1Q25 Market Overview: Forget the Night Ahead

The first quarter ushered in a change of US political leadership and with it a change in global equity market dynamics.

Though 2025 started well for risk assets broadly, sour sentiment took hold of US markets in mid-February as concerns mounted about the economic impacts of the Trump administration's priorities. Meanwhile, non-US markets appeared to be reinvigorated by plans for greater fiscal spending in Germany and China. In contrast with recent US dominance, the MSCI EAFE Index outperformed the S&P 500 Index handily during the first quarter, 6.9% to -4.3%, while US exposure drove a 1.8% decline in the MSCI World Index. In another trend reversal, value outperformed growth across markets.[1]

Of course, circumstances changed dramatically in the early days of the second quarter. The US announcement of a sweeping and severe global tariff package—along with the inevitable retaliatory actions, partial back-tracking and all-around ad hoc vibe of the whole thing—has introduced significant uncertainty that doesn't seem likely to be quickly resolved, escalating what had been a fitful first quarter for a certain cohort of financial assets into a indiscriminate nightmare many investors would prefer to erase from their memory.

KEY TAKEAWAYS

- While hard data released during the quarter continued to show persistent growth and manageable inflation in the US, soft data suggested consumers and businesses had quickly internalized the darkening mood inspired by the new administration's policy priorities.
- US corporate earnings have tracked mounting public debt for most of this century. Years of easy fiscal policy beget difficult choices: Do nothing to contain spending and increase the risk of inflation, or take action to curb it and increase the risk of recession.
- While clearly telegraphed by Trump throughout his campaign, the magnitude and scope of his tariff policy appeared to catch markets off guard and has introduced profound instability to the global order.
- With net interest spending biased higher and nondefense discretionary spending too small to matter, meaningful progress on US debt likely will require entitlement reform and/or higher revenue, not to mention political bravery.

1. Source: FactSet; data as of March 31, 2025.

Sentimental Journey

Trump's election victory in November 2024 initially fueled another leg higher in equities, as markets hoped the campaign trail promises of pro-growth deregulation and stimulative tax policy would bolster earnings for a range of US companies amid steady economic growth and cooling inflation. This optimism began to fade well before Trump took office in late January, however, and the unraveling of the so-called "Trump trade" was underway in earnest by mid-February as it became clear that the new administration's policy timeline prioritized tariffs and program cuts over stimulative measures. It wasn't long before domestic stock markets had given back all of their post-election day gains and then some.[2]

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Non-US markets were mostly unfazed, however, buoyed by the prospect of increased fiscal spending. Germany's new governing coalition spearheaded legislation to permanently exempt defense spending above 1% of GDP from its restrictive constitutional debt brake and created a €500 billion infrastructure fund, measures that will allow the European country with the most fiscal space the flexibility to deploy it.[3] Earlier, the annual meeting of China's parliament emphasized the need to boost consumption in the face of external threats like the escalating trade war with the US.[4] This comes on top of plans to increase fiscal support by 1–2% of GDP this year.

In the US, hard economic data released in the first quarter continued to show persistent economic growth alongside stubbornly above-target inflation. However, soft indicators appeared to capture the early negative impacts of the new administration's policy erraticism and aggressive cost cutting. Consumers, for one, have grown decidedly more cautious in the face of the prevailing uncertainty. Consumer confidence as measured by The Conference Board has declined for four consecutive months, and its expectations index—which captures consumers' short-term outlook for income, business and labor-market conditions—fell to a 12-year low in March and sits well below the threshold that usually signals coming recession.[5] A survey from the University of Michigan indicated similarly crumbling sentiment,[6] while the New York Fed's latest consumer data revealed notable pessimism across prospects for household finances, employment, loan delinquencies and credit access.[7]

Business attitudes have also darkened. On Main Street USA, the NFIB Small Business Optimism Index depicted waning confidence in the economy and high and rising uncertainty in what the future holds.[8] Globally, business confidence in the year ahead approached post-Covid lows in March, with US manufacturing Purchasing Managers' Index (PMI) slipping to below 50, indicating expectations of contracting activity.[9] Perhaps most tellingly, tariffs were mentioned more than 800 times in investor events or conference calls during the first quarter, the highest rate in 15 years.[10] With this level of concern evident even before the announcement of Trump's tariff plan, it seems likely the topic will dominate earnings calls in the weeks ahead.

