

Quarter-In-Review – The first quarter of this year was in many ways the mirror image of the fourth quarter last year, at least when it comes to market performance. Three months ago, all anyone could talk about was the dominant performance of the Magnificent Seven stocks. But sentiment quickly reversed, and the Magnificent Seven lost almost -16% in the first quarter while the average stock in the S&P 500 dipped just -0.7%. Seven industry sectors (out of eleven) within the S&P actually gained ground, with energy stocks leading the charge (+9%), closely followed by healthcare (+5%). Large-cap value stocks were up +5.9% while large-cap growth dipped -7.5%. It's a similar story if you look at U.S. equities versus their international counterparts. At the end of the last year the stories about U.S. exceptionalism were pervasive after another year of barn burning returns for U.S. stocks. But this dynamic reversed dramatically, and the spread between the EAFE return (+8.1%) in the first quarter and the S&P 500 (-4.3%) was the largest since 1988!!

Bonds also provided balance to diversified portfolios. Bond yields fell across the yield curve, and intermediate-term Treasury bonds gained +3.8% while short-term bonds picked up +1.6%. Interestingly, short-term bank loan funds were one of the few bond categories that lost money in the first quarter (-0.1%). The underperformance in this economically sensitive bond category hints at the struggles investors are having in pricing in a far more uncertain economic path than existed just three months ago. More on this below.

The key takeaway for investors in the first quarter is that the benefits of diversification are still real. Late last year conversations centered around why own value or international stocks and how the 60/40 portfolio was outdated. And as these things tend to work, the point of maximum pessimism marked the turning point. What's surprising isn't that the narrative changed in the first quarter, but that relative returns snapped back so quickly.

How to Price in an Uncertain Policy Path? – How much of the reversal in relative returns in the first quarter is due to

Market Benchmarks			
Market Indices	1Q25	3-Yr An	5-Yr An
Global Equities	-1.0%	+6.9%	+15.4%
S&P 500 Index	-4.3%	+8.9%	+18.4%
Russell 2000	-9.5%	+0.4%	+13.2%
Int'l Index (EAFE)	+8.1%	+6.6%	+12.1%
Emerging Mkts	+2.1%	+2.6%	+9.2%

Other Indicators	3/31/25	12/31/24	12/31/23
Fed Funds Rate	4.25-4.50%	4.25%-4.50%	5.25%-5.5%
2-Year Treasury	3.89%	4.24%	4.25%
10-Year Treasury	4.22%	4.57%	3.88%
S&P 500 P/E Ratio*	20.2	21.5	19.5
Crude Oil	\$71.47	\$71.72	\$71.31
Core Inflation	2.8%	2.8%	3.2%

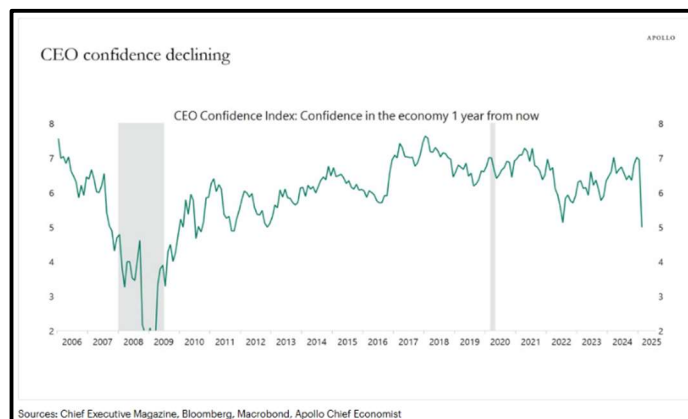
*Forward 12-month operating earnings per S&P

fundamentals and how much is due to a change in investor sentiment is hard to say. Clearly the policy backdrop changed dramatically in the first quarter in a way that few expected. While the incoming administration moved in a number of directions, probably the biggest shock from a market perspective was a very aggressive move on the trade front against long time friends and competitors alike. At the end of last year most analysts thought we'd see trade sanctions levied on China, but few could foresee unprecedented action against both Canada and Mexico. Even before the President's press conference on April 2nd investors were struggling to discern the implications of a far more hawkish approach to trade, but these questions only deepened after the 2nd. There's much we don't know, but any investment outlook has to address how the current approach to trade policy could impact the outlook for growth and inflation.

