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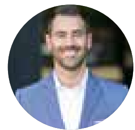
Shifting Currents, Steady Hands

The calendar turned to 2025, and boy, did the market environment pivot with it.



By Mike Harris, Chief Investment Officer

Just three short months ago, the market was enamored with the Magnificent 7, AI, and the future prospects for growth —

animal spirits were out in full force. Weights in the indexes of the top holdings had moved to levels never seen before. Concentration risk became so high, we flagged it as one of the major risks for the year.

The first quarter saw part of the unwind of this concentration risk, as selling has been steady and firm in the Mega Cap Tech stocks, and rotated into other areas of the market almost abandoned last year.

With the major market indexes red on the year, would you believe 7 of 11 sectors were green in the first quarter? Investors in Energy, Health Care, Utilities, Consumer Staples, Financials, Materials, and Real Estate wouldn't know the major indexes have been weak at all. This move is a reminder that there are indeed investable areas outside the Mag 7.

In fact, the only sectors that were deeply negative in Q1 were Consumer Discretionary and Technology. Industrials & Communication Services were just down a touch. Those four sectors represented over 60% of the S&P 500 entering the year, disproportionately taking it lower in Q1 2025, just as they took it higher in '24.

The past 48 hours have clearly changed things in rapid fashion.

Another example of the positioning unwind is Growth Stocks, which are -10% on the year, while Value Stocks are +2%. High Beta (higher risk) stocks are now down a staggering -23% on the year, while Low Volatility stocks are amazingly flat. The Magnificent 7, when basketed together, are now -24% year to date, taking the brunt of the selling. The rotation to safer, more appropriately valued parts of the market has been the theme in the first quarter, and we have plenty of that in our portfolios.

We were ready for this possible shift, and as outlined in our 2025 Outlook presentation, we were focusing on the other 493 stocks in the S&P. It's benefited portfolios greatly.

All About Tariffs

The U.S. announced a baseline 10% tariff on all goods imports (with certain exceptions) and higher "reciprocal" tariffs on imports from countries with which the U.S. has the largest trade deficits. The administration cited reindustrialization, rebalancing trade flows, and raising revenue as the policy's goals. The country-specific tariff rates were applied as half of the estimated total trade barriers for each country.

All countries (excluding Canada and Mexico) will see a 10% tariff applied beginning April 3, and country-specific tariffs will go into effect April 9. Estimates show these measures will bring the U.S. effective tariff rate from 2.4% in 2024 to nearly 30%, the highest in over 100 years.

How does this impact us? One of our research sources summed it up well: "It's harder to gauge the ultimate amount of revenue collected by tariffs considering their massive size and negative impact on economic activity, but the tariffs amount to an additional 2% of GDP in revenues. The last time tariffs raised this amount of revenue as a share of GDP was in the 1870s."

The uncertainty from Wednesday's tariff announcement is in full effect. The markets are in clear risk-off mode, selling first and asking questions later. Many believed, prior to this news event, that these potential tariffs would be broadly used as a negotiating tactic—not a permanent levy. That is now obviously being questioned, which is why we are seeing the market fall. More uncertainty, which leads to more volatility.

Rates & Credit Spread

We entered 2025 with some of the tightest credit spreads on record. That means not much risk was being priced in on any sort of economic disruption or possible issuer default. We took the other side of this with our bond positioning. We remain overweight Treasuries and Investment Grade Corporates. High-yield, also known as junk bonds, are not a place we want to be in this cycle.

There has been significant deterioration. High-yield spreads blew out to the widest since 2023, but nowhere near the widest we saw in 2022. For reference, we are currently +450 bps above Treasuries; we hit +600 bps in '22. Signs of stress are showing.

Treasuries have been a shining star this year, taking pressure off other areas. With interest rates dropping as the growth backdrop gets repriced, bond prices have rallied. It's times like this that remind most how important it is to have bonds in a portfolio. We anticipated they would have a blockbuster year in our outlook this year. Bonds are not disappointing, providing tremendous relief and diversification.