2. Source: FactSet; data as of March 31, 2025.
3. Source: Reuters; data as of March 21, 2025.
4. Source: Reuters; data as of March 4, 2025.
5. Source: The Conference Board; data as of March 25, 2025.
6. Source: University of Michigan; data as of March 28, 2025.
7. Source: Federal Reserve Bank of New York; data as of March 10, 2025.
8. Source: NFIB; data as of March 11, 2025.
9. Source: S&P Global; data as of April 4, 2025.
10. Source: Reuters, S&P Global; data as of April 3, 2025.

Mind the Gap

While the environment has changed dramatically in the early days of the second quarter—more on that later—it's worth noting that the US economy entered the year with an ongoing positive output gap, as well as below-average unemployment and above-average wage growth. A positive output gap indicates the economy is operating above potential, and the resulting inflationary impulse typically invites a cooling response from policymakers. For example, the Federal Reserve's rate hikes in 2022 and 2023 in response to persistently high inflation narrowed but did not close the output gap. With monetary policy settings currently pretty close to neutral, the persistence of the positive output gap likely can be attributed to expansionary fiscal policy and ongoing deficit spending.[11]

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Persistent deficits have also helped support corporate earnings, in our view, and skewed risk perception in US markets. From World War II through the global financial crisis, the country's primary fiscal position was more or less in balance through decades of offsetting deficits and surpluses. Since 2009, however, economic cycles have been characterized by deeper primary deficits at the bottom and shallower deficits at the top.[12]

The level of S&P 500 earnings has more or less kept pace with the mounting pile of debt that has resulted from persistent deficit spending for much of the twenty-first century.[13] Which is to say that as government debt goes, so too goes the nominal drift in the economy and corporate participation in it. Assuming that current levels of debt accumulation are needed to achieve expectations of continued earnings growth, a reacceleration in payrolls, wage growth and inflation are plausible—though underappreciated—byproducts.

Between a Rock and a Hard Place

While it's painless to acknowledge the structural deterioration of the country's fiscal profile, fixing it is not. Easy fiscal policy begets difficult choices: Do nothing to contain spending and increase the risk of inflation, or take action to curb it and increase the risk of recession.

Federal outlays as a percentage of GDP have been chronically high since the onset of Covid-19 and amounted to around 23% in fiscal 2024.[14] Dividing federal spending into its three major components—discretionary, net interest and mandatory—can help illuminate the challenges facing policymakers seeking to address the issue.

Discretionary spending comprises nondefense and defense spending and is funded annually through the congressional appropriations process. Nondefense discretionary spending supports a wide range of programs, from education and public health to scientific research and tax collections. While the Trump administration has identified nondefense discretionary spending as the lowest-hanging and most politically expedient fruit to pick, at 3.3% of GDP, it's a small harvest. So while the Department of Government Efficiency (DOGE) makes headlines by taking a chainsaw to these outlays, its ability to impact the deficit and debt is minimal. For example, while a 20% cut to the nondefense discretionary budget would be significant to the programs impacted, it would only amount to about 0.6% of GDP.

11. Source: Bloomberg, Federal Reserve Bank of Atlanta, Bureau of Labor Statistics; data as of March 31, 2025.
12. Source: Bureau of Economic Analysis, US Treasury, Federal Reserve Bank of St. Louis, First Eagle Investments; data as of December 31, 2024.
13. Source: Bloomberg; data as of March 31, 2025.
14. Source: Federal Reserve Bank of St. Louis and US Office of Management and Budget, data as of March 27, 2025.

On the defense side, spending has shifted markedly lower since the end of the Cold War and in 2024 comprised just 2.9% of GDP, slightly above the all-time low of 2.7% in 1999. Given the shifting alliances amid an increasingly shaky geopolitical landscape, it's hard to imagine this rate going lower. The Trump administration has urged its allies in the North Atlantic Treaty Organization to increase their defense spending in the face of new and emerging threats, and Secretary of State Rubio has signaled that the US would follow suit.[15] Trump himself recently announced that he plans to request $1 trillion for defense in the fiscal 2026 budget, up from about $850 billion in 2025.[16]

Assuming a unilateral restructuring or voluntary default of US debt is off the table, net interest spending is untouchable. The cost of servicing government debt has climbed rapidly in recent years as sub-2% debt issued during the Covid-19 period matured and was replaced by debt at rates in excess of 4%; this trend is forecast to continue.[17] Notably, 2024 represented the first year that net interest spending exceeded defense spending. "Ferguson's Law" posits that any power that spends more on debt servicing than defense faces a heightened risk of imperial decline. With the US in violation of this law, there is perhaps some inevitability to the country's pullback from the global stage.[18]

