



1<sup>st</sup> Quarter 2025 Client Letter

## The Three Bears

April 2025

After last year's election, and through the first six weeks of 2025, the stock market lifted off in anticipation of Donald Trump's second term agenda. The idea of less regulation, fewer government lawsuits, lower taxes, and a friendlier attitude towards tech and AI gave rise to visions of economic expansion. Additionally, the hope was that the use of some tariffs (or the threat of them, anyway) would lead to a renegotiation of American trade with the rest of the world on more favorable terms. A new era of prosperity seemed about to dawn. However, it now appears that the markets were not sufficiently pricing in the two other variables.

First, a major campaign issue (and arguably the reason Trump won the election) in inflation was still lurking, as prices on some goods continued to rise in the first few months of 2025. The price of a dozen grade-A eggs went from \$4.95 in January to an all-time high of \$8.15 in March – an increase of 64.6%.<sup>1</sup> With inflation overall still down from prior peaks, this might have been manageable if there were no other big, disruptive economic events.

But markets had assumed Trump 2.0 would pursue policy in a similar vein to Trump 1.0 and hadn't accounted for potential differences in implementation -- our second variable. Investors were rudely awakened to this possibility when Trump slapped tariffs of 25% on a wide range of goods from Canada and Mexico via executive order February 1<sup>st</sup>.<sup>2</sup>

This was a stark departure from how Trump had pursued trade policy with our two neighbors in his first term, when the threat of tariffs then was used to cajole Canada and Mexico to the bargaining table, without many actually going into effect. This strategy ultimately led to the renegotiation of the NAFTA trade agreement to its current form, USMCA, without many levies having to hit the books and potentially cause economic damage.<sup>3</sup> For Trump 2.0, while the February 1<sup>st</sup> tariffs were delayed by a month to allow time for some discussions between the countries, they were mostly implemented at the beginning of March. Both Canada and Mexico quickly introduced countermeasures.

This new "shoot first/negotiate later" approach to tariffs was not what markets had been expecting. Businesses had to quickly begin projecting the economic fallout from the increased costs of materials and goods. As an example, the average expected cost of a car jumped by \$3,000 over a weekend due to trade-related expenses.<sup>4</sup> Inflation concerns were suddenly back in the public eye, and consumer confidence plummeted by 11% between February and March.<sup>5</sup>

All this turned out to be a preview for the real coup de gras – the sweeping tariffs announced by Trump at his "Liberation Day" conference on April 2<sup>nd</sup>. In addition to setting a 10% baseline tariff on many exports from around 100 countries, some nations would be subjected to even higher duties, none more so than China. The United States and China would then



exchange retaliatory tariffs with one another over the next several days, up to a current rate of 145%.<sup>6</sup> The immediate aftermath of “Liberation Day” was a crushing of the stock market, with a 10% decline in the S&P 500 and 11% drop in the NASDAQ. This wiped out \$6.6 trillion in market value over two days, the largest such loss in U.S. market history.<sup>7</sup> This was on top of a very middling first quarter, which after peaking in mid-February had drifted downwards most of March. (Dow Jones Industrial Average, -0.87% QTD; S&P 500 -4.27% QTD; NASDAQ -10.26% QTD)<sup>8</sup>

Trump eventually called for a 90-day pause on most of these tariffs after several sessions of relentless stock selling that pushed every major index into bear market territory. Markets have since rebounded somewhat, with the S&P 500 now about 10% off its recent low. However, it's worth asking what kind of bear market all these recent actions have put us in?

What we should note before proceeding any further is that bear markets can be very unsettling as they unfold in real time. However, we believe that bear markets are part of the ongoing market cycle – eventually, stocks become too expensive and periodic, sharp drops allow for markets to reset valuations. According to Goldman Sachs, bear markets broadly fall into three categories:<sup>9</sup>

- **Event-Driven:** Caused by one-off events, such as wars, pandemics, or policy changes. Drops can be around 30%, but recoveries usually happen quickly (within a year or so).
- **Cyclical:** Driven by the normal ups and downs of the economy. Average declines by 30%, which can last up to 2 years, with it taking 5 years to recoup previous highs.
- **Structural:** Caused by financial crises or asset bubbles. Average declines can be around 60% and take a decade to recover from. Examples include the Great Depression, the Stagflation Market of the 1970s, the Dotcom Bust of 2000, and the 2007-09 Great Recession.

Let's next examine some bear markets we have personally experienced; each one was different and frightening in their own way.

Black Monday (a.k.a. the Market Crash of October 1987) was a truly horrifying event, with the Dow Jones Industrial average plunging 22.6%, the largest single-day percentage drop in history, and triggered a global sell-off, with worldwide losses estimated at \$1.71 trillion. This event, in addition to rising interest rates and persistent budget and trade deficits, fueled severe investor anxiety. The hidden villain, however, was computerized trading and “portfolio insurance”, a trading mechanism that used automatically generated stock futures transactions to hedge against losses. However, under the stress of an extreme market drop, these programs went on a non-stop selling spree which caused the markets to burn down. What would have been possibly a normal correction turned into a crash.<sup>10</sup>

This fatal program flaw wasn't widely understood at the time, though. What investors were asking themselves was, “Is this a repeat of the first Black Monday in October 1929?” What would end the selling was newly appointed Fed Chairman, Alan Greenspan, having the Central Bank provide NYSE traders with all the capital they needed to allow the system to



continue to function. However, the market didn't bottom until November 30<sup>th</sup>, and the losses wouldn't be recovered until September 1989.<sup>11</sup> This was a panic in the old "financial" sense of the word: The type of pre-1913 market meltdowns that occurred before the Federal Reserve was established. These type of one day events result in financial PTSD that haunted investors and traders all their lives.

