VANN EQUITY MANAGEMENT

HIGHLIGHTS

- What is Really Pressuring Stocks
- **Market Preview:** Does Policy Chaos Continue?
- **Weekly Economic Cheat Sheet:** Focus on Inflation This Week (CPI Wednesday is the Key Report)
- Where Is the Trump Put?
- **Special Reports and Editorial:** Is Europe Finally Ready to Grow? (Positive EU Stocks, Negative German and French Bonds)

STOCKS

S&P 500

- Technical View: The trend in the S&P 500 turned bearish in early March as the index took out the early 2025 lows to close at a fresh post-election low.
- Dow Theory: **Bullish (since the week of July 10, 2023)**
- Key Resistance Levels: 5778, 5843, 5955
- Key Support Levels: 5726, 5666, 5618

SOURCE: Factset and Vann Equity Management Research Team

"Stocks tumbled and turned negative year to date following the imposition (and then delay) of tariffs on Mexico and Canada as tariff and trade chaos continued to pressure stocks."

- ✓ **What is Outperforming:** Defensive sectors, minimum volatility, and sectors linked to higher rates have been relatively outperformed recently as markets have become more volatile.
- ✓ **What is Underperforming:** Tech/growth and high valuation stocks have lagged as yields have risen.

What is Really Pressuring Stocks

Stocks are dropping this month on tariff worries, some disappointing tech earnings, and the chaotic flow of scary headlines. Sentiment remains very negative and calls for continued declines in stocks are getting louder and more frequent. To be sure, the outlook for stocks has changed for the worse in the near term. Before the onslaught of tariff headlines that hit markets in early February, stocks enjoyed a near-perfect setup of stable growth, Fed rate cuts, AI enthusiasm, and expected positive fiscal momentum.

That perfect setup has been damaged; however, it is important to understand why it has been damaged and given the noise in the financial media about various headwinds, that is not entirely clear.

"The reason stocks are dropping is the spike in uncertainty and fear that uncertainty will lead to a whole host of negatives."

Essentially, the CURRENT "market logic" is this:

> *Whiplash tariff headlines will continue for (at least) another month (until the April 2nd reciprocal tariff announcement), while similar policy chaos can be expected on:*
>
> 1) *Averting a government shutdown*
> 2) *Extending the debt ceiling and*
> 3) *Tax cut extensions.*
>
> *All of that uncertainty will cause consumers and businesses to essentially "hole up" and wait for clarity. That restraint on spending and investment will then cause an economic slowdown and a decline in S&P 500 earnings. Since the* ***S&P 500 is still trading over 21X earnings****, IT IS very vulnerable to a 10% decline from here before we get to more solid valuation footing. Finally, since the Fed cannot fix Washington's policy chaos, they cannot help much even if they cut rates an additional time.*

LET US BE CLEAR: If all that happens, this market will decline 10% (or more), and until there is some movement toward stable policy, the best we can hope for is a churn sideways between around 5,700 and 6,000 in the S&P 500.

However, while our investment committee appreciates these fears, **WE WANT TO REINFORCE that IT IS FEAR DRIVING THIS SELL-OFF**, not actual bad data.

1) **Economic data this month has been "fine"** (Powell himself said the economy remained on solid footing even if there is a slight loss of momentum).
2) **Corporate earnings are holding up "fine"** (and we are not seeing wholesale cuts to EPS estimates yet).
3) **For all the chaos, the "bark" of tariffs remains worse than the "bite"** (excerpting USMCA goods seriously reduces the impact of Canadian and Mexican tariffs).

HERE IS THE POINT: Our team appreciates the negative scenario, and it is right to be more cautious on this market and brace for continued volatility, but that negative scenario is not a forgone conclusion or fact on the economy and earnings hanging on. As such, we think the right tactical strategy is to hold onto positions.

Finally, while the outlook for Washington is reasonably dark right now (and deservedly so), there is a positive path here of 1) Tariff clarity and 2) Passage of pro-growth measures. If that happens (and it can happen quickly), then Washington will go from a headwind to tailwind and a switch to more cyclical sectors. For now, "hiding" in low-beta, low-vol strategies like our Large Cap Value Strategy with broad diversification remains a sound way to stay long but weather the current storm.

Economic Data (What You Need to Know in Plain English)

Growth worries have surged in investors' minds thanks mostly to the policy chaos emanating from Washington, but this month's economic data was generally "solid," and while it does not mean a slowdown cannot happen, it does mean that the data is pointing to an economy that has generally solid growth.

Starting with the jobs report, it was basically in line with expectations at 151k jobs added vs. 159k, while the unemployment rate moved to 4.1% vs. (E) 4.0%, and y/y wage growth increased 4.0% vs. (E) 4.1%. It was a Goldilocks number and pushed back on the soft ADP jobs report, implying that the labor market remains solid. That is an important positive for the economy because it is hard to have a recession in the U.S. when the unemployment rate is around 4% and jobless claims are in the low 200k. Yes, we could see a loss of positive economic momentum, but these jobs numbers will have to deteriorate substantially from here to imply a recession.

