
Key Takeaways

- **Increased downside risk.** U.S. trade and tariff policies have significantly altered the path of the global economy since the start of the year, with sentiment among both consumers and businesses shifting in response. As a result, we believe the base case scenario for 2025 is more modest and the risk of a downside scenario has increased. At a minimum, we can see valuations for U.S. large cap equities facing pressure as U.S. “exceptionalism” is called into question, uncertainty over tariff policy leads to caution, and potential for higher inflation/interest rates all weigh on price-to-earnings multiples.
- **Tactical equity adjustments.** Policy uncertainty leads us to have a bi-modal view of potential developments from here. While we may put a lower probability on full-blown recession than some investment strategy teams, we are adjusting to the new reality of increased risk to the downside for equity assets. In response, we are reducing the tactical exposures in our Growth allocation to match the approximate reduction caused by recent performance. To be clear, we are not recommending outright sales of equities – we’re saying that prices are not attractive enough to rebalance into equities given current policy uncertainty.
- **Tactical fixed income adjustments.** In recognition of the greater uncertainty in markets today and the back-up in interest rates in investment-grade bonds, we are recommending a modest shift from Credit Risk Alternatives, which may have greater sensitivity to equity markets, to Short-Duration/Cash for greater liquidity and stability.

The Macro Picture

Aeschylus, a Greek playwright, poet, and soldier who lived near Athens during parts of the fifth and sixth century BCE, once said, “Time brings all things to pass,” highlighting the importance of patience and perspective. At this time of great uncertainty in financial markets and the economy, his voice serves as a calming reminder to investors to step back from the near-term volatility and evaluate their investments against what is known and unknown.

One quarter ago, the consensus investment outlook was quite positive for 2025 but included a cautious eye on things like the unemployment rate, inflation, and interest rates. Now the focus has shifted to evaluating risks ranging from mild economic slowdown to major global recession in the face of the U.S. administration’s unpredictable trade policy. Today it is very difficult to forecast earnings, inflation, interest rates, employment, or economic growth for the year ahead. Therefore, the best allies an investor can have are: 1) a diversified portfolio that allows for tactical risk adjustments; and 2) time to allow uncertainty to clear itself up.

United States. As we kick off the second quarter, 2025 has seen the U.S. dollar weaken versus other major currencies, oil prices drop significantly, a lot of volatility in interest rates (ie. 10-year Treasury) though on net not much change, and a significant decline in equity prices coupled with a spike in daily volatility. Meanwhile, the unemployment rate has remained relatively firm at 4.2% and we even saw a modest dip in inflation as reported by the U.S. Bureau of Labor Statistics for March, showing a year over year change to

2.4%.¹ It's the forward-looking expectations, however, that are impacting sentiment and making forecasts for GDP growth, earnings, inflation, and interest rates unpredictable.

As we consider how to evaluate equities, we must analyze the impact of policy changes and uncertainty on corporate profits, and the adjustments to price-to-earnings multiples that investors may be willing to pay. Earnings will be impacted by where tariffs and retaliatory tariffs shake out, but also by changes in overall demand, which is likely to diminish as consumers and businesses grip their purse strings tighter in a period of uncertainty. This impact on demand could be exacerbated if we start to see a pickup in job losses. Whereas we came into this year with historically high expectations for earnings growth and equally high valuations for U.S. large caps, we've not only stripped out that exuberance but added uncertainty in the near-term and raised the risk of a more significant economic misstep leading to a more significant re-rating of equity multiples. Investors' diminished risk appetites are not likely to bounce back to beginning of the year levels any time soon unless investor attention refocuses on the potential for AI-driven productivity growth, and we see some real progress in terms of stimulative tax policy and deregulation.

Europe and Asia. While the entire world is impacted by tariffs and protectionist policy, one must wonder whether that has spurred politicians in Germany and China, for example, to unleash their own stimulus. How that stimulus balances against potentially adverse impacts from the ongoing trade war is difficult to know. Non-U.S. markets may present less risk for investors, however, as both expectations and prices were quite low in both absolute and relative terms coming into this year. Nonetheless, recent market volatility shows that there is little discernment happening right now as global markets have been moving in closer lockstep in recent days/weeks. Apart from the U.K., interest rates across Europe, Japan and China are lower than they are in the U.S., which is another factor in their favor.

Evaluating the prospects ahead for the world outside of the U.S. will depend not only on U.S. trade policy, but also domestic demand and the ability and willingness to re-route trade to other trading partners around the world.

Fixed Income. Persistent, wild swings in interest rates have been the story recently in fixed income markets as investors contemplate expectations for future inflation, economic growth, and Federal Reserve interest rate policy. In addition, we have finally seen some cracks starting to show in the high yield markets, another indicator of investors' risk tolerance. Starting April 1, the Federal Reserve is further slowing the pace of reduction in its balance sheet by capping the amount of Treasuries it allows to roll off each month at \$5 billion, down from \$25 billion.² The path forward will largely depend on the mix of economic growth, inflation, and sentiment around the U.S. government debt. As with equities, bonds today neither offer such a compelling yield that one would wish to lock in for very long periods, nor much certainty on how much additional volatility may arise in the near-term. We remain focused on short-to-intermediate term durations and quality bonds with an eye on unique risks that may arise in various corners of the market.

The Micro (Bottom-up) Picture

We continue to maintain a bias towards Value stocks in our U.S. Large Cap and Developed non-U.S. equity exposures as gaps in valuation persist between growth and value styles.

Please reach out to your client advisor or [contact us here](#) for the full Tactical Allocation Viewpoints report, which includes detail on Pathstone's current recommended allocations by asset class and sub-class.

¹ <https://www.bls.gov>

² <https://www.federalreserve.gov/monetarypolicy/files/monetary20250319a1.pdf>

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