MARKET COMMENTARY

EQUITY ANALYSIS

WHY MARKET STRESS FAVORS QUALITY: THE MACROECONOMIC CASE FOR QUALITY INVESTING

Recently, market volatility has surged as economic uncertainty grips financial markets. Growth expectations have collapsed, stock market volatility is spiking, and credit spreads are widening. This environment has placed renewed focus on how different stocks respond to macroeconomic pressures — and, crucially, why quality matters more than ever.

Traditionally, market downturns and economic stress trigger debates over whether value stocks or growth stocks will fare better. However, an underappreciated factor in this discussion is quality. High-quality stocks — characterized by low leverage, profitable assets, and consistent results — have historically outperformed their lower-quality counterparts in periods of macroeconomic stress. For years, research has highlighted the defensive characteristics of quality stocks. Academics the world over have extensively studied the relationship between stock performance, risk, and various factors. However, discussions about quality investing often oversimplify the issue. What they fail to fully appreciate is why quality has outperformed and, more importantly, *how quickly* market conditions can flip, making it absolutely critical to position in advance.

THE CHALLENGE OF NON-LINEARITY

Conventional wisdom suggests that defensive equity strategies behave in a predictable, linear fashion — that quality stocks gain an advantage at a steady pace as risk rises. This assumption is flawed. In reality, the relationship between macroeconomic stress and quality stock outperformance is highly non-linear.

This non-linearity is evident in Chart A on page 3. Historically, once the VIX (market volatility index) exceeds 20, high-quality stocks, as identified by the WCA Quality Index, began to meaningfully outperform low-quality stocks, for the time period shown, and the gap widened exponentially. This can happen very quickly. While many rightly assume that higher-quality stocks tend to be more defensive in downturns, most fail to grasp the speed and magnitude of this rapidly occurring, non-linear effect. Traditional risk models may well treat volatility and stock behavior as linear, but our research shows that once uncertainty crossed a certain threshold, market reactions became highly amplified. Blink and you can easily miss the change.

This non-linear relationship between volatility and quality performance raises an important question: If quality outperformance accelerates as market stress rises, shouldn't you ***proactively allocate toward quality before volatility spikes rather than reacting after the fact?***

Building on previous work on factor sensitivity, we now examine how different quality grades respond to macroeconomic changes — not just stock market volatility but also shifts in other outside factors like credit spreads and currency movements.

EVOLVING CONDITIONS

The past three weeks have introduced renewed nervousness to markets. Concerns over tariffs and persistent inflation are dampening economic optimism. For example, GDP growth forecasts for the current quarter are weakening due to escalating trade fears. Simultaneously, equity market volatility has risen, and corporate credit spreads have widened (Chart B, page 4). All of this signals emerging recession concerns, heightened uncertainty, and potential default risk for weaker firms. Time will tell how this all resolves. In the chart, each of these macroeconomic signals point to a familiar and common theme: high-quality stocks are generally better positioned to withstand these external pressures than their lower-quality counterparts.

For the record, since the stock market peaked in the third week of February, the S&P 500 is down 8.5% (as of 3/10/2025), while the aggregate bond market is up 1.7%, reflecting concerns about slowing growth. However, the stocks with the lowest quality and highest valuations have suffered the most. As of the same date, the WCA "Low" Quality Index is down 10.3%, and the Bloomberg 1,000 Growth Stock Index is down 11.2%. By contrast, the WCA "High" Quality Index is down just 1.9%, significantly outperforming other equity categories.

This reinforces our findings: ***lower-quality stocks tend to experience disproportionate losses as uncertainty rises, while the representation of high-quality assets was shown to have provided relative stability.***

QUALITY TEMPERS VOLATILITY WHEN MACRO FACTORS UNEXPECTEDLY CHANGE

As we move down the quality spectrum from "A" (higher quality) to "F" (lower quality), the stocks in each category become increasingly sensitive to outside, macroeconomic factors —

reacting more violently to widening credit spreads or currency fluctuations, for example. A more nuanced point here should also be made. Not only do lower-quality stocks experience greater average sensitivity to external shocks, but there is also a far greater uncertainty regarding how any individual company will perform in response to these factors. The range of possible outcomes in the face of an external shock is far greater the further down the quality scale we go (note the rising standard deviation for each group indicated in grey in Chart C on page 4). Lower quality translates into more sensitivity and greater uncertainty of outcomes.

