

Q1 2025: Gambit

By Peak Trust Company's Chief Investment Officer, Lisa Russell, CFA.

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HIGHLIGHTS

- U.S. markets faced a challenging first quarter. U.S. large-cap stocks ended the first quarter down 4%, while U.S. small-cap stocks declined by nearly 10%.
- The government is pursuing aggressive trade and fiscal policies, using tariffs, and reducing wasteful spending to restructure the federal debt—partly to support extending tax cuts.
- March saw a sharp drop in both investor and consumer sentiment, with tariff-related concerns cited as the key reason for their growing uncertainty.
- The Trump administration is making a high-stakes economic gambit by betting that short-term pain from tariffs and tighter fiscal policies will yield long-term gains in deficit reduction, domestic manufacturing, and rebalanced global trade.

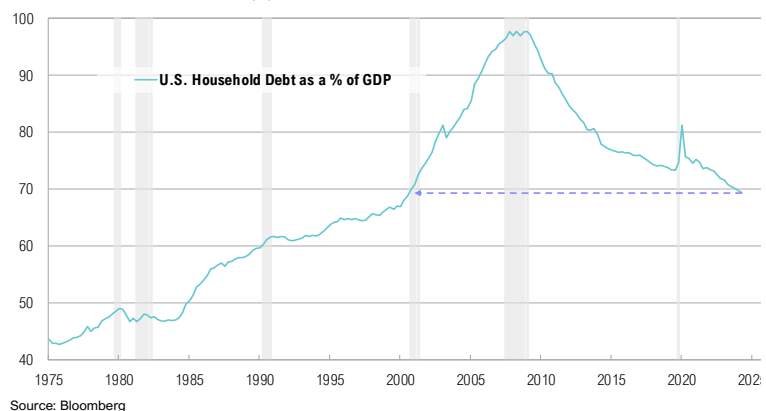
Overview

U.S. equity markets recorded the worst quarter for both U.S. large- and small-cap stocks since the second quarter of 2022. U.S. large-cap stocks, as represented by the S&P 500, ended the first three months of 2025 down 4.3%, while the small-cap Russell 2000 Index declined 9.5%. In contrast, U.S. fixed income markets fared better, with the Bloomberg U.S. Aggregate Bond Index gaining 2.8% in the first three months of 2025.

Final fourth-quarter results for gross domestic product (GDP), released at the end of March, confirmed that the U.S. economy continued its steady pace of growth throughout 2024. GDP growth for the fourth quarter was revised marginally upward, from 2.3% to an annualized 2.4%. Government spending increased at an annualized rate of 3.1%, while consumer spending grew by 4.0%—the strongest pace of 2024.

Personal income has grown steadily in 2025, rising 0.9% month over month in January, followed by another increase of 0.8% in February. Although personal savings remain below pre-pandemic levels, they have started to recover, reaching 4.6% in February as income growth outpaced spending.

Household Debt as a Percentage of GDP is At The Lowest Level Since 2001
U.S. Household Debt as a % of GDP



Meanwhile, U.S. household debt-to-GDP levels have declined to 70%—the lowest since 2001.

Inflation remains sticky, but there are promising signs. Headline inflation rose to 3.0% year over year in January before easing to 2.8% in February, aided by declines in food and energy prices. Notably, core inflation in February rose at the slowest pace since April 2021, increasing by 3.1% year over year. As expected, the Federal Reserve kept interest rates unchanged at its March Federal Open Market Committee (FOMC) meeting. Despite inflation above 2%, Fed officials still anticipate the equivalent of two 0.25% rate reductions in 2025, while market expectations for rate cuts increased from two 0.25% cuts to three, with the first cut expected in June. The Fed also announced plans to slow the pace of quantitative tightening, reducing its monthly runoff from \$60 billion to \$40 billion, with a maximum Treasury runoff of \$5 billion per month starting in April. Fed Chair Jerome Powell attributed this decision to the debt ceiling, which was reached in January.

The 2024 earnings season concluded in March, and S&P 500 earnings grew by a solid 11% for the year. Growth was led by the communication services (+23%), technology (+19%), and financial (+19%) sectors. Looking ahead, earnings growth estimates for the first quarter have declined from 12% at the start of the year to 7% by the end of March. At the sector level, healthcare (+36%), technology (+15%), and utilities (+10%) are expected to drive earnings growth in the first quarter.

