Equity Newsletter

2nd Quarter 2025

March was an awful month for U.S. equities as the S&P 500 Index fell almost 6%. All sectors were negative except Energy (+3.9%) and Utilities (+0.3%), while the Magnificent 7 ("Mag 7") sectors led the rout. Information Technology (Apple, Microsoft, NVIDIA), Communication Services (Alphabet, Meta), and Consumer Discretionary (Amazon, Tesla) all fell over 8% and were the three worst performing sectors.

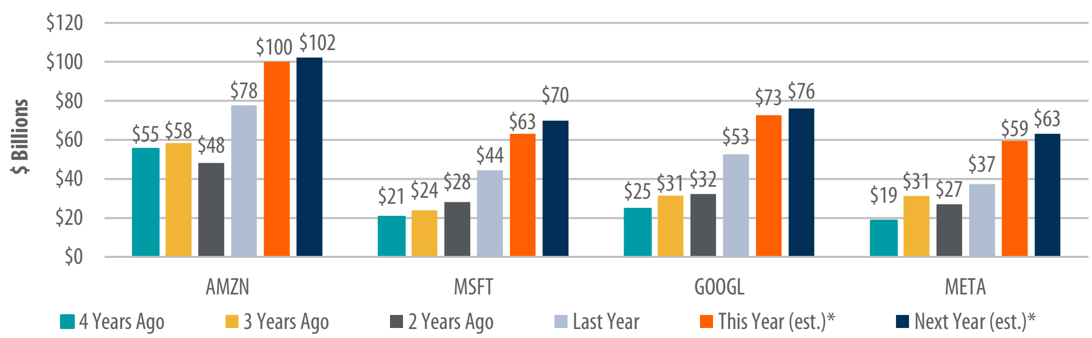
Year-to-date, the S&P 500 Index is now down over 4% and there are all sorts of reasons being given for the negative returns. Tariffs, inflation fears, interest rates, geopolitical events, a possible recession are all legitimate threats to equities today. But why is the Mag 7 and their sectors taking the brunt of the beating relative to others?

Our view is the market simply needed to reset valuations amid all those issues but, mostly, the Artificial Intelligence (AI) trade became too overvalued with too many looming questions. The Mag 7 growth story today is all about AI. Look no further than the capital expenditure ("capex") increases in Chart 1 to see the massive bet the four hyperscalers are making on AI.

The selloff has thus far taken some of the excessive valuation multiple out of the mega cap Mag 7 which had been trading at a large premium to the rest of the market. That started to change in late January with the release of DeepSeek, a Chinese AI model which was developed using much less computing power than prior cutting-edge models. DeepSeek raised questions about the necessity for the massive AI capex from the U.S. players and the potential return on that spending. Until that point the Mag 7 had been riding an ever-growing wave of momentum driven by AI-related spending and there was little reason to question the forecasts. From the close on January 24, just prior to the DeepSeek announcement through the end of March, the Mag 7 were down over 18% while the S&P 500 Index was down 7.8% and the broader equal weight S&P 500 Index was down 4.5%. Additionally, expectations of earnings-per-share (EPS) growth for the Mag 7 fading down to something more in-line with the rest of the S&P 500 Index was more reason for that valuation premium to compress [Chart 2].

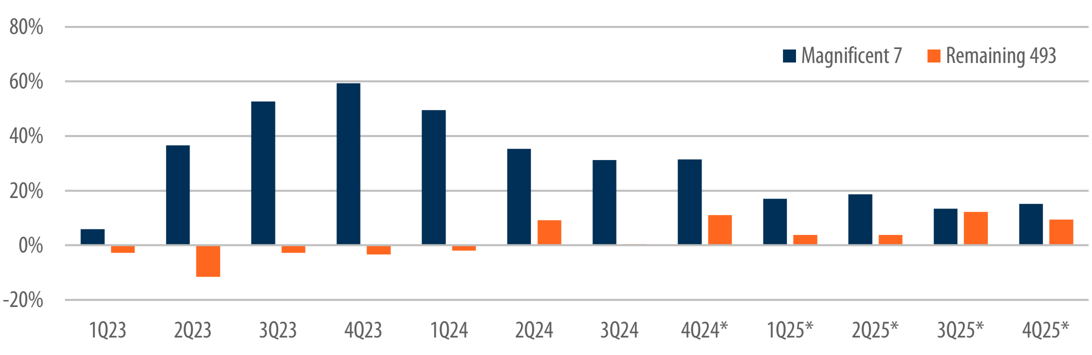
We view the broadening of the market thus far in 2025 as healthy and more a response to excessive valuation in a narrow part of the market than fears of an imminent recession, though no doubt investors are more worried about that now than a quarter ago. This highlights the need to stay diversified and focus on valuation in capital allocation decisions.

