SHAKEN, NOT STIRRED

COMMENTARY

APRIL 2025

At one time we had a goal to collect all of the James Bond books. We saw all of the James Bond movies and could name all of the actors who had played James Bond – even some of the more obscure. (There had been both a spoof version of Casino Royale with David Niven as Bond and a black and white TV movie version of Casino Royale where Bond was a CIA agent, Felix Leighter was the MI6 agent and Peter Lorre played the villain, but we digress.) What made us think of James Bond was his movie drink preference: Vodka Martini – shaken not stirred.

Did you ever think about how shaking a drink impacts the result? While both shaking and stirring a drink end up with the result that the drink ingredients are mixed, they do provide vastly differing results. A stirred drink, for example, doesn't really impact the texture and the ingredients within a stirred drink retain some of their distinctiveness.

In a shaken drink, however, the ingredients are violently churned back and forth with ice, chilling and diluting the ingredients and repurposing them into a new singular flavor. Kind of like what is happening in Washington with the new Trump Administration.

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Typically, when a new administration takes residence in Washington, it has been done with a certain amount of purpose and process (whether you agree with it or not). They get their people in place, start talking about their agenda for the coming 100 days, months and years ahead, and then begin the process of policy making and legislation writing. This involves working with the bureaucracy to push legislation forward, with the result that, even though there are intra-party "disagreements", the process moves forward and nothing really changes. Kind of like a stirred drink. The pieces remain "somewhat" separate. With the new Trump administration, however, it appears to us as if the President is approaching it like Bond did a martini – shaken not stirred.

Fast and Furious

In his first administration, the Trump presidency was beset by a federal bureaucracy that looked upon the (then) incoming president as little more than a blowhard and former reality TV personality. They used his inexperience in dealing with the Washington to slow walk his nominees and attempt to stop or delay his policy designs.

We believe that he learned from his first experience and his personnel push, policy pronouncements, and executive orders are designed to bury the Washington bureaucracy in a legislative and policy avalanche. We believe that the second Trump administration realizes that the chaos of their policy avalanche will create some missteps, but that they need to work fast to enact their policy desires because if they wait, the opportunity will die.

Something else lost in the torrent of pronouncements and the angst from investors and Washington over tariffs is that despite significant volatility around the details of the Trump administrations' trade policy it has been remarkably consistent about its objectives: Reduce the US trade deficit with the rest of the world, reduce federal fiscal deficits and increase manufacturing investment in the United States. The administration believes that tariffs are a key policy tool in order to accomplish those goals[1].

So, what is an investor to do? We will attempt to provide our thoughts in the succeeding paragraphs as we discuss (some of) the data and provide our outlook for the balance of the year.

The Economy

It's been a mixed bag, much as it has been for the better part of a year. The Leading Economic Indicators (LEI) declined for the third month in a row in February, as half of the LEI's components fell. With half of the component

indicators weakening, even though the 6-month growth rate of the LEI is still on an upward trend, the LEI triggered a warning signal (see Figure 1 below).

Figure 1 - Source: The Conference Board

Muddying the waters a bit were the personal income and spending data from the US Bureau of Economic Analysis (BEA). While Personal Income has been rising since November, spending looked to be suffering from a bit of a Christmas hangover as January spending turned negative, only to rebound a bit in February. The result being that the personal savings rate has been increasing (so far) this year (see Figure 2 below).

