Quarterly Outlook

At-A-Glance

In March, the S&P 500 declined into a correction, dropping 10% from its peak for the first time since October 2023.

Corrections are a normal part of investing.

Bucking the trend, international stock markets are beating U.S. stock markets by a wide margin in 2025.

The developed international index (EAFE) is up over 12% while the S&P 500 is down over 3% on a year-to-date basis, as of the March Fed meeting (3/19).

Value stocks are also rallying, while growth stocks are still in a correction from their prior high.

The Russell 1000 Growth Index is down over 8%, while the Russell 1000 Value Index is up nearly 2%.

Bond yields initially went up on prospects of more inflation caused by tariffs and more pro-growth fiscal policies.

Yields started to rise as economic uncertainty grew, and tariffs soon foreshadowed potential optimism around deregulation.

The aggregate bond index is up around 2%. When bond yields fall, bond prices rise.

With bonds and international markets doing better than U.S. stocks, balanced portfolios are generally faring better than the S&P 500 thus far in 2025.

Steering Through Uncertainty

As we navigate through the early months of 2025, the economic landscape presents a mix of optimism and uncertainty. Investors began the year hopeful due to significant AI investments and prospects for pro-growth policies like deregulation and tax cuts. However, as the quarter progressed, cracks appeared, leading to increased uncertainty and weaker economic readings.

The emergence of DeepSeek, a Chinese AI company with potentially more efficient open-source models, raised doubts about the sustainability of such large expenditures by American firms. This has implications for future AI spending and related industries, such as chipmakers.

Focus has also shifted to potential tariffs, creating uncertainty for businesses regarding hiring and production decisions. The public negotiation of tariffs has led to market volatility, and their implementation will be crucial in shaping the economic outlook.

Government spending is under scrutiny, and we narrowly avoided a government shutdown. The Department of Government Efficiency (DOGE) aims to cut federal spending and payrolls, potentially increasing unemployment and reducing government expenditure.

All this feeds into economic data which shows signs of cooling, with weaker consumer sentiment and confidence, and spiking job cut announcements. Despite these concerns, there are reasons for optimism. Questions about DeepSeek's efficiency persist, and historical data suggests the economy can withstand tariffs.

Globally, countries like Germany and China are taking steps to mitigate tariffs' effects and stimulate their economies. Germany plans historic fiscal stimulus, while China is focusing on boosting consumption through wage increases and childcare subsidies.

In summary, while uncertainties persist, several factors provide a foundation for optimism. The resilience of the labor market and potential Federal Reserve actions will be key determinants of the economic trajectory for the rest of the year. Diversification is prudent, and your Cetera financial professional can help you navigate any uncertainty to keep you focused on your personal goals and objectives.

Economy

Investors were optimistic entering the year. Artificial intelligence (AI) spending and pro-growth policies, such as deregulation and tax cuts, would hopefully be ushered in soon. However, uncertainty continued to grow and cracks in the optimism began to emerge in late January. Uncertainty continued to climb into the end of the quarter causing some weak economic readings. Before we discuss reasons to remain optimistic let's go over the growing uncertainties that may persist throughout the year.

Artificial Intelligence

The announcement in mid-January that a group of large tech companies pledged to spend up to $500 billion in AI infrastructure in the coming years added to the AI craze. However, about a week later, enthusiasm faded when news of a Chinese AI company, DeepSeek, emerged. While American AI companies had been spending billions to develop AI infrastructures, the Chinese company appeared to have done it more efficiently with similar results, throwing into question the amount of money American companies have been spending and jeopardizing the growth of future spending, which could potentially impact chipmakers and others who have benefited from this large spending spree. Additionally, DeepSeek's models were open source and free, casting doubt on U.S. companies' business models which looked to generate revenues from charging fees.