Gambit

In chess, a gambit is a strategy whereby a player deliberately sacrifices a piece in the opening to gain a positional or tactical advantage. The goal is usually to achieve faster development, gain better control of the board, or put the opponent in a difficult situation. As the economy adjusts to reduced government spending and the impact of tariffs, President Donald Trump and Treasury Secretary Scott Bessent are willing to accept short-term economic pain to pursue potential long-term gains.

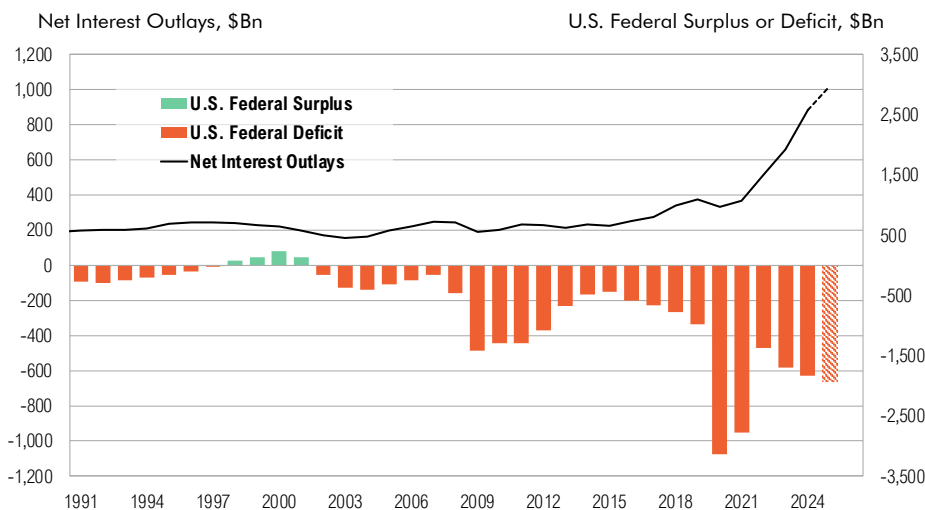
The Mar-a-Lago Accord is a conceptual economic strategy proposed by the Trump administration that aims to restructure the global financial system to reduce U.S. debt and address economic imbalances. Key elements of the proposal include boosting American manufacturing and restructuring U.S. debt by leveraging tariffs and geopolitical influence, including pressuring trade partners to absorb financial burdens and adjust currency values. Though not an official policy, the Mar-a-Lago Accord envisions reshaping global trade and finance by tying economic measures to national security (while sparking debate over its feasibility and risks).

The Trump administration's high-stakes economic gambit seeks to reduce government spending and increase revenue to

extend the expiring Tax Cuts and Jobs Act beyond its scheduled expiration at the end of 2025. The administration has also proposed eliminating income taxes on Social Security benefits, overtime, and tips, which would reduce government revenue by over \$1.5 trillion over the next 10 years.

The government has made it clear that reducing the fiscal deficit is a primary objective. The Department of Government Efficiency (or DOGE)—established to enhance government accountability and efficiency through strategic oversight and reform—claims to have already saved the government approximately \$140 billion. While this remains a small fraction of the \$1.2 trillion fiscal deficit

U.S. Federal Debt Is On An Unsustainable Path, and Requires Intervention



Source: Bureau of the Fiscal Service, Congressional Budget Office.

accumulated so far in this fiscal year, the initiative, spearheaded by Elon Musk, appears to have widespread support, at least for now. Treasury Secretary Scott Bessent has publicly endorsed Musk's efforts, "I am completely aligned with what Elon is doing." Public sentiment also favors cutting wasteful government spending. A recent Harvard CAPS-Harris poll of over 2,400 registered U.S. voters found overwhelming support for the government's policies on eliminating fraud and waste in government spending, as well as reducing previously allocated expenditures. The survey revealed that 77% of Americans believe a full review of government spending is necessary, while 83%—including 72% of Democrats and 94% of Republicans—agree that spending should be cut.

