

## *Volatility picks up...Is this time different?*

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April 2025

### *Reflecting on the First Quarter*

With the first quarter of 2025 officially in the books, we note that the stock market, as represented by the S&P 500 Index ("S&P 500"), generated a loss of -4.3% for the quarter. Though that may sound relatively calm, we think most people will agree that the market action in the first quarter was anything but; headlines about the Russia-Ukraine war, the Middle East, tariffs, budget negotiations and cost cuts and layoffs from DOGE, to name a few, moved markets sharply higher or lower on a daily, and sometimes hourly, basis. Volatility, as measured by the VIX—often referred to as the "Fear Index"—increased sharply.

To recap, the S&P 500 rallied after Trump's election last November, generally continuing for the first six weeks of 2025, with the S&P 500 reaching its all-time high (for now) on February 19. To that point, investors seemed to believe that President Trump's threat of massive tariffs was largely a negotiating tactic—the 'Art of the Deal' so to speak. But somewhere along the line, the rhetoric became more serious, investors got more nervous, and the S&P 500 declined over 10% in 15 trading sessions, one of the fastest "corrections" we have seen in recent history. (A correction is often defined as a drop of 10% or more.) But starting in mid-March, Chuck Schumer, the Senate minority leader, agreed to a budget deal that avoided a government shutdown, the President indicated signs of flexibility in tariff negotiations and the stock market rallied back again, bringing us close to even for the quarter.

In our fourth-quarter letter, we suggested additional market volatility was possible, and we certainly saw that materialize in the first quarter. A volatile environment reinforces the importance of maintaining perspective and focusing on long-term fundamentals.

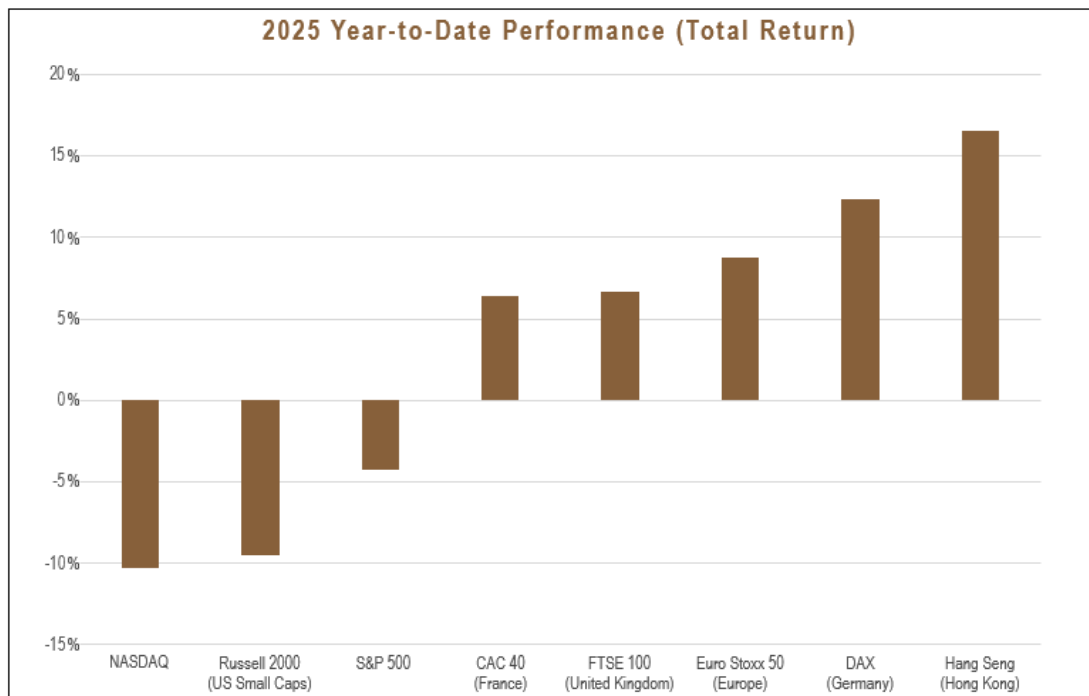
### *Market Overview: Volatility and Key Drivers*

The market's behavior in the first quarter was shaped by a combination of factors:

- **Equity Markets:** The S&P 500 started the quarter strong, but reversed course, with concerns around tariffs, inflation and policy uncertainty weighing on sentiment, ending the quarter down -4.3%.
- **Interest Rates:** The 10-year Treasury yield declined to 4.2%, reflecting increased expectations that the Federal Reserve may cut rates later this year, and concerns about an economic contraction.
- **Volatility:** The VIX rose significantly, underscoring the heightened uncertainty in the market.

The first quarter also saw a notable shift in global market dynamics. While U.S. markets corrected from historically high levels, European and Chinese markets emerged as relative winners. Few would have predicted that the European markets would be up over 8% year-to-date, led by the German market up over 12%. This "broadening out" of market leadership reflects a

combination of factors, including lower starting valuations in Europe and a renewed focus on sectors like defense, which have benefitted from shifting geopolitical priorities.



