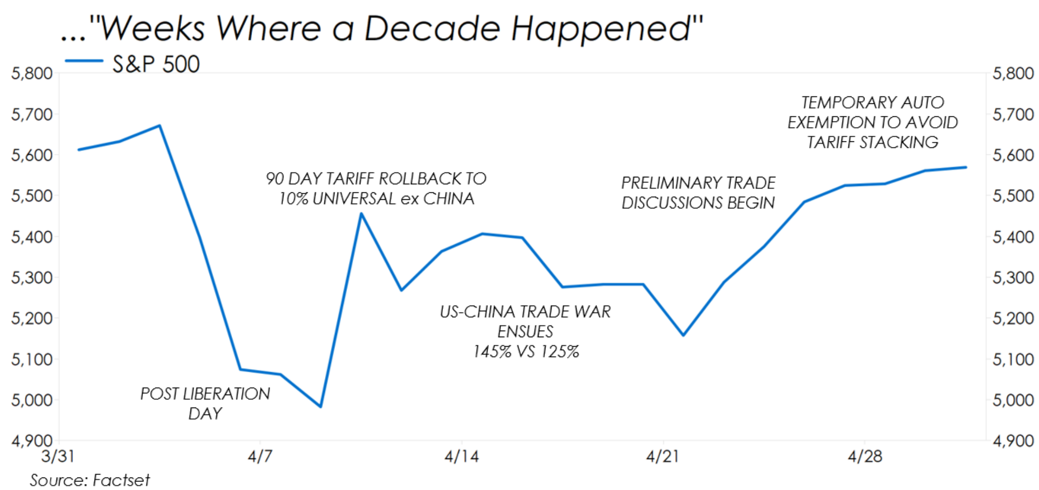
Like Turning a Ship

"There are decades where nothing happens and weeks where decades happen."

– Vladimir Ilyich Lenin – Russian diplomat (*1870-1924*)

It's been said that it takes twenty-five miles to turn a battleship completely around. While that's a gross exaggeration (research suggests that today's ships can turn around in a couple of minutes), this metaphor is meant to serve as a reminder that big shifts don't happen quickly. And yet, in the month of April, it certainly felt like there were tectonic shifts underfoot.

As can be seen in the chart below, headlines around trade and tariffs were fast and furious. The month kicked off with "Liberation Day" on April 2nd which ushered in US reciprocal tariffs levied on foreign goods from 60 countries at reportedly half the rate they charge on US goods as estimated by the Administration (when factoring both tariff and non-tariff trade barriers). The S&P 500 quickly fell about 12% in response to the plan. As the White House pivoted to a rollback of 10% universal tariffs for 90 days to allow for trade discussions to occur, the market rallied back but not before a trade war ensued that left US goods and Chinese goods prohibitively expensive to each respective trading partner. Still, toned down trade rhetoric and reports of preliminary trade discussions with India, South Korea and Japan calmed investors enough for the S&P 500 to finish remarkably close to where it started in the month. Of course, solid first quarter earnings results from almost three quarters of the S&P 500 were a help as well – though guidance was volatile, uncertain and, in a lot of cases, simply nonexistent. Even with a 90 day stay, the speed of tariff implementation was at light years as compared to the time it takes to "turn the ship" – leaving management teams highly uncertain of supply chain costs.