While it is widely understood that quality tends to offer defensive characteristics, the exact way that this plays out is less well appreciated. Our research clarifies that high-quality stocks may offer some relative stability when volatility spikes and markets adjust rapidly. Additionally, we see how different macroeconomic factors can disproportionately impact lower-quality firms and create unwanted risk in the process.

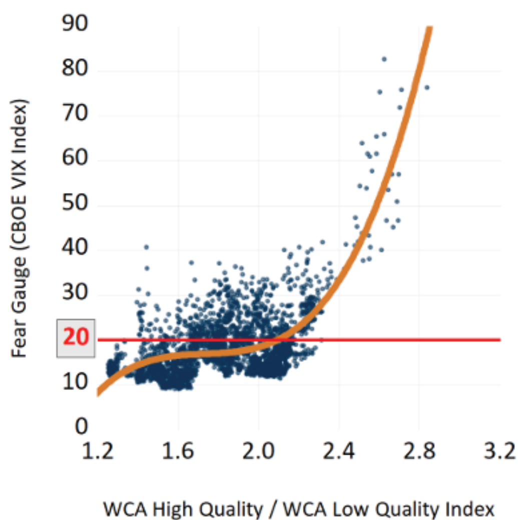
WHAT IF MARKETS ARE WRONG?

Yes, the market has recently taken a step back. But if anything, the past few months and years have shown just how short-sighted and reactive the market can be.

Despite the recent correction, the S&P 500 remains up 11.2% over the past 52 weeks ending 3/7/2025. Moreover, the broader economic backdrop still includes elements of strength, including resilient labor markets and steady consumer spending. If these factors stabilize sentiment, lower-quality and growth stocks could rebound as market participants re-engage with riskier assets. With so much changing daily, predicting the next move remains challenging.

In such an environment, maintaining a focus on enduring quality makes tremendous sense. Whether volatility rises or subsides, high-quality investments may provide a stabilizing force, offering both resilience and potential for long-term outperformance. A key factor is to be positioned ahead of time.

CHART A | THE EXPONENTIAL IMPACT OF RISING FEAR ON QUALITY VS. LOW-QUALITY STOCKS Source: WCA



Data encompasses the WCA High and Low Quality universe for the period 3/10/2015-3/10/2025. Source: WCA

Past performance does not indicate future results.

As the volatility index exceeds about 20, then high quality began to outperform low quality in an exponential fashion.

CHART B | THE MACRO STRESS FACTORS IN ACTION (2/3/2025 – 3/10/2025) Source: Bloomberg

