CHEVY CHASE TRUST
INVESTMENT ADVISORS

April 5, 2025

We penned the attached first quarter 2025 *Investment Update* before the Trump Administration's April 2nd tariff announcement and the strong reactions from trading partners and financial markets.

In our Global Thematic Equity research, we try to focus beyond the noise of the short-term news cycle, as we pursue long-term investment opportunities brought about by broad secular trends that impact corporate performance and stock valuations across geographies and sectors.

Occasionally, however, the news of the moment has long-term implications for businesses and investors. We believe this is one of those times. The new tariffs upend the calculus that business leaders have used to make decisions for decades. Therefore, they require careful consideration.

These tariffs also constitute the largest peace-time tax increase in U.S. history. Yet to be determined is how much of that tax will be borne by consumers versus companies. If unchanged, the tariffs will reduce corporate profitability and raise the risk of a U.S. recession. Retaliatory tariffs likely to be enacted in response by other countries would reduce demand for U.S. exports. $8 trillion in annual sales generated by foreign subsidiaries of U.S.-domiciled multinationals are also now in jeopardy.

Understandably, these changes have roiled equity markets. The S&P 500 declined 11% in the two trading days after the announcement. The index is now down 14% year-to-date.

In addition to studying significant near-term, first-order impacts, we are focused on understanding longer-term, second- and third-order impacts that may outlast this tariff regime, particularly if the announced tariffs are merely a starting point for negotiation, as some posit. This radical pivot in trade policy is only one of several changes that are recasting the role of the U.S. on the global stage, increasing the importance of our *Opportunities Abound Abroad* investment theme.

While these events are deeply unsettling, we believe our time-tested investment process will help us to navigate this policy-induced volatility with a clear-eyed, long-term perspective that will ultimately benefit our clients.

During this tumultuous period, please reach out to us, or to our wealth advisors and portfolio managers, who remain intensively focused on the opportunities and risks of this moment.

Sincerely,

Jeff Whitaker
President & CEO

Amy Raskin
Chief Investment Officer

INVESTMENT UPDATE
FIRST QUARTER 2025

In the first quarter of 2025, financial markets started to reflect several of the risks we noted in our Fourth Quarter 2024 Investment Update. Already grappling with high levels of uncertainty, U.S. companies and consumers started to defer spending and investment. This is an environment for which we have prepared; we will try to navigate it with equal measures of ambition and caution.

AN ABRUPT REVERSAL

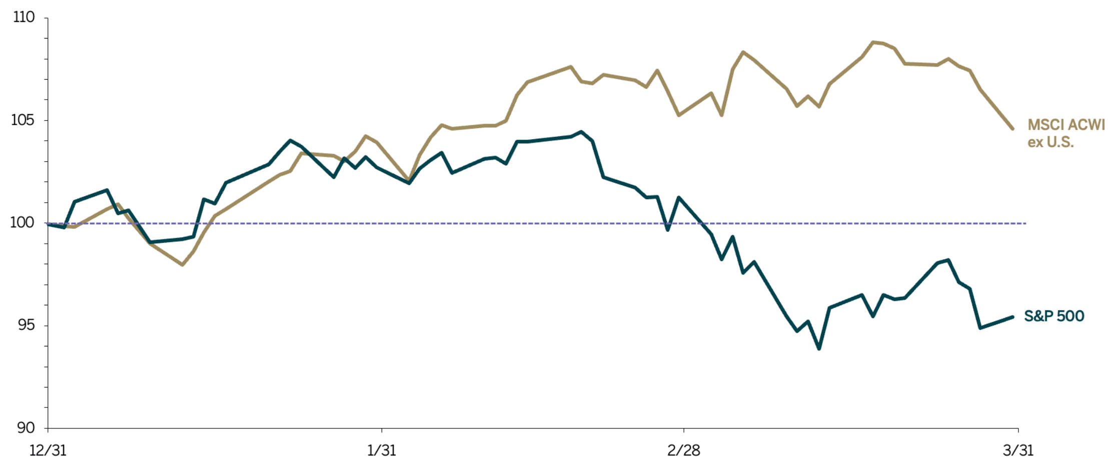
U.S. financial markets had an unsettling first quarter. After starting out strong, with the S&P 500 reaching an all-time high of 6,144 on February 19, the index dropped 10% through March 13, wiping out more than $5 trillion of U.S. equity market capitalization in just three weeks. Non-U.S. equities, however, rose nicely.

