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First Quarter Market Commentary

An Oxford Harriman & Company Market Commentary

The stock market declined in the first quarter after two consecutive years of gains exceeding 20%. The year started off strongly, with the S&P 500 reaching a new all-time high in mid-February. However, sentiment shifted late in February amid rising policy uncertainty in Washington, and the S&P 500 ended the quarter down.

Days after the quarter ended, President Trump announced tariff measures that caught investors off guard, leading to additional market declines. There are many moving pieces, and much uncertainty in the markets, and we will share our perspective in this commentary. We will also address the increase in market volatility and emphasize the importance of maintaining your investment strategy.

Stocks Trade Lower as Valuations Moderate

Equities declined during the first quarter, as rising policy uncertainty weighed on investor sentiment. There was a clear shift from optimism to pessimism, which contributed to valuation compression and lower equity prices.

During the quarter, Wall Street analysts lowered their earnings forecasts, citing the potential for tariffs and slower growth. Meanwhile, the S&P 500's P/E ratio declined from over 22x to approximately 20x. The valuation decline may seem modest, but it had a meaningful effect on returns. Those falling valuations were the primary driver of the selloff as sentiment weakened. Investors started to price stocks more conservatively due to concerns about tariffs, slower economic growth, and policy uncertainty. Stock valuations tend to expand when earnings are growing, but the inverse is also true.

Market leadership shifted in the first quarter as last year's top performers lost momentum. Last year, the Magnificent 7, a group of leading tech stocks, helped fuel 2024's strong returns. The group's strength lifted the broader market, with the S&P 500 gaining 23%. In contrast, the equal-weight S&P 500, which gives all companies the same weight regardless of size, gained only 11%. This year, the dynamics have flipped. Instead of lifting the market, the biggest stocks are now leading the decline. The Magnificent 7 declined 15% in the first quarter, while the equal-weight S&P 500 is down 1%.

Rising Policy Uncertainty is Impacting Sentiment

Developments in Washington took center stage in the first quarter as the Trump administration started rolling out its policy agenda. The administration's early efforts focused on trade policy, tariffs, and reducing government spending. The policies are a notable shift from the status quo and have drawn attention from investors and business leaders due to their potential impact on the economy.

The University of Michigan's Consumer Sentiment Index tracks how optimistic or pessimistic consumers feel about the economy. This index weakened early in the pandemic and hit a record low in June 2022. The decline reflected concerns about rising inflation, expectations for higher interest rates, and broader economic uncertainty. Sentiment gradually recovered from late 2022 through the end of 2024, as inflation eased, economic growth exceeded expectations, and stocks set record highs. However, sentiment has turned down in early 2025. This reversal signals renewed concern among consumers, who have been a key driver of economic growth in recent years.

The Conference Board's CEO Confidence Index measures how optimistic business leaders are about industry conditions. Since the 2010s, the index has fluctuated between 5 and 8. Recent years have been especially volatile due to pandemic disruptions, persistent inflation, high interest rates, and geopolitical uncertainty. In the first quarter, the index fell to 5.0, the lowest level since October 2011. This decline signals increased caution among CEOs as they navigate changing policy, the potential for tariffs, and an uncertain economic environment.

We also examined market volatility during the first quarter, as measured by the CBOE Volatility Index (VIX). Volatility increased in early 2025, starting in mid- February, rising from a mid-teens "complacent" level to above 25. We consider VIX readings above 20 to indicate a greater level of concern. Some market volatility is normal, but the recent spike occurred as policy uncertainty increased and the stock market sold off. Markets dislike uncertainty and until there is more clarity, market volatility could remain elevated. Indeed, in the days following the quarter, the VIX rose above 30 in reaction to the tariff proposals.

These three measures of sentiment signal a more cautious tone among consumers, business leaders, and investors. This is important because sentiment can impact future behavior. Consumers may cut back on spending, while businesses may delay hiring and investment decisions. Sentiment data will remain in focus in the coming months as more policy details are released. Over the past few years, we have seen some of these sentiment measures, also considered "soft data", rise then moderate without having an impact on actual economic activity, or "hard data". We will be watching to see if the current rise in concerns as measured by soft data have an actual impact on the hard data.

An Update on the U.S. Economy

It is important to remember that the stock market isn't the economy. In other words, the performance of the stock market doesn't always reflect real-time economic conditions. This is because the market is forward-looking and prices in expectations for what's to come. The previous section highlighted how rising policy uncertainty affected sentiment in the first quarter, and this section examines the latest economic data. We examined four economic indicators that offer insight into the state of the U.S. economy:

1. Unemployment rate
2. Retail Sales
3. Housing Starts
4. Industrial Production

The unemployment rate continues to remain low by historical standards. Unemployment rose in 2023 and the first half of 2024 as workers attempted to reenter the labor market and job growth slowed. This led to concerns about labor market softening and contributed to the Federal Reserve's decision to begin cutting interest rates in September 2024. However, unemployment reversed lower in recent months as monthly job growth picked up. The data points to a resilient labor market, with demand for workers running up against a still relatively tight labor market.

