INVESTMENT OUTLOOK

A PEAPACK PRIVATE PUBLICATION

FIRST QUARTER 2025: HIC SUNT LEONES (HERE BE LIONS)

Courage consists not in blindly overlooking danger, but in seeing it, and conquering it.
-Jean Paul

There are places that are too dangerous to go to. The ancient Roman and medieval cartographers indicated unknown and unexplored regions by writing in the margin of their maps, “hic sunt leones.” They were conveying the danger, even the terror, of *terra incognita*—or, worse yet, the risk that intrepid seamen could sail off the edge of the (flat) earth.

The ancient Greeks, too, were wary of dangerous places. Odysseus, knowing the temptations of the Sirens, whose irresistible song lured sailors to their deaths, had himself tied to his ship’s mast so that he could listen to their song without succumbing to its fatal allure.

In contemporary culture, the dangerous place to venture into, in polite discourse, of course, is politics. A place we’re told not to go. In today’s fractured American society, it’s a particularly fraught zone.

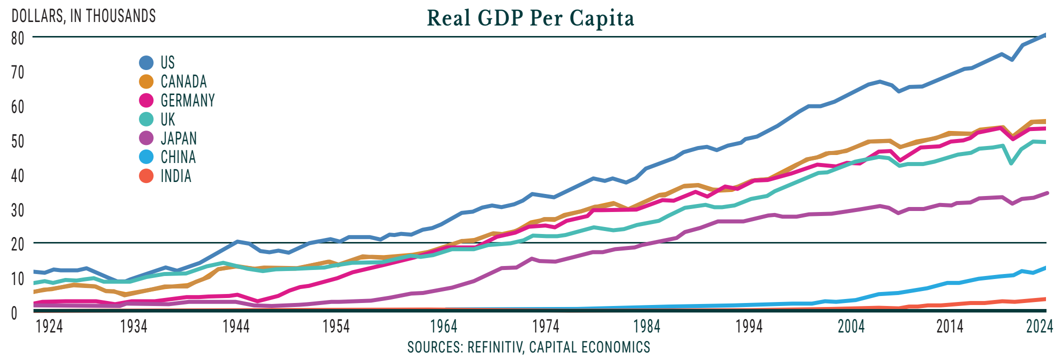
And yet. Some things cannot be avoided. The remaking, not to say disruption, of the world order is having profound effects in all realms, not least the investing world, and we cannot review the economic and investment landscape without ‘going there.’

REVISITING AMERICAN EXCEPTIONALISM

It's a special place, and I believe in the prominence of America,
and having America be and continue to be an exceptional place,
and making no apologies for America being a superpower.
-Ileana Ros-Lehtinen

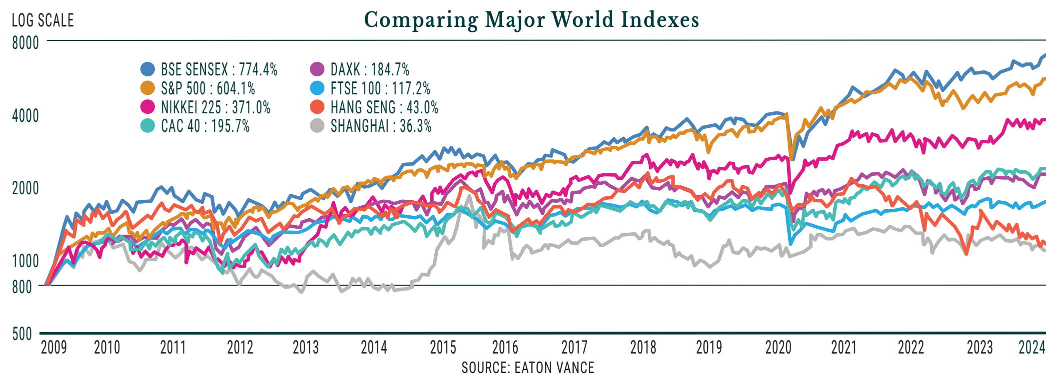
For at least two years, the dominant narrative in the investment universe has been the appropriation of the political science term American exceptionalism, referring to the concept that the US is distinctive, even unique, in comparison with other nations. Elements of American exceptionalism include personal liberty, individualism, self-reliance, laissez-faire economics, and meritocracy. For some, it also embraces moral superiority of the US.