The MSCI All Country World Index excluding the U.S. (ACWI ex U.S.) finished the quarter up 4.6%, driven by double-digit increases in Germany, Hong Kong, Spain and Brazil. The S&P 500 ended at 5,612, *down* 4.6%, delivering its worst quarterly performance relative to the ACWI ex U.S. in over 15 years.

These results defied widespread expectations at the start of 2025 for continued strong U.S. equity market performance and weakness in the rest of the world.

U.S. Equities Underperformed In First Quarter

S&P 500 and MSCI ACWI ex U.S.
(January 1, 2025 = 100)



Source: FactSet

We didn't share in consensus expectations. In our Fourth Quarter 2024 *Investment Update*, we stated that, in our view, "U.S. equity market valuations fully reflect both recent good news and expectations of more, increasing the risk of a correction." We listed seven risks to the S&P 500's extraordinary run: very high expectations, valuations near record highs, U.S. equity domination, unprecedented market concentration, high bond yields, policy risk and extremely broad and high levels of equity ownership.

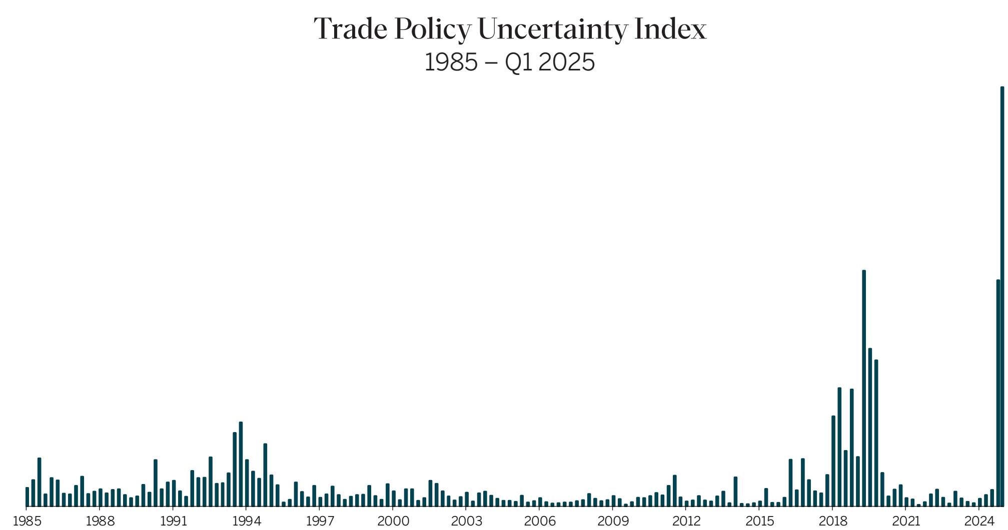
Clearly, trade worries weighed on investor sentiment in the latter half of the first quarter. We believe two other factors were also meaningful contributors to U.S. market declines:

- A newfound measure of realism about the future profitability of artificial intelligence (AI) and continued cash flow growth for the Magnificent 7[1]
- Reduced foreign demand for U.S. equities

TRADE AND TARIFFS: ONLY PART OF THE STORY

During the first quarter, the Trump Administration imposed the highest U.S. tariffs in almost a century, called them off, put them back and threatened more to come, driving the Trade Policy Uncertainty Index to a record high.

Trade Policy Concerns Rattled Markets



Source: Baker, Bloom & Davis, Bloomberg

High tariffs are likely to depress trade and raise consumer prices, if left in place. Uncertainty about tariffs and other policies has already had negative effects. Many businesses are delaying capital investments and hiring until they have more clarity on policy decisions that could affect their return on investments. Wealthy U.S. households have also cut spending due to concerns about an equity market decline. As a result, many Wall Street economists lowered their forecasts for U.S. GDP growth in 2025.

