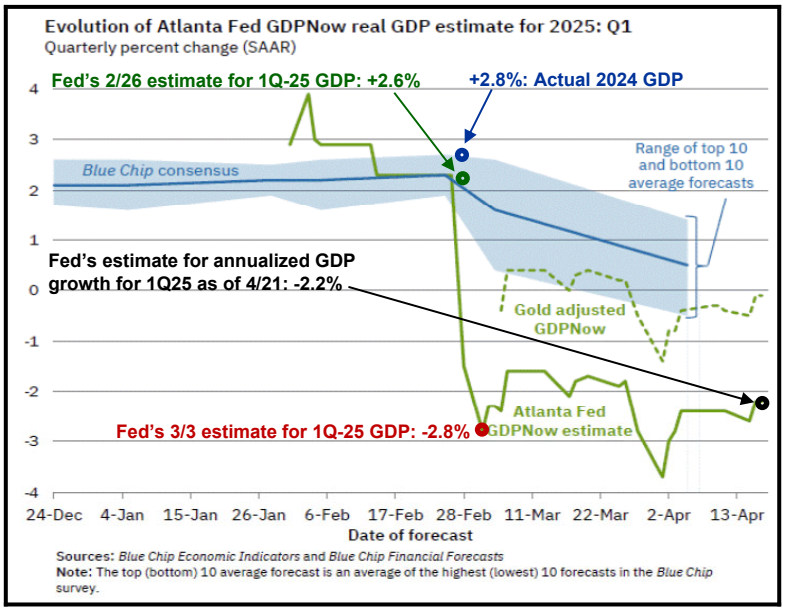
MARKETS ANXIOUS & FED IN A BIND

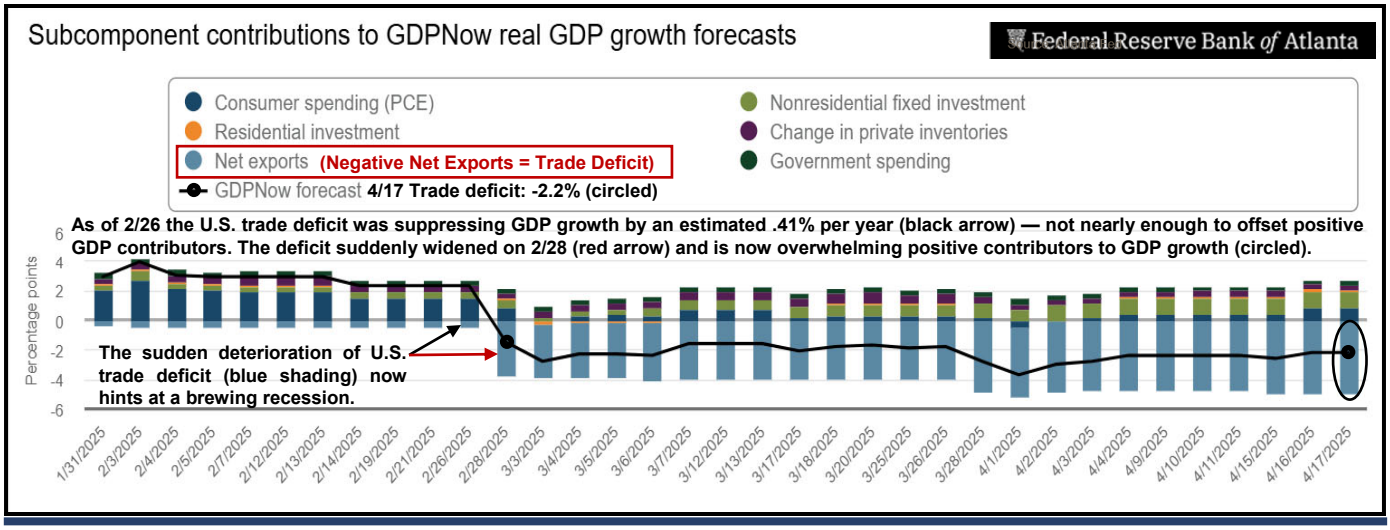
U.S. GROWTH EXPECTATIONS PLUMMET

My last note suggested that although U.S. equity valuations were especially elevated, there appeared to be no imminent threat of economic contraction (recession). Between February 28th and March 3rd, however, the Atlanta Fed's estimate of annualized U.S. economic growth for the first quarter of 2025 plunged from +2.6% to -2.8%. Since my last note the Fed's Gross Domestic Product (GDP) estimation model now includes an alternative, "gold-adjusted" estimate in addition to its standard GDP model. That alternative estimate is beyond the scope of this note so I will not address it.



