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DEALING WITH UNCERTAINTY

Niladri 'Neel' Mukherjee
TIAA Wealth Management
Chief Investment Officer

Alberto Favalli-Ragusini
TIAA Wealth Management
Director, Investment Strategist

Why are stock markets selling off?

Market volatility has erupted over the past week as investors deal with rising uncertainty across three fronts:

- **Tariffs are on.** The Trump administration has announced that tariffs on Mexico and Canada (25% on all imports, with the exception of 10% on Canadian oil) and an additional 10% tariff on Chinese goods (bringing the total increase since President Trump's inauguration to 20%) would go into effect on March 4. These measures represent an unwelcome escalation that, unless rapidly defused, may lead to a damaging tit-for-tat, with ramifications that could be far-reaching for both the U.S. and global economies. We recently published a more detailed note expanding on our thoughts on this topic.

- **Pro-growth no more.** As we discussed in our 2025 Outlook, the sequencing of President Trump's economic agenda would be a key driver of economic and market performance this year. Unfortunately, pro-growth policies (tax cuts and deregulation) seem to have taken a backseat to more disruptive policy priorities (tariffs and immigration curbs).

- **Spending cuts are coming.** The direct impact of the Department of Government Efficiency (DOGE) on total U.S. employment should be relatively contained, given that federal government employment only accounts for less than 2% of total non-farm payrolls. However, second-round effects could be more significant. State and local governments account for ~15% of total non-farm payrolls, and around 25% of their general revenue relies on federal transfers. And the considerable size of federal contracts ($750 billion, or ~2.5% of nominal GDP) creates risks also for private employment, should those contracts be revised or canceled. Therefore, nervousness about the government's focus on slashing budget outlays is becoming more palpable.

The perception that this uncertainty might be already dampening economic activity has been fueled by a string of disappointing economic data, from sluggish inflation-adjusted household consumption to a significantly larger-than-expected trade deficit (which represents a drag on Gross Domestic Product [GDP] growth), falling consumer confidence and anemic housing data.

However, it is crucial to separate noise from signal, and our view is that still robust corporate earnings growth (+13% year-over-year in Q4 24) and positive income growth suggest that fundamentals are better than the headlines suggest.

Looking ahead

Following the U.S. election on November 5, equity prices ran up in anticipation of a market-friendly execution of President Trump's economic agenda, and this optimism has been gradually fading given the dynamics described above, causing markets to reverse the post-election gains. That said, we are acutely attuned to the risk that persistent and growing uncertainty, as well as durable tariff hikes and deep spending cuts, might eventually dent fundamentals in a more concrete fashion. To monitor this risk, we are watching three key factors:

- Whether falling consumer confidence translates into lower spending and higher savings, especially for higher-income consumers (the top 20% of households by income account for almost 40% of total household spending in the U.S.).
- How the combination of budget spending cuts, uncertainty, consumption trends, and tariff-related cost pressures affect corporate profit margins and, in turn, corporate earnings, investment plans and employment decisions.
- How the Federal Reserve (Fed) reacts to uncertainty, and what side of the dual mandate (stable prices and full employment) they prioritize against a backdrop of higher inflation and weaker labor market conditions potentially materializing at the same time.

We will be monitoring some key high-frequency market and economic metrics to gauge the health of the economy—earnings estimates for multinational companies and cyclical sectors like financials, industrials, and consumer discretionary; investment-grade and high-yield credit spreads; market-based inflation and monetary policy expectations; weekly initial jobless claims; the unemployment rate and non-farm payrolls; daily data from the Treasury on budget outlays; survey-based indicators of business and consumer sentiment, with a focus on the service sector; and more.

Conclusions

The fast-evolving environment makes it paramount that investors avoid overreacting to the noise, of which there is plenty. Market corrections are not uncommon, and the S&P 500 has experienced a sell-off of 10% or more from peak to trough 63% of all years going back to 1928. A diversified asset allocation is the best first line of defense against market volatility and growing uncertainty, and the recent decline in bond yields (or increase in bond prices) at a time of falling stock prices has reestablished a key benefit of balanced portfolios, whereby bonds partly offset episodes of equity volatility.

However, recent developments widen the potential range of economic and market outcomes around our base-case scenario (page 9), with risks tilted to the downside. We maintain a preference for high-quality bonds (like Treasury bonds and mortgage-backed securities) over riskier fixed income products like high yield bonds and emerging market debt, a tactical position that we initiated in August 2024 (where applicable) and that has added value to client portfolios over the past month.

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