OPTIMUM®
Global Asset Management

Financial Outlook

Second Quarter 2025

Summary

At a Glance

- President Trump's tariff announcements have upended investors' bullish expectations
- The market now expects the FED to cut rates by up to 1% in response to a weaker economy
- Uncertainty will persist even if tariffs are negotiated down
- The Equity Risk Premium in the US is still very low, making the market vulnerable to further downside

Point of View

Jan Erik Warneryd, Chief Investment Officer

The first quarter of 2025 marked a significant change in market sentiment. After having ended 2024 and started the new year with optimism about deregulation and tax cuts, investors were rudely shaken by President Trump's aggressive tariff policy. Although the President had made tariff hikes a central part of his election campaign, market participants were convinced that it was meant as a negotiating tactic in order to get trading partners to lower their tariffs on the US and ultimately create a "level playing field" with lower trade barriers globally. Adherents of free trade and market economics have so far been disappointed with President Trump as the tariffs that have been imposed go well beyond what would seem like a reasonable opening bid to start a good faith effort to come to mutually acceptable conditions for fair trade. Increasingly, market participants are coming to the conclusion that tariffs will play an important role in President Trump's policies for the next several years.

Investors are now scrambling to assess the impact on the economy from these tariffs; how much will US and global growth slow? Will the Federal Reserve (FED) focus more on rising inflation or a slowing labor market? What about US exports if trading partners retaliate?

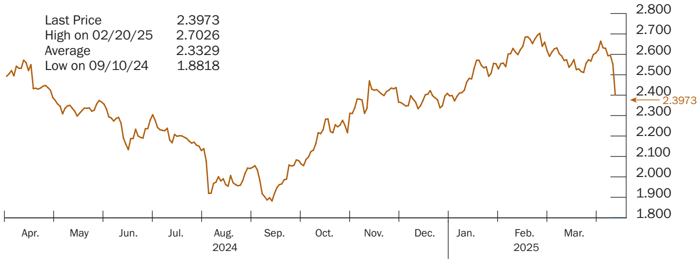
If nothing else, the increase in uncertainty is likely to make corporations slow or postpone hiring and investment decisions until visibility regarding administration policy improves. A weak equity market, if it continues, will induce a negative wealth effect where consumers are less willing to spend. Fear of job losses will further depress consumer sentiment.

Longer-term, other unknown factors include the impact on the labor force from lower immigration. In recent years, most of the growth in the labor force is due to immigrants and it has been a key factor in the US recovery after the COVID pandemic. Lower growth in the number of workers would have to be countered by higher productivity to keep growth at desired levels.

The recent market turmoil has raised expectations for the FED to cut the Funds rate more than previously thought, and as this is written (April 4, 2025) market expectations are for the FED to cut a total of 100 basis points in 2025, possibly starting as early as May and possibly cutting as much as 50 basis points by June. This would result in an effective Fed Funds rate of about 3.30%, a full 57.5 basis points below the median forecast by members of the FED's Open Market Committee (FOMC) which is at 3.875% as of the March 19, 2025, Dot Plot. For the FED to lower the Funds rate as much as the market expects, they would have to be convinced that any inflation spike due to tariffs is **transitory**, a term that gained infamy when used by FED Chairman Jerome Powell in 2021.

Chart 1 shows 5-year market-based inflation (CPI) expectations implied by pricing of TIPS (Treasury Inflation Protected Securities). As can be seen, the market has recently seen a drop in inflation expectations, likely due to forecasts of weak economic growth serving to counteract any short-term inflation increases. The expected rate, however, is still higher than the FED's 2% inflation target which indicates that the market is worried that inflation will be more of a problem than previously thought.

Chart 1: Market-Based Inflation Expectations



Source: Bloomberg and Optimum Quantvest

The FED will likely find it difficult to lower rates as much as the market currently expects if inflation stays high or increases due to tariff-related price hikes. An additional worry is that the US has become somewhat dependent on foreign buyers of Treasury debt as the trade deficit has been recycled into USD denominated assets by central banks and other global investors.

