46 PEAKS
INVESTMENT ADVISORY GROUP

# The Fog of (Trade) War

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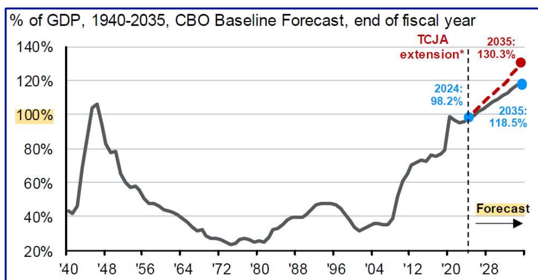
The year began with such **optimism and confidence**. So much, in fact, that our January note cautioned investors to curb their enthusiasm. We warned that 2025 was likely to have its fair share of uncomfortable moments, yet we were cautiously optimistic for a satisfying year.

Well, with 8.5 months still to go before we know how the year will end, we've already had enough uncomfortable volatility to check the box on the core tenet of our outlook for this year. The new administration's commitment to bold policy moves right out of the gates has kept investors around the world on their heels. For many, it's been as disorienting as the fog of war.

As is well known, the White House has embarked on two large-scale campaigns – the cost-focused Department of Government Efficiency **(D.O.G.E)**, and a rewriting of **trade policies**. Ostensibly, both initiatives have the goal of improving the U.S.'s fiscal position – D.O.G.E. by reducing spending and tariffs by increasing revenue.

These are big, complicated issues and policies. First off, let's ask - **Why** does the Administration feel compelled to take such large actions? One of the main reasons is the enormous growth in U.S. debt over the last 20 years, reaching a % of GDP last seen after WW II, as seen here:




During this period, the U.S. has had the largest deficit as a % of GDP of any major country. This was less of a problem when interest rates were near zero, but it is a larger problem now that rates are up sharply. We assume perpetual American superiority, but there have been global superpowers before, all of which ultimately lost that status. In the 1700's, political theorist Adam Ferguson said that any great global power that spends more on debt service than on defense will risk **ceasing to be a great power**. The U.S. **crossed that threshold in 2022**.

While President Trump and Elon Musk are the main faces of the current policies, Americans and investors should know of the new Treasury Secretary, Scott Bessent. He's a long-time Wall Streeter, well respected by people we trust. Mr. Bessent recently said this about the need to act:

*"The easy thing for us would have been to just keep this massive spending going. But it's unsustainable. Could we have kept it going for another 4 years? Yea maybe, but you're risking financial calamity down the road."*

Besides "*Why?*", we may also wonder "***Why so fast?***" For one, the political cycle likely has something to do with it. It's common for Presidents to move boldly and quickly in the first year of any term, but even more so in their second term. If policies require short-term pain, then best to get it out of the way quickly, so things are better before the mid-terms and the next Presidential election campaign.

There's another important reason to move quickly - while most homeowners locked in ultra-low interest rates on 30-year mortgages when rates were between 2-4% a few years ago, unfortunately, our country's financial leaders did not. A colossal mistake. As a result, the U.S. has about **$9.2 Trillion of debt set to mature this year**, at higher rates than currently.

On the spending side of things, Mr. Musk's D.O.G.E. department has been frantically trying to find wasteful spending and/or fraud. It remains to be seen how

successful he will be. A reduction of 10% in the Federal workforce seems quite possible. Beyond staff reductions, the cancellation of contracts with third-party, non-government entities is expected to produce savings as well.

We, of course, sympathize with those who lose their job because of cost cutting. But anyone who has lived through layoffs at a big company will tell you that nearly EVERY organization can trim some fat every now and then. When Mr. Musk bought Twitter (now "X"), he reduced staffing levels from 7,500 to 1,500 – a reduction of about 80%! And Twitter continues to work quite well.

