor about your comfort with risk to ensure you have the right mix of stocks, bonds, and if applicable, alternative investments to weather any more storms ahead.

CONCLUSION

In our previous Market Perspectives, we highlighted our expectations that there would be bouts of volatility given the uncertainty around government policy. This played out during the first quarter, and we don't expect these episodes to end. However, we would view the modest reset in U.S. equity prices as healthy, given the significant move in shares over the past year. Moreover, for many investors, the diversification embedded within their portfolio has proved additive in mitigating any downside risk.

What makes the evolving environment uncomfortable for some is the uncertainty. Given the flood of policy announcements, it's easy to react and focus on the short term. However, our focus remains on the long-term risks and opportunities to help achieve our clients' desired investment outcomes. Given the opaqueness in markets and the economy, we encourage you to engage with us. Please reach out to your Composition Wealth advisor to learn more about how we are assessing how policies and economic conditions may influence your investments and financial planning needs.

1 Source: FactSet. As of March 31, 2025. | 2 Source: Tax Foundation. As of March 25, 2025. https://taxfoundation.org/research/all/federal/trump-tariffs-trade-war/ | 3 Source: FactSet. As of March 31, 2025. | 4 Source: Bloomberg. As of 12/31/24. International stock returned as referenced by the MSCI EAFE Index. Taxable bond returns as referenced by the Bloomberg U.S. Aggregate Index. | 5 Source: FactSet. As of March 31, 2025. | 6 Source: Bloomberg. As of March 31, 2025. | 7 Source: J.P. Morgan Asset Management, Guide to the Markets. Based on the S&P 500, 1980 through 2024.

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