Alley Company Quarterly Letter
Investing and Uncertainty

April 15, 2025

Investing and uncertainty are two sides of the same coin. Without uncertainty, there would be no judgment required when investing as all outcomes would be known in advance. The fact that outcomes are unknown is at the core of why investment opportunities exist. Different sources of uncertainty are present in markets through time, but the presence of uncertainty remains constant.

The new U.S. political administration's implementation of its tariff agenda is at the forefront of the current wave of uncertainty. Broad tariffs have raised questions in the market's collective mind about whether we are on the cusp of a prolonged trade war, or if tariffs represent a negotiating tool that will fade as quickly as they have come. If the former occurs, that could drive inflation higher and derail the progress made toward meeting the Federal Reserve's long-run target of 2%.

Further, a shifting landscape could raise the risk of recession. Business decision makers may delay investment until clarity about the future comes into view and the consumer could tighten their wallet for the same reason.

Naturally, market participants lean defensive when uncertainty spikes. True to form, three of the top four performing sectors within the S&P 500 index during the first quarter of 2025 have been Healthcare, Consumer Staples, and Utilities, as tariff rhetoric prompted investors to seek out more conservative assets.

Moreover, consumer confidence has also dropped. The Conference Board's U.S. Consumer Confidence Index reading fell to its lowest point in four years at 92.9 in March 2025. At the same time, the University of Michigan Consumer Sentiment Index reached 57.0, well below its long-term average of 84.4 and its lowest level since November 2022.

Looking for safety outside of equity markets when uncertainty-driven fear grips consumers is instinctive. But, more often than not, it is prudent to take the opposite approach, as the chart below indicates. It measures the average S&P 500 return in the year following the moment when consumer sentiment has hit a low point (+24.1%), compared to the average return in the year following when consumer sentiment is at its peak (+3.9%). Essentially, better investment opportunities tend to present themselves when uncertainty is elevated.

Consumer Sentiment Index and subsequent 12-month S&P 500 returns

Source: FactSet, Standard & Poor's, University of Michigan, J.P. Morgan Asset Management

Our investment philosophy has always been grounded in owning high-quality businesses with durable cash flows that have proven track records of successfully navigating myriad market environments. It is during these periods that the sound fundamentals and enduring nature of our holdings can provide comfort for investors.

Companies with these characteristics are rarely available at bargain prices. An exception can be during times of market stress. At these moments, we are on heightened alert for the chance to add another great business to our client portfolios, but at an atypical price.

Timing the exact moment when consumer sentiment and stock market fortunes reverse is often a fruitless endeavor. Markets can drop further than an investor initially anticipates, or pessimism can fade sharply and bring about a rapid rebound in equity prices. Awareness of what past periods have delivered during periods of elevated uncertainty, on average, can help investors maintain perspective and stick to their long-term investment plan.