Q1 2025 Equity Market in Perspective Peter Maag, Olga Kuzior

Normalization Now

Q1 flipped the 2024 playbook: Breadth returned, momentum cracked, defensives rebounded, and xUS led. Changing narratives are setting up to reward active, diversified investing again.

The S&P 500 experiences its worst 2-day move since the middle of March 2020, down 10.5% on April 3 and 4, 2025, following the announcement of sweeping global tariffs by the US. The Nasdaq 100 just entered bear market territory, closing at lows 21.4% off its February 19 high. The Magnificent 7 ("Mag7": Apple, Microsoft, Nvidia, Amazon, Alphabet, Meta Platforms and Tesla), equally weighted, have declined 28.4% since their December 17 high. This takes them back to levels first seen in May of 2024. Nvidia is down 37% as its valuation has compressed to 22.5x forward earnings, from 40x in August of 2024, when decelerating sales growth was imminent.

With a volatility index at 45, these numbers and more are bound to dramatically change in the coming days. Although those of Q1 are past, plenty of note happened worth taking stock of. Especially as we recall the extraordinary nature of 2024, shaped by record low return breadth, record high index concentration, and price dislocations surrounding the US elections:

- Only **30% of stocks outperformed** the S&P 500 for the full year (the average is ~45%).
- Just **4 of 11 sectors outperformed** the MSCI All Country World Index ("ACWI"): Those containing the Mag7 (IT, communication services and consumer discretionary), and financials; the remaining 7 sectors underperformed the index by an average of 13.9%.
- Since 2020, only IT and financials outperformed the MSCI ACWI, by 65% and 5%, respectively.
- **Index concentration surged** to unprecedented highs by mid-July and narrowly exceeded that peak in December.
- **US healthcare stocks neared a 17-year relative low** vs. the S&P 500 last visited in May of 2008 before a substantial recovery.
- **Energy transition priced out** of the market: Oil & gas storage and pipeline assets outperformed a basket of renewable-focused equities by 70%.

Shortly before the November 2024 elections, The Economist titled "The Envy of the World" referring to the US economy and its "innovation monopoly". Q4 equity price action was dominated by the narrative of uncontested US exceptionalism. The USD rose by 7.7%, the S&P 500 outperformed European equities by 12%, matching Q3 of 2011, when the EU was in the midst of a debt crisis. The Mag7 outperformed the S&P for 9 straight days leading into their local peak in mid-December. Value indices were mechanically sold off. US healthcare stocks had their worst relative quarter in at least three decades.

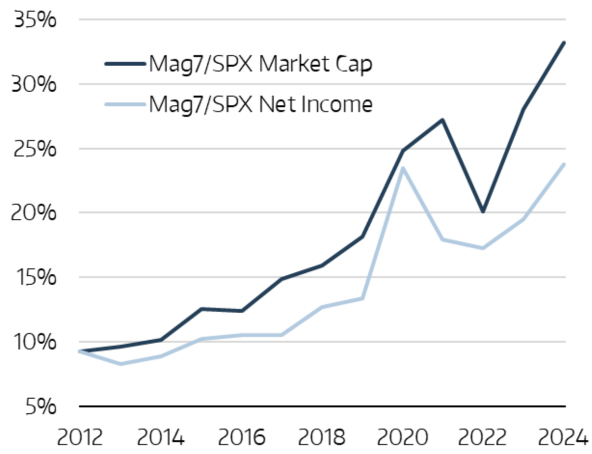
In 2025, these themes and sentiment were quickly challenged: In January, China called into question US tech optimism with a new way of running AI much cheaper than most thought possible. In February, the momentum and retail trade began to falter after an explosive 6-week start to the year. By March, it became clear the new US administration would put on hold the "good stuff" as it relates to expected policy changes in favor of realizing the President's tariff fantasies. What did it mean for markets in Q1?

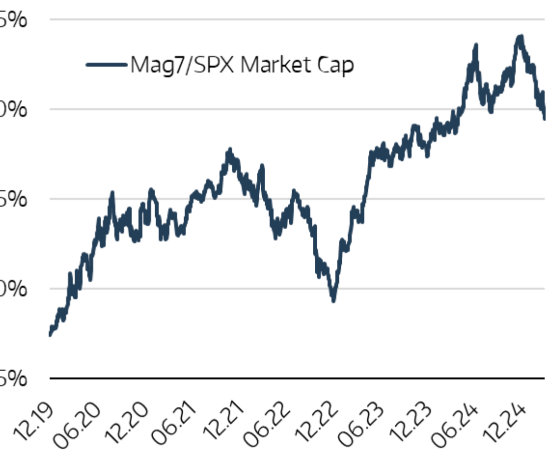
- **61% of stocks outperformed** the S&P 500.
- **8 of 11 sectors outperformed** the MSCI ACWI by an average of 6.5%, as IT, communication services and consumer discretionary lagged by an average of 6%.
- **Index concentration moderated** as the Mag7 trailed the market, led down by Nvidia and Tesla.

