Economic Overview

Steve Scranton, CFA, SVP, Economist

Economic growth appears to have slowed in the 1st quarter compared to the 4th quarter of 2024. Unfortunately, given the fiscal policy volatility and uncertainty that existed during the quarter, economic forecasts are also volatile and uncertain. To give some perspective, the Atlanta Federal Reserve's GDPNow model is forecasting negative growth of -2.8% while the New York Federal Reserve's Nowcasting model is forecasting positive growth of 2.9%. We will not find out the first official estimate of 1st quarter growth until the end of April. What must be kept in mind regarding 1st quarter growth is that not only did fiscal policy uncertainty play a role, but severe winter weather was also a factor during the quarter.

Consumer Spending

The impact of severe winter weather showed up in the January data for consumer spending. Real personal spending fell 0.6% in January after growing 0.6% in December. Spending rebounded in February, but the rebound was muted. Spending rose 0.1% in February. The slow pace of spending was not due to a lack of income. Real disposable personal income (income after inflation and taxes) rose steadily in January and February. Real disposablel income rose 0.1% in December, 0.3% in January and 0.5% in February. It appears that the combination of weather plus fear and uncertainty over government layoffs, threats to government aid programs and pending lawsuits challenging fiscal policy may have rattled the confidence of consumers and caused them to slow their spending.

Business Spending

The news was more positive on the business spending side as businesses continue to invest in equipment and software to increase productivity. The regional manufacturing indices showed improvement during the quarter with some moving back into positive territory. Industrial production slowed in January from the 1.1% growth rate in December to 0.3% in January. Weather was clearly a factor in the slowdown. Activity picked up in February as industrial production grew 0.7%. It appears that many businesses decided to stock up on inventory before tariffs were put in place as wholesale inventories increased 0.8% in January and 0.3% in February. That compared to -0.7% in December. Retailers were more cautious as consumers spending slowed. Retail inventories rose 0.1% in both January and February after falling -0.5% in December.

Government Spending

Even with all of the changes (real or threatened) over government jobs, agencies and aid, government spending was still occurring in the 1st quarter. Congress passed another continuing resolution to keep the government funded over the near term, so any major changes to government spending remain to be determined.

Although it appears that economic growth slowed in the 1st quarter, it is not clear whether weather or fear and uncertainty had the biggest impact since most of the economic data is through February. Once we receive March data in April, we will be better able to gauge what drove slower economic growth in the 1st quarter.

Strategy Review

Derrick Wilson, CIMA®, VP, Portfolio Manager

Diversification proved more relevant this past quarter than in recent years. In January, the emergence of DeepSeek, a Chinese artificial intelligence (AI) firm offering more efficient, lower-cost models, disrupted the highly valued US tech sector. The market peaked in mid-February before declining. Meanwhile, fluctuating tariff policies fueled uncertainty about corporate responses. Markets also appeared to adjust for a slowing US economy and ongoing global economic shifts.

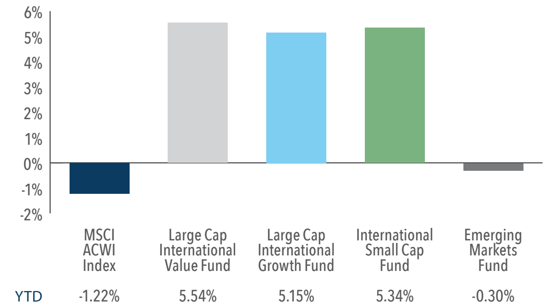
Global equities declined in the first quarter, primarily weighed down by the US market. Excluding the US, international equities had a strong quarter, posting high single-digit returns. The S&P 500 fell 4.27%, while international equities gained 5.36%. Developed markets led with a 7% rise, while emerging markets gained 3%. Large-cap stocks continued outperforming small caps, but a major shift occurred in style, with value stocks significantly outperforming growth. A weakening US dollar supported international investments, further underscoring the benefits of diversification beyond the US and a handful of dominant companies.

