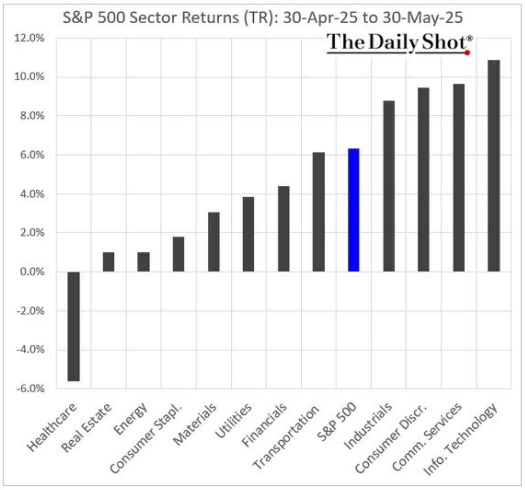
EQUITY MARKET UPDATE

As of 5/31/25 | Volume 14, Issue 5 | FFTAM.com

Stocks had their best month in almost two years despite continued uncertainty surrounding tariffs and a downgrade of US government debt by Fitch. A pause on tariffs against both China and Europe helped sentiment, and the US House of Representatives passed the One Big Beautiful Bill that included far fewer cuts than initially advertised. Investors were delighted with these developments to the extent that an informal trading strategy known as the TACO (an acronym for Trump Always Chickens Out) trade started making the rounds on Wall Street, where investors would buy the stocks most impacted by the President's Executive Orders, betting that he would eventually water down, delay, or negotiate an outcome far less onerous than presented. Better-than-expected earnings from major tech companies associated with the build-out of artificial intelligence along with subdued inflation readings also pushed the markets higher.

The S&P 500 gained 6.29% in May, its best monthly performance since November 2023. Ten of the eleven economic sectors were positive. Healthcare was the sole loser, dropping 5.55%. Investors reverted to past habits by piling into technology (+10.89%), Communications (+9.63%), and Consumer Discretionary (+9.44%). These three sectors are home to the top tech companies known as the Mag 7. They were responsible for 67.84% of the gains last month, with Apple being the only member to decline in value. Year-to-date, the S&P 500 is up 1.06%. Defensive sectors like staples and utilities are the leaders, along with economically sensitive areas like financials and industrials. Despite the recent rotation into technology, the sector is a laggard in 2025. Through May, the Mag 7 accounts for 163.09 points of decline in the index. This means the remaining 493 stocks have seen gains of 2.84% so far this year. One point of interest is that the performance among the Mag 7 has not been uniform. Microsoft and Meta have done very well, while Alphabet, Amazon, and in particular Apple, are dragging down results.



The Dow Jones Industrial Average rose 4.16% for the month. Declines in United Healthcare and Apple weighed on results. Year-to-date, the Dow is slightly positive (+0.08%). Overweight positions in United Healthcare, Apple, and Salesforce have negatively impacted returns compared to the S&P 500.

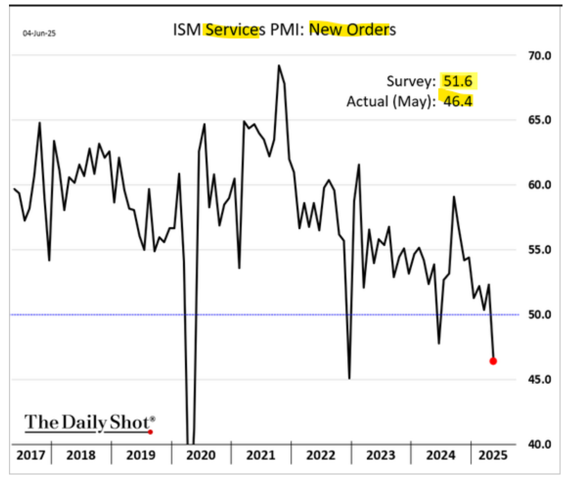
The NASDAQ experienced the best return in May, gaining 9.65%. Strong returns from Microsoft, NVIDIA, Broadcom, Meta Platforms, Netflix, and Tesla lifted the index. Despite the good month, the NASDAQ is underperforming both the S&P 500 and Dow in 2025. Fears about China gaining ground versus the US in artificial intelligence, along with elevated valuation and the lack of interest rate cuts, have made this area of the market ripe for profit-taking. Year-to-date, the NASDAQ is down 0.73%. Mid and small-sized stocks also saw monthly gains. The S&P 400 Mid Cap (+5.39%) and S&P 600 Small Cap (+5.23%) indexes rose on better-than-expected inflation data, which sparked hope that the Fed would consider lowering interest rates at future meetings. Passage of the One Big Beautiful Bill in the House also provided tax and regulatory certainty. Unfortunately, these factors have not been enough to lift these stocks that are still down 3.27% and 8.19%, respectively, this year.

