Hutchinson FINANCIAL ADVISORS

Hutchinson Financial Advisors, Inc.
5243 Hickory Park Drive, Suite C
Glen Allen, VA 23059

Main: 804.729.6420
Fax: 804.729.6425

HutchinsonAdvisors.com

1st Quarter Market and Economic Update

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"The investor's chief problem, and even his worst enemy, is likely to be himself." -Benjamin Graham

"We call a tariff a protective measure. It does protect; it protects the consumer very well against one thing. It protects the consumer against low prices." -Milton Friedman (April 27, 1978, speech at Kansas State University)

I hope this letter finds you doing well and enjoying the warmer weather that comes with the start of spring. I'm a bit late in writing this quarterly update, but I wanted to wait until the tariff news from President Trump was announced, so I could address it in this letter.

I know the recent headlines and the significant market correction, particularly since the tariff announcement, oddly called "Liberation Day", may feel unsettling. That is understandable. The first quote above is from Benjamin Graham, who was Warren Buffett's teacher and mentor, as well as the author of the groundbreaking book on investing, entitled, 'Security Analysis'. Extensive research underscores Graham's wisdom. A well-known DALBAR study illustrates how investors can be their own worst enemy. Over a 30-year span ending in 2013, the S&P 500 generated an annual average rate of return close to 11%, yet the average investor captured returns of less than 4% per year in that time span. Most of that underperformance came down to three human behaviors: 1) chasing performance; 2) panic selling during downturns; and 3) lacking patience when it matters most. To be clear, these behaviors can happen to anyone, as they are formed by the two most basic human emotions: fear and greed. It is the job of the media to play to these basic human emotions with sensational headlines. It is my job to act dispassionately in the face of fear and greed.

As you may recall, in my year-end letter from three months ago, I wrote the following, "*I think the simplest way for me to put it is the following: after being confident going into 2023 and 2024, I am less so heading into 2025. At a minimum, I would expect more volatility and a couple more corrections in 2025*." One reason I gave for my relatively less optimistic outlook was that the stock market was overvalued at the end of 2024. Much of the overvaluation was concentrated in both large-cap technology and consumer discretionary stocks, which are the biggest companies that drive the major stock indices. Those overvalued parts of the market started to sell off as we entered the middle of February and led the indices to a negative first quarter, with the S&P 500 down 4.6% and Nasdaq down almost 10.5%. Interestingly, the correction was mostly confined to those index-moving large-cap stocks, as almost every other sector in the U.S. was positive in the first quarter. When combined with the positive performance of international markets, bonds, and many commodities, diversified portfolios posted some of the best relative outperformance in quite a while.

Unfortunately, the correction broadened out to all areas of the equity market, both domestically and internationally, after President Trump's tariff announcement on April 2nd. The widespread tariffs announced by the President caught most by surprise. In President Trump's first term, he used targeted tariffs, primarily against China, which President Biden kept intact, and the impact was relatively modest in financial markets. This new widespread imposition of tariffs, including against countries with whom we had a trade surplus in 2024, like the U.K. and Australia, has roiled financial markets around the globe. As I type this on Sunday, the S&P 500 has fallen almost 14% since the start of the year, the Nasdaq is now down a bit more than 19%, and the Russell 2000 is down 18%. The bulk of the declines came in the two days since the tariff announcement.

I've been asked by many of you to explain tariffs and to give my opinion on tariffs, so let me do that here. Simply put, a tariff is a tax on imports. The aim of tariffs is to encourage domestic manufacturing and to bring down the trade deficit. While well-intended, tariffs raise the cost of production for a product. As such, all else being equal, tariffs raise the price of goods consumed in a country. Thus, tariffs are inflationary. Tariffs also bring uncertainty. An easy example to illustrate this is an I-Phone. Apple relies on global supply chains, particularly in China and Vietnam. Tariffs put onto those countries will increase the cost of Apple's production. Apple can either choose to eat that extra cost, which would squeeze their profit margins, or it can pass that extra cost along to the consumer. We may not see the increased I-Phone price immediately, as Apple likely added to their inventory ahead of the imposition of tariffs, but I doubt the company will eat that increased cost. Rather, they will likely raise the price of the I-Phone once their inventory is depleted. This is precisely what the legendary economist, Milton Friedman, was getting at in the second quote on page one: a tariff "protects" the consumer against **low** prices. Regardless, whether Apple chooses to pass along the cost to consumers or decides to eat it themselves, in either case, it can be bad in the short run for Apple's business, which may negatively impact its stock price. Meanwhile, not all industries are impacted by tariffs; an example would be an industry like health insurers, which import very little, if anything.

