



# AOR Update: Flexing the Edge

June 2, 2025

## Key Takeaways

- ▶ Periods of substantial uncertainty offer an opportunity for individuals and professionals alike to gain an investment edge by lengthening their time horizon.
- ▶ Resolution of the two largest macro and market unknowns — tariffs and the budget reconciliation package — should help provide the foundation for a durable equity rally, although setbacks along the way will likely lead to bouts of volatility.
- ▶ While a tariff-related air pocket could form in the near term, our comfort with continued economic growth has increased with two positive indicator changes for the ClearBridge Recession Risk Dashboard: Yield Curve and Truck Shipments.

## Time Is on Investors' Side

There are several sources of “edge” available to investors that can drive superior performance. One that is readily available to individual investors is structural edge, which emanates from “the absence of career or industry pressures faced by professionals” according to Morningstar.<sup>1</sup> Professional investors are periodically evaluated relative to their benchmarks, which can drive suboptimal decisions when short-term goals are prioritized ahead of long-term outcomes. As a result, individual investors can generate an edge by taking advantage of mispricings that occur when short-term thinking overwhelms long-term considerations.

During periods of substantial uncertainty such as the present, elevated perceptions of risk can also shorten the time horizon over which investors make decisions. We believe this dynamic has played out over the past few months, with investor time horizons broadly compressing. This presents an opportunity for individuals and professionals alike, as edge is available simply by lengthening one’s time horizon.

If we adopt a longer time horizon and consider what conditions may look like a year ahead, it is reasonable to believe two of the largest unknowns — tariffs and the budget reconciliation package - will have been largely if not fully resolved. While both unknowns have seen [progress toward resolution](#) in recent weeks, we expect continued twists and turns ahead. This could lead to further bouts of volatility before the foundation for a durable equity rally forms.

Catalysts for volatility could include the many questions about the ultimate size, cost and impact of the budget reconciliation package on the U.S. deficit. This means moves in long-term interest rates are likely to remain in focus as investors parse the inevitable changes that will occur to the package as it moves through Congress over the summer. On the tariff front, recent court decisions have introduced a new source of uncertainty as

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<sup>1</sup> Joseph Taylor, “How to avoid throwing away your investment edge,” Morningstar, September 25, 2024, <https://www.morningstar.com.au/personal-finance/how-to-avoid-throwing-away-your-investing-edge>

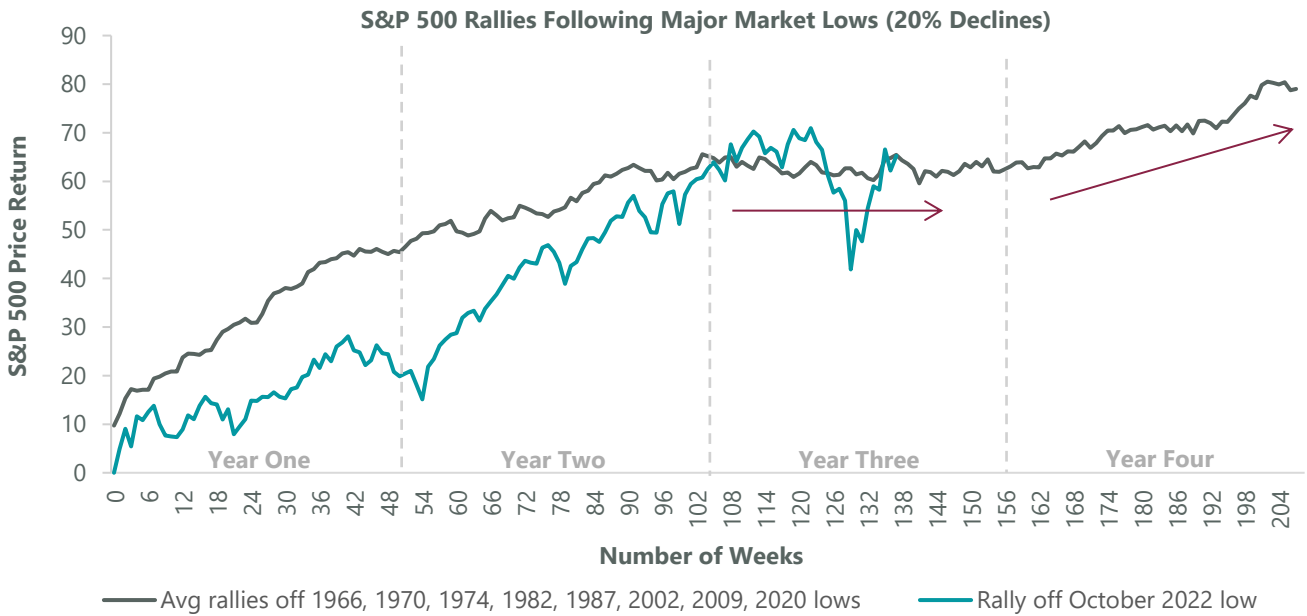
investors attempt to gauge what will be allowed and what steps the administration may take should the recent court decision to block the International Emergency Economic Powers Act (IEEPA)-related tariffs be upheld.