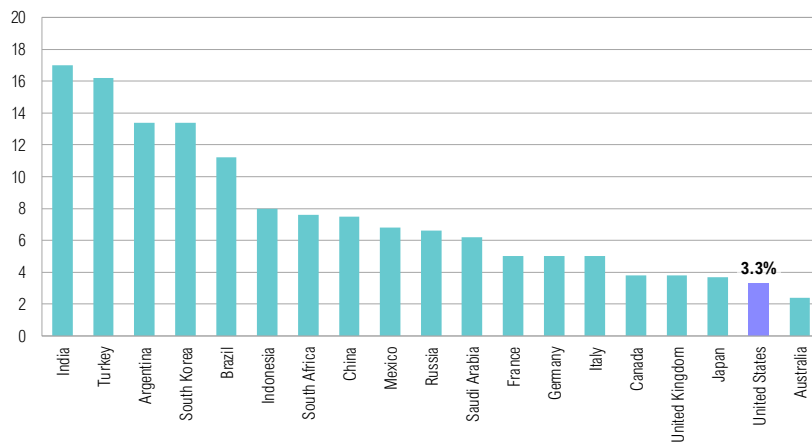
One of the Trump administration's opening moves has been implementing aggressive targeted tariffs on various countries and global trade sectors, citing national security and economic interests. On April 2, baseline tariffs of 10% were announced on all imports to the U.S., and higher rates were implemented for major trading partners. U.S. trade partners with the highest reciprocal tariffs include China (54%), the European Union (20%), Vietnam (46%), South Africa (30%), and Japan (24%). Unlike China, Canada and Mexico avoided additional tariffs. The Trump administration also confirmed a 25% tariff on all foreign-made automobiles.

In 2018, during his first term, President Trump tweeted:

"The European Union is coming to Washington tomorrow to negotiate a deal on trade... Both the U.S. and EU [should] drop all tariffs, barriers, and subsidies. That would finally be called [a] free market and fair trade...."

The U.S. Had Among the Lowest Average Tariff Rates of All G20 Countries

Average Tariff Rate, %



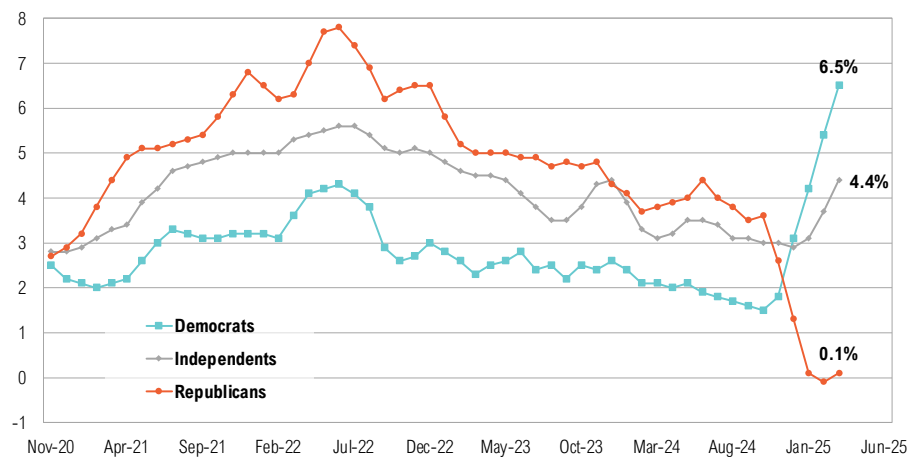
The Trump administration appears to be leveraging tariffs for two primary purposes: as a negotiating tool and as a macroeconomic strategy. When used as a macroeconomic tool, these tariffs are designed to protect domestic U.S. industries and encourage reshoring. Unlike most countries, the U.S. has historically maintained relatively low trade barriers, with an average tariff rate of roughly 3%. A third reason for aggressive tariffs on Canada and Mexico was to curb drug trafficking and stop the flow of drugs crossing into the U.S. via neighboring borders. Recent data from the U.S. Customs and Border Protection show drug seizures in February dropped to the lowest level in at least three years.

Several countries have already proposed tariff cuts on U.S. imports in efforts to avoid reciprocal tariffs. To avoid or mitigate tariffs, global corporations have also pledged nearly \$1 trillion in U.S. investment since Trump's inauguration. Apple, for example, has committed \$500 billion over the next four years, while Taiwan Semiconductor plans to invest \$100 billion to advance semiconductor manufacturing in the U.S., and South Korea's Hyundai is investing \$21 billion over the next three years to improve the U.S. supply chain and build a new steel plant in Louisiana.