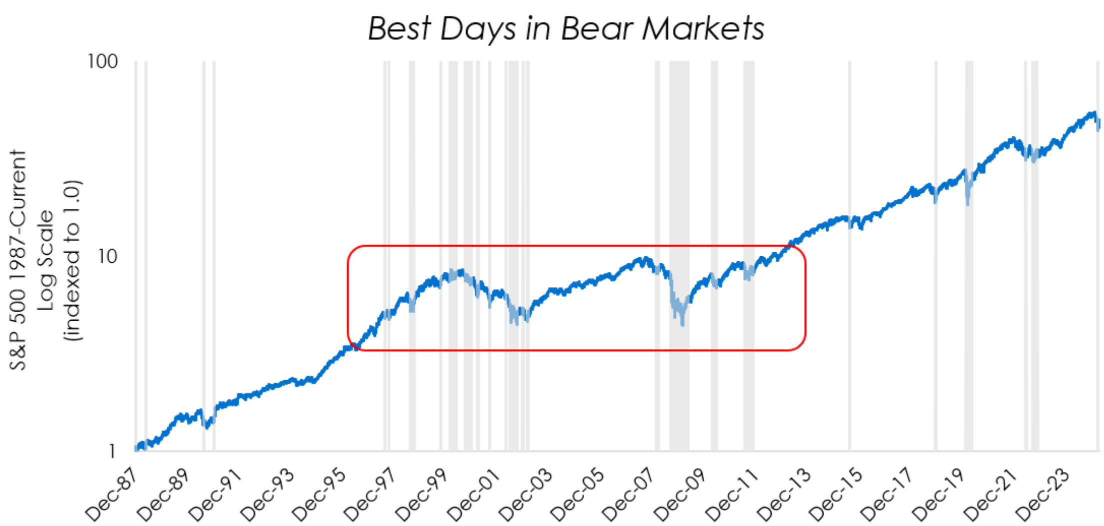
Source: Factset

Battered and bruised, many investors are trying to get their second wind as what felt like a decade of events happened in the span of about four weeks' time.

While we'll certainly take the rally in the back half of the month (to get back to almost even for April), we're reluctant to give the "all clear" quite yet and can't rule out a retest of the lows. In short, a highly uncertain backdrop means there's an increasingly large number of potential scenarios on the table.

Assessing the fundamentals remains paramount. So far, early reads on the economic data in April are probably best characterized as "better than feared". We're watching the labor market closely and noted the recent increase in jobless claims (albeit from low levels) though payroll gains were solid and the unemployment rate unchanged. The April ISM manufacturing survey deteriorated but was also better than anticipated suggesting that there wasn't that initial falloff in demand that had been implied from the bigger drops in the April consumer confidence surveys. Meanwhile, earnings estimate revisions for this year aren't disasterous but are starting to get chipped away at as confidence remains uncertain and the cycle matures. As a result, the earnings bias is lower with increased risk for a pull ahead in the peak forward earnings growth rate.

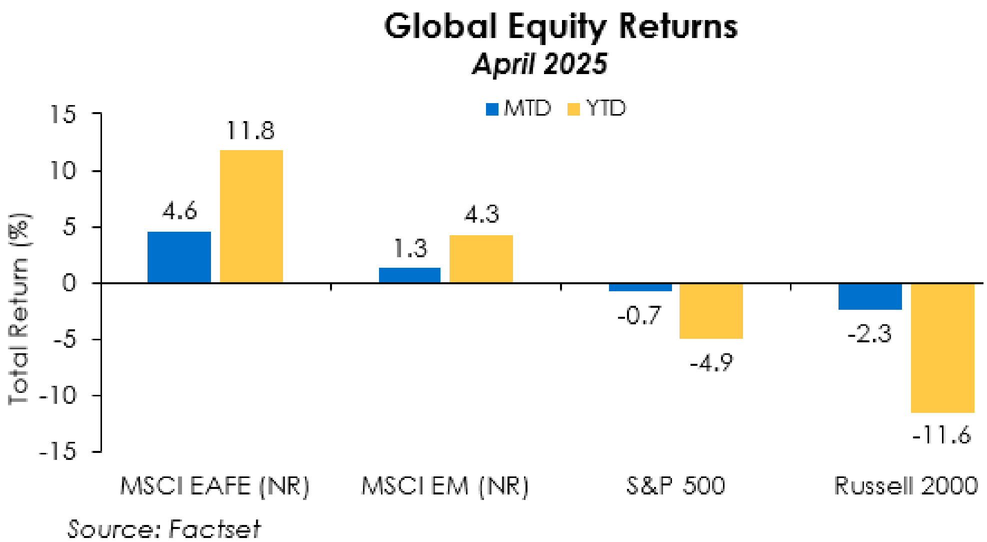
Also important is assessing the nuances of price action – or the technicals – which can give investors a sense of how the market is viewing the backdrop. So far, the S&P 500 has rallied back into resistance with internal momentum and breadth readings improved but shy of the "all clear" mark. We're also keeping track of the "best days" in the S&P 500 (as defined as top 1% daily moves). Counterintuitively, "best days" typically happen more regularly in the throws of secular (volatile and sideways) bear markets and less frequently in upward trending secular bull markets. So far, former instances have been fairly modest since the last major market low back in October 2022 though we did trigger another instance this past month. The more frequently these occur, the more likely we'll have seen a regime shift. We're noting them but we're not there yet.