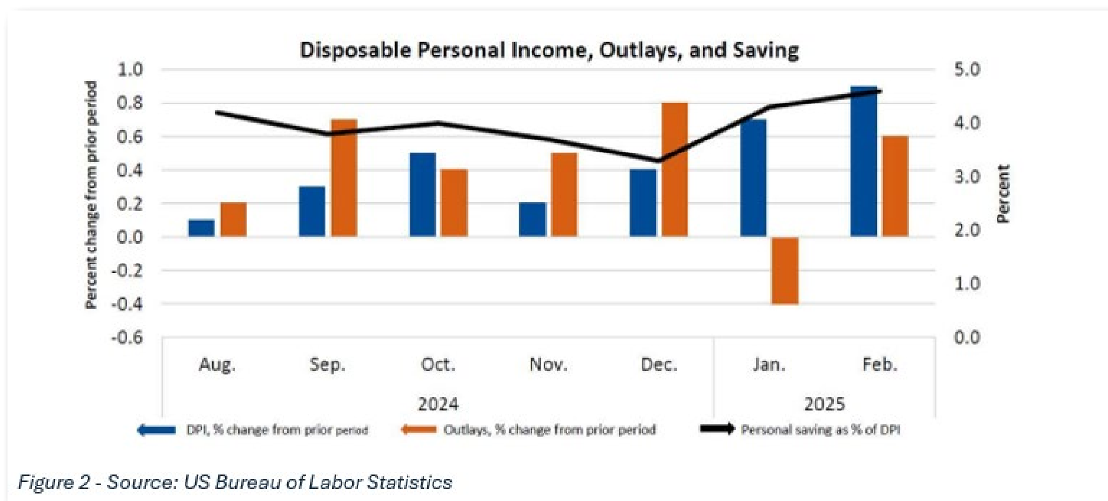


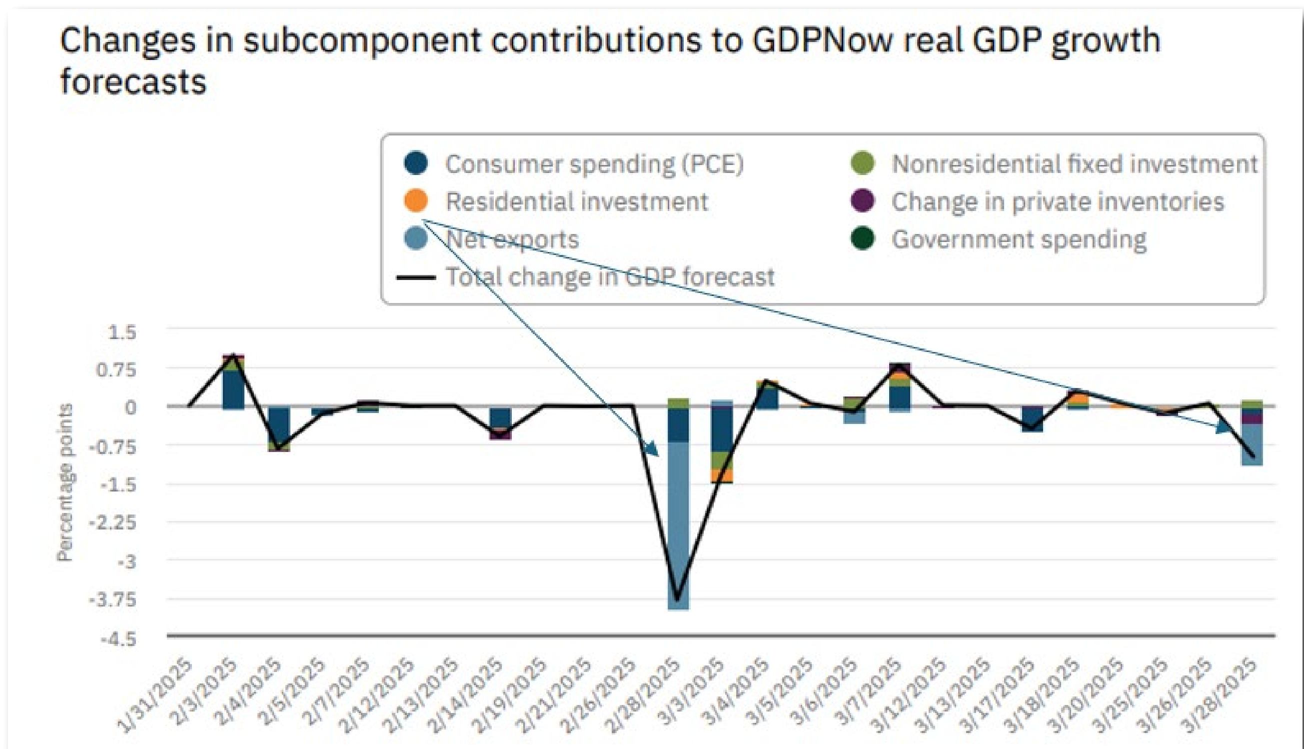
Figure 2 - Source: US Bureau of Labor Statistics

