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Q2 2025 Outlook

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Overview: The new administration has rocked markets with economic and trade policies that were promised during the 2024 presidential campaign, yet few thought would be so whole-heartedly pursued. We exit Q1 near the year's lows in a classically defined stock market correction. The S&P 500 sits about 8.7% below its peak after having closed more than 10% off its peak only a handful of trading sessions ago. The Nasdaq, with higher concentration in the growth names that have driven the last leg of the bull market, is now down over 14% from its high. At the same time, expectations for economic growth have plunged, meaningfully increasing the odds of a recession from near-zero at the start of the year to somewhere much closer to a coin toss.

Uncertainty has been the defining characteristic in both markets and the business world the past two months. Chaotic and erratic threats, and the eventual implementation, of impactful tariffs, with more promised on April 2nd's "Liberation Day," have driven this uncertainty. Domestically, efforts to reign in government spending and waste have been employed in an unorthodox manner, leading to further uncertainty and concern. The aforementioned impacts on financial markets are easily observed, however we have also seen a striking change in thinking and behavior amongst business leaders and dealmakers. Bids for assets have been weak, with accepted offers sometimes being pulled. Spending plans and risk taking have been put on hold. Markets and the economy clearly do not function well when faced with so much volatility and uncertainty, but, once resolved, history shows these events generally create great opportunity. We are positioned conservatively and are monitoring for signals that this opportunity has arrived, allowing us to shift to a more aggressive allocation.

Is there a method to the madness? We sure hope so. Many well-regarded economists have spent time in recent months theorizing that the new administration may be subscribing to a geopolitical and economic plan that is being called the "Mar-a-Lago Accord." Under this theory, the administration will ultimately use these tariffs to set the stage for a negotiation that would reposition the United States' balance sheet (debt load) and its position in the global economy. Free access to US consumers is being taken away from trading partners. Additionally, the US has historically provided security and protection to those partners with our resources and defense department, which is also no longer assured. Coincidentally, those trading partners also hold significant amounts of our national debt. This theory posits that the end focus of the actions to date is to set up a negotiation to reduce the outstanding debt via some sort of exchange or swap for lower coupon, longer dated debt with some portion of principal possibly being forgiven. This would also include a pact, or accord, to work together to weaken the US Dollar, making our economy more competitive in the global market. In exchange for their compliance, these trading partners could regain access to our markets and continue to benefit from our security.

Although it is debatable as to whether or not our nation's current debt balance has become unsustainable, we are certainly not heading down the right path. With unnecessary fiscal imbalances in the form of ever-expanding deficits, more and more debt must be issued and eventually the end buyers of that debt may stop buying, driving up interest rates and bringing national credit quality and solvency into question. The Department of Government Efficiency's task to eliminate waste and reduce the deficit is a noble one in this regard, despite its curious and highly controversial implementation. A potential Mar-a-Lago Accord and the DOGE efforts are far from a panacea. Combined, they make only a small dent in what needs to be done to fix the national debt and deficit issues, and they both certainly come with undesirable side effects. However, bringing these issues under control must start somewhere, and a shift in momentum could reset the country's fiscal trajectory. If this is truly the strategy, and it is successful, the long run results could be very positive.

Unfortunately, the administration has not made it clear that this is, indeed, the plan. Instead, it has focused on other desired outcomes that are likely achievable, but not without negative side effects. There is a clear desire for national self-sufficiency. Trade agreements could give us needed access to natural resources held by other countries, valuable for our changing industrial focus and our ability to manufacture onshore. This "onshoring" of manufacturing should create jobs and help offset our trade imbalance. There is clearly a focus on the potential for GDP growth via more jobs, capital investment and a reduced trade deficit while ignoring potential consequences. The administration's hostile rhetoric towards our global trading partners completely ignores the fact that we already have the world's largest, strongest economy. Americans enjoy an incredible quality of life that has been created by globalization, allowing our large corporations to utilize their lowest-cost providers, grow profits and employ their US employees at high wages, in turn allowing those employees to consume low-cost imported goods that make their lives better.

What will be the economic effects? In the short and intermediate term, economic theory points to tariffs effectively creating a supply-side shock. Instead of taxing consumers and influencing demand, this is a tax on the supply side of the economy that should work to create inflation and reduce output. The magnitude of the impact on both prices and growth is hotly debated. The stock market has clearly illustrated its opinion that it thinks consumers will likely be unable to withstand higher prices and will instead pull back, causing a recession. The decline in stocks reflects the potential for margin erosion due to the tariffs, but also likely a reduction in revenues. The bond market has corroborated what stocks are saying with yields falling sharply since it became clear tariffs would actually be employed. The concern is that, as businesses deal with tariffs that have eroded their margins and made their products less competitive, they will have to look to cut costs to offset that margin erosion. This could mean companies cut jobs and unemployment rises more than the Fed would like. Supporters of the tariffs suggest the impacts could be absorbed by both overseas suppliers and consumers in the US without much pain, and that the increase in revenue from the tariffs will help balance the budget and enable us to create jobs as described above.