Exploring the Logic Behind Tariffs – We have to acknowledge up front that it's been a century since the U.S. has seen significant across-the-board tariff increases.

Every economist alive today has only lived through a period of trade getting ever more unconstrained. This makes modeling the impact of the proposed tariff hikes difficult in a modern economy.

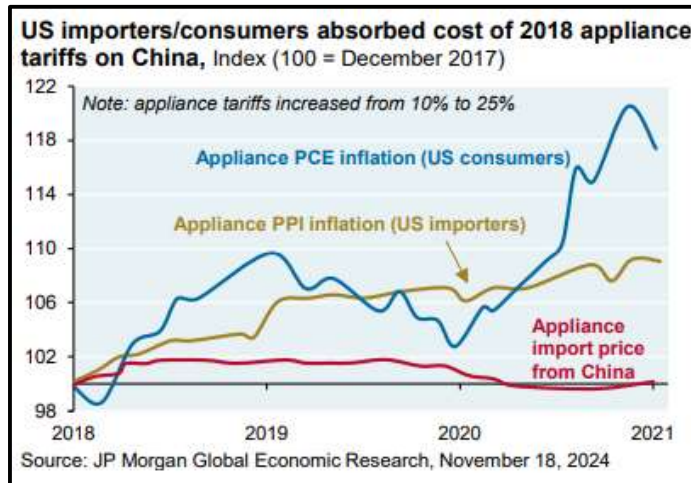
But we do have the tariff increases in 2018 to look at. Granted, they applied only to China, but they do provide some empirical evidence to go



on. A number of studies looking at the washing machine market, for example, found that consumer prices ultimately increased roughly in line with the size of the tariff applied (blue line in the chart to the right). Domestic production did increase somewhat, but the cost of the jobs gained in the U.S. was high when looked at in terms of how much consumers ultimately had to spend. Another example concerns the steel industry. Based on a number of studies, the 2018 steel tariffs created 1,000 jobs for steelmakers protected by tariffs, but they reduced employment by 75,000 in steel-using industries such as autos and construction as prices rose and sales fell.

Based on this and other studies, the logic of tariffs eludes us. Granted, part of the President's plan is to cut corporate taxes for domestic manufacturing companies at the same time tariffs go up to discourage imports and shield domestic producers. But in reality, these two policies are often in conflict. Most domestic manufacturers are also importers, using imported capital goods, industrial supplies, and semifinished goods as inputs. Although these companies are considered "domestic manufacturers" and therefore qualify for the prospective corporate tax cut, they are also subject to rising import duties.

And there is a clear problem with the sequencing of policy initiatives. The trade restrictions are meant to be offset by fiscal largesse, but it is less than clear that any meaningful tax stimulus can be passed this year given the size of current deficits and the slim Republican majority in the House. And to the extent the new tariff regime slows the economy, the fiscal outlook will only darken in the next few months, making the passage of a large package of tax cuts even harder. In the end, it is hard to tell whether these manufacturing companies are better off from lower corporate taxes (which obviously have yet to be passed) or worse off from higher duties. The chart to the right shows that imports of capital goods, industrial supplies, auto parts, and others account for around 68% of manufacturing GDP, which means that a large swath of U.S. domestic manufacturers are going to be hurt by the new tariffs. This is why



