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Fragmenting Global Trade and Economic Order

This first quarter 2025 newsletter has been postponed a week to address the announcements of Liberation Day, April 2, 2025

For the first quarter of 2025, the S&P 500 Index had a total return of -4.27% for the quarter. The MSCI EAFE Index (USD) Net had a total return of 6.86% for the first quarter of 2025 while the MSCI World Index (USD) Net had a total return of -1.79% for the quarter. At the start of the first quarter of 2025, market breadth increased, the labor market stayed tight, and soft data and global GDP growth rates remained solid. Inflation retreated to acceptable levels. The world economies appeared to be in good shape.[1] The S&P 500 Index actually rose to start the year, peaking on February 19, 2025, which happened to be the five-year anniversary of its pre-Covid peak.[2] All changed as U.S. investors began to worry about new tariff policies, less fiscal stimulus, and tight monetary conditions. Consumer and business confidence decreased. The U.S. market began to reverse significantly in the first quarter of 2025. Market leadership shifted as non-U.S. developed markets outperformed the U.S. by a wide margin.[3]

President Trump's Liberation Day on April 2nd clarified his use of tariffs as a tool to bring back manufacturing jobs to the U.S., to improve the standing of the U.S. middle class, to have foreign countries pay for the privilege of selling products to the U.S. consumer and/or U.S. companies, and to re-ignite U.S. productivity. He believes that globalization and China's rise directly contributed to the demise of the U.S. middle class and their jobs. After China's entrance into the WTO in 2001, China's fixed currency and cheap labor made it impossible to practice free trade with a large and growing economy. American consumers benefitted from ever cheaper goods, and U.S. companies were able to arbitrage labor costs to boost their profitability, but the full costs to the U.S. industrial base and its workforce were not addressed. Uninterrupted quantitative easing for 13 years from 2009 was great for wealthy individuals with venture capital, private equity portfolios, and financial engineering but difficult for savers and capital formation. President Trump and his supporters truly believe that the burden of the American taxpayers is too great to continue with its trade deficits and current $36 trillion in debt of which $28 trillion is owed to the public as much leverage has been needed to finance the global order.[4]

The effective U.S. import tariff rate after the April 2nd announcement has increased from 2.5% to 22%, according to Fitch who had previously assumed it would rise to 18%. "That rate was last seen around 1910…This is a game change, not only for the U.S. economy but for the global economy."[5] This will not only reset the global economy but

within economies. Zero Hedge believes the U.S. raised its weighted tariff to 29% which is above the Smoot Hawley tariffs of the 1930s. The U.S. has now assumed a non-tariff barrier with each trade partner leading to a reciprocal tariff function of the bilateral trade deficit as a ratio of gross exports to it."[6] The "reciprocal tariff rates" are not based on specific tariffs or trade barriers imposed by other countries. They are calculated by a formula, which divides the U.S. trade with a country by its total imports from that country. Trump's trade ultimatum for other countries is to build more factories in America or eliminate all trade barriers.[7]

President Trump's tariff policy has departed from the international rules-based order that governed international relations for the better part of 80 years. Business investment, deal-making, and supply chains will likely be impaired as businesses adjust to a new trading system. This new trade policy has not been beneficial for capital market returns in the short-term and may trigger a global recession. The question remains whether the rest of the world begins to bargain for lower rates or accepts high U.S. tariffs as the new normal and adjust around them. Beyond, the uncertainty, tariffs may begin to reduce the fair value of currencies against the USD in the short term, although the impact will be smaller if countries retaliate than if they do not. Given the lack of clarity on which proposals are negotiating tactics and which are likely to be enacted, the situation is very fluid.[8]

Economists note that domino effects underscore how trade wars can quickly escalate, drawing in more countries.[9] China announced that it will impose a 34% tariff on all U.S. imports in retaliation against the Trump administration's announcement. The measure is expected to have the most impact on U.S. agricultural exports including soybeans, wheat, and corn but also pharmaceuticals, crude oil, petroleum gas and liquified natural gas.[10] China has a large internal market and the ability to mobilize more domestic demand. China may also focus on improving its industrial competitiveness rather than entering into fruitless negotiations with Trump.[11] Europe faces a lower 20% reciprocal tariff and has even more room than China for domestic reflation.[12] The U.K. and Australia have a trade deficit with the U.S. so why subject them to a tariff at all?[13] While the U.K., Australia, and New Zealand can withstand a 10% U.S. tariff, Asian economies will have significant issues. Japan, India, South Korea, Vietnam, Cambodia, and Thailand face inflating domestically with the U.S. or sinking into deflation.[14]

