PENOBSCOT
FINANCIAL ADVISORS

MARKET COMMENTARY
Q1 2025

MARKET REVIEW

The first quarter of 2025 was marked by significant volatility in global financial markets, primarily driven by escalating trade tensions following the Trump administration's announcement of new tariffs. Investors grappled with the potential implications of these policies, leading to a cautious and defensive market stance.

U.S. equities faced considerable challenges this quarter. The S&P 500 recorded a 4.6% decline, marking its worst quarterly performance since 2022. Concerns over potential stagflation, spurred by the administration's tariff plans, weighed heavily on investor sentiment. Notably, major technology firms such as Nvidia, Tesla, Apple, and Microsoft experienced significant losses during this period. Conversely, defensive sectors like consumer staples and utilities demonstrated resilience, with companies like CVS Health and Philip Morris posting gains of 50.9% and 31.9%, respectively.

Despite challenges in the U.S. equity markets, several areas posted strong performance in the first quarter of 2025. European equity markets showed notable resilience, supported by improving economic data, a pickup in manufacturing activity, and stabilizing energy prices. The Euro Stoxx 50 index rose modestly, reflecting investor optimism around the region’s recovery. Meanwhile, bond markets also delivered positive returns as falling inflation expectations and renewed interest in risk-off assets led to a broad rally in both sovereign and corporate bond prices. Declining yields across the curve provided a tailwind for total return strategies, and high-quality fixed income saw renewed inflows amid heightened market uncertainty. The Federal Reserve maintained a cautious approach amid the prevailing economic uncertainties. While the benchmark interest rates remained unchanged during the quarter, the central bank signaled readiness to adjust monetary policy as necessary to address evolving economic conditions. Markets priced in expectations that the Fed may cut more than the two times it forecasts, particularly if recent tariff and market upheaval slow the economy into a recession.

Commodity markets experienced notable movements in Q1 2025. Gold prices surged to record highs as investors sought safe-haven assets in response to market volatility. Energy commodities, particularly natural gas, showed strength despite concerns of oversupply in oil markets. Agricultural commodities also experienced a rebound, contributing to the overall positive performance of the commodity sector.

Well-balanced portfolios survived Q1 relatively well despite domestic stock upheaval, with most flat to slightly negative. Diversification can lose popularity during periods where returns are concentrated in one part of the market, but, if nothing else, this quarter demonstrated the importance of maintaining a disciplined asset allocation.

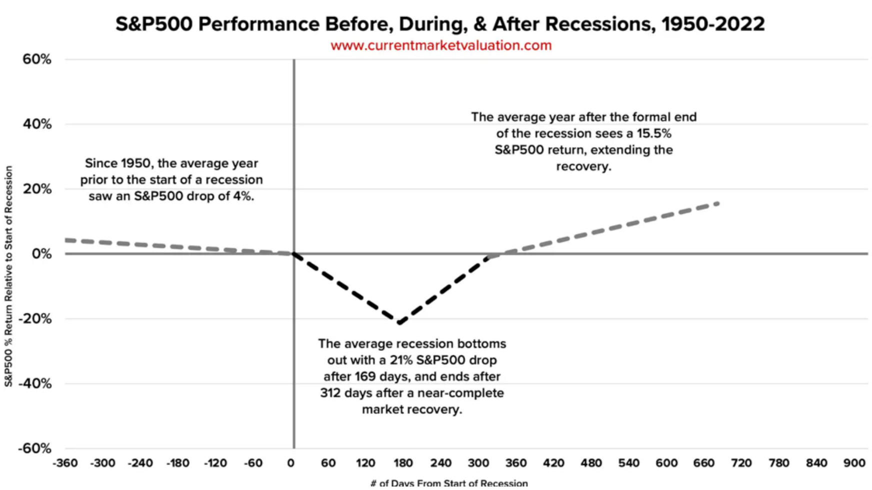
LOOKING FORWARD

RECESSION: ARE WE ALREADY THERE?

It's hard to predict with certainty when a recession will start. In fact, the National Bureau of Economic Research (NBER), who is seen as the arbiter of when recessions start and end, uses backward looking data to determine not only if the U.S. economy is in recession, but WHEN it started. Simply put, we are almost always in a recession weeks or months before the NBER says we are. That said, the U.S. economy may already be in a recession, driven not by organic economic deterioration but by policy-induced shocks—namely tariffs. While consumer spending and employment have held up, there are now 17 consecutive weeks of downward earnings revisions, suggesting that recessionary pressures are mounting beneath the surface.

THE LONG AND SHORT OF BEAR MARKETS

As we start the second quarter, we find the S&P 500, Nasdaq and Dow Jones Industrial average all sliding into the 'Bear Market' category (falling more than 20% from a prior high). This kind of market volatility can create its own recessionary conditions, as consumers and industry pull back on purchases considering market conditions. From an investor's standpoint, though, much of the market drawdown usually happens early in a recession. In fact, market recovery has started prior to the end of every recession over the last 50 years.

