Investor Letter
First Quarter 2025

The S&P 500 Index fell 4.3% during the first quarter of 2025. The NASDAQ fell 10%, and the Bloomberg Aggregate Bond Index was up 2.8%. The stock market rose for the first six weeks of the quarter, continuing the strong momentum from last year. Stocks peaked on February 19 and declined for the balance of the quarter. Top performers during the quarter were Health Care, Energy and Utilities. The worst performing industries were Consumer Discretionary, Information Technology and Communications. (Note that the leading industries were all domestic oriented, more on this below.)

The market entered the year on elevated levels, making it vulnerable to a meaningful decline. All that was needed was a catalyst, and this arrived in February with talk of the US imposing sharply increased trade tariffs on virtually all of its trading partners. This talk was enough to cause concern among analysts and economists about an economic slowdown and led many economists to increase their odds of a recession in the next year. Stocks fell on this news.

The announcement of the specific terms of the tariffs was set for April 2. It was widely expected that the tariff levels for most countries would be around 10%. To most everyone's surprise, the tariffs announced on April 2 were substantially higher than anticipated. Instead of the 10% expected level, most tariffs were set at 20-50%. Most notably, a tariff of 34% was set on goods imported from China. When China responded, the tariff was raised to 84%. Since then, China and the US have raised tariffs on each other several times. The higher-than-expected tariffs and extreme uncertainty caused a steep selloff in stocks as well as US Treasury securities.

Permanent tariffs at these levels would have a meaningful impact on world trade as well as price levels. (The price increase from the tariffs could be thought of as causing a one-time increase in inflation rather than a long term one.) The impact may moderate over time as companies adapt to the new tariffs, but in any scenario the new tariff regime (if permanent) would bring on the biggest change in the global economy in many years.

Note—As we wrote this letter it was announced that the tariffs would be reduced to 10% for 90 days on most countries (but notably not for China.) This could signal that the final level of tariffs will be closer to the expected level of 10%, although that is far from clear at this point. The initial response of financial markets was positive.

How would a world of higher tariffs impact investors? It's likely that companies which are highly reliant on a complex international supply chain would face a challenging situation for some time. On the other hand, companies which manufacture goods or produce services in the US could be better positioned. These might include health care providers, domestic manufacturers, energy companies and utilities. Small cap companies, many of which are more domestically focused than large caps, could also emerge in better position.

A broader concern about the announced tariffs is whether they will meaningfully slow economic activity. As mentioned above, economists and CEOs have been very quick to say that a recession is now more likely. This is a valid, cautious concern to have, although it is not yet backed up by economic data. It should be remembered that these are the same economists and CEOs who incorrectly forecast a recession in 2022. In fact, since 2009, there have been five major recession predictions, and each of them has been wrong. The only recession during that time was the short one during Covid, and none of them predicted that one. Investors should be cautious about anyone who claims to have an economic crystal ball.

Should the economy slow, the Federal Reserve will be in a difficult position. Recall that the Fed is charged with maintaining a healthy economy and also a steady price level. With inflation still above target and tariffs likely to increase at least the short-term inflation rate, the Fed will not want to cut interest rates. On the other hand, a recession would bring a lot of pressure to cut rates, especially if unemployment started to increase meaningfully.

On a valuation basis the market is more attractive than previously. At the lows earlier this week, stock prices traded at the same valuation level (not absolute level) as they did in October 2022, which proved to be a significant low. Of course, significant uncertainty surrounds the level of earnings going forward, although this is always the case at market lows.

In our last quarterly letter, our outlook for 2025 was called Expect the Unexpected. With market uncertainty at near record levels, this proved to be a good prediction. It isn't uncommon in periods of high uncertainty to experience high levels of volatility and negative returns. This was seen most recently in the 2008 Financial Crisis and during Covid. In both cases a strong argument was made for why markets would never recover, but eventually they did. (The gloom during a financial crisis is made worse by the fact that pessimists always sound so much smarter than optimists.) The global economy and human initiative are remarkably resilient and adaptable to changing circumstances. While there are no guarantees in financial markets, our view is that this will once again be demonstrated when the current crisis subsides.

One of the best ways of coping with market volatility is to have a good financial plan. Having such a plan helps investors avoid making rash decisions during a financial crisis, keeps them focused on building their net worth, and can give investors increased confidence that they are working towards a solid financial future. While Western Pacific focuses primarily on managing clients' investments in line with their Investment Policy Statement, we are also able to help clients develop a financial plan that can be helpful during periods like the current one. If you would like to learn more about building such a plan, let us know.

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

Best Regards,

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