With both discretionary and net interest spending unlikely sources of relief, meaningful progress on US debt likely will require entitlement reform and/or higher revenue. The bulk of government outlays—representing 14.1% of GDP in 2024—are directed toward programs like Social Security, Medicare and Medicaid, mandatory commitments whose parameters are enshrined into law. Mustering the necessary political will for changes to programs so broadly popular with voters seems like an insurmountable challenge, though the budget resolution recently approved by the Senate and House has put cuts to Medicaid— which provides health and long-term care coverage to almost 82 million low-income and disabled Americans, with a particularly high concentration of beneficiaries in Republican-leaning states—in the crosshairs. Generating additional revenue through higher taxes would also appear to be a difficult goal given Republican anti-tax orthodoxy, but it, too, is reportedly being considered by GOP lawmakers.

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Enter tariffs. Charged to importers at the port of entry into the US and mostly passed along to end consumers, tariffs act as a sort of backdoor consumption tax on Americans. Yes, they generate revenue for the federal government, but at the likely cost of higher prices and slower economic activity.

Trump championed the benefits of tariffs throughout his presidential campaign, and he quickly—if with shifting degrees of conviction—slapped new levies on specific countries (notably, Canada, Mexico and China) and industries (steel and aluminum) upon taking office. Designating April 2 as "Liberation Day," Trump appeared in the White House's Rose Garden to introduce a wide-ranging package of tariffs, imposing a baseline 10% charge on all imports globally and steeper rates—referred to as, but not actually, "reciprocal"—on countries deemed to be "bad actors."[19]

More extreme than markets seemed to anticipate, the tariff announcement unleashed a rout across risk assets worldwide and a significant spike in volatility. Perhaps of greater concern was the selloff in Treasuries and the US dollar, which may suggest wavering conviction in these assets as reliable "safe havens" during periods of unrest. A week later, via social media and with decidedly less fanfare, Trump announced that while the 10% baseline tariff would continue, the "reciprocal" tariff would be paused for all countries except China, which is now subject to an even-higher tariff of 145%.[20]

15. Source: Reuters; data as of April 3, 2025.
16. Source: Bloomberg; data as of April 7, 2025.
17. Source: Congressional Budget Office; data as of January 17, 2025.
18. Niall Ferguson, "Ferguson's Law: Debt Service, Military Spending, and the Fiscal Limits of Power," Hoover Institution (February 21, 2025).
19. Source: Bloomberg; data as of April 2, 2025.
20. Source: *The Wall Street Journal*; data as of April 9, 2025.

Seeking Ballast amid the Chaos

We make a point of acknowledging our inability to forecast the future even in the most placid of times, but Trumps's to-and-fro approach to trade policy—which thus far has included tariffs, counter-tariffs, counter-counter-tariffs, tariff pauses, etc.—has introduced profound instability to the global order.

Given the lack of both historical comparisons and clarity around many important variables, directionality may be the best one can hope for in a forecast. To that end, the global tariff framework as currently designed likely would raise prices and slow economic activity in the US while weighing on both prices and economic growth abroad. Further, tariffs and their indeterminate impact reflect another investment risk in a world rife with them, the aggregate impact of which suggests a greater likelihood of nonlinear market moves such as those we saw in early April.

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In such an environment, resilience seems a worthy investment goal.

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MSCI EAFE Index (Net) measures the performance of large and midcap equities across developed markets countries around the world excluding the US and Canada. A net-return index tracks price changes and reinvestment of distribution income net of withholding taxes.

MSCI World Index (Net) measures the performance of large and midcap equities across developed markets countries. A net-return index tracks price changes and reinvestment of distribution income net of withholding taxes.

NFIB Small Business Optimism Index is a widely recognized economic indicator measuring the sentiment and outlook of US small business owners across a variety of areas critical to their operations.

A **purchasing managers' index (PMI)** measures the growth or expansion of certain segments of the economy.

S&P 500 Index (Gross/Total) measures the performance of 500 of the top companies in the leading industries of the US economy and is widely recognized as a proxy for the US market as a whole. A total-return index tracks price changes and reinvestment of distribution income.

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