President Trump's attempt to change market dynamics is not without risks, particularly since he has chosen to shock the whole world at once. The Trump shock is a reversal of President Nixon's 1971 decision to end the gold standard aiming to take the U.S. from trade deficits and financialization back to raw U.S. mercantilist power, using parts of the old world system to do so.[15] After the April 2nd announcement, the USD lost value to other currencies. While some advisors to the President prefer a falling dollar to rebalance global trade and capital flows, other advisors hope that the broad tariffs will appreciate the dollar by narrowing the U.S. trade deficit. Under this theory, the dollar appreciation is crucial to prevent tariffs from setting off domestic inflation in the U.S., and they hope that depreciation of other currencies will "pay for" U.S. tariffs in the form

of their own diminished purchasing power. USD resurgence would be the best possible outcome to this situation. However, the U.S. dollar dominance is slipping amid a highly concentrated stock market and shifting global alliances.[16]

Central banks will most likely respond to the new tariffs as a supply side shock. Given the COVID pandemic shock and the miss on inflation, central banks may be reluctant to ease too quickly. The European Central Bank (ECB) and the Bank of England (BoE) have already lowered interest rates. The Bank of Japan (BoJ) had intended on raising rates. The Federal Reserve remains cautious as inflation worries from tariffs are offset by a slowing economy and a slight uptick in the unemployment rate in March 2025. Presently the Fed Fund futures are pricing in 115 bps of rate cuts by year end, which implies a 100% chance of four rate cuts. Since the Trump administration seeks easier monetary and tighter fiscal policy, a lower interest rate would be welcomed news.[17]

The U.S. trade balance reflects many factors, including national comparative advantage. The U.S. sells services, high tech goods, and buys things that can be made more cheaply elsewhere. The U.S. spends more than it saves, which means it imports capital. This is the flip-side of the trade deficit in national accounts, so shrinking the trade deficit will mean less capital coming into the country.[18] There is also the not so small matter of the rule of law. President Trump justifies his tariffs by declaring a national emergency under the 1977 International Emergency Economic Powers Act. No previous President has used that law to impose tariffs. Donald Trump is stretching his authority much as Joe Biden did with his student-loan forgiveness.[19] Trump's global trade policy appears misguided, attempting to fix economic problems in a needlessly expensive way. This means investors will need to make decisions under both uncertainty and the drag of imperfect policies.[20]

The recent downturn did not begin as a financial or credit event, but the market is reflecting that the fiscal and monetary gap is widening between the U.S. and the rest of the world.[21] Global capital markets will remain unsettled in the next several months as the U.S. and its major trading partners negotiate around the recently announced large U.S. tariffs. Global growth may slow, supply chains could be disrupted, and companies may either choose to absorb the costs internally or to pass them onto their buyers. Since U.S. equities have already experienced a sizeable correction in 2025, U.S. equities continue to remain vulnerable. In the U.S., the "wealth effect" of the individuals' portfolios of equities and real estate holdings has been growing. The concerning part is if those assets fall in value, spending will probably too, which will exacerbate a slowing economy. The U.S. consumer is the major economic driver. Additionally, U.S. inflation expectations have been rising in the first quarter of 2025 just as bond yields have begun falling.[22]

Martin Investment Management, LLC believes that U.S. markets were expecting volatility and much flatter returns in 2025. We had anticipated that the changes occurring in the market since 2024 would continue as the market repriced overvalued assets. The U.S. Technology Sector lost value and became more volatile in 2025. We welcomed a shift

from a market based on momentum, narrowness, and fiscal stimulus to a broader market based on fundamentals, quality, and valuation. We did not anticipate the extreme tariffs, which we believe could be a threat to stocks.[23] Michael Cemblast of JPMorgan suggests that the market is probably near peak uncertainty, even if the tariffs stay, they are a one-time rather than a perpetual hit to growth and inflation.[24]

Our hope is that market friendly policies return, including tax cuts and deregulation, to offset the carnage from the new tariffs. Infrastructure permitting reform and banking deregulation may provide a boost to growth. The Boston Federal Reserve also found relaxing Supplementary Leverage Ratios (SLR) greatly improved U.S. Treasury market depth and liquidity. There may be benefits from any new incremental foreign direct investments in the U.S. that the administration negotiates.[25] However, the present U.S. administration appears to be less sensitive to a stock market drawdown and more interested in the bond market and USD value. Despite current conditions, we will continue to be fully invested and focus on quality individual securities rather than betting on policy direction.

Despite the recent storm, wishing you a beautiful spring season!

Please look forward to receiving our firm's published article from PSN Outlook Zephyr 2025 regarding the advantages of separately managed accounts over funds to address customized individual portfolios managed by professional investment managers who view investments for the long-term.

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Note:

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