

PRAGMATIC VS. PANIC

“PEOPLE DON’T WANT ACCURACY. THEY WANT CERTAINTY.”

– MORGAN HOUSEL

Market conditions at present can best be described as not too hot, not too cold, but NOT just right! The stock market’s early bullishness that greeted the incoming administration — characterized by expectations of pro-growth deregulation and structural economic reform—has given way to a wave of policy uncertainty. Between escalating trade tensions, variable geopolitics, Fed policy fatigue, a mixed economy, and impending fiscal contraction, stock market volatility has returned. Several pundits have even suggested a recession may emerge later this year.

However, despite the current increase in stock market volatility, there is no clear evidence of systemic deterioration or the onset of a recession. Recent economic indicators paint a picture that is neither particularly strong nor dangerously weak. While a bear market is not necessarily imminent, the “lukewarm” environment offers little momentum to push equity markets back to the all-time highs reached in February. Investor appetite for risk has cooled, and stretched valuations in the market’s most glamorous stocks have begun to compress under the weight of rising uncertainty and tightening conditions.

In less than two months, aggressive policy actions have reshaped both investor sentiment and global market expectations. The White House has moved rapidly to impose sweeping tariffs on major trading partners, including Canada, Mexico, and China. Simultaneously, federal workforce reductions have begun under the newly established Department of Government Efficiency (DOGE), which aims to eliminate bureaucratic redundancy and reduce federal spending.

The administration has framed tariffs as strategic tools to curb fentanyl trafficking, reduce illegal immigration, correct long-standing trade imbalances, and incentivize the reshoring of manufacturing jobs to the US. However, expectations quickly changed in early March after trade deals could not be struck, and the US proceeded to implement a 25% tariff on Canadian and Mexican imports and doubled the tariff rate on Chinese imports to 20%. The immediate effect has been to ignite retaliatory

measures from trading partners. China and Canada promptly responded with tariffs of their own, while Mexico is finalizing its countermeasures. President Trump also announced the implementation of “reciprocal tariffs” to target other countries with perceived unfair trade practices, set to begin April 2.

A more aggressive US trade policy has also begun to reshape the inflation and growth narrative for the remainder of 2025. Economists now project that tariff increases could lift core Personal Consumption Expenditures (PCE), the Fed’s preferred inflation gauge, to 3%. While this number is not alarming in isolation, the risk lies in inflation expectations becoming embedded in wages and prices, which could rekindle a broader inflation cycle just as the Fed seeks to ease monetary policy.



At its March meeting, the Fed held its benchmark interest rate steady at 4.5%, in line with consensus expectations. However, in a key move, the Fed announced that it will reduce its monthly cap on Treasury security redemptions from \$25 billion to \$5 billion, signaling a less aggressive stance on its balance sheet reduction program (Quantitative Tightening). This pivot also suggests that policymakers may be prepared to resume rate cuts if macroeconomic conditions deteriorate.

Inflation has drifted lower, now at 2.5%, but remains above the Fed’s 2% target. At the same time, fourth-quarter US GDP grew at a steady 2.3%, a deceleration from prior quarters (3.0% and 3.1%). Forecasts for full-year 2025 GDP range between 1.7%-to-2.7%. These expectations reflect an erosion of disposable income and reduced business investment due to heightened policy uncertainty.

In addition, tax policy uncertainty has likely added to the market’s apprehension. The 2017 tax cuts enacted during President Trump’s first term are scheduled to expire at the end of this year. Without congressional intervention, both corporate and individual tax rates will revert to higher levels. This change could compress corporate earnings, reduce capital expenditures, and increase investor risk aversion—all of which would weigh on equity valuations.

In short, the economy is growing but slowing. Inflation has eased but is not yet anchored. The combination of trade disputes, a weakening consumer, elevated valuations, and tax uncertainty has left the most overvalued segments of the market vulnerable to bouts of volatility. Yet, there may be opportunities elsewhere.

ECONOMIC VIEWPOINT

The US economy is entering a phase of deceleration, with all major components of gross domestic product (GDP)—consumption, government spending, investment, and net exports—showing early signs of fatigue. While the post-pandemic recovery was driven by robust consumer spending and historic fiscal stimulus, the momentum underpinning that expansion appears to be waning.

Wage and income growth—the primary fuel for consumer spending—is softening. As a result, consumption, which accounts for nearly 70% of GDP, is losing some steam. While retail data reveals growth in the first quarter, the rolling two-year average remains around post-pandemic lows. Encouragingly, “Control Group” retail sales, a key proxy for core consumer demand, is tracking at 4.0% annualized growth (vs. +4.1% in Q4 2024).