The image to the right captures actual GDP growth during 2024 along with the evolution of annualized first quarter 2025 GDP estimates from the Fed and from other "Blue Chip" forecasting firms through late April. Although those blue-chip forecasting firms are still forecasting a bit of U.S. economic expansion for the first quarter of 2025, **the Fed's running estimate for first quarter GDP has remained solidly negative since it plunged in early March.** As the official arbiter of recessions within the U.S., the National Bureau of Economic Research (NBER) will normally declare a recession after two consecutive quarters of economic contraction, but it may do so sooner in cases where the economic contraction is especially pronounced. **If the Fed is correct that the U.S. economy contracted during the first quarter, the NBER will likely affirm at some point that the U.S. is *already* in recession unless a rebound soon materializes.**

THE CULPRIT — U.S. TRADE DEFICIT



TRADE DEFICIT OVERWHELMS OTHER GDP SUBCOMPONENTS

A country is said to run a trade surplus when the value of that country's exports exceeds the value of its imports. Trade surpluses positively contribute to a country's economic output (GDP) while trade deficits suppress it. The U.S. has run persistent trade deficits since the mid-1970s and those deficits have suppressed economic growth. However, **other components of GDP have generally been large enough and positive enough to offset the negative impact of those persistent deficits, thereby allowing the U.S. economy to grow at a moderate pace most of the time. As of early March, this is no longer the case.**

As noted in the previous image, the trade deficit within the U.S. had been subtracting about .4% per year from annual economic growth through late February. The sudden increase in the trade deficit in early March has continued to widen/worsen. **As of late April, the trade deficit is suppressing overall U.S. economic growth by about 4.9% per year (12 times as much as it had been) and is now overwhelming all positive GDP contributors by enough to put the U.S. on a pace to contract by 2.2% per year.**

TRADE UNCERTAINTY COINCIDES WITH TRADE DEFICIT SPIKE

The deterioration in the U.S. trade deficit at the beginning of March dovetails with the spike in the Trade Policy Uncertainty Index, shown below. Therefore, **the sudden deterioration in the growth prospects for the U.S. economy is being driven by changes in global trading patterns.**

In its April Update to the *World Economic Outlook*, the International Monetary Fund (IMF) writes, "**Forecasts for global growth have been revised markedly down compared with the January 2025 *World Economic Outlook Update***, reflecting effective tariff rates at levels not seen in a century and a highly unpredictable environment."

World Economic Outlook Growth Projections

Source: IMF, *World Economic Outlook*, April 2025

		PROJECTIONS	
	2024	2025	2026
World Output	3.3	2.8	3.0
Advanced Economies	1.8	1.4	1.5
United States	2.8	1.8	1.7
Euro Area	0.9	0.8	1.2
Germany	-0.2	0.0	0.9
France	1.1	0.6	1.0
Italy	0.7	0.4	0.8
Spain	3.2	2.5	1.8
Japan	0.1	0.6	0.6
United Kingdom	1.1	1.1	1.4
Canada	1.5	1.4	1.6
Other Advanced Economies	2.2	1.8	2.0
Emerging Market and Developing Economies	4.3	3.7	3.9
Emerging and Developing Asia	5.3	4.5	4.6
China	5.0	4.0	4.0
India	6.5	6.2	6.3
Emerging and Developing Europe	3.4	2.1	2.1
Russia	4.1	1.5	0.9
Latin America and the Caribbean	2.4	2.0	2.4
Brazil	3.4	2.0	2.0
Mexico	1.5	-0.3	1.4
Middle East and Central Asia	2.4	3.0	3.5
Saudi Arabia	1.3	3.0	3.7
Sub-Saharan Africa	4.0	3.8	4.2
Nigeria	3.4	3.0	2.7
South Africa	0.6	1.0	1.3
Memorandum			
Emerging Market and Middle-Income Economies	4.3	3.7	3.8
Low-Income Developing Countries	4.0	4.2	5.2