Tariffs

Focus soon shifted away from AI spending to tariffs. It is very difficult to quantify the impact of possible tariffs, let alone understand what tariffs will ultimately be imposed. Countries seem to be negotiating the tariffs publicly through the media, adding to market swings based on the newest sensational headline. The potential tariffs are creating a lot of uncertainty for companies as they may decide to hold off on decisions around hiring and production until there is more clarity. After tariffs are implemented, there will likely be concessions.

Additionally, how tariffs are implemented will dictate their size and scope. Countries are likely to make exceptions after the impact of the tariffs are understood more. As companies put plans on hold, this creates economic growth concerns. Inflation around the tariffs may be less of a concern as tariffs would likely cause a one-time increase in prices of goods. Keep in mind that inflation is the change in price and prices would not be expected to continuously increase after the implementation of the tariffs. However, we are already suffering from high prices from previous bouts of inflation during the pandemic. Raising prices even more could put stress on consumer spending, which drives around 70% of GDP growth in the United States.

Government Spending

A government shutdown was largely overlooked by investors, as they are becoming increasingly common. We had our longest government shutdown a little over six years ago. As we approached the mid-March deadline, Congress has approved stopgap funding until September 30 but look for this to be a headline again later in the year.

Causing more near-term uncertainty regarding government spending is the Trump administration's Department of Government Efficiency or DOGE. DOGE seeks to cut federal spending and payrolls which will ultimately add to unemployment and reduced government spending. Again, the impact this has on the economy will revolve around the magnitude of the cuts.

Cooling Economic Data

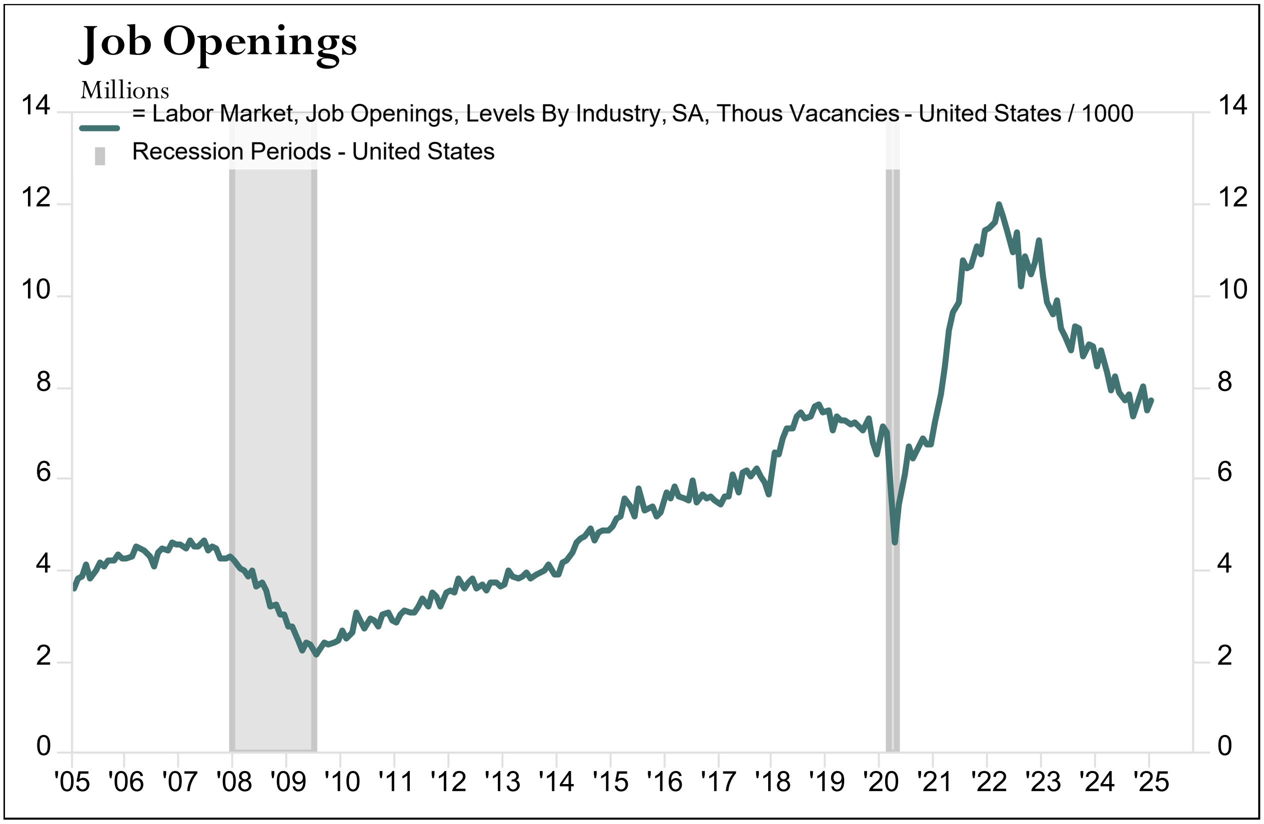
The factors we already discussed are adding to economic growth concerns which is bubbling up in economic reports, especially consumer surveys. Both the University of Michigan's Consumer Sentiment and the Conference Board's Consumer Confidence reports have come in much weaker than expected raising concerns about consumer health. New orders, the forward-looking component of the ISM Manufacturing PMI survey, plunged in February as companies started to put plans on hold as they wait for more clarity around tariffs. Looking to the labor market, Challenger, Gray & Christmas reported job cut announcements spiked the most since July 2020 in February.

