Cornell Capital Group LLC

Investor Memo - Q1 2025

Trump Chaos or Valuation Coming home to Roost

Stock Price Performance in Review

We postponed publication of our quarterly memo awaiting the statement from President Trump on tariffs. That turned out to be wise. His statement hit the market, which was already down from year-end 2024, like a bomb. The impact of that bomb is encapsulated by three related facts.

1. The S&P 500 dropped from 5881.63 at the end of 2024 to 5074.08 as of April 4, 2025, down 13.7%. It was down 17.5% from its all-time high 6147 on February 19.
2. The VIX Index, a measure of expected market volatility, rose from as low as 12.77 during December 2024 to 45.31 on April 4, an increase of 255%.
3. A market value-weighed portfolio of the Magnificent 7 dropped 23.7% over the same time period.

These interrelated facts reflected the impact of two underlying forces. Increased uncertainty related to the on again, off again economic policies of the Trump administration and recognition that the market had previously been priced for a perfection that no longer looked like it was going to arrive.

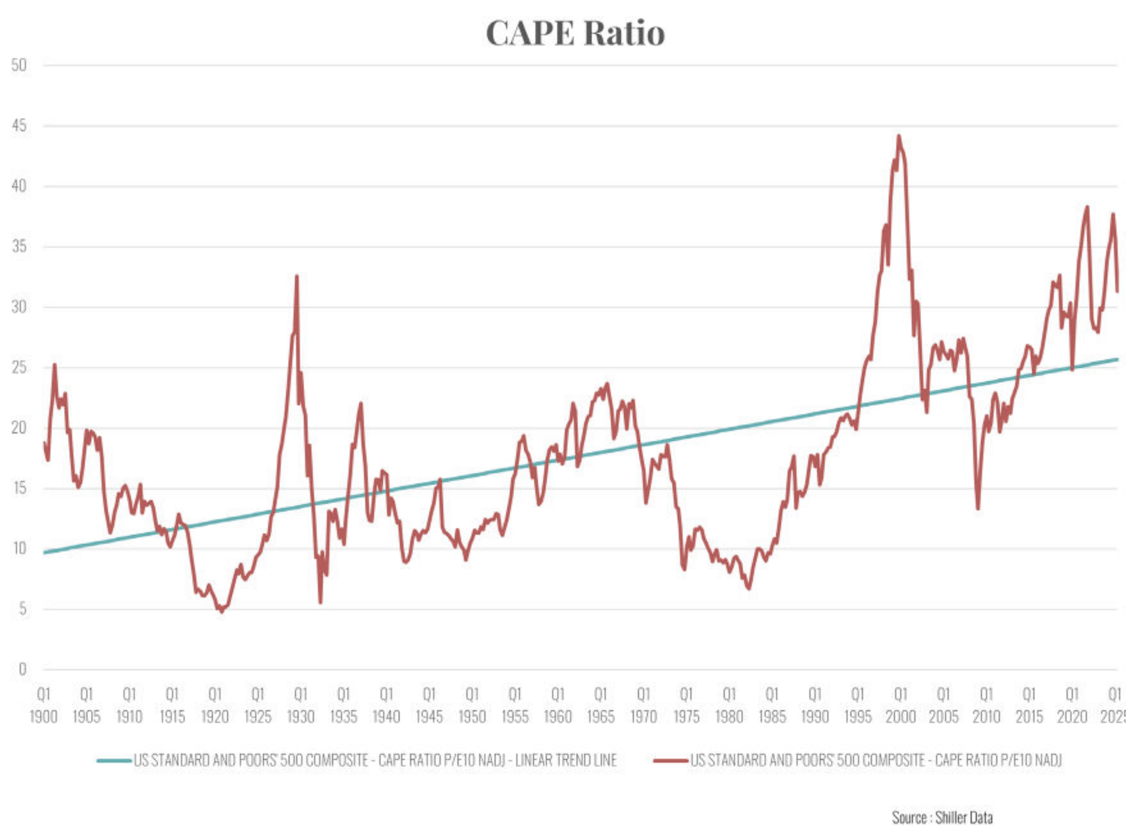
Risk Premiums, Stock Prices, and the CAPE Index

Risk premiums are a key determinant of stock prices through their impact on the discounting of future cash flows. Risk premiums, in turn, depend on a combination of perceived risk and risk tolerance. Following the election of Donald Trump, risk premiums were near historical lows of about 3.5%. As we explained in our video, Reflections on Investing: Risk, recorded when the S&P 500 stood at 6025, a return of the premium to its historical average of about

5% would imply a drop in the S&P 500 to 4297. At the time of the recording, such a drop seemed highly unlikely, but now we are halfway there, and uncertainty is rising.