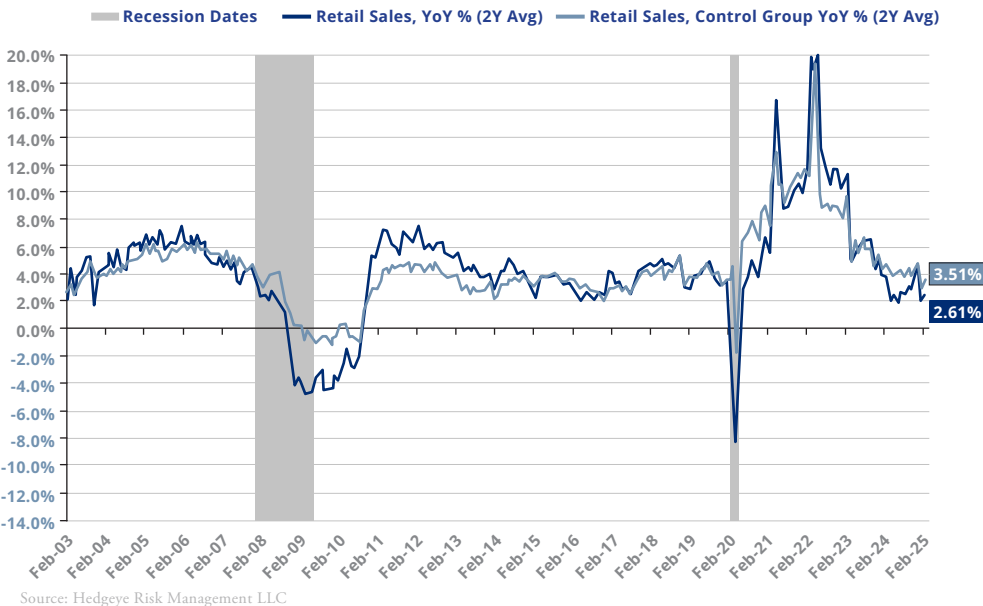
This modest deceleration is well within historical norms but merits monitoring. Elevated uncertainty around trade and tax policy could further dampen consumer activity, as households grow more cautious and increase precautionary savings. A defensive shift in behavior would likely reinforce the modest cooling in consumption.

At the same time, government spending—a key driver of the post-pandemic expansion through significant deficit financing—is facing an inflection point. A ballooning government deficit has translated into a significant percentage of GDP and job growth over the last several quarters. The recent pivot toward austerity or even a moderation of spending would represent a form of “cold turkey” fiscal detox, with short-term challenges for corporate earnings and future CapEx decisions. In essence, the unwinding of fiscal stimulus could act as a brake on growth in the near term.

Trade policy took center stage in global market narratives during the quarter, and ongoing developments will likely dominate in the months ahead. President Trump announced a sweeping escalation in tariffs, imposing a 25% duty on imports from Canada and Mexico while simultaneously doubling tariffs on Chinese goods to 20%. The abrupt escalation raises the likelihood of retaliatory measures from key partners, which could disrupt supply chains, elevate input costs, and potentially strain consumer purchasing power.

Business capital expenditures (CapEx) are highly sensitive to both economic confidence and forward earnings visibility. Private investment, which often relies on both consumer demand and government support, may turn from an economic accelerant to a constraint. The current combination of tariff uncertainty and macroeconomic softness may delay or discourage near-term investment plans, limiting the private sector’s ability to drive the economy forward.

U.S. Retail Sales Growth Persists



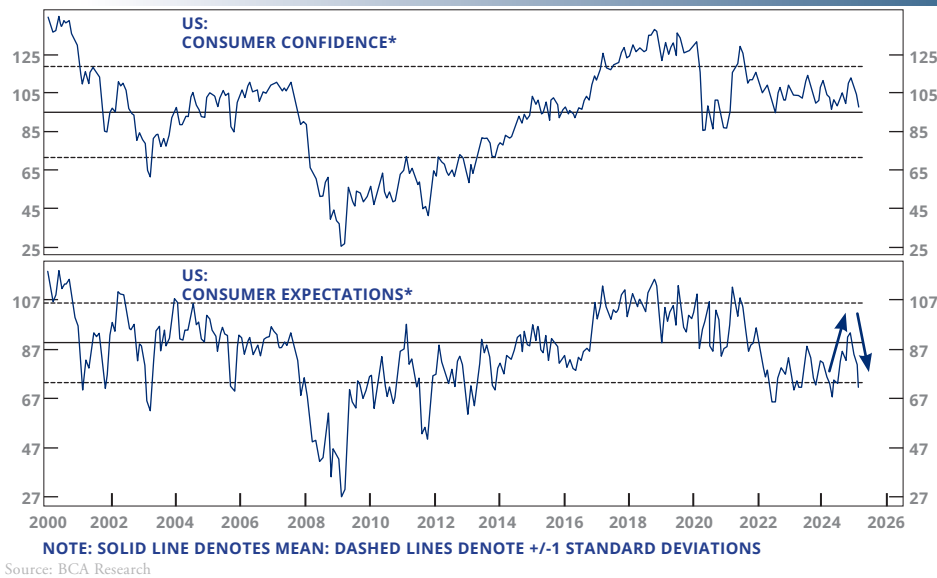
While retail sales growth persists, consumers are cautious. In March, the Conference Board’s Consumer Confidence Index fell sharply to 92.9 from 100.1—the lowest reading since early 2021 and extended a four-month consecutive decline. The Expectations Index saw a steeper drop, plunging to 65.2, its weakest level since 2013. These forward-looking sentiment figures point to growing household unease about job security, income prospects, and economic conditions.

