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Investment Insights Monthly

From the Desk of Bill Hornbarger, Chief Investment Officer March 2025

Navigating Market Uncertainty and Volatility

Recent stock market activity has been gut-wrenching with the broad domestic equity indices (Nasdaq, S&P 500, Russell 2000) falling into correction territory (down 10%). The threat and implementation of tariffs has resulted in a marked softening in sentiment as investors increasingly worry about the double whammy of recession and higher inflation. To date, survey and sentiment-based data has softened more than employment-related data and other broad indicators, such as industrial production and retail sales. The March data (to be released in April) will include the current timeframe and will be closely watched to see if some of those numbers start to deteriorate.

At the same time the tariff news is breaking, the Department of Government Efficiency (DOGE) continues to plow ahead with austerity measures, cutting government spending by eliminating jobs and targeting waste and programs the current administration doesn't support. The result of these combined efforts (tariffs and austerity) is a marked increase in recession "chatter," as well as inflation expectations. On the recession front, the Atlanta Fed GDPNow forecast was recently at -1.8% for the first quarter of 2025. This is counterbalanced by the New York Fed Staff Nowcast, which tracks the current-quarter gross domestic product at 2.69%, and the Bloomberg consensus of private economists currently puts the odds of a recession at 25%. We still believe that the economy will avoid recession, but evolving government policies will lead to greater uncertainty and volatility in the outlook.

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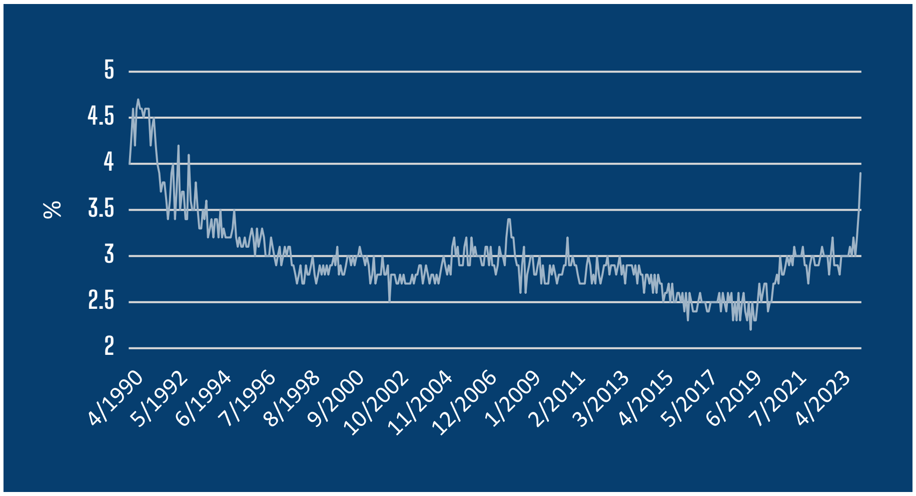
The inflation picture is also clouded. In the most recent University of Michigan Consumer Sentiment release, one-year and five-year inflation expectations jumped to 4.9% and 3.9%, respectively. The five-year outlook is particularly troublesome (see chart below). Not only is this the highest reading in three decades, but it also has the potential to negatively impact consumer spending. This came on the heels of a softer-than-expected Consumer Price Index (CPI) report for February, with the all-important core reading falling to 3.1%, the lowest since the spring of 2021. Shelter, the largest weight in the CPI, also declined to its lowest level since 2022, and the recent decline in mortgage rates could help with that trend.

Expected Inflation Rate, Next Five Years (%)



As of February 28, 2025
Source: The University of Michigan

As we have stated previously, we think it is important to understand the goal of tariffs. We believe that they are a tool to bring other countries to the negotiating table with a goal of fairer trade policies (among other things). If those agreements can be hammered out, then we look for tariffs, and the threat of them, to be transitory. However, if the administration views tariffs as a meaningful source of revenue, we believe it will lead to failure on other goals, such as inflation. Permanent tariffs would break supply chains, lead to higher costs and ultimately change consumer behavior.