Turning to the ISM PMIs[1], they both stayed relatively comfortably above 50 and pushed back on the "slowing growth" narrative. The ISM Services PMI was the most important report last week (outside of the jobs report), and it was solid. The PMI rose to 53.5 vs. (E) 52.5 and is comfortably in expansion territory. Additionally, the details of the report were also solid as New Orders rose to 52.5 from 51.3 and employment increased to 53.9 from 52.3. Looking at the manufacturing PMI, it was not as good, but it was still "okay." The ISM Manufacturing PMI stayed above 50 for the second straight month at 50.3, just below the 50.7 expectation. The details of the report were less encouraging, however, as New Orders fell to 48.6 from 55.1, while Employment dipped to 47.6. Obviously, tariff concerns are impacting the manufacturing PMI (remember it is a survey), but even so, the headline reading remained "okay," although we should expect more weakness in March given the tariff chaos.

Looking at inflation (the second part of stagflation[2]), there was mixed data. The Prices Paid indices in the ISM Manufacturing and Services PMI were both higher month over month and above 60, although they are not at levels that imply inflation is surging higher. Unit Labor Costs, meanwhile, were muted (rising 2.2% y/y vs. (E) 2.5%). Finally, the Beige Book[3] commentary on the economy in February implied the economy was losing momentum, but that growth was still intact.

Now, our investment committee does not want to dismiss economic concerns as the policy chaos being thrown at the economy and markets is real, and it is the stiffest headwind the economy has faced since rising rates. However, the facts remain that through February, the major economic data points still pointed toward solid growth. Both ISM PMIs remained above 50 (signaling expansion), and there was solid job growth and tame wages.

Important Economic Data This Week

[1]ISM manufacturing index, also known as the purchasing managers' index (PMI), is a monthly indicator of U.S. economic activity based on a survey of purchasing managers at manufacturing firms nationwide. PMIs use a monthly questionnaire survey of selected companies, which provide an advance indication of the performance of the private sector. It achieves this result by tracking changes in variables such as output, new orders, and prices across the manufacturing, construction, retail, and service sectors. It is considered to be a key indicator of the state of the U.S. economy.

[2] Stagflation is an economic cycle characterized by slow growth and a high unemployment rate accompanied by inflation. Economic policymakers find this combination particularly difficult to handle, as attempting to correct one of the factors can exacerbate another.

[3] The Beige Book is a Federal Reserve report published eight times a year, summarizing economic conditions across the 12 Federal Reserve Districts based on business and market insights.

As is typically the case following the week with the jobs report and the ISM PMIs, the economic calendar quieted notably, although there will be several potentially market-moving reports starting with Wednesday's CPI.

Inflation has been pushed to the relative back burner of market discussion given tariff and trade volatility and growth concerns, but inflation still matters, and it has been recently elevated inflation metrics that have driven the "stagflation" argument, and Wednesday's CPI risks strengthening those worries or calming them. Additionally, markets are still pricing in two to three rate cuts in 2025, and that is helping to support stocks (the losses would be greater if the market thought the Fed was not cutting rates anymore).

Bottom line: The stagflation theme in the markets has taken hold, and Wednesday's CPI is the biggest headline inflation report of the month. If it comes in hotter than expected, we will see stagflation concerns increase, and stocks are likely to extend the decline. Conversely, if CPI can drop below expectations and fall below 3.0% y/y, that will ease stagflation concerns. While that may not cause a rally, it will help offset tariff anxiety.

Staying on inflation, we also get PPI on Thursday. While PPI is not as important as CPI, it does provide a bit of a leading indicator for CPI. This will be particularly watched to see if there are any hints of companies paying up and "pulling forward" buying to avoid tariffs. If PPI is hotter than expected, it will not be as bad as a hot CPI, but it will feed into fears that tariffs are going to cause higher prices.

The rest of this week's data focuses on employment via the JOLTS number on Tuesday and jobless claims on Thursday. Simply put, stable employment will be an important positive to trying to offset policy-driven uncertainty, and that means Goldilocks numbers, so they are not so hot. The Fed thinks we could see wage inflation (this is very unlikely) but also not so cold that it increases worries that the economy is going too slow.

Bottom line: There are not a lot of economic reports this week, but the ones we get will provide more color on stagflation risks, and if they can refute both the "stagnant" growth fears and the inflation worries, that will help stocks weather tariff chaos.

SPECIAL REPORTS AND EDITORIAL

Where Is the Trump Put?

Stocks declined the second week in March due to stagflationary details in the ISM Manufacturing PMI, which furthered fears that policy-related volatility and chaos is slowing economic growth and on Trump reiterating that tariffs will go into effect on Mexico and Canada.

However, unlike many traditional negative forces on stocks (e.g., declining earnings, rising bond yields, the end of the economic expansion cycle, and slowing consumer spending), the reasons stocks are declining right now are mostly voluntary, and as such, they can simply be removed.

Here is what we mean: The constant tariff threats, along with all the headline general policy volatility, are being driven by the administration. So, if tariffs (or threats of tariffs) lead to very steep market declines, the administration can simply reverse course. Put more plainly, President Trump can simply back off tariff threats and reduce the policy-driven anxiety, and we say that because we have seen it before, during Trade War 1.0.

