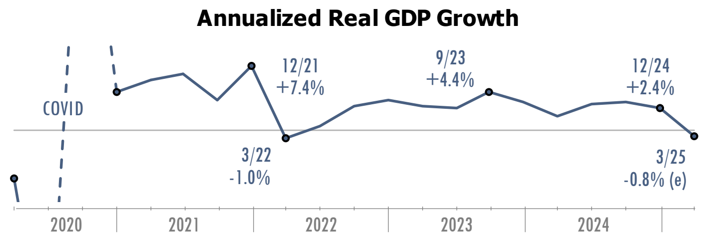
Bellwether CONSULTING

Your Quarterly Update on the Financial Markets
March 31, 2025

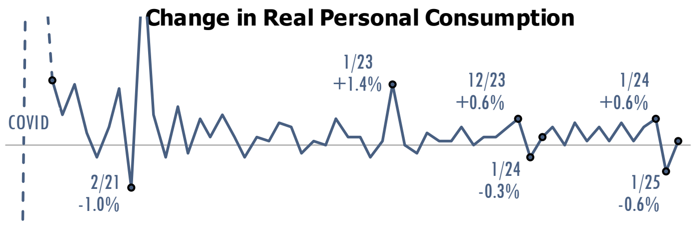
MARKET Recap

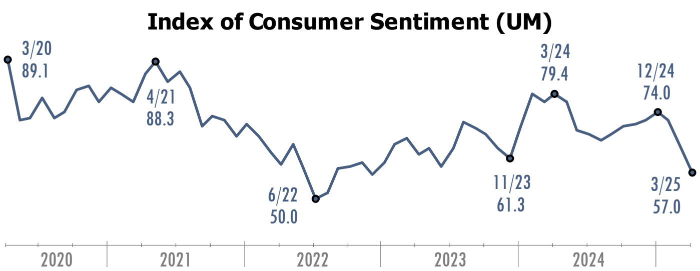
The US Economy: "Sentimental Journey"



Economic growth came in relatively strong for the fourth quarter, buoyed by robust consumer and government spending. Fixed investment and inventories detracted from growth, while imports turned down.

It should be noted that GDP growth is a lagging indicator of economic performance, so the November US election had little impact on Q4 – not so for Q1. A newly belligerent stance on trade, both directly through tariffs and indirectly through posturing, is already moving the markets for goods and services (and more so the financial markets). The Atlanta Fed's nowcast model of Q1 growth shows a contraction of 0.8%, due in part to a surge of imports in January and February as companies fattened their supply chains ahead of tariff implementation. Initially the numbers looked much worse but, as it turns out, a significant portion of the raw data was driven by imports of gold, which does not factor into the GDP calculation.

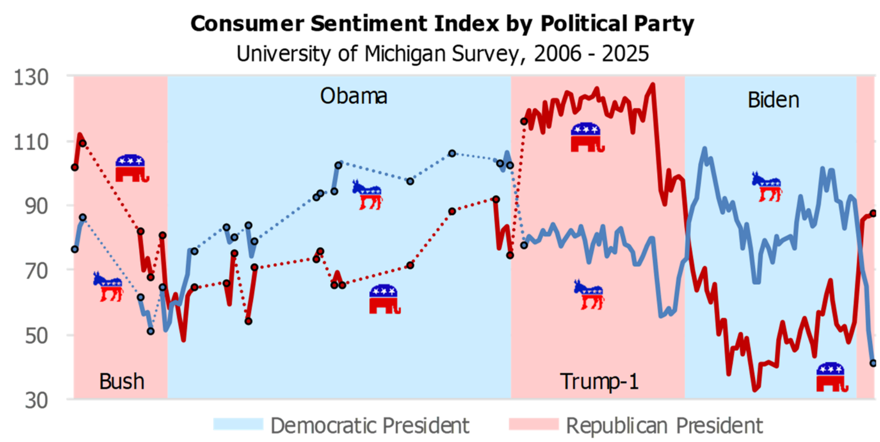




Tariffs carry the specter of stagflation, where an economy experiences both a recession and rising prices due to supply contraction. Early signs of price impacts emerged in the March ISM Report for manufacturing; the price component of the PMI index surged by 7 percentage points, driven by supply chain demand in advance of tariffs. The Administration argues that upward price pressure will subside following an adjustment period. The Fed for its part seems unconvinced, with speakers signaling a slow pace of rate cuts until greater clarity on the forward inflation trend becomes available.

