

April 2, 2025

First Quarter Investment Commentary

After two years of stellar returns, the U.S. investment markets have decided to give back some of their recent gains. We are not in bear market territory quite yet, but the risk of a recession, a slowdown in consumer spending and the uncertainty over trade wars and tariffs, has created some market jitters that are raining on the bull market parade.

A breakdown shows that just about every U.S. investment category was showing double-digit gains in the last two years. The Wilshire 5000 Total Market Index—the broadest measure of U.S. stocks—is down 4.84% in the first quarter of the year. The comparable Russell 3000 index lost 4.72%.

Looking at large cap stocks, the Wilshire U.S. 2500 Large Cap index has lost 4.73% of its value in the first quarter. The Russell 1000 large-cap index is down 4.49%, while the widely quoted S&P 500 index of large company stocks fell 4.59%.

Meanwhile, the Russell Midcap Index finished the quarter down 3.40%.

As measured by the Russell 2000 Small-Cap Index, investors in smaller companies are sitting on a 9.48% loss for the quarter. The technology-heavy Nasdaq Composite Index dropped 10.4% in the past three months.

For the first time in many years, foreign markets are outpacing the U.S. equity scene. The broad-based EAFE index of companies in developed foreign economies gained a robust 6.15%, in dollar terms, in the first quarter of 2025. In aggregate, European stocks are up 9.86% so far this year, while EAFE's Far East Index gained a modest 0.35%. Emerging market stocks of less developed countries, as represented by the EAFE EM index, gained 2.41% in dollar terms in the recent quarter.

Real estate securities continue their recent gains. The Wilshire U.S. REIT index has gained 1% so far this year. Commodities returns also gained; the S&P GSCI index posted a 3.35% return in the 1st quarter, riding the new surge in inflation across the economy. Utility stocks, as measured by the S&P 500 Utilities index, rewarded investors with a robust 4.12% gain.

In the bond markets, we are still experiencing the inverted yield curve. Yields on 30-year government bonds are holding steady at 4.52%; 10-year maturities are yielding 4.16% and 5-year Treasuries yield 3.90% currently. But investors can get higher yields in 3-month issues (4.29%), and 6-month (4.20%) issues. Five-year municipal bonds are yielding 2.87% in aggregate, while 1-year municipal bonds are yielding 2.56%.

What's going on? It's fair to wonder whether U.S. companies, in aggregate, were 40% more valuable at the start of the year than they were two years ago, before the extraordinary two-year run. It's possible that traders were overestimating how much to pay for a dollar of earnings, bidding the price-to-earnings ratio up to nearly 30—very high by historical standards.

Overall earnings are still strong, but future earnings will depend on willing spenders for goods and services. The traditional measure of consumer confidence have declined for the past few months, and this new thriftier attitude is starting to show up in a slowdown in consumer spending—up just 0.1% in February.

The old saying, mostly true, is that markets hate uncertainty, and rarely have we seen more of that than in the back-and-forth promises of tariffs imposed, revoked, discussed, negotiated by the largest trading partner in the world. Tariffs represent a friction on global commerce, particularly manufacturers who assemble products here in the U.S. from components made elsewhere in the world. Nobody knows yet how these tax surcharges will be imposed, but economists and the press are clearly anticipating higher costs, and therefore higher prices, and therefore lower sales volumes--and potentially also lower profits as companies absorb the additional costs.

And, of course, the tariff highway is a two-way street. Economies around the world are mulling reciprocal tariffs in what could become an escalating tit-for-tat trade war, without any clear end point to the tats until somebody blinks.

Short-term, and sometimes longer-term market movements are driven by what economists delicately call 'sentiment,' which simply means what investors are willing to pay more (a bull market) or less (a bear) for companies and their earning potential. When the earning potential comes into question, there can be a retreat to the sidelines.

Of course, uncertainty cuts both ways. If the actual impact of the tariffs turns out to be less than expected, or if the tariffs are negotiated down, or if they prove to be beneficial in the short-term (a boom in facility construction in the U.S., or a shortening of supply chains) the abundance mentality could return. (Economists are already speculating about a 'relief rally' if the trade wars are called off.)

It's worth noting that the threat of a trade war seems to have benefited non-U.S. stocks, particularly in Europe, which is now in a bullish phase and whose markets are outpacing the American ones. The two markets were due for a reversal, but what we are experiencing is extraordinary--a sign that investors are less worried about the tariff impact on European companies than on American ones.

The so-called experts in the markets were extremely bullish just a month or two ago, and now, suddenly, they're sounding downright bearish. The consensus forecast at Goldman Sachs was for the S&P 500 to reach 6,500 by the end of the year. That was scaled back earlier this month to a still bullish 6,200. Now? The projection is 5,700, and we probably have another backtrack or two in store.

The point: when the markets are soaring, the pundits tend to predict more of the same. When the markets are down, they do the same thing. Extrapolating from the recent past is not a prediction; it is clearly guessing, and perhaps pandering to the mood of the moment. Nobody, no matter how many fancy data-crunching engines sit on their desk, can predict the future, and everybody is subject to being swayed by the bullish or bearish crosswinds.

The best course has always been to ignore the predictions, positive or negative, and manage your own sentiment through the choppy investing ride that we're experiencing. The alternative is to pull out of the markets into safe assets that are guaranteed to lose value due to inflation. The threats are real, the uncertainties are always with us, and through it all, patient investors have always been rewarded in time.

Why would the future be any different?

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