[1] Amazon, Apple, Alphabet, Meta, Microsoft, Nvidia and Tesla often referred to as the "Mag 7"

Nonetheless, tariff uncertainty doesn't seem to fully explain the drop in U.S. equities in the first quarter. Many international equity markets that appear to be vulnerable to the new tariff policy performed remarkably well. Some highly cyclical sectors, such as energy, also rose.

AI REALITY BITES THE MAG 7

The Mag 7 fell by just over 16% in the quarter and are well off their all-time highs. Since they collectively represented more than one-third of the S&P 500 when the year began, they dragged the index down, after powering it higher for the past five years.

Mag 7 Has Led the U.S. Market Up and Down

5-Year Cumulative Performance vs. Q1 2025 Performance

	2019YE – 2024YE (% Cumulative)	Q1 2025
S&P 500	81.9%	-4.6%
Mag 7	532.0%	-16.0%
S&P 500 ex Mag 7	35.6%	0.2%

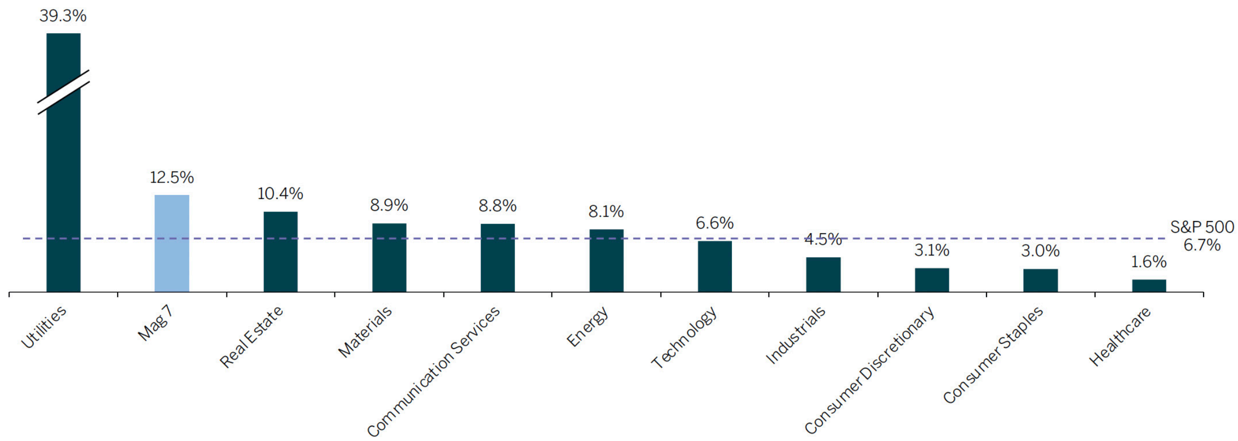
Source: Bloomberg

We suspect that the Mag 7 declined in the first quarter because of growing skepticism that AI will become profitable near term. Most of the Mag 7 are quasi-monopolies. It is hard to see how investing hundreds of billions of dollars in new infrastructure will make these companies *more* profitable than they already are. Furthermore, history shows that major shifts to new technologies have tended to disrupt the existing market hierarchy, not reinforce it.

Concerns about Mag 7 valuations may have also taken a toll. At year-end 2024, the Mag 7 were selling at extremely high valuations: about 44 times earnings on average, including *124 times* earnings for Tesla. In recent years, many analysts have justified Mag 7 valuations by citing their low capital-spending burdens. But now, the Mag 7 are spending heavily on server farms and other assets in response to the AI opportunity. As a result, the Mag 7 have *higher* capital expenditures relative to sales than any other sector, except utilities.

Mag 7: Not "Asset Lite"

Capex as a Percent of Sales for S&P 500 by Sector



Source: Strategas, FactSet, Sectors are ex-Mag 7. Data as of 12/31/24.

