MARKET SIGHT*LINES*

Don’t Wait for the Pullback: Steps to Take in a Resilient Market

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Last week, we discussed how markets may react negatively if the Federal Reserve dissappoints and cuts rates less quickly, or less deeply, than investors expect. We’ve also discussed optimism around artificial intelligence, and how it is playing a key role in our long-term investment themes. 2025 has been an interesting year, where markets declined in April around tariff worries, then recovered and surged against a backdrop of a resilient economy and earnings environment. Now equity valuations are quite elevated, primed for a possible pullback, whether from the Fed disappointing or some other catalyst. In this Sight|Lines, we review the environment and identify what an investor can do today to prepare for any negative volatility.

THE TAKEAWAY: THE ENVIRONMENT HAS BEEN RESILIENT, AND IT’S A GOOD TIME TO PREPARE FOR A MARKET PULLBACK

The economy continues to grow, and markets have moved higher, making this a good time to prepare for a potential market retrenchment. In summary:

- Second quarter GDP was strong, and a positive third quarter points to a solid 2025.
- Despite a decline in April, equity markets have recovered this year.
- Market valuations are now quite elevated, perhaps more susceptible to a pullback.
- For putting money to work, lean on the reliable approach of dollar cost averaging.
- If you are fully invested and overweight stocks, consider rebalancing.
- Some investors may be interested in derisking their investment strategy, especially those moving closer to retirement – and this is a good time to do that.
- Popular stocks like the Magnificent Seven (Alphabet, Amazon, Apple, Meta Platforms, Microsoft, Nvidia, and Tesla) may have seemed out of reach, and a market decline will likely be a good time to establish or add to a position.
- For investors worried about a more severe negative outcome, consider some black swan ideas to increase diversification and protect wealth in an extreme environment.

IN-DEPTH: THE ECONOMY AND MARKETS HAVE BEEN RESILIENT, AND THIS IS A GOOD TIME TO GET READY FOR ANY MARKET DECLINE

While the economy continues to grow and markets seem to keep moving higher, we'll have a market pullback at some point – making this a good time to prepare for such a move. Going deeper:

- A strong GDP in second and third quarter points to solid economic growth in 2025:
  - GDP is estimated to have grown in the second quarter at an annualized rate of 3.8%.
  - The Atlanta Fed GDPNow, a real-time growth estimate, is also at 3.8% for third quarter.
  - The consensus GDP 2025 growth rate is at 1.8% and has been moving higher.
- Equity markets are higher this year, even with a big decline in April around tariff worries:
  - Year to date, the S&P 500 fell -19% through April 8 but is now up about 15%.
- Markets today are more susceptible to a pullback, given elevated valuations:
  - The S&P 500 P/E ratio is 25% higher than its 10-year average.
  - Solid profits and earnings growth are supportive of higher levels, but only to a degree.
- The classic dollar cost averaging approach can be particularly helpful for investors putting money to work:
  - While each situation is different, consider a longer investment horizon, like 12-18 months.
- If you're fully invested and are now overweight stocks compared to your target, consider rebalancing.
  - A stock/bond portfolio at "60/40" to start the year may now be about "63/37."
- For those investors looking to "derisk," this is a good time to begin to lower their stock allocation:
  - For example, investors approaching or in early retirement may want to reduce equity exposure.
- Some investors feel like they may have "missed out" on investing in stocks like the Magnificent Seven, and a market decline may well create a "buying opportunity":
  - In 2022, while the S&P 500 declined -18%, the Magnificent Seven declined -45%.
  - And earlier this year, the Magnificent Seven declined -25% through April 8.
- Some investors may be worried about a more severe negative outcome, perhaps anchored in the U.S. Fiscal Trajectory or the polarized political environment – those may consider black swan ideas:
  - Precious metals: Assets like gold and silver tend to perform well during periods of market stress and uncertainty.
  - Natural resources real assets: Provide essential services and infrastructure that typically remain in demand regardless of economic conditions.
  - Foreign assets and currencies: Exposure to high-quality non-USD sovereign bills and selective foreign exchange can offer diversification against USD-centric shocks.

CONCLUSION

2025 has been an interesting year, with markets declining in April around tariff worries, then recovering and moving even higher given a resilient economy and earnings environment. With equity valuations quite elevated, the market is primed for a possible pullback, whether that be from the Fed disappointing or some other catalyst. But given positive markets, this is a good time to take action to get ready for any market pullback we might experience.

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