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1Q25 Market Commentary

Even a garden-variety recession will likely drive mid- and small-caps into their extreme undervaluation zones, which is, quite frankly, an exciting prospect for those with "cash on the sidelines."

Doug Ramsey
Chief Investment Officer

Throughout 2024, we maintained that a major support for the U.S. economy was the wealth effect stemming from rising stock prices. Despite warnings from other leading economic indicators, the stock market continued to behave in a way that essentially inoculated the economy from a near-term slide into recession. The caveat was that the stock market's prescience in anticipating economic trends was limited to a horizon of about six months. Moreover, the stock market—unlike human forecasters—is very adept at *changing its mind*.

Lo and behold, that's happened in the last two months. The S&P 500[1] dropped as much as 18.9% from its mid-February peak to an early-April low, coinciding with the White House's roll-out of new tariff proposals. In fact, the episode highlights yet another way the stock market influences the U.S. economy: Its swings (in particular, its *downswings*) impact economic policy. The market's emphatic disapproval of the initially proposed tariff rates has forced the administration to backpedal on a nearly daily basis. Some pundits have dubbed this retreat the "Trump put"—a spin on the "Fed put," whereby equity investors assume that a severe market decline will force the Fed to cut interest rates or otherwise loosen liquidity conditions.

Of course, most bull markets in stocks feature at least a few corrections that fail to upend the economy or the bull itself. It's certainly possible that the latest downturn is nothing more than a mid-cycle "cleanse." However, the odds are against that, and a key reason is that the vast majority of our economic and stock market analyses look late-cycle, if not terminal, in nature.

Long before the tariffs and the stock market plunge, the economy was already exhibiting signs that we view as pre-recessionary. For example, in March, year-over-year growth in employment slowed to just 1.2%; in the past, a weakening to such a low rate has always been associated with a slide into recession within relatively short order.

The manufacturing sector was also flashing red flags in advance of the tariff announcements. Three decades ago, we devised an indicator called the NOPE Index, based on the monthly ISM Manufacturing Survey. The index is the spread between the ISM New Orders Index and the Price Index. Elevated and positive NOPE Index readings are consistent with noninflationary growth and have historically been associated with rising stock prices. However, the last two ISM reports have seen significant weakness in New Orders, accompanied by a sharply rising Price Index. The result is a deeply negative NOPE tally—one that's now in the vicinity of those seen during the bear markets of 1990, 2008-2009, and 2022.

From a technical perspective, the most recent S&P 500 high of February 19th looked like a classic bull market peak: Two to three months earlier, a lengthy list of stock market bellwethers[2] topped out, including the Dow Jones Transportation

[1] The S&P 500 is a capitalization-weighted index of 500 stocks designed to measure performance of the broad domestic economy.

[2] Dow Jones Transportation Average is a U.S. stock market index from S&P Dow Jones Indices of the transportation sector; Dow Jones Utility Averages is a stock index from S&P Dow Jones Indices that tracks the performance of 15 prominent U.S. utility companies; Russell 2000 is a small-cap U.S. market index that makes up the smallest 2,000 stocks in the Russell Index; Equal Weighted S&P 500 is the equal-weight version of the widely-used S&P 500; S&P Cyclical Sector Composite is an equal-weighted composite of S&P 500 Consumer Discretionary, Industrials, and Materials sectors; NYSE Daily Advance/Decline Line tracks the difference between the number of stocks rising in price versus the number falling in price.

1Q25 Market Commentary (continued)

Average, Dow Jones Utility Average, Russell 2000, Equal Weighted S&P 500, our S&P 500 Cyclical Sector Composite, and the NYSE Daily Advance/Decline Line. In contrast, a healthy market sees broad participation across assorted industries and equity styles.

Of course, it's easy to cherry-pick the developments to support one's view. That's why we monitor the weight of the evidence, as captured by our weekly Major Trend Index[1] (MTI). The MTI, which assesses the underlying health of the stock market using over 120 factor inputs, slid into bear territory on March 7th, shortly after the onset of the market downturn. That MTI deterioration prompted us to shift net equity exposure lower, to around 45% in our tactical allocation strategies (compared to 58-59% entering this year).

We believe a bear market in stocks is underway in the U.S., and will soon be accompanied by an economic downturn. Many economists fear the economy could enter a period of "stagflation"—a rare condition characterized by below-average growth and stubbornly high inflation. We think a traditional recession is more likely, and if our estimation proves correct, it's doubtful that inflation will continue to be a problem. We'd emphasize, though, if an alternative, rosier outcome is in store, the MTI—and the supporting tools we monitor for substantiation and reinforcement—will alert us.

Our equity portfolios did not lose as much as their benchmarks in the first quarter, thanks to investments in economically defensive industries (Telecom, Health Care, Insurance), and below-average exposure to the richly priced mega-cap growth stocks. The valuation profile of our equity holdings is much more attractive (less pricey) than that of the S&P 500.