As usual, some enthusiasts claim, "this time is different." Unlike the market favorites during the tech bubble of the late 1990s, they say, the Mag 7 companies that are investing heavily in AI are profitable and cash-flow positive. We think that story is dubious at best. We suspect that the Mag 7's AI businesses would be revealed as deeply unprofitable if we could separate them from the cash-cow, quasi-monopoly businesses that support them. Privately held pure-play AI companies are valued at extraordinarily high multiples of minimal sales and are incurring huge losses.

AI Pure Play Valuations Astronomically High

AI Pure Play Valuations

	LATEST ENTERPRISE VALUE	2024 ESTIMATED SALES	MULTIPLE OF SALES
OpenAI	$300 B	$4 B	75x
xAI (Grok)	$80 B	$100 M	800x
Anthropic	$62 B	$1 B	62x
Perplexity	$9 B	$80 M	113x
S&P 500			*3x*

Source: OpenAI February 2025 Softbank funding round. Anthropic March 2025 funding round. xAI March 2025 merger with X. Perplexity December 2024 funding round.

FOREIGN CAPITAL FLOWS MATTER (BOTH IN AND OUT)

Repatriation of foreign funds was another driver of the market drop in the first quarter. For many years, three concurrent factors made U.S. equities very alluring to non-U.S. investors: relatively strong U.S. economic growth, strong equity market outperformance and U.S. dollar appreciation. Much of the S&P 500's 150% rise since January 2019 was due to unprecedented buying from outside the U.S. In aggregate, non-U.S. investors increased their holdings of U.S. equities by almost $10 trillion over five years, while the value of non-U.S. holdings by U.S. equity investors "only" increased by about $2 trillion.

The situation changed in the first quarter. Some non-U.S. investors withdrew from U.S. markets, due at least in part to the sharp rise in political tensions between the U.S. and its long-time allies. For example, the Danish teachers' pension fund, AkademikerPension, with roughly $20 billion of assets under management, said it would sell its remaining Telsa shares, mainly in response to Elon Musk's interference in European politics. The U.K. government is pressuring pension funds to commit 10% of their assets to British equities, up from roughly 4% today. Canada is similarly exerting pressure on institutions to bring assets "home".

If the first quarter is a harbinger of things to come, outflows could weigh heavily on U.S. equities. There are also non-political reasons to expect U.S. and non-U.S. investors to diversify equity holdings into other geographies.

THEMATIC UPDATE – OPPORTUNITIES ABOUND ABROAD

Over the last 15 years, U.S. nominal GDP grew 94%, well above the 10.5% average for the Group of 7 nations[2] excluding the U.S. Over the same period, the S&P 500 rose 427%, while the MSCI ACWI ex U.S. rose only 34%. The U.S. dollar also appreciated sharply versus its trade-weighted index.

There were many reasons for U.S. economic and financial market outperformance in this period. Europe was beset by integration issues and the Sovereign Debt Crisis of 2012-2013. The U.K. vote in 2016 to leave the European Union inflicted further damage. Japan was struggling with the challenge of an aging population, sustained deflation, competition from China, and a weakening yen. Meanwhile, rapid earnings growth from the U.S. tech sector contributed to outsized profits for U.S. companies.

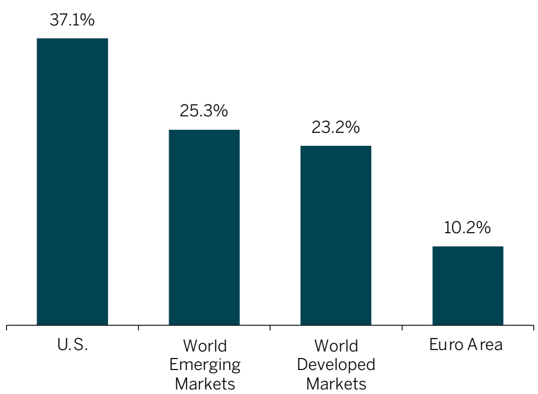
A more prosaic explanation for faster economic growth in the U.S. gets less attention: greater U.S. fiscal stimulus. The U.S. government has spent lavishly and cut taxes to support economic growth over the past 10 years, while other nations ran much smaller deficits relative to their economies' sizes.