Reasons for Optimism

There is no question that uncertainty is on the rise. AI enthusiasm is being questioned and policy changes around tariffs and government spending are changing. All this is creating concerns around economic growth. These are valid concerns, and we will be following closely looking for further deterioration in the data, but currently these concerns may be overblown for the following reasons:

- There are still many questions regarding DeepSeek. American owned company, OpenAI, has accused the company of secretly using data produced by OpenAI's technology. There are also questions surrounding how many chips the company uses and perhaps the efficiencies aren't as much as originally claimed.
- Tariffs will be negotiated, and eventually we will get certainty. Tariffs may also end up being limited to reciprocal. Tariffs are also not new. In 2018-2019 we saw the U.S. impose tariffs on goods and the economy held up. Inflation was 1.9% and 2.3% in 2018 and 2019, respectively. GDP growth was 2.9% and 2.3%, and the unemployment rate remained below 4%.
- Government shutdowns historically have had little economic impact as the impact it has is usually just transferred from one quarter to another. While the unemployment rate isn't expected to climb very much from the DOGE job cuts, the spending cuts could be a drag on economic growth unless the money is put back into the economy through a DOGE dividend or other increases in spending or tax cuts. The net impact is important, and the deficit is unlikely to be reduced significantly (reducing the deficit would hurt GDP growth).
- Consumer surveys can be influenced by political party affiliation and are also becoming a less reliable indicator for consumption growth in recent years. While manufacturing surveys cooled, services surveys fared better, and the service industry is a much larger component of GDP growth.
- Inflation data cooled after January and the Bureau of Labor Statistics showed jobless claims that were slightly lower and job openings on the rise as seen in **Figure 1**. Job openings remain above pre-pandemic levels. If the labor market does weaken, the Fed is likely to accelerate their rate cut timeline.
- A recession, while a concern, does not seem in the cards as much of January's economic data was hurt by cold weather and the labor market is slowing but not imploding.

Figure 1: Labor Demand



Source: Cetera Investment Management, FactSet, U.S. Bureau of Labor Statistics. Data as of 1/31/2025.

Overseas

Impacts from tariffs on foreign countries remain a question mark for them as well, but some are taking steps to combat the potential impacts. Germany, who has traditionally been stricter with fiscal policy, looks to be planning a historic fiscal stimulus plan. They are planning to allow for higher defense spending and removing a balanced budget restriction for state governments.

