Tariff Troubles

Weekender

March 18, 2025

Two things are infinite: the universe and human stupidity,
and I'm not sure about the universe.

If you want your children to be intelligent, read them fairy tales.
If you want them to be more intelligent, read them more fairy tales.

I know not with what weapons World War III will be fought,
but World War IV will be fought with sticks and stones.

If A is a success in life, then A equals x plus y plus z. Work is x; y is play;
and z is keeping your mouth shut.

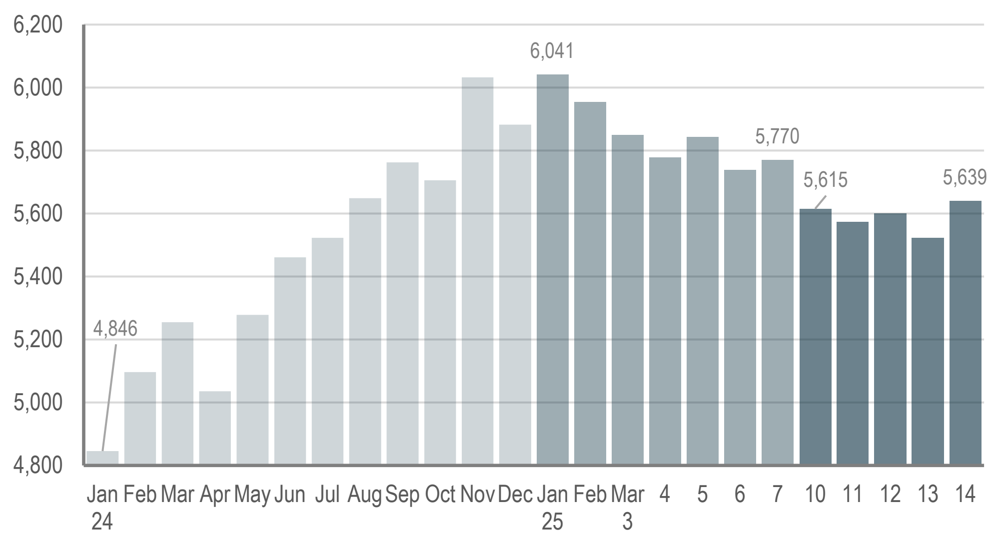
The world is a dangerous place to live, not because of the people who are evil,
but because of the people who don't do anything about it.

Albert Einstein

Good morning, and welcome to the *Weekender* for Saturday, March 15, 2025. It was another very volatile week. A chorus of reciprocal actions by the sovereign recipients followed noisy statements proclaiming new tariffs by the Trump Administration. A tariff war has begun, and even if Trump's trade approach turns out to be nothing more than a negotiating tactic, the fabric of NATO nations will have been made threadbare by the bluster. The United States has borne the weight of global safety ever since the end of the Second World War, and although it was indeed costly, it also yielded astounding benefits. Being the global fiat currency, risk-free rate,

S&P 500 Index Levels

(Source: Bloomberg)



and pillar of safety and security permits us to run deficits to a degree unthinkable without the gift of strangers. On April 2, 2025, a new round of tariffs is expected to be imposed universally. The objective is to equalize tariffs with other nations.

As measured by the S&P 500, US equity markets were down by -2.3% in another negative week. At the end of Thursday, markets were lower by -4.3%, but Friday's low inflation-induced rally picked things up a bit. Price inflation at both the consumer and producer levels came in a tick lower than expected, a difference that doesn't matter but gave a bit of relief to a temporarily oversold market.

Equity markets are down 8.2% from their peak on February 19, 2025, less than one month ago. Over the weekend, a few prominent investment strategists proclaimed an end to the "correction" in stock prices. The water is now warm, so come on in. We disagree.
One helpful way to look at equity valuations is to find a company's or an equity index's free cash flow yield and compare it to a US government bond yield. The question is whether equities are giving investors value and yield compared to the yield on a much less risky alternative, government bonds.

As can be seen on the graph, the S&P 500's free cash flow yields are a terrible alternative to the US government's ten-year bond. Despite the meaningful

S&P Free Cash Flow Yield (Dark) and US Government 10-Year Bond Yield

January 1, 2015 - March 14, 2025

(Source: Bloomberg)

retrenchment of the S&P 500 since mid-February, stocks generally are not a good alternative. However, we believe that now is a fantastic time to begin nibbling on individual equities that provide attractive isolated entry points.

