



Financial Markets Update: 2025 Stock Market Volatility

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After enjoying back-to-back years of strong returns in 2023-2024, US stocks have run into trouble in 2025. After posting a 4.3% decline in the first quarter, the bellwether S&P 500 index endured a sharp drop of nearly 10% over the first four trading days of April, leaving it with a 13.4% year-to-date loss through April 4. At that point the index had declined 17.4% from its most recent high on February 19, leaving it just a few percentage points shy of a traditional bear market (informally defined as a 20% decline). Other widely followed indices have fared worse: Through April 4, the Russell 2000 index representing small cap stocks and the Nasdaq Composite index recorded losses of 17.8% and 19.3%, respectively.¹

Given the healthy returns US stocks have posted in recent years, the sudden weakness in the early months of 2025 has captured headlines and reminded investors of the risk associated with owning stocks. In this paper, we address some of the drivers behind the recent volatility and consider recent declines in the context of a long-term and total portfolio perspective.

Drivers of Recent Market Weakness

There is an old maxim on Wall Street that the stock market hates uncertainty, and this has been proven in spades in 2025. In this case, the Trump administration's rapid application of tariffs on US trading partners has upended the existing global economic system and clouded the outlook for economic growth, inflation, and corporate profits. Concerns across Wall Street have been echoed in corporate America: The latest edition of the Federal Reserve's Beige Book, issued in early March, cited the word 'uncertainty' 45 times, compared to just 13 times in the previous report in mid-January, with some respondents noting plans to pause business investments.²

The administration claims the revised US trade policy will ultimately benefit the economy by encouraging greater investment in US production facilities and supporting US employment. Also, it's feasible that ultimate impacts may be less onerous than originally feared as various countries negotiate individual tariff agreements. We do not opine here on those prospects, but would note that such benefits, should they develop, would likely be longer-term in nature, and, as such, are less visible to investors at the present time. Lacking such clarity, some investors have moved to the sidelines in 2025.

A separate development that has weighed on broad US stock indices is acute weakness among the small group of stocks that had a big hand in powering markets higher in the last few years, the so-called "Magnificent Seven" (Apple, Nvidia, Microsoft, Amazon, Alphabet, Meta Platforms, and Tesla). Through

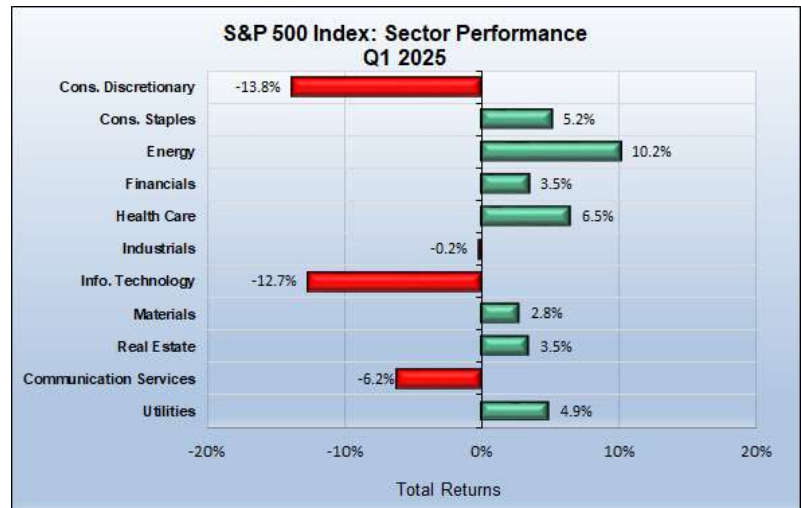
¹ Intra-quarter declines are in price terms while other returns cited are in total return terms (i.e., including dividends)

² As originally reported by Barron's. The Beige Book is a recurring compilation of anecdotal information summarizing economic conditions across the 12 Federal Reserve districts based on interviews with business contacts in each district

April 4, declines in these stocks ranged from 13.2% (Meta) to 40.7% (Tesla), while an exchange-traded fund (ETF) that equally weights the seven stocks, the Roundhill Magnificent Seven ETF (ticker: MAGS), endured a decline of more than 25%.

Whether the “Mag 7” stocks were ripe for profit-taking given their extended rally (the MAGS ETF more than doubled over the prior two calendar years) and rich valuations, or investors were spooked by the emergence of Chinese artificial intelligence (AI) company DeepSeek³, their weak stock performance had a pronounced impact on broad market indices in Q1 given their outsized weighting in those indices. (For example, at the end of 2024 the Mag 7 comprised a full 32% of the S&P 500 index by market capitalization.) While this concentration benefited the index on the way up, it can also, as we have cautioned in the past, have a disproportionate impact on the way down.