Applied to business and finance, American exceptionalism refers to the relative out-performance of the US economy and stock market, compared to other developed nations. And there is some validity to the perception that the US has been a nation of extraordinary, even unique, economic dynamism.



The graphic above reflects the superior growth exhibited by the US economy compared with both developed and emerging markets economies. The more rapid US expansion is evident in more recent decades as well as early in the twentieth century.

The application of American exceptionalism to economics and finance incorporates the view that the rule of law, a culture of self-reliance, smaller government, and less regulation underpin more innovation and faster economic growth. Some of that innovation is evidenced in the more advanced and globally dominant technology and healthcare sectors. Those outcomes, in turn, have led to higher corporate profits and superior stock market appreciation. The chart below appears to affirm this narrative: the Indian stock market is the only one that has, and only recently, out-paced the US stock market.



A TREND DISRUPTED

The only constant is change.
-Heraclitus

As noted, the narrative of American exceptionalism attracted new adherents over the last two years, as the technology-dominated US stock market, stoked by artificial intelligence (AI) enthusiasm, trounced most other world stock markets.

However, in an utter reversal from the past two years, US equities' returns in the first quarter were exceptionally weak relative to overseas equities:

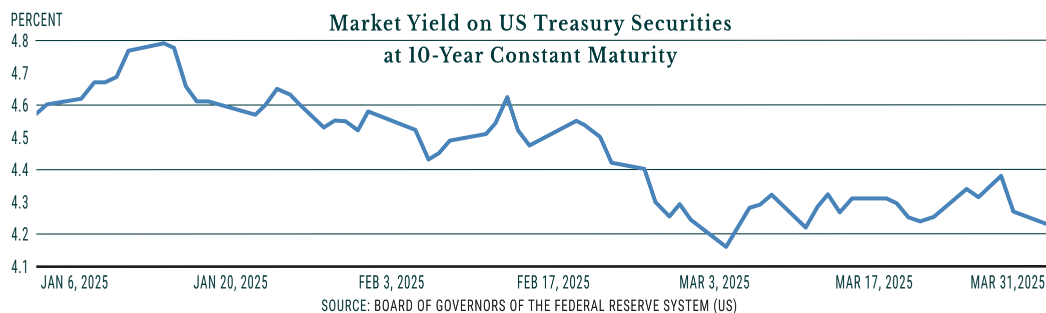
Asset Class	Index	1st Quarter Returns
US Large Cap Stocks	S&P 500 Total Return	-4.3%
US Large Cap Stocks	S&P 500 Equal Weighted	-0.6%
US Large Cap Stocks	NASDAQ Composite	-10.3%
US Small-Mid Cap Stocks	Russell 2500	-7.5%
International Developed Markets Stocks	MSCI EAFE	6.9%
Emerging Markets Stocks	MSCI EM	2.9%
Real Estate Securities	MSCI US REIT	1.1%
Commodities	Bloomberg Commodities Futures	8.9%
Bonds	Bloomberg Barclays US Aggregate	2.8%
Cash	FTSE USBIG 1-Month Treasury Bill	1.1%

SOURCES: THE WALL STREET JOURNAL, STANDARDANDPOORS.COM, FTSE, MSCI, BLOOMBERG

The burst of enthusiasm for domestic equities that began in October, driven by the initial enthusiasm for an anticipated pro-business, pro-growth second Trump Administration, gave way during the first quarter to concerns about the potential economic effects of proposed trade and immigration policies. Particularly hard hit were large cap technology growth stocks—the so-called Magnificent 7 stocks declined 15%, and the technology-heavy NASDAQ index was off 10%.

By contrast, international markets generated attractive returns. More accommodative fiscal and monetary policies and US dollar weakness helped drive strong appreciation in overseas markets.

Bonds turned in positive results too, as investors, anticipating a slowdown in the US economy, sent yields lower and bond prices higher. The yield on the 10-year US Treasury declined by 35 basis points (0.35%) during the first quarter.



