MANAGING UNCERTAINTY

The world has changed since the inauguration of US President Donald Trump barely two months ago. That much is clear. But for investors wondering where to put their money, there is little else that is certain.

More than ever, the outlook for the US and global economy depends on changing government policy in Washington, and its repercussions elsewhere. Markets that welcomed the new Administration with enthusiasm have turned cautious in the face of uncertainty. Market volatility has mirrored policy volatility, US equities dropped sharply from a February peak into mid-March. This week, a relief rally steadied nerves briefly as the Federal Reserve left hopes of further interest rate cuts on the table and reaffirmed its view that the economy came into the year on a solid footing. But by the end of the week, the S&P 500 was little changed and the NASDAQ was down. Bond markets held up well during the week, with the benchmark 10-year US Treasury yields falling roughly 5 basis points during the week, most notably on Wednesday following the FOMC decision and press conference.

The Fed's projections were released this week after its first policy meeting since late January. Federal Reserve Chair Jerome Powell highlighted uncertainty, and "inertia", as one of the reasons why most of the Fed policymakers left their rate projections – the "dot plot" – unchanged. He noted that it was "very very challenging" for the Fed to figure out the likely path for the economy.

Complicating the rates outlook further is that while Fed economists revised down GDP growth, to 1.7% this year, they saw higher inflation than before, with essentially no further progress towards the price stability goal of 2% inflation. Tariff increases were behind the changes, pushing up prices but also increasing uncertainty and inhibiting growth. The two changes would have opposite implications for monetary policy and interest rates, thus arguing for the central bank to wait and see what the data brings.

THE FED NO LONGER THE LEADER

A gradual glide path to a soft landing is no longer the base case for the economy. Major changes underway in government policy, domestic and international, mean that underlying economic developments – on growth, earnings, inflation and employment – are unusually dependent on government decisions. We have grown used to markets and the economy being most sensitive to Fed policy. This week showed that what the Fed does – and says – about monetary policy can still move markets. But government policies on trade, tariffs and eventually taxes and spending will drive economic trends. The Fed is, as Chair Powell said, well positioned to respond. But it is no longer the leader.

In the end, US central bankers left interest rates unchanged this week and most of them projected the same two cuts during 2025 as they foresaw in December. It will be another three months before they revise projections. As Chair Powell indicated, the central bank will be looking hard at the data between now and then on prices and employment.

Looking ahead, the odds still favor US rate cuts this year, even if not quite as many as investors have priced in. The Fed sees current policy as somewhat restrictive. It is comfortable with that as long as unemployment is contained and the labor market remains solid. So far that has been the case. Rate cuts will then depend on what is happening to inflation.

Tariffs will likely push up goods prices. The Fed still worries about inflation and will ignore the President's call this week to cut rates in response to tariffs. But it may be willing to "look through" a rise in prices if this seems a one-off response that is likely to dissipate. Key to the rates decision will be whether inflation expectations stay anchored or if there are signs of prices and wages more generally shifting upwards.

RECESSION IN THE CARDS?

President Trump and Treasury Secretary Scott Bessent surprised this month with their statements about a stock market decline in the wake of tariff announcements. Secretary Bessent noted that a market correction could occur as the economy is rewired to reduce trade deficits. The President went so far as to acknowledge that there could be a "disturbance" in the economy from the imposition of significant tariffs.

The biggest question for investors, as for the Fed policymakers aiming to balance the twin goals of maximum employment and price stability, is where the twists and turns of US trade policy end up. So far, the President has pulled back from significant across-the-board tariffs on Canada and Mexico, two of the US' biggest trading partners, pausing their imposition after just a few days. He has pointed to April 2 as the date that will bring big new tariffs, potentially on all trading partners.

A sustained shift towards protectionism would have a significant impact on business conditions, prices and growth. But whatever happens on April 2 may also be revised or changed, as we have seen.

Even if tariff policies are moderated, uncertainty itself could have a damaging impact on the economy. A pullback in business investment and consumer spending could potentially trigger recession, or at least a sharp slowdown in jobs and growth. The Fed would want to support a weakening labor market with interest rate cuts. But in a world of higher prices because of tariffs, it could be difficult to ease.

Washington decisions on tariffs, taxes, spending and regulation have ripple effects for the global economy as well as the US. This week, the OECD, representing major industrialized economies, downgraded its forecasts for US GDP this year and next. It also forecast slower global growth as a result of trade wars.

Germany has provided a surprising upbeat note. Provoked in part by policy shifts in the US – on tariffs and on Ukraine – the incoming German Chancellor, Friedrich Merz, worked with his outgoing opponent Olaf Scholz to push a significant change in Germany's fiscal policy. The reform to the "debt brake," a key part of Germany's constitution since the euro crisis, will allow more government spending and borrowing, for defense and investment. The loosening of Germany's tight fiscal constraints surprised markets and has led to hopes of faster growth.