Recent Chinese stimulus has been geared toward reducing local government debt, which doesn't have as much of an impact on consumer spending, but that could change soon. The Chinese Communist Party is now looking to boost consumption considering U.S. tariffs. These plans include raising wages and childcare subsidies, which they also hope encourages more children.

The U.S. is also lucky in that it can be energy independent with an abundance of natural gas and oil. Much of the rest of the world relies on other countries for energy. A ceasefire with Russia and Ukraine could potentially lower energy prices for Europe and China.

Summing It Up

It has been a tumultuous start to the year, but keeping a calm mind is important. If you recall the themes in our 2025 Outlook, we anticipated moderating economic data, a friendly but less supportive Federal Reserve and diversification may finally be rewarded.

Economic data appears to be moderating, but it is also creating an economic growth scare as uncertainty has caused companies to put plans on hold and investors are worried about the consumer which has carried the economy thus far. We think the consumer will go the way of the labor market, so that is what we will be watching very closely over the course of the year. At this point, the labor market appears healthy, although also moderating.

The Fed is also watching the labor market though. It is also dealing with uncertainty of its own, while trying to balance four factors: fiscal policy, tariffs, deregulation and immigration. It will be trying to understand what the net effect of these factors will be; however, this may prove difficult because they don't impact the economy at the same time. The good news is that the Fed can afford to be cautious if the labor market holds up. If the labor market shows signs of deterioration, the Fed will likely move up its timeline to cut interest rates and boost the economy. To quote the Rolling Stones, "You can't always get what you want, but you get what you need." While the Fed has paused rate cuts, they will step in when needed.

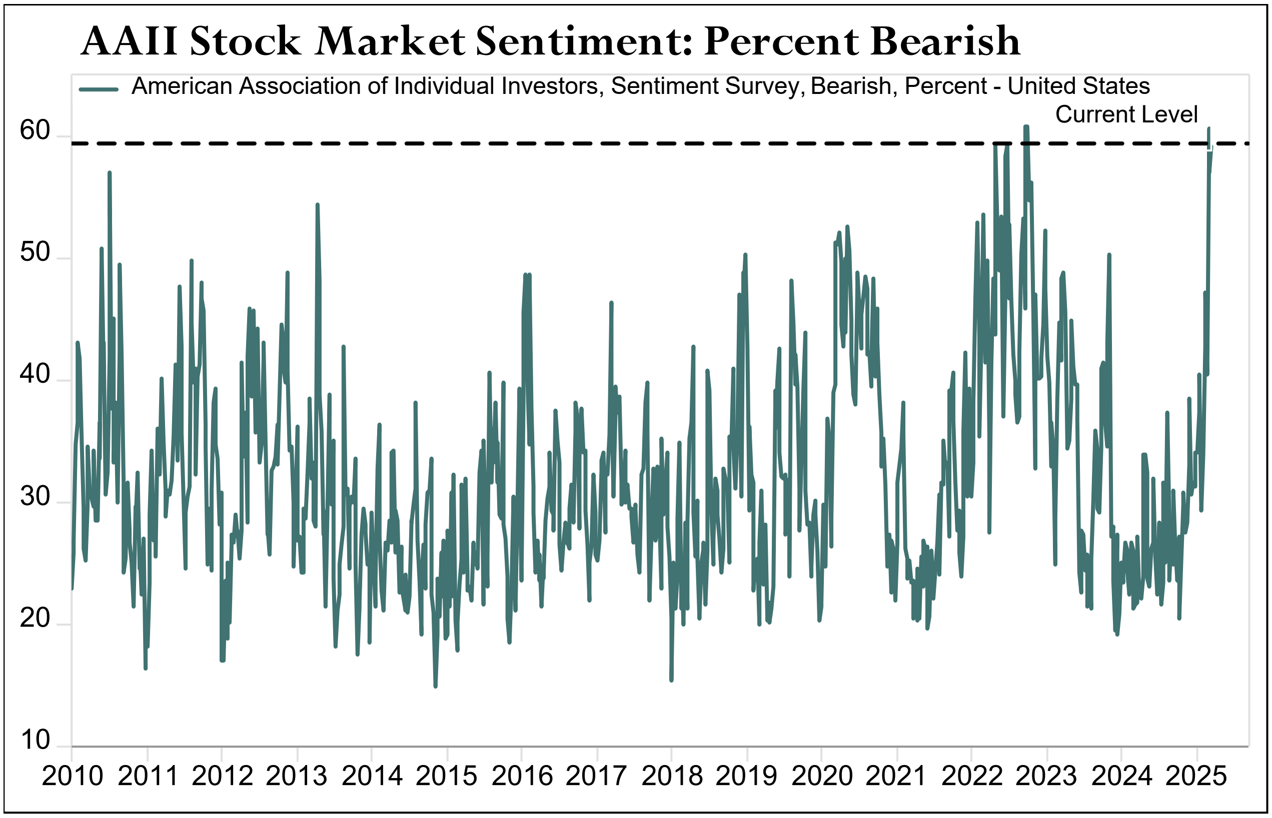
So, while everything seems different this year, it appears to be playing out much like anticipated. We will discuss diversification finally being rewarded in the equity and fixed income sections.