Yet the consumer isn't feeling quite so confident. The Conference Board's measure of Consumer Confidence fell in March to 92.9, its lowest level in four years. While this is a bit troubling, the most disconcerting element is that the Expectations Index fell by 9.6 points to its lowest level in twelve years and sits at 65.2 – well below the 80-level consistent with a future recession. Since the consumer represents more than sixty-eight percent of domestic economic activity[2], if they are concerned about their future, then we should pay attention. That said, as we can see from Figure 3 below, the Expectations Index has spent much of the time since 2022 worrying about the prospects of a recession.

Figure 3 - Source: The Conference Board

Worries and concerns aside, we continue to believe that we should avoid a recession, even if the economy doesn't feel very robust. While the final estimate of Q4 2024 GDP came in largely as expected (the year over year estimate was right on top of expectations at 2.5%, while the quarterly annualized estimate was a tad higher at 2.4% versus 2.3% expected), expectations for Q1 GDP are not nearly as robust with the range of Blue Chip Consensus forecasts between a low of roughly 0.5% to a high of about 2.5% and the current Atlanta Fed GDP Nowcast pointing to an expected contraction.

Interestingly, at least to us, is that the largest contributor to this downturn in the GDP Nowcast is the huge downward move in net exports (See Figure 4 on next page).



We find this interesting because (at least to us) this was the logical result of the Trump administration announcing its tariff regime. It made perfect sense to us that since President Trump made no secret of his intent to impose tariffs that there should be a large increase in imports ahead of the expected imposition of those tariffs. In fact, the data is even more stark if looked at through foreign trade data available from FactSet. Looking at FactSet data, we see that the foreign trade balance declined by nearly sixty billion dollars since November 2024 (see Figure 5 on next page).

Could we see a reversal in the imports data in coming months? We believe most certainly. Yet as we wrote in March, there are certain products (e.g., cellphones and televisions) that have not been manufactured in the United States for more than a decade (or longer). Additionally, net exports have been a drag on GDP for nearly fifty years with only occasional, short jumps above zero – the last happening in the third quarter of 1980 (see Figure 6 on next page).

