Stephens Investment Management Group®

The following contains a brief discussion of the equity markets from Senior Quantitative Analyst, Charles Clavel, CFA.

The Art of Retreat

勝兵先勝而後求戰，敗兵先戰而後求勝。

"Victorious warriors win first and then go to war, while defeated warriors go to war first and then seek to win."
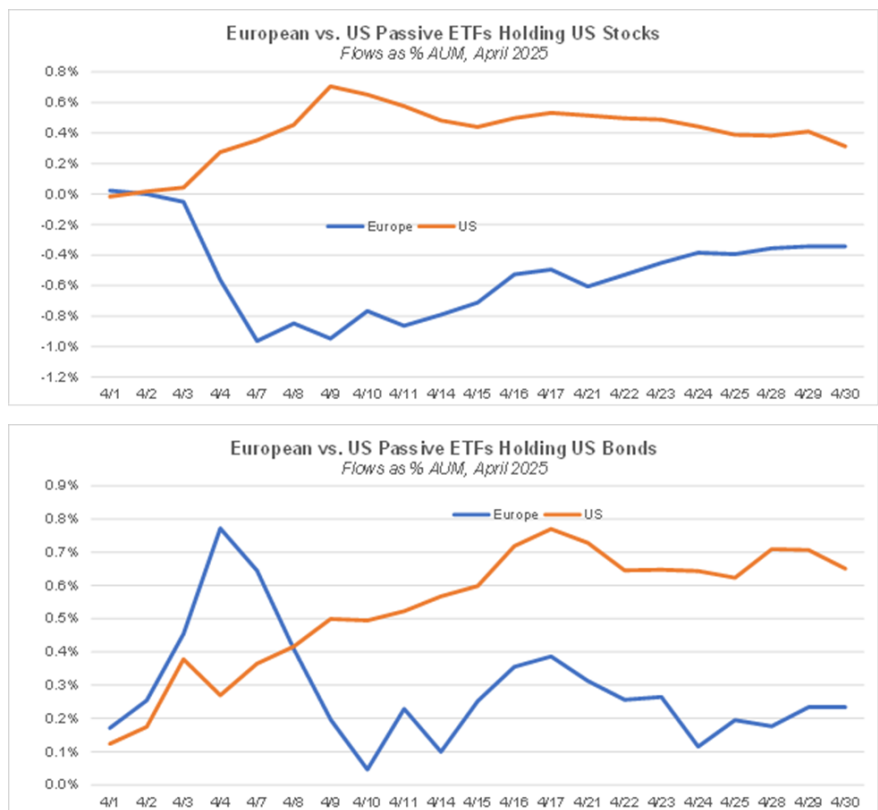– Sun Tzu, *The Art of War*, Chapter 4: Tactical Dispositions

Some historical events change the world irreversibly. Last month's "Liberation Day" was one of them, since it likely marks the end of globalization as we know it, as Keir Starmer – the UK's prime minister – acknowledged. While some (or maybe all) of Trump's tariffs could be rolled back by the courts, a future president or even Trump himself, it is highly unlikely that global trade will get back to its former structure. Many commentators have interpreted the reciprocal tariff announcements as too extreme and poorly thought out but given the substantial amount of resistance from the political and business establishment, Trump had to go for a "shock and awe" approach that would make it hard for future leaders to bring back the former global trade architecture. While his goal is to reduce the US's trade imbalances with all countries, his primary concern is that with China, a country whose trade practices are especially unfair to the US in his view. In typical "Art of the Deal" fashion, he initiated the trade war with a very aggressive move to bring other countries to the negotiating table.