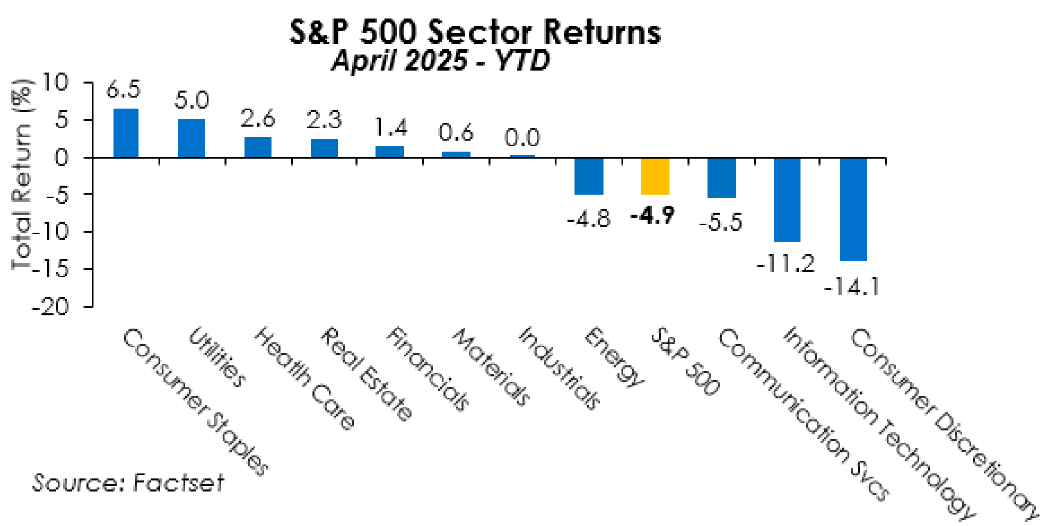
Source: Factset; S&P 500 on a log scale and indexed to 1.0 from 12/31/87-4/30/25. Shaded regions are top 1% days over the stated time period.

April was an extremely volatile month with Stocks, REITs, Commodities, and even Bonds selling off into mid-month following the tariff announcements. The second half of the month was better with markets rallying on oversold conditions and volatility subsiding. International and Emerging Market equities outperformed domestic equities as the dollar weakened. Bonds were more volatile than normal as investors debated whether slowing growth or inflation was the greater threat. REITs declined low single digits while Commodities were the worst performer for the month after being the standout in the first quarter.

