blue river
CAPITAL MANAGEMENT

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After consecutive years of mid-20-something percent gains on the S&P 500 in 2023 and 2024, US stock markets weakened in the first quarter of 2025. The S&P 500 Total Return fell 4.27% during the quarter including a decline of more than 10% from its mid-February highs, officially marking a "correction." Investors gravitated towards "flight to safety" assets like bonds and gold. Bonds, as measured by the Bloomberg US Aggregate Bond Index rose 2.78% as yields were pushed lower by investors looking for the security of bonds as stocks became more turbulent (bond prices move inversely to their yields). Gold, perhaps the original store of value, has been on an impressive run as the shiny yellow metal rose 19% in the quarter and has risen nearly 50% over the past year.

International markets have been significant laggards to US stocks for many years, but in the first quarter they outperformed significantly. The MSCI ACWI Ex-US Index tracks all publicly traded stocks outside of the US; it rose 5.23% in the quarter including dividends. Emerging Markets, a subset of the above index, posted a total return of around 3%.

In our January newsletter, we pointed to speculative behaviors that concerned us: the Magnificent 7 stocks had been rising at astounding rates; Bitcoin had surpassed the psychologically important $100,000 barrier; and the general mood of the market seemed "ready, fire, aim."

Now, just a few months later, the market's sentiment has changed dramatically. The near euphoria of the fourth quarter gave way to a long list of concerns including policy uncertainty, tariffs, stubborn inflation, signs of a softening job market, souring consumer sentiment, and a spike in mentions of the R-word, recession.

Markets like stability and we are clearly in a period of greater uncertainty. When the range of possible outcomes widens, volatility rises, and fear can often crop up when markets are moving more (especially to the downside) than we have been accustomed to. We do not want to belittle these concerns, and we are not ignoring them, but we do view the return of some skepticism to markets as healthy and we saw some encouraging signs in the first quarter.

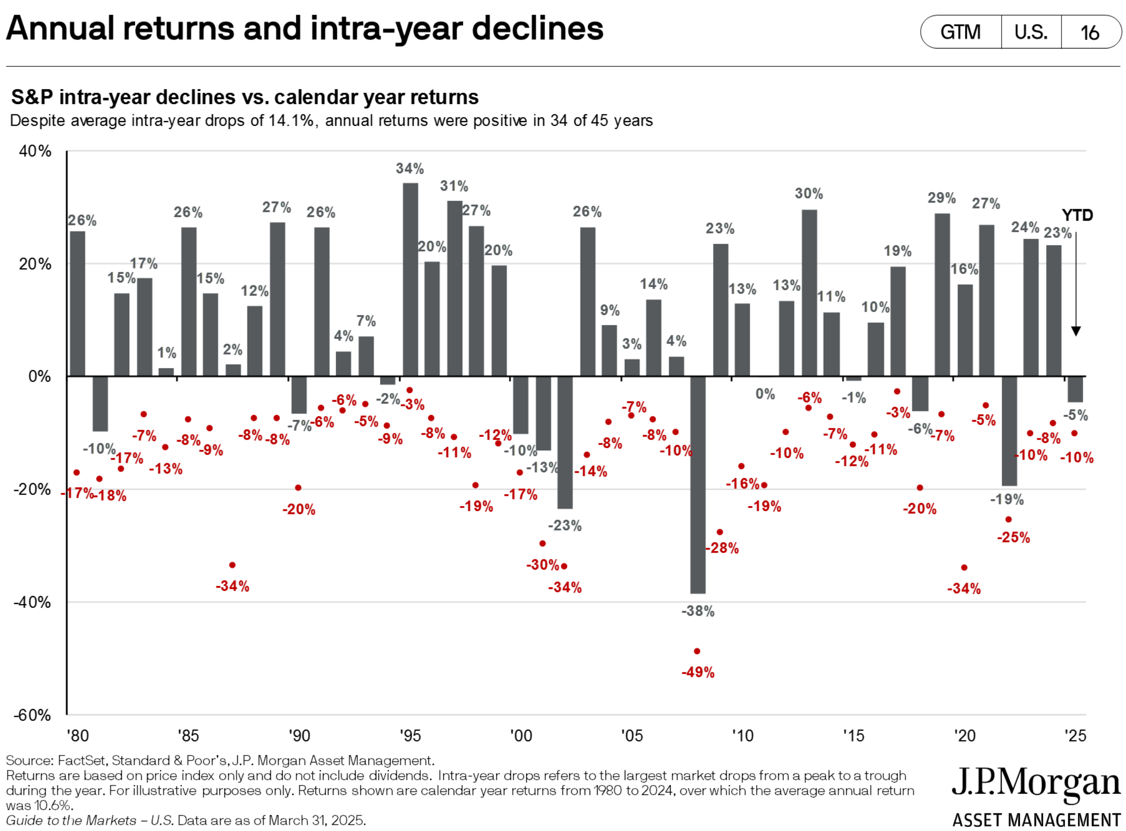
We have been making the case that the enthusiasm around the Magnificent 7 stocks (Apple, Alphabet, Amazon, Meta, Microsoft, Nvidia, and Tesla) was overdone, particularly Nvidia (NVDA). As these stocks soared, so did their influence on the S&P 500. At the beginning of the year, the 10 largest stocks in the S&P 500, which includes the Mag 7, accounted for more than 38% of the index. That level of concentration in so few stocks creates risks for the index should they falter, and that is exactly what has occurred so far this year. Of the Mag 7, only Facebook and Instagram parent company Meta Platforms (META) outperformed the S&P 500, while the other six were down more than 10%, including Tesla (TSLA) the laggard of the group, which skidded nearly 36% in the quarter.

