Q1 2025 MARKET COMMENTARY

Despite the optimism at the start of 2025, the escalation of a trade conflict initiated by the US introduced notable volatility and uncertainty into global equity markets. During the quarter, global equities returned -1.3%, international developed, emerging markets, and U.S. equities returned 6.9%, 2.9%, and -4.7%, respectively. While tariffs were anticipated following the US election, the breadth and depth of the measures exceeded market expectations—stoking fears of higher inflation and slower global growth from impending supply chain disruptions. Although capital initially rotated out of US equities and into international markets, broader risk aversion eventually swept across global markets.

US equities started Q1 2025 strong but quickly turned negative, led by a selloff in AI-related stocks following the emergence of Chinese artificial intelligence company DeepSeek and then exacerbated by President Trump's tariff plans. Growth-oriented companies—particularly those in the technology sector and tied to AI—were hit hardest. Value-oriented stocks fared better as investors rotated out of growth. The popular "Magnificent 7" stocks led the market downturn, collectively shedding $3 trillion in market capitalization during the quarter. Small caps saw the steepest declines, followed by large and midcaps.

In contrast, international developed markets posted positive returns for the quarter, supported by attractive relative valuations and renewed growth prospects. In Europe, inflation eased modestly, and interest rates fell to 2.5%. Geopolitical risks also eased, particularly after Germany's elections concluded with a new leadership coalition approving a €500 billion infrastructure fund aimed at expanding European independence. The news fueled prospects for revitalizing the region's economy, helping narrow the expected growth gap between Europe and the US.

Emerging markets also delivered positive returns, initially benefiting from capital rotation out of the U.S. and supported by a weaker US dollar. Renewed tariffs on Chinese goods and retaliation between the two countries was expected. That said, the Chinese economy has matured significantly, with roughly 85% of revenues now domestically driven, according to a Morningstar global revenue exposure analysis of the MSCI China Index. Broader intra-regional trade within emerging markets is also evidence of a maturing market, signaling a shift away from heavy dependence on exports to the US.

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US fixed income markets saw two primary developments during the first quarter: a broad decrease in market yields and a broad widening of credit spreads. These two somewhat opposing forces worked to deliver the strongest absolute returns from government securities (treasuries and agency MBS securities) while credit-oriented markets earned weaker, but still positive, total returns. Within credit, lower-quality credit components fared worse than higher-quality as spreads widened the most in below investment grade credit. Outside of the US, emerging market debt performance was also subdued as spreads on emerging market debt widened notably in March.

Overall, it remains to be seen how trade negotiations will evolve and what the longer-term path for inflation and global growth for countries will be under the current trade war. A sustained escalation of the trade conflict poses ongoing risks to global equities, and the quarter-end risk-off move into safe-haven assets may persist in the near term, but it may also reverse quickly. Nonetheless, we continue to emphasize having a long-term mindset and maintaining a diversified asset allocation rather than reactively chasing headlines.

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SOURCES

1. DeepSeek AI Platform Brings a $1 Trillion Market Reckoning on Cost - Bloomberg
2. Merz's Landmark Spending Bill in Germany's Bundesrat Upper House - Bloomberg

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