In fact, an equal-weighted version of the S&P 500 index (in which all of the stocks are weighted equally rather than by market capitalization, as is the case with the standard S&P 500 index) recorded a loss of only 1.2% in Q1 and 9.8% year-to-date through April 4, compared to declines of 4.3% and 13.4%, respectively, for the cap-weighted S&P 500. Further to the point, seven of the 11 economic sectors represented in the index actually showed positive returns in Q1⁴, with the three biggest losses occurring in the consumer discretionary, information technology, and communication services sectors—all of which happen to be where the heavily weighted Mag 7 reside.



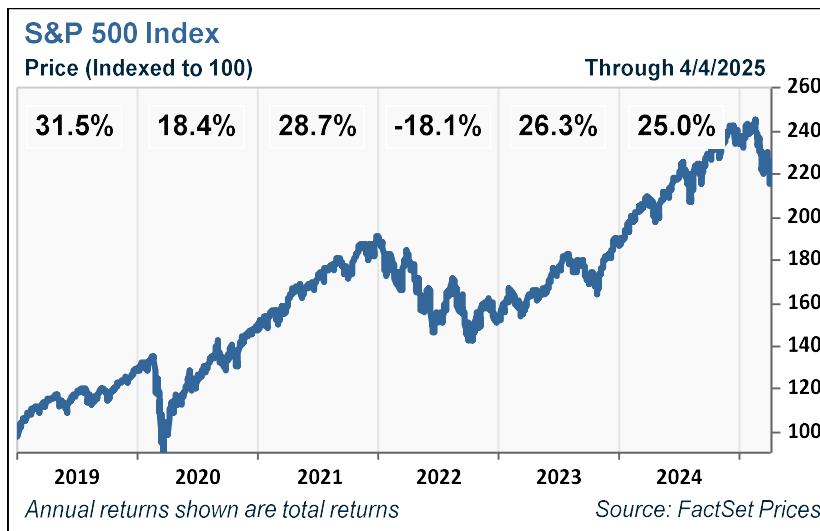
Source: Standard and Poor's

Recent Volatility in a Long-Term Context

While market declines naturally capture headlines and elicit fear, they are, in fact, quite common. According to research conducted by J.P. Morgan, since 1980 the S&P 500 has experienced an average intra-year decline of 14.1%, even while generating positive returns in 34 of those 45 years. We also note that the recent decline follows a very strong six-year run for the S&P 500. As depicted in the accompanying chart, the S&P 500 recorded gains of 20%+ in four of the last six calendar years, and more than 18% in another. Even accounting for the brief, sharp Covid-induced plunge in 2020, the loss of 18% in 2022, and the Q1 2025 decline, the S&P 500 produced a cumulative return of 148%, or 15.6% on an

³ In late-January DeepSeek announced that it had replicated many of the capabilities of advanced American artificial intelligence systems at cheaper cost

⁴ On a capitalization-weighted basis



annualized basis, since the start of 2019 through the end of Q1 2025.

Accompanying this stretch, the valuation of the S&P 500, as measured by its price-to-earnings (PE) ratio⁵, swelled to levels well above the historical average, measuring 27.7x at 12/31/2024 versus a 25-year average of 18.6x. While valuations are not necessarily reliable predictors of short-term market movements, it's reasonable to claim that the index's extended valuation at year-end 2024 left stocks with less cushion to absorb disruptions in market and/or macroeconomic developments. As the

old adage goes, "trees don't grow through the sky," and there are reasonable limits—albeit difficult to pinpoint in advance—to how much stock prices and valuations can rise.

Diversification to the Rescue

On the bright side, diversification has proven beneficial in 2025. Countering the S&P 500's year-to-date loss, other common asset classes have produced gains, as depicted in the table below:

Total Return through April 4, 2025	
	<u>YTD 2025</u>
S&P 500 (Large Cap Stocks)	-13.4%
Russell 2000 (Small Cap Stocks)	-17.8%
MSCI ACWI ex-US (International Stocks)	1.1%
Bloomberg US Aggregate (Bonds)	3.7%
"60/40" (Equity/Fixed Income)	-4.1%

Source: Morningstar. International stocks are in US \$ terms.
60/40: Equity is 70% Russell 3000 and 30% MSCI ACWI ex USA; Fixed Income is 100% Bloomberg US Aggregate

As seen, an investor holding a "60/40" portfolio diversified across US stocks, international stocks, and bonds would have experienced a year-to-date loss of only -4.1% through April 4, much more tolerable than the double-digit declines in the US stock market. The on-going case for diversification is also supported by the so-called "periodic table of returns," depicted on the following page, that ranks annual returns generated by different asset classes. As indicated in this table, historically there has been a fair amount of performance rotation across asset classes from year to year, highlighting the risk of investing through a rear-view mirror. To be sure, there have been select idiosyncratic periods when diversification

⁵ Based on trailing earnings

provided limited benefit, such as 2022 when stocks and bonds suffered simultaneous double-digit losses amidst rapidly rising interest rates; however, in most environments maintaining a diversified portfolio, executed through disciplined rebalancing, can boost the chances of smoothing out the inevitable dislocations that occur in various asset classes.