Source: Neuberger Berman, Bloomberg. Information as of 03/31/25

In the U.S., skepticism around large-cap tech companies has grown, as investors question whether their capital expenditure race will dilute historically high returns on equity (ROE). While this is a valid concern, it is too early to conclude that these companies have lost their leadership position. Their scale-adjusted ROEs remain unmatched, and we continue to believe in their long-term potential.

One of the key challenges in the U.S. stock market, in our view, is the concentration in some of the largest companies and crowding by retail investors into those buzzworthy stocks. This creates some market risk and volatility when the headlines are so uncertain.

While such conditions can feel unsettling, it's important to remember that volatility is a normal part of investing. This leads us to an important question: Is this time different?

### *Key Question: "Is This Time Different?"*

One of the most frequent questions we hear is whether the current environment represents a fundamental shift in the economic and market outlook. The answer, in our view, lies somewhere in between.

- **What's Different:** Certain policies represent significant departures from recent historical norms, such as the imposition of tariffs. These measures could disrupt global supply chains, increase uncertainty for businesses and introduce the risk of higher inflation. Unlike past periods of market stress, these policies are being directed at close allies and trade partners, adding another layer of complexity.
- **What's Familiar:** Market corrections of 10% or more from peaks are not uncommon. Over the past five years, we've seen several corrections driven by similar concerns—Federal Reserve policy, geopolitical tensions and uncertainty about economic growth. While unsettling, these periods have historically been followed by recoveries as fundamentals reassert themselves.

Our approach is to avoid overreacting to the current news cycle, or getting carried away by the (very) heated political dialogue. Instead, we focus on long-term fundamentals, seeking to position portfolios for opportunities and risks that may not yet be fully reflected in the market.

### *Investment Philosophy: A Disciplined, Long-Term Approach*

During times like these, it is critical to remain disciplined and focused on the long term. Our investment approach is grounded in the belief that thoughtful, deliberate decision-making is far more effective than reactionary moves driven by short-term volatility.

We manage equity portfolios with a multiyear perspective, typically holding positions for two to five years. This allows us to look beyond today's headlines and focus on where the market may not yet be pricing in future opportunities or risks; for example, we seek investments that resemble NVIDIA in 2014—an undervalued opportunity with significant growth potential—rather than chasing what is already well known and potentially priced in, such as NVIDIA in 2025.

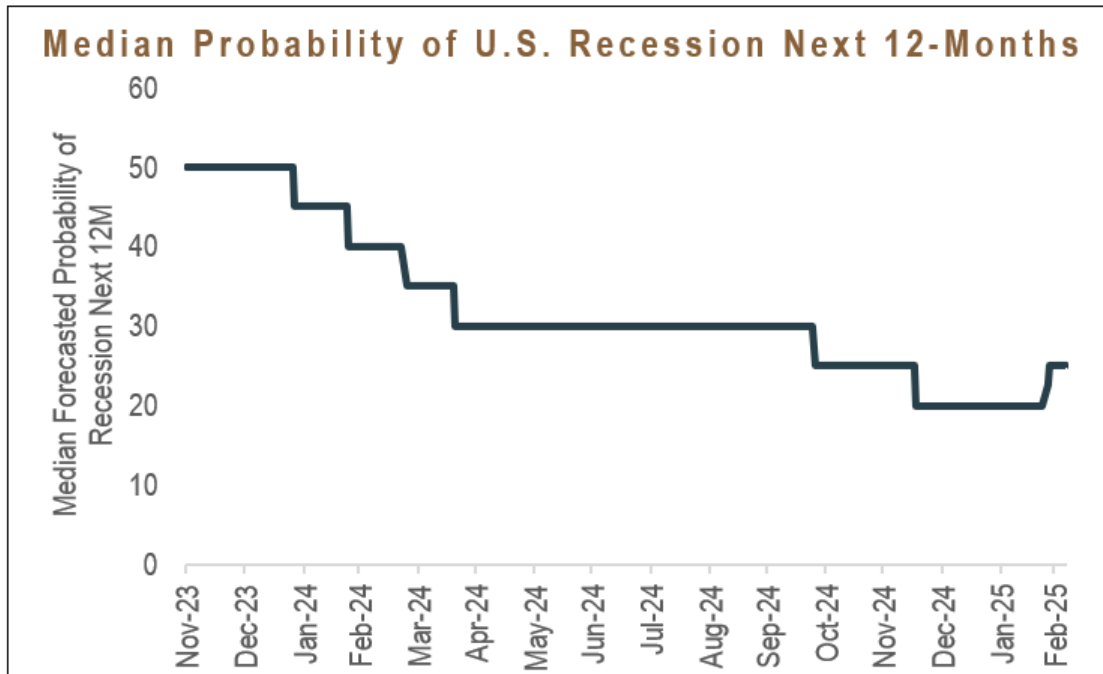
We also take a measured approach to portfolio adjustments. For instance, in 2024, we trimmed oversized positions in some of the largest growth stocks, which we viewed as overextended. At the same time, we identified opportunities in defensive stocks that had been overlooked, as concerns around near-term risks overshadowed their stable, defensive characteristics. This balanced approach allows us to manage risk while positioning for future growth.

