ETF Market Outlook

The Unbearable Burden of Waiting and Seeing

As investors grapple with nagging macro uncertainty, market volatility's likely to continue. But we also see reasons for optimism — and new

STATE STREET GLOBAL ADVISORS

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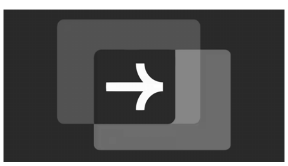
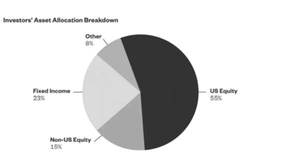


ETF Market Outlook: Overview

Position Toward Quality Stocks and Policy Tailwinds

Seek Stability in Rate and Credit Markets



Diversify Differently to Build Resilience

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Investor sentiment was euphoric at the start of the year. Fund inflows were white hot. Institutional and individual investor surveys were extraordinarily bullish. Annual outlooks from Wall Street's soothsayers forecast a third straight year of solid gains for risk assets, especially US stocks.

US exceptionalism was undeniable. The US economy expanded by a better-than-anticipated 2.8% in 2024.[1] The labor market was solid. Non-farm payrolls surged by 256,000 in December and the unemployment rate edged down to 4.1%.[2] Gainfully employed consumers, particularly the top 20% of income earners, were in great shape. Inflation was expected to moderate, giving the Federal Reserve (Fed) ample room to continue the rate cutting cycle it began in September.

S&P 500® companies were forecast to grow their earnings by nearly 15% in 2025.[3] The US was the unquestioned leader in artificial intelligence (AI), and massive capital expenditures from hyperscalers were going to press the advantage.

The incoming Trump administration was expected to accelerate the momentum with classic Republican policies to lower energy prices, cut red tape, and reduce taxes. And despite sky-high valuations, the S&P 500 managed three more all-time closing highs in the first six weeks of this year.[4]

Everything was going according to plan — until it wasn't.

The S&P 500's last all-time closing high wasn't that long ago on February 19.[5] But it's been a far more volatile and challenging capital market environment since then.

Legendary investor Sir John Templeton famously cautioned that bull markets die on euphoria. Today, anxious investors, tired of waiting for clarity on issues from tariffs to monetary policy, may be wishing they had heeded Templeton's warning.

What's Foiling Investors' Best Laid Plans?

A number of factors are responsible for at least temporarily derailing the bull market, significantly increasing market volatility, and threatening US exceptionalism.

1 The Focus and Pace of the Trump Administration's Policy Agenda

The Trump administration didn't start with the pro-growth portions of its policy agenda as investors anticipated. Instead, the administration sought to simultaneously restructure the global trading system, reshape the global military security framework by sharing more of the burden with US allies, end illegal immigration, and eliminate wasteful and fraudulent federal government spending through the Department of Government Efficiency (DOGE).

The size, scale, and magnitude of these policy goals combined with the administration's frenetic approach surprised market participants. And the rising policy uncertainty has paralyzed businesses, consumers, and investors to some extent. Consumer sentiment measures are plummeting, and short-term inflation expectations are increasing.

2 A Wait-and-See Fed Between a Rock and a Hard Place

Adding to policy stress, the dual mandate of the Fed to promote both maximum employment and stable prices may soon be at odds. Growing uncertainty about the future path of monetary policy has contributed to the difficult investing environment over the last few months. The economic, labor market, and inflation impacts from Trump administration policies are hard to predict.

In the most recent Federal Open Market Committee (FOMC) statement from May 7, the Fed acknowledged that economic activity has continued to expand at a solid pace, labor market conditions remain strong, and inflation is somewhat elevated. Fed officials claim that monetary policy is in a good place, and they prefer to wait and see what happens to the labor market and inflation over the next few months before making any changes.

But as the Fed waits, the risks of a monetary policy mistake are rising.

3 AI Confidence Turning to Skepticism

Investor excitement about the prospects for AI has sent US tech stocks soaring for the past couple of years. But tech stocks plummeted in late January in response to the Chinese startup DeepSeek launching a low-cost AI model. Concern that DeepSeek has created a better AI model at a lower cost with a lighter energy footprint has fractured the AI narrative that has propelled markets. And US tech stocks have not yet fully recovered.