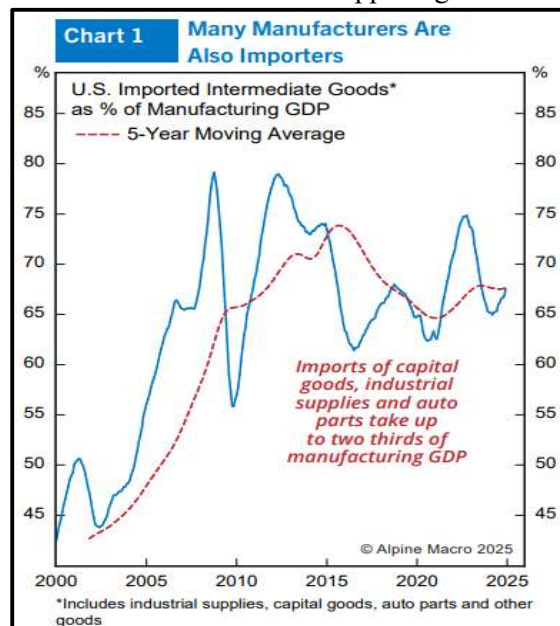
alternative energy, and infrastructure investment. No one should be shocked if these plans are put on hold. If government policy might change next week or next month (or after next year's mid-terms), few companies are going to make multi-billion dollar investments in permanent capital equipment. We rarely quote sentiment data because it tends to gyrate too much, but the recent decline in CEO confidence (chart at the bottom of the previous page) is probably the first sign that investment spending is likely to grind to a halt soon.

Given the above, what do we see as the likely consequences of rising trade tensions?

Shrinking Global Trade – During President Trump's first term trade tensions were largely confined to China. However, with Trump's widening trade war likely leading to foreign retaliations, it is likely that trade flows will shrink materially this year. This adjustment will hurt trade-oriented economies such as Canada, Mexico, Germany, China, and other Asian countries. That being said, Canada and Mexico were omitted from the April 2nd announcement, presumably because negotiations are happening behind the scenes. Perhaps other countries will

also be able to negotiate less harsh terms over time. Whether such negotiations can occur quickly enough to prevent a meaningful global economic slowdown or recession is difficult to forecast.

As for the U.S. economy, shrinking global trade and higher tariffs will cut into GDP growth, but not to the extent of causing a recession in and of itself. A World Bank analysis using data from 2022 found the U.S. trade-to-GDP ratio — the value of imports and exports as a percentage of the country's gross domestic product — was 27%. For comparison, the global average is 63%. Private consumption, not



manufacturing, is the main driver of U.S. growth, and where this goes will determine if we get a recession or not in the coming months.

Lower Consumer Spending – But just because the U.S. system is relatively closed, it doesn't mean there won't be knock-on effects. We are all sick of the following comment, but it doesn't make it any less true. Tariffs are a tax – the money doesn't just appear out of thin air. Who pays the tax? The consensus overwhelmingly says it's the consumer, but at least historically, some of the burden can be shared by producers (currency changes can play a role as well). No one quite knows how big of a tax increase we could be looking at because no one can model how the costs will be divided between

consumers and producers. But the administration has talked a lot about \$600bn a year in tariff revenue, or roughly 2% of GDP. If this is borne entirely by the consumer it would amount to one of the largest tax increases in modern memory (chart to the right). Such a scenario would lead to slower consumer spending barring a fiscal spending offset.

First Inflation, then Deflation – As noted earlier, the immediate response to sector-specific tariffs is for prices of the targeted good to go up. But if prices go up in one sector, this is likely to sap spending power in other sectors, pushing those prices lower. Studies tend to indicate that the net impact of tariffs on core inflation is typically small, and most analysts think a blanket 25% import duty would boost inflation temporarily by between 0.1% and 0.5%, before fading. But there are estimates that the inflationary hit could be larger – between 1% and 1.5% if all the tariffs proposed on April 2nd go through.

However, the recent decline in bond yields indicates that traders think tariffs will be more deflationary than inflationary over the longer term. Shrinking trade flows, lower real income growth, smaller corporate profits, and possibly rising unemployment are all deflationary. There's also a chance China in particular devalues their currency to protect their trade volumes. Only time will tell how the sequencing of events plays

How Current Proposals Compare to the 15 Largest Tax Increases since 1940

Average Annual Revenue Change as a Share of GDP across Major Tax Laws and Proposals



* Tax bills were fully or partially used to fund war efforts in World War II, the Korean War, or the Vietnam War.
 ** The "full-year effect" for the first year of revenue was used, rather than the effect on the first fiscal year after enactment.
 Source: Jerry Tempeliski, "Revenue Effects of Major Tax Bills"; Congressional Budget Office; "Revenue Projections, by Category"; Tax Foundation General Equilibrium Model; Author calculations.



out because, at the end of the day, there is really no historical precedent to go on.