Our tactical portfolios' fixed income remains at below average levels. While spreads on corporate bonds have climbed over the last couple of months, they do not fully compensate for rising economic risks. The duration of our fixed income position is now 6.0 years, which is in line with the benchmark.

In short, we believe the NASDAQ[2] and S&P 500 are poised to experience considerably more downside than either value stocks or the "average stock" during an unfolding bear market. Volatility will help camouflage that move, giving rise to internally bizarre action like that observed in the last few weeks. It's too early to say that the S&P 500 has topped out relative to the broader stock market, since the S&P MidCap 400[3] and Russell 2000 made long-term relative strength lows as recently as April 11th.

We've noted that, at their late-2024 peaks, valuations for mid- and small-caps were notably lower than at the highs of late 2021, and today our work already shows those segments as being nominally undervalued—and that's without 2025 losses having officially qualified as a bear market. Even a garden-variety recession will likely drive mid- and small-caps into their extreme undervaluation zones, which is, quite frankly, an exciting prospect for those with "cash on the sidelines."

Sincerely,

Doug Ramsey, CFA, CMT
Chief Investment Officer

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[1] A proprietary, quantitative discipline composed of over 120 market indicators and economic data within the categories of valuation, cyclical, sentiment, and technical. It is designed to recognize market trends and evaluate the underlying health of the stock market.

[2] The NASDAQ is a market index that includes almost all stocks listed on the Nasdaq stock exchange.

[3] S&P 400 MidCap Index is a value-weighted index that provides investors with a benchmark for mid-sized companies from all major industries.

Other Market Notes

TO BUY OR NOT TO BUY?

While the stock market's decline to-date qualifies as a severe correction, we are pretty confident that, since the S&P 500 peak on February 19th, stocks have entered a cyclical bear market.

When the S&P 500 loss moved beyond the -12% mark on April 3rd, we revisited some analysis from March 2022 when the S&P 500 had also just breached that same -12% threshold. At that time, we tested a variety of simple measures in an attempt to identify whether or not it was "safe" to buy the decline. In that case, it was not, as the index proceeded to move lower into bear market territory for a total loss of 25.4%.

From a technical perspective, there is no magic bullet to assess the health of a correction. Yet, there's an intriguing relationship between the speed of a severe decline and the likelihood of a strong recovery.

Specifically, an S&P 500 loss that breaches -12% within 63 trading days or less is more apt to be near its end than a "meandering" correction that extends beyond a single quarter before reaching that -12% point.

Today, with the S&P 500 having dipped into "severe" correction territory in a mere 31 days, that simple statistical guideline favors dip-buyers.

Technical-oriented rules weren't the only ones considered in our 2022 study. A few dozen that are linked to monetary policy and the economic cycle were also examined. The goal was to evaluate the cyclical backdrop at the time a correction becomes severe to help determine if the downturn was an attractive entry point or poised to become much worse than "correction territory."

The table shows a variety of indicators that help gauge an economic cycle's maturity; today they're all sending the same message as they did midway through the downturn of 2022: The decline, though it already qualifies as severe by our definition, is not yet a "safe" one to buy.

The Faster The 12% Drop, The Stronger The Rebound (Usually) Is

Date Decline Exceeded 12%	Days Needed To Exceed 12%	S&P 500 12-Mo. Fwd. Perf. If... All Periods	No. Days < 63	No. Days > 62
September 26, 1960	290	25.3		25.3
May 10, 1962	103	10.9		10.9
August 1, 1966	119	15.9		15.9
July 14, 1969	150	-21.2		-21.2
November 18, 1971	143	25.0		25.0
May 17, 1973	87	-15.0		-15.0
December 5, 1974	19	32.8	32.8	
August 20, 1975	26	25.6	25.6	
October 12, 1977	267	12.1		12.1
October 31, 1978	35	10.2	10.2	
March 17, 1980	22	31.0	31.0	
August 27, 1981	188	-4.0		-4.0
May 24, 1984	158	24.0		24.0
October 16, 1987	37	-2.5	-2.5	
August 21, 1990	26	17.9	17.9	
August 27, 1998	29	29.3	29.3	
October 15, 1999	64	10.2		10.2
October 12, 2000	140	-19.6		-19.6
February 12, 2003	51	40.7	40.7	
January 16, 2008	68	-38.6		-38.6
May 26, 2010	23	23.6	23.6	
August 5, 2011	68	16.2		16.2
August 25, 2015	66	16.5		16.5
December 17, 2018	60	25.4	25.4	
February 27, 2020	6	27.9	27.9	
March 7, 2022	43	-5.0	-5.0	
April 3, 2025	31	?	?	
Average	**86**	**12.1**	**21.4**	**4.1**
Median	**64**	**16.4**	**25.5**	**11.5**
Largest Gain		**40.7**	**40.7**	**25.3**
Largest Loss		**-38.6**	**-5.0**	**-38.6**

Fundamental/Economic Thresholds For Buying A 12% Dip (from our March 17, 2022 "Chart of the Week")