Most countries reached out to the White House within days to reach a deal, with one notable exception: China, which responded tit for tat to the US's tariff escalations. This seems to have caught the administration by surprise, but **even cursory knowledge of Chinese culture and history would suggest that China would not respond well to the US's ultimatum**. The importance of the concept of "face" in Chinese culture and the memory of the "Century of Humiliation" (a period from the 1840s to the 1940s when the declining Chinese empire was subjugated by Western powers) made it highly unlikely that Xi Jinping would be begging for a deal. It is also conceivable that China may welcome a trade confrontation with the US, since it would help rally the Chinese people against an external opponent and divert attention from the balance sheet recession that was caused by nearly two decades of government induced over-investment in productive capacity, infrastructure and real estate. **The downside of Trump's strategy to "go big and break things" is that he may not have carefully evaluated all the cards in his game**. By contrast, China has a tradition of careful long-term planning and has certainly been getting ready for an eventual confrontation with the US since the Trump 1.0 trade wars. According to Sun Tzu's "The Art of War", the outcome of a battle is decided before the fighting actually begins.

The biggest card in the hands of the Trump administration when negotiating trade deals is the access to the large and very profitable US consumer market. For many exporting countries, keeping that access open is essential to their economy. In the case of China though, its exports represent ~2.5% of GDP (vs. 25%-30% for Vietnam for example), which is significant but not existential. Since Trump's first term, it has been rebalancing the geographic distribution of its exports away from the US and towards other parts of the world, notably Southeast Asia. In addition, while the government has so far refrained from providing meaningful fiscal stimulus in the face of a slowing economy – to avoid depreciating the yuan - it could decide to stimulate domestic consumption in order to absorb the output that was originally meant for US export. It looks that the Trump administration may have overplayed the significance of that card, but more importantly, it seems that it has not carefully considered two major weaknesses in its game:

Time is not on the US's side. The US is a democratic country with very short (2 years) election cycles, which leaves very little time to implement reforms and obtain results before the next election comes along. On top of that, Trump's presence in the Oval Office is almost certain to end in less than 4 years, as the constitution prohibits more than two terms by the same president. Given that his tariff strategy is widely unpopular among the political establishment across both sides of the aisle, it makes sense for foreign leaders to "wait him out" and try their luck with the next president. Xi Jinping doesn't face elections and is president for life (or for as long as he wishes) so he has all the time in the world. Besides, **rebuilding America's manufacturing base may take a decade or more**, since it will take years to build new factories and train a large enough number of US workers to fulfill all those manufacturing jobs. **Negotiating new trade deals is also a complex, multi-year endeavor**. **In the meantime, the consequences (many of which are unintended) of restricting imports from China would be felt very quickly in the US economy.** China provides the convenience of being a one stop shop for manufacturing with a good quality over price ratio. Viable alternatives exist for some products (for example Vietnam in the case of apparel), but not for others: in the case of kitchen/bathroom plumbing equipment (faucets, toilets, etc..), China is hard to bypass, so the sky-high tariffs on Chinese products would be a major impediment for the home building industry. Soon after the China tariff escalation, the Trump administration had to announce some product specific exemptions to address such issues. In addition, while large companies may have the resources and expertise to rejigger their supply chains, such is generally not the case for small businesses, which would have a hard time finding a viable alternative to source their products.

The US is dependent on the rest of the world to finance its large budget (7% of GDP) and current account (4% of GDP) deficits and has accumulated a very large (67% of GDP) negative net investment position since the GFC, which makes the country vulnerable to capital flight. According to Triffin's paradox, **the concurrent goals of preserving the US dollar's status as the world's reserve currency while reducing trade deficits contradict each other** and cast doubts in the mind of foreign creditors regarding the administration's economic competence. The general lack of clarity about the tariff strategy and poorly grounded reciprocal tariffs have lowered foreign investors' confidence in the US as an investment destination, resulting in substantial capital outflows from US equities, US bonds and the US dollar, akin to what typically happens in an emerging market during a financial crisis. The two charts below show the cumulative aggregate flows (as a % of 4/30 AUM) for US vs. European ETFs investing in US equities and US bonds. **In the days following liberation day (4/2), European ETFs investing in US equities and bonds have seen outflows, while US ETFs investing in those same assets have seen inflows**, illustrating the deterioration in European investors' confidence in US assets.