Stocks

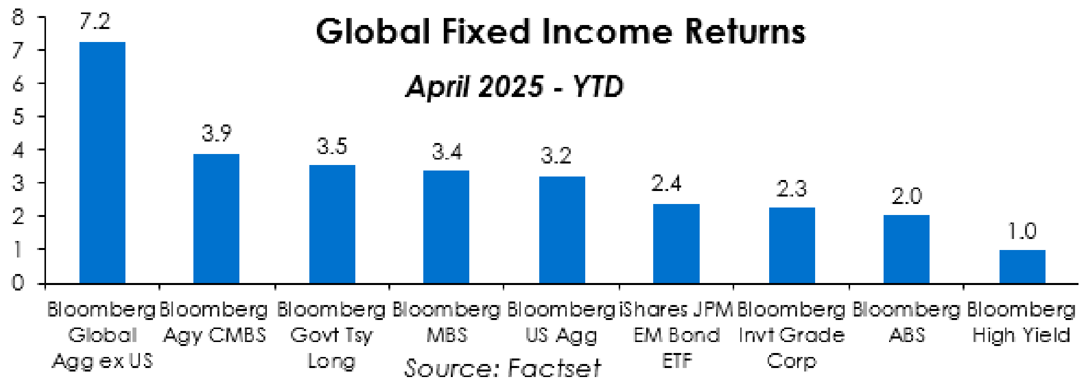


International Developed Markets (MSCI EAFE) posted strong returns in April and year-to-date as the dollar weakened and investors looked to increase portfolio diversification. Emerging Markets (MSCI EM) were positive and continued to perform well despite tariff threats. Meanwhile, domestic stocks underperformed with U.S. Large Caps (S&P 500) and Small Caps (Russell 2000) down low single digits on tariff and stagflation fears. From a sector perspective, performance has been much broader year-to-date with the notable exception of Information Technology, Communication Services, and Consumer Discretionary all having lagged significantly – despite that reversing some in April.



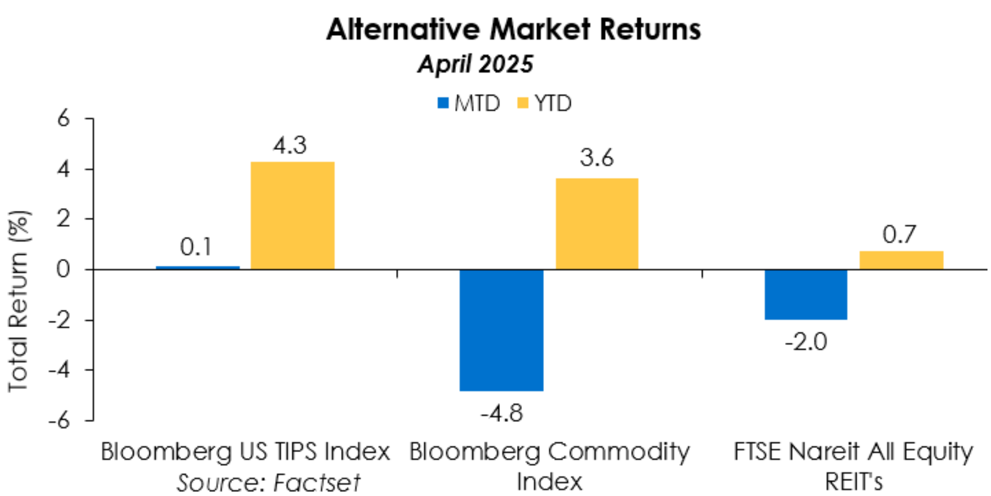
Bonds

Policymakers pivoted to an easing bias by reducing the Fed Funds rate by 50 basis points at their September meeting and another 25 basis points each at their November and December meetings (Fed Funds at 4.25-4.50%). While this easing bias is the first in over four years, policymakers left rates unchanged at the January and March meetings with the same expected for the upcoming May meeting. Since December, the Fed has reduced the number of expected 2025 rate cuts from four to two (25 basis points per) and indicated they expect slower growth and higher inflation by this year's end. Despite the implied "stagflationary-lite" backdrop, Bond returns held up better than (domestic) Stocks year-to-date as investors have generally embraced a higher quality and more defensive tone. International (Bloomberg Global Agg ex US) has been the standout for the year due to dollar weakness while High Yield (Bloomberg High Yield) the laggard.



Alternatives

Commodities were weak in April as energy prices declined significantly on increased oil production amid growth concerns. Meanwhile, publicly traded Real Estate (REITs) posted positive returns for the year though declined again in April on worries over stagflation. Finally, year-to-date returns on Treasury inflation protected securities (TIPs) performed relatively in line with nominal Treasuries amid volatile (first rising, then falling) inflation expectations.



Market Outlook

"It's Tricky to rock a rhyme, to rock a rhyme that's right on time. It's Tricky."