As for the recession half of the equation, it is difficult to envision without a slowdown in consumer spending. Markets were spooked by the January consumer numbers, which declined 0.6% before recovering in February. January slumps are not uncommon, particularly after strong holiday periods. So far, actual data do not support the consumer slowdown argument, but it is very early in the game – and tariff-related price increases have yet to significantly impact consumer prices.

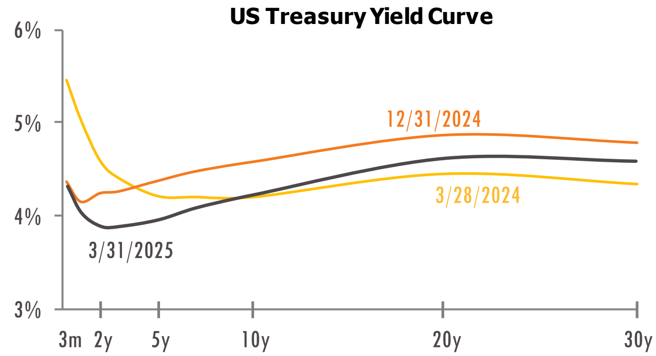
This brings us to the big indicator for the quarter, a sharp decrease in consumer sentiment and expectations. Clearly, people are worried about the impact of the Trump trade policies. The widely-followed Consumer Sentiment Survey conducted monthly by the University of Michigan fell 12% for March and over 30% since the election, challenging levels not seen since 2022 when inflation was at its peak. We should note that consumer sentiment is heavily impacted by the political persuasion of the survey respondent, which UM has measured continuously since 2017 and sporadically for prior periods. But the downturn in sentiment is evident across the board.



Historically, sentiment has not proven to be a reliable direct driver of spending behavior, but it can serve as an early warning sign of recession when the public's perception of economic conditions turns out to be correct and is eventually borne out by laggy "hard" data like inflation and personal consumption expenditures. Consumers, like investors, trade on expectations without waiting for confirmation.

The US Bond Market

The front of the yield curve was unchanged for the quarter as the Federal Open Market Committee ("FOMC") held its overnight target policy rate steady. Near-term Treasury yields (6-12 months) rose 7 basis points as market participants expect more of this wait-and-see mode. However, yields declined further out the curve, by about 40 basis points for intermediate maturities (2-10 years). The extent of FOMC cuts priced into Fed Funds futures increased to 3 cuts of 25 bps each, from just 1 or 2 at year-end. The end of the curve defied the flattening trend, down 24 bps at the 20-year key rate and lower by 19 bps at the far end of the curve, likely representing a renewed inflation-risk premium.



US Bond Index Returns	
Bloomberg Idx	**1Q25**
Aggregate	2.78%
Short Gov't	1.26%
Interm. Gov't	2.48%
Long Gov't	4.67%
TIPS	4.17%
Municipal	-0.22%
Interm. Credit	2.32%
Long Credit	2.47%
High Yield	1.00%
(S&P) Lev. Loan	0.61%
MBS	3.06%

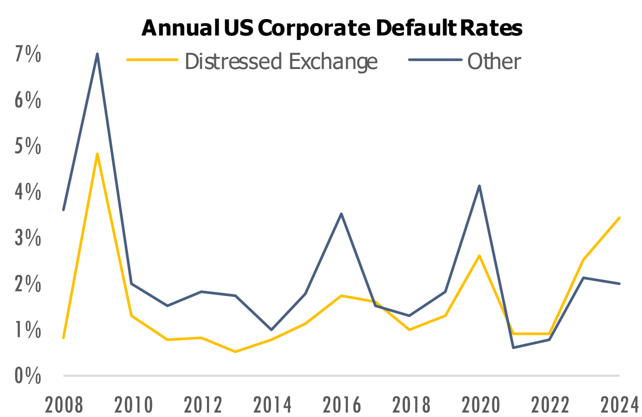
First quarter US bond index returns largely presented a reversal of their fourth quarter numbers as the worst performers of Q4 rotated into Q1 leaders. Yet, the few indices to post positive returns in Q4 (short government, US TIPS, and leveraged loans) managed to stay in positive territory as Treasury yields and yield spreads turned about. Municipal bonds were the only blemish among the major US bond sectors.

