Market Outlook

April 3, 2025

In a presentation from the Rose Garden on April 2, 2025, President Trump announced Liberation Day for the United States. This announcement declared tariffs against all U.S. trading partners, at various rates, to bring the United States back to an era of America First. President Trump referenced the historic creation of the income tax and the elimination of tariffs against foreign goods as the end of the United States' economic dominance. For historical perspective, the first true income tax was assessed in 1862 when President Lincoln levied a 3-5% tax on incomes above $600 to help pay for the Civil War. The 16th Amendment was added to the Constitution in 1913 to grant Congress the authority to levy taxes on corporate and individual income. (Fellow lovers of the musical *Hamilton* might want to listen to Cabinet Battle #1 for the initial introduction of a national tax in 1787.) Back to the present, President Trump's implication was that Americans should pay less in income tax and instead the United States should demand other countries pay tariffs. The reality, however, is that it is not the other countries who pay the tariffs, it is the corporations who build and import goods from other countries. In order to continue to make a profit, companies will incorporate the tariff costs into the final price of goods which is passed on to consumers. The government collects the tariffs paid.

The U.S. engaged in a similar exercise on the heels of the Great Depression in October of 1929. In June 1930, the Smoot-Hawley Act raised tariffs on imports to unprecedented levels in an effort to protect American industries. Unfortunately, the act led to a sharp decline in international trade as other countries retaliated with their own tariffs, further damaging the global economy. (Does this sound familiar?) The result was a decline in U.S. exports, increased unemployment, and deeper economic hardship by the United States. Eventually, there was a shift in trade policies towards more cooperative international trade agreements, including NAFTA, which was introduced in 1994. President Trump's new tariffs are targeted to correct the trade imbalances that some believe resulted from these agreements. Whether this round of tariffs will prove more successful is yet to be determined.

Continuing the theme of Americans paying less in taxes and foreign economies paying tariffs, President Trump noted his intentions to pass the "largest tax cut in history." In reality, much of the promised new tax bill is just an extension of the Tax Cuts and Jobs Act (TCJA) of 2017 as the legislation is set to sunset at the end of 2025. If the TCJA is not extended, the effect will be a significant economic hit. In summary, we should not expect to see significant tax changes or economic stimulus from Trump's promised new tax bill but if it is not passed, we will see economic contraction.

What are the tariffs that have been imposed? There is a baseline tariff of 10% on all imports, effective April 5. Other nations will be subject to a reciprocal tariff with higher rates for what Trump calls "bad actors." The U.S. imports the most goods from Mexico, followed by China and Canada. China is the top supplier of consumer goods and electronics, while Mexico is our largest supplier of agricultural goods, cars, and other manufactured goods. Chinese goods, already subject to a 20% tariff, will be subject to an additional assessment of 34% for a total tariff rate of 54%. Beijing has declared they will take retaliatory measures. A full list of the tariff rates can be found here.

Canada and Mexico, our border countries, are not subject to these new tariffs as the fentanyl tariff of 25% is still in place. Canada's new Prime Minister, Mark Carney, announced a limited set of countermeasures against U.S. tariffs today, while calling President Trump's protectionist moves a tragedy for global trade. Canada intends to impose a 25% tariff on all vehicles imported from the Unites States that are not compliant with the U.S.-Mexico-Canada trade deal (USMCA). Mexico, on the other hand, does not currently intend to issue a retaliatory response.

In addition to China, Mexico and Canada, the U.S. also imports 17% of our goods from the European Union. President Trump's 20% tariff on EU goods was determined in response to the EU's 10% tariff on U.S. autos and the EU's value-added tax (VAT). This is a contentious interpretation that will likely lead to further retaliatory action as the VATs are consumption taxes paid by producers at each state in the supply chain and by consumers at sale. In other words, EU members also pay the VAT so it is not an additional assessment against the U.S. The new U.S. tariff, however, has included the VAT in its calculation. Regardless of the calculation, the EU did have a $175B trade surplus with the U.S. in 2023. In other words, the EU exported $175B more to the U.S. than they imported from the U.S. This imbalance is at the core of President Trump's argument for tariffs as our trade balance will not reverse until the U.S. manufactures more of the goods we buy. In order to put America First again, we must broaden our production which in turn will bring jobs to the U.S. The U.S. is, however, exporting more in services than it imports. Our overall trade balance (goods and services with all of our global trade partners) is a deficit of $131.4 billion, as of February 2025, with $278.5 billion in exports and $401.1 billion in imports.

What does this mean for the U.S. economy and markets?

The U.S. economy, while still growing, is giving signs of slowing. GDP* growth was 3.0% in the second quarter of 2024 and increased to 3.1% for the 3rd quarter. The fourth quarter saw a drop to 2.4% with business investment turning negative. Business sentiment surveys indicate that corporations are concerned about the effect of the tariffs. Though still strong, corporate earnings have declined from 14% growth to 10% growth. If U.S. consumers resist the higher prices, then sales will decline which will lead to job losses and ultimately a broader economic slowdown. The unemployment rate seems to have stabilized at 4% and restrictive immigration policies should keep it low, but current data does not include the recent DOGE layoffs which have affected millions of workers.

