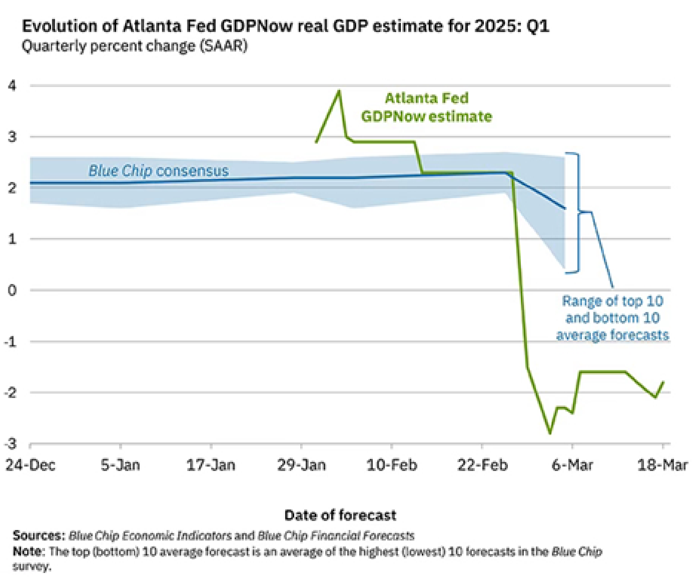
# Prepare for "Crash" Landing

PCM Report April 2025 Volume 16, Issue 4

**Brian Lockhart**

The Fed has been celebrated for its efforts to engineer a "soft landing" for the economy following the multiple rate hikes to bring inflation under control. All signs through the beginning of this year pointed to success in maintaining economic expansion and the focus had shifted to how quickly the Fed would bring rates back down after the initial rate cut in September 2024 of 50 basis points followed by 25 basis point cuts in November and December of last year.

It appears a dramatic change started taking shape with the economy at the beginning of March. While Blue Chip consensus economists slightly lowered expectations for Q1 GDP growth from just over 2% to just below 2%, the model created by the Atlanta Fed, known as GDPNow, plunged to almost -3% for the quarter. The model has recovered somewhat but at the end of the March still showed almost -2% for GDP in Q1.




The most obvious and sourced reason for the dramatic fall in expected GDP is the Trump administration's policy on tariff's. It is true that part of the reversal in growth is a slowdown in exports, but that only accounts for a small drop in growth. The biggest culprit in the model is a slowdown in consumer spending estimated in Q1. Slowing consumer spending seems to be the result of bad weather in January and falling consumer and business confidence. Another major factor is the record high trade deficit, over $150 billion, reported for January. Data suggests the trade deficit surged after the announcement of tariff's as companies who rely on exports to the US dramatically increased shipments to front run expected tariffs.

> **"Slowing consumer spending seems to be the result of bad weather in January and falling consumer and business confidence."**

The stock market, long considered a leading indicator, seems to have anticipated the economic contraction, peaking in mid-February and falling approximately 8% since. Technology, measured by the Nasdaq, has been even harder hit falling more than 11% from the February highs and is now down about 8% for the year. Sell-side momentum appears to be building with expectations for a full-blown correction. Not all the news on the stock market front is negative. There is a clear rotation away from tech and the mega cap names that have dominated stock market performance to traditional value and low volatility stocks. Value and dividend paying stocks have largely sat out the gains of the last couple of years but have surged since February and are about 3% higher on the year. Low volatility stocks that largely are comprised of financials, utilities, and industrials, have surged to gains of more than 6% YTD measured by Invesco's low volatility ETF.