In fact, in early April, US Treasury Secretary Scott Bessent added fuel to the fire by pinning the blame for recent market volatility on China's DeepSeek — not on the newly introduced tariffs from the Trump administration.[6]

4 US Economic Growth Scare

First quarter US GDP decreased by 0.3% on an annual basis.[7] The decline in GDP was primarily due to a surge in imports from businesses and consumers anticipating higher costs from tariffs. But softening economic data throughout the first half of the year, especially survey data, have investors panicked.

Yet, all is not lost.

Reasons for Optimism: Fiscal and Monetary Policy

April 30 marked the first 100 days of the Trump administration, a potentially important turning point for capital markets. The Trump administration took a number of actions in April to significantly advance its deregulatory agenda. The One, Big, Beautiful Bill Act is winding its way through Congress. It will be a messy legislative process, but when passed it will likely raise the debt ceiling and extend substantial tax cuts to consumers and businesses — stimulating economic growth.

The Trump administration and US trading partners, including China, acknowledged that harsh Liberation Day tariffs would not be sustainable. Negotiations between the US and its trading partners have started.

As a result, US stocks have recouped all their losses, providing much needed relief to investors. The post-election, pro-growth policies that investors were most excited about are now firmly underway.

The Fed has plenty of room to revive its rate cutting cycle in the second half of the year. Recent data indicates that inflation was moderating before any potential tariff-related price increases. The Fed mistakenly assumed that tariffs were inflationary in 2018, but they weren't. Tariffs are often described as a tax on imported goods. But higher taxes reduce consumption, which is disinflationary. How can tariffs be both a consumer tax and inflationary?

The target range for the federal funds rate of 4 ¼ to 4 ½ is already notably above the Fed's preferred measure of inflation, the core Personal Consumption Expenditures (PCE) Index. The Fed could cut interest rates by 0.25% three or four times and still maintain a policy rate 1% above core PCE. The Fed will likely restore its rate cutting cycle in the second half, supporting the economy and bolstering risk assets.

Earnings Growth and Better Valuations Lower Recession Odds

It's common for analysts to lower their earnings expectations throughout the year. Over the past 40 years, next-12-months earnings-per-share (EPS) growth has averaged about 2% at the start of recessions.[8] According to FactSet, analysts are projecting S&P 500 companies to grow their earnings by 9% this year.[9] That is significantly lower than the 15% earnings growth forecast back in January but probably still healthy enough to avoid recession. Once sky-high valuations are now better aligned with recent historical averages. More reasonable earnings growth expectations and lower valuations could create a stronger foundation for the next leg of the bull market.

After a brief April tariff-induced scare, economists and market prognosticators have been lowering their recession probabilities for this year. Most market watchers expect that the US will avoid recession in 2025.

Progress on the pro-growth Trump administration agenda, easier monetary policy, still strong earnings growth, better valuations, and lower odds of a recession create an attractive backdrop for risk assets in the second half of the year. But risks remain elevated.

No Time to Be a Hero

Investors are in the uncomfortable position of waiting and seeing across multiple dimensions over the next few quarters:

- Will the Trump administration successfully negotiate trade deals with US trading partners?
- Will Congress raise the debt ceiling and pass the One, Big, Beautiful Bill Act?
- Can all that be achieved without substantially increasing the deficit, inflation, and interest rates?
- Will ominous soft economic data transform into recessionary hard data later this year?
- Can the Fed avoid a monetary policy mistake? Cut rates too early and risk reigniting inflation. Cut too late and risk recession.

It's become cliché to describe potential economic and capital market outcomes as wider than normal. But the economy and investing have never fit a normal distribution where events cluster around the average and extreme events are rare.

Many brilliant investors have lost fortunes trying to fit economic and investing outcomes into a normal distribution. Economic and investing outcomes have fat tails where there are far more occurrences of large gains or losses than expected in a normal distribution.

Investors must determine whether now is a good time to take bold positions by accepting more risk or if better opportunities for risk-taking will arise in the future. Valuations have improved but remain above historical averages. Credit spreads are incredibly tight. And given the heightened potential for bad outcomes, most measures of investor sentiment and capital market volatility are likely too complacent.

The uncertainty that's roiled markets complicates decision-making. But the increased volatility in the first half of the year has created an opportunity for investors to make adjustments to better position portfolios for the remainder of the year.

Investors should consider these three themes:

1 Position Toward Quality Stocks and Policy Tailwinds

2 Seek Stability in Rate and Credit Markets

3 Diversify Differently to Build Resilience

Read: Position Toward Quality Stocks and Policy Tailwinds

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