Tariffs will most certainly be inflationary in the short term, but the goal is that they will ultimately boost GDP and bring down prices for consumers. As inflation is still well above the Fed's 2% target, the Fed's reaction to the tariffs and changing policies is going to be data dependent. They are holding rates steady for now but stand ready to cut rates quickly should growth slow sharply. If inflation spikes, the existing higher rates will keep inflation from ballooning further. The Fed will not hesitate to raise rates if conditions dictate. Chairman Powell's speech tomorrow will be telling.

What Next?

This sounds like a lot of wait and see, and that is indeed where we stand. Fortunately, knowing that we have come into this announcement with well-diversified portfolios across multiple asset classes, sectors, and countries, and a high allocation to steady income from bonds and dividend paying stocks provides a measure of comfort. Our largest allocation is to value-oriented stocks which focus on high cash, low debt, and long-term steady growth rather than high flying returns. This asset class should better weather this storm as it does in every economic contraction or recession. We also have a large allocation to high credit quality corporate bonds, and mortgage-backed securities to provide steady income and low volatility. Bonds serve as a ballast in rocky markets and have a negative correlation with stocks. We are also well invested in European and other international markets whose performance has outpaced the U.S. market thus far in 2025.

Schwab Chief Global Investment Strategist Jeffrey Kleintop said that "global markets could remain volatile in the near term," but noted that "while there are no winners in a trade war, international markets may fare better—especially in Europe—where rising economic and monetary stimulus can help support domestic growth." Again, though the coming weeks and months may be choppy, we maintain conviction in our diversified and defensive approach.

We do recognize that the tides can shift quickly and we will be proactive in our response. Despite yesterday's big announcement, we remain in a game of cat and mouse. The new tariffs are, in part, a negotiating tactic, designed to encourage countries to improve trade terms with the United States. Trump has a history of rapid policy changes and it should be expected that the April 2 announcement be followed up by a series of alterations in country-specific tariffs. Please note that the base 10% tariff will likely remain in effect for an extended period.

In anticipation of tariffs, companies are already revising their earnings to downside, consumer sentiment is declining, and other spending and economic signals are showing weakness. The stock market is in a period of correction but this is largely in the highest growth stocks. Whether or not this contraction accelerates into a bear market is not yet clear. Typically, a bear market occurs alongside a recession. If the tariffs are pulled back, even partially, that will trigger a positive reaction and may stave off a recession, for now.

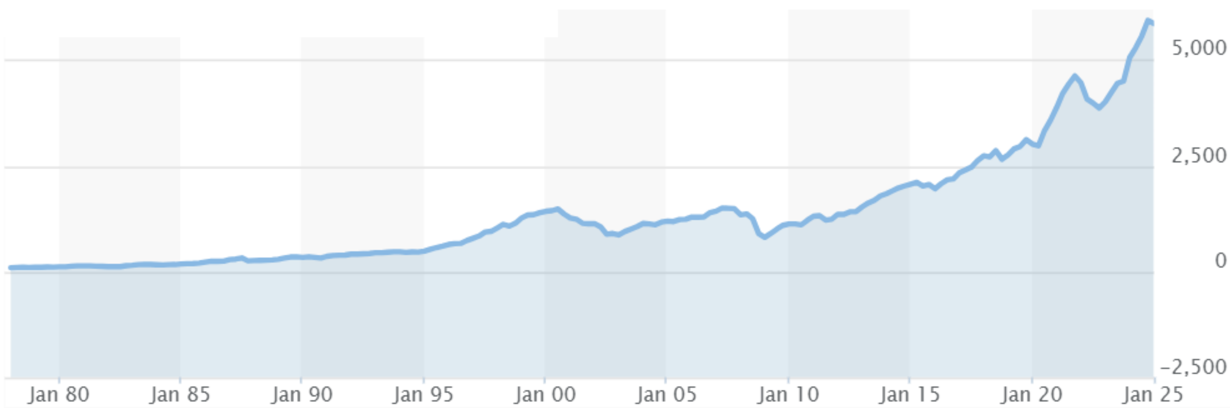
As for bonds, the market reaction to the tariffs is that they will weigh on consumer spending and slow growth. As a result, yields have fallen significantly (investors are requiring less return to keep their assets protected in a high-quality bond), and the yield curve is beginning to invert, again, with longer-term yields paying less than short term. The U.S. dollar has been very strong which has hampered emerging markets as they borrow in U.S. dollars, but the risk of slower economic growth is driving the U.S. dollar lower. This will strengthen the value of foreign currencies and could prove to be a good opportunity to invest further in both developed and emerging markets. Kathy Jones, Schwab's Chief Fixed Income Strategist, noted that "investors still view U.S. Treasuries as a reliable port amid the storm."

Though each day brings new, and sometimes alarming headlines, we have established defensive portfolios for our clients and remain committed to diversification across all investment opportunities. We cannot promise there will be no short-term losses but remind clients that we are invested for the long-term. There will be bumps along the road but maintaining a prudent investment strategy will win in the end. Please do not hesitate to reach out with any questions or concerns. We will continue to keep you updated on economic and market changes.

Warmly,

Priscilla

Priscilla N. Gilbert, CFP®



History of the Growth of the S&P 500

GDP = Gross Domestic Product, the calculation for which is Consumption + Investment + Government Spending – Net Exports. Consumption is by households for goods and services. Investment is business spending on capital goods, as well as residential construction. Government Spending includes goods, and services such as defense, education and infrastructure. Net Exports is the difference between a country's exports and imports. As described above, the U.S. currently operates at a deficit in net exports and President Trump's goal is to reshore production and shift the U.S. to have a surplus in net exports.