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Markets & Economies

Key Points on Tariffs, Funding Cuts, and Market Volatility

Assessing the economic and market impact of the April 2 tariff announcement and other developments.

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New tariffs imposed on a broad range of U.S. trading partners on April 2 have prompted questions from investors about their potential economic and market impact. Here are some observations about the tariff announcement and other recent policy initiatives by the new administration.

1. Based on what was in the April 2 announcement, the negative impact on U.S. gross domestic product (GDP) from the tariffs could be somewhere between 0.5%-1.0% in 2025. Much depends on how long they remain in place; one potential offset is the fact that the broader Canada and Mexico tariffs are still on hold. That said, the breadth and complexity of these tariffs means that they may not be easy to negotiate away; the fact that they could last longer than originally expected may mean that they have a bigger negative impact on the United States than other countries. Another key question is the ultimate effect on consumer prices, and how any uptick in inflation affects spending on goods and services. The effect on business spending is also something to watch. These factors increase the risk of a U.S. slowdown, in our view, though we would emphasize that recession is not our base case right now

2. The tariff announcement comes amid the administration's efforts to cut government spending. The announced cuts have not been seen in hard economic data yet, including the March U.S. payrolls data released on April 4. The U.S. job market remains robust. We have not seen a meaningful rise in the unemployment rate yet, though the cuts could be reflected in that data series in the second half of the year. It's important to remember that Federal Government employees represent less than 5% of the of the total U.S. workforce, so government job cuts by themselves would not be enough to bring down the entire economy. The private sector still looks robust. The potentially negative impact to the economy could be counterbalanced later by planned tax cuts and the possibility of additional fiscal stimulus from Congress.

3. The Federal Reserve (Fed) is in a tricky position and has acknowledged the difficulty. Fed Governor Philip Jefferson recently reiterated that the Fed is not in a hurry to adjust rates and will remain in a wait-and-see mode, which aligns with our view. The Fed is more concerned about the impacts of slowing growth than reigniting inflation. They are likely to overlook price level increases resulting from tariffs, viewing them as potentially one-off events. If growth slows sufficiently, it could help bring inflation back down. And currently, the market is pricing in more Fed cuts, which seems reasonable given the expected negative growth impacts. It will be challenging for the Fed to respond aggressively to softening growth, and they will likely react differently compared to other types of growth shocks because of the inflationary impacts. Note, too, that inflation expectations have been on the rise. This trend will likely be difficult to ignore because the Fed is concerned about maintaining its inflation-fighting credibility. That means the Fed may not react as quickly or aggressively to a slowdown as it has in the past, opting for a more cautious stance.

4. Taking a global perspective, we believe non-U.S. exposure remains attractive compared to U.S. exposure, as the announced broad-based tariffs could potentially hurt the United States more than other nations due to limited substitution options for consumers and companies. European countries like Germany, with more fiscal space, can offset negative impacts. A further weakening of the U.S. dollar also supports non-U.S. exposure.

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Investment Implications

Fixed Income

Given the ongoing uncertainty engendered by the tariffs, we believe a degree of caution is appropriate in this environment. We continue to favor longer-duration, fixed-rate securities and higher-quality, less-leveraged companies. We have been adding duration to portfolios, which has been a hedge for equity and riskier credit exposure, with room for Treasury yields to move lower from here, in our view. That has been the good news, unlike 2022, when most asset classes moved lower.

Despite the need for caution, strong fundamentals in the private sector, including higher-quality high yield bonds with better balance sheets, suggest good investment opportunities. Lower yields could also benefit many companies. Credit fundamentals for many high-quality high yield bonds remain sound, so there may be opportunities to add to positions in these issues should spreads continue to widen.

Equities

We are closely monitoring the potential impacts of the announced tariffs on *innovation equities*. Our portfolios are predominantly U.S.-focused with limited global exposure, and most of our companies do not deal in physical goods. Consequently, the direct impact from tariffs is somewhat limited. However, we are more concerned about the broader implications of lower economic growth and increased recession risks. We are particularly vigilant about companies whose profitability is projected further into the future. Furthermore, the stocks we own are of innovative, growth companies--who then, by nature, are market share takers. The risk for our portfolios is valuation compression if indeed that lower economic growth plays out, and their market share gains are temporarily interrupted by interim spending hesitation from their customers.