Bonds were more stable than in previous volatile quarters, showing a return to more predictable movements. Stock-bond correlations declined, nearing historical norms. As equities fell, bonds gained. The Bloomberg Aggregate Bond Index rose 2.78%, while short-term investment-grade bonds increased 1.63%. Short-term TIPS led fixed income, gaining 3.40% as inflation expectations climbed. Riskier bonds saw smaller gains, with high-yield bonds rising less than 1% as credit spreads widened. Bonds served as a strong diversifier and provided a cushion against equity market volatility.

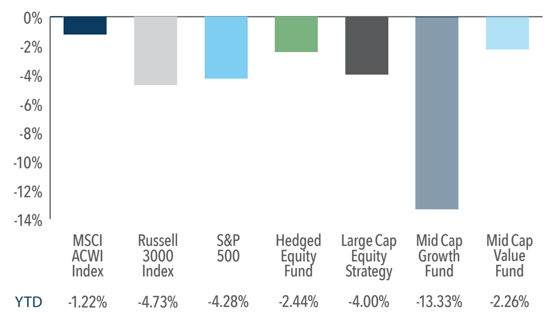
Alternative strategies outperformed bonds and delivered strong results. Broad commodities rose nearly 9% as tariffs and geopolitical events drove prices higher. Gold surged 19% to a record high as demand for safe-haven assets increased. Real assets, including global infrastructure and real estate, gained 4.60% and 2.75%, respectively. Managed futures trend-following strategies, benefiting from long and short positions across markets, posted a gain over 4%. Global macro strategies were in line with bonds between 2% and 3%. Diversifying across asset classes helped mitigate equity market volatility and offered additional stability.

The exceptional returns in US equities over the past two years made the recent pullback a reminder of market cycles. While riding the wave up can be rewarding, downturns can be swift and unpredictable. Diversification may not always be exciting or appear immediately effective, but it remains essential for managing risk and maintaining long-term financial stability.

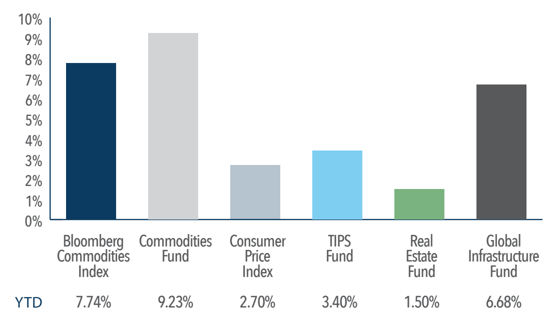
INTERNATIONAL DIVERSIFICATION
YEAR-TO-DATE PERFORMANCE



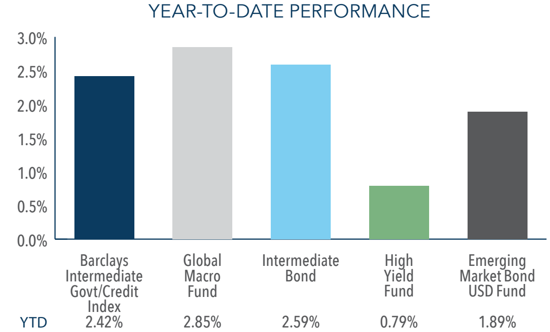
DOMESTIC DIVERSIFICATION
YEAR-TO-DATE PERFORMANCE



REAL RETURN (INFLATION PROTECTION) DIVERSIFICATION
YEAR-TO-DATE PERFORMANCE



INCOME DIVERSIFICATION
YEAR-TO-DATE PERFORMANCE



Domestic Equities

Gayle Sprute, VP, Senior Portfolio Manager

What in the world happened to US stocks during the 1st quarter? After wonderful gains in 2024, the market got off to a positive start in January. Investor sentiment was upbeat and "US Exceptionalism" became a popular phrase. Incoming President Trump's expected agenda items brought hope of deregulation, possible tax cuts, and generally pro-growth policies. The equity market initially viewed tariff threats primarily as negotiating tactics and little impact was factored in at that time – particularly since there was no structure for possible tariffs. Many thought the market was set for another year of gains and January brought a nice month of performance.