### Stimulative Effect of Budget Bill Should Quell Deficit Concerns

Stepping back and lengthening our time horizon, however, we believe Congress will ultimately deliver a bill to President Trump that provides stimulus to the economy. While this will further exacerbate the deficit situation, we believe it will ultimately do so in a manageable way. Similarly, the recent court decisions do not change our view that the most economically damaging tariff possibilities have become less likely. Although the administration may need to use different legal provisions to implement its tariff agenda, there are few indications that the scope and scale will be meaningfully different as a result. Therefore, we believe tariff uncertainty will also continue to ebb in the coming quarters.

A reduction in uncertainty should help the equity markets move through a more volatile period and ultimately form the foundation for a durable rally later in 2025. This would also align with historical patterns, with new bull markets (following bear market selloffs of 20% or worse) typically seeing a period of digestion during their third year. This has been playing out with the current rally as well, with the S&P 500 Index up just 1.7% since the bull market turned two years old on October 12, 2024. Should history repeat, equities could continue to see sideways price action over the next few months before resuming an uptrend as the bull market enters its fourth year this fall.

Exhibit 1: The Year-Three Digestion



Sources: FactSet, S&P Global.

One component crucial for further equity market upside is continued economic growth. Our comfort with this occurring has increased in recent weeks with two positive signal changes for the ClearBridge Recession Risk Dashboard occurring this month: the Yield Curve has un-inverted and improved to yellow from red, while Truck Shipments have improved to green from yellow. The overall dashboard reading remains in green expansionary territory.

Exhibit 2: Recession Dashboard

	May 31, 2025	March 31, 2025	December 31, 2024
<b>Consumer</b>	Housing Permits	↑	↑
	Job Sentiment	×	×
	Jobless Claims	↑	↑
	Retail Sales	↑	↑
	Wage Growth	↑	↑
<b>Business Activity</b>	Commodities	↑	↑
	ISM New Orders	×	●
	Profit Margins	●	↑
	Truck Shipments	↑	●
<b>Financial</b>	Credit Spreads	↑	↑
	Money Supply	↑	●
	Yield Curve	●	×
<b>Overall Signal</b>	↑	↑	↑

↑ Expansion      ● Caution      × Recession

Source: BLS, Federal Reserve, Census Bureau, ISM, BEA, American Chemistry Council, American Trucking Association, Conference Board, and Bloomberg. The ClearBridge Recession Risk Dashboard was created in January 2016. References to the signals it would have sent in the years prior to January 2016 are based on how the underlying data was reflected in the component indicators at the time.

As evidenced by the dashboard, the economy appears to be on solid footing as the ramifications of trade policy uncertainty begin to be felt. However, last Friday’s advance trade data showed the largest decline in goods imports on record during the month of April, indicating that economic data in the coming months could be quite volatile. The risk of an “air pocket” in demand appears likely as individuals and businesses alike “pulled forward” purchases ahead of the expected implementation of tariffs. This should give way to a pay-back period in the coming months where fewer purchases occur.

Evidence of this air pocket emerging in hard data has the potential to spook investors and lead to a renewed compression of time horizons if fears of a recession once again pick up. The resulting market volatility could be amplified if this occurs simultaneously with a setback in the budget reconciliation package or trade negotiations. In these scenarios, we believe investors will once again be best served by lengthening their time horizon as others become more short-term oriented.

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