Market Strategy
by STRATEGAS A BAIRD COMPANY

BAIRD
Private Wealth Management

Quarterly Market Update
First Quarter, 2025

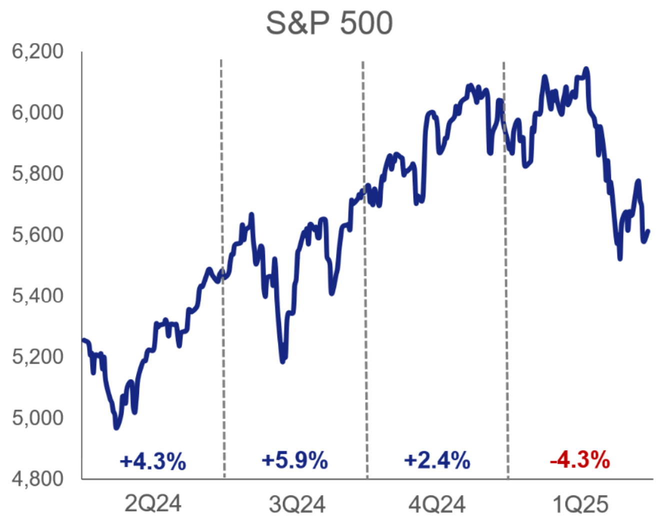
ON A CHALLENGING FIRST QUARTER

Big swings. It might be hard to believe, but it was just six weeks ago that the S&P 500 traded to a new all-time high as animal spirits were running rampant, sparking enthusiasm among both consumers and businesses. While the initial reaction to President-elect Trump's victory in November was certainly pro-risk — stocks rose, the US dollar strengthened, and bond yields fell — the markets have now settled back into an uneasy holding period, acknowledging the challenges that await the new administration with a -10% correction.

Uncertainty. The policy uncertainty stemming from the on-again, off-again tariff announcements does little to restore confidence (as the recent survey data suggests), and the biggest risk now is that the market has entered a negative feedback loop with the Fed contributing to a sentiment-induced slowdown. To be fair, there were weather-related factors that contributed to the weaker Q1 data, but both growth and inflation concerns are widespread among clients. As a result, we raised our odds of a recession from 15% in January to 45% today. Additionally, our Strategy team revised their earnings estimates downward, now expecting only 4% EPS growth for 2025.

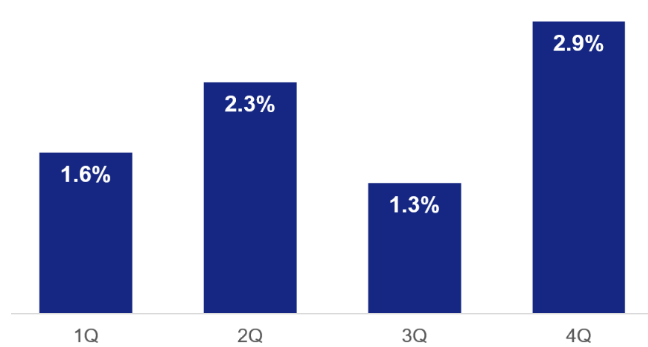
On markets. The good news is sentiment has changed meaningfully from the start of the year. As our Technical team has highlighted, investor expectations have turned upside down over recent weeks, raising the question, "what has the market already priced in?" From a tactical standpoint, the Magnificent 7, which had driven equity market returns over the past two years, has now become the "Lag 7", as investors reconsider stretched valuations and excessive positioning. The outperformance of the S&P Equal-Weighted Index should continue to benefit active managers, as investors question how permanent the style, region, and size shifts will be.