Chart 1: Mega Tech Capital Expenditures



Source: Capital IQ. Data as of 3/31/2025 and capital expenditures are based on fiscal year-end. *Estimates are based on projected capital expenditures for Mega Tech Stocks.

Chart 2: S&P 500 Index Stocks Quarterly EPS Growth Year-Over-Year



Source: S&P Capital IQ. Data as of 3/31/2025. There can be no assurance past trends will continue or projections realized.*Forecast based on quarterly consensus earnings estimates.

Past performance is no guarantee of future results.

The **S&P 500 Index** is an unmanaged index of 500 companies used to measure large-cap U.S. stock market performance.

Magnificent 7 (Mag 7): AAPL: Apple Inc. MSFT: Microsoft Corporation. NVDA: NVIDIA Corporation. GOOGL: Alphabet Inc. AMZN: Amazon.com, Inc. META: Meta. TSLA: Tesla, Inc.

Earnings per share (EPS) is the monetary value of earnings per outstanding share of common stock for a company during a defined period of time, often a year.

References to specific securities should not be construed as a recommendation to buy or sell and should not be assumed profitable.

Index data is for illustrative purposes only and not indicative of any actual investment. Indices are unmanaged and investors cannot invest directly in an index. Index returns do not reflect any fees, expenses, or sales charges. These returns were the result of certain market factors and events which may not be repeated in the future.

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Sector Views

Communication Services

- Internet and streaming firms are investing in Artificial Intelligence (AI) to increase monetization and improve efficiency.
- Growing risk of increasing regulation and anti-trust scrutiny for mega-cap internet.
- Streaming media is increasing mix of ad supported revenue to improve profitability.

Consumer Discretionary

- Low unemployment and strong wages are positives for consumption, but declining job openings and a falling quit rate are early indications that the demand for workers may be slowing.
- Cumulative impact of inflation in recent years remains painful for consumers, especially on the lower end of income distribution. Meanwhile, recent equity market volatility may impact high income consumers' willingness to spend.
- Increasing e-commerce penetration, automation of warehouses are secular positives to profitability.

Consumer Staples

- Defensive sector, but offers what we see as relatively meager growth.
- Valuation not particularly attractive, in our view.

Energy

- We are relatively cautious towards energy given risks to oil prices, but note that energy sector equities provide strong free cash flow generation.
- While U.S. sanctions on Russian and Iranian crude oil are in force, OPEC, including Saudi Arabia, recently decided to increase oil production significantly starting in May 2025.
- The U.S. economy has not yet entered recession, in our view. That said, oil consumption would be impacted by any slowdown in macroeconomic growth.
- Risk to global oil demand from any tariff escalation.
- Geopolitical tail risks to oil supply exist due to tensions in Middle East between Israel and Iran, although any resolution to Ukraine and Russia conflict would ease oil supplies.

Financials

- Trump administration may adopt a more industry friendly regulatory stance towards banking, including less scrutiny of mergers, and the possible easing or delay in further tightening of capital requirements.
- Investment banking revenue and trading expected to strengthen amid increased capital markets activity and market volatility, respectively.
- Loan growth may slow as policy uncertainty increases or if consumer spending slows significantly.
- Credit quality remains reasonable. That said, any significant rise in unemployment would increase delinquencies.
- Valuation levels are attractive, in our view.

Healthcare

- Provides opportunity to invest in growth that is less correlated to the business cycle, that said, post the election, policy uncertainty has significantly increased in the sector.
- Focus within the pharma industry is on key drugs such GLP-1s for obesity, and the need for innovation to re-accelerate growth.
- Biotechnology stands to benefit from secular innovation, and potentially increasing merger activity as cash rich Big Pharma is motivated to replenish their pipelines, additionally, funding environment for smaller biotechnology firms may ease over time.
- Life science tools industry may benefit from progress made towards normalization of excess inventories, but biopharma and hospitals remain focused on maintaining spending discipline.
- Valuation is attractive in the sector, in our opinion.

Industrials

- Demand for capex is a secular driver that may benefit sector, as firms are motivated to reshore supply chains and increase productivity in tight labor market.
- Increasing infrastructure requirements to support data centers another key secular driver for some industrial firms.
- ISM Manufacturing PMI index continues to indicate cyclical weakness in industrial activity.
- Tariff policy is a risk to industrial exports.
- Defense industry names benefit from increasing geopolitical risk long term, but may be impacted by any resolution of the current Russia/Ukraine conflict.
- We believe valuation in sector is reasonable.