Although US equities saw a historically rapid 10% correction as pro-growth rhetoric subsided, the MSCI ACWI ended the quarter nearly flat at -1.3%. Under the surface, significant churn materialized in a rolling broadening of stock participation. We view relative market breadth through the different, interrelated lenses of concentration, US vs. rest of world, factor rotation and state of small and mid caps below, and address implications on equity positioning going forward.

Index Concentration and the Mag7

In 2023 and 2024, the Mag7 stocks grew earnings 35% back-to-back. The remaining companies in the S&P 500, collectively, grew profits at 0%. As a result, mega caps were responsible for the majority of returns in broad indices. Their valuation multiples expanded in anticipation of further sustained growth and the belief that several hundred billion USD in AI capex spend in 2025 and beyond would lead to meaningful returns on that capital. That could still be true. Since Meta Platforms went public in 2012, Mag7 market cap share has grown to 34%, from 10% then. Net income share followed, but the gap had materially widened:



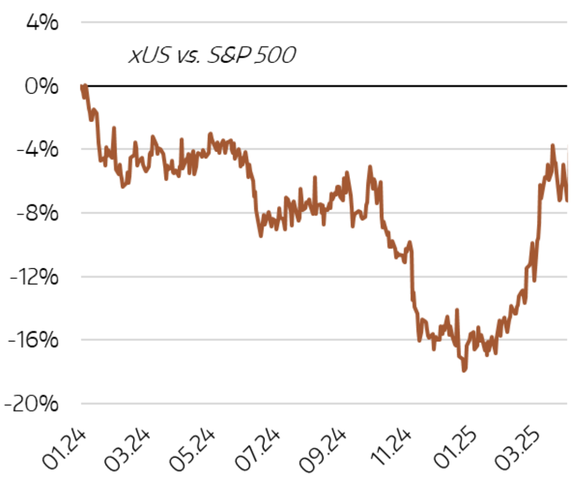


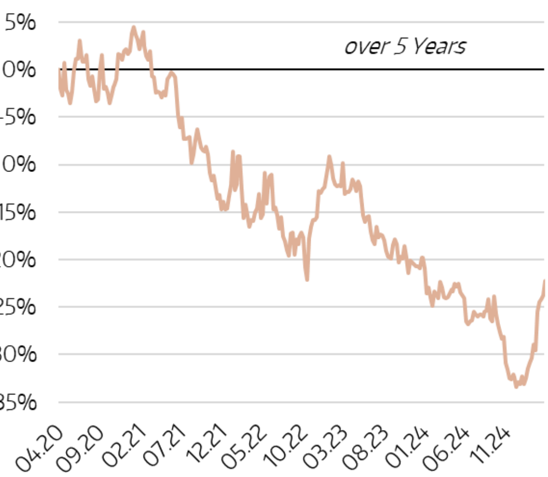
This is concurrent with increasing valuation spreads over the last 5 years within various parts of the market, interrupted only in 2022, when equities declined, and tech and long duration stocks took the brunt of it. Mid-2024, we noted the extreme index concentration, alongside forward earnings expectations suggesting convergence ahead: In 2025, Mag7 earnings were projected to grow at 16% still, and the S&P 493 at 7%, and for 2026, estimates are even closer.

While US optimism provided another boost to the Mag7 and hence index concentration in Q4 of 2024, Q1 saw a notable unwind as the US big tech trade faded vs. virtually everything else. Mag7 market cap share has come off to below 30% as the basket underperformed by double digits.

The Rest of World Trade

Following a dismal Q4 for European equities measured in USD, investor flows increasingly shifted outside the US in 2025. If 2024 was all about positive policy catalysts for the US economy and its capital markets, Q1 of this year quickly reversed that. With a US government intent on reducing debt and deficit while Germany announced a USD 545bn infrastructure package, fiscal conditions suddenly favored xUS markets.





As a result, Europe outperformed the US by over 15% this quarter (and emerging markets did so by 9%).