Credit spreads widened as talk of recession rose. Single-A corporate credits moved out 12 bps and BBB credits widened by 18 bps. High yield spreads increased by 63 bps. Despite these movements, credit spreads remain tight compared to historical averages and were (briefly) wider just 8 months ago. High yield issuance ramped back up, however, the elevation of some large routine borrowers into investment grade status helped push quarterly issuance to a new record, just over the high set in Q1 of 2024. In February, Royal Caribbean Cruises ($20 bn in outstanding debt) was upgraded to IG by S&P Global Ratings.

High yield issuance is not only attractive because it is in relatively short supply. According to Moody's and S&P Global, high yield debt is likely to experience low default rates through 2025. Moody's projects 3.3% and S&P projects 3.5% this year versus an experienced default rate of 5.1% for 2024. S&P Global cites a resilient economy, sustained corporate earnings growth, and the recent easing of near-term borrowing costs as drivers for lower default rates – all accompanied by a heavy caveat: "S&P Global Ratings believes there is a high degree of unpredictability around policy implementation by the U.S. administration and possible responses--specifically with regard to tariffs--and the potential effect on economies, supply chains, and credit conditions around the world. As a result, our baseline forecasts carry a significant amount of uncertainty."

Moody's general assessment of the roughly 500 significant corporate issuers of US public high yield bonds is that they are capable of weathering near-term challenges. Many have refinanced their debt at low fixed levels since the onset of the pandemic or have access to large, liquid pools of capital. What Moody's does find concerning is the floating rate debt issued by smaller lenders who lack the ability to backstop higher-than-anticipated funding costs, should short-term rates remain north of 4%. Portfolios holding these leveraged loans have generally performed well recently, but cracks are appearing.

Within the health care, media, and natural resources sectors, Moody's sees early warning signs of default in 40-50% of issuers. In what they term a "growth recession," they see smaller loan-financed businesses with cumbersome leverage at risk of default even if the economy continues to grow at a healthy pace. For many of these companies, a traditional default event could be avoided even if their balance sheets deteriorate.



Source: S&P Global Ratings

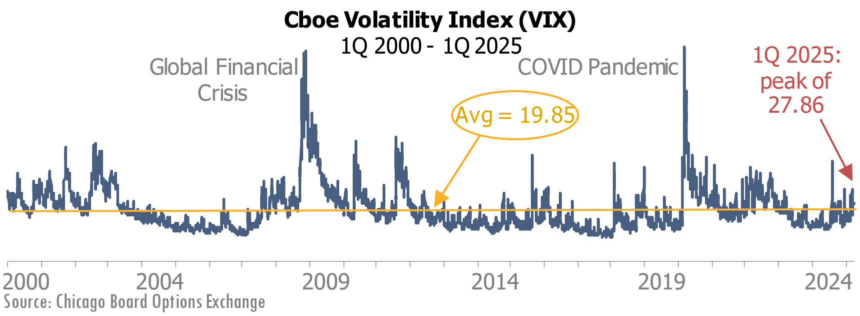
Distressed exchanges have, for the second time, contributed the lion's share of default events, in 2024. The first such occurrence was in 2021, when many creditors were willing to renegotiate their financing terms in order to avoid bankruptcy. Businesses subject to a sudden and unexpected but temporary shuttering were good candidates for this tactic. Creditors accept a relatively small loss in a distressed exchange versus what they would expect to recover in bankruptcy and the negotiations are done out of the courtroom, presenting less cost and burden to both parties. In some cases, creditors may receive equity that ends up more than compensating their losses.

The US Stock Market

The year kicked off with a turbulent quarter as early optimism about potential tax cuts and deregulation was replaced by tariff whiplash and speculation about the possibility of a recession – or even stagflation. Most major benchmark indices posted negative returns. The S&P 500 and Nasdaq marked their largest quarterly declines since the rising rate environment of 2022.

US Stock Indices - Total Returns			
Largecaps	**1Q25**	**Midcaps**	**1Q25**
S&P 500	-4.27%	S&P Midcap 400	-6.10%
Russell 1000	-4.49%	Russell Midcap	-3.40%
Growth	-9.97%	Growth	-7.12%
Value	2.14%	Value	-2.11%
Broad Markets		**Smallcaps**	
S&P 1500	-4.49%	S&P Smallcap 600	-8.93%
Russell 3000	-4.72%	Russell 2000	-9.48%
Growth	-10.00%	Growth	-11.12%
Value	1.64%	Value	-7.74%

