



MARKETS TURN VOLATILE AMID FEARS OF A GLOBAL TRADE WAR



NICHOLAS P. SARGEN, PHD
Senior Economic Advisor

HIGHLIGHTS

- ▶ The U.S. stock market sold off in the first quarter, and President Trump's April 2 "Liberation Day" announcement has triggered a further selloff in risk assets in the second quarter. The 10% increase in tariffs for all countries and higher duties for those with trade surpluses represents a fundamental shift in U.S. international trade policy.
- ▶ U.S. Treasuries rallied in the first quarter, and Treasury yields declined further after the April 2 announcement, as investors anticipate the U.S. and global economy will weaken. However, Treasury yields remain volatile given uncertainty around U.S. growth and inflation.
- ▶ Faced with this prospect, the bond market expects the Federal Reserve (Fed) will ease monetary policy once economic weakness is confirmed by hard data. However, higher prices associated with tariffs will make it difficult for the Fed to ease policy as quickly as in the past.
- ▶ Amid this, we are positioning investment portfolios with a modest overweight to risk. While valuations have improved, they remain above long-term averages despite elevated uncertainty.

INVESTMENT RETURNS: ECONOMIC WORRIES SUPPLANT "ANIMAL SPIRITS"

The start to Donald Trump's second term as president has been dramatically different from his first term, when the U.S. stock market rose steadily in 2017 in response to tax cuts and deregulation. This time, the S&P 500 Index posted a return of -4% in the first quarter while international markets outperformed the U.S. (see Figure 1).

Figure 1. Investment Returns by Asset Class, 2024 and Q1 2025

Total Returns (%) Stock Market	2024	Q1 2025
U.S. (S&P 500)	25.0	-4.3
NASDAQ	29.6	-10.3
Russell 2000	11.5	-9.5
International (EAFE \$)	4.4	7.0
Emerging Markets (MSCI \$)	8.0	3.0

U.S. Bond Market	2024	Q1 2025
US Aggregate Bond	1.3	2.8
Treasuries	0.6	2.9
IG Credit	2.0	2.4
High Yield	8.2	1.0
JPM EM Debt	6.5	2.2

Source: Bloomberg

Following President Trump's April 2 announcement, the stock selloff continued. The S&P 500 Index has experienced a correction of more than 10% from its peak while the Nasdaq Index has entered bear market territory amid concerns about a global trade war.

Worries about the economy also contributed to a rally in the U.S. bond market in the first quarter, as the 10-year Treasury yield declined by about 60 basis points from its January high. The rally continued after the April 2 announcement as the 10-year Treasury yield fell below the 4.0% threshold.

Looking ahead, the main issue for investors is the impact that President Trump's policies will have on the U.S. and global economy. Sweeping tariff increases and cutbacks in government programs will slow U.S. economic activity and have increased concerns about a possible recession. Normally, this would lessen inflation pressures, but higher tariffs are likely to boost it temporarily.

THE ODDS FOR STAGFLATION AND/OR RECESSION HAVE INCREASED

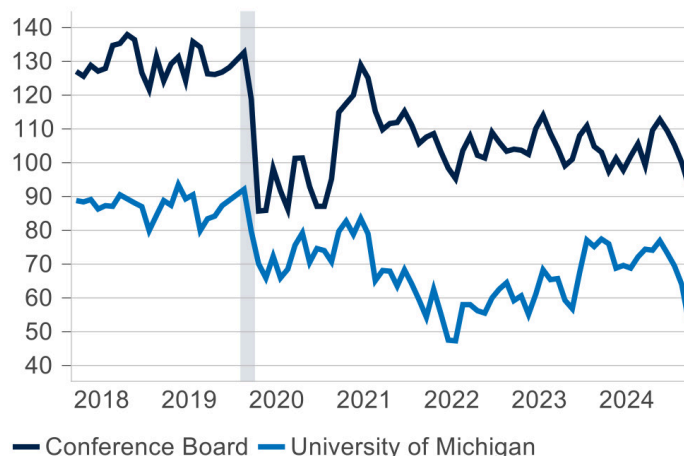
At the start of this year, investors thought that President Trump would follow the same economic playbook that he used in his first term, when the focus was on passing the Tax Cut and Jobs Act and measures to deregulate the economy. Although the president embarked on tariff hikes in 2018, they were mostly directed at China and a truce was reached by the middle of 2019.

This time, the focus of President Trump's policies has shifted to curbing the size of the federal government while also pursuing a more sweeping increase in tariffs against all U.S. trading partners. The speed with which policy changes are being announced and the way they are being implemented has left businesses, households, and investors uncertain about the outcome.

