AVITY Investment Management Inc.®

PERSPECTIVE

April 2025

U.S. stock indices declined in the first quarter strained by tariff uncertainty and a retrenchment in business and consumer confidence. Fixed income investments recorded positive returns as yields declined across maturities due to slowing growth and a flight to safety. Looking ahead, U.S. economic growth is likely to remain subdued while certain international regions may benefit from meaningful fiscal stimulus, holding important implications for the investment landscape.

ECONOMIC BACKDROP

The U. S. economy decelerated in the first quarter but remained relatively resilient. Temporary factors contributed materially to the slowdown, especially a spike in imports, which detract from GDP, as businesses prepared for tariffs. Consumer and business sentiment deteriorated after an initial surge following the election. Retail sales growth slowed with softness apparent in many areas including restaurants, electronics and apparel. Some of the weakness can be attributed to cold weather while other changes in consumer behavior reflect trade uncertainty, stubbornly high interest rates and a volatile stock market, which has weighed on consumer net worth. Businesses slowed capital expenditures, with the technology sector being one notable exception. Despite the uncertainties that emerged in the first quarter, the U.S. labor market demonstrated durability. Weekly jobless claims and the unemployment rate of 4.2% remain low. Inflation, as measured by the Consumer Price Index, has trended down to a recent 2.8% reading. The service sector, as represented by purchasing manager surveys, continued to show strength and corporate profits remain on the rise as companies adjust to evolving business conditions. International economies, which have lacked the economic vitality of the U.S. since the pandemic, are showing modest signs of improvement. Eurozone GDP is expected to accelerate driven in part by lower interest rates and government spending. Japan and China should also benefit from recently implemented fiscal stimulus programs. Overall, global economic growth remains positive, but the outlook is murky given highly fluid trade policies.

U.S. VERSUS INTERNATIONAL STOCKS

The U.S. economy benefits from distinct structural advantages compared with foreign economies. These include strong property rights and rule of law, a dynamic labor market, a robust consumption-oriented economy, geopolitical stability and deep and liquid capital markets. Such characteristics have allowed the U.S. to attract talent and capital from around the world, incentivize research and development, and flourish as the epicenter of innovation. This has created fertile ground for equity investments as U.S. businesses have achieved impressive profitability and consistently pushed the frontier of technology, including the internet, cloud computing, health care, semiconductors, rocket science and artificial intelligence. Our preference for U.S. equities in recent years has been a rewarding decision for our clients. Over the last decade, U.S. stocks have compounded at more than twice the rate of international equity benchmarks.

U.S. versus Foreign Stocks—Past Ten Years

U.S. stocks represented by the S&P 500 Index (black)
International stocks represented by the MSCI ACWI ex-U.S. Index (blue)
Source: Bloomberg

Many of the United States' unique strengths are likely to endure which informs our continued preference for domestic equities. However, a confluence of factors drove a reversal in domestic and foreign stock market trends in the first quarter. While the U.S. contemplates federal spending reductions and confronts a slowdown in activity, Europe and Asia are experiencing pro-growth policy shifts in reaction to deglobalization trends. Meaningful fiscal stimulus is being deployed in Europe, Japan and China. For example, Germany shed its fiscal constraints to approve up to €1 trillion to modernize transportation, energy and the military. The prospect of a ceasefire in Ukraine and a push for deregulation has led economists to increase growth forecasts in Europe. International stock markets were also spurred by a falling U.S. dollar, driven by growth and inflation differen-

tials. Additionally, there is potential for mean reversion between domestic and foreign stock markets given the wide disparity in valuations. Emerging from the Great Financial Crisis of 2008, the S&P 500 Index and MSCI All-Country World ex-U.S. Index traded at comparable forward price-to-earnings ratios of about 12-times but now trade at 21 -times and 14-times, respectively. A large part of the valuation gap between domestic and foreign stock markets is the stark differences in index composition. U.S. markets are heavily influenced by technology-related stocks, whose high growth and profitability justify premium multiples. In contrast, foreign indices have greater exposure to slower growing and less profitable cyclical sectors such as financials, industrials and commodities. While there is value to be found abroad, determining the relative appeal of international stocks requires bottom-up, fundamental analysis, a core competency of our firm. To be sure, foreign risks remain. Europe's spending plans have boosted borrowing costs across the region and an escalation in trade tensions poses a threat to international economies. However, the potential for an improved growth backdrop outside the U.S. is prompting a renewed focus on investment opportunities overseas.

FIXED INCOME

Bond portfolios registered positive returns in the first quarter as slower economic growth and moderating inflation weighed on interest rates. The yield on ten-year U.S. Treasury Notes finished the quarter

Ten-Year U.S. Treasury Note Yield—Past Five Years

Source: Bloomberg

at 4.2%, down from 4.6% at year-end. The yield curve continued moving towards a normal structure with longer dated bonds offering yields higher than those of short-term issues. At its policy meeting last month, the Federal Reserve signaled a pause on interest rate cuts due to the uncertain impact of tariffs on inflation and the economy, but monetary policy remains restrictive and additional rate cuts are expected later this year. However, interest rates are unlikely to return to the extremely low levels experienced prior to the pandemic given higher core inflation and fiscal deficits that will remain sizable despite attempts to reduce spending. Within the bond market, corporate bonds currently offer a narrow yield advantage over risk-free Treasuries, diminishing their appeal somewhat, but also representative of healthy corporate balance sheets. Tax free yields on municipal bonds have recently risen relative to Treasuries, boosted by a surge in the supply of such bonds and concern that their tax exemption could be eliminated in the government's drive for additional tax revenue. We view that change as improbable as the tax exemption confers an important benefit to state and local governments that Congress is unlikely to reverse. In client portfolios we continue to add to longer maturities to take advantage of attractive yields.

EQUITIES

U.S. equites recorded a 10% reversal from peak to trough during the first quarter, and the S&P 500 finished the period with a return of -4.3%. Stocks were pressured by reduced expectations for economic growth and corporate profits this year, as uncertainty of government spending cuts and the trade war loom. As signaled in our prior commentary, the rich valuation of U.S. equities and high investor optimism entering the year made stocks vulnerable to a pullback. Stock market corrections are natural and expected elements of the business cycle. On average, the S&P 500 Index experiences a 10% correction roughly every eighteen months. The 10% drawdown in the first quarter was the third of its kind since the S&P 500 exited the bear market of 2022, and the thirty-seventh since 1950. After two consecutive years of above average U.S. equity returns, areas of the market where valuation excesses had accumulated are experiencing a healthy reset. Our risk management emphasis, including sector diversification, valuation discipline and a recent preference for more defensive holdings, has cushioned client portfolios during the correction. We expect that current market volatility will create buying opportunities for a number of stocks domestically and abroad. In the months ahead, market sentiment should improve with greater clarity on tariff policies and forthcoming tax cuts. Moreover, the Federal Reserve is poised to lend support with additional interest rate cuts if growth prospects deteriorate. In this period of uncertainty, we continue to evaluate investment opportunities worldwide to capitalize on the evolving investment landscape.