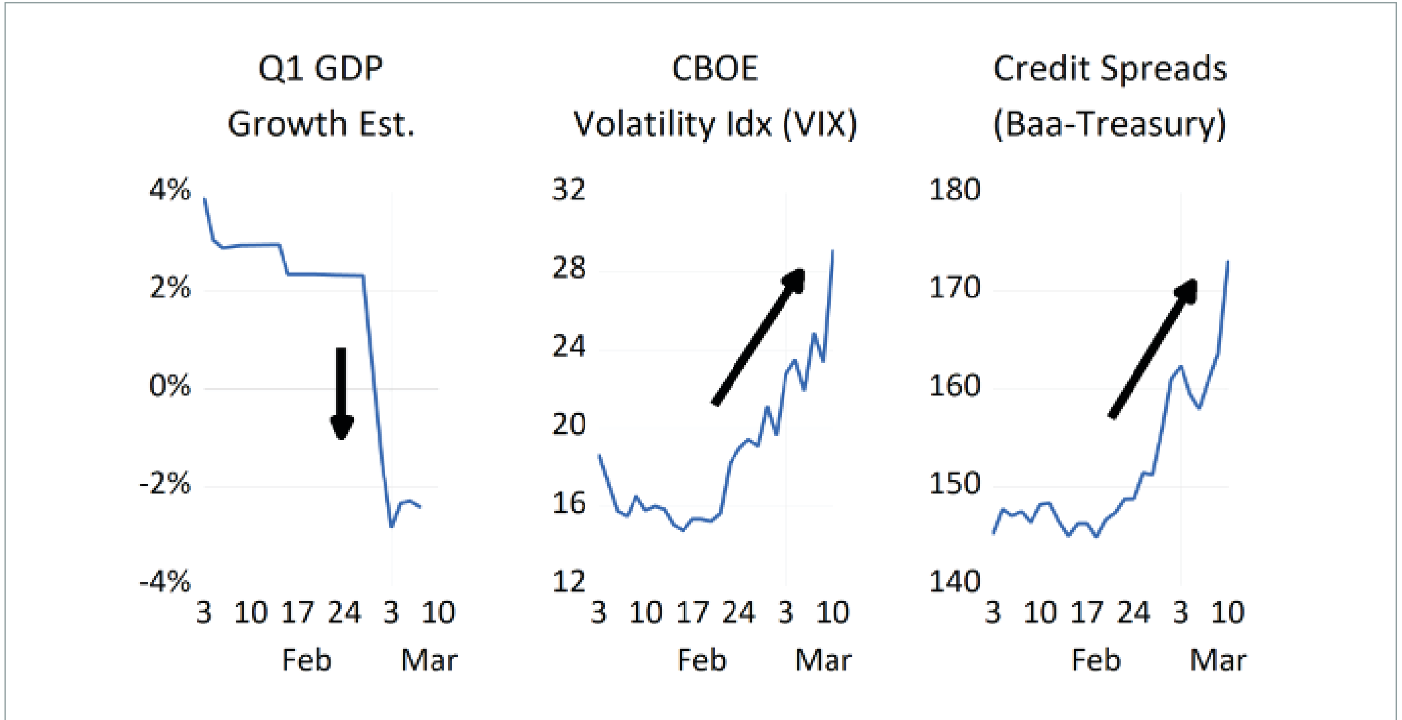
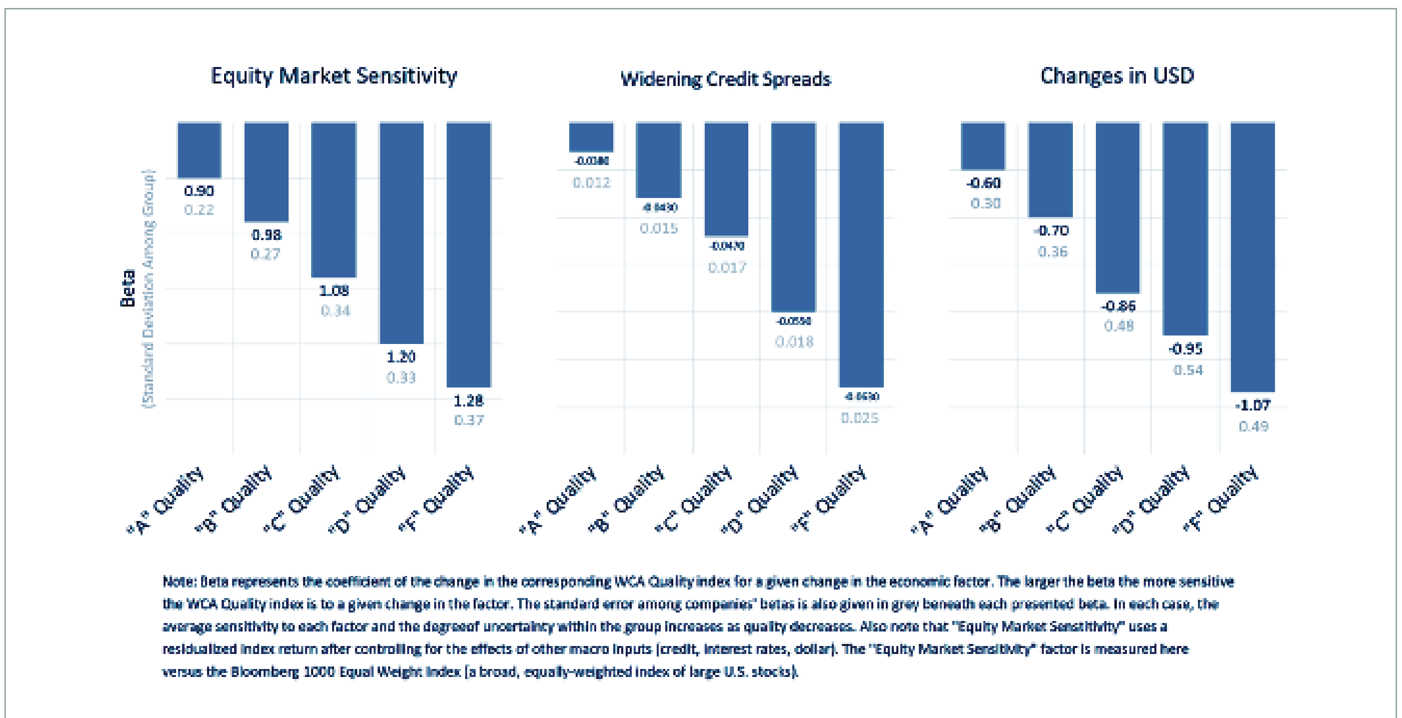


