

## Opportunities Within Volatility

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The start of 2025 has brought a challenging environment for equity investors, with markets facing a sharp correction not driven by external shocks but by a recalibration of domestic and global policy. Unlike past downturns, triggered by crises such as the COVID-19 pandemic or the Global Financial Crisis, today's volatility stems largely from shifts in trade, tax, and regulatory direction. Yet, within this uncertainty lies opportunity. As policy clarity improves and near-term headwinds subside, we believe the foundation is being laid for a stronger, more resilient investment landscape in the years ahead.

### Domestic

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The beginning of 2025 brought renewed enthusiasm to financial markets, spurred by the inauguration of a more pro-business administration. Investors anticipated deregulation, permanent tax reductions, and policies aimed at encouraging private investment and capital formation. While optimism initially ran high, markets were quickly met with a more complex and nuanced reality.

One of the key headwinds has been the administration's aggressive use of tariffs to reset global trade relationships. While a more balanced and fair global trading environment remains the stated goal, the scale and speed of tariff implementation surpassed market expectations. As a result, equity valuations came under pressure. Similarly, expectations for a more M&A-friendly regulatory climate proved overly optimistic, with deal-making continuing to face friction from policy ambiguity.

On the technology front, the recent announcement from DeepSeek introduced breakthrough results that significantly reduce the cost curve of AI development. While these advances are promising, they also introduced near-term uncertainty around data center investment priorities. Despite concerns, hyperscalers maintained or increased capital expenditures, positioning themselves for continued growth in AI-driven enterprise infrastructure, particularly in inference and application-layer investments.

Meanwhile, the new administration is in the process of redirecting a number of economic and social policy initiatives discussed during the campaign season. This period of policy transition is likely to dampen economic activity in the near-term, as business leaders await greater clarity before making capital allocation and operational decisions. However, we believe progress on federal budget planning and corporate tax policy will ultimately provide a constructive tailwind.

Interest rates remain elevated but are trending in a healthier direction, as the yield curve steepened on the long end. Unless a significant economic shock emerges—something we do not view as the base case—the Federal Reserve is unlikely to cut short-term rates. More predictable policy direction, inflation data, and tariff outcomes will be critical to informing the Fed's next moves.

## Global

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From a global standpoint, we believe we've seen the worst of the tariff escalation and expect a more structured negotiation process to unfold in the coming quarters. Encouragingly, the VIX recently broke out to the upside—an indicator that historically coincided with market bottoms. Still, headline risk and macro uncertainty remain elevated, and we anticipate sustained volatility as investors navigate this uncharted policy landscape.

A peaceful resolution to the war in Ukraine and de-escalation of tensions in the Middle East would be welcome developments, potentially easing geopolitical risk premiums embedded in markets.

We are witnessing a global realignment in supply chains and capital deployment. A growing number of U.S. companies are pursuing “country-for-country” or “region-for-region” strategies to mitigate tariff exposure and geopolitical risk. While many firms began this diversification process years ago, the transition is gradual and must make long-term economic sense.

Re-onshoring and manufacturing investment represent promising trends for domestic growth, but these efforts require consistency, policy visibility, and significant capital. In this climate of uncertainty, management teams are finding it increasingly difficult to provide reliable forward guidance. Many have adjusted earnings frameworks—widening ranges, lowering targets, or presenting scenario-based outlooks to account for macro volatility.

## Conclusion

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The recent market correction has been difficult for equity investors. Unlike previous drawdowns driven by external crises—such as the COVID-19 pandemic or the Global Financial Crisis of 2008—this sell-off is largely policy-induced. But therein lies the opportunity: if these headwinds prove transitory and begin to resolve over the course of 2025, we believe the stage is set for a more vibrant, resilient investment landscape in the years ahead.

The Needham Small Cap Growth Fund remains focused on uncovering high-quality companies with strong balance sheets and long-term growth potential. In uncertain times, discipline, research, and conviction matter most.

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