**Pavlic** Investment Advisors Inc.
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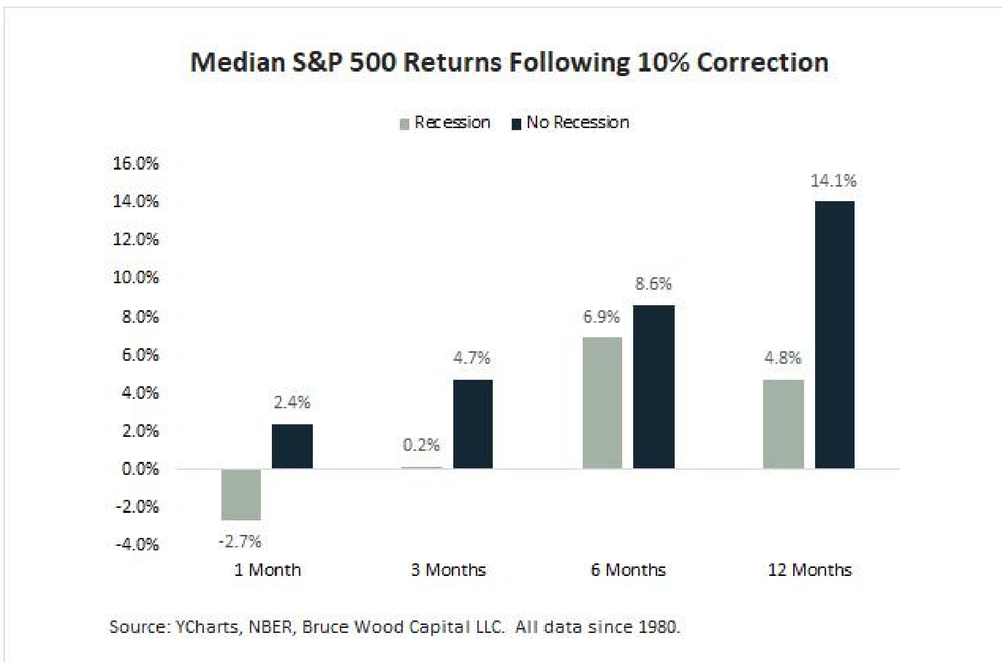
# 1st Quarter 2025 Review & Outlook

Dear Client,

While the first quarter was volatile for the equity markets, our **core portfolio of stocks* performed well on a relative basis down only 1.8% after fees.** This compares favorably to the all-technology NASDAQ (-11.4% in 1Q25), the small cap Russell 2000 (-10.3%), the technology-heavy S&P 500 (-5.5%), and the Dow Jones Industrial Average (-2.1%). While tariffs and DOGE commanded most of the media headlines, it is worth noting that when looking at the stocks driving index level returns, our outperformance on a relative basis was largely driven by maintaining an underweight in the high valuation technology names that declined more. For example, NVIDIA was down 27% off its highs and Tesla was down 35% off its highs during the first quarter.

During the quarter, we lowered our conservative money market position from an average of an ~8.0% weight to a ~5.0% weight and added **Eaton Corp** to our core stock portfolios. Eaton is the largest electrical component supplier for data centers, utilities, commercial and residential buildings. We believe the demand for electrical equipment, especially in data centers, will only continue to increase in the years ahead and used the recent market volatility as an opportunity to add this quality name to our portfolios. We also selectively rebalanced accounts where cash had grown above target from the collection of dividends (and interest income in the case for bondholders).



Source: YCharts, NBER, Bruce Wood Capital LLC. All data since 1980.

In one of our discussions with clients over the past quarter, a comment was made: "5,600 (on the S&P 500) felt a lot better last September than it does here in March." This perfectly describes a cognitive bias we all exhibit called "recency bias" where the same levels in the market feel markedly different. Last fall, we marched higher from low market levels after the inflation driven bear market in 2022. By comparison, in March of this year, we saw a pullback due to uncertainty around tariffs and global trade wars, which makes the same level in the market (5,600) feel a lot worse than it did last fall. This theory rhymes with another psychological bias called loss aversion where the negative impact of losses feels much more significant than the positive impacts of equivalent gains. In fact, studies show the pain of losing is perceived as about twice as powerful as the pleasure of gaining something of equal value. Our job is to encourage you to stick to your financial plan through different economic environments and view corrections as an opportunity to buy high quality businesses at cheaper prices. To back up this claim with market data, the table above shows forward returns following a 10% correction. You will notice the forward 6 and 12-months returns are both positive whether or not we experience a recession. Historically the median 12-month forward return is only +4.8% if we have a recession compared to +14.1% if we do not. While the recession debate will continue to ring loudly, we find comfort in the historical data presented in the chart above.