My opinion of tariffs is a bit more nuanced than one might expect. I have always been a proponent of FREE and FAIR trade. It is the globalization and relatively free trade of the last 40+ years, which helped lead to lower prices for goods in the U.S. Think about how the prices of consumer electronics, clothing, and other goods came down steeply in the 40-year period ending in 2019. One thing Covid did in 2020, however, was to show the weakness in global supply chains. I know we all remember shortages of some items, though panic buying surely contributed to some goods shortages. Unfortunately, the trade-off to that goods disinflation was the loss of manufacturing jobs in the U.S. In economics and finance, everything is a trade-off. According to the U.S. Bureau of Labor Statistics, we now have about 13 million manufacturing jobs in the U.S., which is down from just over 19 million manufacturing jobs in 1980. Interestingly, manufacturing output in the U.S. has more than doubled in that time span thanks to productivity enhancements, such as technology.

More than one thing can be true. Free trade has been beneficial for U.S. consumers, but bad for manufacturing jobs in this country. However, it is also true that many countries don't treat us fairly regarding trade. For example, it's well-known that China has been cheating on trade for decades, including the theft of intellectual property. China is just one example, but many countries have both tariff and non-tariff barriers that hurt U.S. companies' ability to sell products around the globe. Non-tariff barriers would include things like technical regulations, labor issues, intellectual property protection, environmental restrictions, and others. Overall, the U.S. has identified 14 categories of foreign trade barriers and has been monitoring the application of these barriers systematically for ***decades***. So, from this perspective, the idea of tariffs as a means of rectifying the cheating and

theft makes sense. I think it could be a mistake to view these tariffs as an example of yet another haphazard approach by the Trump Administration in policymaking. I also think the tariff policies should be viewed within the context of other Trump Administration work, like DOGE, which I won't get into here. This seems to be an attempt at major structural change in the U.S. economy. While I think it is quite possible that President Trump will make some adjustments through negotiations with various countries, the goals he has laid out seem here to stay: 1) Reduce the trade deficit; 2) Provide income to supplement the budget; and 3) Increase domestic manufacturing, although it would seem that many manufacturing jobs could now be done by automation and robotics. While these goals are certainly laudable, I'm of the opinion that a carrot and a stick could have been used to achieve some of these goals. Said another way, targeted tariffs along with some negotiation "sweeteners" may have been a better approach than the hammer this Administration appears to be using. Then again, as the old saying goes, "*To a man with a hammer, everything looks like a nail*." Besides, no one in the Trump Administration asked for my opinion. 😊

In the end, as I said earlier, I am all for FREE and FAIR trade. I am predisposed to dislike tariffs, and I don't like them. However, I am open-minded to the idea that if President Trump can get this to work as he hopes, then the pain stock markets are feeling now will be short-term. On the other hand, I am also open-minded to the idea that these actions could lead to a broad global trade war, which truly benefits no one. Unfortunately, my permanently cracked and broken crystal ball cannot tell me the future.

As all of you know by now, I don't rely on predictions to allocate capital in your investment portfolio. We will always look to our objective models and indicators to make any asset allocation decisions for your portfolio. As I type, the cyclical bull market is hanging on for dear life, while the secular bull trend is intact. Ironically, it is this current correction in stock prices, which has relieved much of the excess in equity markets that could serve to elongate the secular bull trend, which would be positive. It is too soon to tell whether the tariffs will lead us into recession. The longer a trade war lasts, the more likely a recession will occur.

To be certain, there are always risks, and I worry about everything. The mechanics of the market have changed greatly over the past two decades as more money is traded by computer algorithms than ever before, which leads to periods of unprecedented volatility. It's one reason we see such wild swings intraday. Regulatory changes enacted after the 2007-2009 Great Financial Crisis have led to less liquidity in some markets, and that just adds to volatility. In the end though, investing is about buying assets for the long-term. That's how you grow your wealth over time: buying great assets at good to great prices and holding them until they become overvalued, or something changes with the investment. The key is to remain flexible and to avoid having a myopic view of the macro environment and of the assets into which we've invested.

As I mentioned earlier, the media likes to play on people's fear and greed. Those two basic human emotions elicit reactions. Often, they cause people to make decisions that hurt themselves in the long run. Of the two, fear is the more powerful emotion. Fear draws eyeballs to the screen. So, one suggestion I would make is to limit your exposure to hyperbolic financial news, market commentary, and yes, political commentary. They serve no purpose other than to increase your anxiety. Instead, focus on long-term financial objectives and the things that you can control. Also, focus on the people, places, and things that bring joy to your life.

Housekeeping notes: 1) Please let us know if you need help managing your employer retirement plan. Through our partnership with Pontera, we can manage most employer plans in a compliant manner. 2) HFA is in the process of adding additional services through more strategic partnerships with other companies. I hope to have

more on that in future updates. 3) The pictures from our 2024 client party are now on the HFA website. Those pictures can be found here: https://www.hutchinsonadvisors.com/client-appreciation-2024-event/. 4) I will be on vacation from May 30 through June 7.

I hope you and yours are healthy and enjoying a wonderful start to spring. Please let us know if there is anything we can do for you. We're always here to help. From all of us at HFA, thank you for your trust, confidence, and loyalty. It is a joy and a privilege to work with you and your family.

Best wishes,

Harvey E. Hutchinson IV

President

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