But at what level of stock market "pain" would Trump and the administration reverse course?

Obviously, we do not know the exact number, but if we look back at Trade War 1.0, history implies the "Trump Put" would be elected around a 10% decline in the S&P 500.

Our team notes that since the first trade war began in July 2018, there were five separate actions against China (including new tariffs, increased tariffs, expanded tariffs, and naming Huawei to the "entity's list"). Those tariff actions occurred over a five-month period, and over that time, the S&P 500 declined about 10% from pre-Trade War levels.

The S&P 500 declined 10% from the pre-trade war levels in early December 2018, and that was about the same time that Trump and Chinese President Xi declared a "truce" in the trade war at the G-20 meeting in Japan; and while that "truce" did not cause an immediate relief rally (stocks declined into year-end), the market did rebound solidly in early 2019 on easing trade tensions.

Bottom line: Last time, it took a 10% decline in the S&P 500 for Trump to change direction on trade policy, agreeing to a "truce" with President Xi. If we use that as a general guide and take the "starting point" of the **S&P 500 at 6,045 (where the index was trading on Inauguration Day), then a decline down to 5,440 in the S&P 500 on trade anxiety is not out of the question before we see some hedging on these aggressive trade policies.** For reference, that is another -3.1 % decline from current levels (approximately 5,614).

Positively, if we do see a continued trade/policy-driven decline towards 10%, we think we can expect the broader stock market to continue to relatively outperform along with defensive sectors.

Is Europe Finally Ready to Grow? (Positive EU Stocks, Negative German and French Bonds)

The past few weeks have roiled geopolitical alliances between the U.S. and Europe, and one of the consequences of that is Europe may, finally, prioritize economic growth and deficit spending, and if it does, that would be foundationally bullish for European stocks and negative for European bonds (which would put peripheral upward pressure on Treasury yields).

President Trump's browbeating of Ukrainian President Zelensky, combined with the pause of military and intelligence assistance to the country, has forced European leaders to consider a world where they can no longer simply rely on the U.S. military umbrella for security guarantees.

So, for the first time in 75 years, Europe may need to actually invest, heavily, in its military. This was underscored earlier this week when German Chancellor Merz said Germany would do "whatever it takes" to build up its military, including the previously verboten idea of increasing deficit spending.

For reference, Germany is the largest and most influential economy in the EU. It is also the most fiscally conservative. Germany's debt-to-GDP ratio is just 63%, compared to 115% for France and 124% for the U.S. Put simply, Germany does not spend money (at least not the same way its Western peers do), and one of the results of that extreme fiscal conservativism has been years and years of stagnant growth.

However, being faced with the prospect of having to defend the EU from Russia (or other aggressors) without the safety of U.S. military protection has done something previously thought impossible: It is getting the Germans (and other fiscally conservative EU nations) to spend.

Case in point, there are now plans being formulated in Germany for boosting the debt-to-GDP ratio to 84% in the coming years. Much of that spending increase will come from defense spending as Germany is discussing plans to boost defense

spending from the current 2.1% of GDP to 3.5% of GDP in the coming years. That is comparable to U.S. levels of defense spending and that increased spending will boost German growth.

Think about it**:** Not only is that good for German and EU defense companies, but the support and logistics surrounding those companies will benefit, as will service providers and the general economy from these workers having more money. Additionally, Germany is also discussing a €500 billion 10-year infrastructure fund. Here is why this matters to us and companies in the International ADR strategy…

First, it is good for European stocks. European stocks have handily outperformed U.S. stocks of late because increased deficit spending is good for broad growth and good growth is good for earnings.

Second, it is generally positive for global bond yields. The 10-year German bund yield is up 40 basis points this week, which is a huge amount for that bond. And the 10-year Treasury yield has risen from an intraday low of about 4.13% to 4.28%, all while investors are worried about economic growth. The spiking bund yields are pulling Treasury yields higher (or at least stopping them from falling), which is a problem if it continues because falling yields act as a cushion for slowing growth.

Third, it is negative for the U.S. dollar. Higher deficit spending and likely better EU growth are positive for the Euro and the Euro has surged to a four-month high while the Dollar Index has dropped sharply, falling below 104 for the first time since right around the election. This dollar weakness will help support U.S. corporate earnings, however, so this is a potential positive.

It is unclear whether Europe will actually follow through on this increased spending (there have been head fakes in the past), but in the near term, this does have potential implications for U.S. investors. First, most directly, this is a reminder to review how U.S.-centric holdings have become. For the first time in a while, there is a legitimately bullish case for European stocks, and while they are short-term overbought, this is something worth looking into over the medium term. Second, it complicates the bond markets and challenges the idea that longer-dated Treasuries will protect against a slowdown (they may still, but the answer is a bit less clear).

Bottom line: There is a potential paradigm shift occurring in Europe that could see it take on more U.S.-like spending and if that is the case, it is medium- and long-term positive for European stocks and should support Treasuries (although it will not determine their ultimate direction, just influence the intensity of the move).

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