NONPARTISAN ANALYSIS OF U.S. TARIFF STRUCTURE

The Tax Foundation, a nonpartisan nonprofit group, has studied the revised tariff structure to which U.S. importers are now subject. Its most recent analysis, which was updated April 18th, estimates:

⇒ an increase in federal tax revenues of $166 billion (.55% of GDP) during 2025, resulting in the largest tax hike since 1993.

⇒ an average household could face a yearly tariff-related tax increase of $1,243, reducing after-tax income by 1.2%. The reduction in after-tax income would be in addition to losses of choice as certain goods become prohibitively expensive or unavailable.

⇒ the overall, weighted average tariff rate ***applied*** to all imported goods could reach 25.8%. After considering likely behavioral responses to the revised tariff structure, such as reduced demand and product substitutions by consumers, the study estimates current U.S. tariff policy may result in an average ***effective*** tariff rate of 11.3% which it deems to be the highest average tariff rate since 1943.

⇒ 71% of all U.S. imports (over $2.3 trillion) would face new tariffs resulting in imports to the U.S. declining by 23% (nearly $800 billion) during 2025.

⇒ that after considering the effect of behavioral adjustments to higher tariff rates, current U.S. tariff policy could raise $1.5 trillion in tax revenue over the next decade. Interestingly, the Tax Foundation expects the relatively high (145%) tariff rate that generally applies to Chinese goods to so significantly discourage their importation that comparatively little revenue would result from those specific tariffs.

TARIFFS RESULT IN LOSSES ON BOTH SIDES & DISTORT MARKETS

Standard economic theory teaches that tariffs are trade barriers that restrict an exporter's ability to generate income. It also teaches that tariffs result in an overall loss to the country that imposes them. Tariffs do protect certain domestic producers from foreign competition, but the gains that inure to the benefit of domestic producers is typically outweighed by the losses that flow to the importers and consumers who must cope with higher prices, higher tax burdens, and a reduced supply of goods. Tariffs also frustrate the ability of markets to find a natural equilibrium between supply, demand, and price. Economists sometimes characterize the loss in market efficiency as a "deadweight" loss. My hope is that stiffer tariffs will function as a point of leverage that results in the U.S. and its trading partners resolving whatever differences that now exist.

However, **as the U.S. imposes intensified tariffs on the rest of the world it wounds each trading partner with a loss of income, but *only* with respect to the *particular* good or goods that trading partner exports or wishes to export to the U.S. In contrast, the U.S. suffers a net economic loss with respect to *every* tariff it imposes on *each* of its trading partners.** That is, **the collective losses flowing to exporters will be distributed across *many* exporters whereas *the self-imposed portion of each tariff-related loss will be concentrated within the U.S.* Therefore, the luxury of time seems to rest more with U.S. trading partners, than it does with the U.S. itself.**

U.S. DEBT — A POINT OF LEVERAGE FOR U.S. TRADING PARTNERS

In addition to running persistent *trade* deficits, the U.S. runs persistent *budget* deficits which have culminated in a national debt that now exceeds $36 trillion. These deficits are intertwined.

As a result of the U.S. importing more than it exports, American dollars have flowed into the hands of foreigners who, for decades, have used substantial portions of those dollars to purchase U.S. debt. In essence, the U.S. buys foreign items and foreigners then help finance U.S. budget deficits by buying U.S. Treasury securities. As shown to the right, foreign creditors now hold about $8.5 trillion worth of U.S. debt or about 23% of the total. Notably, t**hese foreign creditors also function as U.S. trading partners.**

The arrangement whereby Americans buy goods from foreign entities who then use that American money to buy American debt has worked well for decades, but this symbiotic relationship has also **culminated in U.S. trading partners having the power to influence interest rates within the U.S. via actions taken in the bond market.** Virtually every interest rate in the U.S. is set in relation to the yields on various types of U.S. Treasury securities and interest rate policy is arguably the most important policy tool in the Fed's arsenal. As creditors, **foreign entities have the power to interfere with U.S. interest rate policy if they choose.**