A rotation to value started in large caps in January and gained momentum and breadth through Q1, with the Russell 3000 Growth Index ultimately lagging its value counterpart by over 11%. The MSCI USA Defensive Sectors Index returned 6.20% for the quarter. Its cyclical counterpart returned -7.47%. Across the capitalization spectrum, mid-cap indices mostly outpaced their large-cap peers. More impacted by the slower pace of Fed rate cuts, small caps underperformed. Why did midcaps outperform? Investors seemed to be seeking the sweet spot between a highly-concentrated large-cap sector where valuations have soared over recent quarters and the less established and often more volatile small-cap sector. Additionally, with a higher proportion of revenue generated in the US than large-cap peers, midcaps may have been too hard to ignore as a hedge against a likely future tariff environment.

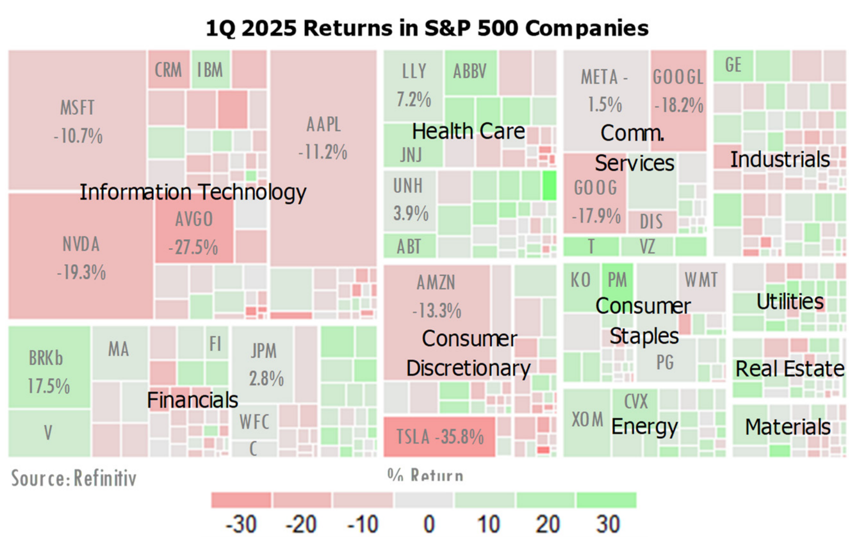


By March, much was being made of increasing market volatility and corresponding VIX levels. Generally attributed to uncertainty created by daily White House announcements, the VIX exceeded its 25-year average for most of March. However, when compared to previous periods, the magnitude seemed to imply that investors were actually taking things more in stride than media coverage suggested.

Dispersion across market sectors remained high at 24%. Returns in the Magnificent 7 were negative, ranging from -1.5% for Meta, which benefitted from an expected AI-supported competitive advantage in digital advertising, to -35.8% for Tesla, which suffered from a decline in deliveries and a Musk backlash. Once again, giants drove performance in their respective sectors and for the broader market. This time, however, their results belied positive returns almost everywhere else. The equal-weighted Roundhill Magnificent Seven ETF returned -15.7% for the quarter.

S&P 500 Sector Components - Total Returns			
Sector	**1Q25**	**Sector**	**1Q25**
Energy	10.21%	Materials	2.81%
Health Care	6.54%	Industrials	-0.19%
Consumer Stpls	5.23%	Comm Services	-6.21%
Utilities	4.94%	Info Tech	-12.65%
Real Estate	3.58%	Consumer Discr	-13.80%
Financials	3.52%		

Energy stocks topped the S&P 500 sectors, profiting from rising natural gas prices and continued impact from geopolitical tensions to the global supply. Additionally, the solid dividends offered by many of the larger names were attractive for investors seeking a safe haven from the beleaguered tech and consumer discretionary sectors. Rebounding from Q4, healthcare was another beneficiary of the rotation to defensive stocks. Last quarter's investor concern over potential regulatory and policy changes under the newly-elected Trump administration was overcome by strong Q4 results, especially in biopharma. Beyond that, CVS Health was the top performer in the S&P 500 overall with a Q1 return of 52.4% on better-than-anticipated Q4 earnings and optimism over its new CEO.



The expectation for Q1 earnings growth in the S&P 500 is 7.3% YoY. This is down from a projection of 11.7% at the beginning of the quarter. Nevertheless, if the 7.3% forecast materializes, it will be the seventh consecutive quarter of YoY growth [FactSet].