## In Depth Stock & Bond Market Review

Regardless of your position on whether tariffs are a good thing, the market views the current environment as more uncertain compared to last quarter. Soft economic data, such as consumer sentiment, continues to reach new lows and investors are focused on playing defense. Stocks in sectors such as consumer staples posted gains, while higher valuation areas such as technology names underperformed. In fact, the tech sector was down 12.7% in the first quarter, with the "Magnificent Seven" down 14.6% since the beginning of the year. The biggest question investors are asking is whether or not tariffs will put continued upward pressure on inflation, and as a result, keep the Federal Reserve from being able to deliver interest rate cuts later this year. If the interest rate cuts do not transpire, will economic growth stall or contract? Our position is that until we have more clarity on the trade front, uncertainty is likely to continue which will result in further market volatility.

You can separate economic data points into "soft" economic data and "hard" economic data. Soft economic data points are survey based such as consumer sentiment. The University of Michigan's February consumer sentiment survey published last week showed consumer confidence fell to 57.0 (7.7 points lower from last month and 22.4 points lower compared to the same period last year). The University of Michigan also conducts an inflation expectations survey which showed consumers expect a 4.1% inflation rate in the coming five to ten years, a +0.6% increase from last month's reading and the third straight month of increased inflation expectations. However, what is interesting to note is that while the soft economic data points remain bleak, the hard economic data has yet to materially decline. Below we reiterate the five questions we asked in our 2025 outlook at the end of last year:

1. Is economic growth stable as measured in GDP?
    a. Yes. The latest reading on GDP growth was +2.4% in 4Q24, however a trade war will push this lower.
2. Is the Fed still in an interest rate cutting cycle?
    a. Yes. Expectations are for two to three -0.25% interest rate cuts this year.
3. Is inflation tame over the medium term?
    a. Somewhat. We remain above +2.5% for CPI and PCE compared to the long-term target of 2.0%.
4. Is corporate earnings growth expected to remain strong?
    a. Somewhat. Earnings expectations remain at +9% YoY growth. However, a trade war will push this lower.
5. Is the unemployment rate below 4.5%?
    a. Yes. The unemployment rate remains at 4.1%, however how will DOGE cuts potentially impact this?

To summarize the above questions, the "hard" economic data remains, "good, not great" and "cooling, but not negative." If this remains the case, then pullbacks like we saw in 1Q25 should be viewed as entry points to buy high quality stocks. Sectors such as health care, energy, and industrials (such as Eaton) are all areas where we see the greatest number of potential buying opportunities from our proprietary stock screening tool. We are balancing these opportunities with a comfortable weighting in the money market fund at ~5.0% across average portfolios and utilizing our investment grade bond strategy for clients who wish to lower their overall risk profile.

**Bond Investors see a welcome reversion to a normal shaped yield curve.** Bond investors are seeing a welcome return to a more normal shaped yield curve. With inflation rangebound near term, we reiterate our belief in a "higher for longer" interest rate environment where rates hold steady at these higher levels. With inflation above the Federal Reserve's 2.0% target, we believe the Fed will be hesitant to aggressively lower the Federal Funds rate this year, absent any unforeseen economic developments. For the U.S. Treasury 10-year note, we foresee a trading range like 2024, with a low of 3.75% and a high of 4.75%. In the investment grade bond market, we are locking in yields across the 10-year bond ladder from 4.5%/year at the short end to as high as 5.7%/year 10 years out to maturity. We view money market funds as offering excellent liquidity, but with lower expected returns now in the low 4%/year range and trending lower to the low-to-mid 3% range by year-end. While we do not proclaim bonds to outperform stocks over any 10-year time horizon, bonds can act as a great hedge to stock market volatility while still earning a satisfactory return for investors.

***"Investing is not a game where the guy with the 160 IQ beats the guy with the 130 IQ. Once you have ordinary intelligence, what you need is temperament to control the urges that get people into trouble."***
***- Warren Buffet***