Retail sales are a measure of consumer spending. Growth was strong in 2023, supported by rising wages and the continued drawdown of pandemic-era savings. However, growth slowed in 2024, an indication that while households continue to spend, they're doing so more cautiously. Contributing factors include high interest rates, persistent inflation, and a return to more typical spending patterns. Consumer spending makes up almost 70% of U.S. GDP, so a continued slowdown could have implications for the broader economy.

Housing starts are a leading indicator of housing activity. The housing market slowed in recent years as it struggled under the weight of high mortgage rates and decreasing affordability. Homebuilders were hesitant to take on new projects amid weaker demand and elevated borrowing costs, and recent policy announcements present even more uncertainty. Tariffs and immigration policies create potential challenges for builders, as they may increase material costs and decrease labor availability. However, despite the headwinds, housing starts are still above pre-pandemic levels.

Industrial production measures the total output of factories, mines, and utilities across the economy. Industrial activity was flat or declined in 2023 and 2024 as high interest rates and economic uncertainty dampened business investment. More recently, industrial output shows signs of recovery, with industrial production growing at the fastest pace since late 2022. The rebound likely reflects expectations for lower interest rates and the resolution of uncertainty after last year's election. The question is how tariffs will impact manufacturing as 2025 progresses.

Taken together, the data suggest the U.S. economy is losing some momentum. However, they also show the economy continues to expand, just at a slower pace. The labor market remains solid, and consumer spending is holding steady. The housing sector has cooled from its pandemic highs, but starts still exceed the pace from the 2010s. Meanwhile, manufacturing activity is showing renewed strength. The risk moving forward is that policy uncertainty could weigh on confidence and trigger a slowdown. Economic data will be in focus in the coming months.

Equity Market Recap – Looking Beyond the Index

Most of the stock market decline occurred in the second half of the quarter, after the S&P 500 set a new all-time high on February 19th. As mentioned earlier, a small group of mega-cap stocks drove the selloff, and their size and weight within broad stock market indices impacted performance. The Growth factor, which includes many of these high-profile mega-cap stocks, declined approximately 10% in the first quarter. Similarly, the Nasdaq 100, an index of leading technology companies that include the Magnificent 7, declined by approximately 8%.

Sector returns highlight the concentrated nature of the selloff. Nine of the eleven S&P 500 sectors outperformed the broad index to start the year. Seven of those sectors posted gains. This is a sharp contrast to last year, when a handful of sectors powered the S&P 500's gains. Technology and Consumer Discretionary, two of last year's top performers, were the two worst performing sectors in the first quarter. It's not a coincidence as these sectors are the most exposed to the Magnificent 7. In contrast, sectors that underperformed in 2024 were the top- performing sectors in the quarter. While the S&P 500 is down by just over 4% in the first quarter, the average stock within the index is only down approximately 1%.

International stocks outperformed U.S. stocks in the first quarter, posting one of its biggest quarters of outperformance since 2000. The underperformance of U.S. mega-cap tech stocks contributed to international's outperformance. Outside the U.S., the MSCI EAFE Index of developed market stocks gained approximately 8% in the first quarter. Much of these gains came from Europe, where investor sentiment improved as governments unveiled plans to increase spending. This triggered a rotation out of U.S. stocks and into Europe in anticipation of increased government spending leading to stronger economic growth. Meanwhile, the MSCI Emerging Index gained approximately 4.5% in the first quarter, underperforming the developed market index but outperforming the S&P 500 by 9%.

Credit Market Recap – Bonds Trade Higher for the Quarter

There were two notable themes in the bond market in the first quarter: falling U.S. Treasury bond yields and wider credit spreads. The 10-year Treasury yield fell from a peak of 4.80% in mid-January to 4.15% in early March. This was a reversal from the fourth quarter of 2024, when the 10-year yield rose more than 0.75% due to renewed inflation concerns. Several factors contributed to the first quarter reversal, including rising policy uncertainty, the potential for tariffs, and concerns about slower economic growth. This combination prompted investors to move money into longer-maturity government bonds, which are viewed as safe havens. Bond prices rise as yields decline, with the Bloomberg U.S. Aggregate Bond Index increasing 2.76% in the first quarter, offsetting a portion of the stock market decline.