Recall that tariffs tend to slow economic growth while also placing upward pressure on inflation. If the Fed were to decide that the nascent recession outlined at the beginning of this letter poses more of an economic threat than does inflation, it might then implement an interest rate cut to stimulate the economy. However, if **the new tariff structure in the U.S. sufficiently irritates its trading partners, they may endeavor to drive U.S. interest rates higher (in the wrong direction) by selling Treasury securities, en masse.** In fact, some reports suggest that one or more trading partners may already have fired such a warning shot.

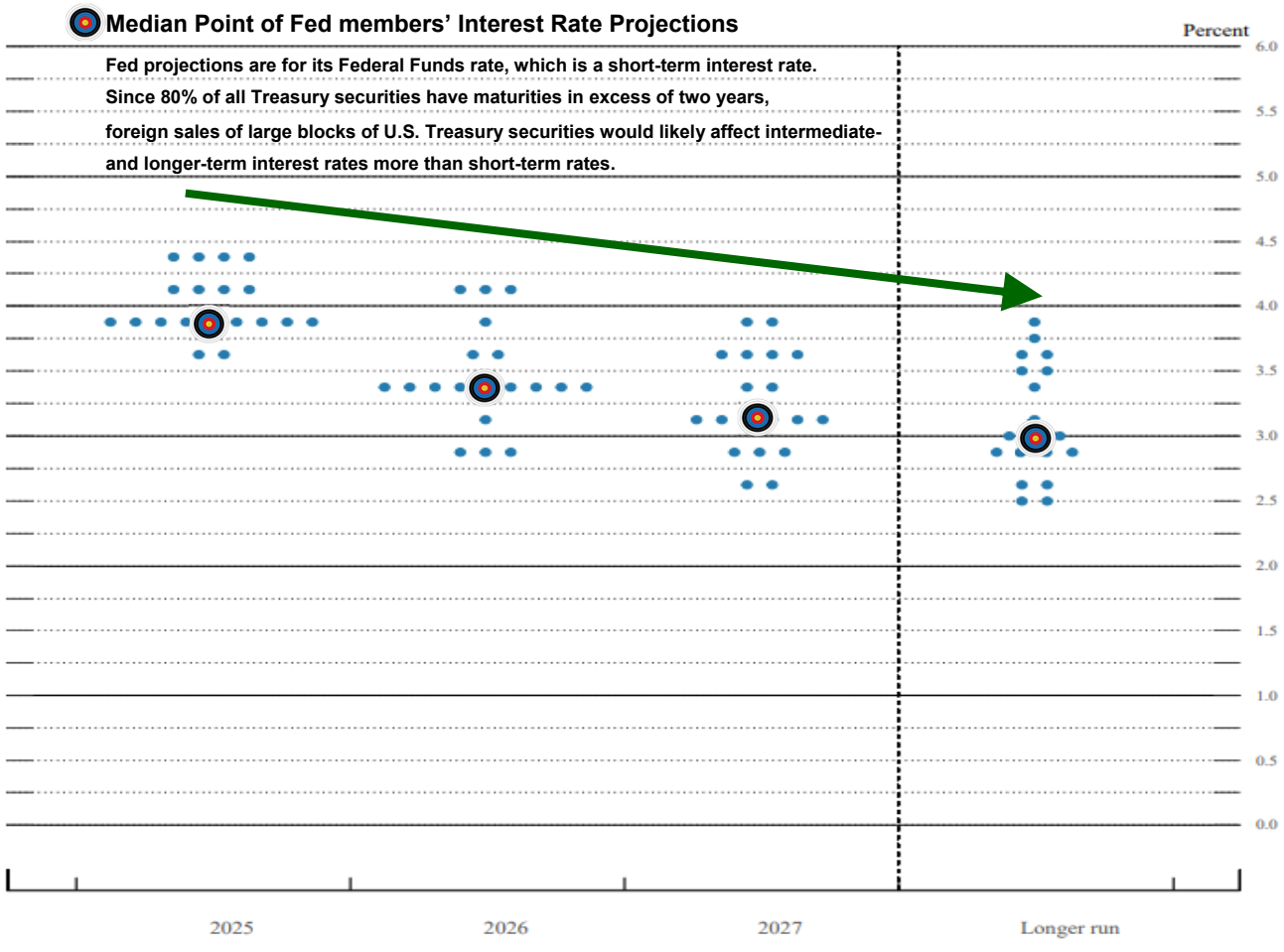
The U.S. has roiled the world economy with the implementation of a new tariff structure and the world has retaliated by exacerbating the U.S. trade deficit enough to raise the specter of a U.S. recession and by reminding the U.S. that it does not have complete dominion over its domestic interest rate policy. So, where does this leave investors?