Periodic Table

Small Cap Core Equity 21.3	Emerging Markets Equity 37.3	Cash 1.9	Large Cap Growth Equity 36.4	Large Cap Growth Equity 38.5	REITS 43.2	Commodities 16.1	Large Cap Growth Equity 42.7	Large Cap Growth Equity 33.4	Commodities 8.9
Large Cap Value Equity 17.3	Large Cap Growth Equity 30.2	US Fixed Income 0.0	Large Cap Core Equity 31.4	Large Cap Core Equity 21.0	Large Cap Growth Equity 27.6	Cash 1.5	Large Cap Core Equity 26.5	Large Cap Core Equity 24.5	Developed International Equity 5.8
High Yield 17.1	Developed International Equity 25.4	Large Cap Growth Equity -1.5	Large Cap Value Equity 26.5	Small Cap Core Equity 20.0	Commodities 27.1	Large Cap Value Equity -7.5	Developed International Equity 16.9	Large Cap Value Equity 14.4	Emerging Markets Equity 2.9
Large Cap Core Equity 12.1	Large Cap Core Equity 21.7	High Yield -2.1	REITS 26.0	Emerging Markets Equity 18.3	Large Cap Core Equity 26.5	High Yield -11.2	Small Cap Core Equity 16.9	Small Cap Core Equity 11.5	US Fixed Income 2.8
Commodities 11.8	Small Cap Core Equity 14.6	REITS -4.6	Small Cap Core Equity 25.5	Developed International Equity 8.6	Large Cap Value Equity 25.2	US Fixed Income -13.0	REITS 13.7	REITS 8.7	Large Cap Value Equity 2.1
Emerging Markets Equity 11.2	Large Cap Value Equity 13.7	Large Cap Core Equity -4.5	Developed International Equity 22.8	US Fixed Income 7.5	Small Cap Core Equity 14.8	Developed International Equity -15.4	High Yield 13.4	High Yield 8.2	Cash 1.1
REITS 8.5	High Yield 7.5	Large Cap Value Equity -8.3	Emerging Markets Equity 18.4	High Yield 7.1	Developed International Equity 12.4	Large Cap Core Equity -19.1	Large Cap Value Equity 11.5	Emerging Markets Equity 7.5	High Yield 1.0
Large Cap Growth Equity 7.1	REITS 5.2	Small Cap Core Equity -11.0	High Yield 14.3	Large Cap Value Equity 2.8	High Yield 5.3	Emerging Markets Equity -20.1	Emerging Markets Equity 9.8	Cash 5.4	REITS 0.9
Developed International Equity 3.1	US Fixed Income 3.5	Commodities -11.2	US Fixed Income 8.7	Cash 0.6	Cash 0.0	Small Cap Core Equity -20.4	US Fixed Income 5.5	Commodities 5.4	Large Cap Core Equity -4.5
US Fixed Income 2.6	Commodities 1.7	Emerging Markets Equity -14.6	Commodities 7.7	Commodities -3.1	US Fixed Income -1.5	REITS -24.4	Cash 5.3	Developed International Equity 4.4	Small Cap Core Equity -9.5
Cash 0.3	Cash 0.8	Developed International Equity -14.8	Cash 2.3	REITS -8.0	Emerging Markets Equity -2.5	Large Cap Growth Equity -29.1	Commodities -7.9	US Fixed Income 1.3	Large Cap Growth Equity -10.0
2016	2017	2018	2019	2020	2021	2022	2023	2024	1Q25

Source: Morningstar Direct

Looking Ahead

As we state often, we cannot predict the short-term direction of financial markets. It is far too early to tell whether the recent market volatility is a blip on the path to continued strong returns or the beginning of a longer and deeper decline. Investors are currently grappling with a range of headwinds affecting the outlook for the economy and stocks, including the angst precipitated by US trade policy actions, uncertainty over the direction of the Federal Reserve's monetary policy, sticky inflation, and still elevated valuations in some corners of the stock market. At the same time, market sentiment and price action may improve if there are reports of accommodative tariff agreements with individual countries, if the Federal Reserve cuts its policy interest rate (the federal funds rate), and/or upon indications the economy may withstand the shock of tariffs.

In the big picture, we remind investors that stock markets have historically weathered ups and downs and still provided attractive long-term returns. As such, we encourage long-term investors to continue following a disciplined approach that includes maintaining a diversified portfolio with appropriate levels of risk that can withstand short-term declines, considering steps to rebalance portfolios to adhere to long-term policy guidelines (subject to funding and distribution considerations and market conditions), and seeking to capture strategic and tactical asset allocation opportunities as they arise. Likewise, we discourage speculative attempts to “time” the market.

Your Gallagher consultants are closely monitoring events and circumstances as they relate to individual client portfolios and will provide the necessary guidance to make financial moves when appropriate.

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