Trade Uncertainties and Markets

March 11, 2025

SUMMARY

The post-election rally that was driven by optimism for deregulation and pro-economic growth policies has faded and been replaced with concerns about trade policies, inflation, and cooling economic data. We have previously noted the increased potential for volatility following two years of 20%+ gains in the S&P 500 as well as the fact that the third year of a bull market, which we are currently in, tends to produce uninspiring gains of 1-3% on average. In addition, we've noted that we are overdue for a healthy 10% correction in the market.

Based on the relatively high valuations in the stock market, the strong recent performance of stocks, and the risks of tariffs and other policy uncertainty emanating from D.C. (which includes potential economic weakness), a step up in volatility in the markets is not surprising. This does not necessarily point to a recession, though. As long as a recession is not the base case, we should view a 10-15% drawdown as normal and healthy and, quite frankly, needed at this stage of the cycle in order to coax more cash into the markets. With our non-recessionary outlook, the pullback should act as an opportunity to re-evaluate exposures in portfolios or as a good buying opportunity for portfolios with excess levels of cash. Also, note that diversified portfolios have fared much better during this selloff than equity markets have.

MARKET VOLATILITY AND POLICY UNCERTAINTIES

Since the markets peaked on February 19th, less than one month ago, the S&P 500 Index has retreated 8.7% while the NASDAQ and Russell 2000 Index have both fallen 13.3% and 17.3%, respectively, putting both indices technically in correction territory. This can feel very unsettling, but it is well within the norm for the equity markets. In fact, a return of volatility should not surprise investors, while what is most notable has been the recent relative calm in the markets compared to history. The last 10% correction experienced in the S&P 500 Index was in the 4Q of 2023 as interest rates were increasing and inflation concerns were stoking recession fears. History tells us that we should expect on average at least one pullback of 10%+ in any given year and smaller pullbacks of 5%+ multiple times a year.

The key driver for the current downturn is uncertainties about the Trump tariff plans, which appear to have had a cooling effect on economic activity beginning in February. Although these data points have sparked fears of a pending recession among some investors, there are multiple signs that the economy remains on solid footing, including strong labor markets, healthy wage growth, double-digit 2025 expected earnings growth, and the potential for more Fed rate cuts. However, the extended valuations of U.S. equities, including relative to foreign markets, is instilling a "sell-first" mentality amongst many investors.

Importantly for diversified portfolios, fixed income investments have performed well during this time as growth fears have driven interest rates lower. In addition, foreign equites have performed much better than U.S. equities year-to-date. As a result, balanced portfolios have not suffered the types of losses incurred in the U.S. equity markets. Also, because we remain optimistic regarding U.S. economic growth and stock market performance, we believe this volatility creates a buying opportunity for high quality US equity exposure. In fact, we've seen an increase in stock market investment in recent weeks as many have put idle cash to work. However, we continue to see a well-diversified portfolio of stocks, bonds, domestic and foreign investments, and public and private strategies as the best way to achieve long-term goals.

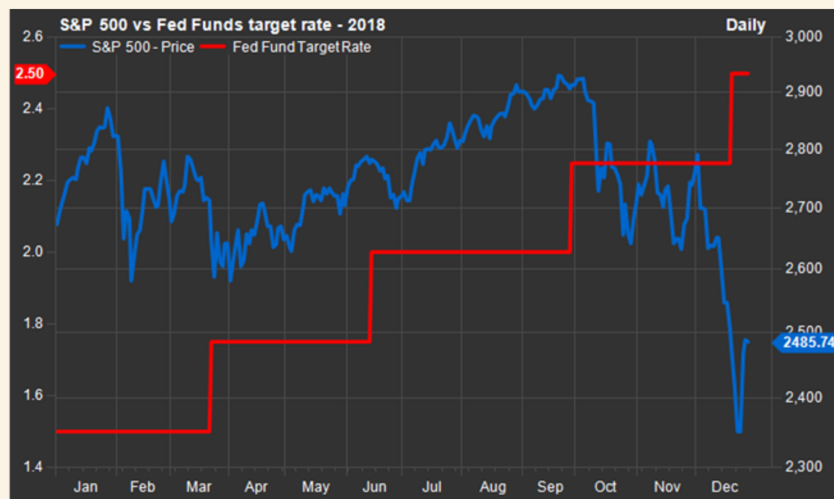
ECONOMIC DATA

Recent data suggests that the economy is moving from an above average period of growth to average, trend like growth or a potentially sub-trend level to the extent the impact of tariffs drive deferred economic activity, higher prices, and stagnant to higher interest rates from the Fed. This fear is being reflected in interest rates with the 10-year Treasury yield down to as low as 4.13% last week from a high of 4.79% in January. The economy moves in cycles, so such a change in trend is not unusual, but it does bear watching for any material change.

Currently we do not foresee a recession occurring and therefore will be looking to opportunistically allocate capital during this pullback. Ultimately, if the market and economy deteriorate materially, we believe there's a good chance that Trump may consider delaying or reducing tariffs (which he has already done more than once). In addition, if growth were to weaken notably, the Fed is likely to signal more rate cuts which could have a boosting effect on the market. As of today, the market is pricing in between 3-4 rate cuts, up from 1-2 just two weeks earlier.

2018 TRADE WAR AND IMPACTS

It's important to note that during the Trump 1.0 administration, tariffs were a key component of trade policy. Then President Trump announced new tariffs on China and other trading partners beginning in January of 2018 which caused a sell-off in the market that lasted much of the first quarter of that year. The peak-to-trough drop on the S&P 500 Index during this period was over 10% (see chart below). The market stabilized and was able to regain its losses over the next six months before rolling over again due to interest rate hikes from the Fed, which occurred due to the Fed's fear of an inflation spike resulting from the tariffs. Despite the volatility, tariffs did not ultimately lead the economy into recession in 2018 or 2019. In fact, in early 2019 the Fed began a rate cutting cycle that produced a 30% gain in the S&P 500 that year.



Source:FactSet; As of 3.10.25

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