



Investment Management Group®

The following contains a brief discussion of the equity markets from Chief Investment Officer and Senior Portfolio Manager, Ryan E. Crane.



FIRST QUARTER 2025 MARKET OUTLOOK

MARKET OVERVIEW ¹

The first four weeks of the year started off well enough. By the end of January, buzz about a new AI Large Language Model (LLM) called DeepSeek, built by a group from China, began to rattle investors. DeepSeek's performance was on par with some of OpenAI's offerings, but its developer claimed the model was trained at a cost of only \$5.6mm. This development caused investors to rethink the pace of investment in AI infrastructure and sent AI-related stocks tumbling.

Eventually, it became clear that the actual training costs were higher, and every tech investor became an overnight expert in Jevon's Paradox. Innovation should be celebrated - driving costs down means that adoption can happen faster and more broadly. Just as the Tech market recovered, economic fears on inflation began to resurface, and then concerns about tariffs.

March was a tough month for equities. While real time economic data looked OK, uncertainty regarding tariffs dominated the headlines. The S&P 500® finished the period down 4.27%. Gold was one of the best performing assets, up over 19% year to date.

OUTLOOK

~~This is version two of my thoughts. As I was finishing writing this the first time, everything changed. It was already stale. This is version three. I feel certain it will be stale by the time you read it.~~

When the facts change, I change my mind. What do you do, sir?

My Dad was an incredible man: a pro athlete at 17, first CFA charterholder in his state, CEO of an NYSE listed company, founder of an investment management firm, an amazing father and role model, a loving husband, and much more. I miss him dearly.

He was a tough negotiator too. He was an intimidating man, with a handshake that would leave you wondering if all your metacarpals were still intact. When I was a teenager, he took me with him to go buy a car. He wanted to teach me how to properly negotiate the best deal possible. I won't go through all the details here, but it was confrontational and argumentative, yet somehow productive. I learned well. When I helped my wife buy her first new car, the manager almost assaulted me he was so frustrated. We got a great deal, though. A few years ago, I took my son car shopping. After a series of conversations, all of which included me walking out or hanging up, we finally sat back at the dealership. I told my son, "be prepared to get up and walk out again, there is a good chance we don't buy this car today." It was an emotional rollercoaster for a young man, who really wanted that car!

The salesman was just as anxious. He wanted the commission, but thought I was being way too difficult with the sales manager. I noticed him physically trembling when I picked up my keys and started to leave when they were asking me to "meet them halfway." For me, there was no halfway. There's the price that I had determined to be fair, and I wasn't about to budge. I was willing to risk not getting what I wanted, in order to have a shot at getting the absolute lowest price the dealer would tolerate.

We bought the car, and we got an amazing deal on it, about three weeks after we started the process. Let me assure you, it was a very unpleasant, perhaps even repulsive process for the uninitiated. For me, I loved every minute of it.

I believe that President Trump, is like my Dad in that he relishes a difficult negotiation, especially when he thinks he's holding all the cards. The downside is that all the bystanders are horrified. My wife has been wanting a new car, and she won't go with me to buy it. She can't stand the drama and arguing, but she enjoys knowing we got the best possible deal. Unfortunately for all of us, with respect to these tariff negotiations, we have to watch the sausage being made.

¹ The S&P 500® Index is a broad-based unmanaged index of 500 stocks, which is widely recognized as representative of the equity market in general. Copyright © 2025, S&P Global Market Intelligence (and its affiliates as applicable). All rights reserved. See additional information regarding S&P ratings at <https://www.stephensimq.com/terms-and-conditions/>. You cannot invest directly in an index.

OUTLOOK

I think we would all agree that free trade is a good thing. Last quarter I encouraged you to refresh your thinking on the relative price-elasticities of supply and demand. Today, I'd point you to Ricardo's work on comparative advantage. If country A is better at making good X, and country B is better at producing good Y, then both countries benefit by focusing on what they're good at, and then trading with their partners. This all works really well in theory. But then you realize some countries don't really have a comparative advantage at producing something, instead the government is subsidizing it (through taxes, financing, or lower regulatory burdens). And then those countries run a permanent trade surplus, not fully cooperating with their trade partners.

David Zervos, Chief Market Strategist at Jefferies, had a thoughtful note recently. He applied economic game theory to this tariff issue, comparing it to the famous prisoner's dilemma. If one party cooperates (the US), and the other party is uncooperative, the other party wins at the US's expense. This has been happening for decades! Think of this regime shift in tariffs as a way to broadcast to the world that we are willing to be uncooperative and screw up the whole system, in an effort to get everyone to move closer to a cooperative/cooperative solution. Perhaps it's a risky endeavor, but the gains will be worth it.

