MORNINGSTAR Wealth

From the Desk of the CIO

Philip Straehl Shares What's Top of Mind: March 2025

Morningstar Investment Management LLC
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A new market regime is here.

Since the start of the year, market leadership has shifted dramatically. Investor confidence was initially fueled by optimism about US growth, driven by expectations of a pro-growth policy agenda from the new administration. However, sentiment shifted sharply in recent weeks, triggering significant price declines. Several factors influenced recent moves:

- The US administration imposed tariffs on major trading partners, including Mexico, Canada, and China, reinforcing expectations that tariffs are now a structural policy feature.
- Election results in Germany, combined with US ambivalence toward military support for Ukraine, have pushed key European nations to increase defense spending.
- Weaker-than-expected economic data points to slowing activity and persistent inflation concerns.
- China's *DeepSeek moment* has reshaped investor perceptions toward Chinese companies, driving a rally in Chinese equities.

The result: US stocks—especially big tech—have struggled, while international stocks have outperformed.

Amid the noise of economic data, tariffs, and geopolitics, it can be difficult to distill the key forces at play. In this month's CIO letter, I break down the most significant drivers of recent market moves, focusing on what we believe to be the core themes: growth expectations and trade policy.

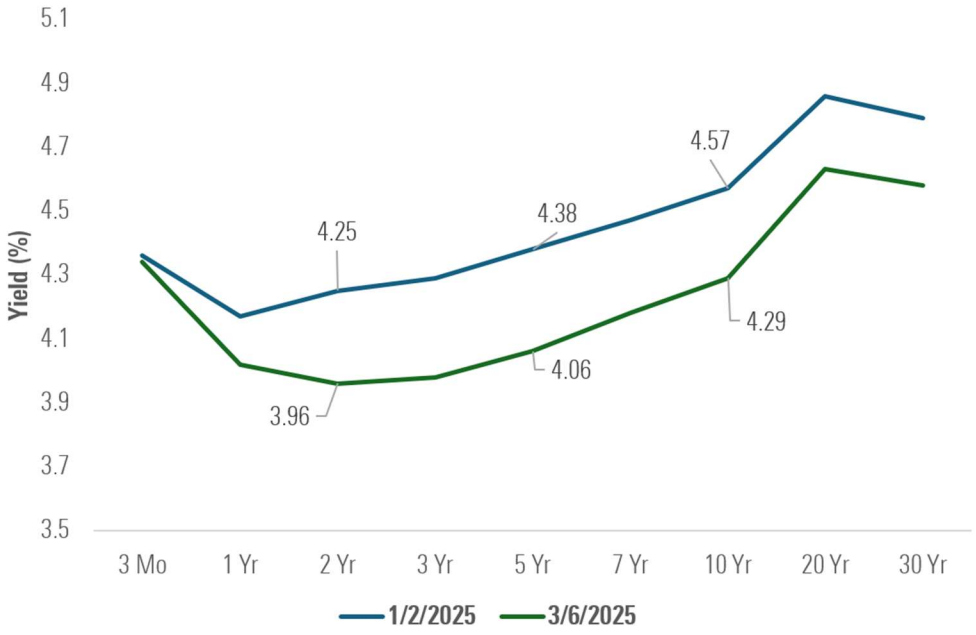
Interest Rates: An Important Microcosm

Interest rates serve as an important microcosm of the global financial system. Treasury securities, among the most liquid in the world, offer valuable insights into investor expectations for the future.

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Exhibit 1 illustrates the downward shift in the yield curve in 2025, with long-term rates declining more sharply than short-term rates, which are more directly influenced by Fed policy.

Exhibit 1: Longer Yields Declined More Than Short-Term Yields



Source: FactSet.

Although yields have declined, these moves obscure the impact of two competing forces shaping the interest rate outlook:

1. Growth: Weak macro data—such as declining consumer sentiment and retail sales—have pushed yields lower.

2. Tariffs: The prospect of higher import prices, due to tariffs has limited the Fed's ability to cut rates in the near-term, which in effect puts a lid on further yield declines.

To quantify the impact of these competing forces, I constructed a market-based growth and tariff risk factor* to assess how their impact has evolved over time.

Growth Concerns Push Yields Lower

Market-based growth proxies provide valuable insight into the key drivers behind recent market moves.