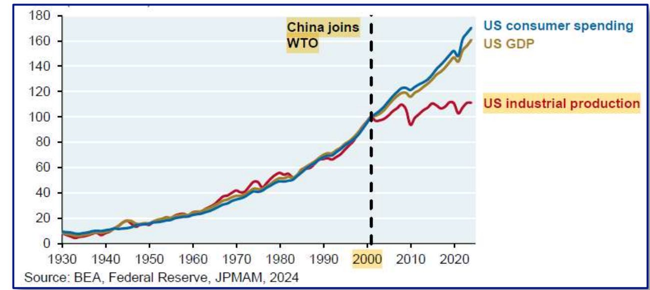
With only three million Federal employees, it will be difficult to move the needle on the U.S. deficit via headcount reductions alone. Much bigger opportunities to reduce spending would be to address fraud or efficiencies in Defense and "Entitlements" (Social Security, Medicare, and Medicaid). Finding just 10% of savings in these areas, since the numbers are so large, would yield $420 billion of annual savings. We're skeptical that D.O.G.E. can achieve its lofty goal of $1 Trillion in savings, but realistic assumptions show it's possible that a productive effort could "save" at least half that. And that's a lot of money.

The other lynchpin of current policy - tariffs – is a much more complex topic. For starters, it's unfair to suggest that we have started a trade war. Consider this list (as of 2024) of our major trading partners that charge lower tariffs on U.S. products than the U.S. charges on theirs:

1.
2.
3.

The list is blank for a reason - it has **zero countries on it**. The U.S. has had some of the lowest tariffs in the world and at the end of last year, every major partner that we trade with had higher tariffs on us than we had on them.

Much of our current trade imbalances can be traced back to China's admission to the World Trade Organization (WTO). This chart showing U.S. industrial production (the red line) going back almost 100 years clearly shows how our domestic industry consistently grew at the same rate as our economy (GDP), but then suddenly stopped growing when China joined the WTO in 2000.

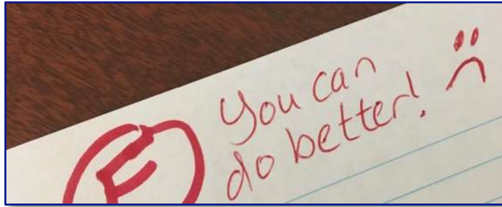



The transfer of much of our manufacturing and industrial production to China (and other countries) has had profound effects on Americans. Yes, many of us have enjoyed much cheaper consumer products – clothes, computers, iPhones, etc. But the % of profits accruing to "Labor" has **dropped from almost 66% to 56%** since China was admitted to the WTO, evidence of a relatively lower share of the economic pie going to blue collar working Americans. Outside of major cities, the **poverty rate has jumped about 30%** since 2000. And the worst consequence that we've seen so far - suicides per capita in America are **up almost 50%** since China joined the WTO.

This topic is not just about China and reshoring U.S. manufacturing. There are, theoretically, many reasons to implement, or threaten to use tariffs:

1. To encourage Made in the U.S.A. manufacturing that creates jobs for Americans.
2. To generate revenue to offset income tax reductions.
3. For national health, defense and safety purposes (e.g. – production of Medicines, Steel, Computer Chips, etc.)
4. To encourage other non-trade goals (e.g. – defense spending and border security.)
5. To obtain reduced tariffs on U.S. products.
6. To decouple economic relations with our adversaries.

Overall, we tend to sympathize with the rationale behind using tariffs as a bargaining tool to seek a more level playing field for trade or to decouple from our adversaries. But to us, the policy announced by the President on April 2nd gets a big fat "**F**". For one, the "tariffs" the Administration claimed other countries are charging us are not really tariffs – the figures are based on a formula of broad trade imbalances. Using this non-tariff formula **seems unserious** and hurts the Administration's credibility. Significantly, the figures are a shocking order of magnitude higher than expected. Also, the quickness with which such large tariffs are being implemented is unfathomable and beyond disruptive; the size and speed will be fatal to some businesses if implemented according to plan.




We continue to hope that much of the tariff policy announced April 2nd is for **negotiating purposes**. If our trade partners come to the table and tariffs for most countries eventually settle in near the announced 10% floor, the global economy and markets will breathe a sigh of relief. Much like the poker player with the biggest stack of chips at the table, the President should be in a strong negotiating position. For one, trade only accounts for 25% of U.S. GDP, the lowest among major countries. Many other countries simply cannot afford to engage in a trade war with the U.S. Thus, it's no surprise that over 50 countries have reached out to the White House to begin negotiations. Several have already offered to end tariffs on U.S. goods. It's early, but this is encouraging.