When I began writing this, the tariffs seemed to be the opening bid in a negotiation. While this still may be true for our closest allies, it seems to not be the case for China. Here, the tariffs are massive and might be more than just part of a negotiation. I honestly don't know. So, it's either outlandish, or it's an extremely bold negotiation opener, that doesn't appear as such.

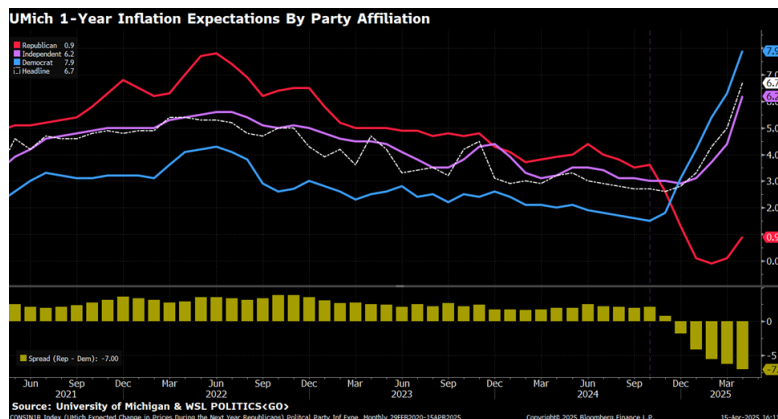
I think it's reasonable to assume that all this is just part of the messy process of tough negotiations. It may be that it's not that different than me offering a lowball number for a car, and then walking out, just to find the limits of the other party. I think I'll end my comments on tariffs there, because there's a high likelihood that things will have materially changed by the time you read this. Let's move on to the second order effects of tariffs...

I stand by my argument last quarter, that tariffs, by themselves, are not intrinsically inflationary. I mean that in the strict definition of inflation – which is a rise in the price-level. They will certainly lead to higher prices for *some* goods, but that's not the same as *inflation*. If you're spending more on imported/tariffed items, then you simply have less money to spend on other items, thereby reducing demand, *ceteris paribus*.

The problem is we are definitely not in a *ceteris paribus* situation. It's not just tariffs that are changing. It's closer to *mutatis omnibus*, or whatever the Latin phrase for "everything is changing at the same time." Taxes are changing. Immigration has changed drastically. DOGE has changed the cadence of some government spending. Exchange rates are changing, along with interest rates.

The handwringing and confusion about tariffs is becoming its own problem, and surely some of the stress and uncertainty around tariffs is very real. Business leaders around the globe are having to recalibrate for a post-tariff world, except that no one really seems to know where and when the tariffs will settle out. We have worried that there may be an economic air pocket due to this pause. This is a quite a bit worse than just seeing how the sausage is made – there is a very real, but hopefully short-term cost to the economy.

Since this subject is politically charged, emotions are running high, with opinions about the merits of these policies largely falling around party lines. As someone who is always looking for situations where human bias clouds judgment (potentially creating investment opportunities), I couldn't help but marvel at this chart.



NOT FDIC INSURED

MAY LOSE VALUE

NOT BANK GUARANTEED

OUTLOOK

I'll leave this chart without additional comment, other than to say that both parties are almost certainly wrong, and both are clearly biased in their opinions about inflation. These biases are becoming evident in some of the market action we've seen lately. If you really believe inflation is set to be 7.9% for the next year, you would make very different investment and consumption decisions than someone who thought we'd only have 0.9% inflation.

Since I'm rewriting this post quarter end, we just got a look at March CPI data, and it was surprisingly tame. The services component, including shelter, have been stubbornly high since 2021, and they are finally showing signs of improvement. The market reaction to better news on the inflation front has been entirely dismissive. My best guess is that many investors are assuming that *mutatis omnibus* and looking at last month's data provides no real insight.

In my opinion, the long-term prospects for inflation have fluctuated quite a bit in the last three months. At first, it was improved – assuming that the efforts of taming government spending are successful. It's been hard to quantify the exact amounts of savings from the efforts of DOGE and other actions, but the fiscal direction and overt recognition of the problem have changed in a constructive way. I'm not alone in my belief that the fiscal path of the US was entirely unsustainable.

More recently, it seems that the DOGE savings might be less impactful than originally thought. And in the meantime, Congress is working on tax legislation that only makes the budget deficit worse. I've heard that many lawmakers have been hearing about how our budget deficit and debt situation isn't sustainable for a very long time, and yet we haven't had a real problem yet. So far, they've been able to kick the can down the road. I now firmly believe that the bureaucracy and the system itself won't change until forced...by the bond market.