We have already seen evidence of changing behavior that is impacting economic data. The Atlanta Fed's GDP Now projection for Q1 GDP is decidedly negative at the moment. A big part of this negative reading appears to have been driven by a rush to import inventories before the tariffs come into effect, creating a wider trade deficit than normal for this time of year. These idiosyncratic inventory-driven moves are not enough to deem a negative quarter of GDP growth a recession; however, other data shows the consumer is concerned and less confident about the future. This usually leads to reductions in consumption that could be deemed a recession. We aren't there yet, but as mentioned earlier, we are getting closer to a coin toss.

One fiscal response that could be implemented in response to the beginnings of a slowdown is a domestic income tax cut. We view this as unlikely and counter-productive in this environment. We doubt receipts from tariffs would be enough to validate a tax cut from a budget perspective. Additionally, tax cuts work to stimulate demand. This would be inflationary and create the risk of spiraling inflation that the Fed could find nearly impossible to control. We think it is more likely, or at least more prudent, that taxes are increased on certain higher income levels to increase government receipts and further balance the budget.

Why are projections so varied? It is hard to see an outcome where economic growth isn't impacted with renewed inflation pressures, but the magnitude of the impact on prices and output is nearly impossible for even the world's smartest economists to predict. This is because economics is behavioral. The end result is really just the summation of millions of decisions made each day by individuals that have their own unique motivations. Economists use the term "elasticity" to describe how much prices may move versus output when a shift like a tariff-driven supply shock occurs. Elasticity is theoretical and not really known until after those individuals with their own unique motivations end up making their decisions. The auto industry is a great example. Executives at the major auto manufacturers have all responded differently. Some acknowledge their asking prices are going up sharply. Others have said they expect to be able to absorb the prices and may shift their sourcing of materials. Some have even suggested they will cut prices to stimulate sales volume and take market share. Assuming prices go up, or are expected to go up, consumers could all react differently as well. Some may rush to buy a new car (inflation takes hold) while others decide they would rather keep a used car and fix it up (recession). Some may decide to keep their car and then change their mind down the road. Economic theory can illustrate what should happen, but only time will tell the actual result and its magnitude.

What is Hollencrest doing and where do markets go next? We remain committed to maintaining objectivity and continue to rely on data-driven indicators to help guide our decisions. Our investment team also works very hard to remove political bias and look at all perspectives. As of the end of Q1, the stock market had not completely broken down despite the meaningful pullback and extremely negative sentiment in the market. The past couple of quarters have been characterized by an "expensive" market that often looked, subjectively, overbought from a price-to-earnings perspective. Strong earnings growth expectations have tempered valuation concerns as companies can grow into their price with profit growth, but when faced with recession concerns those earnings growth expectations reverse quickly, triggering these corrections. We have shifted meaningful segments of our exposure to more defensive strategies and implemented buffered (semi-hedged) products. These exchange-traded funds allow for upside participation with a cap but also protect against a specific amount of drawdown. We have been using products that rebalance quarterly and protect against a 10% drawdown in the Nasdaq 100, which has provided great protection to date and should continue to do so given their March 31st rebalance. We monitor these regularly to make sure we are optimizing our downside protection versus upside participation. Along with these defensive buffered positions, we have made more aggressive levered investments that give market exposure while allowing us to hold cash and earn strong relative returns from interest on short term Treasuries. If our indicators give us a sell signal, we have specific positions in existing portfolios that we are prepared to liquidate to raise cash in a tax efficient manner. We would then look for a traditional bottoming process where we may reinstate exposure at drastic levels of oversoldness and then increase with the emergence of what we call "breadth thrusts" - technical events that work well to signal a new uptrend has resumed.

Because the risk of recession has elevated, and earnings potential appears reduced due to new trade and economic policies, we have had to adjust our expectations accordingly. Earnings should be lower at the end of the year than we would have expected a few months ago, and the increase in volatility has reduced the range of earnings multiples we would expect to see the rest of the year. As such, we see a return to the stock market's February high of 6,144 as an optimistic outcome.

Where does the Fed fit into all of this? The Fed is in a tough position. Fed futures are pointing to rate cuts this year, aligning with the stock and bond markets' vote that we are headed for a meaningful slowdown. We don't see cuts as possible with the current fiscal and trade policy backdrop. The Fed will have to wait until unemployment jumps significantly higher and we are already in a recession to cut rates, knowing that there are significant inflationary pressures being created by these policies and any accommodative policy will only make it worse. Rate hikes should be off the table as well with such clear risk of a pullback in real GDP. Longer-dated Treasuries could see significant volatility. We anticipate that expectations of a slowdown versus inflation will ebb and flow, and interest rates will move accordingly.