Investment Strategy Committee Notes: Despite Recent Volatility, We Maintain Our Constructive Outlook

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At the start of the year, our Investment Strategy Committee outlook was positive for both the economy and the equity market, supported by strong consumer, labor market, and corporate fundamentals. However, we identified investor overoptimism as a significant risk, given the high expectations for President Trump's pro-growth policies and the equity market, which made it susceptible to volatility and disappointment.

With emerging policy concerns (such as tariffs, cost-cutting measures, and potential government shutdowns), economic growth worries (including slowing consumer spending and increased layoffs), and equity market volatility (with the S&P 500 approximately 7% below recent highs), we convened the Raymond James Investment Strategy Committee yesterday afternoon. This committee, which includes our economists, strategists, analysts, and money managers who provide their insights, assessed the impacts of these concerns on our economic and asset class forecasts. After vigorous discussion, here are our key takeaways:

- **Politics In Focus, Likely To Avoid Worst Case Tariff Scenario |** The Trump Administration has adopted a more aggressive trade stance this time around, implementing 25% tariffs on Canada and Mexico, 20% tariffs on China, and proposing additional tariffs, including 25% on the EU, set to take effect on April 2. While some tariffs will likely remain as the administration aims to use tariff revenues to fund its policy agenda (e.g., extending tax cuts), we believe the administration's aggressive approach is a bargaining tactic. We anticipate that the final tariff rates will be much less severe, especially for close allies such as Mexico and Canada. Overall, we expect the effective trade-weighted tariff rate to rise from +2.5% to +7.5%. However, political uncertainty is likely to remain high. The uncertainty surrounding these tariffs and potential retaliations, particularly affecting business investment, remains the biggest economic risk moving forward. Over time, we believe there are three potential guardrails to push back against overly aggressive tariffs: the equity market, CEO feedback, and Republican members of Congress hearing from their districts.

- **Economy Remains On Solid Footing Despite Weak 1Q |** At the start of the year, we estimated US economic growth to be 2.4%. However, weak consumer spending (with retailers noting a slow start to the first quarter of 2025), growing labor market concerns, and reduced business and consumer sentiment have heightened economic growth concerns. Overall, a disappointing first quarter is likely to lower our full-year GDP forecast to around 2%, which is still close to trend growth with limited recession potential. We believe much of the recent first quarter weakness is due to temporary factors such as cold winter weather in January and February, a severe flu season, and tariff-related front-running, which affected net exports. While uncertainty will continue to impact fixed investment, solid consumer fundamentals (e.g., record net worth, continued job growth) should drive economic growth from here.

- **Federal Reserve To Cut Two Times In 2025 |** In recent weeks, Federal Reserve (Fed) members have emphasized the impact of DC policy uncertainty on future interest rate decisions. While tariffs are likely to put some upward pressure on inflation forecasts, concerns about weaker consumer spending and slowing job growth will keep the Fed in easing mode. We expect the Fed to remain on hold until June as it assesses the effects of recent policies, but we anticipate two rate cuts in total by year end.

- **Interest Rates To Remain Range Bound; Favor High Quality Credit |** Despite recent concerns about downside risks to growth driving Treasury yields lower, our view remains unchanged—with the 10-year Treasury yield expected to end the year at 4.50%. Interestingly, despite last year's volatility, the 10-year Treasury yield is largely unchanged from a year ago. With our base case that growth will stay near trend and disinflation will continue, we expect Treasury yields to remain range bound. For yields to fall below 3.75%, the probability of a recession would need to significantly increase, which we do not anticipate. We also remain mindful of potential upward pressure on yields after the debt ceiling is lifted in the summer and the US government issues more debt to fund its operations. While all-in yields are attractive across the fixed income universe, we continue to favor higher-quality sectors, such as investment grade and municipals, as they are better positioned to navigate potential economic challenges in the coming months. Another interesting point is that credit spreads have not widened significantly, if at all, indicating that the bond market does not perceive any underlying weakness in corporate fundamentals and health.

