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Tariff Thoughts & 1Q 2025 Summary

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PSG'S PERSPECTIVES

As of this writing, the US has imposed additional tariffs of 10% to 49% on every trading partner. A tariff is a tax paid to the US Treasury by the party importing the products. The US is the largest "consuming" economy in the world, and trillions of dollars of goods are imported each year.

For the moment, tariffs are a certainty. What remains uncertain is the final level of tariff rates. The Trump administration has stated that further tariffs are possible if countries choose to respond. China has already indicated that they will impose additional tariffs of 34% on US goods in response. The President has also indicated he is open to negotiating with trading partners for lower tariff rates.

There are differing views of who will end up paying the tariffs. Some members of the Trump administration believe the entire cost will be absorbed by the producers and that nothing will be passed on to US consumers. We think this is false. Most professionals who have dealt with tariffs in the past or studied economics know that the extra cost is often shared by the exporter, importer, and consumer, through negotiations between the exporter and importer.

One of the stated goals of the Trump administration is to bring as much manufacturing back to the US as possible. We do not have the trained workforce to manufacture many goods in the US, which is in part why the cost of manufacturing products in the US is higher than it is overseas. Using Apple as an example, we have seen estimates that moving just 10% of Apple's supply chain to the US would take 3 years, cost $30 billion, and the price of an iPhone would rise to $3,500.

In simple terms, prices will likely rise. What is not clear is how the producer, the importer (if there is one) or the end consumer will react after the initial shock. Will end demand change? Employees are not likely to receive raises to cover the added costs from higher prices during a weak business environment. As of now, most corporate plans are either in flux or on hold, as they should be until the landscape is better understood. Why would CEOs commit to making significant capital expenditures when the easiest solution might be to issue earnings warnings and cut back? Increasing profitability over time is a key objective for businesses, and management behavior changes when risks to profitability increase. This is a new unknown. The second part of this letter is dedicated to more on tariffs.

Market Conditions and Portfolio Management

The selloff in stocks that began with some sectors in the first quarter has spread and accelerated. Interest rates on all US Treasuries have declined quickly and significantly. US

Treasuries have become a liquid safe haven and suggest that a period of much slower economic growth or even a recession is possible.

The selloff validates our philosophy on the benefits of portfolio diversification. Stocks that earned the most over the last few years are among the largest losers. Meanwhile, conservative stock portfolios, which earned less in 2023-2024, are losing substantially less now.

We strive to balance sound investment principles with client needs and comfort levels. In the end, we will do what makes people comfortable, but we remind clients that diversified investment plans were put in place knowing that there could be significant negative distortions in the stock market.

Losses in stocks become permanent if one sells and does get back in at the right time. It is reasonable to sell stocks if a client needs cash or does not have enough liquidity to get through a turbulent period. It is also reasonable to sell if a client cannot stomach additional volatility and fully understands that getting back in at the right time is almost impossible, potentially missing sizable gains. There may also be a price to pay (taxes) if stocks in non-retirement accounts are sold with capital gains.

Every protracted period of uncertainty carries some version of a "this time is different" feeling to it, and that is certainly true today. Preparing for uncertainty is one thing; navigating through it is another. It's easier said than done.

Selloffs are a normal part of investing, and we have been through many before. We are here to serve you, and we look forward to answering your questions as quickly and comprehensively as possible.

DEEPER DIVE

THE BIG THING: Eighty Years of Free Trade Policies Out the Window; Growth Expected To Slow In Coming Quarters

- The US has begun to impose tariffs on friends and foes alike, ending an era of US led globalization.
- We expect economic growth and profits to slow / decline.
- Despite the uncertainty, there are few signs of stress in the financial sector or economy, but that is likely to change.
- Consumer prices will rise for many products, some significantly.

POLITICAL COMMENTS AND THE ECONOMIC ENVIRONMENT

Trade policy changes are likely to cause lower growth & higher prices in the near-term

Trump Administration Upending Decades of Free Trade Policies Promise Near Term Pain with Hope of Longer-term Gains

- Numerous tariff policies impacting allies and competitors have been announced.
  - We view tariffs as a tax increase.
  - We believe the near-term results will resemble stagflation - lower growth and higher inflation.

Announced tariffs amount to the second highest tax increase since WWII.

- **US imported $3.3 trillion in goods in 2024.**[1]
  - Assuming a baseline 10% tariff on all goods implies $330 billion in potential tax revenue from US consumers and businesses (assuming no substitution or lower demand from higher prices).
  - The tariff rates announced on April 2 are estimated to be 22%, equating to a tax increase of ~$725 billion, or 2.4% of GDP.
    - ***IF KEPT, THIS WOULD BE THE SECOND HIGHEST TAX INCREASE IN POST WWII HISTORY***[2]
- Higher prices typically reduce demand, leading to weaker profits and slower growth.
  - **This is negative for equities.**

Will Businesses Invest More In the US?