However, while caution is warranted, the latest labor market data shows continued resilience. The four-week moving average of initial jobless claims was 227,000 for the most recent reporting

week. Continuing claims ticked up to 1.829 million. These figures are well within healthy historical ranges, with the caveat that a continued upward trend may indicate early-stage softening.

INVESTMENT STRATEGY

Consumers are Cautious



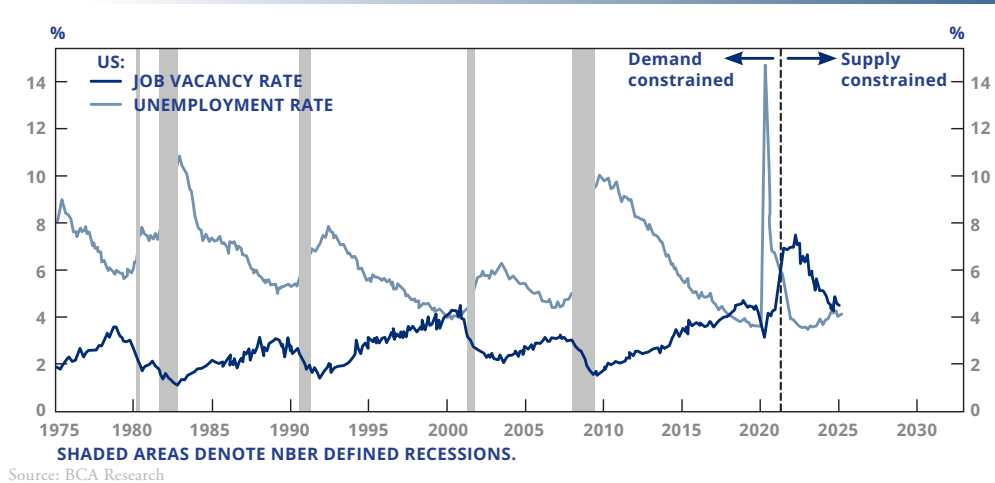
If sustained, higher jobless claims could weigh on wage growth and consumption, while also impacting corporate revenue and margins. For now, the labor market appears resilient, but its peak strength may be behind us. Importantly, the number of jobs that are unfilled and actively being recruited for continues to exceed those looking for work. US labor demand is still running 1.7 million workers above labor supply. The US has never entered a recession under these conditions.

The current market environment is marked by a powerful tension between resilient fundamentals and intensifying macro headwinds. Corporate earnings remain solid, and the labor market continues to hold up. Yet, against this backdrop, bold tariff threats, persistent inflation concerns, and cautious monetary policy are weighing on investor sentiment and appetite for risk.

Tariffs, in particular, have emerged as the most immediate market-moving catalyst, raising concerns about inflation and retaliatory measures from key trading partners. Simultaneously, the technology sector—once the unquestioned driver of market performance—is showing signs of strain under the weight of lofty valuations and normalizing growth rates.

The implications extend beyond trade-sensitive sectors. An unexpected acceleration in inflation, fueled by rising import costs, could influence the Fed's stance on interest rates. Rising prices could force the Fed to maintain restrictive policy longer than expected, potentially steepening the yield curve and introducing renewed volatility to fixed income markets. The prospect of policy missteps—either staying tight too long or pivoting prematurely—has added to the capital markets' unease.

Labor Demand Still Exceeds Supply



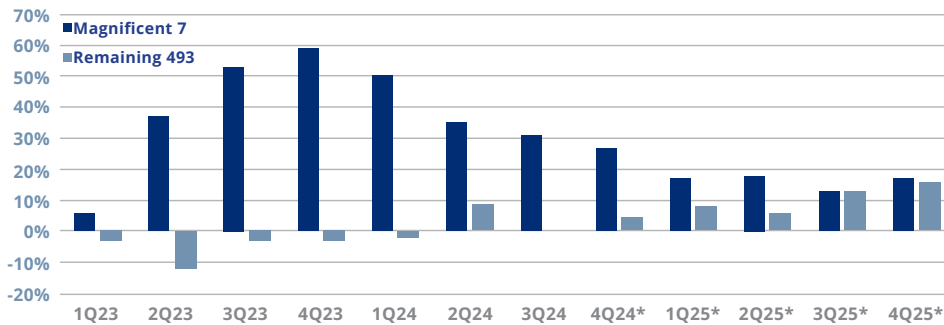
The US economy is not flashing recession signals across the board—but it is flashing yellow. From cooling consumer sentiment to restrained investment and policy-driven uncertainty, the foundational components of GDP may be starting to buckle in unison. However, it's been uncertainty driving market volatility more than the data.

