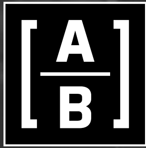


BERNSTEIN

Regime Change

I have titled this letter "Regime Change." But before you dismiss this as yet another political discussion, let me clarify: it's about a shift ***in the markets*** and virtually nothing to do with politics.

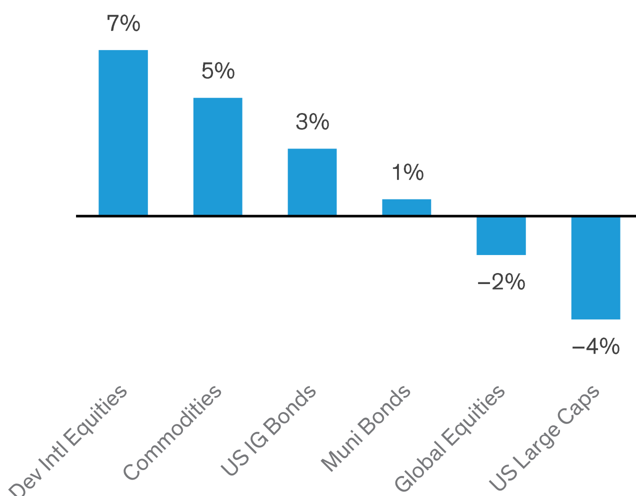
Based on a single metric—the number of meetings our client-facing investment professionals have conducted in the first three months of the year (our busiest quarter since the pandemic)—I know that politics and market dynamics are on everyone's mind. Invariably, the impact of the current administration and their policies are among the top concerns our clients wish to discuss. So, while being extra careful, my aim is to focus 80% on markets and the economy and 20% policy. Let's see if I hit the mark.

Q1 2025 Wrapped

After two straight years of relatively low volatility and strong returns for all assets, particularly US large-cap stocks, the first quarter of 2025 was a reminder that markets can be turbulent and not all trends last.

DISPLAY 1: YEAR-TO-DATE RETURNS OF MAJOR ASSET CLASSES

Percent



As of March 31, 2025.
Source: Bloomberg and Bernstein analysis

Developed international stocks led the way this quarter, climbing 7% and beating US stocks by 11%! While one quarter does not make a market, it does reflect the snapback investors experienced. Commodities rose almost 5% as inflation concerns persisted and geopolitical tensions grew. Investment grade taxable bonds followed closely, returning about 3%, with US bonds rallying as investors sought protection. Municipal bonds returned around 1%. Overall, global equities were down 2%, as strong international returns were offset by a 4% year-to-date drop in US large caps. This figure, however, understates the peak-to-trough decline that has captured headlines and stressed investors, with the S&P 500 down around 10% from its mid-February highs.

When Policy Enters the Chat

While the recent volatility has been tough for some to endure, it has largely reversed the outsized gains seen after the election. Markets rose, and now they seem to be coming down. How did we get here?

Following the election, stocks surged as the market optimistically priced in favored aspects of the first Trump administration—namely, stimulative fiscal policies and corporate tax cuts. At the same time, the bond market had a more measured reaction, with yields rising to account for both higher expected inflation and the increased risk of unexpected inflation and macroeconomic uncertainty. One-year inflation expectations, as measured by inflation swaps, rose from around 2% in October to 2.8% just after the election and reached over 3.2% at the end of March. By and large, that upward march represented the market pricing in the impact of widely expected tariffs.

What about this year? Concerns about a growth shock and a rotation into safe assets have driven yields back down while causing defensive sectors to outperform at the expense of more cyclical ones. This trend was particularly evident in growth stocks—the market's recent darlings. And given the significant weight of growth stocks in the market, their fall from grace has been felt across the board.

Where To From Here?

When it comes to thinking about markets and where the economy may go from here, two key points of context are crucial. First, the equity markets—especially US large-cap stocks—have had an impressive run for two years, gaining around 25% in both 2023 and 2024. While the first year primarily offset 2022's decline, overall, it's been a solid period for stocks since the pandemic. This recent pullback pales in comparison to that longer-term run (*Display 2*), a halcyon stretch affectionately dubbed "The Good Old Days" (with tongue in cheek, of course).

The second crucial piece of context? The significant positive momentum with which the economy entered this year. Inflation has eased in recent quarters, yet at the same time, economic activity and the labor market remain robust. The US economy has been growing faster than most estimates of its potential for several years, outperforming all other advanced economies in the wake of the pandemic. And the labor market, which previously overheated, has returned to a healthy balance. We've seen low unemployment, new entrants being absorbed at a steady rate, and wages growing moderately ahead of inflation without stoking it. The total value of US GDP is just shy of $30 trillion; while not impervious to shocks, it takes fairly massive impacts to derail such a sizable economy. Policy considerations aside, the bar for causing such disruption is high.