The "Dotcom Bust" of 2000 we feel is a deceptive term because by the time the market decline ended in October of 2002, many companies outside of the technology sector were down 50% or more. Regardless, historians claim this bubble began in 1995 with the IPO of Netscape. From that point forward, companies with even a hint of the aroma of technology saw their prices bid up into the stratosphere. This was aided by relentless media coverage, particularly from CNBC, on the money being made in these stocks. By 2000, these valuations had reached nonsensical levels, while at the same time, the Federal Reserve would raise interest rates six times between June 1999 and May 2000.<sup>12</sup>

By the time Microsoft lost its antitrust lawsuit in April 2000, the market was primed for a major unwind. From then to August 2001, the NASDAQ was down over 64% from its peak and the S&P 500 had declined 24.5%. The market may have been trying to bottom at this point, as stocks had come down significantly and much of the excess valuation had been worked off.<sup>13</sup> However, the terrorist attack on 9/11 would destroy any stabilization attempts here: the NASDAQ plummeted another 22% and the S&P 500 dropped an additional 20%, until the basement was finally reached a year later in September of 2002. The final peak-to-trough numbers would be a crushing drop of 78% for the NASDAQ and an equally brutal loss of almost 50% for the S&P 500.<sup>14</sup>

To illustrate in one stock how severe this decline was, Juniper Networks, which made state-of-the-art routers, fell from an October 2000 high of \$243/share to \$4.43/share two years later. Declines like this were common among these types of stocks and were so widely reported that investors felt that a 60% decline in a company like IBM wasn't so bad.<sup>15</sup> The last act in this tragedy was as the market began to fall apart, companies that had been sustained by fraud were unmasked. WorldCom and Enron stock would go to zero, and Tyco saw its stock plummet to single digits, with management of all three companies going to prison. Investor confidence was as low as it had been since the 1970s. The feeling was one of exhaustion and hopelessness. Fortunately, after 2002, there would be a significant recovery, and the markets would go on to hit new all-time highs by October of 2007.

The problem was how, by and large, we got there. Starting in 2002, low interest rates and easy credit began the housing bubble. Lax banking regulation allowed subprime mortgages to be issued, and these in turn give rise to various credit derivatives which were highly rated and sold as safe investments. Hedge funds used massive leverage issued by major banks to fund huge purchases of such derivatives. As it turned out, the lenders as well as the buyers had little understanding of the real risks these investments possessed. This all began to crumble in 2007, when more than 25 subprime lending firms declared bankruptcy in February and March, followed by the collapse of Bear Stearns. By the fall, the contagion had spread to several major Wall Street financial institutions: Lehman Brothers would go bankrupt, Merrill Lynch would disappear over a weekend into Bank America, and AIG,



Citigroup and Bank America would all require massive assistance from the government to stay afloat.<sup>16</sup>

By October of 2008 the bond market came close to collapse which resulted in TARP (The Troubled Asset Relief Program) being passed by Congress with overwhelming bipartisan support. This temporarily stabilized things, but the market began to decline again in January until finally reaching a bottom in March of 2009. The sellers had reached exhaustion, but the TARP program also was beginning to take effect along with positive statements from the new Obama administration. With all of this in hindsight it was as close as we have come to a financial collapse since the 1930s.

Let's return to the Goldman Sachs definitions of bear markets. We think what all these examples really illustrate is how one type of bear market can transform into another one. All of them started off as "Event-Driven" episodes, but only Black Monday really stopped there (via successful monetary policy). The Dotcom Bust may have begun when Microsoft lost the antitrust suit in April 2000, but years of outrageous stock valuations were due to be unwound, resulting in a more "Cyclical" downturn (though 9/11 likely exacerbated it into "Structural" territory). Lastly, the event that heralded the start of the Great Recession was probably the Bear Stearns collapse, but the damage of bad subprime mortgages ran deep through the financial system and ultimately became a "Structural" bear market.

Back here in 2025, it seems clear stocks were overvalued at the beginning of this year: Trump's pursuit of resetting American trade policy has exposed the sensitivity of many businesses to tariff risks, and the potential inflationary effects that could have. That has resulted thus far in what we think is an "Event-Driven" bear market subject to policy news. The outcome of tariff negotiations with China and others, or if a recession materializes (like many Wall Street forecasters are now predicting), could turn this into a "Cyclical" bear market.

All bear markets have standard emotions—anxiety, fear, anger, depression and apathy. What can we as advisors and you as clients do?

- 1) Communicate—we will do our best to stay in touch, but you can call us as well.
- 2) Evaluate our goals and see if we are still on track to achieving them.
- 3) Adjust where necessary. Losses in one area equal opportunities in another.
- 4) Use perspective. Sadly, we are familiar with these kinds of moves in the stock and bond markets, but together we share a history of participating in the recoveries.

Pessimism and optimism are both choices. Both require energy and most people can only fuel one of them. Through 45 years of market cycles, we have found optimism to be the better approach, because it has never failed us. That said, added levels of vigilance are required in times like these.

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