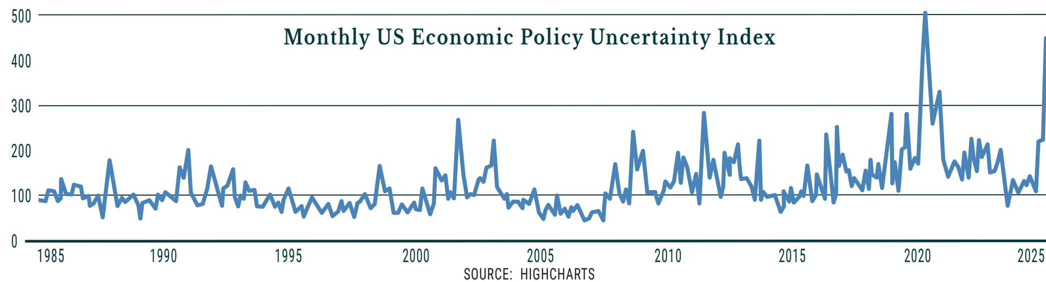
SOURCE: BOARD OF GOVERNORS OF THE FEDERAL RESERVE SYSTEM (US)

The surge in commodities was driven by precious metals. Gold rallied 19% in the first quarter, reaching record high prices. In the energy space, natural gas rose 13%; crude oil was essentially unchanged.

WHAT'S WEIGHING ON MARKETS?

We sail within a vast sphere, ever drifting in uncertainty, driven from end to end.
-Blaise Pascal

In a word, uncertainty.



SOURCE: HIGHCHARTS

As the chart above indicates, US economy policy uncertainty is elevated, at the highest level it has been over the past 40 years other than during the pandemic. It is hard to avoid attributing this policy uncertainty, at least in part, to the mercurial, start-stop, ever-shifting proposed trade policies announced by the Trump Administration. Additionally, while there has been a flurry of executive orders coming out of the White House, a number of them have been challenged in the courts, resulting in injunctions which put those orders on pause.

Policy uncertainty is, of course, not the only issue weighing on investors' minds. The Trump Administration's initial priorities—immigration and trade—are viewed by economists generally as potential negatives for economic growth. Severe limits on immigration remove one engine of faster GDP expansion—population growth is generally viewed as constructive for economic acceleration, and low US birth rates and an aging population suggest that domestic demographics are a concern for future growth.

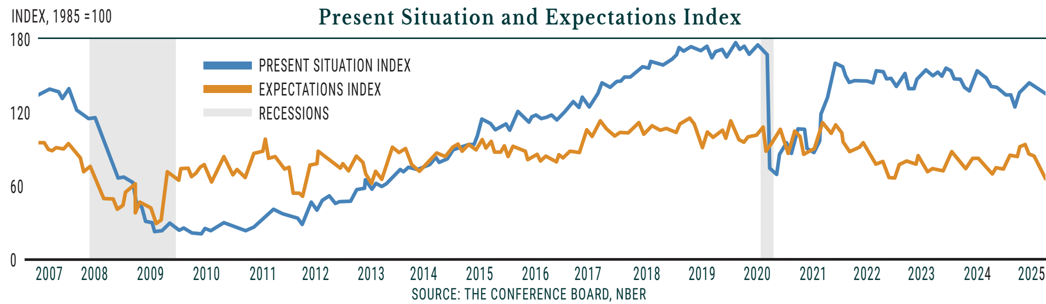
On the trade front, tariffs—wherever they settle out—are generally viewed as a tax on importers and end consumers, which may result in higher prices and slower growth. There likely will be some supply chain disruptions that ensue from a new tariff regime.

By contrast, some of the Administration's policy agenda that is viewed as more pro-growth may be enacted or generate results later in the year or in 2026. Chief amongst these policy issues are deregulation and tax cuts.

There are a number of indications that we are already beginning to see some deceleration in the US economy. Factors contributing to expectations of slower economic activity include slower disposable income growth, fading fiscal tailwinds, rising tariffs, surging policy uncertainty and market volatility.

Soft data—surveys and opinions—have turned down sharply. Some examples would be consumer confidence and manufacturing sector surveys. The March WSJ/Vistage Small Business CEO Confidence Index declined precipitously for both current and future economic conditions, as business executives reduced their revenue and profitability expectations.

The chart below indicates that consumers' confidence is substantially lower than before the pandemic, and has turned down sharply this year. Consumers are particularly gloomy about the future ("Expectations Index").