However, market psychology shifted sharply in February – to that of "risk off" and flight to safety. Immediately after inauguration, President Trump announced that a 25% tariff could be imposed on Mexico and Canada as soon as February 1st. As the weeks wore on, the tariff narrative broadened in geographic scope and magnitude. In addition, some higher-than-expected inflation data came out in late January and into February. This triggered concern that disinflation momentum could be stalling and that the implementation of tariffs could bring inflationary pressures. Hope began to fade for interest rate cuts by the Federal Reserve.

Mounting uncertainty about tariff policy, inflation, the economic landscape, and interest rate policy kept downward pressure on sentiment (and stock prices) and ultimately led to a market correction in mid-March (a decline of 10% from peak levels) for the major domestic indices. Notably, the Dow Jones Industrial Average (Dow) narrowly escaped correction territory.

The January gains helped mitigate the losses that came in February and March. As such, the major domestic indices' performances for the overall quarter were: Dow -0.9%, S&P 500 -4.3%, Nasdaq Composite -10.3%, Russell Mid Cap -3.4%, and Russell 2000 -9.5%. Market shifts and rotations under the surface illustrate the flight to safety and defensive areas amidst the rising level of concern. In terms of style, value rose by 0.3%, significantly outperforming growth which fell by 8.5%. Sector leadership came from energy, up 10.2%, healthcare, up 6.5%, and consumer staples, up 5.2%. Laggards were consumer discretionary, down 13.8%, information technology, down 12.6%, and communication services, down 6.2%. The Magnificent Seven group of companies (the mega cap tech & growth companies that were spectacular performance leaders during 2023 and 2024) fell by 15.7% as money flowed away from growth and high-valuation companies.

This was a tough quarter and investor anxiety remains quite elevated as the 2nd quarter gets underway. The worse-than-expected tariff news on April 2nd only added fuel to the fire of worry. The rapidly evolving policy landscape has caused heightened uncertainty for businesses, consumers, and investors, leading to increased caution and the market's flight to safety. While the Trump Administration has been prioritizing tariff strategy (and negotiations are likely to go on for an extended period of time), we still anticipate the implementation of pro-growth policies, such as deregulation and tax cuts, among others, which should help support market sentiment over time.

Fixed Income

Callen Young, VP, Portfolio Manager

The bond market started 2025 on solid footing, with Treasuries posting three consecutive months of gains. Investor sentiment shifted as the prospect of new tariffs – set to take effect in April – hit economic growth expectations and rattled equity markets. This strengthened the case for Federal Reserve rate cuts and fueled demand for bonds. However, the quarter was not without complications. Even as growth concerns mounted, tariff threats from the Trump administration pushed short-term inflation expectations to multi-year highs. The result was a bond market caught between two competing forces: worries that trade policy will slow the economy while simultaneously driving short-term price pressures higher.

The Federal Reserve, for its part, has remained cautious. The March FOMC meeting saw no change in interest rates, but officials lowered GDP forecasts while raising inflation projections. Chair Jerome Powell attempted to reassure markets that any tariff-driven bump in inflation would be "transitory," though the bond market isn't entirely convinced. Traders are betting that the Fed will ultimately prioritize weaker growth over persistent inflation, pricing in three rate cuts for the year – more than the central bank itself has signaled. This tug-of-war left the bond market in a holding pattern for much of March, with yields staying range-bound as investors waited for clearer signals from economic data and policymakers.

Despite the uncertainty, bonds delivered exactly what they are meant to: stability, income, and risk mitigation. Treasury yields fell significantly from their January peaks, with 2-year, 3-year, and 5-year yields declining between 50 and 68 basis points. The 1-5 year government/credit index returned 2.02% year to date. A notable shift in correlations also emerged, with short-duration bonds once again providing diversification benefits after a period of tighter linkages with equities.