Information Technology

- Key innovations such as artificial intelligence (AI) and process automation offer substantial secular growth opportunities.
- We expect IT corporate spending to accelerate, barring a recession, with some recovery in end markets outside of AI, such as traditional enterprise servers.
- Prefer quality within the sector, particularly firms with strong corporate balance sheets and reasonable valuation.
- We see innovation benefiting cloud software firms, with the implementation of AI features improving value-added to clients.
- Key semi end markets such as AI, high bandwidth memory, and vehicle electrification benefit from secular tailwinds. Due to geopolitical tensions with China, increased export restrictions are a risk to the industry.

Materials

- On a cyclical basis, international economic weakness, especially weak Chinese construction, is a risk to basic materials demand.
- We believe incremental demand from clean energy grid infrastructure and electric vehicle transition is a secular positive for some metals, such as copper.
- Materials sector stands to benefit over time from policies and investment designed to reshore supply chains amid geopolitical tensions.

Utilities

- Defensive, dividend paying nature more attractive in times of macroeconomic uncertainty.
- Utilities are sensitive to interest rate movements, a potential positive if rates have peaked.
- Data center power consumption is a source of secular growth in electricity demand.

Real Estate Investment Trusts (REITs)

- Higher yielding sector sensitive to interest rate movements, stands to benefit if rates decline.
- Data center REITs provide a strong secular opportunity but are sensitive to the IT spending environment on a cyclical basis.

International Views

DEVELOPED MARKETS

Europe

- Inexpensive valuation in comparison to U.S. stocks.
- Economic growth remains sluggish, but positive. German fiscal stimulus announcements have recently improved sentiment towards Europe.
- Tariff headlines are a macroeconomic risk.
- European Central Bank is expected to continue to ease policy amid moderate inflation, as the central bank turns its focus to stimulating growth.
- Any re-acceleration of growth in China potentially stimulates demand for Europe's exports, but we remain cautious towards Chinese growth.
- European sentiment stands to benefit from any de-escalation of the Ukraine/Russia conflict.
- Geopolitical risk from increased influence of populism on national politics within Eurozone, and tariff uncertainty.

United Kingdom

- Manufacturing PMI surveys point to softening of industrial activity.
- The Bank of England expected to gradually ease interest rate policy.
- U.S. tariff policy toward U.K. impacts steel, autos and aluminum industries, pharmaceutical exports are tariff exempt.
- Inexpensive valuation in comparison to U.S. stocks.

Japan

- Growth outlook is tempered by recently imposed U.S. tariffs, including on auto exports to the U.S. Japanese government may refrain from imposing retaliatory tariffs, opening the possibility of a deal.
- Bank of Japan may refrain from any further tightening of monetary policy, given the risks to growth from trade policy uncertainty.
- Japan benefits from "friend-shoring" and increased secular demand for advanced technology exports such as automation equipment.
- Structurally low return on equity, although some corporate governance reforms have been implemented by the Tokyo Stock Exchange.
- Challenging demographics limit long-run potential economic growth.

Australia

- Commodity exporter which stands to benefit from higher commodity prices.
- Exports of raw materials to China key driver of economic growth.

Canada

- U.S. is key trading partner, benefits from strong U.S. growth, but tariff rhetoric creates uncertainty.
- Energy and metals exporter, which stands to benefit from higher oil prices and commodity inflation and would suffer from a U.S. recession or a decline in oil prices.

EMERGING MARKETS

Emerging Asia

- Chinese policymakers have introduced monetary stimulus measures, such as cutting lenders required reserve ratio (RRR) and cutting mortgage interest rates, in an attempt to buttress the beleaguered property market. That said, the Chinese macroeconomic picture remains murky, and we expect China to experience deflationary pressures amid soft international trade.
- Rising geopolitical tensions between U.S. and China present risk to supply chains for key technologies and materials, and complicate U.S. firms' decisions to invest in China. Chinese exports to U.S. are likely to remain in crosshairs of tariff policy, in our view.
- India may be less impacted by U.S. tariffs given less focus on goods exports to U.S. than some other countries; additionally, the Reserve Bank of India (RBI) has adopted an accommodative monetary policy stance.

Latin America

- Mexican economy stands to benefit from exports to U.S. but would be negatively impacted by any eventual U.S. recession. Over time, supply chain diversification away from China may be a structural tailwind to exports.
- Populist election results impact sentiment towards the region, as fiscal discipline may be called into question. Mexico is recent example.
- Brazil and Latin America overall are sensitive to demand for commodity exports, and commodity price inflation.
- Tariffs are a risk to the region, but Mexico benefits from more favorable terms for U.S.-Mexico-Canada Agreement (USMCA) compliant goods.

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