Although xUS valuation discounts were steep and further washed out during Q4, the recent move does not yet mark a major inflection in a longer-term trend, as shown on the RHS chart above. In fact, this quarter's run mirrors that into early 2023 not that long ago. Valuations had narrowed to a similar degree before US outperformance resumed its trend that started in 2009.

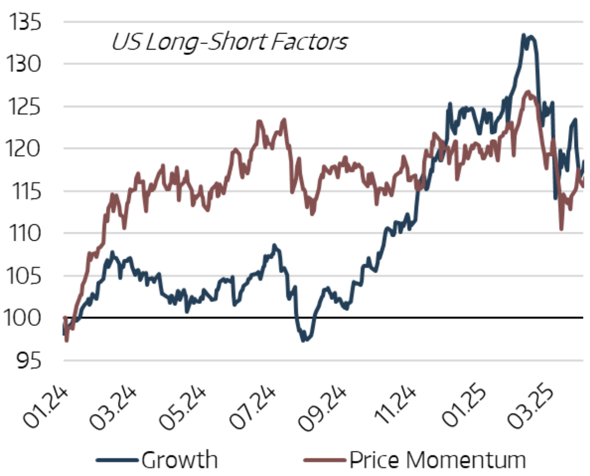
Against the backdrop of what appears like US austerity vs. European fiscal expansion (and China stimulus), this could indeed mark the beginning of a more sustained streak of xUS outperformance. Nevertheless, resolute optimism over this year's move might be premature, when it merely corrected last quarter's oversold conditions. The near term will see EU companies' earnings affected by a much stronger Euro, and a US, or even global, slowdown. Structural challenges in Europe remain and beside Germany, follow-through is required by policymakers.

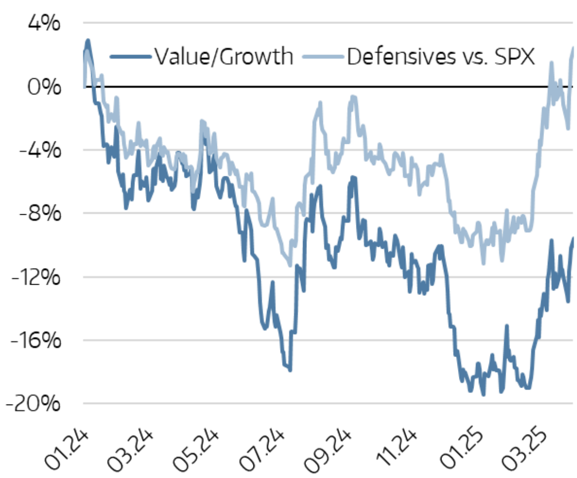
Momentum Unwind and Defensives Revival

The Mag7 (fueled by Nvidia) outperformed global indices by 40% on an equal-weight basis in 2024, building on a similar stretch in 2023. The reasons are well established by now. In Q3 of last year, significant rotation interrupted large-cap growth dominance, but it was short-lived. Starting in September, equity markets became exceptionally price-driven once again, when US elections moved front and center, and speculators increasingly bet on a Republican sweep. The sizeable positioning into (or out of) political trades dictated the tape rather than fundamental developments as market participants leaned into the US, innovation, against Europe, against healthcare, against an energy transition.

Individual investors followed suit aiding the run-ups in popular names such as EV maker Tesla on its CEO's ties to the incoming President or AI defense solutions company Palantir, which stood to benefit from continued US superiority. Cathie Wood's ARKK Innovation ETF was emblematic of the trade. On October 1, 2024, it opened at 47.66$. On February 19, 2025, price touched 68.43$, up 44%. By March 31, it had given back all gains, closing at 47.58$.

This dynamic was reflected in common equity risk factors: The combination of high growth, high valuation and high momentum exposure characterized 2024 pricing, and Q4 in particular. Defensives, most notably healthcare, were derated on near-term sentiment. The same for lower valuation and higher yielding names:



