Review & Outlook

FIRST QUARTER 2025

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Review and Outlook

Over the past several quarters, we've written often about a surprisingly resilient U.S. economy that saw steady growth driven by consumer spending, despite the fact that inflation was slow to subside. But those days are gone. Looking back over the first quarter of 2025, we see a blur of policy changes, growing uncertainty, and a slowing economy.

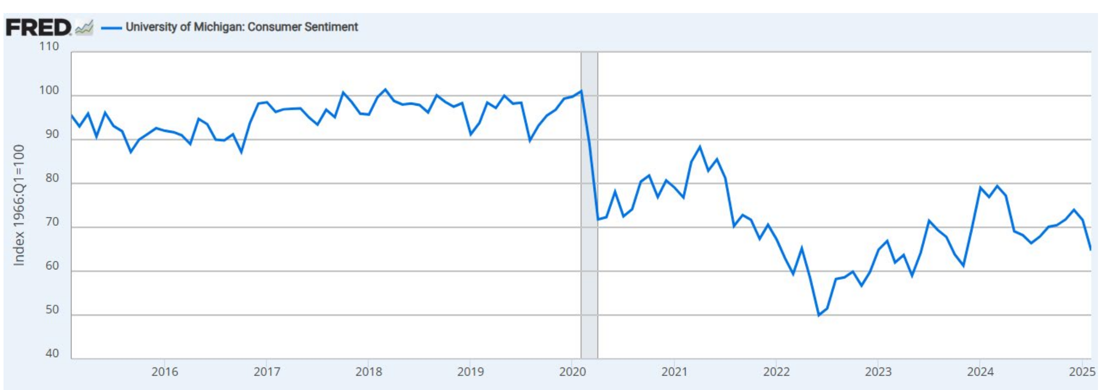
The S&P 500 is down roughly 7.5% since the start of the year, and the S&P 600, which tracks the stock prices of smaller companies, is down about 12%. Notably, both indexes increased from January 1st through mid-February, but the drop in the last half of the quarter has been rather steep, softened somewhat by a small bump at the end of March.

Index Performance Data
Total Return as of 3/31/2025

Indices[1]	Q1 2025	Trailing 12 Months
CRSP U.S. Total Market Index Total Return	-4.82%	7.09%
iShares MSCI ACWI EX-US Total Return	6.31%	3.86%
Bloomberg U.S. Aggregate Bond Index	2.78%	4.88%

The best estimates for current economic activity have been falling along with the stock market. In January, S&P Global Market Intelligence estimated that GDP would grow at an annualize rate of 2%, or slightly more, during the first quarter of 2025. By late March, that estimate had fallen to just over 1%. The Federal Reserve Bank in Atlanta has one model that indicates that the U.S. economy is currently contracting; and after seeing disinflation for much of 2024, the rate of inflation has stopped slowing in 2025. Further, inflation forecasts have spiked higher than what was forecast at the peak of the inflation experienced in 2021 and 2022.

The current administration's rather chaotic tariff policies are the main driver behind the uncertainty and slowing activity. This past quarter, the Trump Administration imposed 25% tariffs on steel and aluminum, 25% tariffs on goods imported from Canada and Mexico (though some goods have been exempted), and 20% tariffs on imports from China. On April 2nd, the Trump administration announced massive tariff hikes on countries around the world. Financial markets tumbled the next day, and forecasts began to include commentary surrounding U.S. and global recession. It is expected there will be continued uncertainty as countries try to negotiate a mix of concessions and counter tariffs.

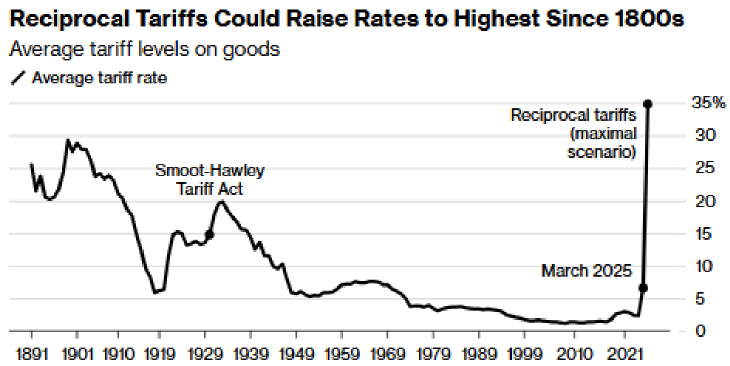


This uncertainty makes economic forecasting extremely difficult. As of March 31st, Goldman Sachs forecast little GDP growth for the rest of 2025, expecting 0.0 to 0.2%.[2] However, IHS Market Insights anticipates stronger growth of 2.2% in 2025, slowing to 1.9 or 1.8% in subsequent years. They also call for inflation to stay above the Federal Reserve's target of 2% until 2027 or 2028.[3] And almost all forecasts call for unemployment to stay below 5% for the foreseeable future.

A key leading economic indicator is consumer sentiment. Consumer sentiment is falling, and that's a worrisome sign given the key role that consumer spending has played in the economy over the past 12-24 months.[4] Consumer spending fell in January, then had a smaller than expected rebound in February. But the question is, "What happens next?"

We imagine consumer spending may rebound a bit in March, as we see people "buying ahead" to avoid tariffs. For example, people who were thinking about buying a car in the next year or two are buying them now so they won't have to pay a higher price due to the tariffs that are planned for April. We also see a lot of companies purchasing steel and aluminum ahead of the tariffs. When we think what's to come, we wonder about April and May. Will the Trump Administration roll back some of the tariffs to increase consumer confidence? Or will the tariffs remain, slowing economic activity as spending and investment decisions are put on hold?