The technology sector, particularly the “invincible” Magnificent Seven, is showing signs of exhaustion. S&P 500 earnings were actually the strongest in three years, with 4Q 2024 profits rising 18% year-over-year. Yet elevated valuations have left little room for continued upside surprises. Despite delivering exceptional earnings that exceeded expectations, Nvidia's stock declined 8% immediately following the announcement.

In parallel, demand for cloud-based AI infrastructure is beginning to normalize. Some of the largest enterprise customers are scaling back spending as competition—led by Chinese newcomer DeepSeek—raises questions about CapEx needs. These shifts suggest that even the most promising secular trends are not permanently immune to the laws of economics.

S&P 500 EPS Growth Profile

Magnificent 7 vs. Remaining 493



Source: S&P Capital IQ. Data as of 1/31/25. *Forecast based on quarterly consensus earnings estimates.

Source: First Trust

However, select opportunities may persist. Despite recent market drawdowns, investor sentiment toward stable, undervalued businesses remains constructive, and equity leadership is broadening. High-flying tech stocks continue to carry extreme valuations—some with P/E ratios above 100—which is prompting a shift toward more reasonably priced, higher-quality sectors. Simultaneously, as earnings growth for companies in the “Mag 7” are normalizing, annualized earnings expectations for the broader market are increasing.

While this rotation may foster healthier market breadth over time, it also introduces near-term volatility. Some pundits caution that a new bear phase may have quietly begun on February 20—the day after the S&P 500 hit its most recent peak. The ensuing decline and abrupt volatility evoke historical analogs like 1962 and 1987: sharp, sentiment-driven corrections that resolved quickly but triggered widespread anxiety.

However, it's important to maintain perspective. Out of the last 39 market corrections, only 13 have evolved into bear markets. In other words, while every bear market begins with

a correction, most corrections do not escalate further.

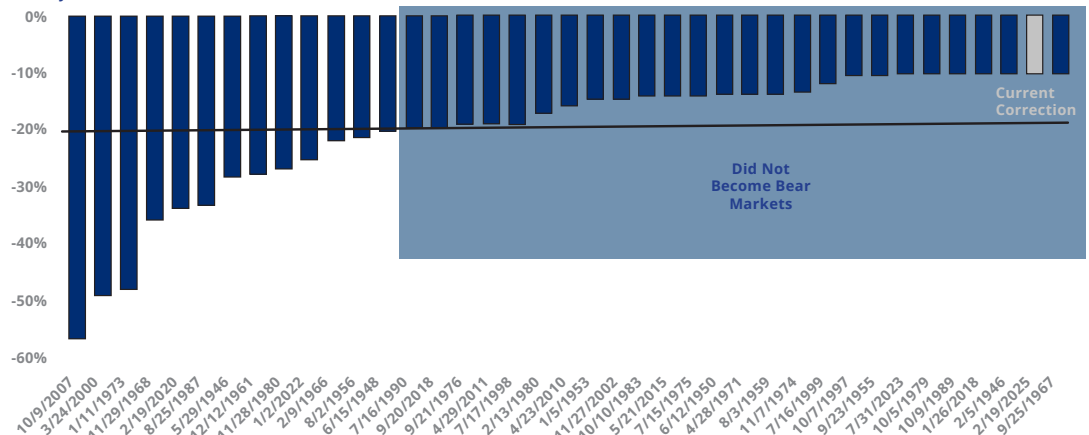
Broader macro and policy dynamics suggest that further downside risks cannot be dismissed entirely—particularly when viewed in the context of elevated valuations, policy ambiguity, and external economic pressures. However, while it is not a time for complacency, it is neither a time for panic nor excessive pessimism. Pragmatism should prevail.

In short, markets are grappling with a difficult recalibration. The policy framework is no longer oriented around direct market support, and the transition toward a leaner economic model is proving disruptive.

Positioning strategies may need to shift accordingly, favoring diversification, quality balance sheets, and exposure to sectors less sensitive to interest rates and trade policy shocks. With geopolitical developments and Federal Reserve guidance still in flux, Goldilocks will have to wait. However, with continued resilience of the economy and corporate profits – the bears may have to wait as well.

Not All Corrections Become Bear Markets

Only 13 of the Previous 39 Market Corrections Since WWII Became Bear Markets



Source: Carson, via topdowncharts.com

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