Municipal bonds faced headwinds in Q1, weighed down by budget negotiations in Congress and speculation over potential tax law changes. Though unlikely, rumors of repealing the muni tax exemption caused investor hesitancy, just as the market absorbed the largest quarter of new muni issuance since 2007. This combination muted muni returns, leaving them looking attractive heading into Q2, particularly for high-tax-bracket investors, where tax-equivalent yields now exceed 4.5%. Meanwhile, credit markets remain steady, and CDs have regained favor, offering creditworthy yield alternatives with spreads around 30 basis points over Treasuries.

As we look ahead, the key question is whether weaker business sentiment will translate into a broader economic slowdown, justifying rate cuts. Trade policy remains a wild card, and uncertainty around fiscal policy continues. Through it all, bonds continue to serve their purpose – offering stability amid volatility.

International

Matthew Clarke, CIMA®, VP, Senior Client Portfolio Manager

The first quarter of the year was tough for domestic investors as post-election exuberance gave way to investor anxiety about policy uncertainty and rising geo-political risks. However, **globally diversified portfolios stood out as European stocks realized their strongest quarter in decades** – initially fueled by a "valuation rotation". Put another way, international is en vogue again, proving that diversification still works.

For more than a decade, international stocks have traded at a discount relative to their US peers. In fact, as of March 31, the MSCI Europe, Australasia, and Far East (EAFE) was trading at a forward price to earnings (PE) ratio of 14.9x vs. the S&P 500 at 20.7x. Attractive valuations are just one reason for the rotation into international stocks. Investors also found international stocks to be an attractive option as concerns about stagflation in the US began to mount. Additionally, and later in the quarter, Germany shifted further away from austerity by voting to significantly increase defense and infrastructure spending by creating a €500 billion infrastructure fund. This helped to foster a tailwind for the German markets, **lifting the German DAX by 11.32% over the quarter** and helping the MSCI EAFE return 9.27% compared to the S&P 500 at -4.28%.

Emerging market equities also had a solid quarter and owe much of it to China. The MSCI China index returned an impressive 15.25%, helping the MSCI Emerging Markets index return 4.67%. China's markets benefited on two fronts: developments in technology and government stimulus. Companies like DeepSeek and Tencent demonstrated gains in technology and artificial intelligence (AI), significantly narrowing the gap with the US. At the same time, stimulus measures, including wage increases for millions of government workers as well as additional support for the real estate and banking sectors, helped to lift their markets.

Global bonds were mixed over the quarter, finishing with modest returns. The Bloomberg Global Aggregate (measure of global investment grade debt) finished higher by 2.64%. US Treasuries returned 2.9% on growing concerns about the potential of recession in the US. German bunds were lower by -1.6% on Germany's aforementioned pivot away from austerity. Finally, Japanese Government Bonds (JGB) closed out the quarter even lower (-2.4%) as inflationary pressures pointed to the potential of additional rate hikes.

As we navigate the year ahead, the view continues to be clouded by mounting uncertainties about trade policy, inflationary pressures, geo-politics and slower economic growth. Our perspective has not changed in that we continue to advocate the importance of **staying disciplined, diversified, and maintaining long-term perspective.**

Additional and expanded information to this newsletter discussion may be obtained by contacting your relationship manager. We will be happy to expand our discussion with you to meet your individual requirements as a client of Wealth Management & Advisory Services.

Contact Our Advisors

Western Washington

Seattle
601 Union St., Suite 3100
Seattle, WA 98101
206.667.8954
888.254.0622

Bellevue
10500 NE 8th St., Suite 1100
Bellevue, WA 98004
425.467.1781
888.445.7166

Spokane
717 W Sprague Ave., Suite 900
Spokane, WA 99201
509.353.3898
800.725.4449

Portland
760 SW Ninth Ave., Suite 1900
Portland, OR 97205
503.778.7060

Southern Idaho / Boise
945 W Bannock St.
Boise, ID 83702
208.345.3343

North Idaho
218 Lakeside Ave.
Coeur d'Alene, ID 83814
208.667.7993

Washington Trust Bank
Wealth Management & Advisory Services