LOWER INTEREST RATES COULD PROVIDE A MODERATE TAILWIND

After the Fed implemented a series of interest rate increases to wring excess inflation out of the U.S. economy, it was hoping to normalize rates by implementing a series of rate cuts. However, inflation began inflecting upward this past fall and the Fed expects the revised tariff structure in the U.S. to place some additional upward pressure on inflation.

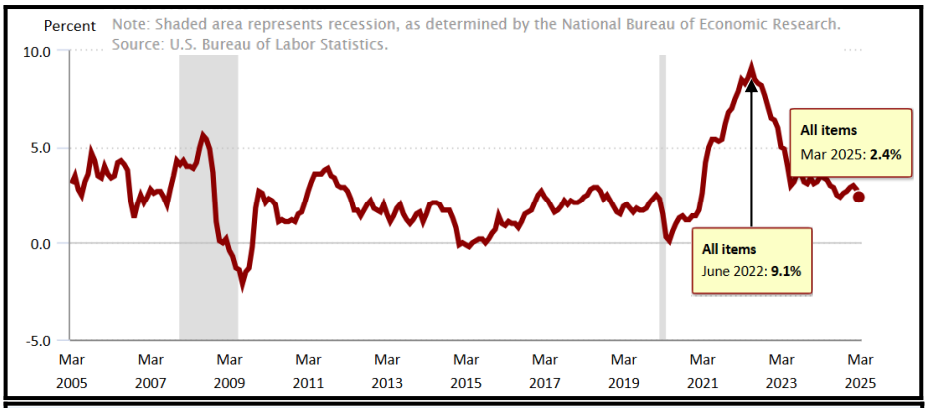
The mid-point target of the Fed's short-term policy rate currently stands at 4.375%. As shown in the Fed's Dot Plot, below, the folks who set interest rate policy at the Fed expect that rate to settle near 4% by year-end enroute to 3.125% by the end of 2027 and 3% on a longer-term basis. **If the Fed's projections materialize, it could provide a moderate tailwind to stocks and bond valuations and to asset values, in general.**

Figure 2. FOMC participants' assessments of appropriate monetary policy: Midpoint of target range or target level for the federal funds rate