Another major theme was credit spread expansion. Credit spreads measure the difference in yield between high-yield corporate bonds and safer government bonds. Spread levels can serve as a real-time gauge of market sentiment, showing how easy or expensive it is for companies to borrow money. A narrower spread signals that investors view credit risk as low, while a wider spread signals higher perceived default risk.

The high-yield spread narrowed in late 2024 as the Federal Reserve cut interest rates, reaching levels last seen in 2007. However, credit spreads started to widen in the first quarter. This increase indicates investors are becoming more cautious, with the potential for tariffs and slower economic growth leading to higher credit risk.

Despite the recent rise, credit spreads remain low by historical standards. Compared to past periods of market stress, today's spread levels suggest financial conditions are still relatively stable, a reflection of the U.S. economy's overall strength. While investors are concerned about policy uncertainty and the potential for slower growth, the market is not signaling financial distress. However, if spreads continue to widen, it could signal tighter financial conditions and raise concerns about potential defaults. The market will be watching spreads closely.

2025 Outlook – Maintaining a Long-Term View While Navigating Uncertainty

Market volatility can be unsettling, but it's a normal part of investing. Periods of enthusiasm often lead to recalibration. It's natural to feel uncertain, but history shows that staying invested through volatility and maintaining a longer-term perspective is the prudent approach.

As we mentioned in our last commentary on the market selloff, market pullbacks like this year are not just common, and a recurring part of investing. Looking at the last 100 years, data show the S&P 500 experiences a pullback nearly every year, with a median intra-year drawdown of 13%. Since 1928, the S&P 500 has experienced a drawdown of 5% or more in 91 out of 98 calendar years, including 2025.

Why Staying Invested Matters

Historical data show that most of the market's strongest days tend to cluster around periods of substantial market volatility. For example, some of the largest one-day gains occur closely following market downturns. This trend can catch investors off guard if they've sold off assets fearing continued losses.

According to a 2019 study conducted by J.P. Morgan Asset Management, being out of the market during just the top 10 best-performing days over the previous 20 years would have reduced an investor's returns from 6% annually to approximately 2.4%. Missing the top 20 days drops those returns to just 0.08% annually. These statistics highlight the critical role "up days" play in building wealth over the long term. (1)

Between 2002 and 2021, missing the 10 best-performing days would have cut the returns of the S&P 500 in half. (3))

Additionally, Fidelity Investments notes that $10,000 invested in the S&P 500 in 1980 would have grown to $1.09 million by 2022 if left untouched. However, missing the 10 best days during that timeframe would have reduced the portfolio value to just $556,944 – a significant reduction simply because of absenteeism during key days. (2)

It is natural to want to panic during market corrections or downturns, selling off assets to avoid further losses. This is especially true due to the constant flow of information being pushed to us on our phones. However, an emotional reaction can cause us to miss the market's recovery when trends reverse. Attempting to predict the perfect time to buy or sell is notoriously difficult. Market timing requires not only getting out at the right moment but also knowing when to re-enter, a feat that is arguably even more difficult than knowing when to sell.

Behavioral Bias

Fear and greed often drive investment decisions, clouding judgment and leading investors to make short-term choices at the expense of long-term strategy. Investing is a marathon, not a sprint. Staying invested, even when the markets decline, has resulted in positive returns over time. A diversified portfolio aligned with your financial goals can help you endure the market's ups and downs. Time in the market beats trying to time the market. As detailed above, missing even a few of the best performing days can materially affect your portfolio's performance.

Final Thoughts

Markets do not like uncertainty. We all desire predictability and confidence, as do the financial markets. Investors react negatively to the unknown, and this leads to volatility. This is evident as major indices swing drastically with updates on trade negotiations, further emphasizing that even mere speculation can disrupt market stability.

For both businesses and investors, the uncertainty underscores the importance of prudent decision-making and diversification to weather these unpredictable headwinds. Until a resolution is achieved, markets are likely to remain reactive, reflecting the pervasive unease associated with trade conflicts.

Despite these frequent and sometimes severe drawdowns, the S&P 500 has delivered positive returns for over a century. This is despite wars, recessions, inflation spikes, financial crises, and a global pandemic. The upward trajectory is driven by economic growth, innovation, and corporate earnings growth. The key takeaway for investors: volatility isn't a sign that something is broken, it's the price of admission to investing. Staying invested through ups and downs has consistently been one of the most effective strategies for building wealth over time. Market declines can feel unsettling in the moment, but history shows the powerful effect of compounding returns over time.

We will continue to provide our thoughts on the markets and the economy as we navigate through this uncertain period.

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