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Overview

The concept of “U.S. exceptionalism,” that the United States’ growth and strong economy enticed steady capital flow into the U.S. markets leading to outperformance of U.S. markets, had long been a dominant market theme in global markets. However recent shifts in geopolitics and the global economy have challenged this view, resulting in a reallocation of capital across different regions and asset classes. Capital flows are now increasingly directed toward international developed and emerging markets. U.S. economic growth is trending down, while European growth is accelerating, leading to outperformance of global equities compared to U.S. equities.¹ For the past two years, the so-called “Magnificent Seven” stocks dominated headlines, their soaring valuations propelling the S&P 500 higher. But momentum has shifted. So far this year, they have stalled or declined,² with their lofty valuations leaving them vulnerable to correction. That trend too has reversed so far in 2025. Both domestic and international large capitalization value stocks have surpassed growth stocks this year, signaling this shift in market leadership.³

The non-traditional policy approach of the Trump administration has introduced market uncertainty and raised concerns about economic growth. The administration aims to shift the U.S. economy from a government expenditure-driven to one that relies more on private spending. The administration sees a U.S. economy de-levered from the public sector as supportive to the private sector. In conjunction with this economic deleveraging, the administration is working to change global trade dynamics and introducing new tax policies designed to support future U.S. growth. Global markets are struggling with the potential unknown consequences of this shift and questioning whether the future growth will materialize.⁴

Much of the headline news today revolves around trade and tariffs and their potential effect on the economy. While the scope and length of tariffs are unknown, along with the number of exemptions, tariffs are clearly a policy tool the administration will utilize. Capital markets and consumer sentiment are concerned that extended tariffs will lead to further inflation and hinder growth.⁵ These concerns regarding trade policy and its effects could persist. The U.S. demand for imported manufactured goods remains high relative to other countries, and the rest of the world needs to fulfill that demand for goods. This dynamic may provide the U.S. with leverage in negotiating tariffs and trade policy.⁶

The growing disconnect between U.S. soft data (surveys and sentiment indicators including consumer confidence and business outlooks) and hard data (measurable metrics such as gross domestic product, employment, retail sales, and industrial production)⁷ is contributing to increasing uncertainty. Soft data, reflecting consumer and business surveys, has turned bearish, signaling unease and suggesting a less optimistic economic future. In contrast, hard data remains robust. We believe it is still unclear which direction the economy will take, and thus, we recommend maintaining diversified portfolios.

While U.S. inflation appears persistent in the near term, bond market expectations are anchored around the view that inflation will not rise significantly over the long term. Both the Fed and the bond market regard tariff-driven inflation as short term which will recede after base effects subside.⁸ We believe that the Fed committed to fighting inflation, but it will assist should the economy weaken. The Fed stepping in sooner than the Trump Administration seems more likely, but significant labor market deterioration would likely be required for Fed involvement.⁹

TABLE 1 - ASSET CLASS PERFORMANCE (AS OF MARCH 31, 2025)

	1Q25	Trailing 12 Months
Bonds		
Short Term (3 Month T-Bills)	1.1%	5.2%
Total US Bond (Bloomberg Agg)	2.8%	4.9%
Stocks		
US Large Cap (S&P 500)	-4.3%	8.3%
US Small Cap (Russell 2000)	-9.5%	-4.0%
International Developed (MSCI EAFE)	7.0%	5.4%
Emerging Markets (MSCI EM)	3.0%	8.6%
Real Assets		
Real Estate (NAREIT)	0.9%	9.9%
Infrastructure (S&P Global)	4.6%	18.8%
Commodities (Bloomberg)	8.9%	12.3%
Currency		
USD	-3.9%	-0.3%

