Q1 Review & Outlook

April 2025

ELEMENT	TREND	COMMENTS
VALUATION	Positive	Valuations remain elevated, but they have declined.
INTEREST RATES	Neutral	Short-term rates are poised to decline even as long-term rates rise.
INFLATION	Neutral	Inflation is lower, though the outlook has become murkier.
VOLATILITY	Negative	Price volatility has increased significantly.
MONETARY POLICY	Positive	The Fed will continue to cut rates, though the pace is uncertain.
DOMESTIC POLICY	Neutral	Tariffs and uncertainty offsetting deregulation.
GEOPOLITICAL	Negative	Tariffs will impact global trade; U.S. international relations strained.

Tune Out The Noise

In the wake of the Great Financial Crisis, the genre of the financial documentary or financial drama entered something of a golden age. Films such as *Margin Call* and *Inside Job* tapped into public distrust of big banks and public distaste for government bailouts. There's also *Too Big To Fail*, *Betting On Zero* (my personal favorite) and *The Big Short*, based on Michael Lewis's book of the same name. There's a new one out, directed by the renowned documentarian Errol Morris, that could not have come at a more opportune time.

Tune Out The Noise, about how a group of young academics who turned the asset management world on its ear when it embraced a crazy idea that markets were largely efficient, is worth the price of admission, which happens to be zero; it is available on YouTube for free because it doubles as an infomercial for Dimensional Fund Advisors, the investment firm these academics founded. Advertisement or not, it is well worth watching, especially given how noisy the last few weeks have been in financial markets.

The general idea is this—one should assume that markets are efficient and acknowledge that while there are factors that can be employed to boost long-term performance, trying to outguess the market over the long haul is a fool's errand. Instead, it's best to let the market work for you and not against you, accepting the risk of owning stocks in exchange for the return of owning stocks over the long term.

The Noise

Since the Great Financial Crisis of 2008, and perhaps the global pandemic of 2020, there has been no better time to remember this lesson about owning stocks than the last several weeks. After quite a pleasant January, market volatility began creeping higher in February, following the administration's February 1 implementation of a 25% tariff on all goods from Mexico and Canada and a 10% tariff on Chinese imports. The tariffs on our neighbors turned out to be tiddlywinks compared to what followed.

After tariffs on Chinese imports went up by another 10% on March 4, the main event was April 2, "Liberation Day," as it were, with a 10% universal import tariff on all goods entering the U.S. and higher "reciprocal" tariffs announced for 57 countries, effective April 9. In the days that followed, markets went into a free fall, at one point, with the S&P 500 down 19% on the year. China retaliated with its own tariffs, and the U.S. instituted new tariffs on China totaling 145%.

The "reciprocal" tariff rates appeared to be based on a formula derived from trade deficits and not directly in response to existing tariffs, which produced reciprocal tariff rates that far exceeded investor expectations.

Then, just when it seemed the world was losing its mind, the administration agreed to a 90-day tariff suspension for all countries except China, resulting in a 9.5% rally in the S&P 500, the biggest one-day rally since October 2008.

While the markets are still lower than where they were on "Liberation Day," it seems as though Financial Armageddon has been postponed for at least 90 days anyhow. Even so, for active traders attempting to handicap what markets would do next, there had already been numerous opportunities to make major portfolio mistakes.

Reality Bites

Markets finished the first quarter on a down note, and then the tariff shenanigans began in earnest in April. Global stocks were down 1.3% for the quarter but have fallen further this month, down 5.6% as of April 11. The S&P 500 was off 4.3% for the first quarter, but those losses had effectively doubled by the 11th to 8.5%. Small caps and growth stocks have been the hardest hit, as markets bake in lower growth for most companies and less liquidity for smaller companies specifically. Stocks outside the U.S. were the best performers amid the tumult.

