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Thoughts on the Tariff News and the Market Reaction

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U.S. President Trump announced a new round of tariffs on April 2—which were higher than expected—and markets sold off hard the next day. While many questions remain, we have put together some initial thoughts on the news. Based on past behavior, we would first remind people that this remains a fluid situation, and important details are subject to quick change. And as the markets digest this news, volatility in both asset prices and economic data will likely stay elevated.

From a macroeconomic level, the impact of this news markedly increases the risk of recession (to at least 50%), with the magnitude of any recession highly dependent on any retaliatory measures. The other major impact will be on inflation, with tariffs resulting in higher prices on many goods, which can be viewed as an effective tax increase on many Americans. Those outcomes could put the U.S. Federal Reserve (Fed) in a tough position, potentially needing to lower rates to combat slower growth at a time when inflation is sticky and/or increasing further from its 2% target.

What Happened

President Trump announced a baseline 10% tariff on all countries (excluding Canada and Mexico) and superseding, reciprocal tariffs on countries with high trade deficits with the United States, which will vary by country. Not all goods will be subject to tariffs. For example, steel and aluminum are not subject to the new tariffs as they already had a 25% tariff applied, and additional sectoral tariffs could be applied in the future on things like lumber, semiconductors and pharmaceuticals.

Potential Winners and Losers

Based on the news we have received to date, a picture of some relative winners and losers is materializing. Winners include Canada and Mexico, who were exempted for now along with countries subject to only the baseline 10% tariff (United Kingdom, Brazil, Australia, United Arab Emirates). The relative losers appear to be China, Japan, Vietnam, Taiwan and the European Union—countries where tariffs are higher than expected. Obviously, companies with large exposure to high tariff countries are also going to be heavily impacted.

What Is Potentially Next?

As mentioned previously, the situation is very fluid, but we would expect announcements of retaliatory measures, which President Trump specifically warned against. In the short-term we would expect retaliation and escalation with long-term reconciliation achieved through trade negotiations and new trade deals and partnerships. One also must wonder if Congress might step in with an attempt to stop this executive order.

Many Questions Remain

While widely expected, this action is so new, and the details are still being digested, that many questions remain. One of the biggest questions revolves around whether or not this is a structural shift and should it change how we view the world. We thought that tariffs would be a negotiating tactic but the rhetoric surrounding these announcements is very firm. We also wonder about the degree of the impact on inflation. Will tariffs result in a one-time marked repricing higher on impacted goods, or is it not only that we will have higher inflation but a higher rate of change of inflation? If tariffs are more than transitory as a negotiating tool, we question if President Trump will be able to accomplish other goals of his administration. Tariffs could result in him losing supporters, eroding the Republican majority in Congress and the ability to pass legislation.

The Economy

As stated previously, the odds of recession have increased based on this news. We would put them at least at 50% with a bias toward higher. Business, and especially consumer sentiment, has been declining, and the risk is that consumer activity will slow as confidence continues to weaken and goods become more expensive. At the same time sentiment has declined, inflation expectations have been rising, with the University of Michigan five-year expected inflation rate at the highest level since 1992. Manufacturing had been trending better before declining in March in a sign that firms had been front-running the expected tariff announcement. To date, employment data has held up relatively well, but the April employment report (due on May 2) will be a good indicator of the preliminary impact (if any) on the job outlook. The Atlanta Fed GDPNow estimate for first-quarter gross domestic product was updated post-announcement and now stands at -2.8%.

The Markets

Domestic equities had been generally weaker prior to the Liberation Day announcement, and the initial reaction has been a global rout for stocks. Even with this weakness, the S&P is just back to where it was last spring and summer.

Corrections/bear markets are nerve-rattling to go through, but after two very strong years for the S&P 500 and the Magnificent 7, valuations were very extended across large swaths of the market, and conditions were ripe for a sell-off—particularly in stocks that were trading at high multiples to earnings and sales. Valuations were high because strong future earnings growth was expected. The tariff news may have just been a catalyst that made investors realize how vulnerable the market was to potentially lower earnings expectations. While we have limited visibility for predicting what impact the tariffs will ultimately have on certain sectors and individual companies, we can be fairly confident that tariffs will have a potentially significant impact on earnings on a broad spectrum of companies.

We would caution against making large changes in portfolios on the initial tariff news until a clearer picture emerges. Having said that, there are some areas that we think will hold up well (on a relative basis) based on this news. They are industries or asset classes that in one way or another have less exposure to the impacts of tariffs. Some of those ideas include domestic real estate investment trusts (REITs); utility stocks; international equities (based on valuations and the dollar); hedge fund strategies (multi-strategy and more quantitative-based strategies); and companies/industries with limited international exposure, such as waste management, U.S. insurers, consumer staples and healthcare. We also think municipal bond valuations are compelling while acknowledging that the tax-exempt status is in the news as often happens under a new administration.

In Closing

Corrections are inevitable (averaging one every year) as are bear markets (about once every 3.5 years). That is the price of admission to earn the higher average annual returns that equities can provide, and we are squarely in the camp that believes market timing successfully long-term is almost impossible.

To be a good investor, one must not only successfully manage their assets but also their emotions. As we wrote in our last newsletter, successful investors are resistant to panic and euphoria. And the most famous of all value investors, Benjamin Graham, once said, "You make most of your money in a bear market, you just don't realize it at the time." None of us know or can control how deep this selloff can get but what we can control is how we react to it. Don't panic, rebalance, selectively buy and don't abandon long-term strategies are all good time-proven behaviors that can help one make good decisions in times of stress.

We will finish with one final thought. Our asset allocation process is very valuation-dependent. Over the last several years we have thought the trends in place since the Global Financial Crisis would eventually change. This might be a catalyst for those changes if tariffs prove to be a structural shift in how global trade works. That could potentially mean more interest in international stocks, lower valuations for tech stocks, and more dispersion across the equity markets. Those are things we will be watching very closely in the weeks ahead.

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