- **We Remain Constructive On US Equities Longer Term |** At the start of the year, we had a below-consensus but still constructive S&P 500 forecast of 6,375, anticipating that investor overoptimism would lead to periods of disappointment in 2025. The Trump administration's aggressive policy approach has contributed to recent volatility, which aligns with our expectations. However, fourth quarter 2024 earnings showed that the US corporate sector remains strong: earnings are accelerating, margins are expanding, and forward guidance has been positive. While tariffs are expected to impact earnings (we estimate that a 0.5% hit to GDP will lower corporate earnings by 1% to $265-267), we still expect earnings to grow a healthy 10-11% in 2025. There may be more downside ahead, and volatility will likely remain elevated, but with corporate fundamentals on solid footing, we reiterate our 6,375 forecast and would use further periods of weakness as a buying opportunity.

- **Recent Tech Weakness Is Inconsistent With Fundamentals |** Year-to-date, the Technology sector has broadly underperformed, lagging the S&P 500 by ~600 basis points—the widest margin at this point in the year since 2008. Despite this, we remain overweight Technology, as the recent weakness does not reflect the sector's strong fundamentals. While sentiment toward the Technology sector may have turned more negative, the recent earnings season has improved its underlying fundamentals. Tech is expected to have the strongest EPS growth and margins of any S&P 500 sector in 2025. Additionally, with AI investment expanding and mega-cap tech companies reaffirming their capex forecasts for 2025, continued AI investment should drive tech earnings going forward. Although the bar is higher for the tech space, valuations have come down (currently trading at the lowest level relative to the overall market since December 2022), making it an attractive sector.

- **Is US Exceptionalism Dead? |** Europe has had a strong start to the year, outperforming the US by the widest margin at this point in the year since at least 1998. Recent fiscal stimulus proposals, particularly from Germany, mark a significant shift from their historically austere approach. While earnings growth in Europe may improve slightly, it will still lag behind the US. A major risk is that if the recent rise in yields continues, it could hinder growth. As a result, we are skeptical that the recent outperformance is sustainable. The US continues to show stronger economic and earnings growth compared to its developed market counterparts and is likely to be less affected by a trade war due to its higher reliance on consumer spending, especially in services. Given that the recent move in Europe appears overextended from a technical perspective (e.g., RSI), we caution investors against chasing this outperformance and continue to favor the growth prospects in the US over Europe and Japan.

First 5% Pullback For S&P 500 In Six Months

Source: FactSet, as of 3/6/25

Bottom Line | Volatility is never comfortable, but it's important to remember that it is an inherent part of the market. Despite the overwhelming headlines about tariffs, government policy, and economic concerns creating the perception that significant changes to our forecasts are needed, the Investment Strategy Committee has only made marginal adjustments. While there's a lot of emotion and fear in the market right now, we always advise against making investment decisions based on emotion. Instead, focus on the fundamentals and the long-term prospects of the financial markets, which remains our committee's primary focus. The good news is that we remain positive about both the economy and the equity market overall.

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The Consumer Price Index (CPI) | The Consumer Price Index is a measure of inflation compiled by the US Bureau of Labor Studies.

Personal Consumption Expenditure Price Index | The PCE is a measure of the prices that people living in the United States, or those buying on their behalf, pay for goods and services.

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HIGH YIELD | Bloomberg US Corporate High Yield Total Return Index: The index measures the USD-denominated, high yield, fixed-rate corporate bond market. Securities are classified as high yield if the middle rating of Moody's, Fitch and S&P is Ba1/BB+/BB+ or below.

S&P 500 | The S&P Total Return Index: The index is widely regarded as the best single gauge of large-cap U.S. equities. There is over USD 7.8 trillion benchmarked to the index, with index assets comprising approximately USD 2.2 trillion of this total. The index includes 500 leading companies and captures approximately 80% coverage of available market capitalization.

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Source: FactSet, as of 3/6/2025