Global Equity Index Performance

	1Q24	2Q24	3Q24	4Q24	2024	Jan.	Feb.	March	1Q25	YTD
MSCI All Country World	8.2	2.9	6.6	-1	17.5	3.4	-0.6	-4	-1.3	-5.6
S&P 500	10.6	4.3	5.9	2.4	25	2.8	-1.3	-5.6	-4.3	-8.5
DJIA	6.1	-1.3	8.7	0.9	15	4.8	-1.4	-4.1	-0.9	-5
NASDAQ	9.3	8.5	2.8	6.4	29.6	1.7	-3.9	-8.1	-10.3	-13.2
Russell 2000	5.2	-3.3	9.3	0.3	11.5	2.6	-5.4	-6.8	-9.5	-16.3
Russell 2000 Value	2.6	-3.7	10.1	-1.1	7.6	2	-3.8	-6	-7.7	-16.1
Russell 2000 Growth	7.5	-2.9	8.4	1.7	15	3.2	-6.8	-7.5	-11.1	-16.5
Russell 3000	10	3.2	6.2	2.6	23.8	3.2	-1.9	-5.8	-4.7	-9.2
Russell 3000 Value	8.6	-2.3	9.5	-2	14	4.5	0.2	-2.9	1.6	-4.9
Russell 3000 Growth	11.2	7.8	3.4	6.8	32.4	2	-3.7	-8.4	-10	-12.7

Source: Bloomberg, Trust Company of the South

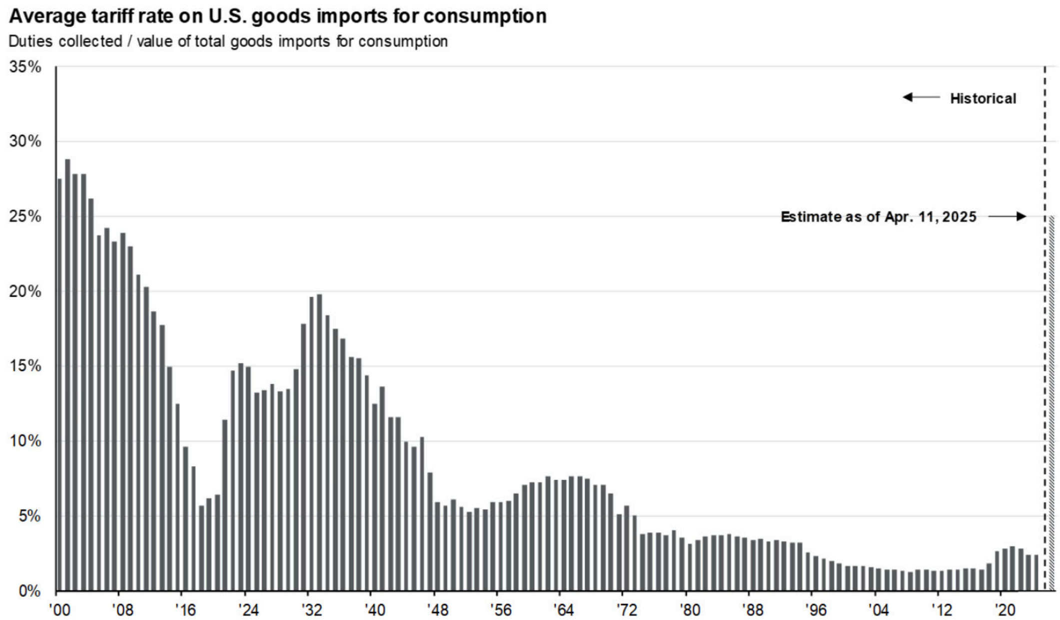
*MSCI ACWI ex USA Net Total Return USD Index

** Through April 11

Many countries use selective tariffs and other trade barriers to protect specific industries for political or national security reasons. Japan protects its rice growers using tariffs and other measures that discourage imports. Europe also has long used quotas and tariffs on agricultural imports. The U.S. has generally kept import tariffs fairly low. There have been some exceptions, such as President Reagan imposing a steep, temporary tariff on imported motorcycles in order to help Harley-Davidson avoid bankruptcy back in the 1980s.

These sorts of limited tariffs are one thing; what is being contemplated today, which amounts to major reconstructive surgery on the global economy, is another. While perhaps well-intentioned, tariffs are taxes that result in higher prices, lower growth and fewer choices. That's just reality. Markets generally do a far better job of allocating resources than governments do. Reagan himself famously quipped that "The nine most terrifying words in the English language are: I'm from the government, and I'm here to help!" Ironically, tariffs and trade restrictions played a huge role in the lead-up to the American Revolution.