It is too early to discern the impact from economic data, and employment is still solid as reflected in a stronger-than-expected jobs report for March. However, declines in consumer confidence (see Figure 2) and data for retail sales point to a slowing in consumer spending that has been the linchpin of the economic expansion since the onset of the COVID-19 recovery. Business sentiment has also weakened in anticipation of the impact higher tariffs will have on business activity and profit margins.

As a result, forecasts for economic growth are being lowered while inflation expectations have picked up. This suggests that stagflation may be in the offing. Economists have also increased the odds of a recession materializing if the trade war escalates, and financial markets are beginning to price in one following President Trump's April 2 announcement.

Figure 2. Consumer Confidence Has Plummeted

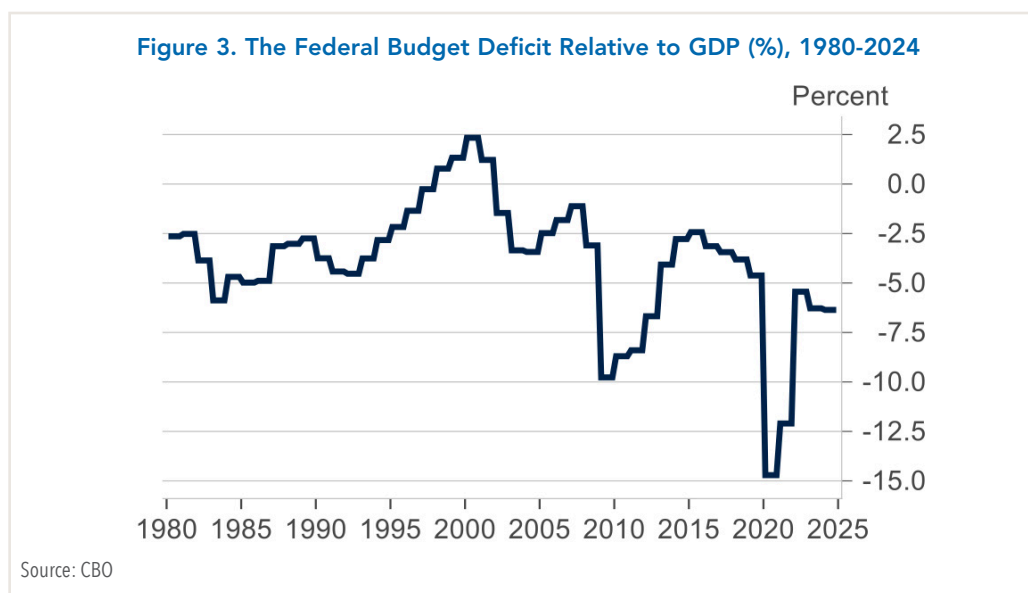


Source: Bloomberg

FISCAL POLICY WILL BE LESS SUPPORTIVE THAN IN PREVIOUS SHOCKS

One of the main concerns of Republicans is that the federal deficit has swelled to unsustainable levels since the COVID-19 pandemic. The federal budget deficit exceeded 6% of GDP in 2024 (see Figure 3), roughly twice the average since the 1980s, even though the economy was at full employment.

Consequently, one of the priorities of the Trump administration is to rein in federal spending, and Congressional Republicans are drafting proposals to lower the deficit in future years. Consequently, fiscal policy is likely to be less supportive than in the 2008 Financial Crisis and the COVID-19 pandemic.



Nonetheless, the prospect for making significant headway on deficit reduction is not encouraging. The biggest challenge is that mandatory programs and interest expense account for well over half of total outlays. With Congressional Republicans targeting spending cuts of about \$2 trillion, they will have to tackle some of the entitlement programs that have proved impregnable thus far. While President Trump has declared that Social Security, Medicare, and Medicaid are off limits, he endorsed the plan of House Republicans that would scale back Medicaid, which totals \$550 billion, or 8 percent of total spending. It could provide a litmus test about whether mandated programs can be modified to meet budget goals.

Beyond this, President Trump created the Department of Government Efficiency (DOGE) led by Elon Musk. When Musk was appointed, he stated that DOGE's mission was to save as much as \$2 trillion per year, but he later cut this estimate in half. Improved government efficiency, however, will not be sufficient to put the federal budget on sound footing, as expenses of federal employees account for only 5% of total spending.

One of the main impediments to deficit reduction is that an extension of the Tax Cut and Jobs Act would reduce federal revenues by an estimated \$4.5 trillion over 10 years. In fact, the plan House Republicans are putting forth would add \$2.8 trillion or more to public debt over the next 10 years, according to the Committee for a Responsible Budget. Passage is likely especially if the economy weakens.

