First Quarter Results Show Orderly Equity Market Transition

BUT TARIFFS SPARK TURMOIL AS SECOND QUARTER BEGINS

KEY TAKEAWAYS

- First-quarter market results reflected an orderly transition from stocks and sectors that had performed very well to those that had been out of favor. Early in the second quarter, tariff announcements caused tension and panic.
- If the Trump administration reorders global trade to favor US exports, a weak dollar will naturally follow, potentially supporting non-US stocks.
- Investors should be conservative in the near term. In the longer term, the technological revolution offers tremendous opportunities that we don't want to miss.
- Investment policies exist to provide guidance in times like this. Investors who stick to their policy are more likely to be well rewarded.

BY RICK PITCAIRN, CFA
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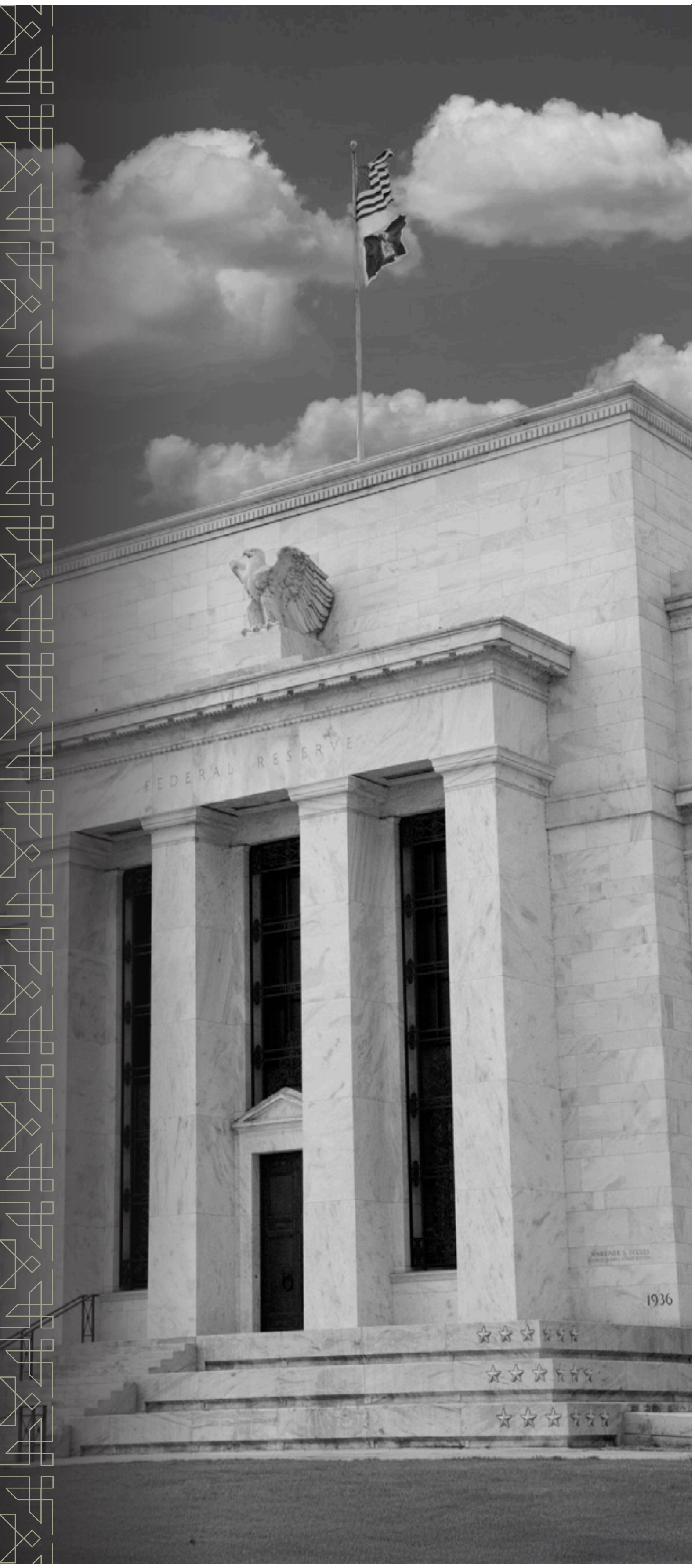
In last quarter's letter, I noted that the Trump administration aspired to be a presidency of sweeping change, like Roosevelt or Reagan. Since the inauguration, we have seen the administration act on those ambitions. Capital markets have responded, but not in ways that were out of the ordinary — until the beginning of April. As we consider the past quarter and markets going forward, we must remember that factors other than politics are typically more fundamental for families building 60-year multi-generational wealth plans.