Equity Markets

Markets continued their 2024 upward climb in January, with the S&P 500 rising nearly 3%, despite the news around DeepSeek in late January. Optimism around deregulation also started to fade as worries around tariffs took center stage. The S&P 500 gave up around half its January gains in February and by March it went into a correction for the first time since October 2023. A correction is a 10% drop from the most recent peak and happens in most years, so one could argue we were due for one, especially given the high valuations that we have been talking about for some time.

After high levels of optimism in stock markets, uncertainties finally pulled the bears out of hibernation. Looking at the American Association of Individual Investors Sentiment Survey, bearishness is currently at high levels as seen in **Figure 2**. This can generally be seen as a contrarian indicator. When everyone is bearish, it can mean that the sentiment will change soon and become bullish and could provide upward support for stocks. This could be seen as a behavioral finance topic. People overestimate how good or bad things are going to get. It explains why people are underwhelmed after achieving a good outcome and relieved after a bad outcome occurs. It usually isn't as good or bad as one anticipated. Yes, there is a lot of uncertainty in the economy right now, but as we discussed there are still reasons to be optimistic. This bearish survey could be another example of a reason to be optimistic.

Figure 2: Bears Come Out of Hibernation



Source: Cetera Investment Management, FactSet, American Association of Individual Investors (AAII). Data as of 3/14/2025.

Earnings growth for the S&P 500 is being revised down for the first quarter, from near 11.5% year-over-year in December to around 7% currently, according to FactSet. Overall, 2025 earnings growth estimates remain relatively intact though down to 11.26% from 12.58% in December. This is also something we will be watching closely. If earnings growth continues to be revised down, this may lead to lower stock prices.

Going back to our last theme in our 2025 Outlook, diversification is finally being rewarded. U.S. large cap stocks, as measured by the S&P 500, are underperforming other parts of the equity market like developed international and emerging markets. As of the time of this writing, the S&P 500 is down 3.5% while the EAFE index is up nearly 12% and emerging markets up around 8.5%. Value stocks are outperforming growth stocks and are positive. Small caps continue to underperform but if U.S. stocks start to rise again, perhaps we could see small cap stocks outperform to the upside as investors hedge their AI stocks. International stocks should continue to benefit from fiscal stimulus and hopefully a ceasefire in Ukraine. International stocks are also less owned, as investors have been flocking to U.S. stocks since the Great Financial Crisis.