In our view, the market retrenchment will provide clients with attractive options as markets shake out and leadership moves from the magnificent seven to lesser-known and possibly forgotten alternatives. A subject of next week's *Weekender.*

Tariff Topics

As we look into the rest of the year, we expect the following factors to influence markets and drive a retrenchment of the broad market. First, consumer sentiment will continue faltering, although at a slower pace. Second, interest rates will remain relatively high, tempering all interest rate-sensitive parts of the economy. Markets continue to be spooked by tariff announcements. While episodic tariff increases tend to be a relatively benign inflation accelerant, tariff wars are economically dangerous, defined as a tit-for-tat tariff escalation between countries. Tariff wars push inflation higher, lifting interest rates and slowing economic output. Recession is often the outcome. If the tariff war does not de-escalate quickly, we expect the US to tip into stagflation, where inflation remains high and economic output well below optimal.

President Trump has threatened and administered targeted tariff increases since his inauguration. These have been principle-based. They are intended to elicit a response from the inflicted country. Initial tariffs on Mexico and Canada were designed to persuade their governments to play a more meaningful role in controlling the inflow of fentanyl across their respective borders with the United States.

The Trump administration will begin a broader application of tariffs in April. For example, on average, the United States charges a 2.5% tariff on imported cars. China charges 25%, before the recent increase in February, plus an additional sales tax of 17%. At the beginning of April, the Trump Administration will increase tariffs charged by the US to the same level charged by other countries. In principle, this seems fair. In practice, it will result in higher prices for consumers. Higher prices from inflation, tariff-related or otherwise, will keep interest rates higher for longer, making an economic slowdown deeper than otherwise expected.

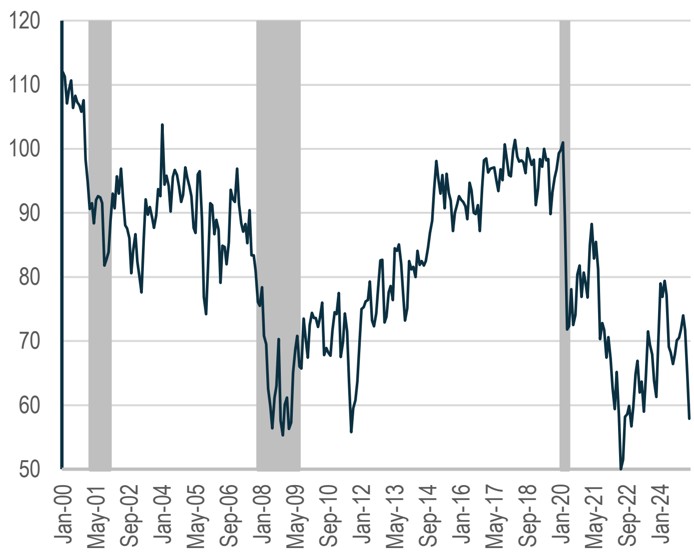
Consumer Sentiment

Anticipating an economic slowdown, consumers are beginning to register market uncertainty as general angst about the future. Consumer sentiment, measured by the University of Michigan, dropped last week and is now at levels typical of a recession. As part of the sentiment survey, respondents suggested they expect inflation to reach 4.1% in the year ahead, more than an entire percentage point higher than present.

Consumer Sentiment

January 2000 - March 2025

(Source: Bloomberg)

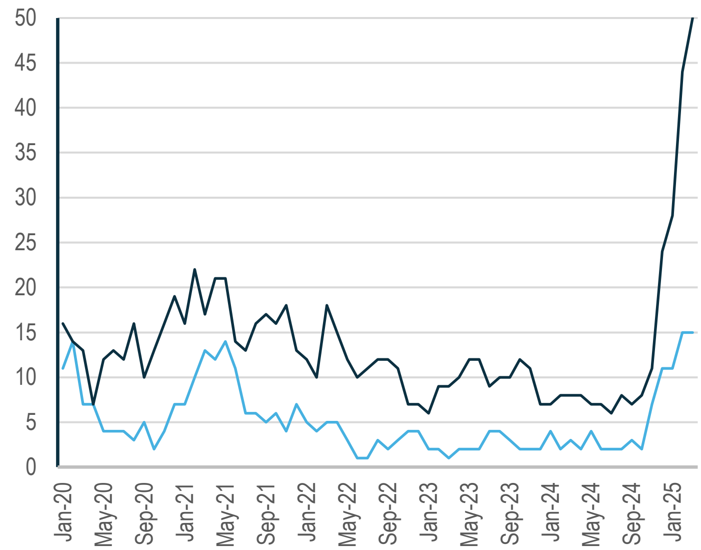


An earlier low in consumer sentiment in mid-2022 was courtesy of higher inflation. With inflation more than half of what it was then, consumer sentiment is being influenced by the negative news cycle on tariffs, economic softness, and the potential for higher inflation. The graph below shows how consumer sentiment respondents perceived the news as being positive (dark) or negative (blue). It is possible to think our way into a recession.