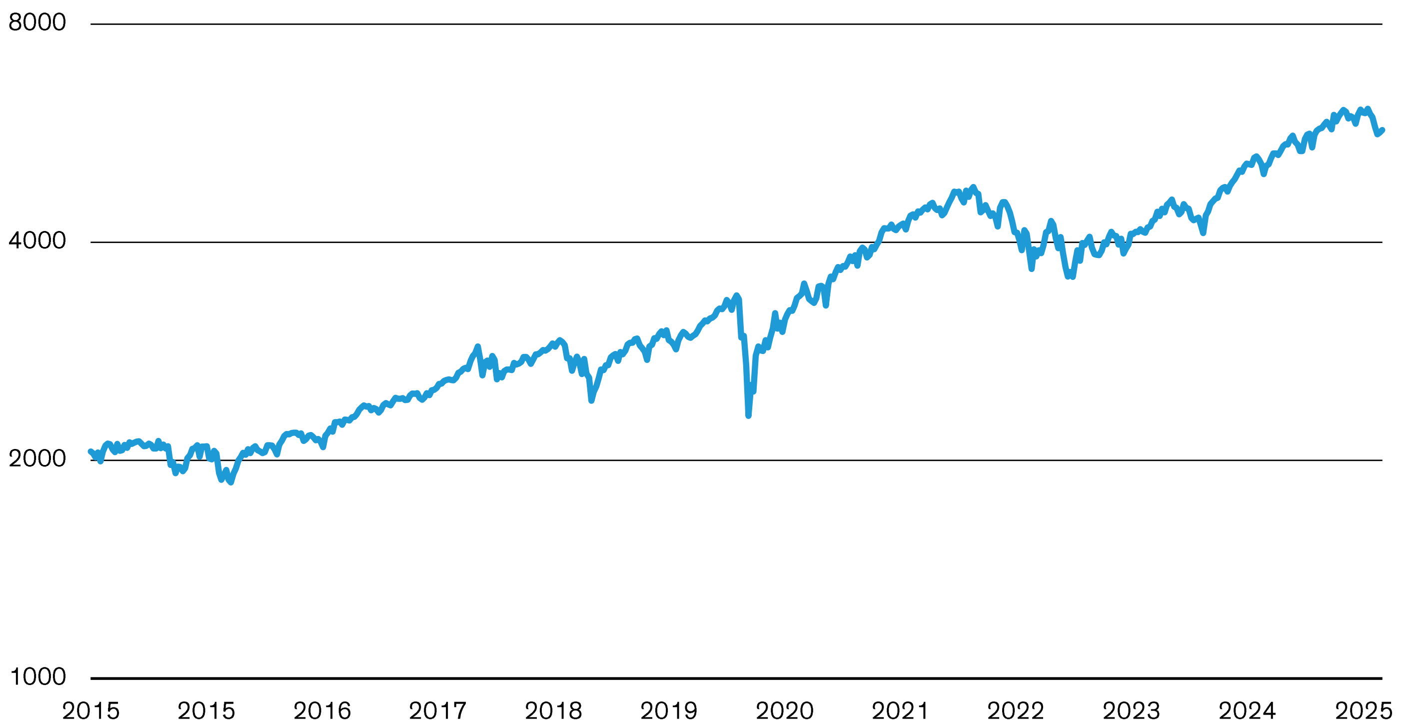
Confidence as a Backstop

That brings us to the policies that have upset the market in recent weeks—namely tariffs, geopolitical realignments, the actions of the Department of Government Efficiency (DOGE), along with a growing level of policy uncertainty.

The US Economic Policy Uncertainty Index has skyrocketed to levels not seen outside of the Coronavirus Pandemic and the Great Financial Crisis. Likewise, the National Federation of Independent Business, which represents small businesses in the US, reports that their uncertainty index hit all-time highs (*Display 3, next page*).

