Market Developments and Policy Impacts

Over the last few weeks, markets have closely monitored various tariff threats from the administration. While most participants have viewed these comments through the lens of negotiations for "better" deals and stronger growth for the U.S. economy, recent actions and the enforcement of some tariffs have convinced investors that the administration is willing to inflict short-term pain on the economy. This has led to a decline in all risk assets, with higher beta assets (Tech/Cyclicals) falling the most. We have observed a deterioration in the economic outlook in surveys, some of which are directly linked to the trade conflict. Notably, the flash February services PMI fell below 50 for the first time in over two years, signaling contraction. While the manufacturing PMI improved for the fifth consecutive month, the press release suggests this may be due to temporary front-loading ahead of anticipated tariffs. Beyond trade concerns, business sentiment is also being weighed down by risks associated with federal spending cuts.

Evaluating Trump 2.0 Policies and Market Reactions

In assessing how the administration's policies impact risk assets, we continue to weigh both the positives and negatives. On the positive side, current policies have notably boosted international markets, with Europe being the top-performing region year-to-date. The market has also responded favorably to the administration's handling of foreign conflicts, including Russia-Ukraine and Israel-Gaza, which have helped lower risk premiums. Domestically, the extension of the Tax Cuts and Jobs Act and deregulatory efforts in financial services are potential positives for markets. We also believe that policy in Tech and AI will be supportive in ensuring U.S. dominance in these sectors. Finally, we await any decisions on tax relief and other measures that may support corporate margins.

However, uncertainty remains. The mounting fiscal deficit and potential budget showdown create an environment of instability. The administration's tariff strategy also raises questions about whether these measures are aimed at fair trade or are more tactical in nature. Immigration policy remains another area of unpredictability. While deportation numbers under the Biden administration averaged 57,000 per month, compared to 37,000 under Trump, it remains uncertain how aggressively enforcement will be in the current term. Given that the U.S. requires approximately 500,000 to 1 million new workers annually to offset retirements, labor market dynamics remain a critical factor.

Our Assessment of Equity Risk

Our expectation for equity markets is to deliver high single-digit returns in 2025, supported by ~10% EPS growth, with some contraction in market multiples. While we adjusted our portfolios earlier in the year to reduce risk, favoring higher-quality defensive companies in sectors like Utilities/Healthcare, we did not see it as necessary to reduce equity risk significantly. Our view hasn't changed for three reasons:

1. **Corporate Earnings -** The Q4 earnings season exceeded expectations, with S&P 500 companies reporting 10% year-over-year EPS growth, surpassing forecasts by 7%. However, only 30% of companies have provided upward EPS guidance, which is below the 10-year average of 42%. This suggests a disconnect between current earnings strength and a more cautious forward outlook, reflecting policy uncertainty, fiscal tightening, and geopolitical risks. The Q1'25 earnings season will likely offer insight into how current policies impact Q1 earnings and, more importantly, how companies plan to navigate the uncertainty.
2. **Growth Outlook** - The Federal Reserve has the tools to guide the economy toward a soft landing. As Chairman Powell indicated in the 2025 monetary

policy forum, the Fed is ready to act if labor markets weaken or indicators point to a slowdown in the economy. It was also notable that while the use of tariffs was pronounced in the Q4 earnings season (the highest level in the last 10 years), the mention of recession was the lowest in the last five years, suggesting that most companies are not concerned about a significant economic slowdown.

3. **Bond Diversifications** – We are pleased to see bonds acting as a ballast for investor portfolios, providing positive returns for 60/40 portfolios year-to-date despite the fall in equity markets.

What Are We Are Watching

1. **Consumer Sentiment -** With personal consumption expenditures comprising 68% of U.S. GDP, consumer behavior is a key driver of economic activity. Heightened uncertainty due to ambiguous policy signals and the looming threat of tariffs has led to scaled-back spending. Additionally, many consumers perceive current policies as inflationary. We are monitoring the effects of this uncertainty on retail spending.

2. **Business Sentiment** - The capital expenditure (CapEx) cycle is encountering headwinds. With tariffs on the horizon and a potential budget showdown looming, companies are exercising caution in committing to new investments. Regulated industries remain concerned about federal workforce reductions.

Portfolio Performance

Overall, portfolios remain resilient. Both PCA Core and PCA Fixed Income are outperforming their respective benchmarks, with private credit funds continuing to add value as expected. We remain committed to a disciplined, diversified investment approach to navigate evolving market conditions.

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