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"What Game Are We Playing? What Are the Rules?"

Dear Clients and Friends: April 15, 2025

To be honest, this has been one of the more difficult client letters we have had to write. The first quarter had enough significant events and developments to fill a letter itself. Unfortunately, the real news flow and market volatility started as the second quarter began. If you read this and everything has changed, know we did our best.

We entered 2025 on solid footing. Last year, on the back of capital investment, exports, and increasing consumer and government spending, U.S. GDP grew better than expected at 2.8%. Cooling inflation allowed the Federal Reserve to lower interest rates three times during the year. Unemployment remained low, hovering around 4.0%. Subsequently, with the November election of Donald Trump, the prospects of tax cuts and deregulation further spurred optimism. All was good.

By mid-February U.S. stocks were notching all-time highs. Then, everything started to go sideways. A relatively unknown Chinese AI company, DeepSeek, unexpectantly upended market momentum, triggering a swift selloff in incumbent AI leaders. This was met with constant updates from the new Department of Government Efficiency (DOGE) and their layoffs, department closings, and cancellations of government contracts. The leading events, however, centered on the President's on again/off again implementation of tariffs on Canada and Mexico combined with laying the groundwork for "reciprocal" tariffs on the rest of the world.

Markets do not like uncertainty, and this was certainly uncertainty. The DeepSeek news hit the Magnificent Seven - which has carried the lion's share of index performance in recent years - hard. These stocks' performance, down -15.7% for the quarter, filtered their way through most other U.S. markets. The S&P 500 finished the quarter down -4.3% while the tech heavy NASDAQ and Small Cap indices both declined -10%. An initial flight-to-safety move to bonds, in their role as safe haven assets, pushed their performance up for the quarter to around +2.5%.

Ironically, the administration's America First policies gave a boost to international markets. The emphasis of Europe's need to be less dependent on the U.S. military for protection has led to planned increases in military spending and other budget areas. Seeing a fiscal stimulus injection from European governments, along with a now falling U.S. dollar, international stocks posted positive gains in the quarter, up 7.0%. Our portfolios benefited from this diversification.

Tariffs

As mentioned, it was the beginning of April when the real fireworks started. Many consider the U.S. to be on various unsustainable economic paths: our accumulated debt, ongoing deficit spending, unfair trade practices, declining domestic manufacturing, and the security of supply chains for strategically important industries to name a few. To his credit, Trump has chosen to address these problems where previous presidents, his first term included, failed to do so. The Trump 2.0 campaign made a lot of promises and wasted little time getting started on them.

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On that note, a quick, and admittedly simplistic, history lesson. Most economists believe that as the U.S. helped reconstruct the global economy after World War II, many advantages were tilted in our favor. After all, our manufacturing base, which had been ramped up to supply and then fight the war, was really the only one left standing. As a result, our might and influence grew, as did the world's dependence on the U.S. Dollar for trade. Over time, this dependence led to a general strengthening of our currency. On one hand, a highly valued currency allows us to borrow cheaply, attract capital for investment, and keep inflation low by making goods we import less expensive. On the other hand, the ability to export our goods to other countries becomes difficult and more expensive. This downside is a root cause in the steady decline of U.S. manufacturing over the years.

For 80 years, while not perfect, we have benefited greatly from this arrangement. However, those benefits may have run their course. We have found ourselves on the unsustainable paths mentioned above. Enter Trump and his answer to all these problems: Tariffs.

What is a tariff? A tariff is a type of tax levied by a country on an imported good at its border. Historically, tariffs have been used by governments to collect additional revenue but are also used as a way to protect domestic producers by making imports more expensive. Trump's plan wants to do both. The income generated from tariffs can help fund tax cuts while making it more attractive to manufacture products inside U.S. borders.

On the surface, this plan is simple and makes sense. However, poor communication, muddled by what looks like competing factions in the White House, left markets dazed and confused. Team Navarro's vision, led by senior trade advisor Peter Navarro and Vice President JD Vance, is to construct very high tariff walls that make it unattractive and prohibitively expensive to sell <u>any</u> goods in the U.S. that are not made in the U.S. They believe this path would reinvigorate domestic manufacturing, create millions of new jobs, and bolster a struggling middle class. These tariffs represent a **permanent** reset in global trade and are not a veiled attempt at negotiations.