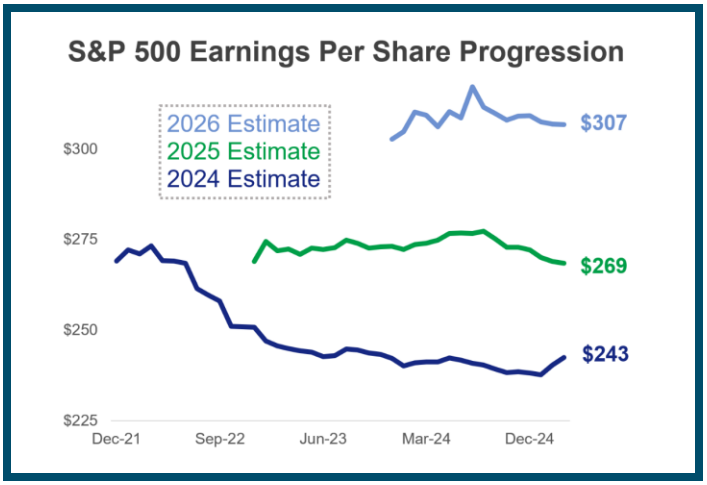
Portfolio building. Ironically, international shares have been big beneficiaries in the early days of the Trump administration, as both fiscal and monetary policy now appears more robust abroad than at home. Additionally, more value-oriented sectors like Financials and Energy seem to be better insulated from the tariff discussions. Of course, no sector would be immune in a recession scenario, but for now, it continues to make sense to maintain a more defensively positioned portfolio. From a size perspective, mid-caps seem to be the sweet spot, offering the right mix of growth potential and more favorable debt maturities than those of small-cap peers. Over the last six weeks, negative news (particularly tariff-related) has dominated the headlines, but if attention shifts away from tariffs to deregulation or tax relief, investors may be encouraged to take on risk once again.



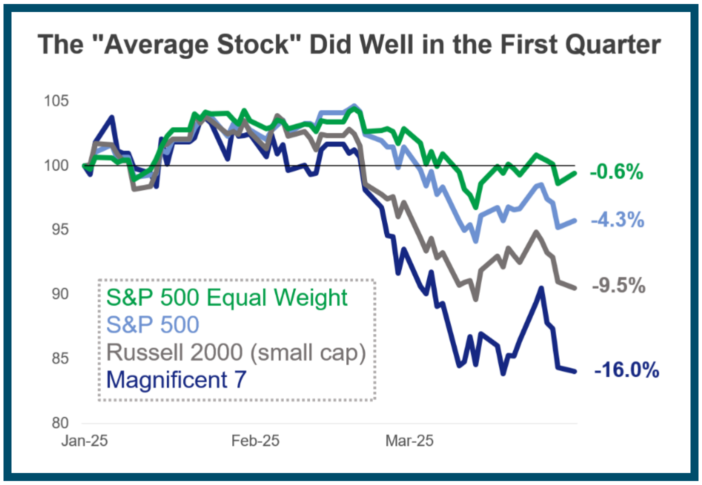
Asset Class	Representative Benchmark	Q1 '25	FY '24
US Large Cap	S&P 500	-4.3%	25.0%
US Small Cap	Russell 2000	-9.5%	11.5%
International	MSCI AC World ex-USA (USD)	5.4%	6.1%
Commodities	Bloomberg Commodity	8.9%	5.4%
Gold	LBMA Gold PM ($/oz)	19.4%	25.5%
Municipal Bonds	Bloomberg Municipal Bond	-0.2%	1.1%
Taxable Bonds	Bloomberg US Aggregate	2.8%	1.3%
Cash	Bloomberg 3-Month T-Bill	1.0%	5.3%