Source: FactSet, SIMG Analysis

Given that it has been Scott Bessent's objective to bring long term Treasury yields lower, the sharp rise in long term Treasury yields that occurred during the week of 4/7 – 4/11 seems to have scared the Trump administration. Further, sentiment on the US dollar has declined, as illustrated in The Economist magazine's cover from 3 weeks ago. As a result, **Trump has softened his stance on tariffs to a meaningful extent**, for example, by announcing a 90-day pause on reciprocal tariffs (for countries other than China) and product specific exemptions. Trade deal negotiations – including with China – seem to be moving along behind the scenes, and a major crisis seems to have been averted for now. However, **this brief episode of foreign capital outflows has served as a warning that the US cannot unilaterally reshape the global trade architecture on its own terms.**


Source: The Economist

While that brief episode of stocks down, bonds down, dollar down has spooked investors, it is worth noting that **days when all three assets decline concurrently have not been that infrequent historically**. Over the past 55 years, such days have occurred ~11% of the time, on par with more classic risk-off days when equities are down but Treasuries and the dollar are up.
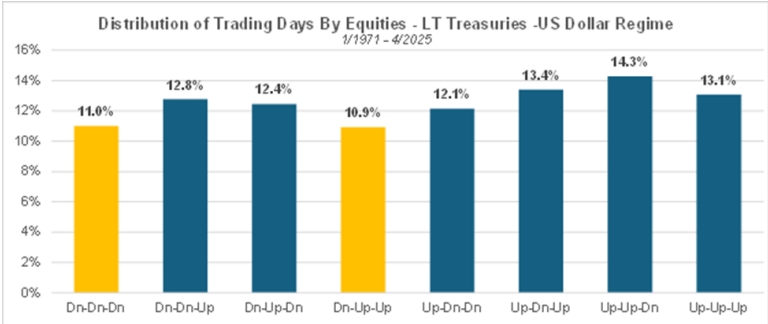

Source: Bloomberg, SIMG Analysis

Historically, the frequency of stock down, bonds down, dollar down days has been much higher in the 1970s or in the mid-1990s than so far in 2025. However, the US's debt level was much lower then than it is now, which helps explain why such occurrences are more prone to degrade investor sentiment in the current environment.
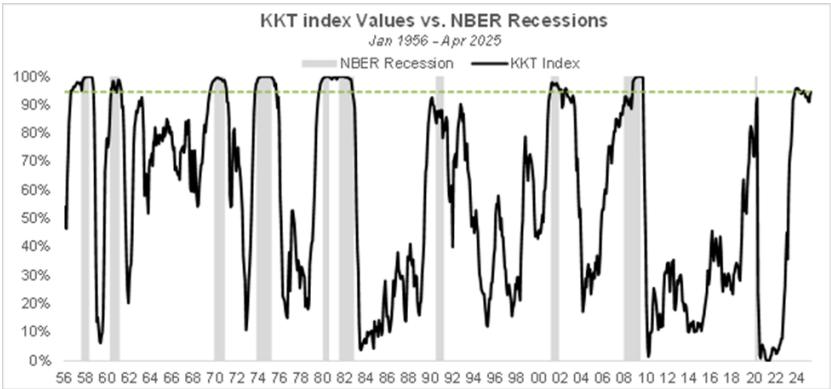