Figure 1: Tariffs on U.S. Imports



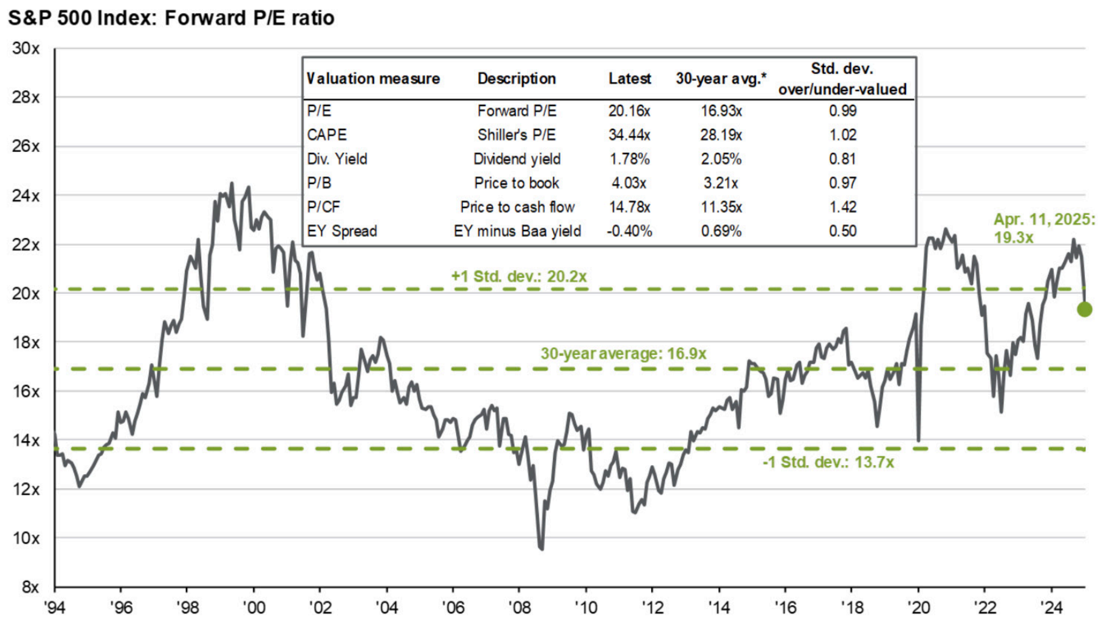
Source: Goldman Sachs Investment Research, United States International Trade Commission, J.P. Morgan Asset Management. For illustrative purposes only. Estimates about which goods are USMCA compliant come from Goldman Sachs Investment Research. Imports for consumption: goods brought into a country for direct use or sale in the domestic market. The estimate does not consider non-tariff barriers, such as value-added taxes. Figures are based on 2024 import levels and assume no change in demand due to tariff increases. Forecasts are based on current data and assumptions about future economic conditions. Actual results may differ materially due to changes in economic, market, and other conditions.

Guide to the Markets – U.S. Data are as of April 11, 2025.

So, we would like to be on the record as being anti-tariff. Tariffs will negatively impact economic growth, and while the economy and the market are not the same thing, they are correlated. Protectionism only protects consumers from low prices and maximum choice, as it offsets comparative advantages that maximize economic growth. To paraphrase Howard Marks in a recent interview with Bloomberg Television, and at risk of being slightly politically incorrect, the world is a better place when the Italians make the pasta and the Swiss make the watches.

High global tariffs would severely impact global economic growth and would negatively impact the prices of most financial assets. What makes this particularly concerning is that prior to the tariff tantrum, equity markets, especially in the U.S., were priced for continued strong growth. The S&P 500 had been trading north of 20x forward earnings, well above the long-term average of about 17x. A question worth asking is, if the average was 17x in a world largely without tariffs, what does the market pay for a world with high tariffs? Stocks could move well lower from here, no doubt, unless these tariffs are modified or eliminated.

Figure 2: S&P 500 Valuation Measures



Source: FactSet, FRB, Refinitiv Datastream, Robert Shiller, Standard & Poor's, Thomson Reuters, J.P. Morgan Asset Management.