With all the focus on D.O.G.E and Tariffs, few are paying attention to anything else. Lost in the shuffle is that **the economy started the year in decent shape** – not flying high, but certainly at a comfortable cruising altitude and speed. Some might argue that's irrelevant now, but it's not - there is some cushion in the economy to absorb a shock from these new policies without sliding into a recession.

On the other hand, it's easy to see how the economy will stall quickly if there is prolonged uncertainty. Companies cannot make business decisions – hiring, building new factories, engaging in new strategic partnerships – without a stable rulebook and playing field. And consumers can't make big decisions – to buy a house, a car, or plan a vacation – if they are worried about their jobs.

Other good news lost in the shuffle is that inflation WAS coming down. A third-party (non-Government) measure of inflation that seeks to quantify "true" inflation estimates U.S **inflation UNDER 2.0%.** That would be bullish. But a shrinking labor pool (from tighter immigration policy) and significantly higher tariffs may stop the inflation progress.

On the subject of interest rates, the **Federal Reserve** now finds itself in a precarious position again, worried about battling the two-headed stagflation monster featuring a slowing economy and higher inflation. Markets expect the Fed to cut rates several times this year. Lower interest rates are, of course, a big positive not just for our national debt, but also for homeowners and investors.

Before we address the volatility of early April, we should take stock of some interesting performance developments in the first quarter.

- Non-U.S. stocks were up almost 7% in the first quarter while the S&P 500 fell 4.3%. The **11% quarterly outperformance of non-U.S. stocks was the most in a quarter since 2009.**
- Growth stocks trailed Value stocks in the quarter by 12% - the most since 2001.
- Core Bonds were up 2.8%, outperforming Large Cap Stocks by over 7%.
- The popular Large Cap U.S. Growth stocks (Apple, Google, NVIDIA, Amazon, etc.) known as the Magnificent 7 declined over 15% in aggregate.

So even before the President's big announcement in early April, markets were acting much differently to start the year. After the somewhat uncomfortable first quarter, all eyes turned to the Administration's grand reveal of its official tariff policy with the hope that it would be manageable and stabilizing. Unfortunately, it did not go that way. As we said earlier, we thought the announcement had serious flaws. And so did the rest of the world as **stocks declined 10% in the two trading days** after the April 2nd announcement.

Clearly, we are now in a very fluid situation. Predicting what happens next is impossible - we're not just in unchartered waters, we are in **foggy unchartered waters, with ever-changing winds**. Things can move significantly in the blink of an eye - during the President's tariff announcement, markets rallied over 2% when it looked like the policy would be only a 10% tariff across the board. But just a few minutes later, when significantly higher tariffs were revealed, markets flipped to down 2% – **a reversal of over 4% - in seconds**!

In this kind of environment, where a few spoken words can move trillions of dollars of investment value, it would be foolish to make confident predictions. With that said, we think it's highly likely that:

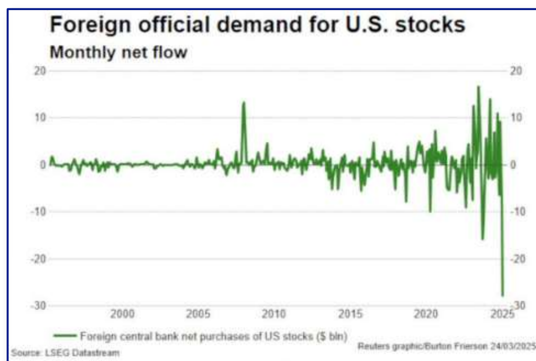
1. **In the short term, volatility will remain elevated**. Perhaps for many months. After a market correction, the bottoming process is often multi-step, resembling a "W" not a "V".

2. If we avoid a recession, and that's a big if, then the bottom may be in for stocks. Or the downside should be limited to one more 5-10% "flush". But don't expect to know the recession answer for months.

3. If we slip into a mild recession later this year, there's likely another 15-20% downside in stocks from here. But it could be more severe.