S&P 500 Average Quarterly Return (since 1928)
All data is from FactSet

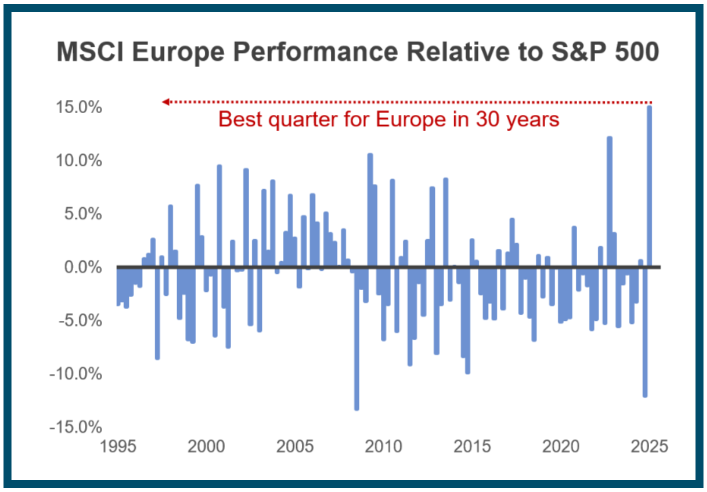




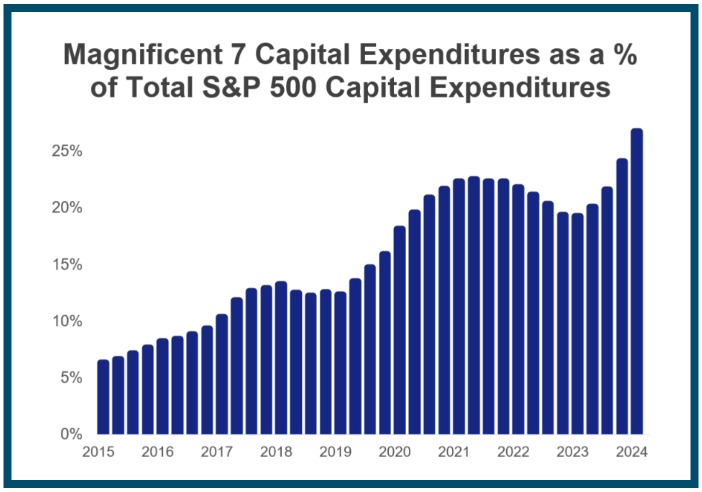
Consensus earnings growth expectations remain at a bullish +10% year over year for 2025, but amidst softer top-line growth and increased operating pressure, we have reduced our internal estimate for S&P earnings to $255.25 (from $265); the resulting +4% Y/Y implied growth rate is worrisome. By our lights the economy can punch through, but there is little room for error or uncertainty. With tariffs now in place, we expect a resetting of earnings expectations to come during the first-quarter reporting season, which could lead to additional downward pressure on equities. *(Data source: FactSet)*



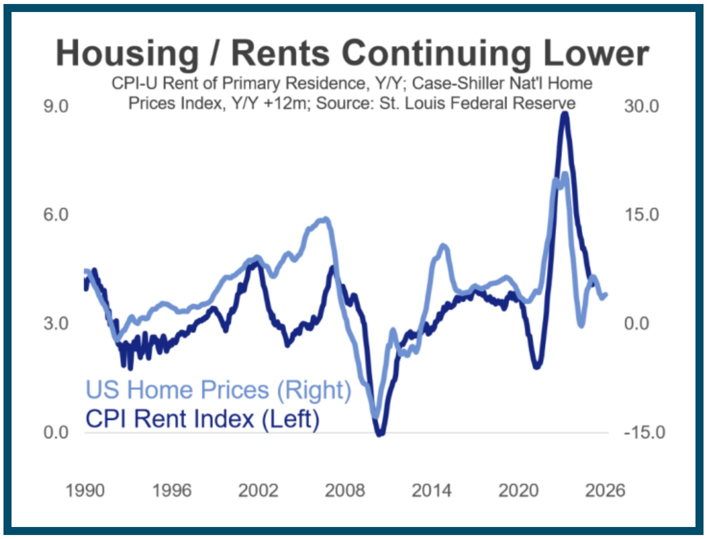
Despite volatility and a historically quick -10% correction, the first quarter was not as dire as headlines might suggest. Not only did US bonds, Gold, and international stocks outperform, but US equities were not as bad as the S&P 500's decline made them seem. Of the 11 stock market sectors, 7 were up on the quarter (and an 8th – Industrials – was only down 0.2%). What's more, the Equal Weight S&P 500 (the "average" stock) closed Q1 down just -0.6%. While tariffs are now driving headlines, Big Tech weakness obscured a market that looked decent under the hood in Q1. *(Data source: FactSet)*