Negative (Dark) and Positive (Blue)

January 2020 - March 2025

(Source: Bloomberg)



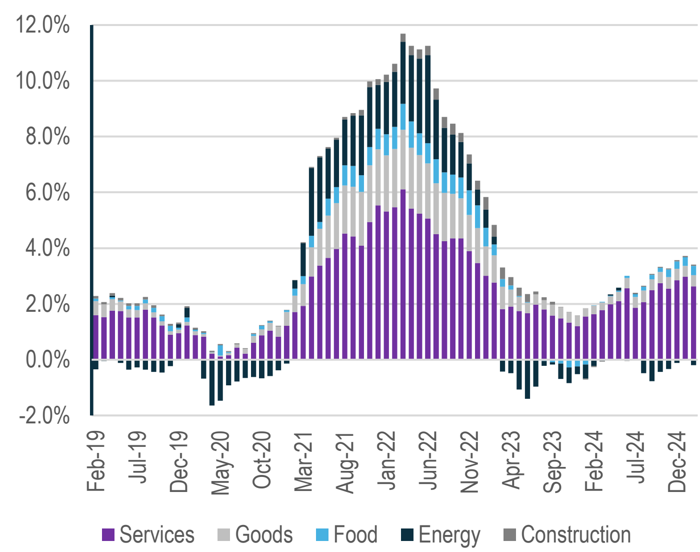
Two inflation readings, the Consumer Price Index (CPI) and the Producer Price Index (PPI), were released last week. Both showed a modest decline in price pressures in almost all areas except services (purple).

Producer price inflation tends to be a precursor to consumer price inflation. Although service price inflation has been upwardly sticky, we believe it is short-lived. Recent earnings reports from service providers like airlines show a rapid deterioration in service

Producer Price Index (PPI)

February 2019 - February 2025

(Source: Bloomberg)



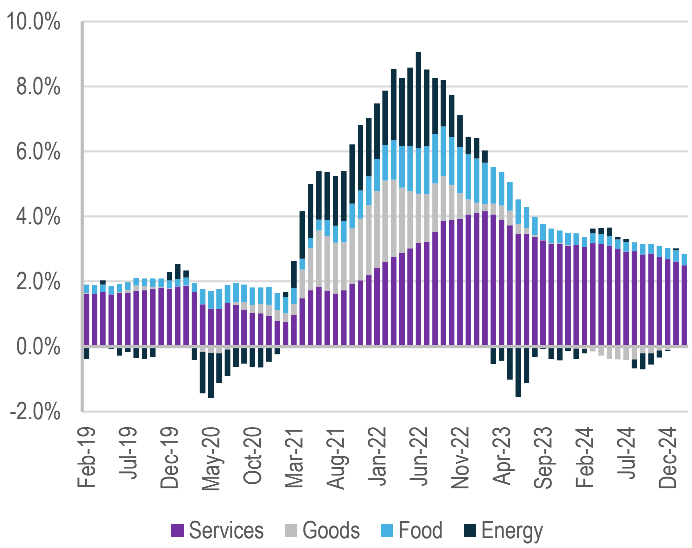
demand. We also expect other components of services inflation to begin trailing lower in the coming months. Perhaps not enough to combat the upward pressure from tariffs, but it will help.

At the producer level, service inflation comes from myriad sources. On the consumer front, shelter inflation is the tail that wags the dog. Owner's equivalent rent has not moderated and is not likely to do so in the near term. Demand for housing remains strong, and new inventory is weak. As long as the labor market remains "fully employed," few catalysts appear that could bring inflation down to the Federal Reserve's target of 2.0%. However, if the labor market breaks, all bets are off—more on that in the next *Weekender.*

Consumer Price Index (CPI)

February 2019 - February 2025

(Source: Bloomberg)



Conclusion

That's it for this Weekender. Have a wonderful week.

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