Fixed Income

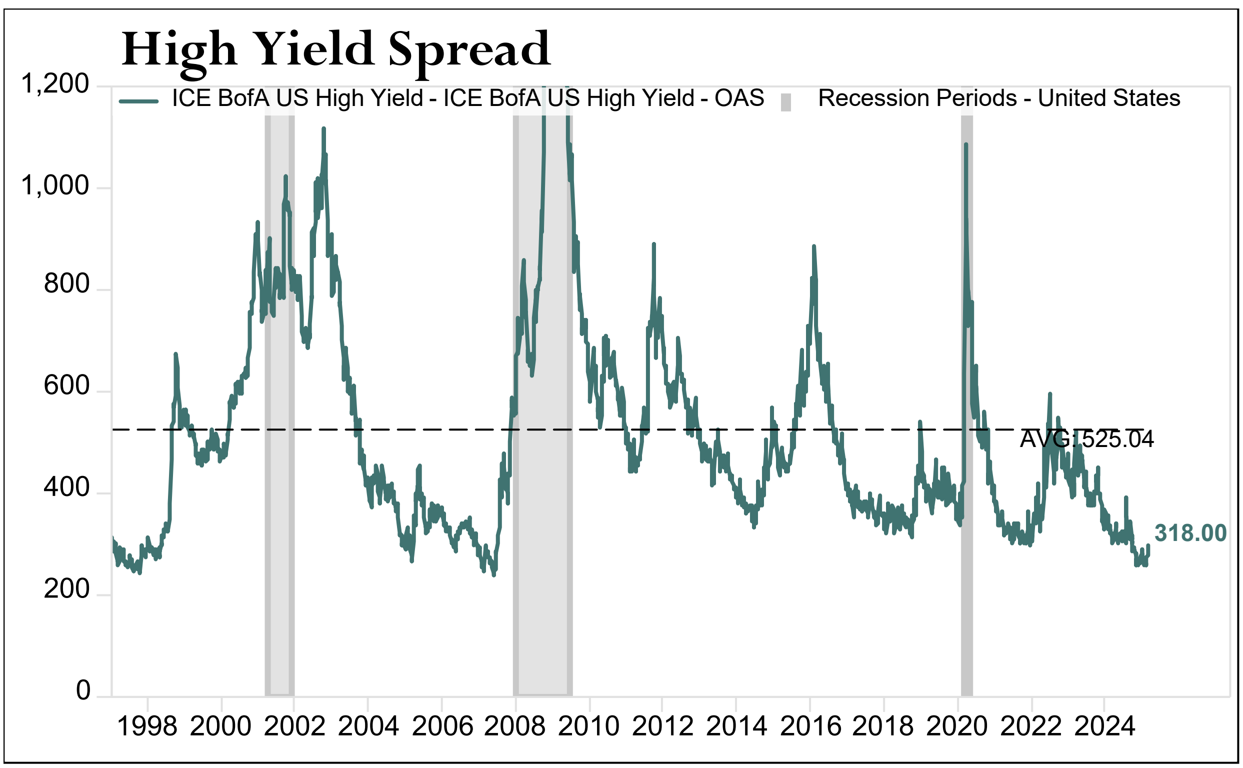
Bond returns have been relatively modest in the first three months of the year. However, let's look deeper at the fixed income world because it can tell us what bond investors are thinking and provide insights to their thoughts on the economy and even the stock market. These insights can often be a forward-looking indicator.

The yield on 10-year Treasury notes has fallen around 0.25% after starting the year at 4.58%. The yield initially rose in 2025 as bond investors were optimistic about economic growth and a little worried about inflation. Long-term bond yields rise on growth and inflation expectations. This tells us that these expectations have fallen since the start of the year, however, only modestly. With the recent correction, there also hasn't been a lot of investors flocking to long-term bonds for safety which is a sign that stock investors are not too fearful.