US Foreign Trade

-30
-40
-50
-60
-70
-80
-90
-100
-110
-120
-130
-140

2015 2016 2017 2018 2019 2020 2021 2022 2023 2024

Foreign Trade Balance, SA, Bil USD

50
40
30
20
10
0
-10
-20
-30
-40

2015 2016 2017 2018 2019 2020 2021 2022 2023 2024 2025

(% 1YR) Exports (% 1YR) Imports

Figure 5 - Source: FactSet

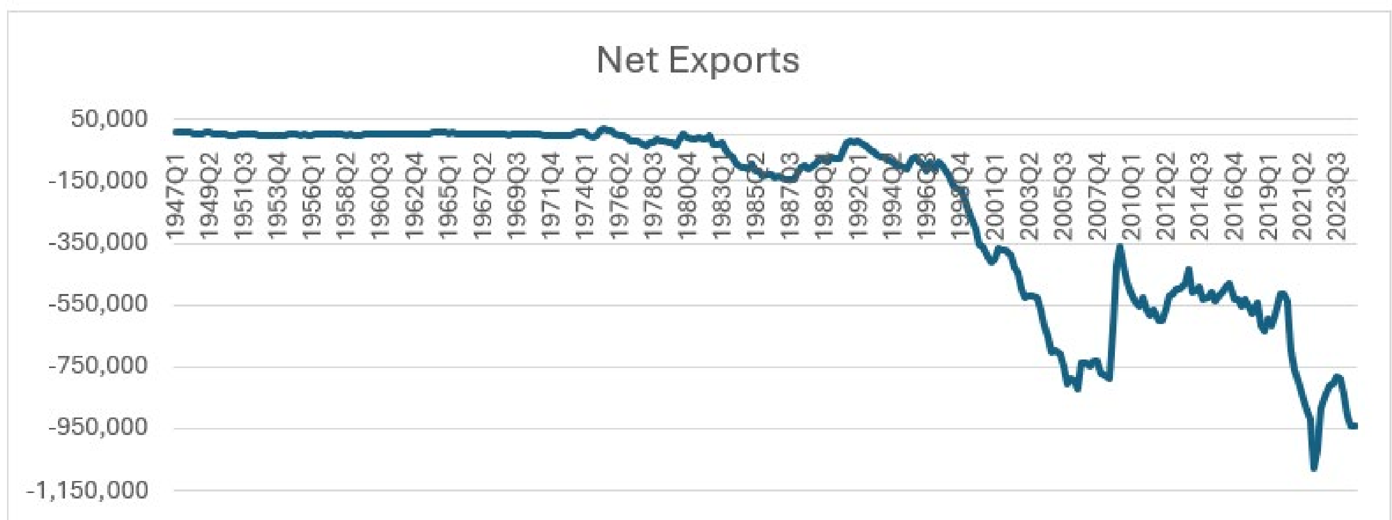


Figure 6 - Source: US Bureau of Economic Analysis

Which gets us to jobs. While tariffs have been getting a large part of the press since the beginning of the year, we can't move on from the economy until we discuss the job situation. After all, we believe that people's views of the future economy are largely tied to, not only the current job market, but their views about future job prospects. While consumers' views about the current labor market have improved (33.6% said jobs were plentiful, unchanged from February 2025, and fewer said that jobs were hard to get (15.7% vs 16%)), their outlook for the future has deteriorated as fewer consumers expect more jobs to be available and more anticipate fewer jobs[3].

Inflation, which we doubted would be able to sustainably arrive at the Federal Reserve's goal of 2% (equivalent to a 0.17% monthly rate) has been rising since hitting a monthly low of 0.10% in November of last year. The February release saw the Core PCE Deflator rise 0.37%, to a level not seen since February 2024. Higher inflation could likely keep the Fed on the sidelines until they feel more comfortable that inflation is trending down before renewing steps to resume easing.

Fixed Income

January kind of lulled investors into a false sense of security as rates really didn't move very much. Everything changed post-January as the tariff pronouncements hit. Treasury yields dropped in maturities from 6-months