Even after their recent stumble, the ten largest stocks still account for around 35% of the S&P 500, which is very elevated compared to the past 30-plus years, so the concentration risk remains. We were pleased to see the S&P 500 Equal Weight Index only down 0.61% in the first quarter, including dividends. This relative outperformance of the Equal Weight Index means that, on average, the stocks within the S&P 500 did better than the size-weighted index.

Fortunately, near the beginning of the year we made a tactical shift in our client accounts away from the Mag 7 stocks into a basket of stocks that we believed had better risk-reward characteristics. Our timing on this trade could hardly have been better, but in hindsight it's easy to wish we had been much more aggressive in our shift.

Another tailwind in the quarter was our exposure to international stocks. Over the past decade, we all wish we had only owned the S&P 500, which has provided a remarkable 225% cumulative total return compared to the MSCI ACWI Ex-US, which has returned 70%. Historically there have been benefits to geographic diversification and considering the continued concentration risk in the S&P 500, we believe investors will be well served to have broader exposures going forward. Compared to US stocks, international stocks still look much cheaper, and we expect that over time the performance gap between US and international stocks will narrow, but it will likely take years.

Volatility seems likely to persist in the near-term, and while it may not be as fun as the "up and to the right" advances we have had the past couple years, volatility is normal. JP Morgan produces one of our favorite slides that helps remind how common these types of drawdowns are, even when annual returns have often been positive:



Even if these intra-year declines are common, that does not mean that they are fun, which is why diversification in accounts is so important.

Probably the greatest argument for diversification is that nobody *knows* what is going to happen. At best, market participants probability weight a wide range of potential outcomes, and then position themselves for what they think is most likely to occur.

Tariffs were a primary concern during the first quarter and often received the finger point of blame. On April 2nd, the attention heightened after President Trump announced his "Liberation Day" tariffs, which were greater than expected, increasing uncertainty and the probability of recession.

In his sweeping tariff announcements, President Trump claimed that since the European Union purchased $235 billion less than the $605 billion that we bought from them, the EU, allegedly, is imposing a 39% tariff on the US (235 divided by 605 = ~39%). In response, Trump announced a so-called "reciprocal" tariff of 20% on goods imported from the EU. Trade imbalances are not tariffs, and considering the World Trade Organization estimates actual tariffs on EU purchases from the US are about 2.7%, it is difficult to argue they are reciprocal rather than punitive.[1]

We doubt that Trump and his administration want to create a trade war or to cause a recession. When combined with the dubious math, we suspect the objectives are to initiate trade negotiations—with the hope of increasing purchases of US goods—and to encourage companies to bring manufacturing to the US from overseas. A domestic manufacturing renaissance is an admirable goal, but it will not happen overnight.

During the first quarter, skittish investors migrated toward the safety of bonds. The benchmark US 10-year Treasury Bond fell 35 basis points (or 0.35%; 1 basis point = 0.01%) to 4.23%. That downward trend in yields continued early in April. We know things can change quickly, but one possible benefit, intentional or not, is that these lower interest rates come at a good time for the US. A staggering $9.2 trillion of outstanding bonds come due in 2025, which represents about 25% of our national debt.[2] As the US government is forced to refinance this debt, lower interest rates are very helpful. Every 50 basis points of interest expense savings translates to about $46 billion annually.

During these periods when question marks and concerns are more abundant, we generally receive more inquiries from clients and prospects, and we welcome them all! To our growing roster of clients and those who have made referrals, we thank you deeply. It is a privilege to serve you.

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This information is intended to be educational and is not tailored to the investment needs of any specific investor. Investing involves risk, including risk of loss. Blue River Capital Management does not offer tax or legal advice. Results are not guaranteed. Always consult with a qualified tax professional about your situation.

[1] https://www.politico.eu/article/donald-trump-us-trade-tariff-math-is-crazy-wisdom-of-crowds-author/
[2] https://www.jec.senate.gov/public/vendor/_accounts/JEC-R/debt/Monthly%20Debt%20Update.html

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