4. Interest rates may decline in response to economic weakness, but **their long-term floor is likely to be higher**, due to increased global competition for capital.

5. It seems likely that over the next few years foreign capital is likely to flow OUT of the U.S, back to its home countries. This could weaken the U.S. Dollar, increase interest rates and weaken demand for U.S. stocks. This has already started (see chart). Continuation of these flows would be a headwind for U.S. stock performance and a **tailwind for non-U.S. stocks**.




6. Long-term, compared to expectations a few months ago, **stock returns in the U.S. and around the world may be lower**, due to the combination of lower valuations justified in the face of elevated uncertainty, structurally higher interest rates, and potentially lower profits in a higher friction, higher tariff global economy.

7. U.S. firms that are domestically focused (think mid-caps) may do better than those that are more global. The Mag 7 stocks especially, may face challenges.

In times like these, when it's hard to be optimistic, we think it's important to look for **potential positive catalysts**. While a lot can go wrong, a lot can still go right.

1. Many countries may make aggressive concessions on trade policy in the months ahead.

2. Looking beyond trade, the new Administration is keen on potentially **stimulative tax and regulatory policies**.

3. Food prices have been coming down and **oil prices have fallen** to multi-year lows.

4. The market expects the Federal Reserve to cut interest rates this year. While it may be for the wrong reasons (slower growth), lower rates are important support for stock, bond, and real estate valuations.

In addition to these potential catalysts, if you're looking for reasons to be optimistic about the markets, a review of previous episodes shows that corrections like we are currently experiencing are <u>usually</u> (not always) good long-term buying opportunities. This occurs for several reasons.

1. Many sellers in these waterfall-like declines are overleveraged or (systematic) computer generated. Once these forced sellers are done, selling pressure is exhausted.

2. Government institutions - the Fed, Congress, or the Treasury - step in with market calming measures.

3. Markets reach **long-term technical support levels**. In the last 40 years, the Nasdaq 100 index had only two <u>sustained</u> breaks below its 200-week moving average (in 2001 and 2008), and as this chart since 2010 shows, none in the last 15 years.

While these are stressful times, it's **important to maintain perspective**. Through Friday April 4th, the S&P 500 had declined about 17% from its recent high. That is about the **historical average decline for a calendar year** since 1930. So, while faster than average, this year's decline is not atypical. Importantly, the S&P 500 is back to levels last seen about twelve months ago. Conservative portfolios are still up over the past twelve months. Yes, the last few days and weeks have been painful, but focusing on your portfolio's "high water mark" is always a mistake. The fact that most portfolio values are simply **back to where they were a year ago** should help ease the pain. So that brings us to the evergreen question of what should investors do?

Well, **if you want to reduce your stress and increase your chances of long-term investment success**, **do this**: Turn off biased TV. Focus on the long-term (*Do not check your portfolio daily, weekly or even monthly. Try checking it every 3-4 months. Studies show that the more often 401(k) participants check their accounts, the lower their returns.*

*Surprised? Probably not.)* When you do look, focus on the total portfolio and not the most volatile individual pieces. Embrace **cautious optimism**, which over time has usually served investors better than fear and pessimism. Understand the likely downside boundaries of diversified portfolios and make sure your portfolio's risk profile is aligned with your risk tolerance. Don't do anything rash, quick, reactionary, or emotional.

At 46 Peaks, we are not engaging in any knee jerk reactions. Our portfolios are well diversified. We are reviewing our non-U.S. exposures with an eye toward a slight increase. Recently, we moved some U.S. equity exposure from a passive, index-based strategy to an active management strategy that incorporates insider buying as a stock selection tool. And we continue to look for opportunities to play either offense or defense, depending on the fluctuating odds of a recession.

While three months ago we were mildly confident in a satisfactory year-end outcome for stocks, we're admittedly less confident today. There's **simply a much wider range of outcomes now**. The direction of the next 20% move in stocks is likely a 50/50 coin toss. But we remind ourselves and readers that **bonds and alternative strategies can be key contributors to portfolios**, stocks don't always go up, bear markets are part of investing, and diversified, resilient, intelligently designed portfolios can help smooth the bumps and straighten the curves while navigating through even the densest of fog.

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