First-quarter market results reflected an orderly transition from stocks and sectors that had performed very well to those that had been out of favor. After a 58% return over two years, US stocks corrected, with the S&P 500 Index falling 4.3%. This is the way markets behave. Early in the second quarter, tariff announcements caused tension and panic. This is also the way markets — and some investors — behave. They respond emotionally in times of uncertainty. Let me stress that not all investors were beset by emotion. Those of

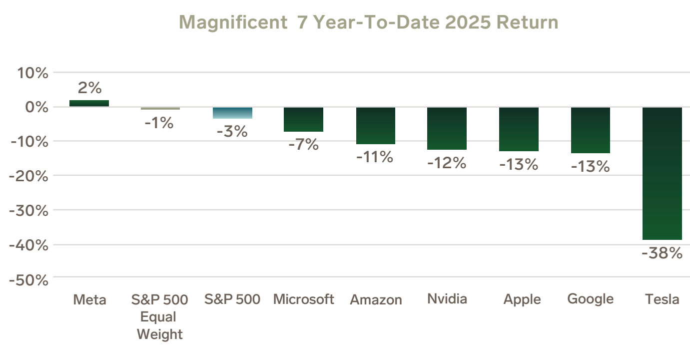


us who consistently followed our investment policies stayed above the fray. Still, the market action has been historic in its volatility as both equity and Treasury markets suffered meaningful damage.

US Stocks Undergo Orderly Transition in the First Quarter

For the last year and a half, I have been relatively bearish on equities — that is, bearish for me, who has often been called a "perma bull." That's natural, given how far US stocks have risen over the last few years, particularly as gains largely came from a narrow group of stocks. How often have we focused on the Magnificent Seven and compared the current period to 1999's internet-fueled market regarding valuation and innovation? The first quarter correction was expected. The market broadened, and the Equal Weight S&P 500 Index outperformed the weighted index, which outperformed the Magnificent Seven. See Chart A below.

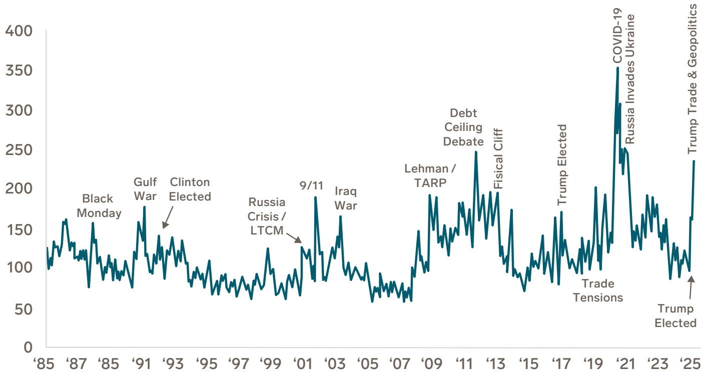
Chart A: **First Quarter 2025 Magnificent 7 Returns**



Many of the stocks and sectors that held up best in the first quarter were the very investments everyone hated last October, including core Europe, emerging markets, and US large-cap value stocks. Pitcairn portfolios generally made money in the first quarter precisely because diversification works.

Before the November election, I said markets might react poorly to another Trump presidency, given fears about unpredictability in a second term. That was not the case in the fourth quarter, but what we saw in the first quarter may have been a delayed reaction amid concern about whether his policies would be effective and a cacophony of worries from the financial media. Notably, the market's first quarter actions were logical, an unwinding sparked by higher political uncertainty. Chart B shows the ebb and flow of political uncertainty over recent decades.