REGIME SHIFT?

Uncertainty about US government policy on trade and tariffs has fed into a bigger rethink of global trends. Can US exceptionalism and extraordinary innovation continue to buoy stock markets, or will the apparently cheap markets in Europe and parts of the emerging world finally reward investors? Some believe that the dollar is poised to rise, balancing tariff increases. But it is also possible that changes in US policy towards trade and capital inflows weaken its status as a safe haven. Gold this week reached record levels, briefly touching \$3,057 before ending the week around \$3,020 an ounce.

The President's affinity for tariffs can be seen in the context of a broader approach to the rest of the world. In contrast to the post-World War vision of American leadership within a system of rules, including on trade, that promote both US and global growth, he sees a zero-sum game. In this view, countries that export more goods to the US than they buy are undermining America, weakening US production and taking away good jobs. Tariffs can solve the problem – and raise significant revenues to boot. Most analysis and experience suggest that widespread tariff barriers will instead drive up prices and reduce the competition and innovation that has driven American productivity and made its economy the strongest in the world. They would also tend to strengthen the dollar, which in turn would weaken exports. And to the extent that imports are reduced, projected revenues from tariffs will also decline.

Administration officials admit to some of these contradictions in trade policy. There is, however, a growing interest in providing an intellectual framework for the dramatic shift in trade and currency policy. As outlined in a paper by President Trump's pick for chief economic adviser, Stephen Miran, and referred to by Treasury Secretary Bessent, international agreement on higher tariffs combined with a weaker dollar could reduce the US trade deficit, seen as a burden on the economy.

Others, including the former chief economist of the International Monetary Fund (IMF) and former senior Treasury and Fed officials, are not convinced that a so-called Mar-a-Lago Accord could be successful, especially in the midst of a trade war, or even desirable. As President Trump has also implied, the role of the dollar as a reserve currency– which he supports– confers privilege rather than a burden on the US economy. It encourages investment inflows, boosting growth and productivity and helping to finance government and other borrowing at lower interest rates.

TAXES, SPENDING AND DEREGULATION

Tax changes and spending cuts will be an increasing focus in coming weeks, as Congress puts flesh on the bones of the budget agreement reached last week. The remarkable success of Congressional Republicans in passing an overall budget bill, despite opposition from almost all Democrats, showed the strength of President Trump's political power. This is likely to be exercised again during the detailed negotiations over spending and taxes which will absorb Congress in coming months. Senate Majority Leader Chuck Schumer went along with Republicans this week, to avoid a government shutdown. Upset Democrats will want a more robust challenge to the detailed plans.

Business leaders and financial markets have pinned their hopes on a generous tax bill that preserves and extends the 2017 tax cuts. Paying for that will be difficult, not to mention including President Trump's promised tax relief on tips and on social security benefits. Universities (and non-profits) already suffering from cuts in federal support are right to fear that tax benefits for endowments could come under the microscope. Supporters will likely outweigh detractors. But this is an area that RockCreek will watch carefully.

EQUITIES

This has been a remarkable period of capital rotation within the US equity market. Coming into this year, the last time momentum had been so in vogue was the 1990s. Now, roughly two years' worth of momentum gains have been wiped out in a matter of two weeks. The week of February 17 saw crowded stocks roll over, especially those levered to the AI phenomenon. This was followed the next week by a broader deleveraging across consumer, airlines, and industrial cyclicals. Much of the selling appeared to come from commodity trading advisors (CTAs) and other hedge funds with short-term investment horizons. The large multi-manager platforms were reportedly down in the order of 3% or more, which led them to trigger risk reductions. Institutional and retail investors have not been rushing to buy the dip, but neither have they been stampeding for the exits. Instead, they have been largely trimming to account for greater uncertainty and higher market volatility.

The question now is whether this has been a technical correction or part of a more significant regime change, mirroring the regime change in economic policy. US benchmarks are already in correction territory, down more than 10% from their all-time highs, so the end may be near from that perspective. On the other hand, a larger peak-to-trough, perhaps closer to 20% may be more likely if market conditions ultimately reflect a pronounced US economic slowdown, stagflation, or other such hard landing scenario. One piece of bright news was an apparent stabilization in credit- and debit-card spending in March after falling in January and February. As ever, the US consumer is the bedrock of the US economy.

Tariffs would certainly have a major impact on consumer behavior and corporate earnings. According to analysis by JPMorgan, if the full 25% tariffs on Canada and Mexico and the 20% tariffs on Europe were to go into effect, they would bring forecasted earnings on the S&P 500 down from approximately $265 to $245. The market is clearly not pricing in this scenario, anticipating tariffs will get delayed again or watered down. Even after this recent sell-off, the US is still trading at about 20x forward P/E versus 16-17x historically and analysts are forecasting 10% earnings growth into the foreseeable future. This seems optimistic given current policy uncertainty and a major reason why foreign flows into the US have slowed in favor of Asia and Europe.

