BACK FROM THE BRINK?

President Trump has said that he loves tariffs. He also loves deals. This week, equity markets cheered that the dealmaker triumphed over the tariff-lover – at least for the time being. Analysts are pulling back on their most dire recession predictions. Those who bought on the April dip have seen remarkable gains. Time for investors to relax and celebrate? Not so fast.

Equity markets took off this week after the May 12 announcement that the two biggest economies in the world – the US and China – had reached a deal on trade. Other US markets were slower to celebrate. Fixed income markets were essentially flat this week while the dollar climbed by 0.5%. The S&P 500 was up 5% jump.

Investors in stocks, drilled to "buy the dip" showed little restraint. By the end of this week, the S&P had more than recovered all of the ground lost since the April 2 "Liberation Day." That was when President Trump announced much higher than expected "reciprocal" tariffs on virtually all US trading partners, sending markets into a potentially dangerous tailspin. Bond prices slumped and the dollar weakened. Investor fears were eased somewhat a week later when Treasury Secretary Scott Bessent effectively took over trade negotiations and the President announced a 90-day pause on most of the reciprocal tariffs. But escalation between China and the US had kept markets, and companies, on edge.

The Administration has now shown willingness to compromise or even, some would say, to back down from maximalist positions. In deals with the UK earlier in May and with China this week, actual and planned tariffs have been cut back sharply – for China in the context of another 90-day pause. Is the US back to "Trump 1" policies, as many had expected after the election? During President Trump's first term in office, he levied some tariffs, notably on China. But these were limited and did not do much damage to the economy. Growth remained strong, until hit by Covid, while corporations and higher income earners received sizable tax cuts.

RISK VERSUS UNCERTAINTY

Gauging risk, and deciding how much is worth taking on at current prices, is never an exact science. But in recent weeks, it has been unusually difficult to distinguish between risk and just plain uncertainty. Sudden – and unexplained – policy shifts have been announced that would have major economic impact if left in place. What is signal and what is noise?

Looking at fundamental drivers of earnings and growth should help. But again, policy shifts have complicated the picture. Available "hard" data on jobs, inflation and earnings show a still solid economic performance through April. Some business leaders had warned of a tsunami impact from tariffs, particularly the extraordinarily high rates to be levied on China. "We are on the beach and the water has gone out, but the wave is not yet here" one said. This fit with anecdotal reports of delayed shipments, reduced port activity and fewer trucks crisscrossing the country before the new pause on China tariffs was announced. Major retailers predicted shortages would affect Halloween and Christmas, given the lags involved. But a buildup in inventories in Q1 and moves to build resilience in supply chains together with a rush now beginning in China to produce and export to the American market during the 90-day pause could weaken the tsunami.

WHY TARIFFS MAY STILL HURT

An all-out trade war now seems much less likely than a month ago. That is straightforwardly good news. But it may be too soon for unconditional celebrations. Part of the economic damage projected to come from tariffs reflected estimates of the direct effect on the US economy. As the International Monetary Fund (IMF) and bank analysts rushed to cut 2025 growth projections in April, they explained that tariffs would act like a tax on imports, raising costs and depressing demand. Retaliatory tariffs from other countries would worsen the impact. Instead of growing by 2.8% this year, the IMF estimated the US would only notch up 1.8%. Others were more pessimistic. Recession probabilities ranged from 40% to 60%.

The impact on the real economy of tariffs is not limited to their direct effect. Shifting proposals also heighten uncertainty, making it harder for consumers and businesses to plan. Bill Dudley, former President of the Federal Reserve Bank of New York (FRYBNY) has characterized the current policy uncertainty as “corrosive”.

When financial markets flashed red in early April, the obvious signs of trouble were in fixed income and foreign exchange markets. Instead of providing the usual safe haven, US Treasuries and the US dollar weakened. The drop in the dollar was particularly surprising in light of rising tariffs, or taxes on imports. Tariffs can be seen as equivalent to a partial or one-sided depreciation that makes imports more expensive. Many analysts had expected the dollar to appreciate in response to tariffs against currencies of “tariffed” countries.

When this did not happen, and instead dollar assets weakened, it seemed possible that the Administration’s drastic actions and rhetoric against trade and globalization were signals of a regime shift, away from a global financial system anchored on the US financial markets, Fears of a flight from the dollar, even the end of US exceptionalism, were behind the most gloomy recession forecasts. A sudden regime shift with unloading of dollar assets now seems less likely. But a slower leakage as foreign investors reevaluate could occur over coming years.

Fixed income and foreign exchange markets are still signaling some concerns about the US. The ten-year yield is back up near 4.5%, keeping mortgage rates high. The dollar, which plummeted by 5% in the aftermath of “Liberation Day” has recovered. But it is still 8% below its peak this year on January 13. The price of gold – the safe haven for traditionalist worriers – soared in April. Despite a dip since then, gold is still up by 20% this year. Customers who get gold bars from Costco are now limited to two per purchase.

WHAT IS DRIVING TRADE IMBALANCES?

It is clear that the President would like to reduce America’s long-standing trade deficit. Hence the likelihood that tariffs will remain a feature of White House policy. A base level tariff of 10% on all imports is widely seen as the most likely outcome, but with higher tariffs on imports from some countries – e.g., China – and in some sectors – as with steel, aluminum and autos. Effective tariffs could be as high as 20-30% on average. As economists have argued, import taxes of this size will tend to depress the economy, although the fact that trade in goods is only equivalent to 13% of US GDP means that tariffs are less costly than for other, more open economies.