BONDS CONTINUE TO OUTPACE INFLATION

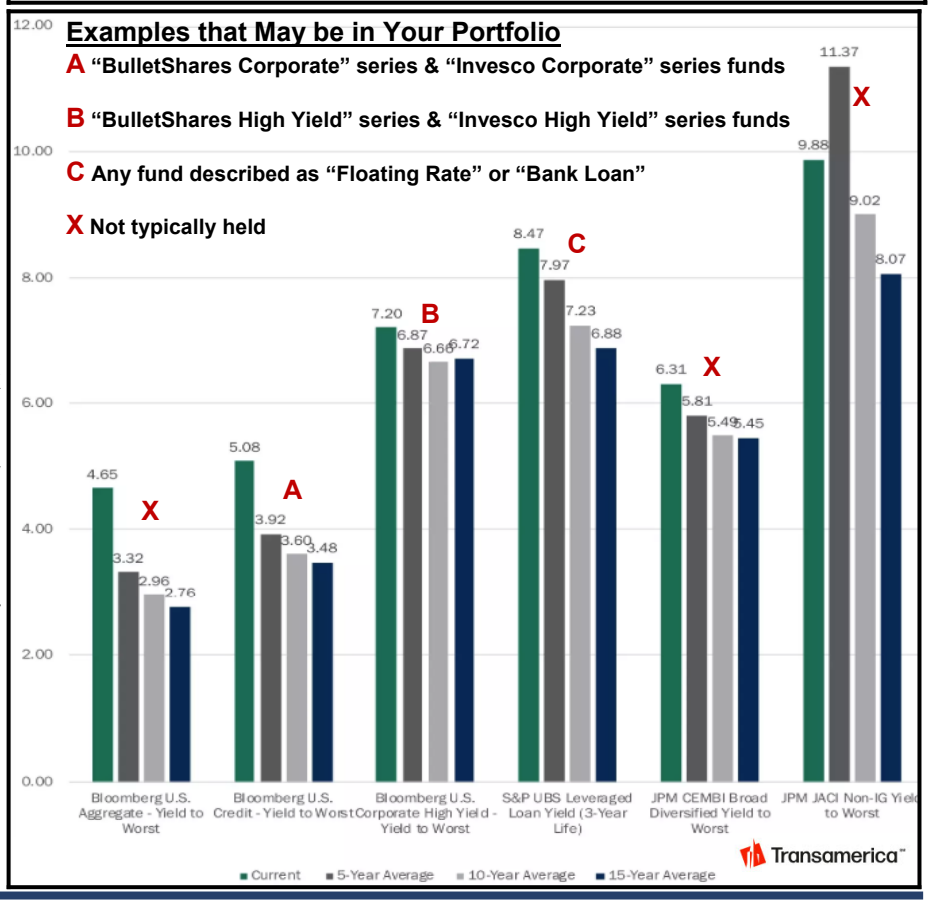
After having declined to 2.4% last fall, the annual rate of inflation within the U.S. crept back up to 3.0% during January. However, it has once again settled back to 2.4% (upper image). Tariff-related inflation may be brewing, but it is not yet apparent. For the time being, the overall, annual rate of inflation appears to be a tame 2.4%.



The Federal Reserve Bank of Cleveland has a forward-looking inflation model that suggests inflation might average a bit over 2,6% per year over the next two years, a figure which is still within the realm of the Fed's 2% target.

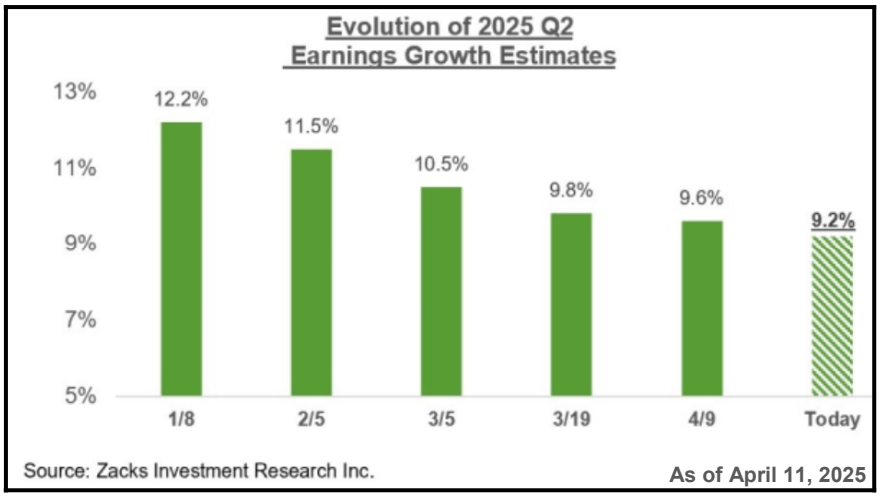
Last quarter, I shared some data that suggested that credit losses within the bond market would continue to be moderate. The image to the right depicts the current yields (in green) offered by various types of bonds compared to average yields over the past 5 years (dark gray), 10 years (light gray), and 15 years (blue). Yields are currently more attractive than they have been, but it's worth noting that yields were suppressed for a decade or so after the trouble that occurred in 2008/9.

More importantly, various types of bonds continue to offer yields that are significantly higher than the current, 2.4% rate of inflation.

