Fortis Financial Group

April 17, 2025

Dear Clients and Partners:

The markets closed out the first quarter of 2025 poorly after a very strong 2024. Below we show the first quarter results by size and strategy.

	Value	Blend	Growth
Large	2.1%	-4.3%	-10.0%
Mid	-2.1%	-3.4%	-7.1%
Small	-7.7%	-9.5%	-11.1%

Source: JP Morgan

1Q25 was effectively an exact flip of 4Q24. This quarter Value dominated, especially Large Cap Value. Growth performed poorly with Mid Caps doing the best of them all. This quarter, Small Caps continued their underperformance. In reality, this was a Mega Cap sell-off after a fantastic run. Let's look at this closer.

1Q25 Results in Detail

Under the hood of the S&P500 there are 11 sectors. Of those sectors, only four ended the quarter in the red and two of the four (Industrials and Communications) declined less than 1%. As a result only two sectors really led this sell-off, Technology and Consumer Discretionary.

Effectively, this was a Large Cap tech driven pullback. The predominant theory for the pullback is that the "AI trade" is over. We do not know what will happen regarding the "AI trade" but AI is coming, and it is coming fast. This is truly transformative technology for anyone that has utilized it.

Zooming out it is worth looking at (i) the primary Large Cap AI companies and their performance since November 30th, 2022, the date of ChatGPT's launch and (ii) the pullbacks since their stock prices peaked:

	11/30/2022	Current	% Change
Semis			
NVDA	17	110	549%
AVGO	52	168	223%
Mega-Cap Tech			
MSFT	254	382	50%
GOOG	95	160	68%
AMZN	92	193	110%

	Peak	Current	% Change
Semis			
NVDA	149	110	-27%
AVGO	250	168	-33%
Mega-Cap Tech			
MSFT	468	382	-18%
GOOG	208	160	-23%
AMZN	242	193	-20%

The conclusions here are relatively straightforward. Growth, especially the AI trade, had a fantastic run. Trillions of dollars were created. The stocks themselves got ahead of the business valuations and traded back down towards more reasonable levels. This is how the markets have always worked and always will since the markets are still driven by human beings and that involves a lot of emotions.

What happens next is the key question. Generally, there are two options: (i) the companies' earnings continue to grow and the stocks follow or (ii) the earnings were largely overstated, and the stocks will need to trade to a reasonable figure on the new earnings / growth expectations.

When it comes to AI, we remain fully in the first camp. The speed of this revolution is very real. The use cases are expanding rapidly. The valuations of the primary companies are very reasonable, if not cheap. It is a reasonable argument that the "easy money has been made" but we continue to believe that this is short-sighted. This is very likely to change the world in exciting and scary ways. These companies will benefit massively.

Most of you are much more interested in the trade war and tariffs than AI right now so let's address this. We will also address bonds.

Trade War / Tariffs

As everyone has seen, President Trump has implemented a floor of 10% on tariffs with reciprocal tariffs (paused for everyone but China) layered on top. A 10% tariff likely results in lower overall GDP but it is manageable. Most organizations have some slack in the business and can find offsetting expenses for the tariffs on their import costs. However, it is important to remember that their slack is someone else's revenue (employees, marketing costs, etc.).

The reciprocal tariffs created a large problem. Most businesses do not have 20% or more of their import costs in slack business operations (if they do then they should have addressed that long ago). More importantly, it is incredibly challenging to plan (most large businesses plan years ahead, especially for large capital expenditures) when you have no idea what your costs are going to be. This effectively shuts down large parts of the economy. This is why the markets fell about 15% before the reciprocal tariffs were paused.

We are going to discuss everyone but China and then address China.

Where we go from here is anyone's guess. The bull case is that the President negotiates tariffs down to zero both for us and our trading partners and we actually have increased global trade. His Administration is very focused on trade deficits. Many of the trade deficits are impossible to remedy because many countries cannot afford a lot of our primary exports which are very expensive vs. the cost of living in those countries. However, our larger trading partners (EU, Japan, etc.) can buy large quantities of goods from us to lower the deficit similar to how China previously negotiated lower tariffs by agreeing (open question as to whether they did) to buy large amounts of soybeans, etc. from us. If we can lower trade barriers between the US and our trading partners and have them buy more of our products this could end up positive.