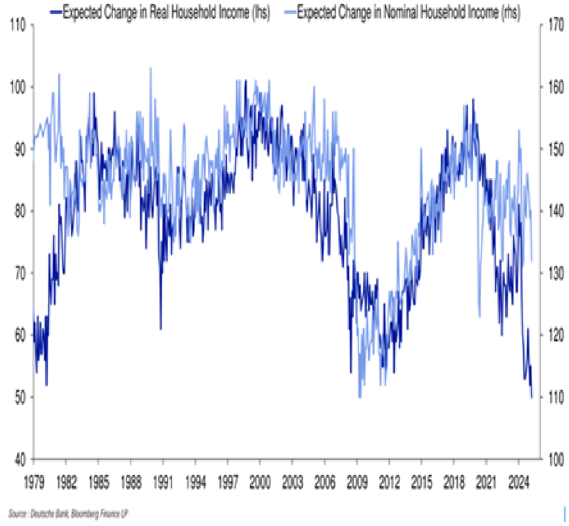
The environment created by this rotation in the stock market will likely highlight stock pickers over index buyers, at least until indices return to sustainable valuations. The drop in the broad indices is driven by weakness in the Magnificent 7 stocks (AAPL, MSFT, FB, NVDA, TSLA, AMZN, GOOG) that is largely due to the revenue they rely on from outside the US. For example, AAPL has just 42% of revenue from the US while companies like MSFT, NVDA, and FB average around 45% of their revenue from the US. The more company's rely on revenue from outside the US, the more exposed they are to the impact of tariffs.

It appears to me the long-anticipated recession in the US has arrived. The start date of the recession may revert back to Q4 of 2024 when revisions are analyzed, but the impact to investors is already being felt. The focus for portfolio managers shifts to forecasting how long and deep the recession will ultimately be and how much further equities are likely to correct before reaching a bottom.

There have been 11 recessions since 1950 and the average length is 10 months according to data from Statista. Interestingly, the stock market has tended to achieve a bottom, on average, 5 months before the end of a recession. If a recession is determined to have started January 1 of 2025 and lasts through October or November, the market may achieve a bottom around May or June. There is limited data about recessions caused by policy actions such as tariff's but my guess is that companies (and countries) adjust quickly in today's world and this recession will resemble what an average recession has looked like. That would mean investors should expect extremely high levels of volatility at least through Q2 with equity market losses of 25-30% from current levels according to historical patterns. Once hitting a bottom and attractive valuations, it may represent a compelling buying opportunity for companies that will lead for the next decade at attractive entry points.

PCM Report March 2025 | Volume 16, Issue 3

## Squeezing the Consumer




The latest data out of the University of Michigan survey suggest the Fed will be facing a dilemma in the coming months. Expectations for consumers real income (adjusted for inflation) will fall to the lowest level in the survey's 47-year history. The data suggests wages will remain flat for the next one to two years while prices continue to increase. Almost 70% of GDP in the US is comprised of consumer spending that means the expected squeeze on consumers will likely lead to economic contraction as forecasted in the GDPNow model. The drop in nominal income is more modest suggesting unemployment will not necessarily rise as high as in prior recessions. How much the economy is ultimately impacted may depend on where inflation rises the most and how tariff policy will influence that.

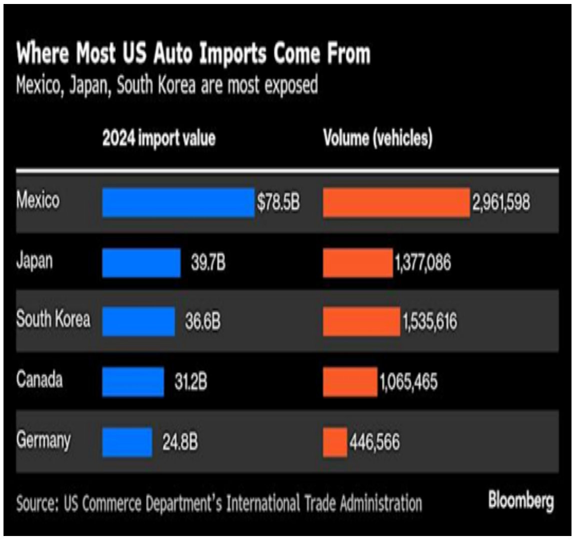
- The political divide in the US has reached the point of impacting economic forecasts today with those on the left believing inflation will rise much more than those who affiliate with the political right.
- The Fed will have to navigate the potential for economic contraction with the likelihood that inflation remains above their targets, making interest rate policy decisions a dilemma.
- The impact of this data on fixed income investors will be meaningful. Expect spreads to widen hurting returns on high yield debt while long-duration Treasuries are more likely to rally on the slowdown.