Team Bessent, represented by Treasury Secretary Scott Bessent and Elon Musk, see a different path. Their vision is that tariffs represent an opportunity to **renegotiate** global trade barriers. They recognize all goods cannot be made affordably in the U.S. and it's probably reasonable to forgo some production and focus on bringing home more manufacturing of strategic industries like semiconductors, pharmaceuticals, steel and aluminium, autos, and aerospace. These negotiations will correct other countries' taxes, regulations, and quotas that put American manufacturers at a disadvantage involving trade.

The President has voiced a consistent message of tariffs being "reciprocal"… we will tax others what they tax us. Then came "Liberation Day" where a new 10% minimum tax plus much-larger-than-expected "currency manipulation and trade barrier" levies on all imports were announced. Several things quickly became clear; these tariffs were not reciprocal at all, friend and foe being treated alike, and U.S. tariffs would sit at 100-year highs. Worse yet, the country-by-country number was a back-of-the-envelope calculation that captured a measurement trade economists in both political parties panned as being nonsensical. If a nation wanted to negotiate, it wasn't clear which policies even needed to be addressed.

The stock market plummeted in response, reflecting global fears that the new tariffs could disrupt supply chains, supercharge inflation and trigger a severe economic downturn. The S&P 500 lost 12.5% over the next three sessions as Team Navarro and Team Bessent flooded the screens with conflicting messages of the purpose, duration, and permanency of the tariffs. Trump would even post "MY POLICIES WILL NEVER CHANGE."

One week after Liberation Day, Trump's policies changed. All reciprocal tariffs were paused for 90 days, except for China, while the 10% minimum tax remained in place. This would give the administration time to negotiate trade deals with everyone. Equity markets rejoiced, having one of their best days on record. Depending on who is speaking, either sudden unusual movements in the bond and currency markets triggered Trump to reassess or this was the plan all along. Either way, equity markets have suffered significant price declines coupled with tremendous volatility over the last week. We hope for a good reason.

Outlook

When investors take a step back, it's stunning how much is going on right now. Markets continue to digest a huge range of significant variables at a non-stop pace. As do businesses and consumers. Here in lies the worries and concerns we have.

Not knowing the rules of the economic game has injected paralysis into businesses' decision-making processes. Many companies followed Trump's first term guidance and moved manufacturing from China to more friendly nations. Those decisions are now being penalized. Making new, long-term capital allocation choices regarding building billion-dollar factories that will take years to construct, seems just as perilous. Like the new tariffs, businesses are pausing. You can't plan in this environment.

Contrary to what was said on the campaign trail, the U.S. company importing a good is responsible for paying the new tariff. They will undoubtedly try to negotiate lower producer prices and will eat some of the tax themselves, but the bulk of the tax will be passed along to the consumer through higher prices. This too will affect consumer behavior and purchasing decisions. We have already seen hoarding behaviors similar to what we saw during the pandemic. As higher prices show up as additional inflation, the Fed's ability to support the economy with lower interest rates now becomes a more complicated issue.

Even as the drama has turned attention to a possible slowdown and recession, we feel the U.S. is still in a strong economic position. With the pause in tariffs, the worst outcomes seem to have been avoided. However, a new countdown has started, and the quicker these issues are resolved, the better. Some of the negative effects increase cumulatively over time and can be difficult to reverse. Like supply chains, reliability and trust cannot be easily or quickly rebuilt. Jamie Dimon, CEO of JPMorgan, recently said, "America first is fine, as long as it doesn't end up being America alone." We could not agree more.

Amid markets moving so quickly, we must be careful not to make rash decisions. Prudent diversification, already in place, and a focus on lower valuation/higher quality investments has been a bulwark against the volatility and should continue to help portfolios.

Thank you again for your continued confidence and trust as we work through these extraordinary times. We welcome your comments, questions, and referrals. Please don't hesitate to contact us. Stay safe and well.

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