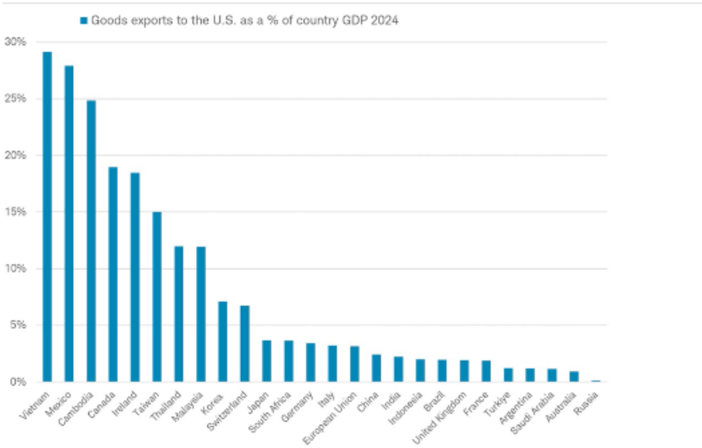


While bear markets can feel especially painful in the moment, history offers reassuring perspective: they tend to be both shorter and less impactful than bull markets. According to data from Invesco and First Trust, the average bear market since World War II has lasted about **13 months**, with an average decline of around **33%**. In contrast, the average bull market lasts approximately **64 months**—five times longer—and delivers gains averaging **166%**. This disparity underscores the importance of maintaining a long-term investment strategy and not making emotional decisions during downturns. Markets historically spend far more time climbing than falling, and the biggest gains often follow the steepest declines.

THE REAL WORLD OF TARIFFS

Tariffs are a tax on imported goods. Importers collect the tariffs from domestic buyers who may, in return, pass the higher costs on to their customers. This would be expected to result in declining profits for companies who purchase goods at higher costs, and increases to the costs borne by consumers when companies raise prices to offset the hit to profitability.

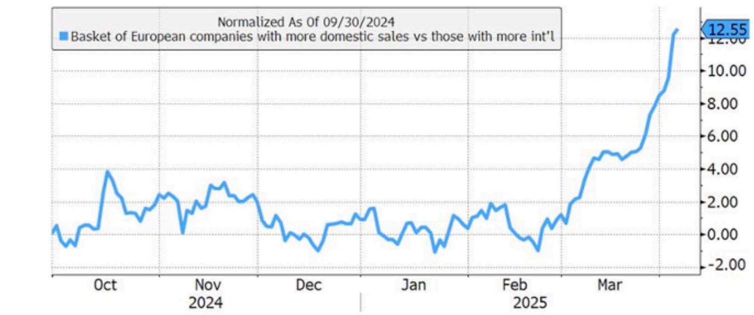
Predicting the trajectory and outcomes of a global tariff trade war is exceptionally difficult due to the sheer number of moving parts and the wide variation in country-level exposure to U.S. trade. While some economies—like Vietnam, Cambodia, and Mexico—have significant portions of their GDP tied directly to exports to the U.S., others, including most of the European Union, have relatively limited economic dependence on U.S. trade flows. This divergence in exposure results in varied incentives and response strategies, complicating any forecasts about which countries may concede, retaliate, or seek alternative trade alliances. Overlay this with the political calculus in both the U.S. and abroad, and the volatility in policy direction, and it's clear why markets are struggling to price in a coherent endgame.



Source: Charles Schwab, U.S. Bureau of Economic Analysis, IMF World Economic Outlook (Oct 2024), data retrieved 4/6/2025

Even within the boundaries of a country, there can be significant dispersion in how stocks perform in the face of a trade conflict. European stocks with a greater share of domestic revenue significantly outperformed their internationally-focused counterparts in the first quarter. This trend reflects investor preference for companies less exposed to global trade tensions and U.S. tariffs. Domestically oriented firms have been better insulated from export-related disruptions and have also benefited more directly from region-specific stimulus measures, particularly in countries like Germany. The performance gap illustrates how, in times of geopolitical and trade uncertainty, local revenue exposure can serve as a relative safe haven within equity markets.

European stocks with less US tariff exposure outperform



Source: Charles Schwab, Bloomberg, Goldman Sachs, data as of 4/2/2025. Performance normalized, or set to zero, at 9/30/2024. **Past performance is no guarantee of future results.**

SCFR Schwab Center for Financial Research

VALUE STILL TO BE FOUND?

Small-cap and value stocks are currently trading at some of the deepest discounts relative to the broader market that we've seen in years. This valuation gap has been driven in part by investors crowding into larger-cap, growth-oriented names—particularly those tied to AI and technology—while steering clear of more cyclical and economically sensitive segments of the market. Uncertainty around interest rates, recession risk, and access to capital has further weighed on smaller companies.

Small-Cap Stocks Continue to Trade at Deep Discount Relative to Broad Market Valuation

Source: Morningstar Research Services, LLC. Data as of March 24, 2025.

However, for patient investors, these depressed valuations may represent a compelling opportunity. Historically, small-cap and value stocks have delivered strong returns coming out of economic slowdowns, and the current dislocation could offer a favorable entry point for long-term capital.

Value Stocks Continue to Trade at a Deep Discount Relative to Broad Market Valuation

Source: Morningstar Research Services, LLC. Data as of March 24, 2025.

OUR TAKE

As we move into the second quarter, several core themes remain front and center in our investment outlook. First, the importance of portfolio diversification cannot be overstated—especially in markets as volatile and policy-driven as the one we face today. Spreading risk across asset classes, geographies, and investment styles provides a much-needed buffer when headline-driven volatility sends markets swinging.

Second, we continue to search for value in areas of the market that have been overlooked or undervalued. With certain segments—particularly large-cap growth and AI-related stocks—still trading at elevated valuations, we believe selectivity matters more than ever. Areas like small-cap, value-oriented equities, and high-quality fixed income present opportunities for long-term investors willing to look beyond recent performance.

Finally, we're reminded that discipline is one of the most powerful tools in an investor's toolkit. The temptation to abandon a well-structured plan often peaks during periods of heightened fear. But as history repeatedly shows, markets tend to bottom when sentiment is darkest—and the investors who stay committed are often the ones best positioned to benefit from the recovery.