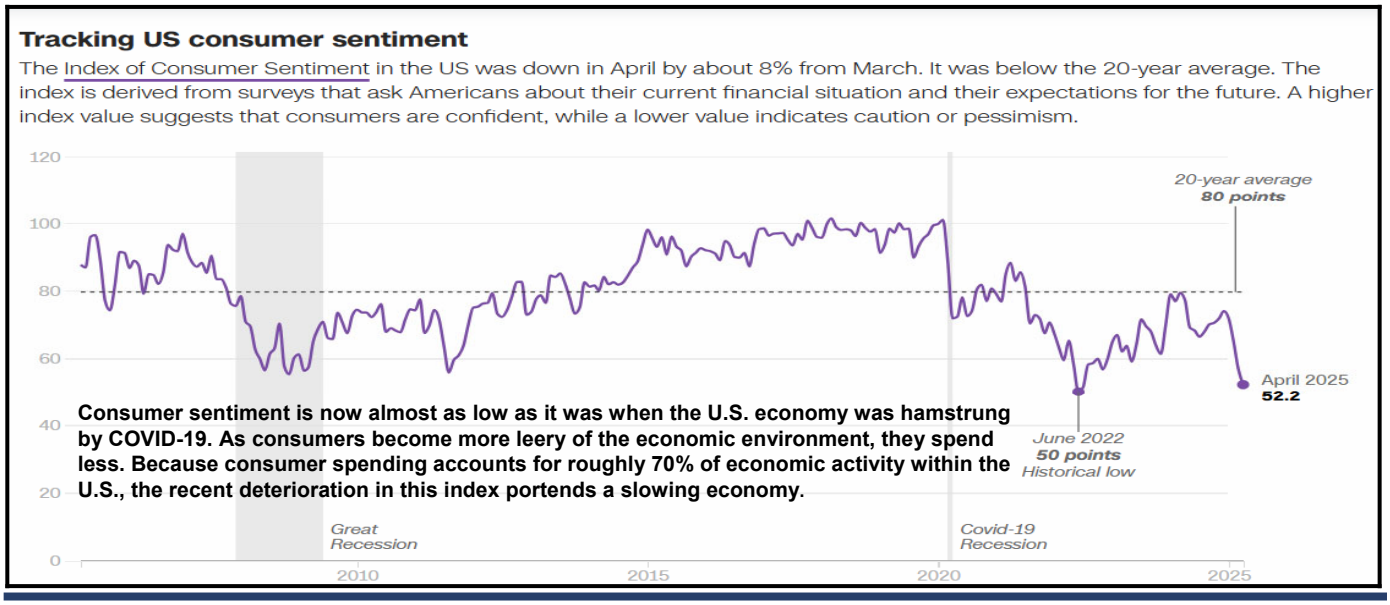


CORPORATE EARNINGS GROWTH INTACT FOR NOW

Earnings growth drives stock prices and, for now, the outlook for continued growth remains intact as analysts expect corporate earnings to increase 9% this year on revenue growth of 4.5%. Growth estimates for 2026 and 2027 are even more robust, as shown to the right. However, estimates will most likely drift lower as the effects of trade uncertainty and slowing U.S. economic growth more fully permeate analysts' longer-range estimates.