In contrast to other downturns in the economy in recent decades, a recession in 2025 would likely not be met with fiscal and monetary stimulus to anywhere near the extent seen during the 2008 financial crisis and the 2020 COVID Pandemic. While the FED continues to focus on bringing inflation down longer-term, the Trump administration is focused on cutting the US budget deficit in order to bring it down from 6% of GDP to 3%. A recession would make it very difficult to reach that goal as "automatic stabilizers" built into entitlement programs and the tax system increase government spending and reduce tax revenue in an economic downturn. Any incremental spending enacted to stimulate the economy as a response would serve to further worsen the deficit. There will therefore be severe tension between the Trump administration's stated objective of cutting the budget deficit and the pressure for spending to increase in order to counter a likely economic slowdown. We should expect the fiscal response to be slow or non-existent, which risks making any economic downturn more severe than otherwise would be the case.

The suggested tariff policy will negatively affect not just the US economy but the rest of the world as well, since all countries trading with the US will be subject to a 10% tariff regardless of whether they have a surplus or deficit in trading with the US. Reduced global trade will also erode the US dollar's status as a recipient of the reserves created by other countries' trade surpluses. The US has been receiving a significantly larger share of capital inflows from the rest of the world (ROW) than its share of global GDP would suggest, but that may now change. The ROW may now be significantly less inclined to invest in the US, both because of lower surpluses but also because of the perceived hostility towards foreign countries from the current administration. It probably doesn't help that the US equity market has outperformed other global markets and that the US dollar

Point of View (cont'd)

Jan Erik Warneryd, Chief Investment Officer

has been strong, contributing to large overweights of US assets in indices such as the MSCI World, where the US share reached about 70% recently. This has created a situation where rebalancing away from the US would be likely to happen even without a catalyst in the form of a trade war.

In conclusion, it is difficult to see short to medium term positive results from President Trump's tariff policies as they have been presented. If, as some members of the administration have hinted, the tariffs are negotiable, the outlook for the US and global economy could be better than what's outlined above. The most positive, but unlikely, scenario would be one where trade barriers globally come down. There is no doubt that global prosperity would benefit from tariff-free trade and there is an outside chance that progress towards that may have begun with recent events.

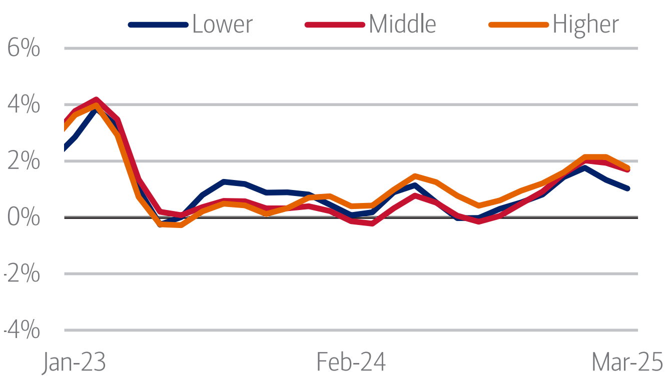
Bond Markets

Mark McDonnell, Senior Portfolio Manager

Past is Prologue

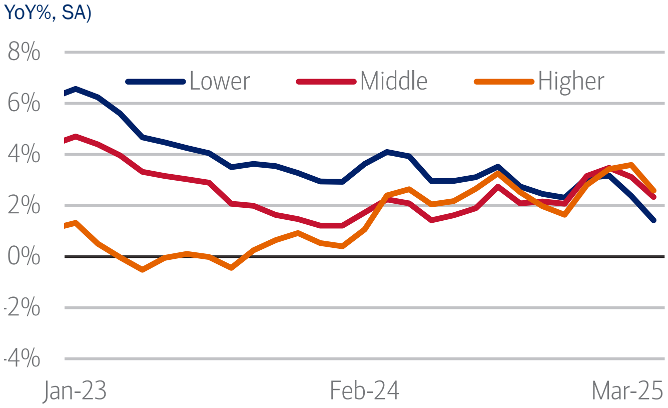
The consumer ended strong in 2024, and retail sales accelerated in December. Inflation continued its downward trend through September, bottoming at 2.44% though subsequent months showed a move back towards 3%. However, consumers were starting to show changes in their behavior that could signal a type of exhaustion. It started to appear mid-year in the small ways. Spending in leisure saw changes like a tendency to watch a movie with the family more often at home rather than in the theaters for considerable savings. The quarterly earnings calls ending early this March for the fourth quarter offer both statements on the past as well as forecasts for the upcoming quarter. 60% of the consumer driven companies followed by Morgan Stanley's research team guided future earnings estimates lower with a theme of *Need Versus Want* starting to develop. Consumer confidence, especially for the lowest one third of income earners, fell. Credit card and sub-prime auto loan delinquencies restarted a rise higher as the savings rate dropped. Wage growth slowed, probably a large contributor, as shown on Chart 1 and 2 below.