Given the seismic shift to global commerce from President Trump's tariff announcement and executive orders, economic data remains resilient. The US economy has clearly softened in recent months, but nothing outside of sentiment surveys indicates a recession is at the doorstep. Consumer spending is firm, but it is primarily coming from the highest income households. For months, many metrics have shown financial stress building among lower-income households, and recent consumer sentiment surveys indicate the potential for higher prices from tariffs is front-of-mind. Labor, which has been the bright spot for the past two years, appears to be returning to more normalized conditions. May payrolls showed that another 139,000 jobs were created. Unemployment held steady at 4.2%. Wages were up 3.9% from one year ago, an amount that continues to exceed both the Fed's expectations and the pay raises seen pre-COVID. The labor market is tight, but competition to recruit and retain employees has obviously waned. The JOLTS report showed that there are 7.39 million jobs open but unfilled, which equates to 1.1 job openings for every unemployed person. This is below the levels seen pre-COVID, and it indicates that getting a new job is becoming harder for people on unemployment. Weekly reports on the number of new people filing for unemployment have also increased, but the overall level is still manageable.

Consumer inflation took another step towards reaching the Fed's target, with prices increasing 2.3% from one year ago. Core inflation that removes food and energy held steady at 2.8%. PCE data, the Fed's preferred measure of inflation, showed total prices climbing 2.1%, while prices ex-food and energy rose 2.5%. These statistics were better than expected, and market participants increased the odds of a Fed rate cut by September. However, the large unknown is how much room the Fed has to lower interest rates, especially if the threatened tariffs push prices higher.

Despite wage growth and relatively low unemployment, clouds are forming over select segments of the consumer population. Personal income grew 0.8% in May. Total spending rose 0.2%, while retail sales gained 0.1%. Consumers have increasingly funded their expenditures with the use of debt. Credit card balances are at record amounts, and debt delinquency has climbed from one year ago in both credit cards and auto loans, especially among people with lower credit scores. Until President Trump provides greater details on his economic policies, monthly job reports and weekly unemployment claims are vital pieces of information to watch to gauge the strength of the consumer.

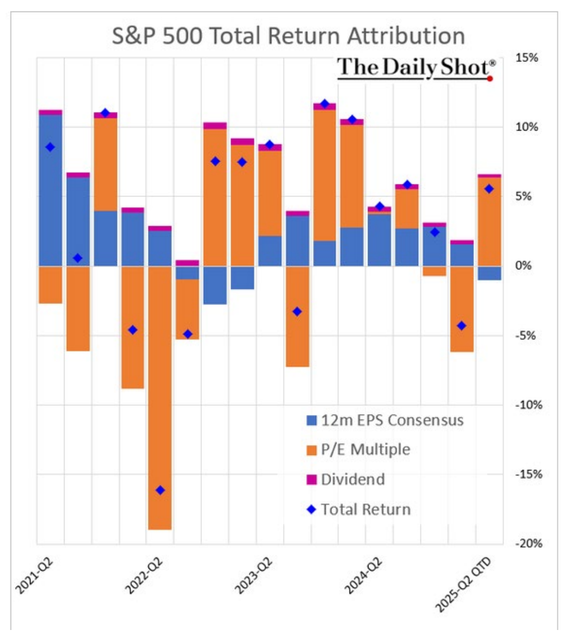
Business investment took another step backwards in May. The ISM Manufacturing PMI Index was 48.5. This index has contracted 28 of the last 31 months. Employment data (46.8) contracted once again. Manufacturing jobs have fallen in 24 of the last 28 months, something that historically happens only during recessionary periods. New orders (47.6) improved, but the reading is still in contractionary territory. This data, along with erratic movement in the trade deficit the past three months, is providing skeptics with fuel that businesses are ordering products and components as a precaution against proposed tariffs. Unfortunately, prices paid (69.4) remained at their highest level since June 2022, adding to fears that inflation from proposed tariffs could be bubbling. Services have been the engine powering the economy, but it too has slowed in recent months. The ISM Service PMI Index contracted with a reading of 49.9. Service employment (50.7) held steady, while new orders (an indicator of future demand) plunged to 46.4, its weakest reading since December 2022. Just like its manufacturing cousin, prices paid for services (68.7) were very hot.



