UBS

The Howard Group
Market Commentary

Balancing Act

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I mentioned in our January note that I thought 2025 would be a pretty good year for stocks, but we would likely get a few 5% to 10% pullbacks along the way. I was not, however, expecting one of these pullbacks to happen so early in the year, but here we are as the S&P 500 is off about 9% from its all-time high. While this is perfectly reasonable after two 20%+ years for the market, this quick move likely has some investors on edge. [1]

Many portfolio managers, including myself, believed the Trump administration would focus on the pro-growth, market-friendly agenda items first - such as deregulation and lower taxes - and later pivot to parts that could restrict growth like tariffs and cutting government spending. It's been just the opposite which could make sense for three reasons:[2]

1. The stock market was coming off two really good years and excess optimism had started to creep in post-election. Therefore, resetting investor sentiment is likely a healthy development and could help to extend the duration of this bull market.1
2. If the economy slows in the first 100 days of this administration, they can still blame the previous administration. If the economy slows in the back half of the year, they will have to own it. [3]
3. The US Treasury Department is expecting to refinance a significant amount of debt this year, therefore getting interest rates down was a priority. Since mid-January, the 10-year treasury rate has dropped from 4.8 to 4.2% and the U.S. dollar has declined about 5%. While this has caused concern over economic growth, it certainly helps with U.S. financing cost and brings Fed rate cuts back in play. [4]

Regardless of one's political views, markets are driven by liquidity or money flow within the economic system.[5] Broadly speaking, markets tend to do well when liquidity is being pumped into the system and tend to struggle when it's being drained. There are many ways to add liquidity to the system- lowering interest rates, quantitative easing by the Fed, fiscal stimulus, or government spending, lowering taxes, reducing government regulations, and increasing energy production. Conversely, each of these levers can be pulled in the other direction to have the opposite effect.[1]

Since 2020, fiscal policy has been the largest driver of liquidity which we've written about many times. The best example is when the U.S. avoided a recession when the Fed was aggressively raising interest rates. While the Fed was attempting to drain liquidity out of the system to fight inflation, the fiscal spending not only offset this liquidity but increased the overall amount. [6]

Now we have a much different approach as Trump 2.0 is looking to increase the private sector side of the economy and roll back government spending. [7] This debate over supply-side economics versus Keynesian economics has been going on for many years. Supply-side economists believe economic growth is best achieved through a robust private sector via lower taxes and less regulation, while Keynesian economist believe growth should come largely from government policy designed to increase aggregate demand. [8]

However, given the amount of U.S. debt and the interest expense on this debt, most economists would agree that continuing to run these types of deficits is unsustainable. But it's going to be a balancing act to make this transition in the economy without pulling too much liquidity out of the economy and causing growth to slow. Therefore, in order to offset the reduction in government spending and tariffs, we will need to see, in my view, an increase in capital investment, lower interest rates, and greater bank lending. Time will tell, but the recession fears are overblown in my opinion. The only way out of this debt crisis is more economic growth and given that tax revenue is highly correlated with stock market performance, there is most likely a Trump and Fed Put if things get worse.

So what does this mean for markets?

Again, portfolio managers have been frustrated with the sequencing of the policies being rolled out in Washington and are trying to price in the worst-case scenario with tariffs and DOGE in a short period of time.[2] While it would be great for the narrative to shift to the more pro-growth parts of the agenda, I don't necessarily think it has to happen for the market to find its footing again. Markets don't usually bottom on good news; they bottom when the news goes from bad to less bad, alongside extreme bearish sentiment.[1]

To that point, we have seen investor sentiment go from extreme bullishness to extreme bearishness in a short period of time. In fact, AAII (American Association of Individual Investors) survey is now showing bearish sentiment last seen in March of 2023.[11] While we could get one last flush down that shakes out the weak hands, I feel we will get a pretty aggressive bounce in the next day or two and the quality of this bounce will give us clues as to whether the bottom is in or the market has more work to do.

Over the past few weeks, defensive stocks such as consumer staples and healthcare, have been the top performers in the U.S. and the more cyclical sectors have gotten hit the hardest. 1 If we get a bounce, I will want to see the rally led by these more cyclical sectors to have greater conviction that the worst is behind us. Furthermore, international stocks have outperformed the U.S., particularly China and Europe, which makes sense as China and Europe are both adding fiscal stimulus to their economy while the U.S. is trying to reduce it.[1] I question the durability of this recent trend, especially given Europe still has highly regulated economies and very little innovation.12 While having some international exposure can make sense, I highly doubt the U.S. exceptionalism trade has come to an end.

In summary, after two exceptional years for the stock market, a 10% correction is very healthy and normal, albeit it doesn't feel that way at the time. [1] However, I think we will look back a few months from now and realize this was a great buying opportunity, especially in U.S. companies that should benefit from deregulation, lower taxes, and artificial intelligence. While the next few weeks will likely remain choppy, I encourage investors to block out all the hysteria as this too shall pass. And as Ernest Hemmingway said, "Courage is grace under pressure"

Please feel free to reach out if you have any specific question or comments.

All the best,

Gray

Please note: If you do not have assets under management with our group and would like more information on our process and performance, please let us know.

Sources;

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