In my opinion, during Trump's first term, he looked to equity markets as a proxy for a report card – a strong stock market was a sign of success. Today, I believe the administration is laser focused on long term interest rates (partly because of Bessent's influence, and partly because of the \$9T that needs to be refinanced in the next year), and short-term stock market performance is inconsequential. While internet memes usually lack seriousness, occasionally they can be quite informative. I think this one is spot on.



I'm a little concerned that long term rates haven't moved lower, especially given the drawdowns and volatility in equities – where one would expect Treasuries to be a safe haven. My guess is that the administration is concerned too. The US Dollar hasn't performed well either. With the global system of trade and finance rapidly changing, it's not exactly clear why long-term yields have risen. Less buying from foreign entities? China selling? Inflation or stagflation fears? We will be keeping a close eye on this, as I'm sure Secretary Bessent, self-proclaimed bond salesman for the US, will too. I hope that the administration sees rates and FX as the dashboard, for knowing how hard to push on tariffs.

Is all *mutatis omnibus* pulling forward the bond market's enforcement?

I don't know. I don't think anyone knows. The last five years have taught us to be skeptic of the experts, and I think this is no exception. The global economy and market are in a state of disequilibrium, and I would expect us to continue in that state until the new rules are established, and the market participants believe as much. As we saw on April 9th, the facts can change instantly.

Speaking of experts, the action or inaction of the Fed has been a bit inconsistent relative to prior messaging and policy, in my eyes. First off, I think we can all agree that over the last five years the Fed has demonstrated zero ability to forecast inflation, so I'm not sure why we want to trust their take on the impact of tariffs. Secondly, they've claimed to be data dependent. The data has been very clear – inflation has slowed significantly, and GDP is weakening. The Atlanta Fed's GDPNow metric is showing -2.2% GDP growth (-0.1% if you take out all the gold transfers). The data, which is always backward looking, is giving them the green light to cut rates.

OUTLOOK

It's important that we spend some time thinking about the goal of these tariffs. The administration has stated that these policies are designed to incentivize and bolster US manufacturing capabilities. The COVID experience was an eye-opening event: that decades of globalization gave us low-cost goods, but if we don't control the production of these goods, in times of trouble, we are at the mercy of our trading partners. For cheap t-shirts, maybe this is acceptable. For other, more strategically important goods, it might be wise to control our own destiny.

This seems to be a well-intentioned and noble goal, but this can only be achieved in the long run. I worry that we underestimate how difficult it will be to steer the economy in this way. Decades ago, goods with a "Made in China" stamp on them were generally perceived to be of lower quality, perhaps rightly so. But that is not the case today.

There's a parable that relates to this, and an experiment that has been replicated several times. The most popular version comes from the book *Art & Fear* by Bayles and Orland.

The ceramics teacher announced on opening day that he was dividing the class into two groups. All those on the left side of the studio, he said, would be graded solely on the quantity of work they produced, all those on the right solely on its quality. His procedure was simple: on the final day of class, he would bring in his bathroom scales and weigh the work of the "quantity" group: fifty pounds of pots rated an "A", forty pounds a "B", and so on. Those being graded on "quality", however, needed to produce only one pot — albeit a perfect one — to get an "A". Well, came grading time and a curious fact emerged: the works of highest quality were all produced by the group being graded for quantity. It seems that while the "quantity" group was busily churning out piles of work — and learning from their mistakes — the "quality" group had sat theorizing about perfection, and in the end had little more to show for their efforts than grandiose theories and a pile of dead clay.

China has clearly been the equivalent of the group on the left — producing as much as they can, as fast as they can. The unexpected side effect has been that the quality of the work is now quite good. I worry that this desire to revitalize the manufacturing base in the US is righteous enough, but may take a very long time to rebuild, longer than the election cycle.

Let's shift gears and spend a few minutes on the AI space. Earlier this year, a group out of China released an AI model named DeepSeek. DeepSeek's performance was on par with some of the well-known and more established LLMs but was claimed to be trained on older generation NVIDIA chips and at a much lower cost. This news sent shockwaves through the AI investable universe, and investors worried that such a breakthrough would curtail demand for chips and other infrastructure.

The claims on training costs have since been disputed, and some are questioning whether some of the technology was built on existing techniques and possibly data from other AI firms. Regardless, DeepSeek did demonstrate some meaningful performance improvements, particularly around the Mixture-of-Experts (MoE) architecture.