Chart 1: Total Credit and Debit Card Spending Per Household (3-month moving average, YoY%, SA)



Source: Bank of America

Chart 2: After-Tax Wage and Salary Growth (3-month moving average, YoY%, SA)

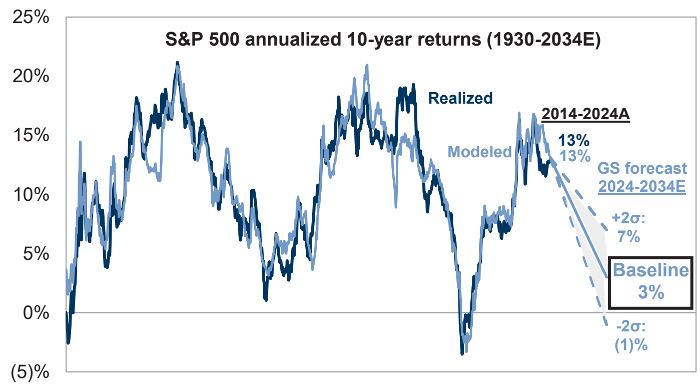


Source: Bank of America

The Markets

With that backdrop, the markets continued to price in virtually no risk of a recession. As Chart 3 below shows, the equity market was so extended that Goldman Sachs' model forecasts a modest 3% return over the next 10 years.

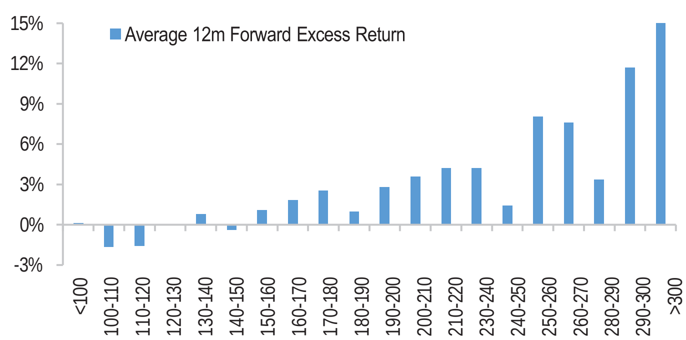
Chart 3: S&P 500 Annualized Trailing 10-Year Returns: Modeled vs. Realized and Forecast



Source: Goldman Sachs

The picture was not appreciably better for the corporate bond market. Corporate bonds are purchased because they offer more yield than a similar maturity Treasury bond. The investor wants to get compensated for additional risks such as the chance of default which we call credit risk. That additional yield, called spread, closed 2024 at very low levels, implying a very small chance of a recession or any other disruption. These spreads were at levels that historically have led to negative performance relative to similar Treasuries over the next twelve months. Indeed, historical excess return over the subsequent 12 months when JULI is sub-120bp has been negative (Chart 4).

Chart 4: Average 12-Month Forward Excess Return



Source: JP Morgan

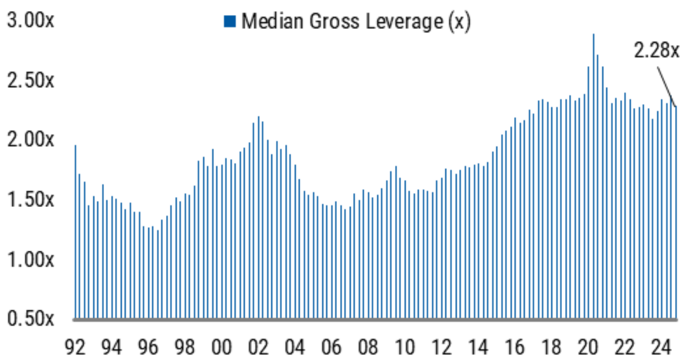
Bond Markets (cont'd)

Mark McDonnell, Senior Portfolio Manager

As investment-grade bond managers, we invest in bonds that are in the Bloomberg Aggregate Index. Broadly speaking, the index is comprised of Treasuries, Mortgages, and Corporate Bonds in roughly equal weights. Our starting point being the Index, we build out the framework of the portfolio with Treasuries, varying the weights of bonds of different maturities based on our expectations of future economic growth, inflation, and Federal Reserve policy. All else being equal, we would have weightings in mortgages and corporate debt similar to that of the Index. However, that is not the case today. Corporations, when viewed though the lens of a corporate bond investor, were doing a number of good things.

