Financial Market Update
March 10, 2025

In a December 2024 research note we pointed out two significant concerns for equity markets—overvaluation and an unusually high level of optimism. In the past, these two factors have often preceded a stock market correction, although the timing and magnitude are impossible to predict. (Another factor that is impossible to predict is the catalyst, the particular event which investors will use as an excuse to start a selloff.)

Since February 19, 2025, markets have seen a sharp selloff. As of this writing the S&P 500 Total Index is down about 9% from its high on February 19. The immediate catalyst for the selloff has been concern about the US economy slipping into a recession. While there is little concrete evidence of a slowdown so far, there are a few data points which could support this view. In addition, concern about geopolitical tensions has also risen. While geopolitical tensions always exist, it is fair to say the current geopolitical climate is more volatile than usual.

Extensive use of tariffs and the potential for trade wars are a new factor for investors to consider in the current environment. As tariffs have not been widely used in recent decades, economists, investors and policy makers do not have good tools to predict their impact. There is some evidence suggests that the actual impact of tariffs on businesses and consumers is often lower than the headline tariff rate, as companies adjust their business models by shifting supply chains, reclassifying products, negotiating costs, or absorbing some of the price impact. Furthermore, a 2019 study by the New York Fed on US tariffs imposed on some Chinese goods showed that only about 25% of the tariffs were ultimately borne by US consumers. But this limited impact is far from certain as there are also examples of tariffs triggering successive rounds of retaliation, which could be detrimental to an economy which is so globalized.

From an investor's standpoint, several metrics have changed since the beginning of the year. Valuation levels have improved (since the market went down), and while not yet compelling for the overall market, we are moving towards what has historically been a good buying level for stocks. Sentiment has declined dramatically (remember this is good). From very high levels of optimism at the end of the year, sentiment has now reached extremely bearish levels which in the past have often coincided with a market low. On the negative side, many economists believe the risk to the global economy has increased. If the US were to go into recession, there would most likely be a further selloff, although it would likely be mitigated somewhat by expected interest rate cuts by the Fed.

It is important at times like this to keep a balanced perspective. For the most part, the positives which were true at the end of last year remain. The economy is being transformed by exciting new technologies like artificial intelligence. The US economy, which some economists are now predicting to contract, was remarkably resistant to recession during the steep interest rate increases in 2022. There will be a time in the future when investors will refocus on these positive aspects again.

Financial markets do a good job of reflecting the economy over time but are subject to overreacting to day-to-day events. We previously highlighted some research from Vanguard which showed that, while the market rises 10.6% per year over the long term, the annual return is only within two percent of this amount *eight* percent of the time. The other 92% of the time the market is either over or underreacting to current developments. This means that an investor who is active in financial markets for 50 years would only expect to see four "normal" years during their investment career. This aspect of investing is unlikely to change in the future.

Thank you as always for being a client. Please feel free to call Roger or me if you would like to discuss your investments.

Best Regards,

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