Risks Are Rising Until Policy Changes

– Given the comments above it is clear that we think the risks of stagnant growth or recession are clearly rising. Opinion is certainly divided on the risks of recession – Goldman Sachs thinks it has a probability of 1 in 3, others might go as high as 60%, but in reality, it's impossible to say. How much will consumers pull in their spending plans over the next couple of months if some prices jump meaningfully? Will they redirect spending into something else, or favor building up

cautionary savings? The market weakness is likely to weigh on consumer spending, but by how much is unclear.

All we can say with certainty is that the risk of recession is rising. The moves on the trade front are a misstep in our mind as it relates to the market outlook, and if policy isn't softened in the near term, the recent volatility we are experiencing is likely to continue. But how could policies change in the next few weeks? We see three paths forward:

- The tariffs announced on 'Liberation Day' are just an open gambit, and negotiations unfold that lead to a more accommodating stance. Optimists see hints of compromise in Germany's move towards greater defense spending and both Vietnam and Israel scrapping their own tariffs on trade with the U.S. Time will tell.

- We can't discount the scenario that the Fed begins another easing cycle in either May or June, especially if the jobs numbers start to deteriorate. But it's an open question what the Fed is going to be more worried about – a possible spike higher in inflation or an increase in unemployment? They have yet to address this issue.

- Progress on the fiscal front that leads to a spending bill that has a high likelihood of passing this summer.

Equity Strategy in an Uncertain Environment

– Our general sense from our

S&P 500 Performance After Closing in Correction Territory					
Entered Correction	One Week	One Month	Three Months	Six Months	One Year
6/26/2008	-1.6%	-2.0%	-5.5%	-32.0%	-28.4%
10/22/2008	3.7%	-10.8%	-7.7%	-5.9%	21.9%
11/6/2008	0.7%	-3.2%	-4.0%	1.6%	18.2%
1/20/2009	5.0%	-4.4%	3.4%	18.1%	41.3%
5/20/2010	2.9%	4.3%	0.0%	12.0%	24.4%
8/4/2011	-2.3%	-2.2%	4.4%	12.1%	15.9%
8/24/2015	4.2%	2.1%	10.3%	1.9%	14.9%
1/13/2016	-1.6%	-1.3%	10.2%	13.9%	20.3%
2/8/2018	5.8%	6.1%	3.5%	10.7%	4.9%
11/23/2018	4.8%	-8.2%	6.1%	7.2%	18.1%
2/27/2020	1.5%	-14.7%	1.9%	17.0%	27.9%
2/22/2022	0.0%	4.8%	-9.4%	-3.9%	-7.3%
4/29/2022	-0.2%	0.6%	0.0%	-5.6%	0.9%
9/16/2022	-4.6%	-7.5%	-0.5%	2.2%	14.9%
10/27/2023	5.9%	10.5%	18.8%	23.9%	41.1%
Average	1.6%	-1.7%	2.1%	4.9%	15.3%
Median	1.5%	-2.0%	1.9%	7.2%	18.1%
% Positive	66.7%	40.0%	60.0%	73.3%	86.7%

Source: Dow Jones Market Data

conversations the last few weeks is many investors answer this in a binary way – if there’s a recession I want to be in cash, but if there’s no recession then buy the high-multiple growth stocks on the dip. We think this is the wrong approach for a few reasons:

First, it has generally paid to be a buyer of stocks after a 10% or greater correction rather than a seller. For example, the chart at the bottom of the previous page shows the subsequent returns after a 10% correction in recent history. While not uniformly positive 12 months out, the data is certainly biased towards a positive outcome.