Generally speaking, corporations were maintaining good capabilities to repay investors when their bonds mature. For example, leverage is one commonly viewed metric (Chart 5). However, as we noted, the sector was priced to perfection. Credit spreads (compensation for credit risk) was over 60 basis points below the long-term average of 147 basis points.

Chart 5: Median Gross Leverage



Source: Morgan Stanley, Bloomberg

Tariffs

There is an old saying when one tries to discuss the inner workings of the Supreme Court: Those who tell don't know, and those who know don't tell. We are tasked as investors with navigating the Tariffs and at this point Tariffs are anyone's guess. Paradoxically, that uncertainty helps us. Investors demand additional compensation for that uncertainty. In the stock market that is expressed by way of the Price to Earnings multiple or PE. All else being equal, that means lower equity markets. In corporate bonds, that means investors demand higher additional yield over Treasuries and this is exactly what we are seeing. Credit spreads moved from providing approximately ¾ of a percentage point over Treasuries to over 1% (or 100 basis points) over Treasuries. We believe that is a solid start, but spreads still have a good probability of going wider.

Residential or home mortgages comprise most of the last third of the index, the Securitized Sector. The vast majority are rated AAA. Mortgage-Backed Securities were fairly valued entering the weeks of Tariff Turmoil. Surprisingly, they held up quite well, widening very modestly to Treasuries. We look for that additional spread to be sustained over time.

STRATEGY

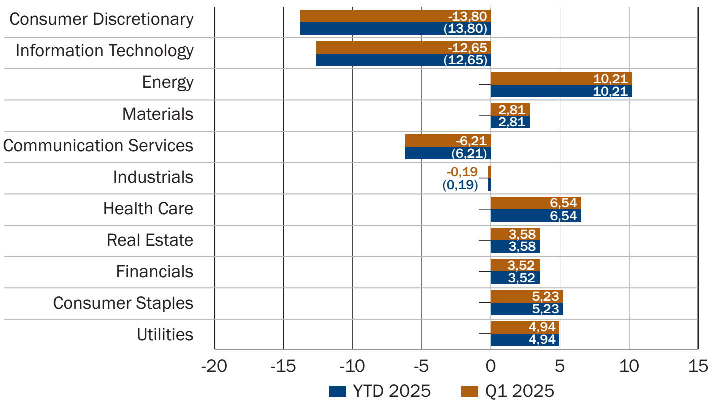
We believe that we are well positioned for the increased volatility introduced by the tariffs. We are closely monitoring the spreads of both corporate debt and mortgages for opportunities. Systemic risk opens up the possibility of mispriced idiosyncratic risk as investors throw the baby out with the bathwater. We hope to add value by judiciously purchasing companies and mortgages that get caught up in that systemic risk.

U.S. Equities

Jan Erik Warneryd, Chief Investment Officer

The first quarter of 2025 saw an abrupt end to the bull market in US equities that started in the fall of 2022. The S&P 500 fell 4.27% in Q1, led lower by Consumer Discretionary (-13.8%), Information Technology (-12.65%) and Communication Services (-6.21%). Industrials was the only other sector with a (small) negative return (see Chart 1 below). All other sectors, led by Energy (+10.21%), posted positive returns.

Chart 1: S&P 500 Index
Total Return (%) by Sector - Quarter End March 2025



Source: S&P Global and Optimum Quantvest

At first glance, US Equity performance in Q1 2025 appears to be just a minor reversal of 2024; sectors that led the market higher gave back some gains in favor of the laggards from last year, but that may be too facile an explanation for what is happening to the investing backdrop in the US.

Most market observers can probably agree that, if nothing else, uncertainty about economic policy has increased dramatically since President Trump's inauguration on January 20. What was initially assumed to be a market-friendly administration focused on deregulation, government efficiency and tax cuts, creating a benign environment for investors, has turned out to have a much more ambitious and potentially disruptive agenda than expected.

In trying to address the large US trade deficit with the rest of the world and to raise revenue, President Trump has introduced steep tariffs on most imports. The impact of these tariffs on the US economy is as yet unknown, but it seems reasonable to, at a minimum, expect consumer prices to rise as well as supply bottlenecks and potential shortages of various inputs for US domestic use as trade patterns adjust. The impact on US GDP growth is likely to be negative, with first-order effects such as a surge in imports to front-run tariffs likely to result in negative Q1 growth. In the medium to longer term, lower imports (and exports, too, due to likely retaliatory tariffs from our trading partners) will dampen growth as economic activity slows.
Any inbound investment by foreign companies relocating manufacturing to the US will take many years to have a meaningful impact on domestic output while higher inflation will force the Federal Reserve to keep interest rates higher than would otherwise be necessary. Of course, there is always a chance that these steep new tariffs will be negotiated lower, but the damage to sentiment is likely to last a long time.