Source: Bloomberg, SIMG Analysis

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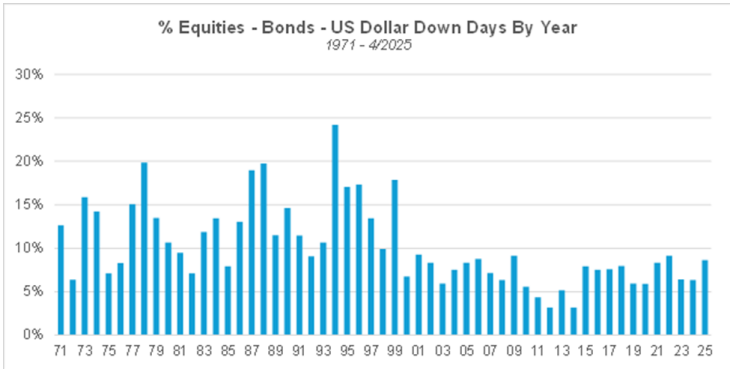
At the micro level, stock returns in the growth universe in the week post liberation day have been highly correlated with China revenue exposure (negatively) and with US revenue exposure (positively) in large and mid-caps, but not so in small caps. The breakdown of the growth universe into large, mid and small caps in the below is based on the constituents of the Top 200, Midcap®, and 2000® Russell Growth indices.

Correlation With Post Liberation Day Returns (4/2 - 4/8)
Russell 3000 Universe
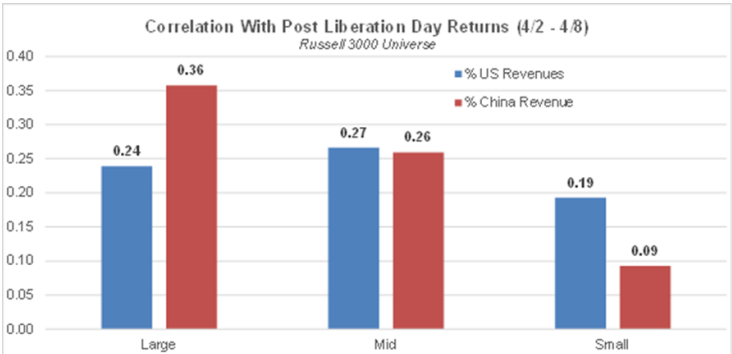
Source: FactSet, SIMG Analysis

Given the recent market turmoil, one would expect the Trump administration to pivot away from trade issues and towards tax cuts and de-regulation in the months ahead, as those topics are much more popular with both investors and voters. To avoid the optics of appearing to lose the trade war, some vaguely worded memoranda of understanding or frameworks may be announced, with the idea that detailed trade agreements would be finalized much later, but without a specific timeline, akin to what happened with the announcement of the "phase one" agreement during the Trump 1.0 trade war with China. Until then, tariff uncertainty is likely to keep businesses' investment decisions in a holding pattern. In addition, even if DOGE delivers much less than expected in terms of government spending cuts (the DOGE tracker indicates 165 Bn of estimated savings vs. 2 Tn promised during the presidential campaign), those cuts will have a recessionary impact on the economy. According to the BEA, real GDP growth in Q1 was -0.3%, primarily because of a surge in imports ahead of expected tariffs. Economic uncertainty, a decline in government spending, an increasingly financially strained US consumer along with persistently high interest rates are factors that could cause the economy to further contract in Q2. After sequential improvements late in 2024 and earlier this year, **the KKT index has reverted to 94.6%, a clear recessionary reading at the end of April. The long-awaited recession, that has been delayed by large amounts of fiscal stimulus, seems to have finally arrived, at least according to the KKT Index.**

KKT index Values vs. NBER Recessions
Jan 1956 – Apr 2025

Source: St Louis Fed's ALFRED database, Robert Shiller's data (http://www.econ.yale.edu/~shiller/data.htm), Bloomberg, SIMG Analysis. The methodology behind the KKT model is explained in the research paper below: A NEW INDEX OF THE BUSINESS CYCLE by William Kinlaw, Mark Kritzman, and David Turkington
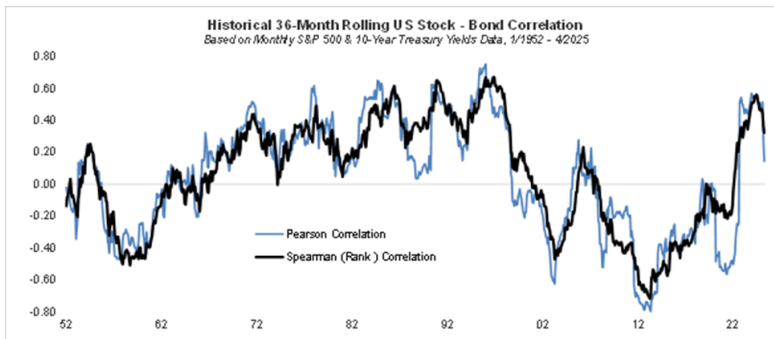
As shown below, economic growth in the past 2 years has been supported by the service sector, while manufacturing has been consistently in recession territory. However, recent readings suggest that the ISM services index has weakened meaningfully in recent months.