Price-to-earnings is price divided by consensus analyst estimates of earnings per share for the next 12 months as provided by IBES since March 1994 and by FactSet since January 2022. Average P/E and standard deviations are calculated using 30 years of history. Shiller's P/E uses trailing 10-years of inflation-adjusted earnings as reported by companies. Dividend yield is calculated as the next 12-months consensus dividend divided by most recent price. Price-to-book ratio is the price divided by book value per share. Price-to-cash flow is price divided by NTM cash flow. EY minus Baa yield is the forward earnings yield (consensus analyst estimates of EPS over the next 12 months divided by price) minus the Bloomberg US corporate Baa yield since December 2008 and interpolated using the Moody's Baa seasoned corporate bond yield for values beforehand. Std. dev. over-/under-valued is calculated using the average and standard deviation over 30 years for each measure. *Averages and standard deviations for dividend yield and P/CF are since November 1995 due to data availability.

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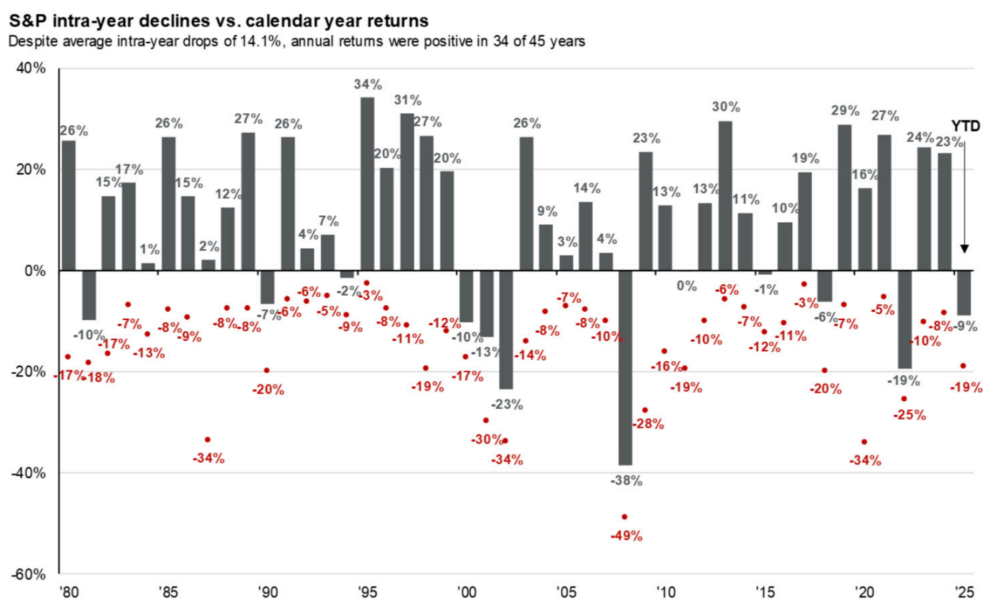
And that's where it gets tricky because we don't know to what extent they will be changed. The chaotic nature of the tariff roll-out adds to the risk premium that the markets are charging for equity ownership, but that is actually a positive for long-term investors. There's a lot of potential for self-correction at work here; if the tariffs remain long enough to produce economic self-harm, they won't last much longer in a republic. As Winston Churchill observed, "You can always count on Americans to do the right thing, after they've tried everything else."

Plot Twist

But our stance on tariffs and economics does not make us less likely to own stocks; in fact, just the opposite is true. That's because it will be markets, however impugned and maligned, that will get us through this episode.

First, even though the volatility of the tariff tantrum was the highest since 2020, and the sell-off was gut-wrenching for several days, the market's powerful rally demonstrated that, on the most fundamental basis, demand for shares of publicly traded companies is strong. One of my favorite market sayings is that bear markets are when stocks are returned to their rightful owners. Even though the recent drawdown was painful, it wasn't even that abnormal. Going back 45 years, the S&P 500 has experienced an average annual intra-year drawdown of 14%. What's more, annual returns have been positive in 34 of those 45 years.

Figure 3: Annual Returns and Intra-Year Declines



Source: FactSet, Standard & Poor's, J.P. Morgan Asset Management.

Returns are based on price index only and do not include dividends. Intra-year drops refers to the largest market drops from a peak to a trough during the year. For illustrative purposes only. Returns shown are calendar year returns from 1980 to 2024, over which the average annual return was 10.6%.