When assessing the impact of lower growth on the US equity market, we must look at the current valuation to see if investors are getting compensated for the increased risk we foresee.
Chart 2 below shows a measure of the Equity Risk Premium defined as the spread in percentage points between the inverted CAPE (Cyclically Adjusted Price/Earnings, also known as the Shiller P/E) ratio and the real yield on 10-year TIPS (Treasury Inflation-Protected Securities).

Chart 2: Equity Risk Premium

Source: Bloomberg and Optimum Quantvest

As we can see on Chart 2 above, the current Equity Risk Premium is now at levels last seen in 2002. The recent sell-off in the S&P 500 and the fall in yields has raised the risk premium slightly in the last few weeks, but essentially, it is close to 23-year lows. Investors need to ask themselves if this is justified given the outlook for the US economy, earnings and the general environment of unpredictability that the current administration has engendered.

The equity market appears to already be shifting in leadership as can be seen in Chart 1 above. It may be worth taking a look under the surface of the broad capitalization-weighted S&P 500, to see how alternative indices have performed so far this year. The S&P 500 Value Index, for example, returned 0.28% and the S&P 500 Low Volatility Index was up 7.26% in Q1 2025. The Equal Weight S&P 500 was down less than the broad S&P 500, at -0.61%. Could this be an early sign of a rotation in market leadership, away from Technology-heavy sectors into laggards such as Health care and Utilities?

Technology and the other two tech-heavy sectors, Communication Services (Meta, Alphabet, Netflix) and Consumer Discretionary (Amazon, Tesla) have led the market for many years as optimism about technology and, lately, specifically Artificial Intelligence inspired investors to focus on a few large cap names.
The monikers Fang, Faang and Magnificent 7 have all been used to describe what were a small number of dominant tech-related stocks whose moats and networks were believed to guarantee them unassailable global leadership positions for many years ahead. Overall earnings growth expectations for the S&P 500 are +10% (Thomson Financial Consensus EPS estimates) and 18% for the Information Technology sector in 2025. Given the tariff news, it would be surprising if estimates weren't adjusted down in the coming months.

U.S. Equities (cont’d)

Jan Erik Warneryd, Chief Investment Officer

Chart 3: CAPE Ratio

Source: Bloomberg and Optimum Quantvest

Chart 3 shows the CAPE ratio for the S&P 500 by itself. As can be seen, at 31.7 times 10 years of average real earnings, the ratio is not at an all-time high, it is nonetheless very high. It also appears that it is trending lower and, if history is any guide, will continue to fall to levels reached during recessions in the past. This means that there is potentially significant downside to US equities from these levels.

STRATEGY

The US economy is likely to slow significantly due to several factors, including fiscal tightening (lower budget deficit), higher consumer prices due to tariffs on imported goods, lower immigration leading to less labor supply and a negative wealth effect from a declining equity market. While the FED is expected to cut interest rates as the economy slows, higher inflation will act as a brake and result in less monetary stimulus than would be expected under normal circumstances.

As mentioned above, we believe a change in market leadership will result in better relative performance for sectors that have lagged the multi-year equity rally. Cyclical and Value sectors such as Financials, Health Care, Utilities and the Telecom sub-sector are likely to outperform the overall market if, as now seems likely, the Magnificent 7 stocks give up their leadership. The timing of this shift in leadership has been difficult to predict but the catalyst could be a likely economic slow-down coupled with ongoing uncertainty about future Washington policy.

The high valuation for US equities after a relentless bull market through 2024 makes recent policy changes more likely to trigger a negative shift in the outlook for the asset class.

Our Team

Jan Erik Warneryd, CFA
Chief Investment Officer
Telephone: 469 802-8493
jwarneryd@optimumquantvest.com

Mark McDonnell
Senior Portfolio Manager
Telephone: 469 794-0011
mmcdonnell@optimumquantvest.com

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OPTIMUM QUANTVEST CORPORATION

1345 River Bend Drive, bureau 100
Dallas, TX 75247, U.S.A.
+1 263 381-5677
info@optimumquantvest.com

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