The bear case is that the tariffs are not revoked. This will require a large realignment of US industry which will take a very long time, likely past this Administration. We will likely enter some sort of recession and things will be very rocky for a while. This is categorically not what most Trump voters voted for and therefore we find the worst-case outcome to be relatively unlikely.

Our best guess on the above is that it will end up somewhere between the bull and bear case. Some countries will have tariffs around 10% but not many will have high tariffs and we will muddle through as we always do.

China and the US have effectively put on trade embargoes rather than tariffs. Almost no one is going to import goods at over 100% tariffs unless they absolutely have to. So, for now, trade has pretty much stopped between our two countries outside of specific goods exempt from the high tariffs.

Similar to the above, we anticipate there will be some sort of grand compromise with lots of press. China will need to make some reasonable concessions they can deal with, and we will go back to arguing over chip bans and other similar things.

The concept of reflexivity is starting to raise its head here. Reflexivity refers to the theory that action in one direction increases the likelihood of action in the other direction. Said another way, large decreases in the US dollar, US bonds, stock markets, etc. will increase the odds those in power will take action to address these.

US Treasuries have begun to sell-off hard meaning higher yields. There are a lot of theories around who is doing the selling, but it would make a lot of sense if you were one of our trading partners to put pressure on our bonds and try to force the Administration to the negotiating table. The bond market is the only market with a 100% batting average. When it gets bad the politicians have to change their positions. Especially when there are $9 trillion dollars to refinance this year. We are going to hold off on a long discussion of Treasuries for now. If we see a continued sell-off we will send out a separate note and be reaching out as it means there are some real problems that we need to discuss.

To summarize, we would expect some deals, likely with a large trading partner first that provides a framework followed by a grand Chinese summit. We have no idea, nor does anyone else, of the damage done thus far to the economy. It is not a trivial figure, but assuming a reasonable outcome in the next 90 days it will be a short-term growth slowdown (potentially similar to 2022) not a disaster longer-term.

We encourage you to give us a call if you have any specific questions and we can walk through those. This could probably be a 50-page letter if we went into every detail.

One item to address is International and Emerging Markets equities.

International and Emerging Markets Equities

For many years we have been both underweight and continuing to reduce International and Emerging Markets exposure. This has been the right move and has largely been because value creation, as simply measured by earnings growth, has been relatively stagnant internationally over the last 20 years compared to robust growth in the US as you can see below:

For the first time in many years, in our asset allocation models we have begun to slightly increase the allocation to International and Emerging Markets. There are a few reasons for that:

- **Capital Flows** – Many foreign investors have, for many years, been pushing savings into US capital markets to take advantage of the strength of the dollar and the earnings growth here in the US. With the tariffs and other actions taken by the Administration that is now reversing with money flowing out of the US. This is causing an increased protectionist movement across the globe which is causing those foreign investors to begin pulling assets out of the US and invest more in their home countries. Like anything else, equity prices are determined by supply and demand, so as demand for foreign equities starts to meaningfully increase, we could see those markets perform better than they have historically. This is also buoyed by the widest valuation gap between the US and international markets in many decades.

- **Fiscal Spending** – Under the new Administration, it is becoming clear that the US will require other countries to shoulder more of the national defense burden. For example, the US is pulling back on defense spending in key parts of Europe which is forcing those countries to shift from more of an austerity mindset to growth mindset to cover these costs. As a result, we anticipate a fairly rapid increase in fiscal spending to boost defense forces, leading to a trickle-down effect on those economies and provide a tailwind to corporate earnings.

Conclusion

The next 90 days are very important to determine the future direction of our economy and, therefore, the markets are reflecting elevated levels of volatility as participants try to figure out a wider range of potential outcomes. We are here to speak with you and partner with you through these unprecedented times so please don't hesitate to reach out. We have a range of tools at our disposal to make adjustments to your portfolio if need be.

Regards,
Your Fortis Team

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