International Markets

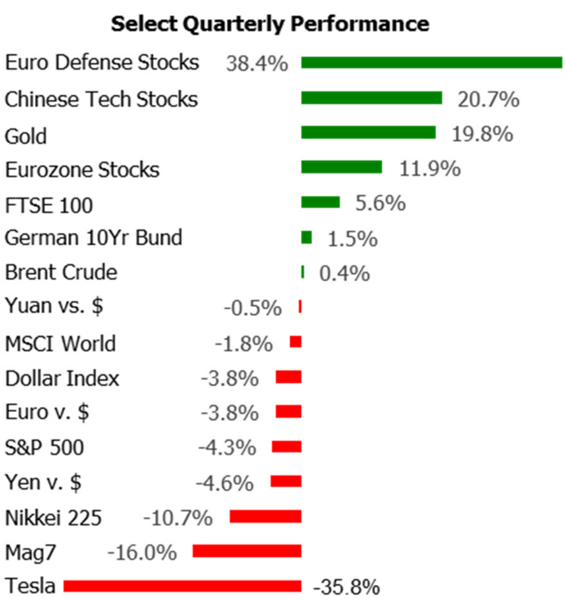
Market volatility was the watchword this quarter as global market performance gyrated with the spectre of tariffs and retaliatory tariffs. World equities ended the quarter down slightly as the Trump trade unwound. European equities surged and yields rose while US equities and yields fell. US tech darlings (Mag7) were hard hit as global investors rotated into European defense names. Gold had its best quarter since 1986 and the US dollar had one of its worst starting quarters since the Global Financial Crisis.

Unhedged Foreign Markets Indices - Total Returns

MSCI Stocks	1Q25	Bloomberg Bonds	1Q25
ACWI ex-US	5.23%	Global Aggregate	2.64%
EAFE (Developed)	6.86%	Pan-Euro	3.53%
Emerging Markets	2.93%	Asian-Pacific	1.35%
Europe	10.48%	Eurodollar	2.25%
Japan	0.34%	Other Currencies	5.69%
China	15.02%		
Latin America	12.70%		

Asia

China reported Q4 GDP growth of 5.4%, outpacing the 4.6% growth in Q3. The economy also showed signs of recovery across some key sectors in 2025. Activity in the manufacturing sector expanded in March at the fastest pace in a year, and manufacturing and non-manufacturing PMI advanced, exceeding February's numbers. Frontloading of Chinese goods purchases before the new wave of tariffs likely helped fuel new orders. There were some domestic incentives to demand too thanks to the government's fiscal support. Faced with the tariff uncertainty, Beijing has been ramping up policy support to build up economic resilience, outlining a plan aimed at further strengthening consumption. The finance ministry said it will issue 500 billion yuan of special treasury bonds this year to recapitalize four of the country's biggest lenders, a move aimed at boosting lending amid weak credit demand. The government's support showed some signs of improvement in consumption. Retail sales accelerated and increased 4% from the same period a year earlier, up from December's 3.7%.



However, there have been ongoing challenges such as low inflation and high unemployment which rose to a two-year high and reached 5.4% in February. The real estate sector, a sore spot in China's economy, continued to struggle. Property investment fell 9.8% YoY. New construction starts dropped by about 30% from the year prior.

A mix of economic data, policy shifts, and external factors led to significant volatility in China's stock market. The year began with a notable downturn, marking the weakest start in nearly a decade. The MSCI China Index dropped by almost 7% in the first two weeks of the year due to concerns over US trade policies and China's economic strategies. By mid-March, the market rebounded, driven by technological advancements, regulatory easing, and equity issuance growth. Chinese tech companies, especially in artificial intelligence and electric vehicles, gained. AI-related Tencent and the emergence of startups like DeepSeek, a homegrown artificial intelligence platform, contributed to renewed optimism. DeepSeek offers cost-effective solutions developed at a fraction of the cost of comparable US platforms. In the electric vehicles industry, BYD proved to be a clear winner.

At the same time, the Chinese government's decision to relax scrutiny on tech firms allowed for a more favorable investment environment. Attracting both domestic and international investors, it lead to a 15.02% advance of the MSCI China Index in the first quarter of 2025.

