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TARIFFS SOURING SENTIMENT ON WALL STREET AND MAIN STREET

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The beginning months of the new administration have been eventful for investors. An unexpected market selloff, aggressive tariff rollout, and government job cuts have upended established thinking and market trends that had been in place for some time. In this Focus*Point*, we cover some key market developments and themes investors are focused on.

Market volatility has picked up meaningfully and should remain elevated

The S&P 500 index hit a new all-time high of 6,144 on February 19. Since then, it has pulled back by ~8%. The 10-year Treasury yield has fallen by 60 basis points (bps) since peaking at 4.79% on January 14. The main culprit behind this aggressive risk-off price action has been policy uncertainty. Within a matter of weeks, investors' focus has shifted from optimism around rising animal spirits, to recession fears as consumer and business sentiment has weakened.

Coming into this year, the range of outcomes for the economy and the markets was wide, given that some Trump 2.0 policies like tax cuts and deregulation are stimulative, while others like tariffs and immigration are growth negative in the near-to-medium term. The White House has decided to lead with tariffs this time around, including initiating trade wars with Canada and Mexico, which potentially impacts a significant portion of the U.S. consumption and inflation basket—including autos, food and energy. Additionally, the rapid pace of tariff announcements and reversals, coupled with the lack of clarity, is weighing on investor sentiment. It is natural for investors to feel nervous during times like this. However, a few points are worth highlighting:

- **Market volatility is normal and can be a source of opportunity for long-term investors.**
  - For the S&P 500 index, since 1928, 94% of the years (91 out of 97) have had drawdowns of 5% or more, and roughly two-thirds of years have experienced a drawdown of 10% or more.
  - Over the past 40 years, the S&P 500 delivered a 16% total return, on average, over the 12 months immediately following a 10% drawdown not caused by a recession.

- **Equities had been on a relentless tear.** The S&P 500 rose by ~50% since November of 2023, and ~70% since October 2022. Over the last 5 years (2020-2024), the index's average annualized total return was ~14.5%. That is well ahead of its ~11% annualized returns over the long term. There was bound to be some moderation in returns, and along with that comes volatility.

- **Diversification is working this year.** Year to date (through March 11, 2025), the S&P 500 is lower by 5% while Bonds are up 2.3%; International stocks are up 6.1%; and Large Cap Value stocks are down 0.1%.[1] Diversification across and within asset classes has been a key factor underpinning the resilience of balanced portfolios during these rocky times.

The U.S. economy is resilient but downside risks to growth have increased

The U.S. economy had entered the year with good momentum—consumer spending was strong, the labor market was resilient, corporate profits were rising. Productivity growth continues to be solid and corporate sentiment improved on the prospect of deregulation and a more business-friendly environment. Many of these dynamics are still in place but on the margin, concerns are building that a combination of tariff uncertainty and DOGE-led job cuts could cause consumers to pull back on spending and businesses to stop investing and even lay off workers. Many survey-based indicators have deteriorated recently—both University of Michigan consumer sentiment and Conference Board consumer confidence were weaker than expected.

Weaker sentiment data did not translate to weaker economic activity in recent years. Some hard data like consumer spending and construction activity have also softened recently, although some of the weakness is likely due to colder-than-usual weather and payback from strong consumer spending to end 2024. We are closely following both soft[2] and hard[3] data to monitor the increasing downside risks to growth. After several years, where analysts have only raised their forecasts for GDP growth and price targets for the S&P 500 index, there has been some trimming in both forecasts in recent weeks. A recession may not be imminent, but heightened policy uncertainty may push GDP growth to sub-2% levels, compared to over 2.5% last year.

Chances for Federal Reserve (Fed) interest rate cuts are higher now

Contrary to consensus expectations, there has been a dramatic drop in interest rates in recent weeks. This has less to do with inflation moving lower and is more a reflection of growth concerns. In fact, both the market-based and survey-based measures of inflation expectations have risen this year. This is problematic for the Fed, which is on pause for now. And the Fed is likely to remain on pause when it meets next week on March 19. But looking ahead,

1 Referenced indexes: S&P 500, Bloomberg U.S. Aggregate Bond Index, MSCI All-Country World Index (ex. USA), Russell 1000 Value Index.
2 Survey-based indicators like consumer confidence and business sentiment.
3 Measurable and objective data like Gross Domestic Product, Consumer Spending, etc.

tariffs may present both upside risks to inflation and downside risks to growth and employment, therefore making the Fed's job that much harder.

However, our view is that the Fed is more sensitive to downside risks to growth than risks around higher inflation. The key metric for them is the unemployment rate. If the unemployment rate increases towards 4.5%, the Fed is likely to cut rates multiple times, on the condition that inflation remains below 3%. The February nonfarm payroll report was on the softer side, and the unemployment rate did rise a touch to 4.1%. Notably, markets are now expecting the Fed to cut the Fed Funds rate three times this year, up from one just a few weeks ago.

Geopolitical fragmentation is accelerating faster than anticipated

Our view has been that countries will increasingly move to reduce their external dependencies and invest in their domestic industries, including in defense capabilities. China has been doing this for some time, and Germany now is a prime example of this paradigm shift. The U.S. pivot on Ukraine, wavering support for NATO, and threat of tariffs have provided a jolt of urgency to European leaders.

Germany's incoming Chancellor is pushing for the country's strict fiscal rules to not apply to military spending, and to set up a EUR 500 billion infrastructure fund for investment into transport, energy and digital infrastructures. This still needs to pass parliament but there is no question that this is a big, bold, and "whatever it takes" moment for Europe. The German stock market is up 13% this year and the German 10-year bond yield has spiked higher by 45 bps.

Investors are rethinking the U.S. exceptionalism story, particularly around technological dominance

The selloff in artificial intelligence (AI)-related trades has led many investors to declare the end of the U.S. exceptionalism story. International equities are outperforming U.S. stocks, and European equities have been competing with the U.S. for investment flows. Meanwhile, U.S. stocks remain vulnerable, given that we don't seem to have reached peak policy uncertainty yet, and valuations (while cheaper) remain well above the 20-year average (~20x Price/Earnings [P/E] ratio vs. 16.5x).

We are still believers in the U.S. exceptionalism story over the long term. The U.S. economy is supported by strong structural dynamics: it remains an innovation giant and enjoys faster productivity growth than most developed market economies; it is energy independent; the U.S. dollar enjoys reserve status; and demographics are favorable compared to Europe and China. However, it is also true that other countries are adopting more expansionary fiscal policy and making advancements in technology and AI, which could allow their valuations to gradually close the gap with the U.S.

Conclusion

While no one can consistently predict which years the market will end in positive or negative territory, history demonstrates that fears of lasting negativity are typically overblown. These types of markets demonstrate that professional portfolio management can assist when it comes to dispassionately navigating market volatility, and can help investors stay on track to reaching their long-term financial goals. When the economic environment is uncertain, a disciplined approach to managing investment assets is critical for cancelling temporary noise, mitigating risk, managing expectations, and remaining focused over time.

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