Looking at shorter-term Treasury notes, the yield on 2-year Treasury notes also declined around 0.25% after starting the year at 4.25%. Often investors look at this yield as an indicator of what bond markets think the Fed Funds rate will be one year from now. Currently, the Fed Funds rate is in a range of 4.25% to 4.50%. So, at the beginning of the year, bond investor expectations were that maybe we would see one rate cut or even no rate cuts in 2025. Those expectations have changed to one to two 0.25% cuts in the next 12 months. As uncertainty has grown, investors expect the Fed to help a little more.

High-yield bond investors tell us about downside risk in the stock market as correlations between these junk bonds and stocks are high. If they feel the economy is faltering, these bond investors will demand more yield to compensate for the increased risk of default or downgrade. One way to look at this is looking at the high yield spread over Treasuries. This yield was very low, under 3%, to start the year. We have been cautious in this category because we didn't feel rewarded for the risk. With the recent stock market correction, the spread has increased to around 3.2%. While bond investors are demanding more yield for the increased risk, this is still very low. This is good news for the economy and stocks as high yield investors are not too worried about the economy rolling over and defaults rising. During recessions this number can climb above 10% as seen in **Figure 3**.

Figure 3: Tight Spreads



Source: Cetera Investment Management, FactSet, ICE BofAML. Data as of 3/18/2025.

The Bottom Line

Despite the uncertainties that have emerged early in the year, there are several reasons to remain optimistic. While AI spending is facing some scrutiny, the long-term potential of AI investments remains strong. Tariffs, though creating short-term uncertainty, will eventually be negotiated, and historical data suggests the economy can withstand their impact. Government spending cuts by DOGE may add to unemployment, but the overall economic impact could be mitigated through other fiscal measures.

Cooling economic data, such as weaker consumer sentiment and job cut announcements, raises concerns. However, the labor market remains resilient and inflation has cooled, providing a buffer against economic downturns. Overseas, countries like Germany and China are implementing fiscal stimulus plans to counteract the effects of tariffs, which could support global economic stability.

Equity markets have experienced a correction, but bearish sentiment may indicate a future bullish trend. Fixed income markets show modest changes in growth and inflation expectations, with low high-yield bond spreads suggesting limited concern about economic downturns.

In summary, while uncertainties persist, the economy is showing signs of resilience. The labor market and Federal Reserve actions will be crucial to watch, as they will play a significant role in shaping the economic trajectory for the rest of the year.

Diversification is prudent, and your Cetera financial professional can help you navigate any uncertainty to keep you focused on your personal goals and objectives.

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A diversified portfolio does not assure a profit or protect against loss in a declining market.

The S&P 500 is a capitalization-weighted index of 500 stocks designed to measure performance of the broad domestic economy through changes in the aggregate market value of 500 stocks representing all major industries.

The Bloomberg US Aggregate Bond Index is a broad based flagship benchmark that measures the investment grade, US dollar-denominated, fixed-rate taxable bond market. Eligible bonds must have at least one year until final maturity, but the index holdings have a fluctuating average life or around 8.25 years. This total return index is unhedged and rebalances monthly.

The ICE BofA US High Yield Index tracks the performance of US dollar denominated below investment grade rated corporate debt publicly issued in the U.S. domestic market. Securities must have a below investment grade rating (average of Moody's, S&P, and Fitch) and an investment grade rated country of risk (average of Moody's, S&P, and Fitch foreign currency long term sovereign debt ratings). Each security must have greater than 1 year of remaining maturity, a fixed coupon schedule, and a minimum amount outstanding of $100 million.

The MSCI EAFE is designed to measure large and mid cap equity market performance of 21 developed markets, including three regions (Europe, Australasia, Far East) excluding the U.S. and Canada. The Index is market-capitalization weighted, covering 85% of the free float-adjusted market cap in each of the 21 countries.

The Russell 1000 Growth index is a subset of the Russell 1000 as measured by three factors: sales growth, the ratio of earnings change to price, and momentum.

The Russell 1000 Value index is a subset of the Russell 1000 as measured by three factors: the ratios of book value, earnings, and sales to price.