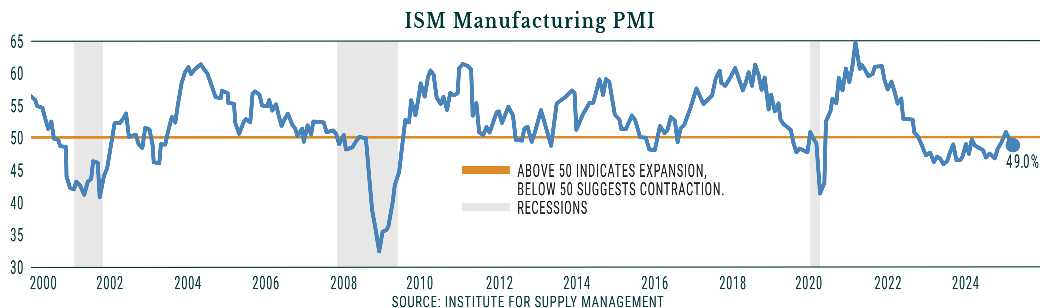


Thus far, hard data do not confirm the soft data but are sending warning signals. While personal incomes rose in February, consumer spending has not kept pace, indicating some caution. (Spending on discretionary items in particular has slowed.) Traditionally, the savings rate rises as consumers become more concerned about the economy and the job market.

With consumer spending constituting more than two thirds of US economic activity, the health of the labor market is key to supporting consumption. Labor market data is mixed, with unemployment inching up to a still-low 4.2%, monthly nonfarm payroll gains steady, average hourly wages up 3.8% over the past year, new weekly unemployment claims stable, an ongoing decline in the number of unfilled jobs, and higher announced layoffs. DOGE-driven cuts to the federal workforce are not yet visible in labor market data.

So it is particularly noteworthy that even without any strong evidence of labor market weakness, consumer facing companies are warning of fading consumer demand. Airlines including Delta, Southwest and American warned that first quarter results will disappoint. Retailers from Walmart to Dollar General to Lululemon Athletica are indicating sales and profit growth will slow this year, in the face of uncertainties from global economic and geopolitical conditions. Shipping concerns FedEx and UPS have reduced their earnings guidance for 2025 as a pullback in consumer spending is resulting in fewer package deliveries and, therefore, declining sales and operating margins.

Two of the weaker sectors of the economy, housing and manufacturing, remain moribund. The housing market is challenged by poor affordability, due to elevated home prices and high mortgage rates. The manufacturing sector faces softening demand, increased costs, and economic uncertainty.



Many economists have revised their forecasts, reducing estimates of 2025 GDP growth to 1.5% or less. They have also raised the probability of a recession. Indeed, the Fed itself, in its most recent Summary of Economic Projections, reduced its estimate of GDP growth this year from 2.1% to 1.7%, increased its estimate of year-end unemployment from 4.3% to 4.4%, and increased its estimate of inflation from 2.5% to 2.7%.

All in, this is a whiff of stagflation—an unfortunate combination of sluggish growth and higher prices.

ECONOMIC UNCERTAINTY, MARKET CERTAINTY

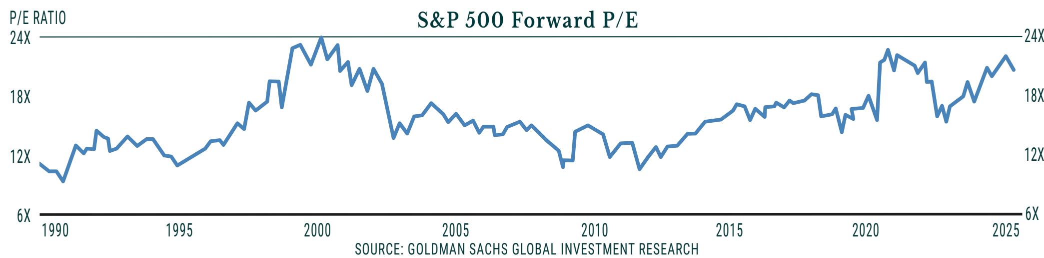
For all of its uncertainty, we cannot flee the future.
-Barbara Jordan

Economic uncertainty is a prescription for both businesses and consumers to defer spending and investment plans. Equity and fixed income markets are reacting to economic participants' deer-in-headlights moment. Their message? With clarity, they are telling us that a meaningful slowdown appears to be on the horizon.