– Run DMC, *It's Tricky* (1986)

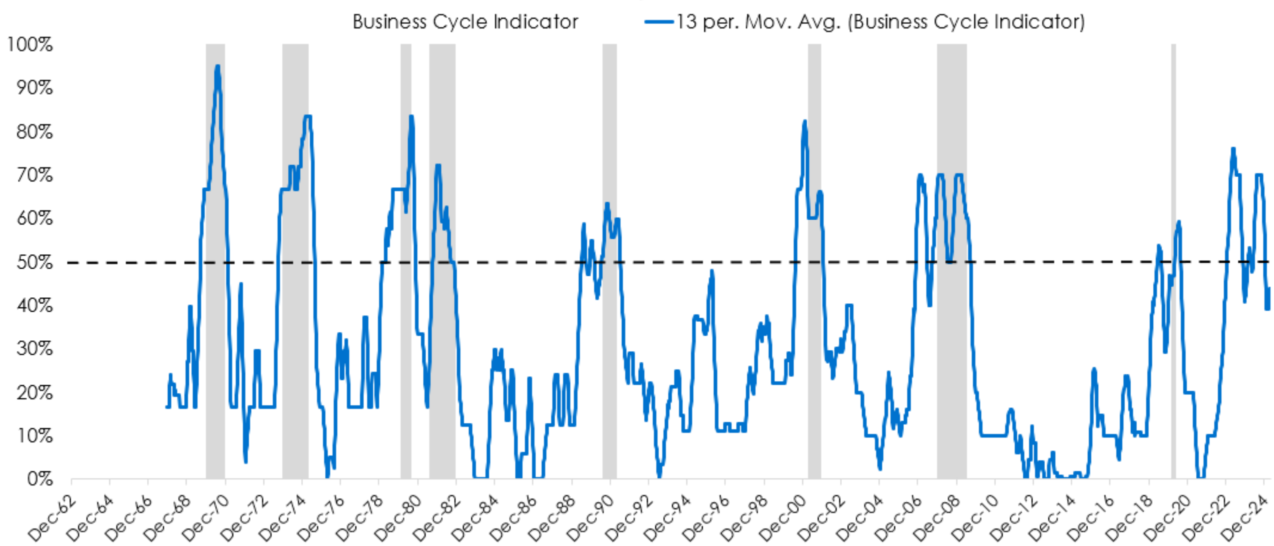
As the page turns further into 2025, we remain focused on the ever evolving Tricky "Tri-Cycle" – the "three cycle" framework we're using to assess the landscape. A stagnating (and late) Economic Cycle, quickly maturing Profit Cycle and wildly reversing Policy Cycle – makes for the continuation of a Tricky backdrop that requires investors to keep their proverbial eyes up and "Head on a Swivel". Let's explain.

Tricky "Tri-Cycle"

Cycle	Stage
Economic Cycle	Stagnating
Profit Cycle	Maturing
Policy Cycle	Reversing

