“Imagine That!”
Market Commentary – May 2025

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The advance estimate of Gross Domestic Product (GDP) shows that the output of goods and services produced by labor and property located in the U.S. decreased at an annual rate of 0.3% in the first quarter of 2025. This is much lower than +2.4% in 2024 Q4 and the first negative reading since 2022 Q1. The components of the 2025 Q1 GDP number are: consumer spending +1.21 percentage points, investment +3.60 percentage points, net exports -4.83 percentage points, and government spending -0.25 percentage point. The sum of these numbers equals -0.27%. With respect to investment, once factoring out the volatile inventory category of +2.25 percentage points (unsustainable), fixed investment contributed a solid +1.35 percentage points (mostly due to nonresidential equipment). The large negative net exports value means that imports exceeded exports, likely the result of Americans buying foreign goods ahead of tariffs. This may swing wildly in the opposite direction as 2025 progresses. Lower government spending is actually a goal of the Trump administration. Overall, the weak headline number appears to skew economic reality.

The effect of tariffs on inflation “depends”. If tariffs are being used to negotiate more favorable trade deals for the U.S., they may be temporary (benign for inflation). If tariffs are permanent, the effect on inflation may depend on the timeline. In the short run (less than 1 year), there does not seem to be much effect on inflation. Note how the price of oil has collapsed, despite the weak dollar (a barrel of oil should cost *more* dollars, but market participants anticipate softer demand more than offsets the weaker dollar). In the medium run (1-3 years), inflation is a concern. Businesses must either eat higher input costs (with lower margins) or pass them on to consumers with higher prices. In the long run (more than 3 years), inflation should be muted because businesses will have time to source inputs and sell products in ways that minimize the tariffs (e.g., build new U.S. factories, import from different countries, etc.). Labor costs would likely rise in the U.S., although it is unclear to what extent costs may be offset by automation and technology.

The Federal Reserve risks committing a policy error by not slashing the federal funds rate to spur growth. The Fed is worried about lower rates stoking inflation, but that is a medium-term concern. In the short-run, disinflation is the story, and there is a possibility of a collapse in demand (caused by many people simultaneously taking a “wait-and-see” approach to the trade uncertainty). The U.S. Treasury yield curve shows 3.60% for 2 years, 4.17% for 10 years, and 4.69% for 30 years. The federal funds rate should be 3.5% to 3.75% for a normal upward sloping yield curve, which is 0.75% lower than it currently is. Sparring in the media between President Trump and Fed Chair Jerome Powell has injected politics, ego, and stubbornness into the mix. The next Fed announcement on monetary policy is scheduled for May 7.

Technical factors of the market are bearish (more supply than demand), while fundamentals are fairly priced – therefore, we are mildly bearish on the market. The Standard & Poor’s forecast for S&P 500 operating earnings per share (EPS) through March 31, 2026 is $271.06, which implies a price-to-earnings (P/E) ratio of 20.5 with the S&P 500 at 5,569. The earnings yield (E/P) of 4.87% represents fair value relative to the 10-year U.S. Treasury note yield of 4.17%. The yield spread is 0.70%. Future earnings expectations are unclear given the economic uncertainty, so they may be adjusted accordingly.

Bears are in control as the S&P 500 hit an intraday low of 4,835 on April 7, before bouncing back to close April at 5,569. There is a lot of resistance overhead: 5,600 (50-day moving average); 5,750 (200-day moving average, late March 2025 high). The April 2025 low (4,835 intraday and 4,982 closing) should provide major support, given the assumption that something does not “break” (i.e., a financial black swan rips through the global economy). Such a scenario could cause markets to tailspin worse than they did in early April, possibly creating a historic opportunity to deploy cash. Meanwhile, we just completed the annual update of our universe, which uncovered some new potential buys. Our next step is to perform detailed research on these companies with plans to incrementally buy into weakness. While it is easy to fear financial Armageddon, what if we actually enjoy a *favorable* outcome in months ahead? Imagine that!