There is a shortage of skilled labor which is not addressed by tariffs.

- The tariffs announced on April 2 are claimed to be the maximum announced, assuming no retaliatory tariffs.
  - Tariffs could be lowered through negotiation.
- These moving targets make it challenging for businesses to plan.
  - It is unclear if the business community will believe the new policies will last long enough to risk new investment in the United States.
  - We believe business investments could be made but will not begin until tariffs are stabilized.
- Part of the reason we manufacture goods overseas is because those workforces are better trained and less expensive.
  - We are doubtful a meaningful number of companies will risk building new plants relying on manual labor when (a) many struggle to staff the ones they already have and (b) there is little certainty these policies will last more than a few years.
  - There are currently 7.1 million "working age" men (25-54 years old) unemployed and not seeking jobs in the United States,[3] and we are doubtful their needs will be addressed by these tariffs.
- We expect investments in US manufacturing to be heavily skewed toward robotics.

Tariffs, the Budget Deficit, & Fiscal vs. Monetary Impacts

Deficit reduction is negative for growth in the near term.

- Tariffs as a tax should modestly reduce the US budget deficit.
  - Any reduction in the **$1.8 trillion US budget deficit** will come at some cost to the economy, regardless of whether it comes from lower spending, higher tariffs, or higher income taxes.
  - Faster growth can lower the deficit, but these policies are likely to do the opposite in the near term.
  - The controversial Elon Musk led Department of Government Efficiency (DOGE) estimates savings of $140 billion[4], a large absolute number but far less than the $1.8 trillion budget deficit.
  - Both spending cuts and tax increases (tariffs) are negative for growth in the near term and raise the probability of higher federal spending to help unemployed.
- Lower growth in the near term is consistent with the Administration's stated goal to reduce long-term interest rates, but rising prices may counter that.

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[1] US Bureau of Economic Analysis[4], FRED
[2] JPMorgan, "There will be blood," 4/3/2025
[3] Bureau of Labor Statistics (BLS), FRED
[4] Source- doge.gov as of 3/30/2025

    - Lower growth and coinciding lower wages often lead to lower inflation expectations and lower long-term interest rates.
- If the current policies are ineffective at lowering long-term interest rates, we are concerned the situation could create a pretext for invoking new executive powers to force the Fed to buy long term bonds (via monetary printing).
    - We believe such a policy, if pursued, would lead to persistently higher inflation in the intermediate term, but absent the typical economic "brake" of higher interest rates that usually come with higher inflation.
    - The 58% increase in gold over the last year suggests market participants are anticipating more monetary induced inflation.

How Do We Think About Stocks, Bonds, and Alternative Portfolios In The New Regime?

We expect equities to be under pressure until impacts from tariffs are understood.

- Client asset allocations reflect the near certainty of bear markets at some point within the time horizon of their investment plans.
- **Equities** will be under pressure until the impacts of the new tariffs are understood.
    - Business will adopt to whatever policies are imposed upon them and strive to grow earnings.
    - Fiscal stimulus in the US is being reduced (through lower budget deficit), while fiscal stimulus is being ramped up in Europe.
        - We are considering increasing exposure to international equities for the first time in over a decade.
        - We have to weigh the lower valuations and fiscal impulse from spending in the EU with the impacts from tariffs, shrinking populations, less business-friendly environment, and removal of the US security umbrella.
        - If the US administration changes course & pursues monetary stimulus as described above, equities would likely benefit.
    - Some sectors should be more insulated from tariffs, such as communication services and utilities.
    - We believe equity returns will be higher than bond returns over the intermediate to long term, though volatility is likely to be higher than the past 10 years.

Interest rates could move sharply higher or lower; individual bonds will pay coupons and mature.

- **Bond "**performance" in the near term is a tougher call as the possible stagflation environment from the tariffs are balanced against lower growth.
    - If inflation were to rise and not be transitory, it would lead to higher interest rates (which slow growth further), which would be negative for bond returns.
    - Our bias is interest rates will continue to fall - the 10-year Treasury interest rate is down 0.5% since the start of the year[5] - as energy price increases are not prevalent like they were in the stagflation era of the late 1970s,[6] which would be positive for bond returns.
    - Regardless of the direction of interest rates in the near term, **the individual bonds in client portfolios will pay their coupon and mature, delivering the yield expected when purchased**, assuming no defaults.
    - We expect lower quality bonds to be under pressure in either scenario.
- There should be numerous opportunities in **distressed credit** as good companies with too much leverage could be pushed to insolvency.

