A Shroud of Uncertainty Weighs on Sentiment

The S&P 500 fell in the first quarter after two consecutive years of gains exceeding +20%. The year started off strong, with the index reaching a new all-time high in mid-February before sentiment shifted amid rising policy uncertainty from Washington. In this letter, we'll recap the first quarter, discuss the drivers behind the recent market selloff, and provide an update on the economy.

A significant development was the decline in stock market valuations, driven by dampened investor sentiment. Wall Street analysts' profit expectations for the S&P 500 over the next 12 months remained relatively steady, while the amount investors were willing to pay for those future earnings—the price-to-earnings ratio—dropped significantly from over 22x to around 20x. This contrast highlights how earnings forecasts tend to be less volatile than investor attitudes, which often fluctuate between optimism and pessimism. Sentiment shifted from optimism to caution, leading to lower valuations and a fall in stock prices.

Market leadership also shifted as last year's top performers lost momentum. In 2024, the Magnificent 7 delivered an impressive +63% return which lifted the broader market by +23%. In contrast, the equal-weight S&P 500, which gives all companies the same weight regardless of size, gained only +11%. To begin the year, dynamics have flipped with the biggest stocks now dragging it down. The Magnificent 7 has declined -15% year-to-date, while the equal-weight S&P 500 is down only -1%.

Rising Policy Uncertainty Impacted Sentiment – Developments in Washington dominated headlines as the current administration began rolling out its policy agenda. The administration wasted no time focusing on key priorities: reshaping trade policy, introducing tariffs, and pushing for significant reductions in government spending. The prospect of tariffs raised concerns about increased costs for businesses and consumers, while cuts to government spending hinted at shifts in fiscal priorities that could alter economic growth trajectories.

Sentiment across different sectors of the economy shifted noticeably toward caution as these policies took shape. Among consumers, optimism began to wane after a steady recovery from its nadir in June 2022, when sentiment hit a record low amid soaring inflation, rising interest rates, and pervasive economic uncertainty. That recovery, which spanned late 2022 through 2024, had been fueled by cooling inflation, stronger-than-anticipated economic growth, and a stock market that recently notched record highs. Consumers, who have been a linchpin of economic expansion in recent years, now appear uncertain of the latest policy shifts.

Business leaders echoed this wariness as CEO confidence, which has oscillated between moderate optimism and restraint since the 2010s, dropped to its lowest level since October 2011. This decline reflects the challenges executives face as they grapple with an evolving policy landscape, including the potential for tariffs to disrupt supply chains and raise operational costs, alongside persistent uncertainties tied to inflation, interest rates, and geopolitical tensions. The combination of these factors has left corporate leaders hesitant, potentially putting hiring plans, capital investments, and expansion strategies on hold awaiting a clearer economic picture.

Financial markets grew nervous as well. Markets, which prefer predictability, have struggled amid the administration's bold moves and the lack of granular detail. While some degree of market fluctuation is routine, the recent uptick stands out, driven by concerns over how tariffs and spending cuts might reshape corporate earnings, trade flows, and overall economic momentum.

This convergence of caution across consumers, business leaders, and investors carries significant implications. If households tighten their belts, consumer spending—a mainstay of economic activity—could falter. Similarly, if CEOs delay hiring or investment decisions, business activity might slow, further dampening growth prospects.

US Economic Update – The stock market isn't the economy, its forward-looking nature doesn't always mirror real-time conditions. Rising policy uncertainty has affected sentiment but now we turn to the latest economic data for insight into the U.S. economy, focusing on unemployment, retail sales, and industrial production.

Unemployment remains low historically. It rose in 2023 and early 2024 as workers rejoined the labor force and job growth slowed, raising concerns about a softening labor market. This influenced the Federal Reserve's decision to cut interest rates in September 2024. Recently, unemployment dipped as job growth rebounded, signaling a resilient labor market with steady demand amid tight conditions.

Retail sales, a key measure of consumer spending, grew strongly in 2023, fueled by rising wages and pandemic-era savings. Growth slowed in 2024, suggesting cautious spending due to high interest rates, inflation, and a shift to normal patterns. As consumer spending drives nearly 70% of GDP, a continued slowdown could ripple through the economy.