Against this backdrop, equities have experienced a period of pronounced weakness. Many investors are nervous that this 10% correction will turn into something worse. Statistically, since World War II, there have been 48 separate 10% corrections, and 12 have turned into bear markets as defined by a 20% or more peak-to-trough drawdown. It is our experience that the worst bear markets (and we are not in a bear market at this point) typically accompany recessions, which we believe the U.S. economy will avoid.

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While none of us know when the market will bottom, we do know that decisions in weak markets are critical to successful outcomes. A few thoughts and statistics to help navigate these uncertain times:

1. **Successful investors are resistant to panic and euphoria** – Managing emotions is often more difficult than managing assets, but not getting caught up in FOMO (fear of missing out) in strong markets and conversely selling at the first hint of a decline are important behaviors. We firmly believe one's investment objective and asset allocation should not change materially with market conditions but instead serve as important guideposts to help navigate uncertain times.

2. **Corrections are inevitable** – According to data compiled by Bloomberg, the average annual return from 1980 through 2024 for the S&P 500 was 10.6%, and annual returns were positive in 34 of 45 years—or about 75% of the time. Over that same time frame, the average intra-year drop was 14.2%. Calendar-year 2023 was a good case study, featuring a 24% gain for the S&P 500 for the full year, but many people forget that it suffered a 10.3% drawdown during late summer. Last year (2024) also made strong gains, with the S&P 500 up over 25% for the full year despite suffering an 8.5% drawdown during the summer. On average, markets experience a 10% correction annually and a bear market (a decline of 20% or more) about once every 3.5 years. This volatility is the price of admission to realize the gains of investing in equities.

3. **Diversification works** – One of my favorite investment quotes is, "You know your portfolio is diversified if you are always unhappy with the performance of some part of it." This year has been a tough start for parts of the stock market, but there are still asset classes and market sectors that are up for the year as evidenced in the following table. Diversification works and is one of the best risk-management strategies available to investors.

Index	Year-to-Date Return as of March 17
Bloomberg Magnificent 7 Total Return Index	-14.02%
S&P 500 Index	-3.63%
NASDAQ Composite Index	-8.34%
MSCI EAFE Index	9.05%
FTSE NAREIT Composite	1.28%
Bloomberg U.S. Aggregate Index	2.08%
Dow Jones Utility Average	3.98%
MSCI Europe Banks Index	23.24%

Source: Bloomberg

4. **Investors hate uncertainty more than almost anything** – Inflection points in monetary or fiscal policy, changes in the political or economic climate, and geopolitical tension are often accompanied by increases in volatility as investors think about and/or reposition portfolios accordingly. The current headlines surrounding tariffs have led to heightened uncertainty surrounding the trajectories of the economy, inflation and earnings, and volatility has increased with the increase in tariff headlines. It is important to stay focused on long-term goals and remember that the U.S. economy and financial markets are the envy of the world for their depth, transparency and innovation.

5. **Price matters** – In the current selloff, the so-called Magnificent Seven have significantly underperformed. As shown in the previous table, an index comprised of that group of stocks (Meta Platforms, Amazon, Alphabet, Apple, Microsoft,

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Nvidia and Tesla) is down more than three times the amount of the broader S&P 500 index. While those companies are world-class market leaders in terms of innovation, they were trading at very high multiples of most metrics (price/earnings, price/sales, etc.) making them more vulnerable in a selloff. More importantly, there is a long-term relationship between forward returns and starting valuations. Less-expensive valuations are typically associated with higher forward returns over the long term, and vice versa.