The risk premium is closely related to the famous Shiller CAPE index which is plotted below. The CAPE measures how much investors are willing to pay for an average stream of earnings. During good times investors are willing to pay more for that earnings stream and the reverse in bad times.

When we recorded our video on Risk, the CAPE was at 37.0 as shown in the chart below. By April 4 it had dropped to 31.3. Because there is evidence that the CAPE index has risen over time, we include a trend line in the chart (see our publication Structural Change and Valuation). That trend line implies a current value of about 25.0 for the CAPE. Therefore, as with the risk premium, the CAPE analysis implies a market level of approximately 4300. Once again, we are about halfway there. Needless to say, a drop in the CAPE to its long-run historical average of 17 would imply a much larger decline in the market.



In short, both the risk premium analysis and the CAPE index indicate that the situation remains precarious for investors. It is premature to conclude that the current decline has eliminated excess valuations. It is easy to forget that during October 2022 the S&P 500 was at 3577 and as recently as November 2023 it stood at 4117. And while the market value of the Magnificent 7 portfolio dropped 23.7% percent in the recent sell-off, it is still 93% above where it stood at the end of 2022.

Trump Tariffs and the Market Decline

The Trump Tariffs set off a market collapse. On Thursday and Friday, April 3 and 4, the S&P 500 Index dropped 10.5%, one of the largest two-day declines in history. While it is easy to say that the tariffs were the sole cause, this is not the case in our opinion. The tariffs had the impact they had because the market was priced close to perfection with, as we just noted, very low risk premiums. It was primed for a large drop if new risks emerged. And Trump introduced such risk and uncertainty in spades. However, the Trump fire burned so brightly because it was fueled by the dry brush of excessive valuation.

We leave detailed discussions of the economic impact of the Trump tariffs to others but note one key fact. Tariffs are a tax levied on imported goods. That tax must be paid by some combination of the foreign producer and the American buyer. The exact breakdown depends on the nature of the good and its market, but the general point is always true. It follows that Trump's tariffs will lead to higher prices for consumers – more inflation. In addition, the added tax, like any added tax, will tend to be a drag on output. Put the two pieces together and you have stagflation. And stagflation has always been bad news for the stock market.

Finally, with regard to the tariffs, it is easy to forget all the benefits Americans have gained from world trade. As Howard Marks noted in a recent Bloomberg interview, *I believe that the last 80 years since World War 2 have been the best economic period in the history of mankind and one of the major reasons was that the growth of trade. I think that we have truly had a rising tide that lifted all boats, and trade was a big part of that.* The tariffs are a threat to the continuation of those gains.

Outlook and Investment Implications

The market opened 2025 priced for perfection with risk premiums near historical lows and a CAPE ratio of 37. What was there to worry about? It did not take long for President Trump to provide an answer – across the board massive tariffs. Suddenly, the international economic outlook became highly uncertain. However, it is precisely during these periods of uncertainty that maintaining investment discipline is paramount. Our strategy is built upon a foundation of rigorous fundamental valuation, a principle that guides us in navigating market fluctuations and helps us stay focused on long-term financial success. No matter the economic conditions, rational investment always consists of comparing price (what you pay) with value (what you get).

Throughout 2024, as we discussed in our videos and memos, prices were so high that there were few opportunities where our estimate of value exceeded price by a margin of safety sufficient to justify investment from a risk and return perspective. Now with risk premiums rising and prices falling, we will continue to analyze our estimates of value to see if opportunities are emerging.

Finally, we are wary of the temptation to conclude that hard times are over when the market makes a big positive short-term move. As we noted in our Reflection on Investing, The Best of Times, The Worst of Times, 80% of the largest one-day increases in the NASDAQ Composite Index occurred during the three biggest drawdowns in NASDAQ history. Attempting to draw investment conclusions from short-term market movements is no substitute for long-run valuation analysis.