Gold Haven

Gold has been simply stellar, seemingly making new all-time highs daily in the first quarter. It was up +19% this year through the 1st quarter, breaking through not only the big round $3,000 an ounce number but went out above $3,100 to end the quarter. It's the best performing asset one could have their money in this year and helping portfolios big time.

Did you know gold has outperformed stocks over the past 1, 3, and 5 years? We were expecting a bull run after building positions over those longer-term timeframes, but this has been quite something. We aren't gold bugs, but saw the macro catalysts continue to build for the precious metal. We are starting to hit some aggressive targets we have had from way back, so don't be surprised to see us ring the register a bit to take profits after this incredible move. We took some off the table this week into the record high prices.

You are hearing gold talked about more and more, which tells us sentiment is definitely in the bullish zone. We like selling high and buying low, not the other way around.

Valuations

Valuations were one of the largest risks we highlighted entering the year. In our January newsletter I wrote, "We enter 2025 with some of the most expensive valuations in history on a number of metrics. Multiple expansion markets are by far the most difficult to navigate, because they can last against odds for quite some time, but if a catalyst arises to revert valuations to the mean, that's when huge volatility and downside occur." Unfortunately, that's exactly what we are getting now.

Coming into 2025, the S&P 500 was trading at nearly 25x forward earnings. That is the 99th percentile of historical valuations. After the decline thus far, valuations have recalibrated back to around 19x 2025 earnings estimates. A big reversion to the mean at rapid speed. Historical valuations over the past 20 years are more like 17x, and since the financial crisis, 18x. So, we are getting back closer to the average. The good news is we aren't as expensive any longer; the bad news is multiples are based on future earnings expectations, and well, those are likely to come down a bit.

Sentiment

This last week's Conference Board Expectation of Stock Price Increases versus Decreases fell to its lowest level since 2009. Sentiment has definitely shifted negative; prices tend to move sentiment. Lots of oversold conditions are popping up in the market, but it needs a catalyst to reverse the sour sentiment.

Fear is high, with the Volatility Index (VIX) hitting 45+ this week. VIX hit 80 during COVID for reference, 35 in the 2022 turmoil, and nearly 90 in the financial crisis. So yes, fear is quite elevated and has surpassed 2022 levels. To see a lasting low or bottom, we need to see fear like this and a large spike in VIX. We also need to see internals (number of stocks seeing new lows expand), illustrating investors are selling everything indiscriminately. We got action like this over the past few trading sessions. These signals usually indicate a bounce is near. Participants are reaching for puts as the put/call ratio is jumping, trying to buy insurance after the event is being priced in.

Staying Grounded as We Move Forward

Being a long-term investor can be trying in environments like this—especially after it seemed so simple in 2023 and 2024. Remember 2022? That was a tough investment environment too, but we got through it. It's important to stay disciplined even when the world seems chaotic and confusing.

As we entered 2025, we felt some things were "off," yet Wall Street analysts were still bullish with targets for 10% higher for the S&P 500 for the year. We felt these would prove overly optimistic. Things are decidedly less optimistic now.

In these challenging times, we reflect on the actions we have taken over the past few months to protect the bottom line:

- We lowered growth exposure to reduce risk. Valuations drove this decision, but it can be difficult to go against the herd. We are glad we did.
- Increasing exposure to value. Those "boring blue chip" stocks we have been talking about ad nauseam. Sometimes boring can be a needed reprieve. Boring sure feels good in this environment.
- Holding significant gold and having discipline around the position. Taking profits when prudent.

To say it has been an interesting start to the year is a vast understatement, it's been brutal. We are in the thick of things—truly battling. This is when our experience, analytical discipline, and risk management shine the brightest and provide light when it is needed most.

We are not perfect—no one is—but you can count on us going to work in volatility like this. "Dark and early" isn't just a catch phrase Mike Frazier throws out there—it's a way of life at Bedell Frazier.

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