

## Market Update

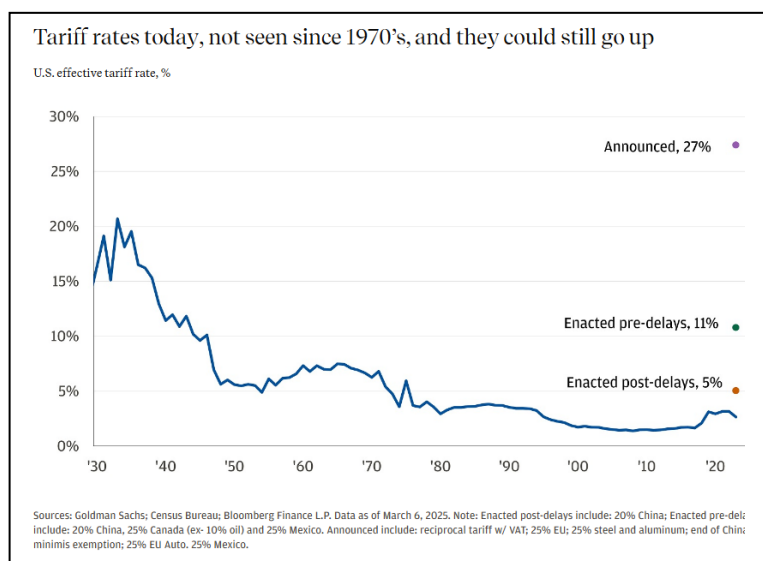
4/4/2025

Markets have sold off the past two days since the announcement of the new tariff regime. We came into 2025 with a view that the policies of the new administration could lead to a wide range of outcomes. The market started the year well expecting a reflationary environment positive for risk assets. We foresaw solid organic economic growth driving earnings growth in the stock market, keeping inflation stubborn and yields high.

For the first two months the conventional wisdom has been that tariffs are a negotiating tool and the new administration's bark was worse than the bite. But starting in early March the soft data pointing to future growth began to deteriorate with the markets becoming concerned that tariffs might actually been enacted. Twenty percent tariffs were imposed on China and fear of broader tariffs hit consumer and business sentiment.

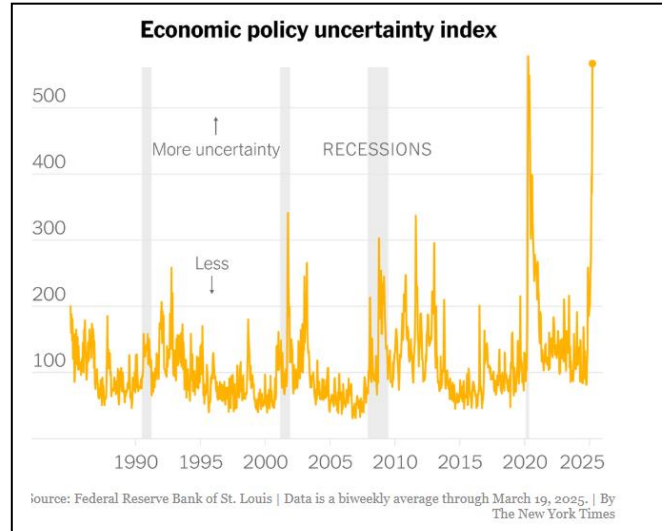
Hard economic data, on the other hand, has been largely positive, with low unemployment, solid real consumer spending, and good income growth. The worry has been that at some point the weak soft data turns into weak hard data as households and businesses pull back spending, investing and hiring.

Then a broader new tariff policy, announced on Wednesday, was much more severe than expected by the markets. A universal 10% tariff on all countries will take effect on April 5. This would be followed by country specific tariffs starting April 9. New tariffs were announced on a broad range of trading partners, taking the US tariffs rate to between 25-30% from 2%. It will be the highest tariff rate in over a hundred years. China has already announced retaliation and the EU is planning on countermeasures.



Tariffs are essentially a tax on households and businesses. The cumulative tariff hike can be viewed as a tax increase of roughly \$660bn or 2.2% of GDP. According to Yale University's Budget Labs, a 20% tariff rate will cost \$4200/family.

The tariffs have led to a very high level of uncertainty due to the impact on economic growth and inflation. Higher tariffs can lead to stagflationary shock with lower economic growth and higher inflation. It is estimated by several banks that with these newly announced tariffs, US inflation might rise by 1% to 2%, lifting core inflation from 3% to 4%-5%. In addition, tariffs could negatively impact US growth by 1% to 2%, taking 2025 growth from 2% expected at the beginning of the year down to between 0% to 1%, putting the US economy very near to recession. JPMorgan estimates recession odds at 60% this year.



A stagflationary environment is very negative for financial assets. The new tariff regime has turned the fundamental view- from positive to negative with significant impact on financial markets:

Equities have pulled backed meaningfully the past week particularly yesterday.

- \$2 trillion of market value was wiped out yesterday and since mid-February when the markets became increasing more concerned about tariffs around \$7 trillion has been erased.
- Higher tariffs should raise input costs and reduce revenues as demand falls. As a result, profits will be significantly impacted.
- In 2018 when there was a trade war with China, the S&P 500 was down -20%. However, the scale of the tariffs was much smaller than compared to today.
- The S&P 500 has gone into correction mode and is down more than 10% since February. Small caps in a bear market down more than 20% and Mag 7 down more than 25% since its December peak. If the US economy goes into recession, there could still more downside.

Bond yields have fallen the past week which has boosted bond prices and provided some ballast to a portfolio. The US 10 Year Treasury has fallen from 4.3% last week to 3.9% today. Markets believe that that the Fed will reduce rates and are pricing in 3 to 4 rate cuts in 2025.

- However, market might have over-estimated the support that the US Fed will provide.
- With inflation expected to rise significantly above the Fed's target, there is not much room to support growth. The Fed is caught between a rock and hard place. That is what makes stagflation very difficult.

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- Moreover, tariffs are a supply-side shock which makes monetary policy less effective. The Fed cannot make costs go down.

Commodities have been mixed.

- Gold does well compared to other assets in a more stagflationary environment. Gold climbed to a new all time breaking about \$3,000/oz two weeks ago.
- Energy and industrial commodities have fallen due to concerns about weaker demand.

The US dollar has reacted very differently than in previous times of higher global volatility.

- Historically, the dollar has been seen as a safe haven and appreciated during times of crisis.
- However, the past few days the dollar has significantly weakened, particularly against the Euro and Japanese Yen.
- Foreign exchange markets might be pricing that the US could be more negatively affected than other countries.

The situation is very fluid with many unknowns and is likely to lead to continued volatility. In times of elevated market stress, we recommend clients keep calm, focus on long term goals, stay liquid and not take large bets. If an investor is extremely underweight in equity exposure to their strategic target they should consider slowly legging in using staged increments, but other than that – no major changes. It is important to use diversification, particularly core fixed income, to ride out the high market volatility.

We are monitoring the market events very closely and will be releasing a podcast that goes into more depth on the market volatility.

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