More fundamentally, the trade deficits that President Trump abhors are a reflection of the fact that American consumption and investment – including by the government – outstrips savings. The US deficit is matched by excess savings in a number of countries, notably China but also Japan and Germany. These countries produce more than they consume and export the surplus. Germany at least is now planning to boost government defense and infrastructure spending. China would like to raise domestic demand and consumption. But it is historically reluctant to use fiscal policy to do this. Relying on monetary policy alone is unlikely to succeed.

THE FISCAL PIECE OF THE PUZZLE

A "big beautiful" budget bill working its way through Congress is likely to leave the US fiscal trajectory worse rather than better. Proposed spending cuts would not match the cost of planned tax cuts. That caused the bill, which was broadly in line with the President's priorities, to hit a snag on Friday. Deficit hawks in the Budget committee joined with Democrats to reject the bill. Work to find a compromise will continue over the weekend. But further spending cuts to please the deficit hawks will upset Republicans in swing districts. Some of the spending reductions – notably to Medicaid and child health support – may prove too painful for the full House and Senate to swallow in the end. Meanwhile, Republicans in high-tax – and swing districts – want to increase deductions for state and local taxes. In short, far from providing a long-term fix to large trade and current account deficits the federal budget is set to boost American spending and borrowing.

EQUITIES

What does all of this mean for equity markets? It's a cliché to say we've been on a roller coaster. We haven't really had the panic-inducing freefall the largest and best coasters provide. The S&P 500 dropped almost 60% and 50%, respectively, during the financial crisis and dot-com bubble crash. This year's drop was fast. But it didn't quite make 20%. So far, riding US equities has been more like riding the Wipeout or the Scrambler, hurled in one direction and then another out of the blue. Corporate earnings were solid this quarter though many companies withheld guidance, electing to not try to predict the next gyration.

The recent announcements of trade deals have lifted benchmarks back to pre-Liberation Day levels. But the performance gap between US and other major markets that opened up in February and March remains in place. The recent US rally was led by riskier, lower-quality assets amid rapid short covering on the part of hedge funds.

As mentioned above, buying the dip proved to be the correct strategy in April. Investors are now asking whether the market has overshot. We still have substantial tariffs in place and a long way to go with bilateral trade talks. Being nimble and ready to adjust your views can be a major advantage. Long-term investors are maintaining exposure to a range of secular trends that are unlikely to end any time soon. They include advancements in AI and robotics, the need to expand and fortify the US power grid while continuing to invest in energy innovation, surging demand in aerospace and defense, investments in supply chain resilience and friend-shoring, and growing healthcare needs for aging populations. Astute investors are taking advantage of this volatility by gaining exposure on bad news days and harvesting profits on good news days. In the longer run, we expect more diversification away from the US into Europe and non-China Asia in equity, bond and FX markets, as well as some of the sectors mentioned above, especially as Europe spends more on infrastructure and its own defense.

Despite all of these gyrations, there are still concerns as to whether we will see signs of a potential thaw in private equity market activity. In April, software company Figma filed to go public – and just this past week, digital bank Chime followed suit. Unlike many of the IPOs over the past six months, both companies have deep venture backing and the scale to deliver meaningful liquidity to long-tenured shareholders. Figma, which Adobe tried to acquire for $20 billion in 2022, before the deal was scrapped in late 2023, was last valued at $12.5 billion in a Series F round that closed mid-2024. Its UK-based peers, Monzo and Revolut, are also rumored to be lining up IPOs in the near term – further suggesting that a long-awaited exit window may finally be reopening. Overall market uncertainty has obviously impacted IPOs more generally.

FIXED INCOME, COMMODITIES, AND CURRENCIES

As mentioned above, following “Liberation Day” neither the US Dollar nor Treasuries provided the traditional risk-off hedge to which investors have grown accustomed over the past several decades. Another traditional risk-off hedge, gold, has performed well over this time. These market moves have driven discussions around a potential structural weakening of USD. This goes hand in hand with the concern over what it will take to attract foreign capital into the country to support the large amount of Treasury issuance needed to fund ongoing fiscal deficits. Indeed, this is perhaps the most cited rationale, along with inflationary pressures caused by tariffs, for a back-up in yields witnessed in the past several weeks.

The degree and breadth of dollar weakness have been notable. Against the Mexican Peso, the dollar has weakened by 8% YTD with about half of that following last month’s trade announcements. The Canadian dollar has also strengthened notably despite weak oil prices and a more accommodative central bank. In Europe, the Swiss Franc and the Euro have appreciated most against the dollar.

The strengthening of the Euro has cleared a path for the ECB to be more accommodative in its monetary policy decisions than it otherwise could be while the Fed’s policy rate is on hold. This has had a positive effect on fixed income, with German and French ten-year yields falling slightly as the US equivalent rose 36bps. The improved sentiment around European growth given expected fiscal support has also boosted credit on the continent. The outperformance of Euro, duration, and corporate credit spreads vs. the US has driven significant outperformance of global bond markets vs. the US since the tariff announcements.

Gold’s outperformance is really an extension of a longer running trend where sovereigns and central banks have sought to diversify their holdings out of USD. Data from the World Gold Council shows stable, elevated demand from Central Banks and other institutions. This structural demand helped set the stage for gold’s recent stellar run, which was exacerbated by fear over both growth and inflation shocks and demand for alternatives to the dollar given the policy uncertainty from this administration.