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Tariffs Are Biting Markets

Increased volatility and a flight to safety

Summary: As markets drop on the back of new tariffs, we recommend keeping a steady hand and consider addressing the prevailing risks without overreacting by trimming underweights to international equities and extending duration in US fixed income investments.

In this update we discuss *What* has happened that is negatively impacting capital market prices and *Why* recent events are important to investors. We also present the *&Partners Investment Team View,* and advise *What To Do* in response to current market conditions.

The What?

Markets reacted negatively to the imposition of new tariffs on Mexico, Canada and China, a move which had been suspended for thirty days in early February to give more time for the US, Mexico and Canada to reach agreement on issues regarding border surveillance and the illegal export of Fentanyl into the US. Trump has signaled that these increased tariffs will remain in place until the trade balance with key trading counterparties narrows. China and Canada have announced a set of retributory tariffs. Mexico has indicated that a response is forthcoming and will be announced this weekend.

Market action this year (total returns as of 03/04/2025, source Factset):

- Underperformance of US equities: S&P 500 is down -1.55% YTD and has eliminated all post-election gains, while MSCI EAFE is up +9.25% YTD.
- Underperformance of USD vs. DM peers: *e.g.*, EUR up +1.5% vs. USD YTD.
- Rally in safe-haven US Treasuries: -40bps on 10-year US treasury yield YTD, with the ICE BofA US Treasury Index up 2.79% YTD.
- Value outperformance vs. growth: S&P 500 Value +2.35% vs. Growth -2.81% YTD.

Announced and expected tariffs:

- Tariffs on imports from China doubled to 20% (from 10%).
- Tariffs of 25% were imposed on all imports from Mexico and Canada (with the exception of energy in Canada where the tariff is 10%).
- Retaliatory tariffs have been implemented by Canada and China. Mexico will announce possible retribution by Saturday.
- Further tariff announcements are likely to come (*e.g.,* tariffs on EU imports and import duties across all agricultural imports into the US). These measures will likely be met with further retaliation against the US.

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The Why?

Increased tariffs create the potential for reduced growth and higher inflation. Corporate earnings may be dampened, and the uncertainty could result in further re-rating of US equity prices. An inflation shock could reduce the Fed's ability to spur economic activity by lowering rates should the economy begin to stagnate.

- Yale University Budget Lab estimates that the current step-up in tariff rates equates to an approximately $1.5 trillion tax burden over 10 years that will fall disproportionately on lower-income groups.
- Goldman Sachs predicts that the package of combined tariffs if sustained will reduce its earnings estimates by 2-3% for the companies within the S&P500.*

* https://www.goldmansachs.com/insights/articles/how-tariffs-are-forecast-to-affect-us-stocks

&Partners Investment Team View:

We expect that markets will remain volatile, and equity returns are likely to be muted in the face of uncertainty. Investors will need more clarity about the durability of the tariffs, the potential for additional trade barriers, the extent of retaliatory actions and the flexibility of supply chains for confidence to return. The effects of tariffs on inflation and growth could also impact monetary policy. If an economic slowdown associated with these new tariffs is viewed as more negatively impacting the Fed's dual mandate of price stability and maximum employment than price pressures, the Fed might decide to lower interest rates to stimulate the economy. Conversely, if the inflationary impulse outweighs the growth shock, the Fed might raise interest rates to cool the economy even further, which can weigh on stock prices by increasing the cost of capital and reducing consumer spending.

The increased volatility and potential impact on corporate earnings will likely dampen equity prices in the short to medium term. These effects might be felt differently across sectors. While companies with highly integrated global supply chains (*e.g.,* manufacturing, technology or retail) might feel the largest negative impact, more domestically oriented business models, like insurance or utilities, could be less affected. Overall, our view is that higher tariffs reduce the potential for upside in US equity markets *vs.* our base case. While the risk of an economic contraction increases, we do not believe that we will enter a recession in the US. As a result, we do not expect a more extended sell-off in US equites.

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What To Do?

Keep a steady hand and diversify. We recommend staying the course and remaining focused on long-term performance. As markets are likely to remain choppy and returns could be muted for the short to medium term, we believe it is important to address the most pressing risks that prevail today without overreacting to current volatility. To better weather turbulent market conditions, ensure you have a well-diversified portfolio and target a risk level that is consistent with your long-term objectives.

Specific steps to consider, including:

- Incorporating international exposure and trimming existing underweights to developed markets outside of the US.
- Increasing duration in your fixed income portfolio. We believe fixed income will continue to play a diversifying role *vs*. equities, similar to what we have seen over the past few weeks.
- Where appropriate, employing structured notes to provide for asymmetric returns.
- For accredited investors, adding private market investments, such as private equity and private debt, for additional portfolio diversification.

Appendix

1) Revenue split US vs. abroad by sub-asset class (as of 03/04/2025, source Factset, proxied by passive ETFs on those indices)

Revenue share equities

Category		Index / Measure	Value
Large Cap			S&P 500
	out of country		42.9%
Mid Cap			S&P 400 Mid Cap Index
	out of country		25.1%
Small Cap			S&P 600 Small Cap Index
	out of country		22.9%
EM	EM		MSCI Emerging Markets
	US exposure		12.5%
International			MSCI EAFE
	US exposure		19.6%

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Investment and portfolio diversification is generally recommended to reduce the overall volatility of a portfolio, but diversification will not assure a gain or prevent a loss (especially in declining markets). Diversification is generally more effective to reduce volatility when a portfolio includes investments that are uncorrelated or negatively correlated with one another from a performance and investment risk standpoint. Historical correlation of investment performance correlation (or lack thereof) is, by its nature, backwards looking and does not guarantee the correlation (or lack thereof) will continue or remain constant.

Indexes are unmanaged and cannot be invested in directly. Index performance does not include fees and expenses an investor would normally incur when investing in a mutual fund. Diversification and strategic asset allocation do not assure profit or protect against loss in declining markets.

Morgan Stanley Capital International (MSCI) EAFE Index is a benchmark of the performance in major international equity markets as represented by 21 major MSCI indexes from Europe, Australia and Southeast Asia. This international index has been in existence for more than 30 years.
The ICE Bank of America US Treasury Index tracks the performance of US dollar-denominated US government debt securities.

The S&P 500 Index tracks large cap equities in the US and is comprised of 500 constituents.

The S&P 500® Value measures constituents from the S&P 500 that are classified as value stocks based on three factors: the ratios of book value, earnings and sales to price.

The S&P 500® Growth measures constituents from the S&P 500 that are classified as growth stocks based on three factors: sales growth, the ratio of earnings change to price, and momentum.

The S&P 400 Mid Cap Index tracks medium-sized companies and is comprised of the largest 400 companies after the first 500 largest companies.
The S&P 600 Small Cap Index tracks equities and is comprised of the largest 600 companies after the first 900 largest companies.

The MSCI Emerging Markets Index captures large and mid-cap representation across 24 Emerging Markets (EM) countries*. With 1,250 constituents, the index covers approximately 85% of the free float-adjusted market capitalization in each country.

The MSCI EAFE Index is an equity index which captures large and mid-cap representation across 21 Developed Markets countries* around the world, excluding the US and Canada. With 722 constituents, the index covers approximately 85% of the free float-adjusted market capitalization in each country.

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