CHART C | SENSITIVITY TO ECONOMIC FACTORS BY WCA QUALITY GRADE (3/10/2015 – 3/10/2025) Source: WCA



Note: Beta represents the coefficient of the change in the corresponding WCA Quality index for a given change in the economic factor. The larger the beta the more sensitive the WCA Quality index is to a given change in the factor. The standard error among companies' betas is also given in grey beneath each presented beta. In each case, the average sensitivity to each factor and the degreeof uncertainty within the group increases as quality decreases. Also note that "Equity Market Sensitivity" uses a residualized index return after controlling for the effects of other macro inputs (credit, interest rates, dollar). The "Equity Market Sensitivity" factor is measured here versus the Bloomberg 1000 Equal Weight Index (a broad, equally-weighted index of large U.S. stocks).

IMPORTANT DISCLOSURES

Standard & Poor's 500 Index (S&P 500) is a capitalization-weighted index that is generally considered representative of the U.S. large capitalization market.

The Washington Crossing Advisors' High Quality Index and Low Quality Index consist of the largest 1,000 U.S. stocks by market capitalization. After these stocks are determined, each one is assigned a letter grade (A, B, C, D, F) based on consistency (earnings and stock price volatility), leverage (debt/enterprise value), and profitability (return on assets). Companies that are assigned an A or B rating will be included in the High Quality Index, while companies with C, D, and F ratings are included in the Low Quality Index.

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Beta is a measure of the volatility, or systematic risk, of a security or a portfolio relative to the market as a whole. A beta of one is considered as risky as the benchmark and is therefore likely to provide expected returns approximate to those of the benchmark during both up and down periods. A portfolio with a beta of two would move approximately twice as much as the benchmark.

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FOR MORE INFORMATION, PLEASE CONTACT US:

Washington Crossing Advisors

- **Kevin R. Caron, CFA,** Senior Portfolio Manager | (973) 549-4051
- **Chad Morganlander,** Senior Portfolio Manager | (973) 549-4052
- **Matthew Battipaglia,** Portfolio Manager | (973) 549-4047
- **Steve Lerit, CFA,** Head of Portfolio Risk Management | (973) 549-4028
- **Suzanne Ashley,** Relationship Manager | (973) 549-4168

Sales and Marketing

- **Eric Needham, Director,** External Sales and Marketing | (312) 771-6010
- **Jeffrey Battipaglia,** External Sales and Marketing | (973) 549-4031

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