6. **Market timing successfully long-term is almost impossible** – No one likes to see the value of their portfolio fall, and headline-induced volatility makes watching that even more difficult. In a rapidly falling or volatile market, or even after a strong increase in market value, many investors react emotionally to the need to "do something" by selling, with the intent of buying back in at a later point. That strategy has multiple potential pitfalls, most notably tax inefficiency and the need to make two correct decisions, when to buy and when to sell. A disciplined rebalancing strategy can be an effective risk management tool and offer a systematic strategy for activity in volatile market environments. DALBAR publishes an annual study (DALBAR Quantitative Analysis of Investor Behavior report) that shows how investor behavior influences investment returns. In 2023 (latest data available), the average equity investor earned 5.5% less than the S&P 500 in 2023, a relatively common theme in the history of the survey. Cited as one of the driving factors of this performance gap is the fact that investors tend to sell out of investments during downturns and miss out on rebounds.

7. **Cash is a poor long-term investment** – Over the past 97 years, the U.S. stock market has compounded at nearly 7% per year over and above the rate of inflation, while three-month T-bills, a cash proxy, have grown at an inflation-adjusted rate of less than 0.3% per year. Except for a few months, inflation was significantly higher than the three-month T-bill from the fall of 2009 until the spring of 2023.

8. **Bonds deserve a role in most portfolios** – High-quality bonds add important attributes to a portfolio, including equity market risk mitigation, income and liquidity. These qualities are especially desirable in times of equity stress/volatility. The recent increase in yields has resulted in not only higher nominal yields but positive real (after inflation) yields after a decade-plus of the opposite.

9. **In equity investing, time is your best friend** – The U.S. stock market has historically delivered an average annual return of around 10%. But short-term results may vary, and in any given period stock returns can be positive, negative or flat. Despite the year-to-year volatility, investors can increase their chances of a positive outcome by maintaining a long-term focus. Using data back to 1926 and calculating rolling returns, the longer the holding period, the greater the odds of positive returns as exhibited in the table below.

U.S. Stocks: CRSP U.S. Total Market Index

Time Period: January 1, 1926 - February 28, 2025

Rolling Period	% of Time of Positive Returns
1 Year	75.5%
3 Years	84.8%
5 Years	89.5%
10 Years	95.7%
20 Years	100%

Source: Lazy Portfolio ETF

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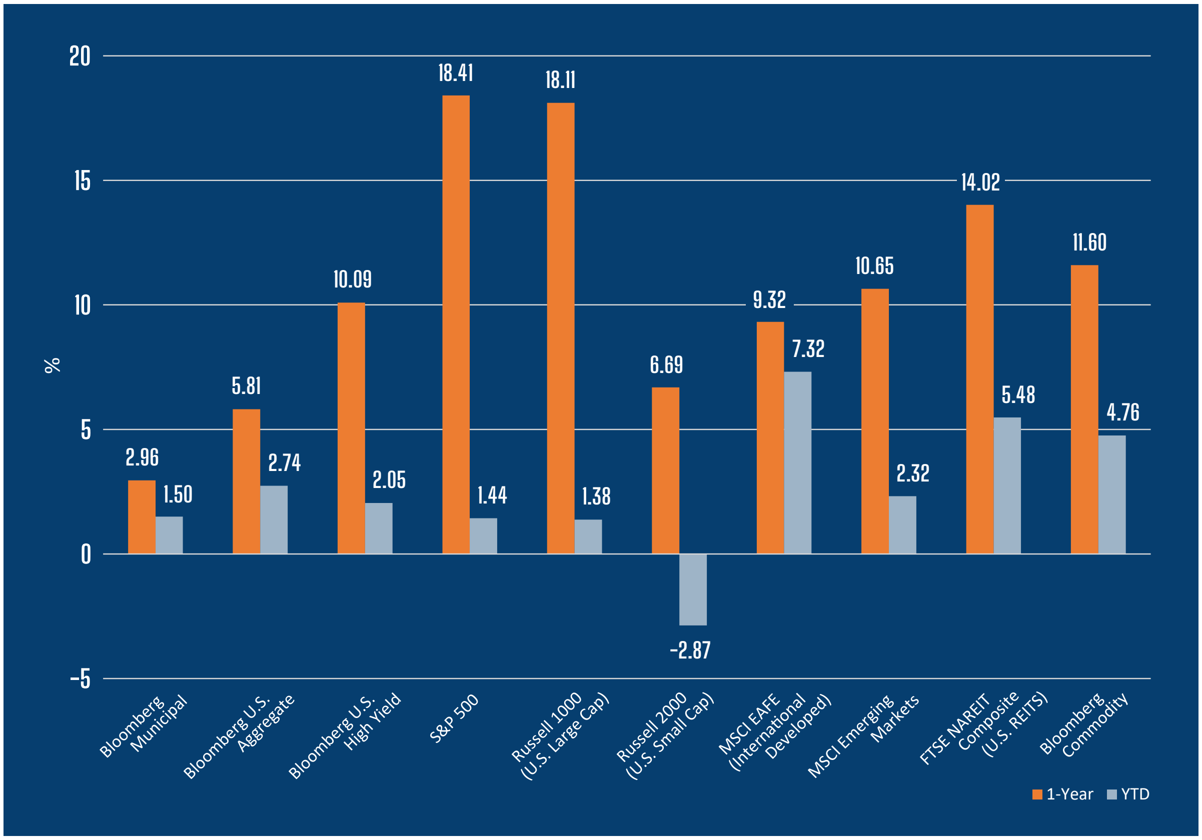
Asset Class Returns