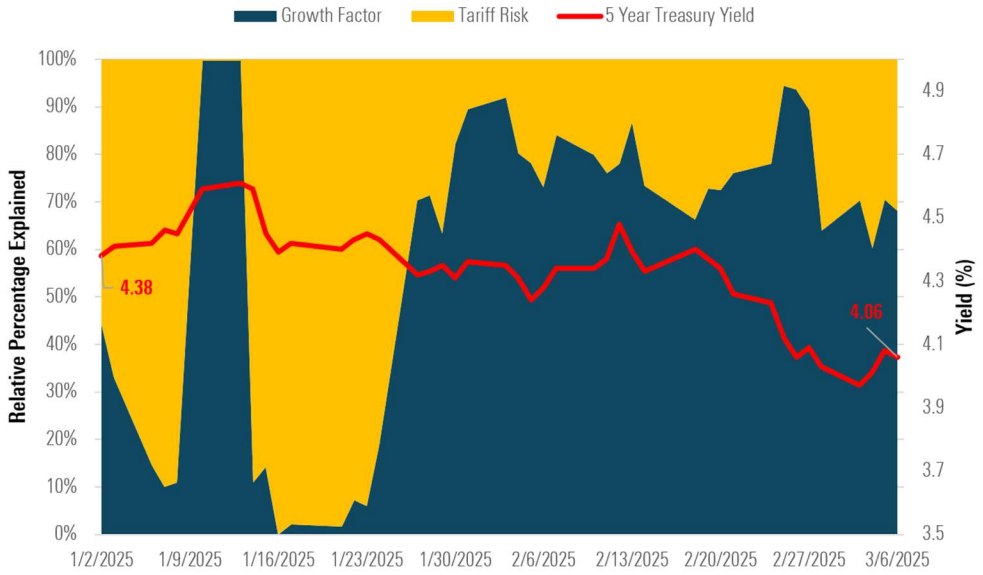
To analyze this, I examine the factors influencing 5-year Treasury yields since the start of the year, as shown in **Exhibit 2**. The yield itself is represented in red, while the extent to which yield movements are

* I use research baskets from Goldman Sachs as market-based proxies for growth and tariffs. Growth is based on the difference between the US Cyclical and US Defensive Basket. Tariff risk is proxied by the difference between the 2024 US Tariff Risk and US Tariff Immune baskets. Growth and tariff factors are orthogonalized against the US market and each other. I run rolling 30-day regression to obtain r-squared shown in the charts below. R-squared measures the % of variability explained by the variable in a regression.

explained by either growth or tariffs is depicted using an area graph: blue for growth and yellow for tariffs. Falling yields are driven by the following factors:

- The downward trend in yields—especially since February—has been primarily driven by concerns over slowing growth, as indicated by the more dominant blue area. Tariffs have played a secondary role.
- In early January, positive growth expectations lifted yields. However, as growth concerns emerged in February, yields declined.

Exhibit 2: Growth Concerns Drive Yields Down



Source: FactSet, Morningstar Wealth analysis.

Next, we examine the slope of the yield curve between the 2- and 5-year tenors, as shown in **Exhibit 3**. The slope provides insight into the direction and timing of Fed policy, as lower short-term rates typically imply more rate cuts.

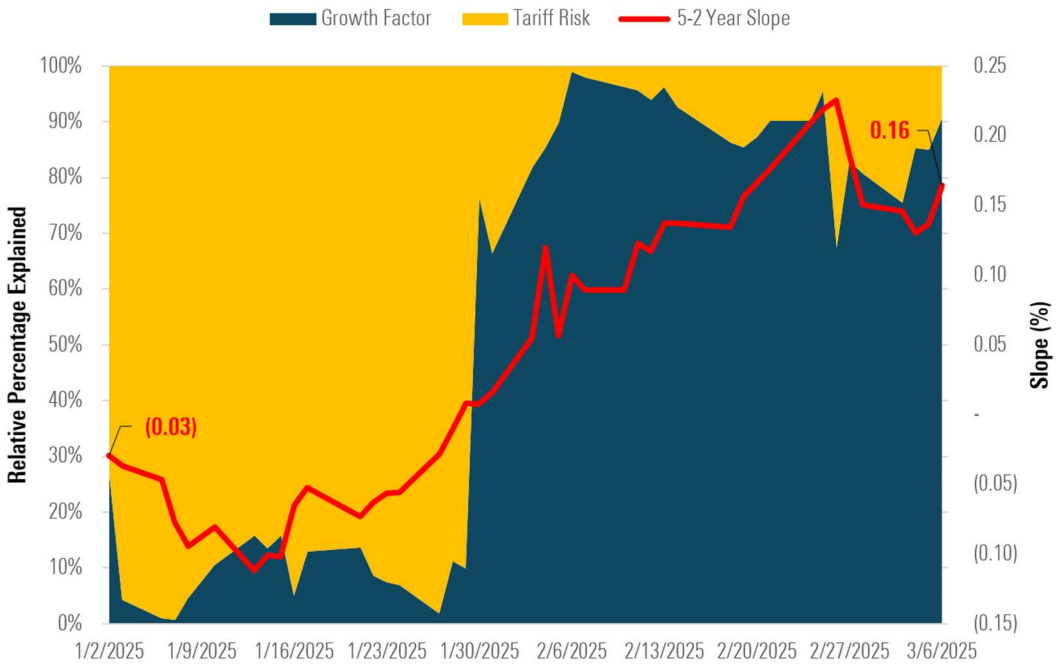
In recent weeks, the slope in the "2s-5s" curve steepened as 2-year yields declined more sharply than 5-year yields.