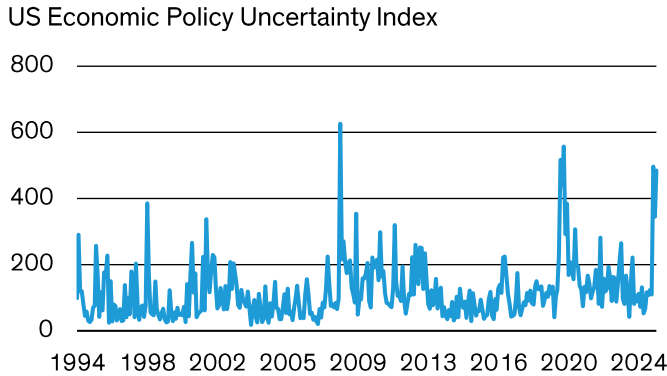
DISPLAY 2: THE RECENT DOWNTURN IS LESS SCARY IN CONTEXT OF THE LONGER TERM

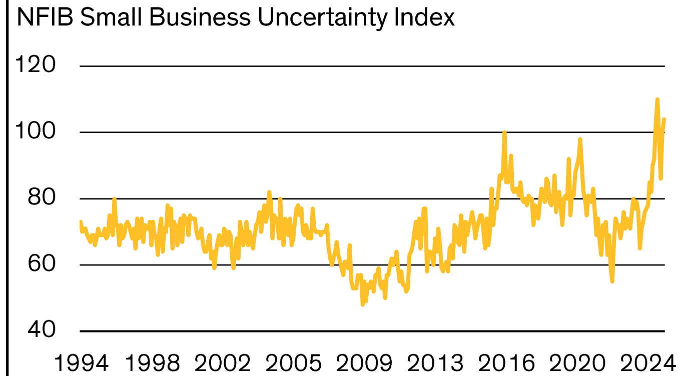
S&P 500 index



As of March 31, 2025.
Source: Bloomberg and Bernstein analysis

DISPLAY 3: UNCERTAINTY IS INCREASING IN THE ECONOMY ACCORDING TO SEVERAL MEASURES





As of March 31, 2025.
Source: Baker, Bloom and Davis; Bloomberg, NFIB and Bernstein analysis

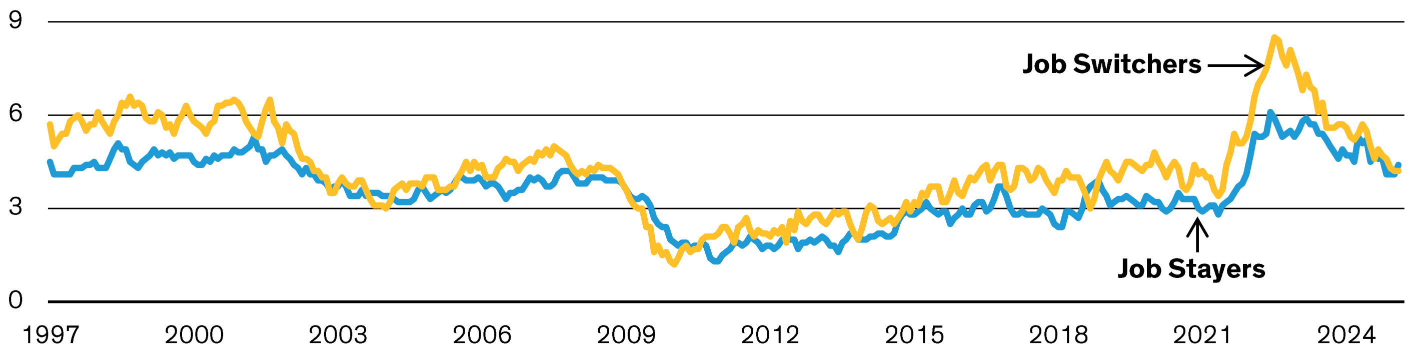
Uncertainty and its counterpart, risk, pose significant challenges for businesses and markets. As the range of outcomes widens or the likelihood of negative outcomes increases, stocks tend to sell off while bonds rally, much as we've seen so far this year. Yet while unnerving, one quarter of market returns matters less than the longer-term trends taking shape.

As long as businesses and consumers remain confident—consumers continue to spend, businesses continue to hire and invest—markets may experience volatility, but economic and earnings growth will serve as a backstop. However, if consumers and businesses pull back in response to uncertainty, we would need to reassess our outlook and adjust our positioning accordingly.

And that's why it's so important to watch the labor market like a hawk. It is strongly correlated to consumer spending and may be the single most telling economic indicator during this phase of the cycle. Post-pandemic, when the labor market was overheating, we noted the gap in wage growth between job switchers and job stayers, with switchers' wages outpacing stayers' by 2.5 percentage points. Now, we're beginning to see the reverse, with stayers' wages growing faster (*Display 4*). This shift has only occurred in a meaningful way three other times in the past 30 years—following the Dotcom Bubble, during the Global Financial Crisis, and in late 2018. As it currently stands, this trend might still be random and not cause for concern, but we'll be closely watching to see if it reverses or deteriorates in the coming months.