### *Risks and Challenges*

The current environment presents several serious risks that we are monitoring closely. In addition to tariffs, the impact of a dramatic reduction in government spending, and a period of “detox” as Treasury Secretary Bessent described it, could have negative near-term effects:

1. **Earnings Pressure:**
  - **Direct Risks:** Companies with significant government contracts, particularly in the technology and defense sectors, could face renegotiations or reduced spending as policymakers reassess budgets.
  - **Indirect Risks:** Government job cuts or delays in spending could dampen consumer sentiment, leading to reduced spending and slower economic activity.
2. **Business Uncertainty:** The volatility around tariffs and trade policies may delay corporate planning and investment decisions. For example, one of our clients in the apparel business has seen a steep decline in orders, as customers hesitate to replenish inventory amid uncertainty about future costs.
3. **Inflation and Interest Rates:** Tariffs could increase the cost of goods, potentially driving inflation higher. If inflation expectations rise, interest rates may also rise, which could slow demand for interest-sensitive purchases like homes and cars, ultimately weighing on economic growth.

These risks could, at the extreme, lead to a recession. Few are predicting this outcome (we aren't either), but an economic slowdown, and the potential for earnings disappointments for corporate America, could have a chilling effect on the U.S. equity markets. This outcome could also create opportunities for disciplined investors to find value in areas where short-term uncertainty has created mispricing.



Source: Neuberger Berman, Bloomberg February 2025.

### *Opportunities and Positive Developments*

Despite the challenges, we see several reasons for optimism:

- **Tax Policy:** The likely extension of Trump 1.0-era tax cuts provides a degree of stability, reducing uncertainty for corporate planning and potentially supporting earnings growth.
- **Infrastructure Investment:** Spending on infrastructure—particularly in areas like artificial intelligence, data centers, and transportation—remains robust. This investment is unlikely to slow, as evidenced by large-scale projects like JFK airport's redevelopment, and the many data centers around the country. (We recently visited one of Tesla's data centers in Texas and were awed by the scale and sheer level of power consumption at just one facility.)
- **Regulatory Efficiency:** Over the long term, improvements in government efficiency, such as streamlined regulatory processes, could boost productivity and liberate resources for innovation and growth. In particular, financial regulatory reform will be a welcome change, and could lead to increased lending, further helping to fuel economic growth.

These opportunities highlight the resilience of the U.S. economy and the potential for long-term growth, even amid near-term challenges.

While the U.S. market faces challenges, we believe that the global “broadening out” story creates opportunities for diversification. For example, the monumental shift in Germany's defense spending framework led to the European defense companies emerging as new regional leaders, replacing luxury goods as market drivers. This shift highlights the importance of maintaining a global perspective in portfolio construction.

Additionally, America's long-term strengths—its world-class human talent and reserve currency status—remain intact. These foundational advantages underpin our belief in the resilience of the U.S. economy.

### *Interest Rate Environment: Caution and Opportunity*

Interest rates declined across the longer end of the yield curve in the first quarter, reflecting inflation moderation and concerns about economic growth. While lower rates can support demand for housing and autos, they also signal caution about the broader economic outlook. If the Federal Reserve takes steps to manage the yield curve, it could provide temporary relief. However, we believe structural challenges in inflation and fiscal deficits are likely to drive the long-term direction of interest rates.

We believe rates are likely to remain higher for longer, underscoring the importance of careful portfolio positioning in both equity and fixed-income markets.

### *Conclusion: Navigating Political and Market Cycles*

As we reflect on the current environment, it's important to recognize that we are in the early stages of a new political cycle. Historically, the first year of a new administration is marked by "breaking eggs", painful adjustments that set the stage for future recovery. President Trump's tolerance for short-term pain in pursuit of his agenda suggests that these challenging headlines may persist through the first half of the year.

By the time you get this letter, Liberation Day, the day that President Trump has declared a new tariff regime will start to add billions of dollars to the U.S. economy, will be upon us. As always, the devil will be in the details. We will wait to see which countries or industries are most affected, and which escape with minimal consequences. We certainly cannot predict how this plays out in the short term, as negotiations continue, but we can predict continued volatility along the way. We remain optimistic that the U.S. economy will continue to thrive over the long term and that the stock market will continue to provide interesting opportunities to deliver attractive returns to long-term investors. Patience will be critical. As Charlie Munger famously said: "The big money is not made in the buying or the selling, but in the waiting."

We also recognize that heightened volatility leads many clients to reassess risk tolerance, especially after a few good years in the stock market. As always, we stand ready to help you work through your asset allocation. Thank you for your trust and partnership. Please don't hesitate to reach out with any questions or concerns.

Sincerely,

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