During periods of economic uncertainty, the scarcity of secular growth companies increases and earnings visibility becomes crucial. Therefore, we are reducing exposure to businesses with highly discretionary customer spending and instead continue to favor those with subscription-based revenue models. This approach helps mitigate the risk of future negative estimate revisions in the coming quarters exacerbating market valuation compression.

As we noted earlier, we believe now is an attractive time for non-U.S. exposure. Given the possibility that the United States may feel a greater economic impact from the tariffs, an allocation to *non-U.S. equities* could be a good way to achieve geographic diversification.

In looking at *value equities*, we anticipate a negative impact on the market as the tariffs were higher than expected. On the positive side, the Fed is in an easing cycle, so unlike the 2022 environment, monetary policy can potentially support the market. Also, the release of first-quarter earnings may provide companies the opportunity to trade on their fundamentals rather than macro factors.

From a technical standpoint, the market trend remains challenged, but market breadth is reaching oversold levels. Many investor sentiment indicators have been at these oversold levels for weeks, often signaling the potential for a relief rally. Nonetheless, we remain cautious until we see improvements in market trends, such as indexes moving above key moving averages and an expansion in uptrends and snapbacks.

Municipal Bonds

High-quality municipal bonds are currently providing compelling tax-equivalent yields across the curve. Longer duration municipals are showing attractive relative value compared to Treasuries, as the municipal market remains one of the few segments of the fixed income market where investors are generously compensated to extend duration. Intermediate term bonds also benefit from municipals' steeper yield curve and allow for one of the best risk/reward dynamics.

In terms of fundamentals, tax revenues continue to experience growth and muni issuers' rainy-day balances are near record levels. It's also important to consider that the municipal market is a primarily domestic asset class and provides exposure to domestic industries that will not face tariffs. Given the positive backdrop for municipal credit, the high yield muni segment also merits consideration, in our opinion. And while the fundamental strength of the municipal market is near record levels, it's also worth noting that municipal credit has historically shown resilience in past recessions.

We recently discussed the potential impact of federal spending reductions on municipal bond sectors. While certain segments of the market are more exposed to federal funding changes, we do not anticipate substantial near-term impacts from these reductions.

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Glossary Definitions

A **basis point** is one one-hundredth of a percentage point.

Diversification is the spreading of investments both among and within different asset classes and is an important tool in managing investment risk.

Duration is a measure of the sensitivity of the price (the value of principal) of a fixed income investment to a change in interest rates.

The **Federal Reserve (Fed)** is the central bank of the United States. **The Federal Open Market Committee** (FOMC) is the branch of the Fed that determines the direction of monetary policy in the United States.

The **federal funds rate** is the interest rate at which depository institutions lend reserve balances to other depository institutions overnight on an uncollateralized basis. **Fed funds futures** are financial futures contracts based on the federal funds rate and traded on the Chicago Mercantile Exchange. These futures are considered a direct reflection of collective marketplace insight regarding the future course of the Federal Reserve's monetary policy.

Spread is the percentage difference in current yields of various classes of fixed-income securities versus Treasury bonds or another benchmark bond measure. A bond spread is often expressed as a difference in percentage points or basis points (which equal one-one hundredth of a percentage point). The option-adjusted spread (OAS) is the measurement of the spread of a fixed-income security rate and the risk-free rate of return, which is adjusted to take into account an embedded option. Typically, an analyst uses the spread versus Treasuries.

Treasuries are debt securities issued by the U.S. government and secured by its full faith and credit. Income from Treasury securities is exempt from state and local taxes.

Yield is the income returned on an investment, such as the interest received from holding a security. The yield is usually expressed as an annual percentage rate based on the investment's cost, current market value, or face value.

Yield curve is a line that plots the interest rates, at a set point in time, of bonds having equal credit quality, but differing maturity dates. The most frequently reported yield curve compares the three-month, two-year, five-year and 30-year U.S. Treasury debt. This yield curve is used as a benchmark for other debt in the market, such as mortgage rates or bank lending rates. The curve is also used to predict changes in economic output and growth.

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The value of investments in fixed-income securities will change as interest rates fluctuate and in response to market movements. Generally, when interest rates rise, the prices of debt securities fall, and when interest rates fall, prices generally rise. High yield securities, sometimes called junk bonds, carry increased risks of price volatility, illiquidity, and the possibility of default in the timely payment of interest and principal. Bonds may also be subject to other types of risk, such as call, credit, liquidity, and general market risks. Longer-term debt securities are usually more sensitive to interest-rate changes; the longer the maturity of a security, the greater the effect a change in interest rates is likely to have on its price.

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