Chart B: **US Policy Uncertainty Index**



Source: policyuncertainty.com

Tariff Announcements Rattle Markets in Early April

The early weeks of April were a different story. The severity of the Trump tariffs was about double what had been expected, and that compounded to remove the bid in the market. China quickly retaliated, and other countries threatened retaliation, causing further turmoil. As of Friday, April 4, US stocks were down about 14% year to date.

In periods such as this, nearly all stocks are likely to be somewhat negative on an absolute basis, with the highest-value stocks like the Magnificent Seven down the most. I have never sold into panic, and I certainly wouldn't suggest clients do so either. What markets need now is some space between emotions, valuations, and trading so we can see where things stand.

Federal Reserve Less Likely to Be the White Knight in 2025

Over recent decades, the Federal Reserve has supported capital markets in the wake of the great financial crisis in 2008 and during the pandemic in 2020. We may not see a repeat performance. Market expectations for Fed interest rate cuts are back to five cuts for this year, which seems like wishful thinking. Forecasts for S&P 500 earnings growth are still healthy, at 11%. This tells me that either the expected rate cuts won't happen or earnings forecasts will have to come down.

Former Fed Vice Chair Roger Ferguson recently noted that hard economic numbers are not bad at present. I doubt the Fed will cut against a weakening but still positive growth picture. That could mean no cuts until later in the year. Furthermore, the relationship between President Trump and Fed Chair Jerome Powell appears to be poor. While Powell may stay in place until his term ends, Trump is likely to appoint a new chair in May 2026. When all is said and done, the market's forecast of five rate cuts seems overly optimistic. I think Powell waits for hard data showing economic weakening.

Decoding Tariff Talk

The scope and scale of the Trump administration's trade policy is significant. He is attempting to reorder the global economy and relationships that stretch back to World War II. The risk of execution error is very high. The initial market response to the tariffs was quite negative. While some are already calling this an execution failure, it would be impossible to initiate the massive change in international trade envisioned by the administration without a severe reaction. It may turn out to be a failure, but I'll withhold judgment.

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What I see is classic Trump, whether you believe he is igniting a global trade war or employing a negotiation tactic. All of our trading partners are unhappy. Is that because the president is being exceedingly unfair, or has the trade system in place since World War II been unjust to the US? It's very expensive to support capitalism, democracy, and other countries, as the US has done in its role as the benevolent superpower. We may agree with Bill Clinton and George W. Bush that the alternative is something worse, like Russia's Putin or China's Xi. We may also recognize that America's global role, stability, and rule of law have made the dollar the most admired global currency. Nevertheless, $36 trillion of US government debt raises the question of whether we can keep doing this even if we want to.

As Trump attempts to reorder the global trade system, the US has a strong hand in negotiations because we are the largest consumption engine. That may be why people in the administration have suggested countries will get a better deal if they negotiate sooner rather than waiting.

I have always believed non-US stocks were the way to fill your diversity boat, and I anticipate promising opportunities for international stocks over the next year.

While tariffs included nearly every country, Trump appears most focused on China. He sees long-term strategic conflict and opportunity in Asia, with the potential for a win-win realignment that anchors his legacy. Tariff talks with Mexico and Canada were batting practice for the real World Series versus China.

Geopolitically, Trump wants little involvement in the Middle East and prefers to get the war in Ukraine off his plate so he can shift to China. That may mean ceding more to Russia than any of us would like. It's worth noting that if the Ukraine-Russia war ends, there's a chance for capital markets to enjoy some kind of a peace dividend.

