

Caution: Stocks could face speed bumps ahead

Monthly Market Playbook



Key Insights

- Reduced fears of major U.S. tariff hikes have powered a sharp rebound in U.S. stock prices from their April lows.
- While it is not clear how high tariffs might rise under the Trump administration, the economic effects still are likely to be negative.
- Earnings forecasts appear very optimistic and valuations are high. Our cautious approach underweights equities and tilts toward value and non-U.S. markets.



Tim Murray, CFA®
Capital Markets Strategist,
Multi-Asset Division

The U.S. stock market has rallied sharply since early April due to reduced fears of large U.S. tariff hikes. However, forward earnings estimates remain extremely optimistic and valuations are historically high. We believe caution is warranted.

After peaking in early April, trade concerns eased significantly in subsequent weeks as talks with some U.S. trading partners made progress and the Trump administration suspended the worst of its threatened tariff hikes. Then, in late May, federal judges ruled against most of the tariff increases the administration had implemented or proposed.

These developments triggered a sharp rebound in the S&P 500 Index, reflecting the reality that tariff policy has been the

driving force behind U.S. stock market performance ever since President Trump was elected last November. In fact, if we invert the Bloomberg U.S. Trade Policy Uncertainty Index and overlay it on the S&P 500 Index (Figure 1), we can see that the two have moved nearly in lockstep since the election.

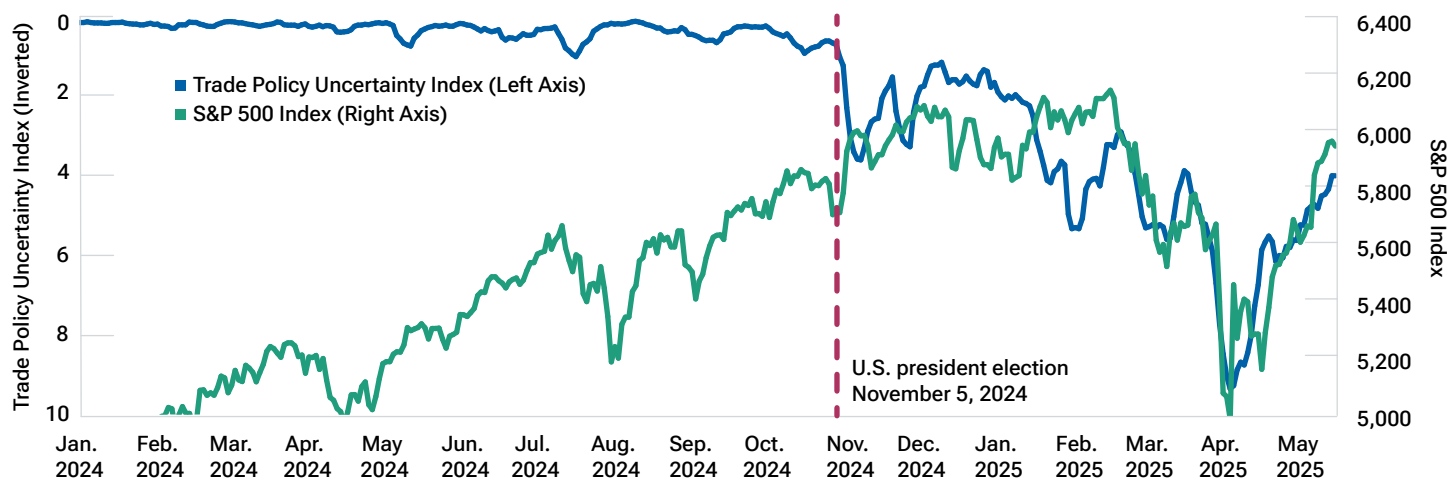
Tariffs remain a key economic risk

Positive trade news may continue to boost U.S. stock prices over the near term. But that trend could prove short-lived.

While it is unclear how much tariffs ultimately will rise under the Trump administration, the economic effects almost certainly will be negative. Consumer spending could

U.S. trade policy has been driving stock prices

(Fig. 1) Bloomberg U.S. Trade Policy Uncertainty Index vs. the S&P 500 Index



January 1, 2024, to May 20, 2025.

Past performance is not a guarantee or a reliable indicator of future results.

Sources: Bloomberg Finance L.P. and Standard & Poor's (see Additional Disclosures).

fall. Inflation could accelerate. Corporate profit margins could be squeezed. And small businesses that have little or no pricing power and must operate on thin profit margins might be forced to lay off employees or shut down permanently.

Earnings expectations and valuations are high

Despite lingering tariff risks and signs of a slowing U.S. economy, as of late May equity investors were not pricing in a cautious outlook. In fact, the opposite appeared true.

As of May 20, consensus estimates projected that S&P 500 earnings per share would grow 10.7% over the following 12 months—even though they rose only 9.1% over the previous 12 months. Even if the Trump tariffs ultimately prove to have a relatively limited economic impact, such a robust level of earnings growth seems very unlikely.

Similarly, investors are placing an extremely elevated valuation multiple on those estimated earnings. As of May 20, the forward P/E for the S&P 500 was almost 21.4 times the expected level of earnings 12 months ahead (Figure 2).

U.S. equity valuations are historically high

(Fig. 2) S&P 500 Index estimated and trailing price-to-earnings ratios (P/E)



January 1, 2005, to May 20, 2025.

Past performance is not a guarantee or a reliable indicator of future results.

Actual future outcomes may differ materially from estimates.

Source: Standard & Poor's via FactSet.

This was close to the highest P/E reached over the past 20 years and almost five points above the 10-year median.

Conclusion

While trade concerns have eased considerably since early April, they could still impose a considerable drag on U.S. economic activity in 2025. But the U.S. stock market is not currently pricing

in a muted outlook. Instead, we see very high earnings multiples being awarded to some extremely optimistic earnings projections.

In light of these issues, T. Rowe Price's Asset Allocation Committee is taking a cautious approach. We currently have an underweight position in equities, while maintaining overweight positions in short duration fixed income. Within equities, we also favor areas that feature less challenging valuations, including U.S. value stocks and non-U.S. markets.

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