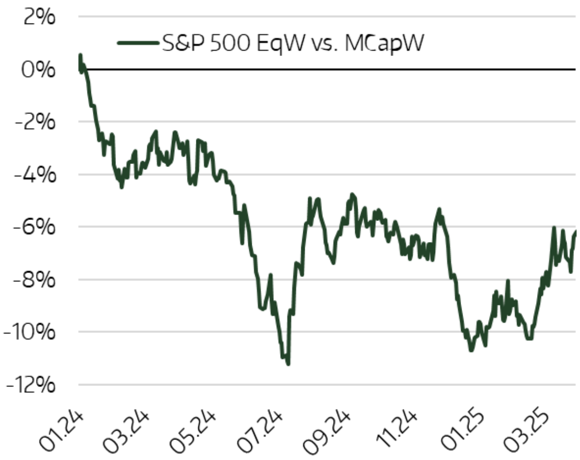


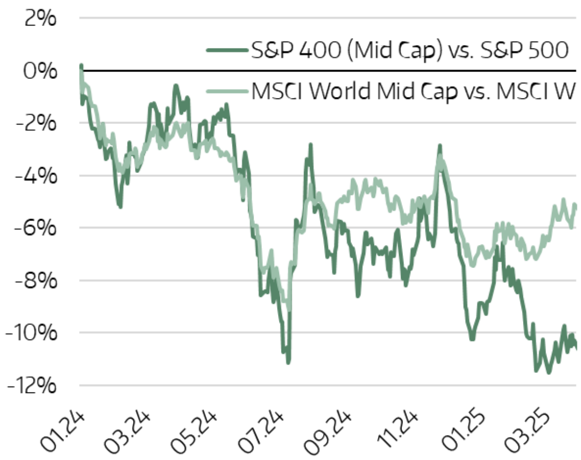
Like ARKK, much of that reversed in Q1. Following the mid-February break in momentum, defensives have taken over leadership, alongside dividend yield and value stocks. Political and macro narratives have dramatically shifted in the first few months of 2025, and markets have stayed highly sentiment-driven in reaction to fast-changing policy and economic news. However, the tone is now quite different as volatility and caution was firmly re-introduced to investors.

As whatever new reality sets in, this should eventually continue to benefit longer-term, fundamental, and diversified investing. Our view is that new leadership is being established, and that process started last summer, interrupted by the "Trump Trade" and subsequent unwind.

The State of Size

As large-cap dominance moderates, common sense would suggest smaller caps to outperform. But the picture is mixed. Rather, participation has spread from the well-known handful to large caps more broadly. That effect is naturally most pronounced in the US, where small and mid caps trailed the S&P 500 in Q1, by 4.7% and 1.9%, respectively. Globally, mid caps have kept up better, outperforming the broad index by 1.6%. These numbers fade in comparison to the outperformance of defensives, value, and international stocks. The primary reason for protracted smaller cap underperformance is clearly fears of a meaningful economic growth slowdown, if not worse, in 2025.





However, as the simplest proxy for relative market breadth, the equal-weighted S&P 500 did outperform its market cap-weighted equivalent by 3.6% during Q1. That relationship inversely correlates with the extent of return concentration, and it has not made a new low since July of last year (as charted above). Contrasting index concentration, there is ample runway for further excess return of baskets of stocks more diversified than cap-weighted indices. While the equal-weighted S&P 500 lagged the main index by 3% p.a. for the last 10 years, it has outperformed it 78% of rolling 10-year periods over the last 50+ years. In 2010, it had outperformed the cap-weighted S&P by an annualized 7% over the trailing 10-year period.

Among major outlets, Goldman Sachs' equity strategy team keeps making the case that mean reversion implies a 2% p.a. outperformance over the coming 10 years, and accounting for the extreme starting concentration could lift it as high as 8%. It conforms with the idea of ongoing moderation of US mega-cap technology supremacy.

Final Thoughts

US equities ended 2024 with their best rolling 15-year above-cash returns since 1970 (12.2% p.a. vs. a 5.9% average), according to a recent Bridgewater study ("Investing in a New World"). Historic market concentration reflected investors' bet on unabated US exceptionalism.

Today's backdrop raises the bar for a repeat of similar performance: Compared to 2010, inflation and interest rates are higher, central policy tighter, geopolitical risks rising, globalization retreating, energy security in question, US equity valuations stretched. At the start of 2025, US stocks were required to return 10% compound earnings growth over the next decade, vs. 6% 10 years ago (they did 8%) to achieve an equal 10% price growth. The remaining key factor is technology, with AI needing to deliver on its transformative promise, much like the internet during the 2010s.

The implications on equity positioning are more straightforward than attempting to forecast any of the above. As demonstrated by the past six months, sentiment can be short-lived. Decisive shifts in factor and sector leadership, coupled with economic uncertainty higher than perhaps ever in recent history, continue to advocate for active diversification across regions, styles, and market caps.

April 5, 2025. Sources: Kieger, FactSet, Bloomberg, GS Investment Research, Bridgewater.