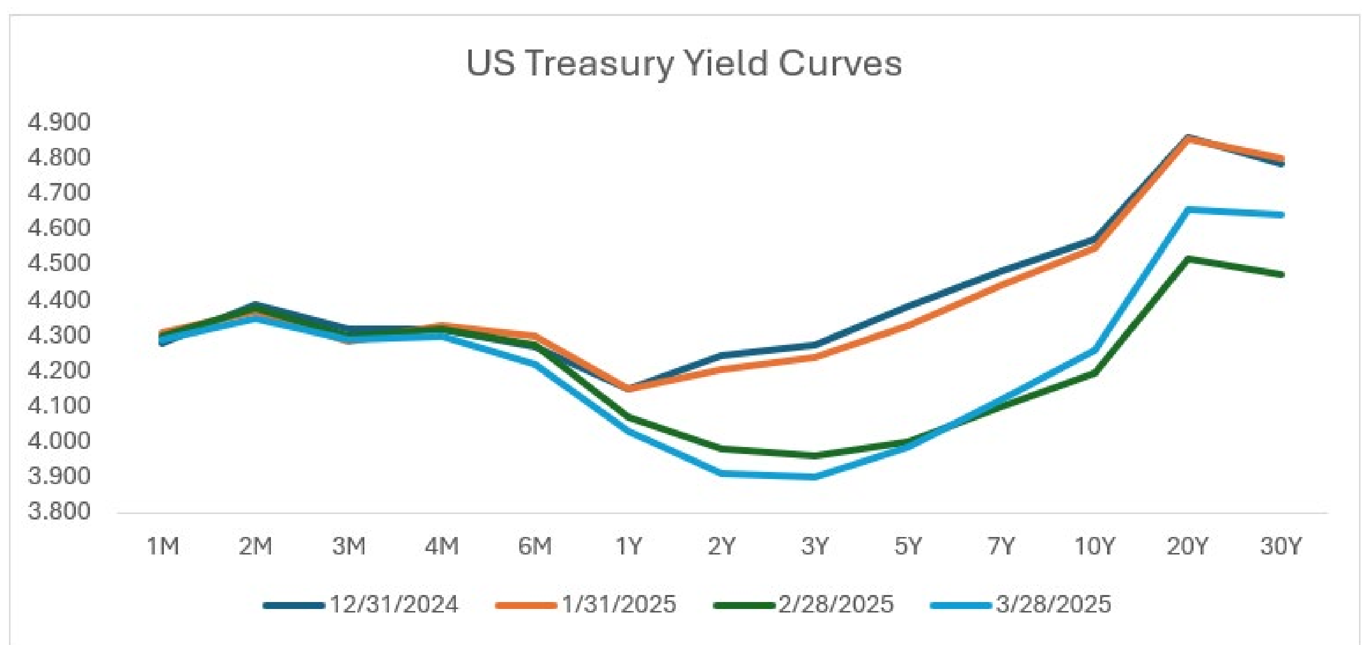


Figure 7 - Source: FactSet

to 30-years, with the result that both bond investors (as described by the Bloomberg Barclays Aggregate Bond Index) and Treasury investors have realized reasonably positive returns through the first quarter. It has also meant that the curve has inverted (long rates lower than short rates) from 6-months to 10-years. We believe this is more in reaction to the inflation and economic fallout from tariffs than it's potential as a recessionary indicator. We also believe this is supported by the fact that rates from 10-years to 30-years are still above shorter-term rates and provide a continued upward slope to the entire curve.

Equity Markets

Volatility has picked up in the equity markets so far this year, but it is important to understand that the volatility we are currently experiencing is more akin to "normal" volatility. We can see that by looking at a chart of the CBOE's Volatility Index or VIX below.

