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EQUITY OUTLOOK

THE PICTON REPORT
2025 MID-YEAR UPDATE

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FROM WHIPLASH TO RENEWED LEADERSHIP

The start of 2025 has been anything but predictable for equity investors.

Since our last update, markets have experienced dramatic swings—so much that an investor who stepped away in early March and returned in early May would generally find the major indices virtually unchanged, despite a rollercoaster of volatility in between. This "whipsaw" environment has tested most market participants, with sharp declines and swift recoveries driven by shifting policy and sentiment.

Tariff Announcements Triggered Plunge, Then Sharp Rebound

- The catalyst for the Q1 selloff was the unexpected announcement of sweeping tariffs—dubbed "Liberation Day" by some—which caught markets off guard both in scope and execution.
- A lack of clarity around the administration's endgame created uncertainty, spooking investors and triggering a sharp 15% drop in the S&P 500 Index through April.
- However, the subsequent rebound was equally dramatic, with the S&P 500 Index rallying 18% as incremental positive developments emerged.
- Notably, the announcement of a 90-day pause on tariffs for countries other than China provided much-needed breathing room, signaling that the worst-case scenario may already be priced in and that the administration's aggressive stance could be walked back.

Earnings and Consumer Spending Support Stocks

Further supporting the market's rebound was a strong first-quarter earnings season and a divergence between hard and soft data. While U.S. GDP dipped due to surging imports, consumer spending remained robust and not overly reliant on credit, offering comfort to investors concerned about a broader economic slowdown.

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Leadership Changes: Dynamic and Extreme

At the start of the year, investors crowded into mega-cap AI-related stocks, a trend that morphed from momentum (MOMO) into fear of missing out (FOMO). However, news of advancements by DeepSeek undermined long-term capex growth expectations, leading to a sharp reversal in the Nasdaq Composite Index and a nearly $1 trillion (USD) loss in market capitalization for AI bellwether Nvidia.

- Investors quickly repositioned, with leadership shifting into other growth stocks and propelling markets back toward new highs—only for momentum to unwind again as tariff concerns resurfaced.
- The momentum factor experienced one of its fastest declines in 40 years, with investors rotating into low-volatility stocks for protection.
- As markets rallied once more, capital flowed out of low-volatility and back into other areas of the market.

Today, momentum and market leadership are less crowded and more diversified than at the start of the year, with less concentration in any single factor, theme, or industry.