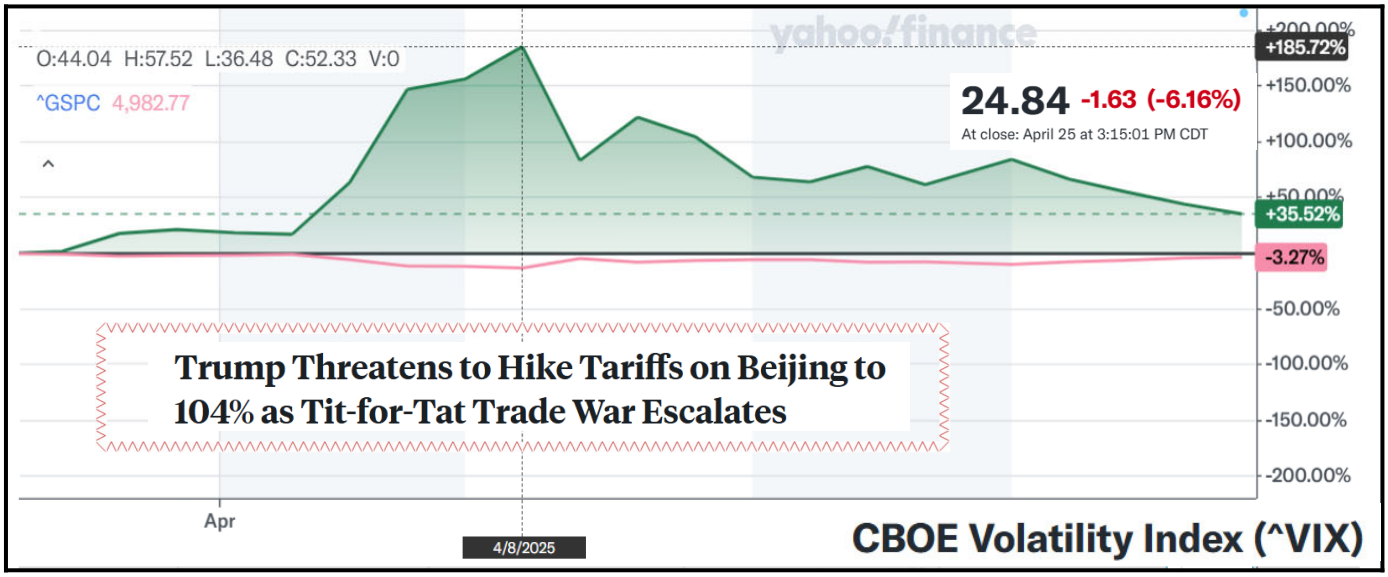
This next image provides some sense of the degree to which analysts have been trimming their earnings estimates for the second quarter of 2025. Because nature provides an almost unlimited number of ways for events to unfold worse than intended or planned, analysts are accustomed to trimming their estimates as their conjecture meets reality. **Until U.S. tariff policy is set and fully implemented, it will be hard to assess the impact on corporate earnings and the returns from stocks.** In fact, some companies have withdrawn their earnings guidance until they can better assess the impact of the new tariff structure.



DECLINING VOLATILITY — A GOOD SIGN FOR STOCKS

Investors are generally less willing to buy risk assets such as stocks and real estate whenever uncertainty is on the rise. As the level of uncertainty increases, buyers retreat and asset values relax. The Chicago Board Options Exchange (CBOE) publishes an index known as the Volatility Index (VIX or "^VIX") that is designed to estimate the annualized price volatility of the stocks issued by the 500 largest companies in the U.S. (the S&P 500) over the ensuing 30-day period. The image that appears below spans the 30 days ending April 25th.

The green line represents the relative level of the VIX and the red line represents the relative value of the S&P 500. Note that they almost always move in opposite directions. All else being equal, a reduction in the VIX will correspond with an increase in the value of the S&P 500, and vice versa. The April 8th spike in the VIX coincided with the headline embedded in this next image.



The VIX is probably the most widely recognized measure of volatility. It is designed to be interpreted in terms of annualized stock market volatility. Values of 13-19 are considered to be normal. In late March, the VIX stood at approximately at the upper boundary of this "normal" range. An index value of 19 would then be interpreted as stocks having a 68% probability of trading within a range of +/- 19% of their current value one year hence. **Index values above 20 mark heightened uncertainty and values above 30 mark periods that are especially fraught with uncertainty.**

On April 8th, the day President Trump threatened to hike tariffs on China, the VIX closed at an extremely elevated figure of 52. This figure would be interpreted as stocks having a 68% probability of trading within a range of +/- 52%(!) of their current value a year from now. As the VIX rose from 21 on April 2nd to 52 on April 8th, the S&P 500 declined by about 8%. The VIX has relaxed since then, but remains elevated at almost 25.

Recent statements from President Trump, such as his suggestion that he intends to be "very nice" to China, have resulted in some optimism that tariffs may be applied with more nuance, at lower levels, or that certain trade deals may be reached. If the VIX relaxes further, I would expect stocks to rebound. — Glenn Wessel