[5] As of April 3, 2025

[6] OPEC announced increased production on April 3, despite oil prices near 3 year lows.

    - We expect many high yielding products with low quality borrowers to be under severe pressure and suffer outflows.
- **Gold** has already moved significantly.
    - Lower growth implies a more challenging environment to close the 6% budget deficit, making a monetary solution (money printing) more likely, a long term positive for gold.
    - The seizure of Russian assets plus recent isolationist actions by the US has increased the appeal of gold reserves to foreign governments.
- It is difficult to time market turning points; trying to guess if and/or when policy reversals will be announced seems even riskier.

MARKET SUMMARY – 1Q 2025

Most US equity indices were down in the quarter. Large cap value was up, small cap and growth stocks did worst.[7] Impacts and confusion from Trump administration tariff policies coupled with high valuation led to declines. Most international indices were up. High quality bond portfolios were up (both tax-free and taxable), and interest rates fell. Gold was up double digits. Alternatives were mixed, with many credit-oriented hedge funds up while equity hedge funds were down.

QUARTERLY REVIEW

EQUITIES

Mag 7 stocks dragged down S&P 500 returns; less expensive stocks did best

Small Cap & Growth Lost the Most, "Cheapest" Did Best

- Stocks with the lowest valuations did best, most expensive stocks did the worst.
- Large Cap Value & Mid Cap Value offered the most protection in a volatile and uncertain environment.
- The S&P 500 was down 4%, driven by the "Magnificent 7" (Mag 7), which make up 30% of the S&P 500. [8]
    - All of the Mag 7 stocks were down in the quarter; six were down double digits.
    - Within the S&P 500, only sectors with Mag 7 exposure were down more than 1% in the quarter.
- Many large cap stocks were up in the quarter; the equal weighted S&P 500 was down less than 1%.
- Small cap companies, which tend to have the most exposure to tariffs & slower growth, underperformed mid and large cap.
- US equity indices started the year off higher, but all stock indices have declined since mid-February as the size and scope of tariffs and administration comfort with lower stock prices in the near term became clear.

[7] Large-cap growth = Russell 1000 Growth Index; Large-cap core = S&P 500; Large-cap value = Russell 1000 Value Index; Mid-cap growth = Russell Mid-cap Growth Index; Mid-cap core = Russell Mid-cap Index; Mid-cap value = Russell Mid-cap Value Index; Small-cap growth = Russell 2000 Growth Index; Small-cap core = Russell 2000 Index; Small-cap growth = Russell 2000 Value Index; Developed international = MSCI EAFE Index; Emerging markets = MSCI Emerging Market Index. These terms will be used throughout the commentary. Source: FactSet & PSG.

[8] Magnificent 7 stocks are (name, ticker, % of S&P 500 as of 1/7/25): Alphabet Class A, GOOGL 1.8% & Alphabet Class C, GOOG, 1.6% (3.4% combined); Amazon, AMZN, 3.8%; Apple AAPL, 7.0%; Meta, META, 2.7%; Microsoft, MSFT, 5.9%; NVIDIA, NVDA, 5.6%, Tesla, TSLA, 1.5%; Source – FactSet & State Street.

BONDS:

Bonds delivered diversification benefits in 1Q

- Interest rates fell across the US Treasury yield curve. (***See Table 1.)***
- High quality corporate and municipal bonds rose in value.
- Lower yields imply bond markets are more concerned about slowing growth than rising inflation.
- The Federal Reserve is taking a wait and see approach to tariffs.

Table 1

US Treasury Yields *(source- FactSet; numbers may not sum due to rounding)*

Maturity	12/31/24	3/31/25	1Q25 Yield Change
3 Month	4.3%	4.3%	**(0.3%)**
2 Year	4.2%	3.9%	**(0.3%)**
5 Year	4.4%	4.0%	**(0.4%)**
10 Year	4.6%	4.3%	**(0.3%)**
30 Year	4.8%	4.6%	**(0.2%)**

Private Investments / Gold / Alternatives:

Gold was the best performer in 1Q.

- Gold has been an area of focus for us and was the best performing assets in 1Q, making all-time highs, +19%.
- Alternatives were a mixed bag; equity funds were down though generally less than the S&P 500, while many credit-oriented managers performed well.
- We continue to favor distressed credit.

FUN FACTS

- Seven of the eleven S&P 500 sectors were up in the quarter.
- Amazon sales topped Walmart's in the most recently reported quarter for the first time ever.
- The Mag 7 were down on average 25% from their 52 week highs and were responsible for 96% of the S&P 500 decline.[9]

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[9] Source – FactSet, Bespoke Research