Corporate Earnings: Resilience Amid Uncertainty

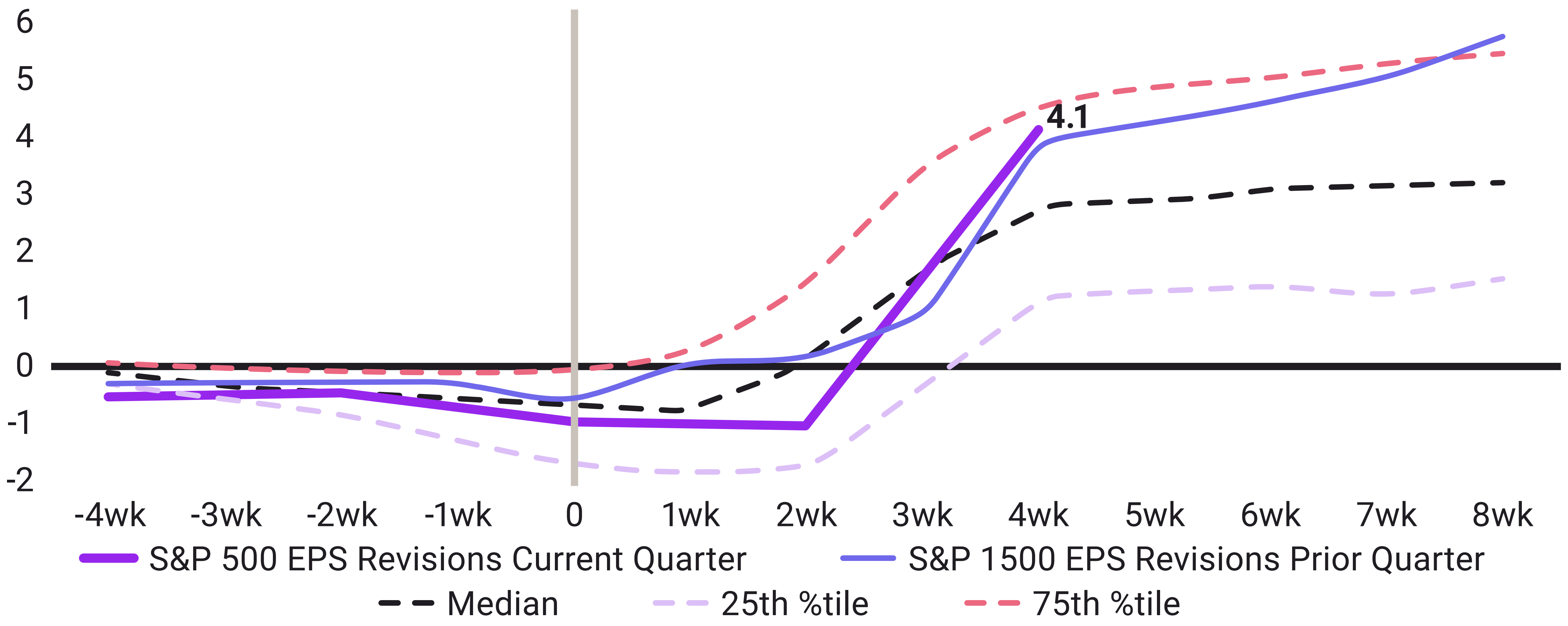
- The first quarter of 2025 has underscored the resilience of U.S. corporates. Heading into earnings season, expectations had been slashed due to tariff concerns.
- Earnings releases, however, were much better than feared with 63% of companies beating revenue estimates, and 78% beating on earnings per share (EPS)[1].
- Even more surprising, 2025 revenue estimates for reporting companies have increased by nearly 6% over the past three months, reversing some of the earlier cuts.
- Areas of corporate weakness tended to be industries that are already facing structural headwinds, such as transports working through post-Covid inventory distortions and manufacturing sectors in prolonged contraction.
- On the consumer front, management commentary from Q1 earnings reports was consistent: Lower-income consumers generally remain under pressure, upper-income consumers are relatively resilient, and there are early signs that spending by the middle-income cohort is softening.
- Weak consumer confidence and soft data has yet to hit corporate results.

A Tale of Two Retail Models: New Keeps Beating Old

Traditional brick-and-mortar retailers continue to struggle, but companies benefiting from the “New Consumer” reported standout results. Amazon.com, Inc., Netflix, Inc., Spotify Technology S.A, The Walt Disney Company, Uber Technologies, Inc., and DoorDash, Inc. all delivered strong performances in the first quarter of the year, highlighting a stark contrast with traditional consumer companies. This shift underscores where consumer spending is likely migrating.

FIGURE 1

EPS Revisions in First Quarter Surprise to the Upside (%)



Source: FactSet, Bloomberg, 22V Research.

[1] FactSet, Q1 2025 by the numbers, May 29, 2025.