## Factor Performance


With this year's market volatility, it's worthwhile to compare factor performance across the U.S. equity market. The S&P 500 is officially in correction territory, having declined -10% from its all-time high and broke through its 200-day moving average. It's not surprising that the momentum factor, with its concentration in names such as Nvidia and Tesla, has underperformed on a relative basis. Likewise, small-cap stocks, which face mounting worries from uncertain tariffs and recession fears, have taken the worst decline across the factors. It is encouraging, however, to see factors like low volatility and value, that should be more resilient in a drawdown, perform relatively well.

- The low volatility factor could gravitate towards stocks that are not highly sensitive to tariff uncertainty, which could provide diversified exposure to a market cap-weighed S&P 500. Likewise, value stocks could provide a downside cushion should the market continue to trade lower, given their lower multiples, while high quality stocks with solid balance sheets could see a bid higher.
- If we avoid a sideways, whipsaw market, the momentum factor could eventually rebalance and pick up a new trend to the upside, which would help relative performance. Small-cap stocks, however, could continue to face headwinds if consumer demand wanes and we enter a recession.

## Auto Tariffs




President Donald Trump has announced steep new tariffs of 25% on imported vehicles and key auto parts, effective April 3. Wall Street analysts warn that these tariffs could increase vehicle prices by $4,000 to $15,000, depending on how much of the car is imported. Even locally made vehicles will see price hikes, as tariffs on parts could raise manufacturing costs by up to $8,000. While USMCA-compliant parts will be temporarily exempt, the overall disruption could significantly impact global automotive supply chains. Analysts predict that Tesla will be the least affected due to its domestic production, though CEO Elon Musk acknowledged that imported components will still drive costs up. As Trump's largest campaign donor, Musk has maintained close ties to the administration, though his company isn't completely shielded from these economic shifts.

- Increased costs for manufacturers and consumers could slow economic growth, especially if retaliatory tariffs from other countries further disrupt trade and business investment.
- Higher vehicle prices could lead to decreased car sales, making it more expensive for consumers to purchase new cars. Rising costs may also push some buyers toward the used car market, increasing demand and prices there as well.
- Investors reacted negatively to the tariff announcement, with auto stocks and companies reliant on global supply chains seeing declines.

**Quinn VandeKoppel**

## Macro View – Consumer Sentiment Falls

Consumer sentiment in March declined more than expected as inflation concerns intensified, according to the University of Michigan's Survey of Consumers. The index dropped to 57.0, an 11.9% decline from February and 28.2% lower than last year. The survey's consumer expectations index also fell sharply to 52.6, marking a 32% annual decline. Inflation fears were a key driver of the downturn, with one-year inflation expectations rising to 5% and five-year expectations hitting 4.1%, the highest since 1993. The report also noted labor market concerns, with unemployment expectations at their worst level since 2009. Additionally, Trump's tariff plans are raising worries about further inflation, potentially limiting the Federal Reserve's ability to cut interest rates. The stock market reacted negatively, with the Dow Jones dropping over 500 points following the report.


