WHEN THE "LEVIES" BREAK

Market Correction

Investor sentiment shifted significantly in the first few months of 2025. After hitting an all-time high on February 19, the S&P 500 pulled back 10% through the end of March. Volatility returned to equity markets as well, with the Volatility Index ("VIX") nearly doubling to 29 during that same period (a typical range is 15 – 35, with the higher end implying high volatility). In our last commentary, RMC highlighted the risk of momentum-driven markets, which was put on display as prices of large cap technology stocks retraced from historically high valuations. For the first quarter, the S&P 500 was down -4.6%, but looking under the hood, the "Magnificent 7" stocks were down -14.6% while the rest of the index was up 0.4%[i]. As the S&P 500 went double the average length of time without such a correction this was hardly unexpected, but in happening over just 20 trading days, this was the 5th fastest pace in the last 75 years[ii].

More recently, however, President Trump's expansive levies on most U.S. trading partners were much more punitive than expected. Following his April 2 "Liberation Day", the S&P 500 fell 10.5% in two days. The VIX reached 45, or its highest level since the start of the pandemic, and Treasury yields moved lower, reflecting heightened fears of a tariff induced recession. The plan includes a 10% "baseline" tariff for nearly all U.S. imports (excluding Mexico and Canada, which have their own tariffs from earlier this year) and "reciprocal" tariffs on specific countries that were deemed to have unfair trade barriers. The "reciprocal" tariffs did not just match other countries' tariff levels but were based on the trade deficit with that country. In its first 100 days, the administration has been focused on the trade and fiscal deficit. The Department of Government Efficiency, with its aggressive approach to cutting government spending, is focusing on the fiscal deficit. When changes in tariffs were announced, however, the aggressive approach to the trade deficit is what broke the market down.

Why Tariffs?

President Trump is attempting to reorganize the order of global trade from the last 80 years. Following World War II, the Bretton Woods Agreement set forth a free trade and international monetary system to rebuild post-war economies. This spurred a significant increase in international trade, with the U.S. at the center of influence. After the collapse of the Soviet Union, establishment of the World Trade Organization (WTO), and internet boom, globalization of trade dominated the world economy. As a result, the U.S. has a trade deficit with most countries, meaning the value of goods and services it imports is greater than its exports. The U.S. evolved into a predominantly services-based economy, exporting services like technology, banking, insurance, etc., instead of a goods economy, as manufacturing moved to lower-cost countries. Political discourse on tariffs and trade barriers has been prevalent for decades. Politicians from both sides of the aisle have lamented the loss of American jobs, human rights violations, environmental concerns, and intellectual property risks, particularly with China, that has come with unleashing cheap goods into the U.S. market.

The intent of the Trump administration is to bring back goods manufacturing to the U.S., creating American jobs and increased wages. The U.S. has enabled many countries' economies to modernize, allowing them to now compete against the U.S. in global trade. U.S. consumers account for ~30% of worldwide consumption with just ~4% of the world population, and he believes countries should pay to have access to our markets. U.S. trading partners have several ways to make U.S. goods less competitive - whether it's direct tariffs on U.S. exports making them more expensive, currency manipulation to make foreign exports cheaper, or even domestic policies, such as taxes and subsidies that bolster domestic industries. Globalization gave rise to low-cost manufacturing hubs, like China, Vietnam, and India, among many others, which produce clothing, cars, and high tech electronics. It was economically sensible for companies to move operations out of the U.S.; however, regional economies and job markets were decimated in their wake. While reshoring American jobs is a noble cause, the President's desired goal is unclear, as it will likely not make financial sense for many industries. It may be plausible for technology, pharmaceuticals, and steel, if national security is considered a greater issue, given supply chain issues highlighted during the pandemic. Trade deficits are likely to persist, however, given the strength of the U.S. consumer versus the rest of the world.

Portfolio "Gut Check"

The financial markets will likely remain unsettled until there is clarity on trade negotiations. Given the scale of these levies and the unknown degree of willingness to negotiate, the outcome is unpredictable. What is predictable, however, is that a prolonged trade war will maintain uncertainty, causing trade to slow and corporate earnings to come under pressure, while prices potentially move higher. The market reaction has been harsh as stock prices need to discount these risks versus the original expectations of a pro-business administration. When participating in the stock market, investors must keep an historical perspective when in a downturn. Since 1928, the S&P 500 has had a 20% correction from its high, on average, every 141 trading weeks[iii]. Through the first quarter, it had been 124 trading weeks since such a pullback, and it is inevitable, regardless of the cause.

When establishing your investment policy statement, we focus on your risk tolerance and ongoing liquidity needs in the context of the long term objectives of your portfolio. If you are a retiree or are an organization with spending needs, it's important to remember you are not using all your money at once, and there is a liquidity plan in place to meet your distribution needs. If you are still building wealth, it's important to stick to your plan for retirement and other long term goals. Stocks are and must be viewed as long term investments, as the timing, severity, and length of pullbacks is unknowable. This is why maintaining your financial plan and remaining invested in your diversified portfolio is key.

[i] JPMorgan Asset Management
[ii] FS Insight - Fundstrat
[iii] Northern Trust Asset Management