Comparing Recent 1-Year and Year-to-Date Total Returns



As of February 28, 2025
Source: Conway Investment Research

Fixed Income

- Treasury and other sovereign debt yields declined in February, fueling gains in core fixed income and municipal bonds.
- Credit continued to benefit from clipping higher coupons amid the benign corporate credit environment. Spreads widened slightly last month.
- Bonds outside the United States got an added boost from the weaker U.S. dollar.

Equities

- U.S. equities fell in February as investors questioned U.S. economic growth, geopolitical tensions and the impact of tariffs.
- Growth/tech was the weakest style segment along with small caps, which lagged large caps.
- The February weakness occurred despite strong earnings growth numbers.
- Developed markets outside the United States exhibited relative strength versus the United States, driven by financials and other value sectors.
- Similar to what occurred in the U.S., small caps lagged large caps within Europe, Australasia and the Far East (EAFE) and emerging markets.
- Emerging markets eked out a small positive return in February, largely driven by China.
- U.S. dollar weakness boosted EAFE returns by about 100 basis points (bps). Emerging-market currencies were mixed versus the U.S. dollar, so the impact was actually -25 bps.

Alternatives

- Real-estate investment trusts (REITs) posted another strong month as rates fell.
- Commodity prices were higher. The top three performers for the month were coffee, natural gas and cocoa, followed closely by gold and silver. Crude oil and gasoline were lower for the month.