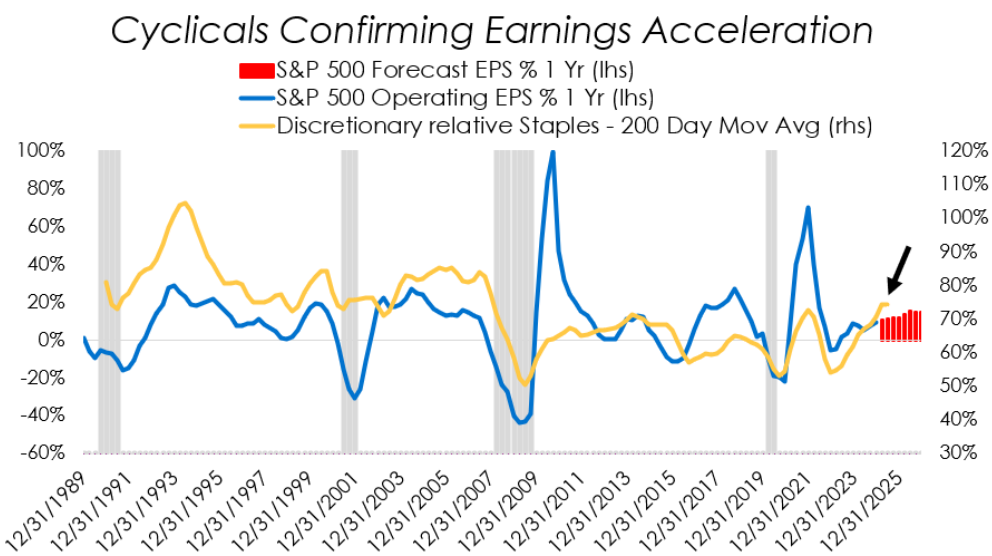
Economic growth is at risk of slowing materially, in part, from the inaction related to elevated uncertainty. Slowing growth might also come with sticky inflation of higher priced (tariffed) goods until demand recalibrates into disinflation. What's more, we believe there's fundamental evidence – including the yield curve, leading economic indicator composites, certain survey relationships and especially labor market measures – that point to being on the later side of the economic cycle. As can be seen below in our business cycle indicator, an increased percentage of measures being triggered is a good illustration that we remain at comparable late cycle levels in the economy (with recessions designated by shaded regions).

Business Cycle Indicator



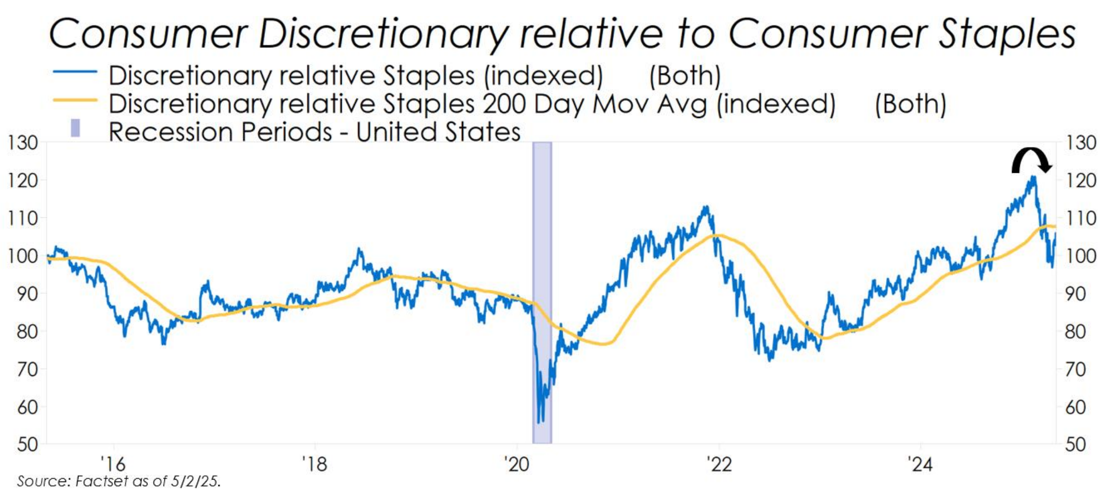
Source: Yellow Cardinal Research; the Business Cycle Indicator is a proprietary dashboard of financial conditions that historically have provided some context of business cycle duration and lead time on recessionary events. When more than half of the weighted average signals were triggered, this often preceded a recession. The Business Cycle Indicator is a weekly signal with the 13 week moving average smoothing the volatility.

<u>At this point, the profit cycle doesn't look as late as the economic cycle but changes in the policy setup – namely higher potential taxes imposed from tariffs – suggest a quickly maturing backdrop.</u> As can be seen in the chart at right – profit growth (blue line) continues to ramp off of the earnings recession trough in 2022 with the consensus forecast (red bars) not suggesting a peak in growth until 2Q26. Also note, that when comparing the price action of the Consumer Discretionary sector against the Consumer Staples sector (both on an equal weighted basis using the relative <u>200 day moving average</u> – yellow line), the pro-Discretionary tilt implies a cyclical bias that tends to coincide with an acceleration in earnings growth.