Indicator*	BUY Threshold	Current Reading
NOPE Index	> -5	-24.2
ISM Mfg. Price Index	< 65	69.4
Consumer Conf. - Present Situation	< 120	134.5
Confidence Gap*	> -20	-69.3
FRB NY Recession Probability	< 25%	27%
Unemployment Rate	> 5%	4.2%

*Consumer Confidence - Expectations Minus Present Situation

***DEFINITIONS**

NOPE Index: The spread between (1) the Institute for Supply Management's (ISM) New Orders Index (a component of the ISM Purchasing Managers Index (PMI) that measures the rate of change in new orders received by manufacturing firms), and (2) **ISM's Manufacturing Price Index** (a component of the ISM PMI that represents purchasing managers outlook for future raw materials prices).
Consumer Confidence—Present Situation: The Conference Board's survey of consumers' assessment of current business and labor market conditions.
Confidence Gap: The Conference Board's survey of consumers' short-term outlook for income, business, and labor market conditions (Expectations Index) less the Present Situation Index.
FRB NY Recession Probability: The difference between 10-year and 3-month Treasury rates per the Federal Reserve Bank of New York.
Unemployment Rate: The number of unemployed as a percentage of the labor force.

Other Market Notes

LEADERSHIP ROTATION FROM GROWTH TO VALUE

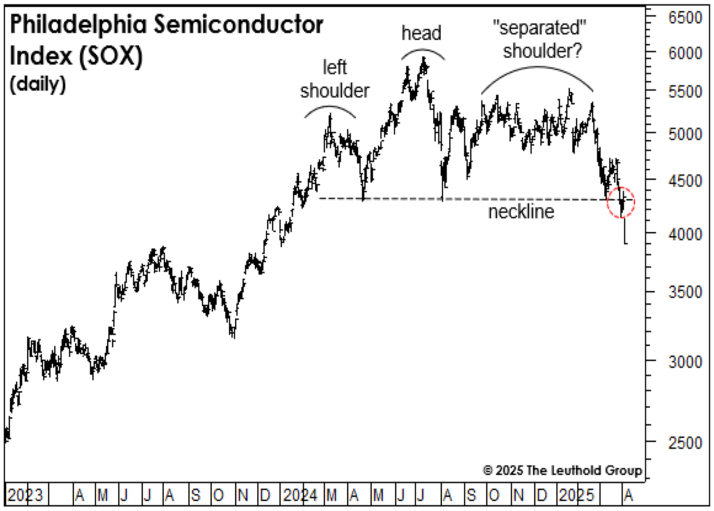
In early April, the market saw deep declines across stocks of all styles and sizes. Nonetheless, there are signs that a rotation out of the previous years' high-flying mega-cap growth[1] stocks and into value[1] is underway. It's worth noting that, historically, the most reliable catalyst for a leadership change in the stock market is a *bear market*.

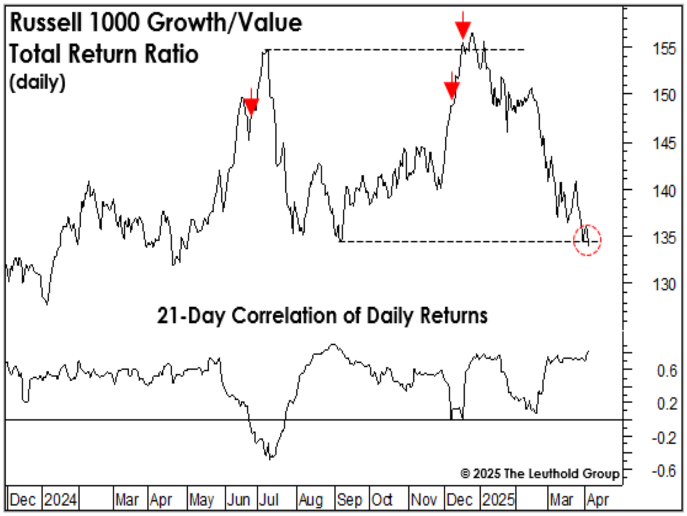
First, the bellwether Philadelphia Semiconductor Index[2] (SOX) has broken down from the 15-month head-and-shoulder pattern we've been monitoring for several weeks. If the SOX reaches the price target prophesied by the pattern, it will translate to a 50% loss from its peak. The important message here is that the backbone of the mania (i.e., Artificial Intelligence (AI) and the technology that enables it) has been broken.

Second, relative to value stocks, large-cap growth has (just barely) broken through last summer's initial relative-strength low. Growth stocks have looked rich compared to value for a long time, and we noted in mid-2024 that the breakdown in the correlation between the returns of these two subsets might herald a turning point, as it did in both 2000 and 2020. So far, so good.

[1] The Russell 1000 Growth Index contains more expensive firms with higher expectations of financial progress, while the Russell 1000 Value Index includes companies trading at a discount due to mispricing or lower growth expectations.

[2] A modified market capitalization-weighted index composed of companies primarily involved in the design, distribution, manufacture, and sale of semiconductors.





Arrows highlight days when the correlation between returns turns negative.

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