## Fixed Income – Treasury Yields Steady Amid Uncertainty

U.S. 10-year Treasury yields remain relatively flat after fluctuating between 4.16% and 4.34% in March, still well above 2024's low of 3.63%. According to Rob Haworth, senior investment strategy director at U.S. Bank Asset Management, bond markets are currently priced for 2% GDP growth and inflation above 2%. However, expectations for rising inflation—evident in the University of Michigan survey projecting 4.9% inflation over the next year—suggest yields may not decline significantly. The Federal Reserve has slowed its balance sheet reduction, trimming Treasury roll-offs from $25 billion to $5 billion per month, while maintaining $35 billion in mortgage-backed securities reductions. Meanwhile, the government has hit its debt ceiling, using extraordinary measures to sustain operations, adding liquidity and pressuring yields lower. The yield curve remains flat, and markets do not anticipate a Fed rate cut before June 2025.

| SYMBOL ↑ | COMPANY | YIELD | CHANGE |
|---|---|---|---|
| US10Y | U.S. 10 Year Treasury | 4.249% | -0.12 |
| US1M | U.S. 1 Month Treasury | 4.308% | +0.018 |
| US1Y | U.S. 1 Year Treasury | 4.044% | -0.061 |
| US2Y | U.S. 2 Year Treasury | 3.908% | -0.09 |
| US30Y | U.S. 30 Year Treasury | 4.629% | -0.10 |
| US3M | U.S. 3 Month Treasury | 4.299% | -0.002 |
| US6M | U.S. 6 Month Treasury | 4.227% | -0.004 |

## Taking Stock – Strained GPUs at OpenAI

OpenAI CEO Sam Altman announced that ChatGPT's new image-generation feature is being rate-limited due to overwhelming demand, straining GPU capacity. Launched Tuesday, the tool allows users to create diagrams, logos, artwork, and customized edits, with access for ChatGPT Plus, Pro, and Team users now and Enterprise and Edu users next week. Viral trends, like anime-style renderings, have driven adoption, and free-tier users will soon have a three-image daily limit. Meanwhile, AI competition is intensifying. Google's Gemini, Anthropic's Claude, and Elon Musk's Grok are advancing their own multimodal capabilities. OpenAI is working to optimize servers before scaling the feature further. With AI models evolving rapidly, companies are racing to improve efficiency, accessibility, and image quality to stay ahead.


## Technical – Technical Correction

The Nasdaq Composite (NASDAQINDEX: ^IXIC) has been a major driver of stock market gains and investor enthusiasm over the past two years. This tech-heavy index surged ahead, delivering double-digit annual gains fueled by excitement over artificial intelligence (AI) and expectations of a lower interest rate environment. However, what rises must eventually fall, and the Nasdaq did just that following President Donald Trump's tariff announcement, which introduced uncertainty into the market. Investors feared the new duties would weigh on corporate earnings and the broader economy, prompting them to steer clear of stocks most sensitive to economic shifts. Earlier this month, the Nasdaq slipped into correction territory, falling more than 10% from its December high. While the index briefly rebounded, exiting correction territory, it slipped back down last Wednesday. Now, the question remains: Will what falls eventually rise again?

# Currencies and Stock Returns

**Clint Pekrul, CFA**

We've written about the recent outperformance of international equities versus domestic stocks because the return differential year-to-date has been meaningful. While the S&P 500 Index, including dividends, is lower by roughly -3% for the year, international equity indexes such as the MSCI EAFE have surged by more than 10% over the same period.

Some of this outperformance is attributable to certain factors such as GDP growth forecasts and earnings expectations in relation to current valuations metrics, such as price multiples. Perhaps investors in general see better value overseas relative to the U.S. given the degree to which domestic stocks have outperformed over the past several years.

While the same fundamental factors ultimately drive stock performance in the long run, such as profitability and earnings growth, there is one additional factor that can weigh heavily on the shorter-term performance of foreign stocks versus domestic equities - currency exchange rates.

As the value of a foreign currency, such as the Euro or the Yen, fluctuates relative to the U.S. dollar, performance for foreign investments will be impacted through a process known as currency translation.