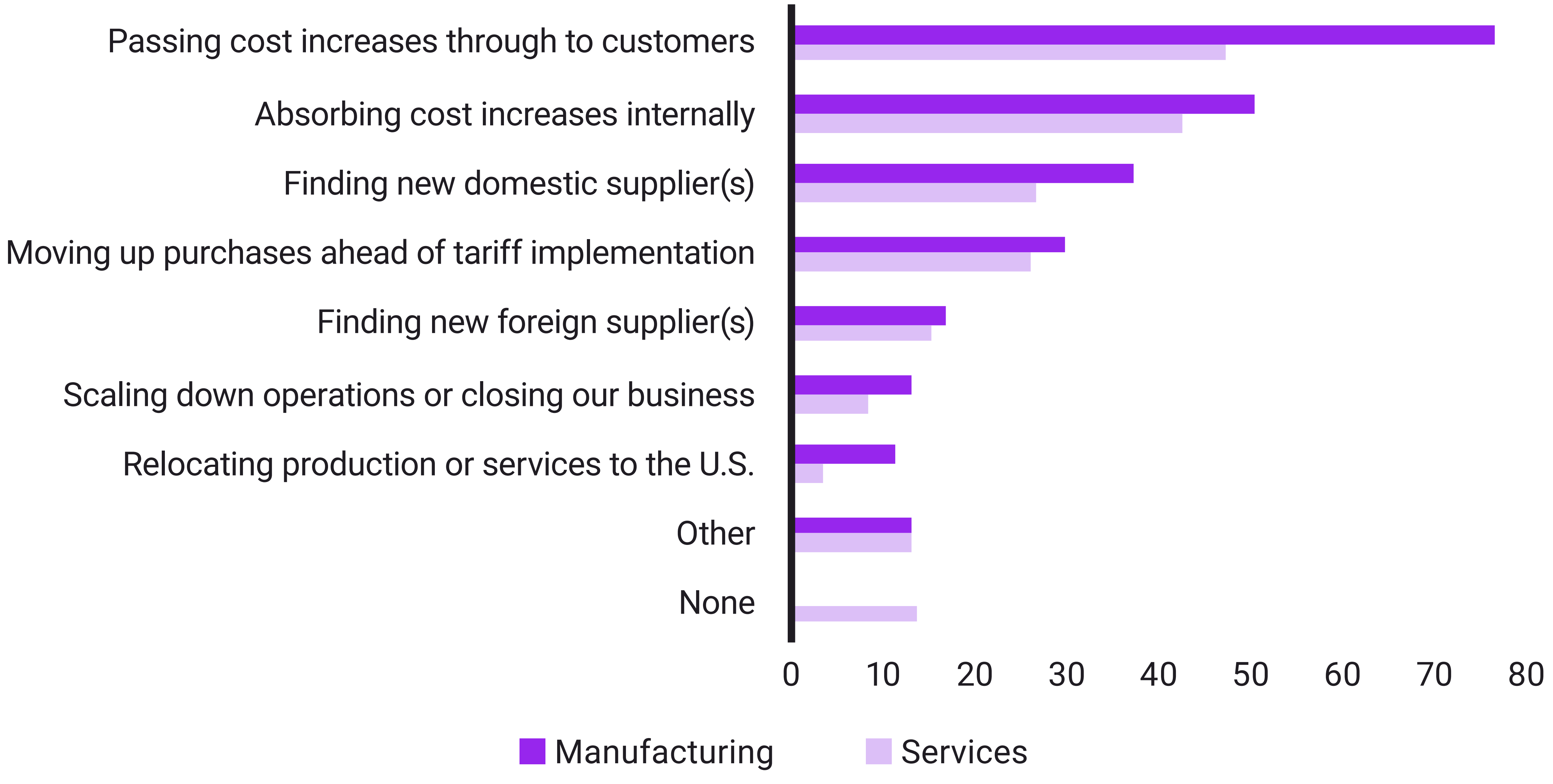
Cost Pressures from Tariffs Manageable (At the Moment)

- Guidance trends reveal that most companies have incorporated in-force tariffs into their outlooks, leaving room for adjustment should new tariffs be enacted.
- Cost pressures from tariffs to date are expected to be manageable and largely mitigated by year-end as supply chains are reworked.
- Surveys in May conducted by the Federal Bank of New York and Atlanta showed companies are primarily passing cost increases through to consumers, though some may be reluctant to publicly acknowledge this due to political sensitivities.

FIGURE 2

For the Most Part, Companies Plan to Pass Tariff Costs Along

What actions, if any, are you taking (or planning to take) in response to higher tariffs?



Source: Federal Reserve Bank of Dallas. Apr 2025.

The Big Test for Earnings Lies Ahead

- Looking ahead, the key question is whether high uncertainty, weak corporate confidence, and a possible pullback in consumer spending will ultimately weigh on earnings.
- Early May earnings may have been boosted by demand pulled forward ahead of tariffs, clouding the true demand picture.
- The housing outlook also bears watching, as rising bond yields could ripple through the broader economy, dampening growth.

MAG-7 Magnificent Once Again. But Can it Continue?

The AI trade rebounded during the Q1 earnings season, with the "Magnificent Seven" and other major AI capex spenders showing resilience. Meta Platforms, Inc., for example, announced in it Q1 earnings report that it raised its 2025 capex guidance by $5.5 billion (USD), citing strong returns from AI investments in advertising.

While AI remains a bright spot for now, the critical question is not 2025 growth, but the sustainability of growth rates from 2026 onward—especially given the outsized weight of these companies in equity markets.

Vigilance Required: Markets Vulnerable to Unwelcome Surprises in Q2

With stocks rallying from April lows, any negative surprises in Q2 could be met with outsized reactions, as the margin of safety is now lower. The pull-forward of good news and a reversal in flows may leave markets vulnerable later in the year.

Despite the recent dominance of macro factors and periods of high correlation, longer-term structural changes in market dynamics—including reduced correlation and increased dispersion—can continue to create attractive opportunities for skilled long-short managers to generate alpha through security selection.

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