ISM Manufacturing & Services vs. GDP Growth
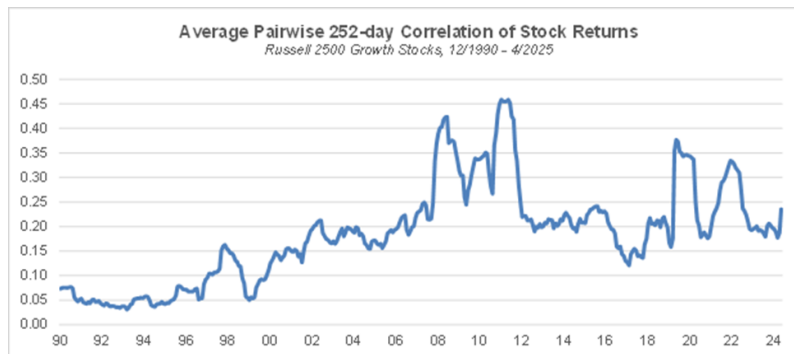*1/1998 – 3/2025*

Source: Bloomberg, SIMG Analysis

In the face of a deteriorating economy, it is likely that the administration will do what it can so that the "Trump recession" phrase doesn't gain traction ahead of the midterms. **However, the fiscal and monetary cavalry is unlikely to come to the rescue right away**. The budget reconciliation bill (and associated tax cuts) probably won't be passed until August at the earliest. As for monetary stimulus, the Fed doesn't seem to be in a hurry to cut rates. In its most recent statement, it dismissed Q1 GDP's weakness and indicated that the unemployment rate remains low, and that inflation remains elevated. While official measures of inflation are still above the 2% target, the real time measure provided by Truflation pegs the inflation rate at 1.58%, suggesting that real rates remain too high given the recent economic weakness.

Note that while the real time measure of inflation from Truflation has weakened considerably since the beginning of the year, **the meaningfully positive stock-bond return correlation suggests that the US remains in a long-term inflationary regime**. A research paper entitled "Empirical Evidence on the Stock-Bond Correlation" by Roderick Molenaar, Edouard Senechal, Laurens Swinkels and Zhenping Wang (https://papers.ssrn.com/sol3/papers.cfm?abstract_id=4514947) provides **evidence of a statistically significant, positive relationship between the level of inflation and the stock-bond correlation based on US data since 1952, i.e. since the Fed started implementing contra-cyclical monetary policies.**

Historical 36-Month Rolling US Stock - Bond Correlation
Based on Monthly S&P 500 & 10-Year Treasury Yields Data, 1/1952 – 4/2025

Source: Bloomberg, SIMG Analysis

Our preferred long-term measure of investor sentiment, **the average pairwise correlation of stock returns, has risen sharply since the end of March, consistent with a spike in risk aversion**. However, risk aversion remains far from historical extremes.
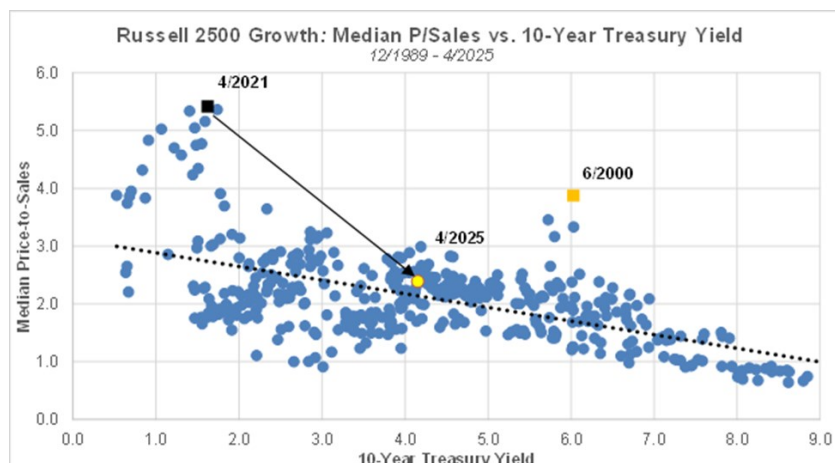