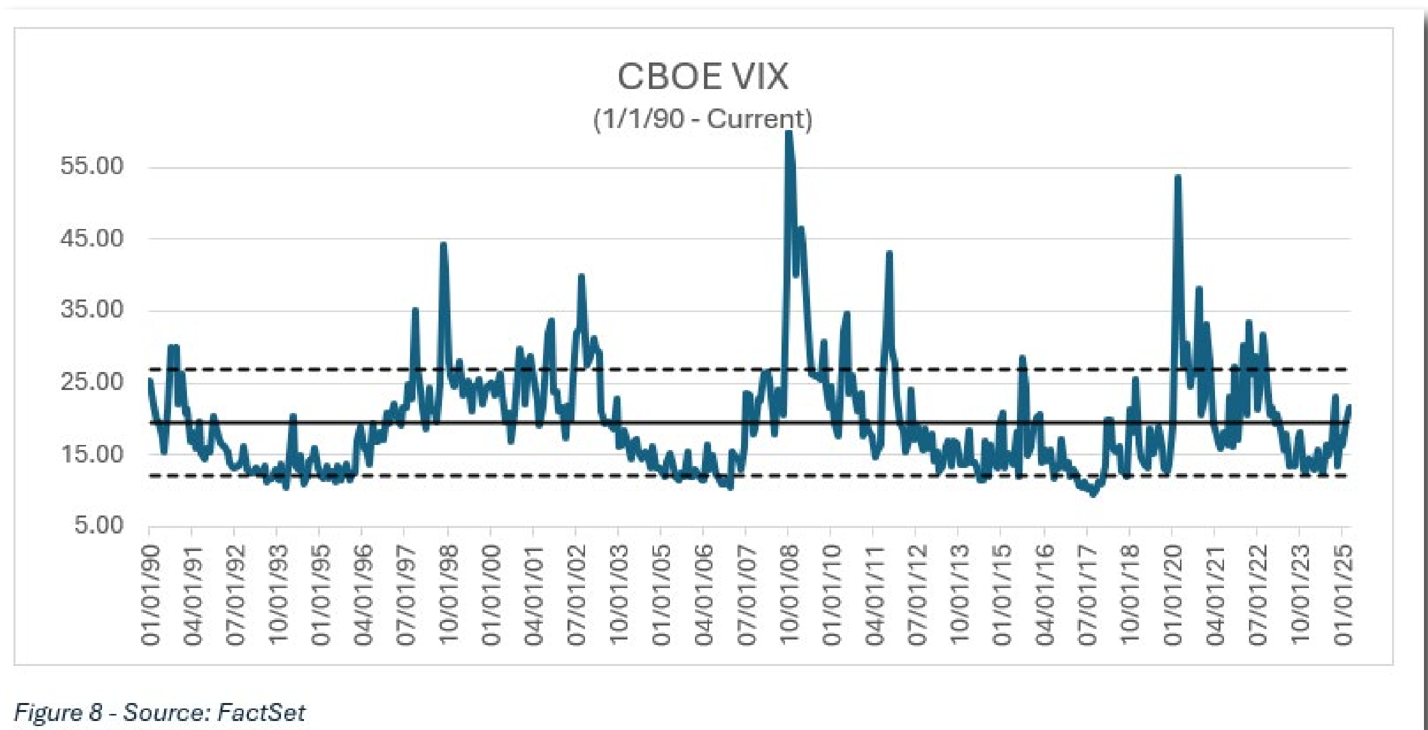


Figure 8 - Source: FactSet

What we should note is that while volatility has certainly picked up from the below average levels of 2023 and early 2024, it really isn't that different from average (21.65 current versus the average of 19.54). The other thing to note is that the VIX really measures more upside volatility than downside, which makes sense. We don't believe that investors care all that much about upside volatility (markets rising), they care more about losses. So, a rising VIX largely means that equity markets are facing difficulty when the index rises above its average and is often in a bear market when it rises above the first standard

deviation as it did in the late 1990's (the dotcom bust), 2008 (the Great Recession) and early 2020 (COVID). Barring an "extreme" dislocation like those just mentioned, we don't believe the market is facing anything other than "normal" volatility.

In the performance derby, year-to-date, value is outperforming growth with the Russell 1000 Value providing modestly positive returns and the growth benchmark declining nearly ten percent. The market has also been broadening out as the S&P 500 outperformed the "Magnificent Seven" (down 4.27% versus -15.73% for the Mag-Seven as described by the Roundhill Magnificent Seven ETF), and the S&P 500 Equal Weight (as explained by the Invesco S&P 500 Equal Weight ETF) outperformed the headline index -0.66% to -4.27%.

Unfortunately, smaller (so far) has not been better as returns got worse the farther investors went down the market capitalization scale. Large cap (S&P 500) outperformed mid cap. -4.27% vs -6.10% (S&P 400) and mid cap outperformed small cap (S&P 600), -6.10% vs -8.93%. The big surprise for the quarter was that international stocks, whether developed or emerging, outperformed domestic stocks.

As we have indicated in past comments, the performance of US stocks versus the international stocks is highly correlated to the performance of the dollar. Given that the dollar has struggled versus international currencies (see Figure 9 below), it should not be a surprise that international stocks have outperformed. Indeed, Both the MSCI EAFE (developed international markets) and the MSCI EM (emerging international markets) have