The chart on Page 2 puts current U.S. tariff policy in historical context.[5] At the end of 2024, there was talk about record breaking profit margins and earnings growth, perhaps even 14-15%. Strong earnings growth was a large part of the story behind the very good performance equities had last year. And there was hope at the end of 2024 and very early in 2025 that a business-friendly administration would allow robust returns to continue, aided by tax cuts. But tariffs have thrown a spanner in the works, adding to the cost of goods purchased, and creating uncertainty for many businesses. Forecasts for profit margins are falling, with all the major indexes falling as well. Retailers from Target to Lululemon have said they expect sales to be much lower in 2025, and their stock price has fallen as a result.



Source: US ITC, Customs, Census Bureau, Bloomberg Economics
Note: March 2025 figure includes tariffs on China, aluminum, steel, and non-USMCA-compliant Mexico and Canada. Bloomberg Economics' maximal reciprocal tariff estimate includes non-trade barriers, VAT and other grievances. Estimates based on 2024 trade composition.

In Focus

It is tempting to focus on whether the tariffs and threats are likely to achieve their stated purpose, which Bloomberg News recently referred to as "The Impossible Trinity at the Heart of US Tariffs."[6] The trinity in this case refers to the Trump Administration's goal of generating significant revenue to reduce the U.S. debt, incentivizing the reshoring of manufacturing, and meeting other foreign policy objectives. Most economists view these goals as incompatible with each other, as the idea that tariffs will generate much revenue requires some fanciful math. U.S. consumers and businesses are the ones who actually pay tariffs, which are essentially a tax on consumption. So, higher tariffs can mean lower consumption due to rising prices.

Whether the tariffs might bring about a significant amount of reshoring or a renaissance in manufacturing is a complicated issue. Any business thinking of building a manufacturing facility in the U.S. to avoid tariffs would need to believe that the tariffs are permanent, and that other factors also suggest such a strategic decision makes sense. If the goal of reshoring manufacturing is to increase manufacturing jobs, this will likely be diminished by highly automated factories. A likely consequence of the newly implemented tariffs is a global reorganization of trade. Due to the tariffs, Japan is already working with countries they previously avoided, having recently met for discussions with South Korea and China. And Canada is exploring options for exporting its oil to countries other than the U.S.

Further, by implementing these new tariffs, the U.S. is ignoring previously negotiated trade agreements, including the USMCA with Canada and Mexico, which was negotiated by the first Trump administration. This is significant because if the U.S. is seen by other countries as an unreliable trading partner, those countries will look elsewhere to diversify.

One outcome looking more and more likely is the re-emergence of stagflation, which is when there is both a slowing economy and rising prices (inflation). At one point, economists thought stagflation impossible, but that was disproved in the 1970s, during periods when oil prices rose significantly. The Financial Times estimates that the Trump Administration's tariffs on Mexican and Canadian imports will result in lower imports and exports overall, and in lower income for all three countries. The current administration seems to be betting that Mexico and Canada will capitulate to U.S. demands (which are not clear at this time) because the drop in income per capita would be larger in those countries. The Financial Times model also shows that the impacts worsen as countries retaliate and reciprocal tariffs take effect. Mexico and Canada could suffer larger income declines, but the U.S. would experience the greatest inflationary impact. And some countries would be disproportionately impacted, like Ireland, which relies heavily on income from exporting pharmaceuticals to the U.S., but does not import a significant number of U.S. goods.[7]

When we consider the Trump Administration's immigration policies alongside the new tariffs, there is more reason to think that growth will slow and that prices will rise. Deportations and new hurdles for legal immigration can reduce growth in labor productivity. Slower growth in productivity means slower growth overall, and lower productivity will result in increased domestic production costs.

Stagflation is a two-headed monster for policy makers. While raising interest rates can help fight inflation, it can also precipitate lower economic growth. At the same time, fighting lower economic growth with stimulative policies is likely to stoke inflation. So, policymakers are stuck with the decision to deal with one problem while likely making the other one worse.

As we see increasing signs that the U.S. is entering a period of stagflation, we remain cautious with our allocation to equities. The Federal Reserve will likely lower short-term interest rates as the economy slows, but will likely be slower than ideal as inflation persists. The advantage to holding an overweight position of short-term fixed income is that it can still generate some interest income, while providing liquidity to buy back into the market as reasonable opportunities emerge. We are keeping a close eye on the economy and the financial markets going into the second quarter of 2025.

1. Index performance data provided by ICE Data Services, and calculated by Black Diamond, an SS&C Advent company.
2. Scott, M. (2025, March 30). Goldman Sees More Fed Cuts This Year as Tariffs Dent Growth. Bloomberg.com. https://www.bloomberg.com/news/articles/2025-03-30/goldman-sees-more-fed-cuts-this-year-as-tariffs-dent-us-growth
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4. University of Michigan: Consumer Sentiment. Federal Reserve Bank of St. Louis. (2025, March 28). https://fred.stlouisfed.org/series/UMCSENT/
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6. Burgess, R. (2025, March 31). The Impossible Trinity at the Heart of US Tariffs. Bloomberg.com. https://www.bloomberg.com/opinion/articles/2025-03-31/the-impossible-trinity-at-the-heart-of-us-tariffs
7. Burgess, R. (2025, March 31). The Impossible Trinity at the Heart of US Tariffs. Bloomberg.com. https://www.bloomberg.com/opinion/articles/2025-03-31/the-impossible-trinity-at-the-heart-of-us-tariffs