US and Global Economic Growth May Slow

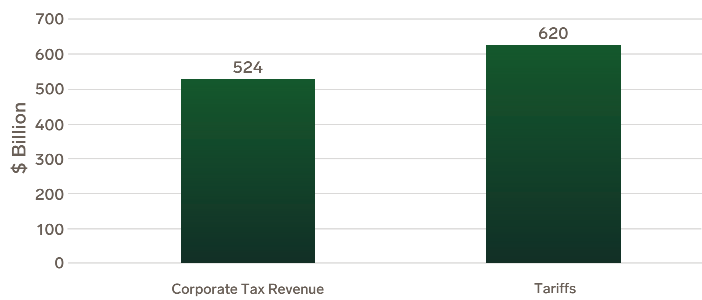
We are beginning to see softness around economic numbers and consumer sentiment. Global growth forecasts are coming down, and recession expectations have risen. Economists are worried about the possible inflationary effects of tariffs. Some have even mentioned stagflation. In reality, stagflation is rare. If the 10-year Treasury yield moves to 3.5% or 3.7% in response to economic slowing, we probably won't have an inflation problem, which defuses the risk of stagflation.

Could execution errors by the Trump administration roll us into a global recession that rivals 2008? It's possible but improbable, in my opinion. A milder recession is possible, however. Some Trump officials have suggested that cutting the government spending component of GDP means the US economy and the capital markets will need to "detox."

This administration appears comfortable with the notion of getting a recession out of the way early in the term, resetting capital market valuations, and taking a hard chop at inflation. They have some degree of confidence that either a recovery will provide a tailwind by the midterm elections or voters won't blame them for the downturn. The Trump administration believes it has a mandate, but the US has been politically fickle. Playing chicken with a recession or a 2008-type market disruption could be costly if their confidence is misplaced.

The pressure is now on Congress to get Trump's tax cuts passed. If the announced tariffs stand, the government is projected to take in more money from tariffs than it did from the corporate income tax. (See Chart C.) This would facilitate a revenue-neutral tax cut. However, little attention has been paid to the fact that the US has pivoted to a service economy and there will be a lag, possibly significant, before companies can manufacture products US consumers want.

Chart C: **Tariffs**



Potentially Weaker US Dollar Favors Non-US Stocks

Traditionally, high tariffs have led to a stronger currency, but so far, we are seeing a weaker dollar and a stronger yen. During early April, the yen was perceived as a more appealing safe haven than the dollar.

If the Trump administration rejiggers global trade to favor US exports, a weak dollar naturally follows, potentially providing support for non-US stocks. I have always believed non-US stocks were the way to fill your diversity boat, and I anticipate promising opportunities for international stocks over the next year. There are risks with alliances in flux. Nonetheless, we can't overlook the huge gains from German stocks in the first quarter after that country stated it would borrow a trillion dollars for defense because it no longer trusts US support. There is no question there will be opportunities in a weaker dollar world.

Fixed Income Performs Well, Small-Cap Stocks Suffer

Fixed-income markets responded well in the first quarter. The 10-year Treasury yield peaked at 4.9% in December and fell below 4% by April 4, 2025. That reflects a bull market in fixed income, consistent with existing uncertainty. Holding fixed income in some blended fashion will likely benefit portfolios. Some investors will probably chase fixed income should fear or uncertainty increase further.

Conversely, small-cap stocks have been hit hard by multiple headwinds. Small companies were not immune to tariff drama; they are just as vulnerable to supply chain upheaval as large-cap stocks. Furthermore, recession fears weigh more heavily on smaller companies. Rising recession risk has pressured positive earnings forecasts for 2025. The small-cap market had priced those expectations into share prices. I have always advocated for the diversity that small-cap stocks add to portfolios. More recently, we have noticed that the cream of the small-cap crop has stayed on the private equity side rather than in publicly traded markets. Going forward, it may be sensible to underweight publicly traded small-cap stocks and access that exposure through private equity. That is a strategy we are pursuing but haven't fully realized yet.