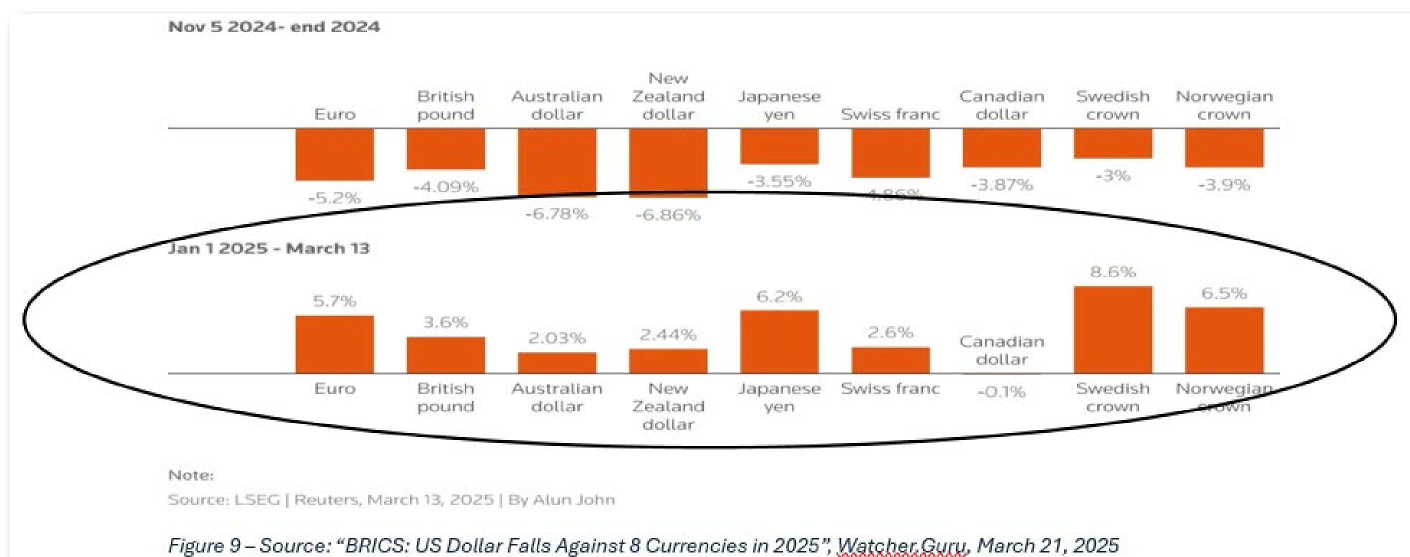


Figure 9 – Source: "BRICS: US Dollar Falls Against 8 Currencies in 2025", Watcher.Guru, March 21, 2025

turned in a positive performance versus the S&P 500. The former rising 3.03% and the latter adding 2.73%. Can this continue? It largely depends on how the dollar performs. We don't think that the current administration would mind a modestly weaker dollar as it would offset some of the impact of current and expected reciprocal tariffs from other countries, but long-term we also don't believe a weak dollar is an appropriate strategy.

Our Outlook

We continue to find it difficult to envision a scenario where the Fed is very aggressive in cutting rates. Their decision to slow the pace of quantitative easing (allowing its bond portfolio to shrink) from $25 billion in monthly redemptions to $5 billion beginning in April, has provided some policy wiggle room as it, effectively, acts as a back-door policy ease without an actual change in rates. Does the Fed ease two more times this year as expected? Potentially as we thought that reducing the range of Fed Funds rates to 3.75%-4.00% made sense. That said, given that the Fed continues to be "data dependent", and if the inflation rate continues to tick up, we also wouldn't be surprised to see them hold steady for far longer than expected.

We continue to believe that the domestic economy avoids a recession – even though we fully expect the economy to slow. Recessions, particularly this century, have tended to be preceded by some type of major dislocation (Covid in 2020, The Great Recession financial crisis in 2007-2009, Y2K and the dotcom meltdown prior to the 2001 recession). Do the tariff increases proposed by President Trump and the potential retaliatory tariffs by other countries count as a major dislocation? While we do know of some commentators that are fully expecting the tariff tussle to grow into a full-blown recession, and it is clear to us that the tariffs are quite inflationary, we are not as clear as to the economic impact and are not expecting a recession…yet.

We believe that the equity markets will continue to favor the "other 493 stocks" of the S&P 500, and that value should continue to outperform. That said, we also expect the benchmark S&P 500 to rebound a bit, allowing the index to achieve positive returns for the year.

Will small stocks continue their underperformance? While smaller companies are not as impacted by tariffs, earnings are likely to continue to be negatively impacted because of how smaller companies finance themselves. Many finance themselves via banks which typically charge floating rates, generally SOFR (Secured Overnight Financing Rate) plus some kind of spread. While SOFER has declined from its peak of greater than 5%, rates remain higher

than they have been for much of this century. (SOFR has only been around since 2023 as a replacement for LIBOR which was replaced because of a rate manipulation scandal.)