While the economy entered the new year in fairly good shape, with low unemployment and moderating inflation, the equity market began 2025 on shakier ground. The S&P 500 sported a rich valuation of 22 times expected earnings for the next twelve months. Further, those expected earnings were a lofty 15% increase over 2024 S&P 500 earnings.

As noted above, a wide range of companies has signaled that their earnings will come in below expectations. Slower growth for the economy implies reduced demand, which in turn weighs on corporate profitability.

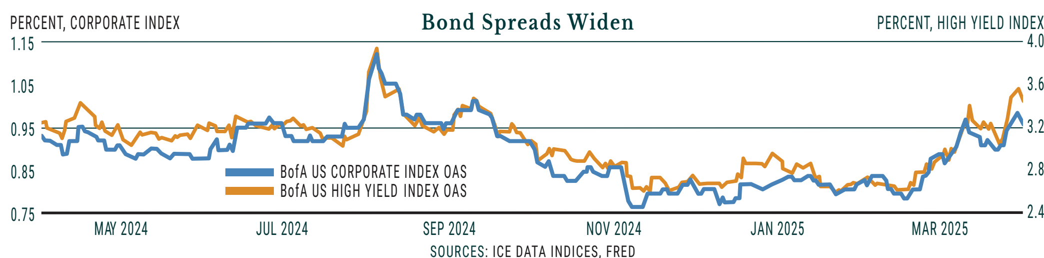
For the S&P 500 as a whole, projected earnings growth has been reduced to 10%; many market analysts expect further cuts will be made to projected earnings. FactSet reports that the number of companies issuing negative earnings per share (EPS) guidance is above five- and ten-year averages (and, conversely, the number of companies issuing positive EPS guidance is below average). Reduced earnings expectations are evident across all eleven sectors of the market.



When elevated valuations (which imply optimistic projections of future profitability) bump into lowered earnings expectations, the logical response is falling stock prices. After all, ultimately stock prices are driven by future earnings expectations discounted back to the present day. The S&P 500 is now trading at 20.5 times expected earnings for the next twelve months—lower than at the start of the year, but well above long term averages.

The bond market tells a similar tale of reduced economic expectations. Even though the FOMC has held the Fed funds rate steady, market interest rates across all maturities were down sharply for the year. Bond investors are anticipating that the economy will grow more modestly, reducing credit demand and increasing the likelihood that the FOMC will lower interest rates later this year.

The fixed income markets' message of a growth slowdown can also be seen in spreads. Investment grade and high yield bonds trade with a spread, or extra yield, above benchmark US Treasury bonds. When bond spreads widen, it's an indication that investors perceive that the risk of default or economic uncertainty has risen.



As the chart indicates, spreads bottomed in late 2024, and have been widening for the past few months. We pay attention to widening credit spreads because they often, though not always, precede and predict a recession.

TARIFFS AND DE-LIBERATION

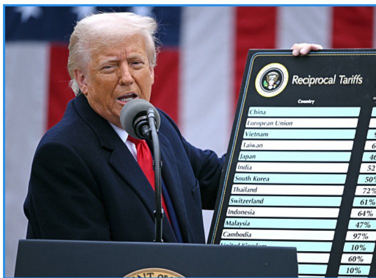
Liberation is not deliverance.
-Victor Hugo

Ka-boom! That's the sound of Liberation Day tariff announcements hitting financial markets!

In the first trading day after the Wednesday evening reveal, market reaction was instantaneous and unambiguous. Bond yields plummeted, with the 2-year US Treasury yield 18 basis points lower and the 10-year US Treasury yield 14 basis points lower. Equity markets fell precipitously, erasing $2.5 trillion in market value the day after the tariff announcement was made. The S&P 500 fell 4.8%, and NASDAQ plunged 6%.

The US dollar slumped, oil prices dropped more than 6%, and even gold, which had been rallying strongly, fell.

President Trump, the master showman, held his cards close to the vest with this major policy reset. That may make for good television, but financial markets were evidently unprepared for the magnitude of, and the time frame for, tariffs that are being imposed. The Administration utilized an unconventional definition of reciprocal tariffs that focuses on trade imbalances rather than actual tariff barriers.



Among the tariffs that were initially announced: a 10% tariff on all imports; higher tariffs on imports from a number of countries with substantial trade surpluses with the US and an additional 34% tariff on imports from China, on top of the previously imposed 20% tariff. The 25% tariff on foreign-made autos and parts was made effective as of April 5th. All in, the tariffs are expected to generate revenue of more than $600 billion.