Amid international strength in Q1, an often-asked question is whether this is a secular shift or another head fake. As fiscal spending shifts from the U.S. to abroad, investors are becoming excited about the potential for a pick-up in economic growth. However, near term, global outperformance is driven by a re-rating of multiples, fueled by a historically steep valuation discount (i.e., international stocks are historically cheap vs. US). However, we don't see a catalyst that could drive an extended period of outsized growth abroad. We will be watching for international earnings estimates to be revised higher, as multiples expansion can only drive returns for so long. *(Data source: FactSet)*

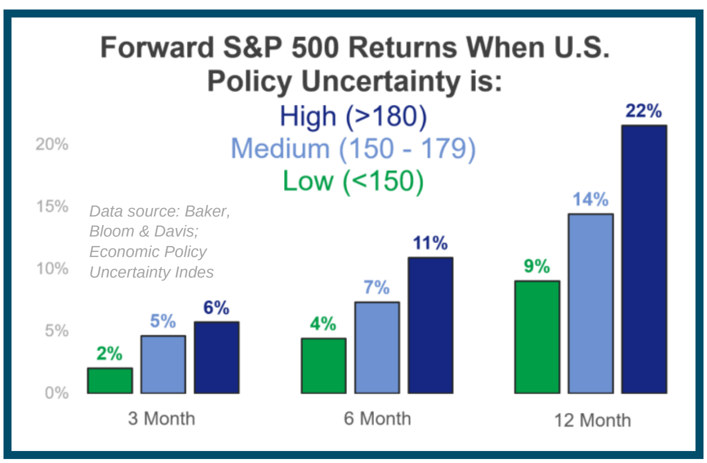


The AI arms race has unleashed capital expenditure that now accounts for 27% of total S&P 500 capex, up from 19% in 2023. Notable winners have been companies selling the "picks & shovels" (think Nvidia), but the market appears to be voting with its feet more recently as to what the durability of the miners' businesses in the AI gold rush. This is evident in the decline in free cash flow growth for the rest of the Magnificent 7 (excluding Nvidia), which peaked in 1Q24 at 52% year over year, but has since declined to -3% as of 4Q24. At what point will investors look for a return on investment on AI capex? *(Data source: FactSet)*

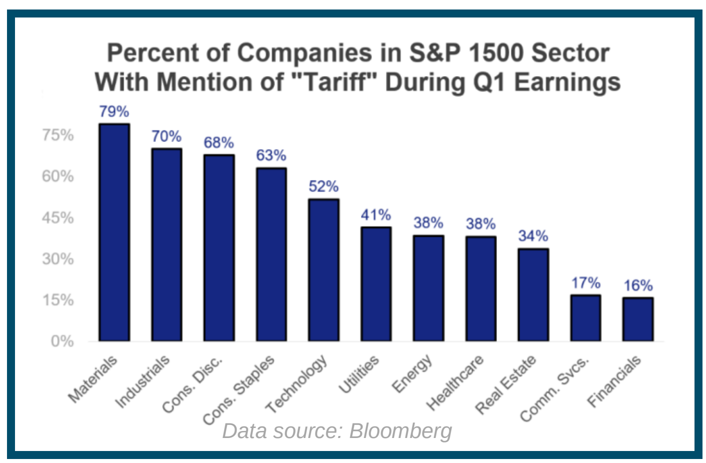


The rent component of key U.S. inflation metrics like the CPI has a heavy weight but is slow moving. Recent new rent data continues to moderate, opening the door to some downside inflation risk in 2025. This matters because survey measures of U.S. inflation expectations have fluctuated recently (in part due to politics). Reality may be more sanguine. Bottom line: there could be inflation risk at a longer-term time horizon, and this depends on the policy mix that the U.S. government chooses. A second wave of inflation is likely off the table in 2025 if shelter prices are anchored lower, however.

