First Citizens Wealth™

Making Sense

Basis Points | March 12, 2025

Expected Volatility

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1. Expected Volatility

The S&P 500 has drawn down over 9% from its recent peak, the largest selloff since 2022. **We often remind clients that moderate drawdowns in risk assets are the norm, not the exception.** Heightened volatility and lower market returns have been central tenets of our 2025 market views, as market pricing was leaving little room for error, especially given the increasingly uncertain policy outlook. We think market volatility likely persists from here, and next steps likely depend on the extent to which tighter financial conditions and elevated uncertainty filter into the real economy and corporate earnings. **Balance in portfolios remains key. And in volatile and uncertain markets, it is important for clients to reference their financial plan and remember that long-term, risk-on assets are just that: long-term.**

2. Navigating Uncertainty

Higher uncertainty is not just when risks are perceived to be elevated, but also when it is more difficult to evaluate the risks in the first place. As a result, market and economic participants tend to act more aggressively than tactically in managing their risk exposure. Investors may abandon risk assets, businesses may cancel planned investments or pause new hiring, and households may put off big-ticket purchases. Prolonged periods of uncertainty can translate into negative market and economic outcomes even without a concrete negative event actually taking place. **That said, for long-term investors uncertainty only highlights the importance of having a plan and sticking to it. As we often hear, it is time in the markets, not timing markets, that yields solid long-term returns.**

3. Fundamentally Intact

Volatility and uncertainty are elevated, but fundamental factors generally remain in place even if several have weakened on the margin. For example, bottom-up analyst estimates of corporate earnings growth for 2025 have been revised down, but the latest estimate is still for +11.6% growth this year.[i] Public-sector job cuts likely number at least 100,000-200,000 so far, but even this accounts for a relatively small fraction of the total workforce, and the unemployment rate is still near-generational lows.[ii] Credit spreads have widened, but they are still extremely tight. The upshot is that while fundamentals may not be as strong as they appeared a few months ago, they are flashing yellow – signaling to proceed with caution – not a steady yellow – and thereby not signaling a red light is inevitable. Investors will be exceptionally attuned to the highest frequency data on corporate earnings, the labor market, and economic activity to monitor whether this is still the case.

4. Fed on Hold

Despite higher volatility and elevated uncertainty, the Federal Reserve is still on hold. After cutting interest rates by 100 basis points last year in a mid-cycle adjustment, the Fed now has to pay attention to both sides of its dual maximum employment and stable prices mandate. Unlike last year, when the Fed cut rates because it anticipated a softer labor market and slower economic growth, this year it may wait to see more convincing evidence that inflation is returning to the 2% inflation target before cutting interest rates. Today's CPI inflation report was encouraging, but policymakers likely need to see a longer trend, especially given the uptick in household inflation expectations this year. Although markets are pricing a near-zero chance of a rate cut at the upcoming March Federal Open Market Committee meeting, **investors will still be paying close attention to assess how the Federal Reserve may react to a slowing economy – even if inflation is still moderately above the 2% target.**

5. Policy Brief

Trade policy is dominating the news with the United States floating the steepest tariffs in several decades. **But several other important policy factors are in play behind the noisy headlines.** In coming weeks, Congress and the White House may begin to discuss tax legislation to address several expiring individual and business tax provisions from the 2017 tax reform. Although Congress may use steep government spending cuts to pay for further tax cuts, that reduced spending may also weigh on economic growth. Ongoing changes at regulatory agencies could affect the pace of business activity and deal flow. **As long-term investors, we will be following each of these factors to assess how they may affect corporate earnings and economic growth.**

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[i] Source: FactSet *Earnings Insight*, 3/7/2025.
[ii] Source: Bloomberg

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