But all gambits come at an immediate cost. Investor sentiment declined sharply in March. The American Association of Individual Investors (AAII) sentiment survey showed bearish sentiment rising to a one-year high of 61% in the last week of February, and sentiment remained negative throughout March. An average of 58% of survey respondents expressed a bearish outlook for U.S. equities over the next six months. Similarly, the Bank of America's Global Fund Manager Survey in March recorded the largest pullback in investor sentiment in five years. In just three months, the percentage of fund managers overweight in U.S. equities fell from a record-high level to one of the lowest levels in over 20 years. While the National Federation of Independent Businesses (NFIB) Small Business Optimism Index remained above average in February, the Small Business Uncertainty

Depending on Political Affiliation, Consumer Inflation Expectations Notably Differ

1-Year Inflation Expectations by Political Party, %



Source: University of Michigan

Index rose to its second-highest level on record since 1975.

Consumer confidence followed a similar downward trajectory. The Conference Board's Consumer Confidence Index in March fell to its lowest level since the pandemic, and the University of Michigan's survey recorded its lowest sentiment reading since November 2022. The University of Michigan survey also found that expectations for personal finances hit the lowest level since 1978, and an unprecedented 51% of respondents made unsolicited negative comments about government economic policy. Depending on political affiliation, consumer inflation expectations notably diverged over the quarter. Those

identifying as Democrats expect inflation to more than double, rising to 6.5% over the next year, while Republican-leaning survey respondents believe that inflation is going to all but disappear over the next 12 months. Across both investor and consumer surveys, tariffs were cited as the primary driver of growing uncertainty.

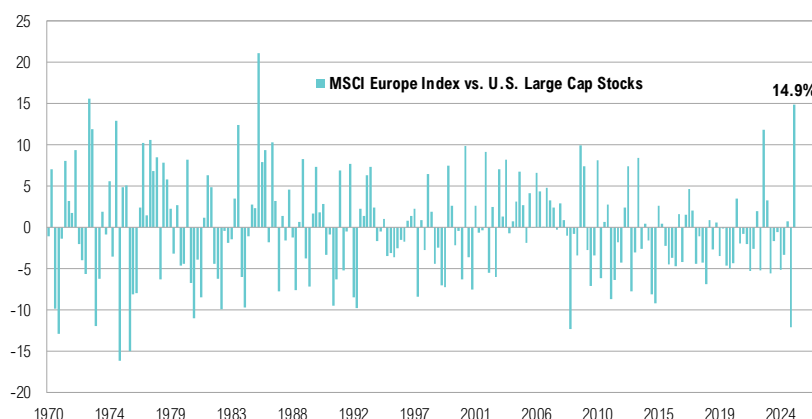
The Federal Reserve's latest economic projections, released at the March Federal Open Market Committee meeting, suggest that they believe tariffs are unlikely to have a lasting impact on inflation. While year-over-year inflation expectations for 2025 have risen from 2.5% to 2.8%, the Fed forecasts inflation to decline to 2.2% in 2026 and 2.0% in 2027, indicating that any potential tariff-related price pressures may be temporary. The Fed's 2025 outlook expects a slight slowdown in economic growth (from 2.1% to 1.7% year over year), and unemployment is projected to remain near historic lows at 4.4%.

Markets

U.S. equity markets reached a stalemate in March. Large-cap stocks fell over 4% for the month, capping off their worst quarter since early 2022 and underperforming global equities by the widest margin since 2009. Returns were partially offset by European equities having their strongest quarter relative to the S&P 500 since September 1985, outperforming U.S. large-cap stocks by 15% when the Plaza Accord was signed with the goal of weakening the dollar to reduce the U.S. trade deficit. U.S. small-cap stocks ended the quarter down nearly 10%, their worst quarterly performance since the second quarter of 2022 when the Russell 2000 declined by 18%.

European Equities Outperformed U.S. Equities By the Most Since September '85

MSCI Europe Index vs. U.S. Large Cap Stocks, Quarterly Differential %



Source: Bloomberg. U.S. large cap stocks as represented by the S&P 500 Index.

The Magnificent Seven—Apple, Microsoft, Amazon, Alphabet, Nvidia, Meta, and Tesla—have been a driving force behind the S&P 500's rally in recent years, fueled by strong fundamentals, market leadership, and exposure to transformative trends like artificial intelligence. However, together, the group ended the first quarter down 16%, driven by Tesla (-36%), Nvidia (-19%), and Alphabet (-18%). The downturn in stock prices led to a pullback in valuations, bringing the Magnificent Seven's valuation premium relative to the rest of the S&P 500 to its lowest level since 2017.