Source: Factset; S&P Global Indices with operating EPS defined on a trailing twelve month basis. Discretionary relative Staples is defined as the relative 200 day moving average using the S&P 500 equal weighted sectors indexed back to inception through 5/2/25.

That is – up until recently – with analysts starting to revise earnings estimates lower as the combination of dented confidence and higher potential supply costs threaten profit margins, end demand or both.



Lower stock prices is the market's way of trying to anticipate this move. The chart at left shows the <u>daily</u> price change against that 200 day moving average measure. <u>The recent weakening of Discretionary stocks relative to Staples stocks (blue line) is material enough to suggest that we may be nearing the peak in the forward earnings growth rate faster than the consensus expects.</u> Such a change would suggest a downshifting in the profit cycle that has historically come with some rotational leadership changes.

The bottom line is that the equity market is anticipating that the abrupt policy changes of late might lead to a faster maturing profit cycle.

Add to that, the third leg of the stool – a policy cycle that's abruptly reversing from looser fiscal and (relatively) tighter monetary to one that suggests the opposite. An unhealthy deficit setup is leading to reductions in government spending (tighter fiscal) and higher than anticipated tariff rates are likely to cause the Fed to react in lowering rates (looser monetary) – though this might be delayed due to the inflationary nature they initially cause. This abrupt change in policy is causing investors, consumers and companies to re-think the backdrop. With what seems like an increasingly large number of potential scenarios, it's no wonder that the only certainty might be a high degree of uncertainty.

The Certainty of Uncertainty

Past Policy	Future Policy
Looser Fiscal	Tighter Fiscal
Tighter Monetary	Looser Monetary

So what are the implications and key takeaways for portfolios?

From a portfolio positioning perspective, we continue to emphasize the importance of diversification and balance as a way to mitigate the high uncertainty as referenced above. While diversification has previously been an uncontroversial concept, the concentration present in passive indices today – by virtue of the price action over the last couple of years – suggests this notion remains a relic of the past. We respectfully disagree and earlier this year took the opportunity to rebalance portfolios to maintain that degree of balance. In so doing, we took some profits in US Large Caps and added to our overweight (OW) in US Core Fixed Income. As a result, we've remained UW the most expensive and concentrated areas where we've viewed the long-term risk reward less favorably.

Within equities, our positioning incorporates balance geographically (tilt toward International) and within our US Large Cap exposure especially. Our bias has generally been to have more exposure to less expensive areas (down market cap vs top). As such, we've maintained a larger OW in Cyclical Value and Defensive sectors combined with a smaller sized cap bias. We remain UW the most concentrated and expensive Cyclical Growth areas.

Within fixed income, we remain biased toward the higher quality US Core Fixed Income segment – where we're longer in duration and have previously repositioned our Treasury exposure in acknowledging the steepening yield curve. This exposure remains among our largest OW in portfolios for diversification purposes though we've also added to International Fixed Income (EW), where the end of negative interest rate conditions has led to more attractive opportunities. Maintaining a higher quality bias means that we still remain

UW the most expensive part of the bond market (High Yield) where tight spreads have made this unattractive in our view (with that beginning to reverse modestly).

Within alternatives, we remain fairly balanced across the board with neutral positions in Diversifed Alternatives, Real Estate and Commodities. Most recently, we adjusted our mix of Diversified Alternative managers in order to provide greater insurance against market volatility by emphasizing income and short exposure – areas that can benefit from choppy market conditions, thus, enhancing diversification.

Above all else, we find investors should keep in mind the following:

- Stay focused on the things you can control like ensuring you have adequate 6-12 month liquidity needs which should allow your long-term investment monies to stay invested.
- Has the structural integrity of your plan changed (purpose of money, time horizon, liquidity needs, risk tolerance)? If the answer is no, then recognize that the economy and the market run in cycles that diversified portfolios are there to help mitigate.
- Short term volatility is often the price one pays for the benefit of higher long-term returns.

Thanks for giving this a read.