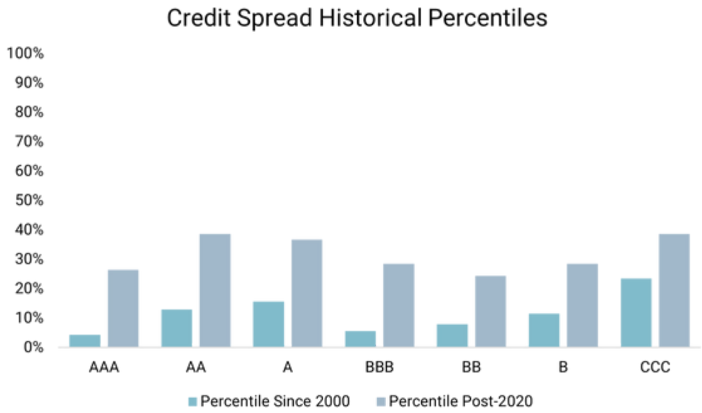
With the US exceptionalism narrative waning, investors are finding Europe and Asia comparatively more attractive. Europe's renewed fiscal spending and resolve to improve its own defenses and China's major technology companies showing competitiveness in the AI race have become new narratives for investors who are looking for alternatives.

FIXED INCOME

In a month of tariff starts and stops, volatile economic data, and even a Federal Reserve meeting, the standout story in fixed income markets is in Continental Europe. Germany's fiscal reforms announced at the beginning of March drove bunds 30bps higher on March 5. That is the biggest single-day yield move for the 10-year German government bond since the completion of German reunification in October 1990. Markets were evidently surprised by the new mood in Berlin. The move higher in nominal rates was accompanied by increases in both German real rates and breakeven inflation, suggesting that markets view the additional fiscal spending as constructive for the economy.

In the US, attention was centered on the Fed meeting, which took place on March 19. Markets had gone from expecting less than two rate cuts for the year at the beginning of 2025 to approximately three going into the meeting. As discussed above, the Fed's newly released Summary of Economic Projections (SEP) showed no change in the median expectation of FOMC members for two cuts by the end of 2025. This, in addition to the Fed decision to slow the pace of quantitative tightening from next month, seemed enough to reassure markets. Immediately after the meeting, US yields from six-months out fell, continuing the rally in bonds since mid-to-late February when the markets began to show concerns over growth. The Bloomberg US Aggregate up 1.1% over that period.

That positive performance for bonds has not been without volatility, particularly in March. Credit spreads have widened from essentially all-time tights earlier this year, although they remain tight to average depending on the lookback window and quality rating. The widening began in the second half of February and continued into March. Investment grade spreads have widened about ten basis points since the end of January on average, while high-yield spreads have backed up by 40-110 basis points, depending on rating. Recent economic, political, and geopolitical developments likely triggered the moves. But their limited nature suggests that credit markets are not overly alarmed.



CURRENCIES

European rates and equities, as mentioned above, were not the only asset classes to exhibit fireworks in the wake of the German fiscal proposals. The Euro strengthened considerably vs the dollar, reflecting both improved growth prospects and the resultant forward rate differential adjustment. This strengthening also brings into sharp relief the dollar's fall from its recent highs.

While the Euro is the biggest weight in the most common broad dollar indices, the British Pound, Japanese Yen, and even Chinese Renminbi, among others, have strengthened against the dollar in recent weeks. The broad reversal suggests the bid for dollars is waning in the current environment, with implications for the attractiveness of international vs domestic assets.

CURRENCIES

Geopolitical developments have also led to re-pricings in various commodity markets. With increased dialogue between the US and Russia on a potential ceasefire in Ukraine, several commodities most acutely affected by the conflict sold off in the latter part of February and into March.

The most common European natural gas contract, TTF, plunged during the month on the back of increased dialogue between Washington and Moscow. Some speculate that Russian gas could begin flowing back to Europe on a more regular basis as soon as the second half of this year, potentially encouraged by a relaxation of US sanctions on Russian LNG exports. WTI and Brent crude have behaved similarly, selling off beginning in late January. More recently, prices for both have lifted off their lows, as progress on a peace deal has slowed.

Outside of the energy complex, agricultural commodities including wheat and corn, two of Ukraine's key exports, are in pronounced price downtrends in reaction to speculation around a peace deal for Ukraine. Gold, as mentioned above, and other precious metals continue to appreciate as a weaker dollar and lower US Treasury yields leave investors searching for more fiat alternatives.