What's behind the market reaction? The tariffs are so broad and so massive that the disruption to the economy looms large. The tariffs are too substantial for exporters or importers to absorb them, in which case end purchasers will bear a substantial part of the increased cost. In the near term, it seems inevitable that consumers will see higher prices, even as corporations face a risk to profit margins.

But the greater concern investors are expressing is that the President's trade policy will significantly retard economic growth. Potential results from this policy stance: reduced consumer demand as prices rise, reductions in force—and rising unemployment—as companies seek to defend profit margins.

The news is bad enough, on the face of it. That said, businesses cannot yet solidify strategies to address and work through these trade issues. Uncertainty remains, as it's unclear if these new tariffs will hold or if they'll be negotiated on a transactional, bilateral basis, country by country and product by product.

FACING THE LIONS

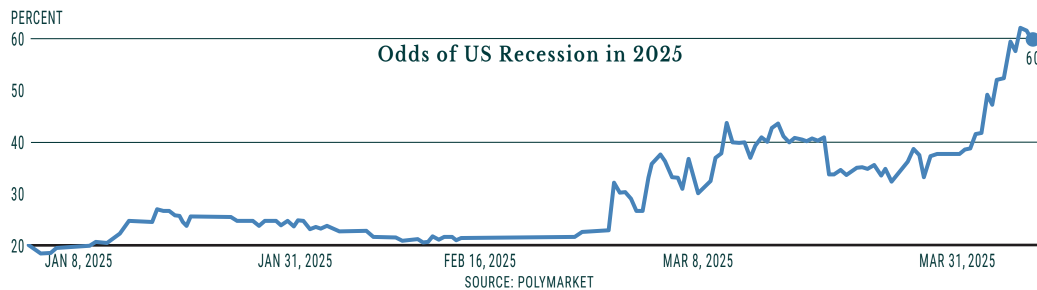
I'd like to be a lion tamer, sequins and tights and silk top hats.
I know I could be a lion tamer, I've always gotten along with cats.
-Stephen Schwartz

With uncertainty mounting, lions are everywhere to be found, and they are roaring. It can seem daunting to navigate these challenging markets without sailing off the end of the earth.

At such times of fluid and variable policy backdrops, it is wise for long-term investors to focus on their strategic goals while being more cautious about making tactical changes. A carefully crafted asset allocation that is well diversified among domestic and international equities, across capitalization levels and value/growth styles, along with fixed income, real estate, and commodities, will dampen volatility and mitigate risk.

At the same time, there are some adjustments at the margin that investors could consider, based on a sober assessment of high-probability outcomes. In the fixed income realm, for some time we have advocated extending duration—that is, lengthening maturities—given the likelihood that we've already seen a cyclical peak in interest rates. With the prospect of a global economic slowdown, the FOMC may be under pressure to resume cutting rates. The increased probability of a recession and the potential for credit spreads to blow out suggest that upping the quality of bond holdings is also prudent.

Polymarket, which bills itself as the world's largest prediction market, offers a platform where investors can place bets on various future events, including economic indicators. The chart below shows that on Polymarket's site, the probability of a recession has risen dramatically.



For equity investors, concentrating on high quality stocks also makes sense. By high quality stocks we mean companies with strong balance sheets generating free cash flow driven by durable competitive advantages. And, in an economy growing more slowly, the appeal of stocks offering sustainably higher and growing dividends is enhanced. Defensive sectors may, in the near term, hold up better than cyclical sectors—that is, than sectors that fare best when economic growth is accelerating.

In coming weeks and months, it seems likely that many companies will issue reduced forward guidance even if they meet earnings expectations—expectations for the first quarter that have already been whittled down from 10.4% to 5.9%. Volatility is likely to remain elevated in the near term as policy uncertainty persists and recession fears grow.

We are, as the expression goes, in uncharted waters from a trade policy perspective. Like medieval seafarers, investors are sailing at the edge of the known world. Equipped with soundly constructed portfolios, they will weather the sometimes perilous journey and avoid sailing off the end of the earth. With a little pluck, investors can navigate turbulent waters by staying the course, positioning themselves to capitalize on future growth.

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