[2] Group of 7: Canada, France, Germany, Italy, Japan, the U.K. and U.S.

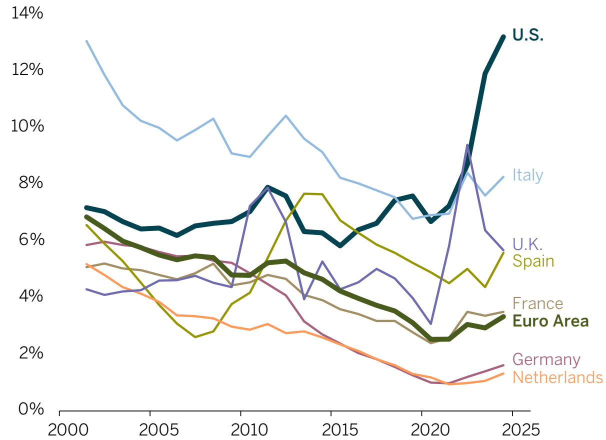
This situation isn't likely to last. Until 2022, extremely low interest rates allowed the U.S. to accumulate increasingly higher levels of debt without interest expense spiraling out of control. However, the higher interest rates of the last few years have caused interest expense to soar. Today, interest expense is a greater share of total expenditures in the U.S. than it is in Italy, a country long associated with fiscal profligacy.

More Room For Fiscal Stimulus Outside U.S.

Cumulative Primary Fiscal Deficit as a Percent of GDP
2016 - 2023



General Government Net Interest Expense as a Percent of Total Expenditure



Note: World Developed Markets includes U.S.
Source: IMF, BCA Research 2025

Therefore, it seems unlikely that lavish government spending and tax cuts will continue to spur the U.S. economy. By contrast, we think that U.S. tariff and defense policies are likely to prompt expansionary fiscal stimulus elsewhere.

The policy changes underway in Europe are akin to shifting tectonic plates that could set off an economic earthquake. The European Union (EU) appears to have both the will and firepower to stimulate economic growth. In a paper published early this year in the *Financial Times*, leaders of the European Central Bank and European Commission declared: "Europe has got the message on change. We are ready to do whatever is necessary to bring Europe back on track." The European Commission is an independent AAA-rated bond-issuing entity, and the debt-to-GDP ratio for the EU currently sits at a relatively low level of 81%, well below the 122% for the U.S.

One area that we are confident will garner additional European investment is defense. Historically, military spending has been a strong driver of countries' economic growth, with benefits for innovation and productivity.

In addition, European banks, which dominate European sovereign lending, are the healthiest they have been in decades. They have ample capacity to step up purchases of EU and national debt and to make consumer and business loans.

Of course, it is not all rosy across the pond. The imposition of U.S. tariffs could severely dent European exports of goods to the U.S. A tariff war with the U.S. would be unambiguously negative for the EU economy, but the damage may be somewhat offset by stimulus from increased fiscal spending.

We added our *Opportunities Abound Abroad* theme to portfolios almost two years ago, in the second quarter of 2023. Admittedly, we were early in this call, but we are pleased with the traction we have seen since late last year. Despite the mid-single digit increase in the first quarter of 2025, European equity indices are still significantly cheaper than the S&P 500, and we think expectations are still too low for the Continent. We are excited by opportunities in other regions, as well.

CONCLUSION

The past quarter's returns clearly demonstrated the benefit of diversification. After several years in which a handful of mega-cap U.S. technology stocks dominated global equity market performance, positive returns came from many geographies, sectors and ideas that have been overlooked.

While the Mag 7 are down significantly from their recent highs, they are still very expensive, and their outsize share of the S&P 500 still poses a significant risk to the U.S. index. Meanwhile many non-U.S. equities are priced at such a deep discount to the U.S. that not a lot has to go right for investors to wake up to their value.

As always, we are trying to look past the short-term noise to focus on longer-term opportunities we believe are emerging for our clients.