Source: FactSet
financial data
and analytics

U.S. Equity Sectors

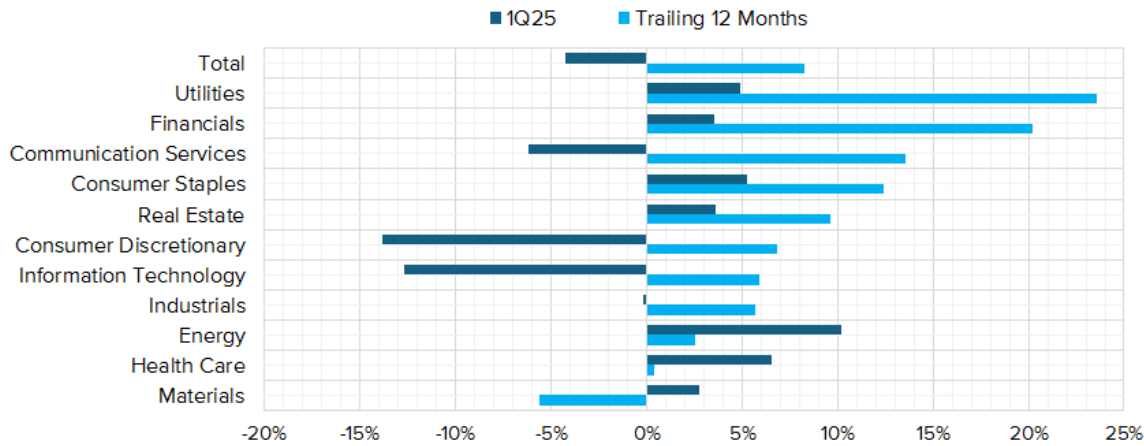
The first quarter of 2025 felt like déjà vu. Markets remained choppy, echoing the volatility of late 2024, as investors grappled with stubborn inflation, potential tariffs, weakening consumer sentiment, and geopolitical event. Riskier growth assets bore the brunt of these concerns, while value strategies proved more resilient. In many cases valuations of these names were at significantly elevated levels compared to recent years, making them ripe for a correction.

Compounding the uncertainty, a steady flow of government directives has weighed on business and consumer confidence, amplifying recession fears. Over the past two decades, CEO confidence has been correlated with economic growth¹⁰ and any deterioration could add discomfort around corporate expenditures, the labor market, and consumers sentiment. The lower income consumer has faced financial strain for over a year and there are signs that pressure is extending to higher income groups, as evidenced by a slowdown in luxury item purchases. Year-to-date, consumer discretionary stocks have underperformed. These stocks are vulnerable to trade policy due to oversized tariff risk and diminished pricing power, compounded by already elevated price levels.¹¹ Bank executives indicate that, while consumers are generally stable, they recognize the increasing issues weighing on the consumer amid uncertainty and are seeing some pause in consumer behavior. Overall they have more difficulty forecasting consumer and business spending given the overhangs.¹² Finally, there are increasing signs of slower travel and reduced leisure activity spending, some of which could be due to lower asset prices for higher income consumers creating a negative wealth effect, and that has the potential to increase if the stock market struggles further.¹³

Amid ongoing market uncertainty and volatility, equity performance has broadened beyond the “Magnificent Seven” and U.S. large cap growth stocks as these groups and speculative assets have been more impacted in the latest market selloff. The group started with high valuations amid elevated expectations. Additionally relative earnings growth between the broader market and the Magnificent Seven has reduced, leading to better performance for non-Magnificent Seven stocks.¹⁴

Value, quality, and dividend growing stocks have held up better, and large cap value has taken over market leadership early on this year.¹⁵ Sector wise, consumer discretionary and technology stocks have traded down sharply while energy and health care are leading the way. U.S. value stocks, represented by the Russell 1000 Value Index, increased 2% in the first quarter 2025, while U.S. growth stocks, defined as the Russell 1000 Growth Index, declined 10% in the quarter.¹⁶ While overall valuations remain above long-term averages, we think relative valuations for value stocks remain more attractive compared to growth stocks, despite the significant pullbacks in growth sectors early this year. As such, we believe it is still early in the process of market rotation.

TABLE 2 - S&P 500 Sector Returns (AS OF MARCH 31, 2025)



Source: FactSet financial data and analytics

International Equities

With a weakening growth outlook in the U.S. due to reduced fiscal spend, higher interest rates, tariff and immigration policies,¹⁷ and weaker relative earnings from large capitalization U.S. companies, capital has shifted to international markets. Market now participants view the growth outlook outside of the U.S. as more favorable. Economic expectations for European countries are increasing, and the region has more potential fiscal and monetary policy changes available than the U.S. does. Recently Germany announced plans to accelerate defense and infrastructure spending which could boost European GDP growth.¹⁸ We believe Europe has more room for fiscal adjustments and its monetary policy remains less tight than in the U.S., contributing to these changing views.