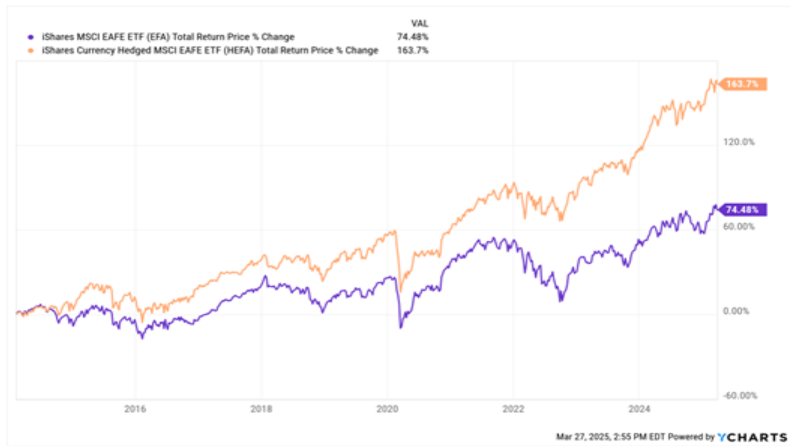
*The USD Index (DXY)*


To visualize how currency translation works, consider the USD Index illustrated above. The index represents the value of the USD relative to a basket of six foreign currencies – the Japanese yen, the Euro, British pound, Canadian dollar, Swedish krona and Swiss franc. When the index declines the USD is weakening and, conversely, when the index rises the USD is strengthening relative to other currencies.

The average exchange rate is important for domestic-based investors allocating to foreign stocks. When the USD is strengthening, much like it has since the financial crisis of 2008, it serves as a headwind and can hinder performance from foreign investments.

When a U.S. based investor buys shares of a foreign stock, that business generates cash flows (e.g., earnings, dividends, etc.) in a currency other than the dollar, such as Euros. Likewise, shares of a foreign stock trade in a currency other than the dollar. Ultimately, a U.S. based investor must convert his or her shares back into dollars.

When this transaction takes place (foreign currency to domestic currency) it results in a gain for the U.S. based investor if the dollar is weakening or a loss is the dollar is strengthening against the foreign currency. The chart below illustrates the performance between the MSCI EAFE Index (EFA) and the MSCI EAFE USD Hedged Index (HEFA) going back to 2014.




Over this period, the USD was generally strengthening as per the DXY Index. The result was considerable outperformance from the hedged version of the EFA index, which outpaced the unhedged version 163% to 74% over the period.

However, referring to the USD Index chart, the dollar doesn't always strengthen. For example, from 2003 up until the financial crisis of 2008, having unhedged currency exposure to international stocks would have been a benefit for U.S. based investors.

Exchange rates fluctuate daily and reflect the demand for, or the supply of the goods and services produced by the country and the flow of investments into or out of the country. For example, if the U.S. produces goods that are in demand globally, it will produce an inflow of foreign investment, a demand for dollars and a supply of other currencies. Likewise, interest rates and tariffs in particular can impact exchange rates.

Ultimately, predicting currency movements is a difficult task and deciding when and if to hedge currency exposure can be problematic. Investors should keep this in mind when investing in foreign markets.

## Q: Are markets overreacting to the Trump tariffs?

Probably the most reliable Wall Street axiom is that markets hate uncertainty. The phrase was first uttered by commodity traders but applies to equity traders as well. Trump's negotiating style could be described as 'go big or go home' as he has often used the threat of something dramatic to reach a compromise that is more centrist. I think the markets are having difficulty differentiating bluster from actual policy objectives. The market's managed to move higher from Inauguration Day until mid-February even though there was plenty of discussion of tariff's, including on our closest neighbors, Canada and Mexico. It is quite possible that the double-digit fall in equity indices is less about concern directly over the impact of tariff policy and is positioning for a recession in 2025. Yes, tariff policy certainly plays a role in any expected economic contraction but the underlying issues that may result in a recession are far broader.