International equity markets outperformed U.S. equities in the first quarter of 2025. Large-cap stocks in developed international markets outpaced their U.S. counterparts by more than 10%, with the MSCI EAFE Index gaining 7%. In Europe, investor optimism—fueled by an \$860 billion defense spending package—helped push the MSCI Europe up 11% during the quarter. Of note, German stocks, proxied by the MSCI Germany Index, rallied 16%.

Among emerging markets, Brazil (+14.1%) and China (+15.0%) led the gains. Meanwhile, after reaching a two-year high on January 13, the U.S. dollar weakened, ending the quarter down 4%. This sharp reversal in performance brought relative valuations between U.S. and non-U.S. stocks back in line with their five-year average, although they remain above longer-term averages.

Fixed-income markets had a strong start to the year, with U.S. intermediate-term bonds gaining 3% over the quarter. After rising to 4.8% in mid-January (the highest level since October 2023), the 10-year U.S. Treasury yield ended March below 4.2% due to rising uncertainty surrounding tariffs. The yield curve (the spread between the 10-year and 2-year Treasury yields) remained positive throughout the quarter, finishing March at 0.3%.

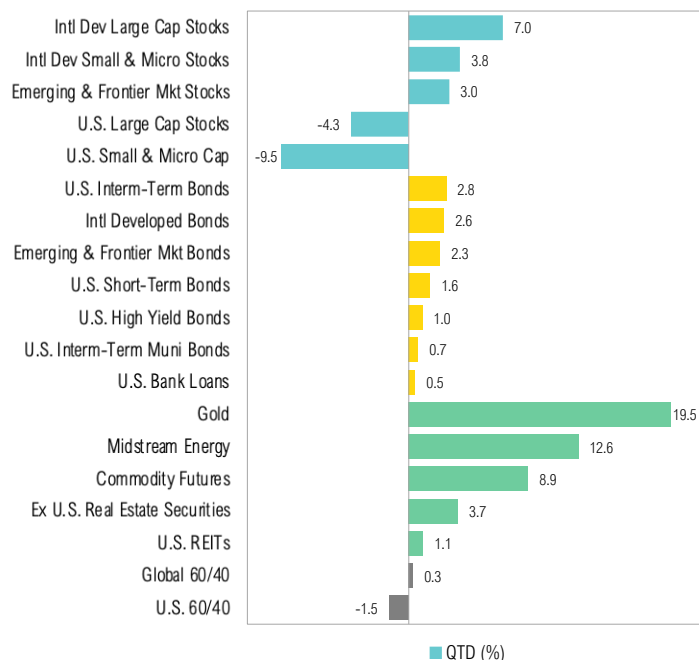
Gold gained 20% over the quarter, closing March at a new all-time high above \$3,100. West Texas Intermediate (WTI) crude oil prices declined by \$7 per barrel over the quarter to end at \$71 per barrel, despite news of slowing U.S. oil production, which in January fell to the lowest level in a year.

Looking Forward

President Trump and Treasury Secretary Bessent appear to be playing the long game, hoping that consumers and markets—particularly bond markets—will look beyond a short-term period of uncertainty, or “detox” in the words of Bessent, in exchange for the long-term benefits stemming from a reduced fiscal deficit, increased domestic manufacturing and reshoring, economic growth, and more balanced global trade practices. In many ways, their approach resembles a gambit in chess—deliberately sacrificing short-term stability in pursuit of long-term gains. The key question remains: Is this a calculated risk that will ultimately pay off or will this so-called chess game end in checkmate for U.S. economic growth?

Peak is paying close attention to the latest developments as well as all the hard data that come out. Even with the negativity and pessimism during this quarter, a global 60/40 portfolio was still slightly positive on the year with the help of international stocks, gold, and fixed income. Diversification worked as intended.

Q1 2025 Key Market Total Returns



Source: Bloomberg

About Lisa

Lisa Russell started with Peak Trust Company in 2003 and currently serves as Chief Investment Officer. Lisa brings over 25 years of investment experience to the Peak team. She specializes in designing unique investment programs for high-net-worth clients and trust accounts. She is highly attuned to the tax consequences of investment actions.

Lisa holds a Master of Business Administration in Finance from Emory University and a Bachelor of Science in Business Administration from the University of Southern California. Lisa holds the designation of Chartered Financial Analyst (CFA), and is a member of the CFA Institute and the CFA Society of Seattle.



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