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Weekly Investment Commentary

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An attempt to define the current state of play

Tariff war and eroding confidence

Investors and businesses came into this year with misplaced optimism that President Trump (empowered by the Republican electoral sweep) would promote pro-growth policies and fuel higher risk asset prices. In a matter of months, Trump has instead effectively sidelined the U.S. exceptionalism theme, triggered a significant stock market correction, severely impaired what was a strong U.S. economy, and is approaching the brink of a "crisis of confidence." A sustained recovery in stock prices beyond a near-term bounce relies on a clarification/reduction of his trade policy before further damage occurs to consumer, business, and investor sentiment.

With hindsight, President Trump's conflicting mix of economically supportive policies (tax cuts and deregulation) and stagflationary isolationism (widespread tariffs and deportation/anti-immigration) created confusion at best, and economic damage at worst. The market reaction has been clear that investors are losing confidence in Trump's policies.

The U.S. yield curve, especially at the long end, has steepened notably. At best, it may take a U.S. recession to offset the increased Treasury term premium and materially lower bond yields, which is a big risk for the Republican Party before the mid-term election. A key for investment strategy going forward is whether tariffs are an ideological issue for the Trump administration, which increases the likely persistence of such policies despite economic pain. While this increasingly appears to be the case, there is clearly room for negotiation, as indicated by the 90-day pause on the trade war, with some notable exceptions such as China.

Promises of trade imbalances (in recent decades)

1. U.S. and global businesses would receive outsized profits by establishing manufacturing hubs in lower-cost countries.
2. U.S. consumers would be able to purchase much cheaper goods imported from abroad, thereby satisfying their short-term spending desires.
3. Effectively, U.S. consumers received instant gratification and boosted their living standards, while business and investment community received increased wealth.
4. The persistent current account deficit reflects a lack of competitiveness in the U.S. manufacturing sector, which now goes well beyond lower-cost labor abroad, and includes manufacturing ecosystems and distribution channels in Asia and Mexico.
5. There is a natural tendency for currency markets to reflect this divergence in competitiveness and rebalance the current account via a much weaker U.S. dollar.

Trade going forward

The Trump administration has based its trade policy on the assertion that U.S. manufacturing is competitive but has been held back by unfair trade practices abroad. Instead, the root cause is a lack of competitiveness that will likely only be rectified by depreciation of the U.S. dollar and other policies to improve U.S. labor and manufacturing productivity. Barring a U-turn by President Trump, we expect other countries to retaliate, which will hurt both U.S. and global growth. However, the retaliation is likely to morph from a trade war to a capital account war, whereby foreign governments target sales of U.S. companies that will cause the most equity market damage, and sell their U.S. Treasurys.

Possible Trump goals and next steps include: 1) President Trump will be watching the opinion polls very carefully, and despite what he claims to the contrary, the stock market as well. 2) Tariffs are a tool for many objectives (especially with China). 3) He loves to do deals. 4) He needs/wants a win. 5) He would like to use tariffs to reduce the budget deficits. 6) He would like to lower interest rates and possibly extend the maturity of federal debt. 7) He wants to punish/isolate China.

The economy, the Fed, and the bond market

The U.S. economy was in reasonably good shape entering this year with no meaningful underlying fundamental cracks or excesses that would create significant vulnerabilities. (Having said that, we entered the year with caution as we observed slowing in consumption and the labor market and were concerned about valuation.) The policy choice to embark on a trade war is the main reason why the U.S. economy is set to slow meaningfully and may even set course on a recessionary path. The question is whether the Trump administration is responsive to the fact that the costs of pursuing a trade war have been escalating. The announcement of a 90-day pause in tariffs on non-retaliating countries is an encouraging development in that regard.

The trade war puts the Fed in a tough spot. The prescription for a potential slowdown/recession would be to cut rates preemptively. However, the Fed will be wary of compounding inflation's upside and risking further increases in longer-term inflation expectations. The Fed will likely wait, looking for signs of weakness in the economy/labor market or financial system strains in order to cut rates. In the meantime, however, if Treasury yields continue to move higher, the Fed may well intervene sooner via its balance sheet, especially should there arise any concerns on financial stability.

The end of a 'Golden Era'?

The U.S. corporate sector will likely be a casualty of the Trump tariffs and isolationist policies that likely mark the end of an extraordinary era of profit growth and financial strength. The U.S. corporate sector has been a huge beneficiary of globalization over the past several decades, which has allowed companies to reduce costs by moving production offshore as well as access buyers in foreign markets, and in some cases, reduce taxes by extensive use of offshore accounting entities.

The increase in corporate profits, in turn, has powered a remarkable rise in U.S. equity prices over the past four decades. The improvement in corporate profitability is more striking when gauged against U.S. GDP. Both pre- and after-tax profits as a share of GDP have climbed dramatically since the early-1990s and are at record highs. The improvement in after-tax margins is especially pronounced because of the steady decline in the effective corporate tax rate, which, in turn, primarily reflects the fall in the federal statutory rate from 50–55% in the 1950s and 1960s to 34–35% from the mid-1980s until 2017, and the 21% rate since then.

The U.S. corporate sector has benefitted tremendously from its foreign operations. Inflation-adjusted profits from the rest of the world have exploded in recent decades, and more than quintupled since 1990. Real foreign profits have risen more slowly since the global financial crisis, in part because of the appreciation of the U.S. dollar, which depresses overseas profits when they are translated back into the stronger U.S. dollar. Nonetheless, foreign profits have continued to contribute positively to overall profit growth. Foreign profits still account for more than 20% of total profits. Foreign profits of U.S. corporations are equivalent to approximately 1.3% of global ex-U.S. GDP, up sharply from 0.4% in the early 1990s.

The elevated P/E ratio implies that a period of de-rating is also likely in the next 10 years, thereby acting as a weight on stock prices and total returns. The risk of a cyclical and structural de-rating of the U.S. market is real.

Conclusions

The equity price correction thus far merely reflects a de-rating, i.e., a decline in the 12-month forward P/E ratio to 20.5 from a peak of 22.8 immediately after the election.

Equities remain expensive (P/E, price/cash flow, price/book, EV/EBTDA) by the standards of the past 30 years, highlighting that they remain vulnerable to further de-rating in the event of a full-fledged growth scare or something more severe. Earnings downgrades are inevitable as companies and analysts factor in trade tariffs, although it is impossible to gauge the magnitude until the tariff details are clearer.

On balance, we view risks for global growth, equities, and credit as tilted to the downside in the near term, while acknowledging the U.S. policy backdrop is inherently fluid, given President Trump's personal participation in setting tariffs. That said, we assign low odds that the capital market conditions prevailing in late-2024 can be restored anytime soon.

Sources: MRB, BCA, Strategas, and Piper Sandler

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