Average Pairwise 252-day Correlation of Stock Returns
Russell 2500 Growth Stocks, 12/1990 – 4/2025

Source: Bloomberg, SIMG Analysis

As of the end of April, the median price-to-sales multiple of small & mid cap growth stocks remains at a level that is consistent with the 10-year Treasury yield, suggesting that **SMID growth stocks are fairly valued.**

Source: FactSet, SIMG Analysis

Regarding styles, **the best performing cohorts year-to-date continue to be large caps, low volatility and high-quality stocks, consistent with stock pickers positioning their portfolios towards an economic slowdown/ recession**. By contrast, small caps, high volatility, and junk stocks have underperformed materially. **Interestingly, stocks with low interest rate sensitivity (that benefit when rates decline) have outperformed for the 4th month in a row.**

Style Performance, Top or Bottom Quintile vs Market
Russell 3000 Growth Universe, Through 4/30/2025

	High Volatility	Low Volatility	Most Shorted	Least Shorted	Large Caps	Small Caps	Quality	Junk	High Rate Sensitivity	Low Rate Sensitivity	High Passive Ownership	Low Passive Ownership
Jan 2025	(2.6%)	(0.2%)	0.1%	(0.6%)	3.1%	(3.0%)	0.3%	(2.4%)	0.3%	0.6%	(0.1%)	(1.7%)
Feb 2025	(3.5%)	5.0%	(3.8%)	4.7%	2.6%	0.8%	4.3%	(2.6%)	0.3%	1.2%	(0.8%)	(1.8%)
Mar 2025	(5.8%)	4.7%	(1.9%)	2.1%	1.9%	(4.4%)	4.3%	(5.0%)	(1.5%)	2.8%	2.4%	(2.3%)
Apr 2025	5.7%	(1.9%)	2.0%	(1.2%)	1.2%	2.1%	(1.6%)	3.7%	(1.8%)	0.9%	(3.1%)	1.9%
2025	(6.2%)	7.6%	(3.6%)	5.0%	8.8%	(4.5%)	7.3%	(6.4%)	(2.7%)	5.4%	(1.6%)	(3.9%)

Source: FactSet, SIMG Analysis

Within the factor space, top ranked stocks in terms of profitability, trailing sales growth and FCF yield have continued to out-perform so far this year, consistent with **an investor tilt towards high profitability companies with robust cash flow generation. By contrast, stocks with high revenue growth expectations have under-performed materially this year**. High momentum stocks have out-performed last month after two consecutive months of underperformance.

Alpha Factor Performance, Top Quintile vs Market
Russell 3000 Growth Universe, Through 4/30/2025

|	Fwd P/E	Price/Sales	FCF Yield	ROE	Gross Profit	Total Yield	Sales Growth (T12M)	Sales Growth (FY2/FY1)	12-M Price Mom.	1-M. Mom. Reversal	Earnings Revisions
Jan 2025	0.7%	1.4%	0.7%	0.1%	1.8%	(0.6%)	2.2%	(1.3%)	1.0%	0.1%	(0.3%)
Feb 2025	0.7%	2.0%	2.0%	2.7%	1.6%	1.2%	(1.1%)	(4.0%)	(1.5%)	0.4%	0.9%
Mar 2025	2.3%	(0.3%)	1.6%	2.0%	0.6%	2.4%	(0.1%)	(2.7%)	(0.5%)	(4.2%)	(0.4%)
Apr 2025	(2.7%)	(3.7%)	(2.9%)	(0.4%)	0.4%	(2.8%)	1.6%	0.8%	2.4%	2.6%	3.8%
2025	1.0%	(0.7%)	1.4%	4.5%	4.5%	0.3%	2.6%	(7.3%)	1.3%	(1.2%)	4.0%