We should all remember that technological advancement isn't a linear progression; it's much closer to a step function. Breakthroughs lead to lower costs or better performance, and that in turn leads to broader adoption and more demand. This is a feature of innovation, not a bug. Amazingly, I'm still shocked at how few of my friends use AI in any meaningful way (despite my pleas). We are still in the infancy of this trend.

In the last three months, we have seen huge improvements in publicly available AI tools. Most model providers are offering "deep research" versions, where the AI tool will spend a significantly longer time on the request, accessing sources in real time to construct a response. The latest versions of image generation tools seem like a quantum leap from those just a year ago. I think the most important takeaway is that we have yet to see diminishing improvements, despite the mindboggling pace of investment.

What's exciting to me, is that the AI investment narrative isn't one-sided anymore. The mania and excesses we saw last year have faded (e.g. SMC). We are back to having a market, complete with AI Bulls and AI Bears, and as such, there is more opportunity for stock picking. I'll repeat my plea: if you're not using ChatGPT, Perplexity, Claude, Grok, or some other tool on a daily basis, you're missing out. Take the plunge!

Putting it all together

A lot has happened since the beginning of the year. I think it's safe to assume that this next quarter will be similarly news-filled and complicated. I know I sound like a broken record, but it's worth repeating: the pace of change is accelerating. So much so, that it is nearly impossible to keep up with it all.

OUTLOOK

I don't know where this all leads. There is a lot at stake. I personally have been convinced that our country is on an unsustainable path with respect to spending and debt. I hope that Trump's plan is ultimately successful. Many markets are in disequilibrium right now and will probably remain so until there is some certainty on tariffs and other issues. As this administration is trying to build a new system of trade and revitalize manufacturing, we should expect that nothing creative or unorthodox is off the table.

As we have spent a great deal of time examining our portfolio's exposure to companies with tariff-related risk, one thing is clear. Small and mid-sized companies generally have less risk than their large counterparts. In fact, we have some companies who do all their manufacturing and sourcing entirely within the US and aren't directly affected at all.

Remember the lessons of Behavioral Economics. The recency and vividness of tariffs is probably crowding out thinking and analysis on all the other things affecting the economy. Losses hurt more than gains feel good. Everyone is anchored to the old regime; it will be very hard to recalibrate. Confirmation bias will drive us to reinforce our prior conclusions (especially about Trump). As scary as this market is, it's been terribly exciting for us. Bias is everywhere and efficiency is as low as I've seen in a very long time. For long-term investors with a stock picking focus, opportunity abounds.

As quickly as this tariff drama escalated, it could potentially resolve. I don't think that car sales manager liked me very much, but at the end of a hard and unpleasant negotiation, we ended up shaking hands and both walked away with something we wanted. How long that process takes is THE question, and no one knows the answer.

You cannot invest directly in an index. The S&P 500® Index is a broad-based unmanaged index of 500 stocks, which is widely recognized as representative of the equity market in general. Copyright © 2025, S&P Global Market Intelligence (and its affiliates as applicable). All rights reserved. See additional information regarding S&P ratings at <https://www.stephensimg.com/terms-and-conditions/>

The investment objectives, risks, charges and expenses should be carefully considered before investing. SIMG nor their representatives provide legal or tax advice. Please consult your tax advisor before making any decision.

There are additional risks associated with investments in smaller and/or newer companies because their shares tend to be less liquid than securities of larger companies. Further, shares of small and new companies are generally more sensitive to purchase and sales transactions involving the company's stock and to changes in the company's financial condition or prospects and therefore, the price of such stocks may be more volatile than those of larger company stocks. Clients' investment results and principal value will fluctuate.

Stephens Investment Management Group, LLC is a registered investment advisor specializing in equity investment management, specifically small and mid-capitalization growth companies. The firm maintains a complete list and description of composites, which is available upon request.

Opinions expressed are those of Ryan Edward Crane and are subject to change, are not guaranteed and should not be considered recommendations to buy or sell any security.

Stephens Investment Management Group, LLC ("SIMG") claims compliance with the Global Investment Performance Standards (GIPS®). GIPS® is a registered trademark of CFA Institute. CFA Institute does not endorse or promote this organization, nor does it warrant the accuracy or quality of the content contained herein. To receive additional information regarding SIMG, including GIPS-compliant performance information for SIMG's strategies and products, contact SIMG at (713) 993-4200 or write SIMG at 9 Greenway Plaza, Suite 1900, Houston, TX 77046 or marc.little@stephens.com.

Stephens Investment Management Group®

*For more information on Stephens Investment Management Group,®
please see us at www.stephensimg.com*

NOT FDIC INSURED

MAY LOSE VALUE

NOT BANK GUARANTEED