Collectively, the data shows the Fed is winning the battle with inflation, although as stated above, the proposed tariffs from President Trump insert a high degree of uncertainty for future prices. The FOMC held interest rates steady at 4.25% to 4.50%. Dot plots indicate the central bank believes rates will be between 3.75% and 4.00% by the end of 2025, implying rates will only be cut twice in 2025. The Fed is holding on to its wait-and-see position given the uncertainty surrounding the President's threatened use of tariffs against major trading partners.

The S&P 500 currently trades at 21.9x forward earnings estimates. This is more than one year ago (20.7x), and it is above the 5-year (19.9x) and 10-year (18.4x) averages despite the higher interest rate environment. The equity risk premium that compensates investors for the excess risks associated with stocks compared to bonds remains thin.

We have concluded another earnings season. First-quarter year-over-year profit growth was 13.3%, well ahead of Wall Street expectations. However, investors should note that analysts have made a larger-than-average cut to earnings estimates for the current quarter in response to several companies suspending their forward guidance given the uncertainty surrounding tariffs. The consensus forecast calls for 2025 earnings growth of 9.1%, a drop from last month's 9.5% view and a sharp decline from the 11.3% growth estimate just two months ago.



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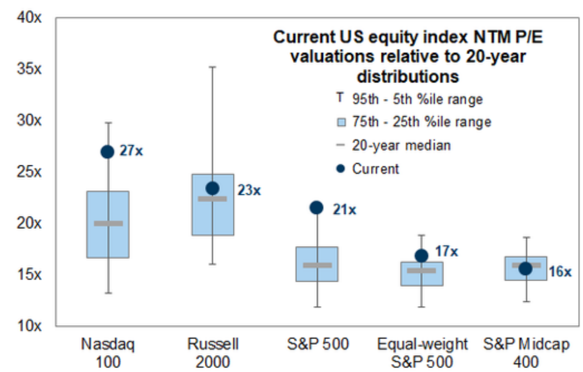
With the market trading above valuations of the past decade, stocks are vulnerable to headline risk from the White House. All major economic reports are also being closely scrutinized for signs of weakness. Coming into 2025, the S&P 500 experienced two years in which returns exceeded profit growth, resulting in back-to-back years of PE multiple expansion. This told us investors were fully convinced that inflation and interest rates would be coming down while overall demand for goods and services would remain intact (i.e., soft landing or “Goldilocks” scenario). This view has become clouded due to the lack of clarity from President Trump on the use and implementation of tariffs, along with higher long-term interest rates in reaction to the CBO’s estimate that the One Big Beautiful Bill would increase the nation’s deficit.

For months, we have written about the large difference in valuation between the big tech companies at the top of the index and everybody else. Currently, if you equal weight the names inside the S&P 500, the forward PE ratio drops from 21.9x to 17.5x. It appeared the wide margin was poised to close significantly after tech performed so poorly in February, March, and April; however, the rally in AI-related stocks from the Liberation Day lows has reopened the gap to the widest level seen in years. After adding to our technology exposure in April and May, we are now cautious once again given the steep valuations assigned to this area of the market even when you factor in future growth opportunities. We remain bullish on financials, utilities, and parts of healthcare. Finally, our preference for quality companies with strong balance sheets and growing dividend streams to enhance performance remains strongly intact.

Valuations

Exhibit 36: US equity index P/E valuations vs. history



Source: Compustat, FactSet, IBES, Goldman Sachs Global Investment Research

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