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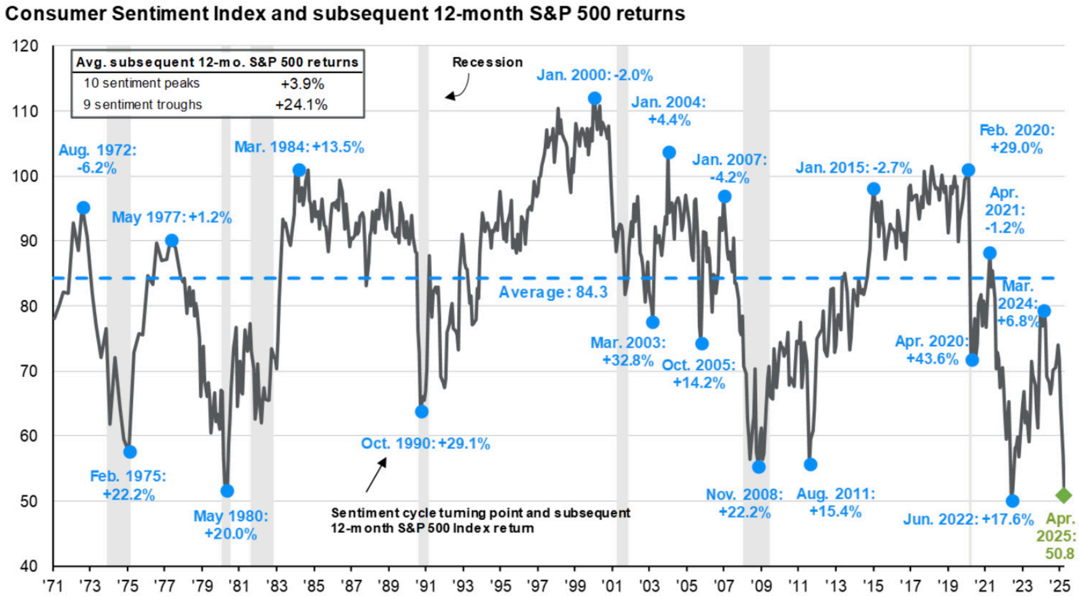
Second, as valuations fall and sentiment deteriorates, expected future returns rise. Valuations have not even fallen that much, but the more they do, the better off long-term investors will be going forward. Consumer sentiment and stock market returns are not positively correlated; they are inversely correlated. So, the fact that the University of Michigan Consumer Sentiment

Index reading plummeted to one of its lowest readings in its history shows true trepidation among consumers, but it is not terrible news for stocks.

Figure 4: Consumer Confidence and the Stock Market



Source: FactSet, Standard & Poor's, University of Michigan, J.P. Morgan Asset Management.

Peak is defined as the highest index value before a series of lower lows, while a trough is defined as the lowest index value before a series of higher highs. Subsequent 12-month S&P 500 returns are price returns only starting from the end of the month and excluding dividends. Past performance is not a reliable indicator of current and future results.

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None of this is to diminish the real fear that gripped markets just days ago, but it's generally a better idea for queasy investors to revisit how much they can allocate to stocks and still achieve their goals vs. trying to time the market and waiting for the all-clear. By then, the best opportunities will likely have passed, hurting long-term performance. It's also a good time to consider what's happening overseas; while international markets have also been volatile, they have not been as volatile as the U.S., and with the US dollar weakening a bit, having a healthy allocation to international equities has proven to be valuable diversification.

Film Premiere or Rerun?

The global financial system has not been forced to endure a meaningful trade war in many years, and we cannot be assured of the outcome. Will the U.S. dollar lose its global reserve status as a result? Will the Chinese government, under severe financial pressure, rationalize an invasion of Taiwan? Who can say? Are these events possible? Sure, but perhaps not probable.

Amid the uncertainty, the best way to handicap the chances of these events, or any other events occurring, is to let the market set the odds.

While the markets may not have had to contend with a trade war in a long time, markets contend with uncertainty all the time—uncertainty is the very reason markets exist. So, while the episode on Trade Wars might seem like an exciting world premiere, the reality is that conflict and uncertainty are at the heart of every good film. The world may have temporarily forgotten about the price elasticity of demand, but it will remember soon enough.

Until then, tune out the noise.

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