Additionally, when it comes to the recession call, we have to realize our ability to predict economic cycles is limited at best. Even at the best of times, we’ve found few analysts who can consistently predict a downturn ahead of time, and just as importantly, predict the eventual recovery. And with such policy uncertainty today, the task is doubly hard. But assuming you get the recession call correct, the common perception that stocks plummet during a contraction isn’t entirely true. The table above shows market returns six months before recessions, during, and after they end. It’s clearly a mixed bag, and it’s just as common to make money during recessions as it is to lose it. This is because the market usually bottoms way before a recession is officially over. One other fact from this table is worth noting – at least historically, recessions have presented good buying opportunities for long-term investors, not reasons to sell.

If we had to guess how the market dynamics will play out going forward, we suspect that the diversification theme of the first quarter has some legs to it. We think the bullish fever about the Magnificent Seven has broken, and that money will continue to move out of the mega-cap stocks and into other sectors of the market. And let’s not forget the international angle to this story. Asian and European investors are still massively overweight U.S. large-cap stocks because that has really been the only game in town the last few years. But the on-going trade war is likely to accelerate the trend of big overseas institutional investors

Recession	6 Months Prior	During the Recession	One Year	Three Years	Five Years	Ten Years
Nov 1948 - Oct 1949	9.83%	4.12%	31.48%	87.98%	171.33%	497.04%
July 1953 - May 1954	-6.46%	27.57%	35.92%	83.74%	144.81%	294.38%
Aug 1957 - April 1958	9.28%	-6.51%	37.31%	66.35%	89.72%	211.33%
April 1960 - Feb 1961	-1.04%	18.40%	13.61%	35.06%	68.41%	111.33%
Dec 1969 - Nov 1970	-7.78%	-3.45%	11.24%	20.63%	25.16%	145.87%
Nov 1973 - Mar 1975	2.86%	-17.90%	28.32%	21.99%	55.33%	252.40%
Jan 1980 - July 1980	7.67%	16.14%	12.92%	55.89%	100.89%	345.64%
July 1981 - Nov 1982	-1.02%	14.66%	25.40%	67.24%	103.23%	350.51%
July 1990 - Mar 1991	3.09%	7.64%	11.04%	29.84%	98.21%	284.66%
Mar 2001 - Nov 2001	-17.84%	-7.18%	-16.51%	8.44%	34.33%	33.16%
Dec 2007 - June 2009	-2.33%	-35.46%	14.43%	57.70%	136.98%	294.17%
Mar 2020 - April 2020	1.92%	-1.12%	45.98%	???	???	???

Sources: NBER, Returns 2.0

repatriating capital back to their home countries. This is likely to pressure the relative performance of the mega-cap expensive U.S. growth stocks relative to other sectors.

All our portfolios are positioned with a tilt towards value stocks, and we continue to like this allocation. Large-cap value indexes made money in the first quarter, and

growth stocks still sell at a significant premium to value stocks. Value stocks currently have a forward price-to-earnings ratio of 17.6, representing a 41% discount to growth stocks' P/E of 30.1. International stocks could also help diversified portfolios going forward, especially if the dollar continues to swoon. Overseas stock performance in the first quarter certainly boosted the relative returns of our portfolios, and there is room to increase this allocation in the coming months. But the feasibility of this trade is going to depend on how other countries respond to April 2nd. For now, we have more confidence in U.S. value stocks relative to their overseas peers, but we are in the process of reassessing our positioning.

Final Thoughts - Trade uncertainty is injecting an enormous amount of uncertainty into any economic or market forecast. And the fact that the policy backdrop could change tomorrow or next week makes things doubly difficult. That’s why we offered up the final two tables showing market performance after both modest corrections and recessions. This time may be different, but the lesson from history is not to overreact to whatever the crisis of the day is. If money is invested for the long term, the long term inevitably includes bear markets and recessions. But over time investors have been rewarded for sitting tight. We think this time won’t be different in this regard. But this doesn’t lessen the imperative to consult with your financial advisor during periods of turmoil. Are your cash reserves sufficient to manage through this period of uncertainty? Where are you relative to your financial plan? Is your mix of stocks and bonds appropriate? Don’t hesitate to reach out to talk through your particular situation.

Charles Blankley, CFA
Chief Investment Officer

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