DISPLAY 4: WAGE GROWTH IS NOW STRONGER FOR JOB STAYERS THAN JOB SWITCHERS

Percent



As of March 31, 2025.
Source: Atlanta Fed, Bloomberg, and Bernstein analysis

What Matters: Consumers, Jobs and Policies

In his first term, many noted President Trump's attentiveness to the market's reactions to policy proposals, sometimes reversing course if the market responded negatively. This behavior was colloquially referred to as the "Trump put." For those unfamiliar, a "put option" is a financial derivative that acts as a hedge in a downturn. The concept in economic policy has historical roots; starting with the 1987 crash, then Fed Chairman Alan Greenspan would backstop the markets by sharply loosening monetary policy during moments of crisis. This strategy became known as the "Greenspan put" and evolved into the broader notion of a "Fed put" in the modern economy.

Fast forward to today, where investors initially assumed that President Trump would continue supporting the markets, much as he did in his first term. However, this assumption was challenged in February when President Trump clarified that he would prioritize advancing his agenda even if markets pulled back. He further expressed a willingness to accept negative market outcomes, including the possibility of a recession, as a consequence of implementing his new policies.

As a result, the term "Recession" has resurfaced in headlines. Let's be clear: while we came into 2025 expecting the economy to slow throughout the year—and still maintain that view—there is a difference between a slowdown and a recession. Our base case continues to call for a slowing yet still growing economy. Although elevated uncertainty has increased the probability of a recession, it remains much less likely, due to the strength, momentum, and sheer heft of the US economy. In other words, despite the challenges in policy development and implementation, our outlook has changed only slightly.

With that said, this letter is set to publish on the day when the delayed Canadian and Mexican tariffs—along with other policies—are set to take effect. So, as you're reading this, we may be gaining insights into the extent to which investors can still rely on the Trump put.

Diversification Is the Best Protection

We strive to analyze and assess potential developments in the economy and markets, but no one has perfect foresight or ability to time the market. In fact, studies have shown that even with perfect foresight, many investors still struggle.

To help protect portfolios, we rely on diversification—across asset classes, geographies, sectors, themes, and more. The year 2024 was not a great year for diversification. Many clients wondered why we held bonds, small-cap stocks, and international stocks in their portfolios, given the dominance of US large-cap stocks. However, as I mentioned at the outset of this letter, the opposite pattern has emerged so far in 2025. That's why we diversify.

Europe, especially European defense stocks, has been a standout in many of our portfolios this year. After a decade and a half of austerity, European policymakers are reacting to the evolving geopolitical landscape. Notably, Germany—long a force for fiscal conservatism—has voted to exempt defense and other security-related spending from their constitutional debt brake. What's more, they have approved a $548 billion infrastructure and climate fund. This increased fiscal spending is expected to directly boost profits for European companies and likely have an amplified impact as it flows through the economy, stimulating growth and development across various sectors.

In addition to diversifying across publicly traded asset classes like stocks and bonds, we continue to find more attractive risk-adjusted returns in private markets, including private equity, private credit, real estate equity and debt, and hedge funds. These opportunities arise from the more imbalanced supply and demand for capital in these markets, as well as varying fundamental and technical trends in each area. While these are less liquid than publicly traded ones, they often provide a buffer against the volatility experienced by investors. During periods like the current drawdown, we've seen the lower volatility in these private markets take less of a psychological toll on investors, allowing them to navigate market turbulence with a clearer head.

As always, I thank you for your trust in our team and our processes here at Bernstein. We take our fiduciary duty seriously and remain committed to allocating your capital to the best of our ability, regardless of the challenges that may arise. As winter gives way to spring, I hope you find yourself outside in warmer weather and breathing fresher air.

Best regards,

Alex Chaloff
Chief Investment Officer

Alex Chaloff is the Chief Investment Officer and Head of Investment and Wealth Strategies at Bernstein. In this role, he leads a national team of strategists across investments and wealth planning—including asset allocation advice, investment platform oversight, model portfolio construction, new product development, manager research, tax planning and solutions, and estate planning research—while remaining continuously focused on moving our clients forward with strong after-tax risk-adjusted returns. Alex has spent his Bernstein career refining our investment platform, listening to clients, and conducting deep research into investment and wealth planning topics that are critical to achieving clients' goals.

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