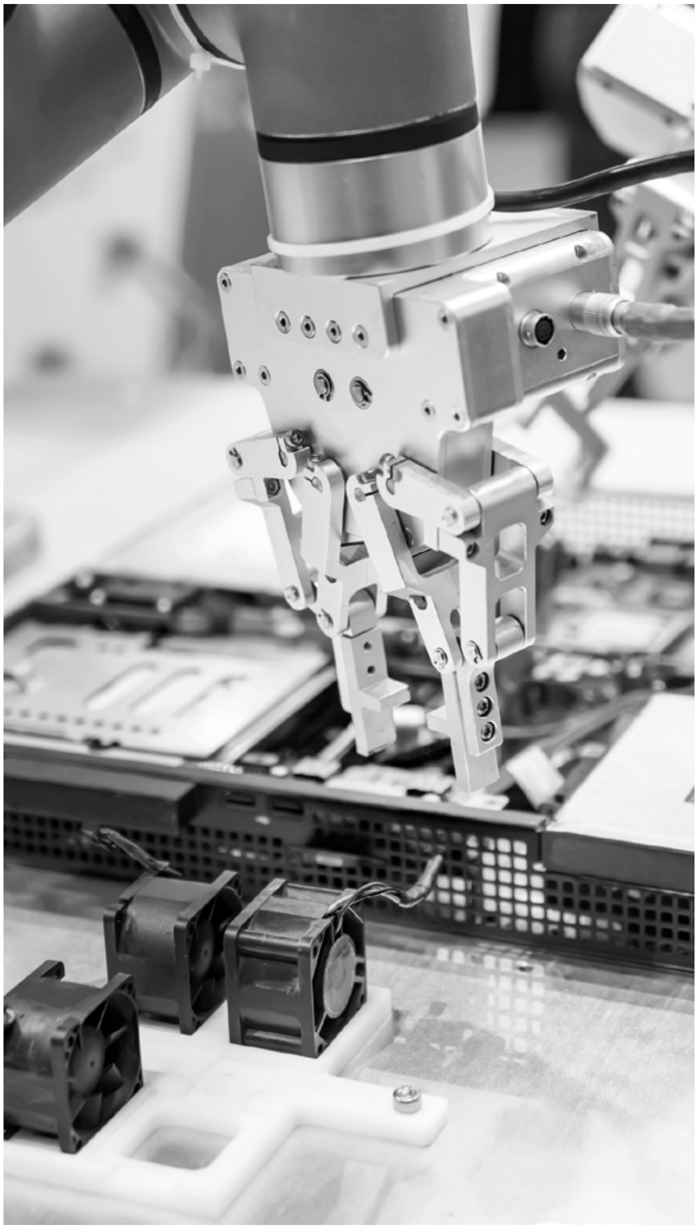
Technology Revolution

I'm still super optimistic about the technology revolution. At a recent conference, an investment manager I respect explained that he was playing "small ball" because it's difficult to predict Trump administration actions. At the same conference, multiple presentations trumpeted the abundant potential inherent in the technological revolution now underway. This revolution will benefit capitalism — military and healthcare applications are just two examples. Rapid technological change will accrue rewards for investors. Given the contrasting outlooks, I have two thoughts: In the near term, investors should be conservative, and in the longer term, there are tremendous opportunities we don't want to miss.

Conclusion

The most important thing clients should remember in the present environment is that Pitcairn has been effective in past markets like this one precisely because we don't hit the panic button. We allow market shifts to play through. Our clients have benefited from the massive equity uptick over the past decade, and throughout the bull market, we have cautioned that there could and should be pullbacks along the way. Last quarter's results and the unwinding after the tariff news don't feel especially scary to me. I would tell anyone under the age of 45 that they should get ready to buy if they aren't already invested. Not quite yet, given unchecked emotions, but be ready. When we look back at this exceptional time in financial history, I am confident that, like the Great Financial Crisis in 2008 and the 2020 pandemic, this will be a difficult period that, in the long run, does not change the fundamental relationships on which our investment policies are built.

I also don't give credence to the idea the world will turn upside down, primarily because I believe any progress the Trump administration makes toward its goals will be incremental due to the three branches of government and a near 50/50 political split in this country. The alignment of all three branches won't last for longer than two or four years, and that's not enough time to sway 60-year trends.



I mentioned the concept of playing "small ball." That means sticking to an investment policy. Every family at Pitcairn has an investment policy. That policy doesn't say follow the rules until you get scared, until Trump surprises the market, or until geopolitics makes us feel like we are in a place we've never been before. Policies exist because we need guidance, particularly in times like this. Things happen, but if you stick to your policy now, you are more likely to be well rewarded in the future. I believe that 100%.

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