A more robust European economy and a stronger Euro could lead to better performance for Emerging Market (EM) equity, assuming there is no U.S. recession.¹⁹ A weaker dollar benefits EM equities as they normally trade inverse to the U.S. dollar.²⁰ Year-to-date, EM earnings have been higher than expected, led by China, and earnings revisions are improving helped by lower interest rates and a weaker dollar.²¹ We believe correlation between EM and the U.S. could decrease with more changes to U.S. trade policies. EM could provide more portfolio diversification.²² However, the impact of tariffs remains uncertain, as some countries may benefit while others could face challenges depending on the scope, duration, and location of trade restrictions.

Interest Rates

The 10-year Treasury reached a year-to-date peak at 4.79% in January. Since then, the yield has stabilized half a percent lower on macroeconomic concerns.²³ At the most recent Federal Open Market Committee (FOMC) meeting the Fed reaffirmed two rate cuts remained the plan for this year. The federal funds rate (the rate at which banks borrow from each other) remains 4.25-4.50%. Chair Powell downplayed inflation worries and emphasized economic growth. He indicated the Fed could respond to economic weakness by lowering rates, but it would wait to see slowing economic data before acting.²⁴ This is consistent with the data-dependent decision-making the Fed has been employing for some time. The bond market aligns with this stance and reflects anchored inflation expectations despite near term uncertainty. We believe the Fed will need to see a worsening labor market before increasing the pace of the easing cycle.²⁵

Bonds, Real Estate, & Infrastructure

Despite the economic and geopolitical disturbance, we've seen the fixed income market remaining stable, and credit spreads remaining tight. High yield spreads, which can indicate weakness, are still below long-term averages and suggest limited concern. Companies have access to capital markets, allowing them to refinance or add new debt. While credit markets may weaken on macroeconomic news, we believe companies have strong balance sheets and may be in better positions to manage a downturn than in the past.

A more cautious economic growth outlook and expectations for lower interest rates drove capital to interest rate-sensitive assets classes and defensive sectors such as bonds, real estate, and infrastructure. These groups outperformed the broader market. Bonds increased 2.8%, real estate grew 1%, and infrastructure returned 4.6%.²⁶ We believe that incorporating real estate and infrastructure into portfolios enhances diversification. Both are long-duration assets with low correlations to public equities, which can help reduce portfolio volatility while providing a steady income stream.

Outlook

At a time when uncertainty is driving the market and sentiment, we see opportunities alongside the risks. While the risk of broadening weakness from more forceful trade, immigration, and fiscal policies could expand to capital spending and payrolls and sustained inflation could hinder monetary response,²⁷ we see the opportunity for a broadening of the market away from growth and U.S. technology stocks. After years of growth-driven market leadership, we are encouraged to see value making a strong comeback. Year to date, value has significantly outperformed growth, reflecting a shift in investor preferences.²⁸ While the timing of market rotations is always uncertain, we think the widening valuation gap between growth and value in recent years made this transition inevitable. Cracks are also emerging in the growth narrative—most notably, signs of overcapacity in AI, last year’s hottest investment theme. As with past technological booms, the initial surge in expectations, valuations, and stock prices has given way to a more measured reality. AI remains a transformative force, but its market enthusiasm may have outpaced its near-term fundamentals.

A broadening of market leadership beyond a handful of high-growth names is a positive development. A more balanced market should create attractive opportunities for value investors and support a healthier, more sustainable investment landscape. Despite signs of economic slowing, we remain optimistic about the road ahead, supported by attractive valuations. Anchor portfolios are designed to navigate volatile markets, and their performance this year reinforces that resilience. Given the uncertainty surrounding global economic conditions and the difficulty in predicting market direction, we believe that maintaining asset class and geographic diversification in portfolios is essential.

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