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2025 Performance Figures	Q1	YTD
DJIA (Dow Jones)	(0.28%)	(0.28%)
S&P 500	(4.27%)	(4.27%)
NASDAQ Composite	(10.26%)	(10.26%)
MSCI EAFE (Net)	6.86%	6.86%
Russell 2000 Small Cap	(9.48%)	(9.48%)
Bloomberg US Bond Aggregate	2.78%	2.78%
MSCI World All Cap	(1.32%)	(1.32%)

Equity Markets, Beyond the Index – Most of the stock market decline occurred in the second half of the quarter, after the S&P 500 set a new all-time high on February 19th. As mentioned earlier, a small group of mega-cap stocks drove the selloff, and their size and weight within broad stock market indices impacted performance trends. The Growth factor, which holds many of these high-profile mega-cap stocks, returned -10% in Q1. Similarly, the Nasdaq 100, an index of leading technology companies that include the Magnificent 7, returned -8%.

Sector returns highlight the concentrated nature of the selloff. Nine of the eleven S&P 500 sectors outperformed the broad index to start the year. Seven of those sectors posted gains, while the other two were flat. Technology and Consumer Discretionary, two of last year's top performers, are the two worst performing sectors this year. It's not a coincidence that these sectors are the most exposed to the Magnificent 7, which weighed on their returns just like the broader S&P 500. In contrast, sectors that underperformed in 2024 are the top-performing sectors this year. While the S&P 500 is down by -4.3%, the average stock within the index is down -1%.

International stocks outperformed U.S. stocks in Q1, posting one of its biggest quarters of outperformance since 2000. The underperformance of U.S. mega-cap tech stocks contributed to international's outperformance. Outside the U.S., the MSCI EAFE Index of developed market stocks gained +8% in Q1. Much of that strength came from Europe, where investor sentiment improved as governments unveiled plans to increase spending. This triggered a rotation out of U.S. stocks and into Europe in anticipation of increased government spending leading to stronger near-term economic growth. Meanwhile, the MSCI Emerging Index gained +4.5%.

Credit Markets – The bond market saw two key trends: falling U.S. Treasury yields and widening credit spreads. The 10-year Treasury yield dropped from 4.80% in mid-January to 4.15% by early March. Rising policy uncertainty, potential tariffs, and slower growth concerns pushed investors into Treasuries, viewed as safe havens. As demand grew, yields fell, offsetting some stock market losses. After narrowing in late 2024 following Federal Reserve rate cuts, credit spreads expanded as investors grew cautious. Spreads remain low historically, suggesting stable financial conditions and reflecting the U.S. economy's resilience. A sustained widening, however, could tighten conditions and signal default concerns.

The falling Treasury yields highlight a flight to safety, while wider spreads show unease about corporate risk. Together, they depict a bond market balancing economic strength against policy uncertainty. Treasuries offered stability, and credit markets flagged caution without signaling distress. For now, the market remains watchful but steady, with investors weighing risks against a still-solid economic backdrop.

2025 and Long-Term Outlook – Market volatility can be unsettling, but it's a normal part of investing. Periods of enthusiasm often lead to recalibration. It's natural to feel uncertain, but history shows that staying invested through volatility and maintaining a longer-term diversified perspective is the prudent approach.

Market pullbacks like this year are not just common, they're a healthy and recurring part of investing. The S&P 500 experiences a pullback nearly every year, with a median intra-year drawdown of -13%. Since 1928, the S&P 500 has experienced a drawdown of -5% or more in 91 out of 98 calendar years, including 2025. These inevitable periods can be uncomfortable, but they serve the important functions of resetting valuations and curbing speculative excess. Without occasional declines, markets could become dangerously overextended, increasing the risk of more severe and extended downturns.

Volatility is the price of admission for long term returns. Staying invested through market fluctuations has consistently been one of the most effective strategies for building wealth over time. Diversification is another time-tested approach whose merits dimmed during the concentrated equity returns experienced over the last two years. However, sentiment can reverse quickly, and a diversified portfolio paired with a thoughtful financial plan are proven historical strategies to compound returns over the long term, despite elevated uncertainty over the near term.

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