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February 28, 2025	MTD	QTD	YTD	1-Year	3-Year	5-Year	10-Year
Fixed Income Indices							
Bloomberg U.S. Treasury Bill 1-3 Month	0.33%	0.70%	0.70%	5.15%	4.22%	2.58%	1.82%
Bloomberg Municipal	0.99%	1.50%	1.50%	2.96%	0.99%	0.67%	2.33%
Bloomberg US Govt/Credit Intermediate	0.70%	1.16%	1.16%	5.54%	2.47%	1.53%	1.71%
Bloomberg U.S. Aggregate	2.20%	2.74%	2.74%	5.81%	-0.44%	-0.52%	1.51%
Bloomberg U.S. High Yield	0.67%	2.05%	2.05%	10.09%	4.94%	4.93%	5.06%
Bloomberg Global Aggregate	1.43%	2.01%	2.01%	2.98%	-2.83%	-1.95%	0.45%
U.S. Equity Indices							
DJ Industrial Average	-1.39%	3.32%	3.32%	14.41%	11.17%	13.79%	11.69%
S&P 500	-1.30%	1.44%	1.44%	18.41%	12.55%	16.85%	12.98%
NASDAQ Composite (Price)	-3.97%	-2.40%	-2.40%	17.12%	11.08%	17.08%	14.27%
Russell 1000	-1.75%	1.38%	1.38%	18.11%	12.07%	16.54%	12.71%
Russell 1000 Growth	-3.59%	-1.69%	-1.69%	19.75%	14.84%	19.71%	16.01%
Russell 1000 Value	0.41%	5.05%	5.05%	15.75%	8.65%	12.51%	8.95%
Russell Mid Cap	-2.84%	1.29%	1.29%	12.25%	7.18%	12.41%	9.35%
Russell 2500	-4.69%	-1.32%	-1.32%	7.64%	4.55%	10.85%	8.30%
Russell 2000	-5.35%	-2.87%	-2.87%	6.69%	3.34%	9.39%	7.23%
Russell 2000 Growth	-6.77%	-3.82%	-3.82%	5.83%	3.62%	7.87%	7.17%
Russell 2000 Value	-3.83%	-1.85%	-1.85%	7.58%	2.79%	10.32%	6.91%
Non-U.S. Equity Indices							
MSCI World	-0.69%	2.84%	2.84%	16.13%	10.75%	14.45%	10.40%
MSCI ACWI	-0.57%	2.79%	2.79%	15.57%	9.66%	13.31%	9.66%
MSCI ACWI Ex-U.S.	1.40%	5.51%	5.51%	10.23%	5.16%	8.07%	5.34%
MSCI EAFE	1.95%	7.32%	7.32%	9.32%	6.97%	9.23%	5.79%
MSCI EAFE Growth	0.14%	5.56%	5.56%	3.29%	4.03%	7.51%	6.07%
MSCI EAFE Value	3.74%	9.05%	9.05%	15.90%	9.85%	10.59%	5.26%
MSCI Europe	3.69%	10.84%	10.84%	11.90%	8.08%	10.40%	6.05%
MSCI Japan	-1.35%	0.19%	0.19%	1.04%	5.45%	7.56%	5.77%
MSCI AC Asia	0.19%	1.24%	1.24%	9.41%	2.79%	5.84%	5.07%
MSCI EAFE Small Cap	-0.28%	3.17%	3.17%	6.89%	1.18%	6.16%	5.59%
MSCI ACWI Ex-U.S. Small Cap	-1.05%	0.29%	0.29%	4.89%	1.70%	7.54%	5.60%
MSCI Emerging Markets	0.50%	2.32%	2.32%	10.65%	0.92%	4.68%	3.89%
MSCI EM Asia	0.68%	1.45%	1.45%	13.78%	1.26%	5.28%	4.84%
MSCI China	11.76%	12.83%	12.83%	39.36%	0.24%	-0.14%	2.73%
MSCI EM Eastern Europe	6.20%	19.35%	19.35%	16.45%	-16.12%	-16.63%	-4.89%
MSCI EM Latin America	-1.81%	7.55%	7.55%	-16.31%	1.11%	2.25%	1.71%
MSCI EM Small Cap	-2.62%	-5.30%	-5.30%	-1.34%	3.14%	10.36%	5.17%
MSCI Frontier Markets	1.86%	4.95%	4.95%	14.15%	1.23%	4.43%	3.24%
Hedge Fund Indices							
IQ Hedge Multi-Strategy	-0.52%	1.24%	1.24%	7.62%	4.37%	3.80%	2.83%
Real Assets Indices							
FTSE NAREIT Composite	4.24%	5.48%	5.48%	14.02%	1.39%	5.24%	5.92%
Alerian MLP	3.43%	12.53%	12.53%	28.49%	25.83%	23.37%	5.01%
Bloomberg Commodity	0.78%	4.76%	4.76%	11.60%	0.71%	10.56%	1.84%
S&P Global Infrastructure	0.15%	2.45%	2.45%	21.74%	7.39%	7.59%	6.17%
Other							
Oil Price Brent Crude	-4.59%	-1.18%	-1.18%	-12.74%	-10.27%	7.63%	1.55%
CBOE Market Volitility (VIX)	19.48%	13.14%	13.14%	46.49%	-13.33%	-13.32%	3.94%

Source: Morningstar

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