Despite solid U.S. economic performance in recent years, consumer sentiment remains near the bottom of its historical range. We have a package of evidence suggesting we should take the risk to U.S. growth seriously, and with tariffs also surprising to the upside, we have raised our odds of a U.S. recession in 2025 to 45%. Our concern is that the consumer is not interested in paying higher prices after already seeing one inflation shock this decade. So, if the tariff doesn't make it to the end consumer, it has to get pushed back onto the company's profits, and that could spur a broader downturn.



Recent weeks have featured heightened policy uncertainty with few comparable examples in the last few decades (the pandemic being possibly the only exception). For investors seeing the toxic mix of high valuations, a slowing economy, and a stubborn central bank, the last thing needed was a surge of policy uncertainty. But on the back of trade war fears, the Policy Uncertainty Index surged in March and now sits at levels only matched by 2020 in the history of the index (since 1985). However, the combination of historic bearishness (e.g., AAII survey) and record policy uncertainty is, oddly enough, a bullish cocktail for forward returns, as seen here.



The industries that have experienced the largest downward revisions to net income this year are those directly impacted by tariff announcements (autos, household durables, air freight & logistics, etc.). Companies have already been mentioning tariffs at a near-record clip on earnings calls, but the upcoming earnings season will be especially insightful to get a read on how different companies and industries are responding to the new tariff regime – will they attempt to pass costs on? Negotiate with foreign exporters? Lobby for exemptions? Profitability drives prices, so taking a fine-tooth comb to upcoming earnings calls will be prudent.

S&P 500 Index (Large Cap / U.S. Stocks): A representative sample of 500 leading companies in leading industries of the U.S. economy. These are equity securities of large capitalization (generally $7 billion plus market cap) companies having growth and value characteristics. ● **Russell 2000® Index (Small Cap / Small Core):** Measures the performance of the 2,000 smallest companies in the Russell 3000® Index, which represent approximately 10% of the total market capitalization of the Russell 3000® Index. These are equities of small capitalization. ● **MSCI EAFE Index Net (International / Developed Markets):** A free float-adjusted market capitalization index that is designed to measure the equity market performance of developed markets, excluding the US and Canada. As of December 2024, the MSCI EAFE Index consisted of the following 21 developed market country indices: Australia, Austria, Belgium, Denmark, Finland, France, Germany, Hong Kong, Ireland, Israel, Italy, Japan, the Netherlands, New Zealand, Norway, Portugal, Singapore, Spain, Sweden, Switzerland, and the United Kingdom. ● **BBgBarc Aggregate Bond Index (Taxable Bonds / Bonds):** Composed of approximately 6,000 publicly traded bonds, including U.S. Government, mortgage-backed, corporate, and Yankee bonds with an average maturity of approximately 10 years. ● **BBgBarc Muni Bond Index (Municipal Bonds):** Bonds must have a minimum credit rating of at least Baa, an outstanding par value of at least $3 million, part of a transaction of at least $50 million, issued after December 31, 1990, and have a year or longer remaining maturity ● **FTSE 3-month T-bill Index (Cash):** This index measures monthly return equivalents of yield averages that are not marked to market. It consists of the last one-month and three-month Treasury bill issues, respectively. ● **Bloomberg Commodity Index (Commodities):** Composed of commodities traded on U.S. exchanges, with the exception of aluminum, nickel and zinc, which trade on the London Metal Exchange (LME). Subindices include Petroleum, Grains, Industrial Metals, Livestock, Precious Metals, and Softs.

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