Parsing the relative impact of tariffs and growth concerns on this steepening, we find:

- While tariff risks contributed to early increases in the yield curve steepness due to higher 5-year yields, the recent decline in 2-year yields relative to 5-year yields has driven the curve's steepening.
- Growth concerns, shown in blue, have been the primary driver of this recent steepening, as weaker economic data has led markets to anticipate more aggressive rate cuts over the next few years.

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Exhibit 3: Lower 2-Year Yields Relative to 5-Year Driven by Growth Concerns



Source: FactSet, Morningstar Wealth analysis.

Overall, growth concerns remain the dominant force in explaining both yield levels and the slope of the yield curve. However, nominal yields are influenced by both real yields and inflation expectations.

Inflation Expectations Pinned by Tariff Risk

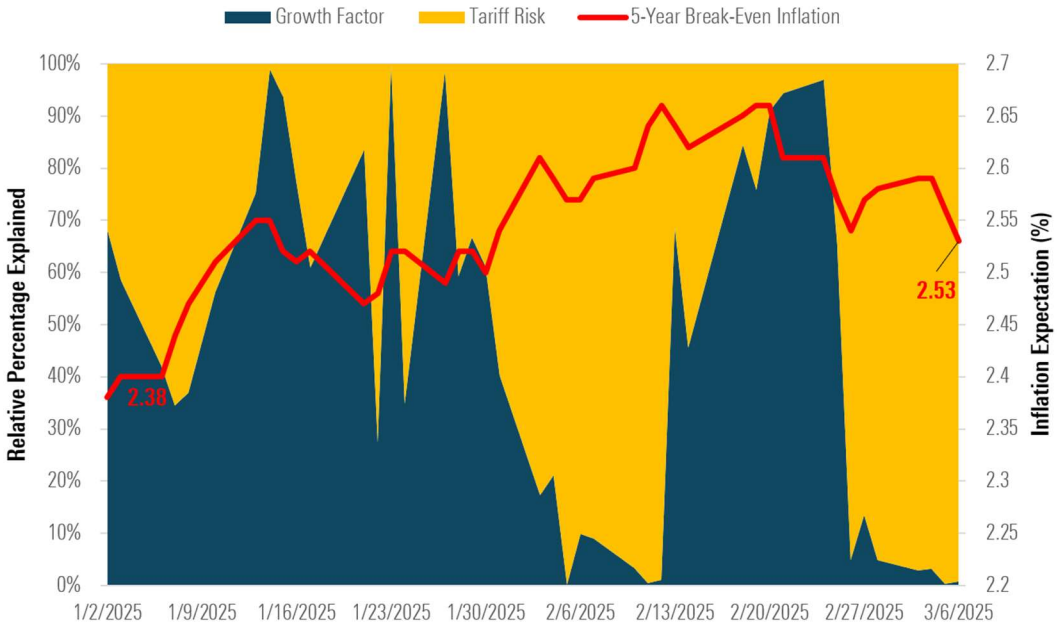
Next, we turn our attention to inflation expectations, as measured by 5-year breakeven inflation rates.

Exhibit 4 shows inflation expectations alongside the relative explanatory power of growth and tariff risks. Despite weakening growth expectations, inflation expectations have risen even as growth expectations declined. The expanding yellow areas highlight this dynamic—rising tariff concerns pushed inflation expectations higher, even as near-term growth concerns loomed.

How can we reconcile these opposing economic forces? A plausible explanation is that the market fears higher import costs from tariffs, which could, in turn, slow near-term growth. This aligns with a consistent stagflation scenario, where an external supply shock—such as tariffs—reduces economic growth while simultaneously driving inflation higher.

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Exhibit 4: Increasing Inflation Expectations Driven by Tariff Concerns



Source: FactSet, Morningstar Wealth Analysis.

Lessons for the Future

As long-term investors, we generally try to tune out short-term macro narratives and focus on the long-term value of assets. Yet, we believe this recent regime shift holds valuable lessons, which includes:

- **Structural Uncertainty:** Investing involves navigating structural uncertainty—this is nothing new. Uncertainty means grappling with the unknown. Few people expected the US economy to slow going into 2025. We believe diversification is essential for navigating potential market outcomes that are unknowable ahead of time. This is why our multi-asset strategies maintain global diversification across regions, stocks, bonds, and alternatives.

- **Macro Robustness:** Macroeconomic regimes are important determinants of portfolio outcomes. A key tenet of our process is assessing portfolio construction through the lens of macroeconomic robustness—that is, the ability to withstand different economic environments. To that end, we routinely stress-test our portfolios against various growth and inflation scenarios. This includes stagflation, even if such scenarios have few historical precedents.

Our investment team entered the year concerned about elevated US stock market valuations, balancing defensive and offensive investment ideas. While we did not explicitly forecast stagflation, our process guided us to prepare for a range of economic scenarios.

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As the market sells off, our playbook remains unchanged: buying assets that trade at a discount to our estimate of intrinsic value. Lower prices often create a fertile hunting ground for attractively valued opportunities.

Investing is simple but not easy, as Warren Buffett says. This rings especially true during periods of uncertainty, in our view.

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