Source: FactSet, SIMG Analysis

At the end of April, our momentum timing model continues to indicate a high risk of under-performance for those stocks in May. Note that the timing model's current indication is primarily driven by the high recent volatility of the momentum factor along with the high relative price-to-book multiple of high momentum stocks, with the other 4 variables having more moderate values. This observation suggests that the model's negative indication is less robust than earlier this year.
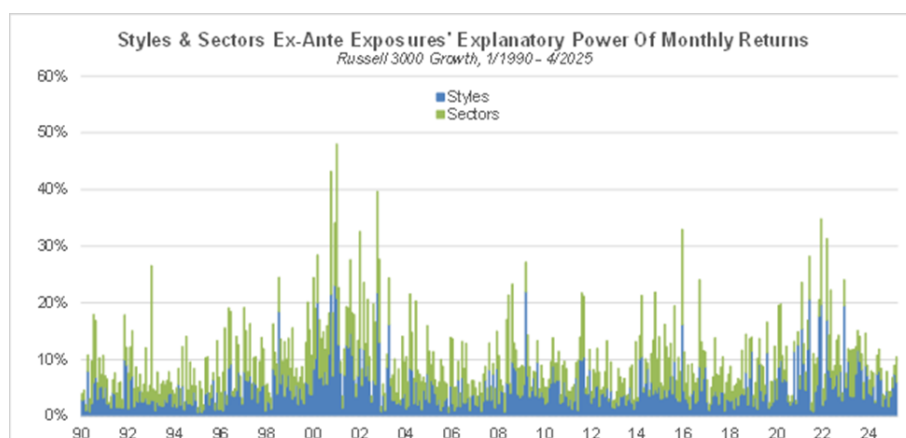
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Apr 2025 Momentum Timing Score & Components
Russell 3000 Growth Universe, as of 4/30/2025
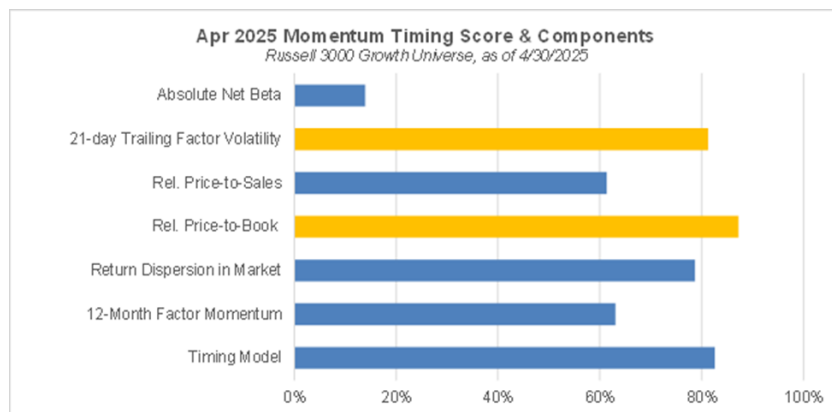
Source: FactSet, SIMG Analysis

The percentage of cross-sectional monthly return dispersion (within Russell 3000® Growth stocks) that is explained by exposures to styles and sectors has risen in April into the 63rd percentile relative to the last 35 years. This percentage tends to spike during periods of macroeconomic stress or high market volatility as we have experienced last month.

Styles & Sectors Ex-Ante Exposures' Explanatory Power Of Monthly Returns
Russell 3000 Growth, 1/1990 – 4/2025

Source: FactSet, SIMG Analysis

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