The bifurcation in the markets, with large cap and mega cap growth getting crushed while value and low volatility make gains, is likely portfolio managers and astute investors knowing the stocks that have risen the most in the last couple of years will be the same companies that suffer the most in a recession. Stocks deemed to be overvalued are typically the most vulnerable to correction when the air begins to be let out of the markets and that may be driving the markets more than concern over tariffs.

The Trump tariffs have dominated the headlines this year, which is somewhat surprising given that the president made it abundantly clear that tariffs would be a central part of his foreign economic policy. After peaking in February, the S&P 500 Index experienced a roughly -10% pullback over concerns that the tariffs would impede economic growth and potentially lead to higher overall prices, or a condition known as stagflation. By many measures, whether based on price-to-earnings ratios or earnings forecasts, the U.S. stock market seemed overvalued heading into 2025. Against this backdrop, the imposition of tariffs and a potential trade war was enough to send stock valuations lower.

However, one thing for investors to keep in mind is that the Trump tariffs are not necessarily permanent but imposed by executive order. Recall that during the Great Depression, legislation such as the Smoot Hawley Tariff Act was passed through congress and signed into law. In contrast, the tariffs imposed today can be quickly reversed by the Trump administration. If negotiations between our trading partners progress, the tariffs can be reduced or withdrawn, in which case markets would likely recapture some of the losses we've experienced this year. Markets will ultimately adjust, but it's likely that as time passes, tariffs will be less impactful.

## Q: Will international equities continue to outperform?

The rotation that has seen value stocks come to favor has certainly been a tailwind for international equites. The benchmark iShares EAFE (Europe, Australia, Far East) ETF is up more than 9% year-to-date, outperforming almost all other asset classes. US equities have dominated their overseas counterparts, outgaining them in 8 of the last 10 years. Even more impressive, using 10-year rolling periods, the US markets have outperformed for 134 consecutive periods according to State Street Global Advisors. The result is that coming into 2025, international equities had attractive valuations while US stocks were seen as over-priced. The rotation to sell US stocks and buy international was very rational when economic data began to flash a recession was possible this year.

I believe the negative correlation between US and international equities will be short-lived based on recent history. Foreign stocks should have less volatility since their starting valuations were much lower but I expect all stock markets to post negative returns if the US experiences a recession in 2025. International equities are likely to underperform US value but probably outperform US growth that has much further to fall based on valuations. Investors who buy international equites need to be concerned with currency volatility that is likely to be exasperated by tariff policy. Overseas economies are also struggling with the UK and Japan likely already in a recession and Germany perceived to be on the brink of a recession. Stocks will struggle to rise long-term if the underlying economies are contracting.

While we've talked about international equity performance in recent PCM reports, it's worth mentioning again as foreign equities continue to provide compelling returns. For the year, the MSCI EAFA Index, which measures the returns of developed economies outside the U.S., is higher by roughly 10% compared to a decline of approximately -3% for the S&P 500. Likewise, emerging markets are higher for the year by roughly 6% as measured by the MSCI Emerging Markets Index. Some of what is driving international returns is a weaker U.S. dollar. Year-to-date, the ICE Dollar Index is lower by roughly -4%, which is a tailwind for international investors.

According to the most recent capital market assumptions from J.P. Morgan, developed equity markets outside the U.S. have a slightly more favorable return expectation for 2025 (in USD terms) compared to U.S. large cap stocks. This forecast is due in part to lower beginning valuations overseas relative to the U.S, coupled with positive GDP growth expectations. Furthermore, J.P. Morgan foresees modestly better projected returns (in USD terms) from developed markets outside the U.S. over the next 10-12 years, primarily due to lower starting valuations. These relative return forecasts aren't too surprising given the elevated price multiples today across U.S. mega cap stocks.

# PCM

PEAK CAPITAL MANAGEMENT

**9250 E. Costilla Avenue, Suite 110.**

**Greenwood Village, CO 80112**

**Phone: 720.361.4016**

**Email: info@pcmstrategies.com**

**Website: www.pcmstrategies.com**