As we wrote last quarter, there is nothing wrong with taking risk as long as you get paid for it. We believe that we have entered a period where investors are questioning whether their payment (expected returns) is sufficient for the risks they have been taking… and are expecting. We continue to believe that volatility will remain elevated, so it will be important to focus on those things that provide more certainty from an equity standpoint, and that likely means value outperforms growth. We also believe that some modification of our beginning of the year expectations is in order. While we still think that equity returns will end the year in positive territory, we are trimming our expectations for smaller stocks and are more constructive with international stocks over the short-term.

We have learned a thing or two over our more than thirty-year investment career. Specifically, when many within the investment community (both professional and individual) are quickly de-risking their portfolios by shedding anything and everything that even smacks of risk – good investments often get mis-priced to our advantage. This means that we should be much more on the lookout for the proverbial baby getting thrown out with the bathwater. The other thing is that proper diversification through asset allocation helps us get through the times when it feels as if everyone else has lost their collective minds. While it may often not be comfortable for the components, shaking a drink often changes a beverage for the better.

1. Source: “Trade Policy and the U.S. Economy in 2025”, Macro Signposts, March 26, 2025, PIMCO
2. Source: US Bureau of Economic Analysis, Gross Domestic Product data, Quarterly, 12/31/2024.
3. Source: The Conference Board, “US Consumer Confidence tumbled again in March”, March 25, 2025.

Definitions:
Leading Economic Index® (Indicators) (LEI) and Coincident Economic Index ® (CEI) for the IS: The composite economic indicators/Indexes are key elements in an analytic system designed to signal peaks and troughs in the business cycle. Comprised of multiple independent indicators, the indexes are constructed to summarize and reveal common turning points in the economy in a clearer and more convincing manner than any individual component. The CEI reflects current economic conditions and is highly correlated with real GDP. The LEI is a predictive tool that anticipates – or “leads” – turning points in the business cycle by around seven months.

PCE Deflator: The **PCE price index (PePP)**, also referred to as the **PCE deflator, PCE price deflator**, or the **Implicit Price Deflator for Personal Consumption Expenditures (IPD for PCE)** by the Bureau of Economic Analysis (BEA) and as the **Chain-type Price Index for Personal Consumption Expenditures (CTPIPCE)** by the Federal Open Market Committee (FOMC), is a United States-wide indicator of the average increase in prices for all domestic personal consumption. It is benchmarked to a base of 2012 = 100. Using a variety of data including U.S. Consumer Price Index and Producer Price Index prices, it is derived from the largest component of the GDP in the BEA’s National Income and Product Accounts, personal consumption expenditures. The Core PCE Deflator removes the impact of the more volatile Food and Energy Components from the index.

MSCI EAFE: The MSCI EAFE Index is an equity index which captures large and mid cap representation across Developed Markets countries around the world, excluding the US and Canada. The index covers approximately 85% of the free float-adjusted market capitalization in each country.

MSCI EM: The MSCI Emerging Markets Index (EM) captures large and mid cap representation across Emerging Markets countries. The index covers approximately 85% of the free float-adjusted market capitalization in each country.

SOFR: The Secured Overnight Financing Rate (SOFR) is a broad measure of the cost of borrowing cash overnight collateralized by Treasury securities. The SOFR includes all trades in the Broad Collateral Rate plus bilateral Treasury repurchase agreement (repo) transactions cleared through the Delivery-versus-Payment (DVP) service offered by the Fixed Income Clearing Corporation (FICC), which is filtered to remove a portion of transactions considered “specials”.

LIBOR: London Inter-Bank Offering Rate was an interest rate average calculated from estimates submitted by the leading banks in London. Each bank estimated what it would be charged were it to borrow from other banks. It was the primary benchmark for short-term interest rates around the world.

Disclosure: Investment advice offered through Stratos Investment Management, a registered investment advisor.

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