RISK OF A GLOBAL TRADE WAR

The main uncertainty to the outlook is the impact that tariffs President Trump has announced will have on the U.S. and global economy. While market participants initially viewed the threats as a bargaining ploy, the scope and magnitude of the prospective tariff hikes is unprecedented. The initial round of tariff hikes was directed at Canada, Mexico, and China, which are the three largest trading partners of the U.S., accounting for one third of U.S. imports.

In his April 2 “Liberation Day” speech, President Trump announced tariffs would apply to all trading partners of the U.S. The president indicated he would impose a 10% baseline tariff on all imports to the U.S., with higher reciprocal tariffs being applied to countries that have large trade surpluses with the U.S. and are deemed to pursue “unfair” trade practices.

President Trump has stated that the concept of reciprocal tariffs is straightforward. Namely, the U.S. will impose the same tariffs as what countries impose on the U.S., “No more, no less.”

The actual proposals, however, are far from straightforward, and the calculations of reciprocal tariffs were based on the size of a country’s bilateral trade surplus divided by its exports to the U.S. Also, to justify tariffs of 20% on European goods, the Trump administration is claiming the EU’s VAT is discriminatory, even though it applies to all goods, irrespective of whether they are produced in Europe or abroad. While the EU has threatened to retaliate if they are implemented, the White House paused most reciprocal tariffs from rising above the baseline 10% the following week. However, China’s government immediately raised tariffs on U.S. goods, which is resulting in a tit-for-tat escalation of tariffs between the U.S. and China, which was excluded from the reciprocal tariff ‘pause.’

Looking ahead, the risk is that global trade could contract if President Trump follows through on his plans. Fitch economists estimate that the U.S. effective tariff rate has increased to around 20% from 2.4% previously. This would be the steepest increase in tariffs in the post-WWII era and even greater than the Smoot-Hawley tariff during the Great Depression.

HOW WILL THE FEDERAL RESERVE RESPOND?

While the Federal Reserve’s dual mandate is to aim for full employment and price stability, it now faces the added challenge of assessing the impact of a global trade conflict. At the press conference following the March FOMC meeting, Fed Chair Jerome Powell indicated that President Trump’s trade agenda would likely drive up prices, although there was considerable uncertainty about the magnitude of price hikes and whether they would be temporary. He said that while inflation had previously neared the Fed’s goal of 2% inflation, “I do think with the arrival of tariff inflation, further progress may be delayed.”

The economic projections that accompanied the FOMC meeting showed respondents lowered their forecasts of growth in 2025 to 1.7% from 2.1% previously, while they raised projections for core PCE inflation to 2.8% from 2.5%. Despite this, the projection for the federal funds rate was not changed, with the majority of respondents expecting two rate cuts of 25 basis points later this year.

The bottom line is that Fed officials, like market participants, are unsure about how conditions will play out. Therefore, the Fed is likely to stay on hold a while longer but ultimately may feel compelled to lower rates if the economy slows materially and unemployment increases.

However, the Fed may be constrained by lowering rates as quickly as it has in the past, because inflation is likely to increase temporarily due to the tariff increases. The bond market currently is pricing in cuts in the fed funds rate of 125 basis points this year ending the year at 3.0%-3.25%.

POSITIONING INVESTMENT PORTFOLIOS

In balanced portfolios, we favor a modest overweight to equities relative to fixed income. Although equity valuations have improved, they remain elevated compared to long-term averages and offer limited margin of safety despite increased economic risks. Full valuations coupled with increased economic risks support a cautious stance within bond/stock portfolios.

In fixed income, we are positioning portfolios with a slight overweight to credit risk. Credit spreads widened over the quarter but ended the period still tight relative to history. Portfolios are positioned with a high-quality bias and remain focused on compelling bottom-up opportunities given limited relative value prospects across sectors. Interest rates declined during the quarter amid growth concerns and a risk-off tone in markets. We believe the level of longer-maturity interest rates are compelling and anticipate volatility will present opportunities for tactical adjustments.

Within equities, we are maintaining a cautious stance but are selectively finding bottom-up opportunities. Despite recent price declines, valuations are still above long-term averages following a 51% return for the S&P 500 since the beginning of 2023 while earnings growth has been more modest. We are prioritizing high barrier to entry businesses with high returns on capital and maintaining a moderately defensive posture within portfolios.

This has been distributed for informational purposes only and should not be considered as investment advice or a recommendation of any particular security, strategy, or investment product. Opinions expressed in this commentary reflect subjective judgments of the author based on the current market conditions at the time of writing and are subject to change without notice. Information and statistics contained herein have been obtained from sources believed to be reliable but are not guaranteed to be accurate or complete.

©2025 Fort Washington Investment Advisors, Inc.



**Fort Washington
Investment Advisors, Inc.**

A member of Western & Southern Financial Group

▼ **Uncompromised Focus®**