The Bank of Japan held interest rates steady at 0.5%, in line with expectations, as the central bank considered the potential impact of the US tariffs. The Nikkei 225 closed the quarter in correction territory, down 10.7%. The expected 25% tariff on imported cars has been a headwind for Japan's automobile sector. Mixed economic data, with industrial production exceeding expectations while retail sales came in below forecast, buffeted equity markets. All sectors declined, with sharp losses in the technology, consumer, and industrials sectors. Notable underperformers included Toyota (-9.3%), Disco Corp (-24.1%), and Fast Retailing (-12.0%). The yen strengthened at the quarter close as investor anxiety over tariffs fueled demand for safe-haven assets.

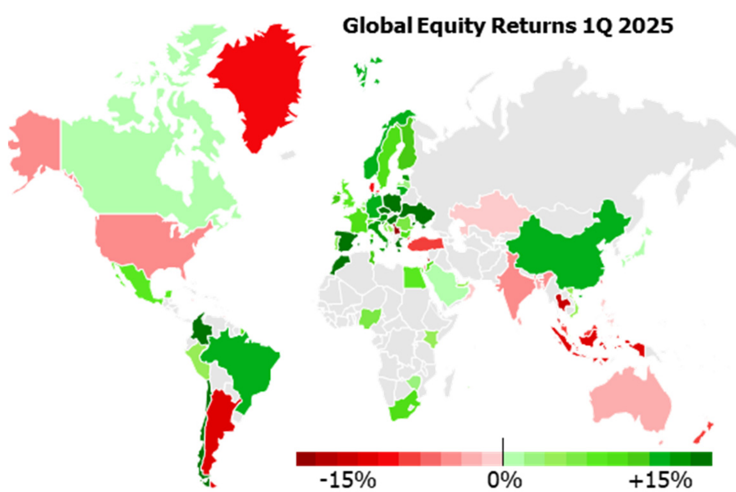
Europe

In early March, the German government announced an overhaul of its fiscal spending plans with three significant changes: creation of a new €500 billion infrastructure investment fund, an exemption from Germany's "debt brake" rule on defense spending above 1% of GDP, and a rise in the net borrowing cap for federal states from 0% to 3.5% of GDP. Financing will come from an large increase in government-backed debt. German and European equity markets responded positively, rallying sharply on the news. However, European and German fixed income markets reacted with less enthusiasm. The 10-year German bond yield ended the week of the announcement 43 bps higher at 2.84% on concerns of the amount of government debt needed to fund the initiative. The 10-year Bund closed the quarter at 2.70%.

European equity markets outperformed, emerging as one of the beneficiaries of uncertain US tariff policies. The MSCI Europe Index outpaced the S&P 500 by nearly 15 percentage points. The rally, which contradicted investor expectations that Trump's "America First" agenda would have a chilling effect on European equities, has investors wondering if this is the start of a lasting rotation or just a flash in the pan. Buyers were initially attracted by the value offered by European equities that were cheap after years of underperformance. But, Germany's fiscal plans lifted the mood around the outlook for the economy and corporate earnings. Big winners have been in the defense sector, with Germany's Rheinmetall seeing significant gains. The stock was up 126.1%, as investors bet that Europe's rearmament will boost earnings. Thyssenkrupp, historically known for steel and industrial manufacturing, rallied 159.2% as investors wagered on infrastructure modernization and potential reconstruction efforts in Ukraine. While many sectors have benefited, historical market drivers like automakers and healthcare companies underperformed.

Headline inflation is forecast to be around 2.2% in March, down from February's reading of 2.3%. Core inflation, which removes volatile components such as food and energy, is expected to have risen by 2.5% YoY, down from 2.6% in February. As inflation moves directionally toward the ECB's 2% target, it helps take pressure off of the bank for additional rate cutting. Economists expect inflation to continue to cool over the coming months. However, ECB President Christine Lagarde warned that US tariffs and a trade war could push inflation higher by up to 0.5% and retaliatory tariffs and supply chain disruptions could lead to higher costs for European consumers and businesses.

In response to signs of deteriorating economic activity and weakening inflation, the ECB cut its deposit rate to 2.5% in early March, the lowest in 2 years. Lagarde kept the door open to additional rate reductions. The ECB also lowered its economic growth forecast for 2025, expecting an expansion of just 0.9%. After the March meeting, Lagarde spoke to the level of uncertainty in the global economy on the eve of a looming trade war with the US, saying that firms are already holding back investments as they look for clarity on Mr. Trump's plans.



Americas

After a great start to the quarter, Canada's equity market struggled with momentum. Initially withstanding the negative impact of US tariff threats on the economy, the S&P/TSX gave up most of its 2025 gains, rising just 1.59% for the quarter after returning -1.90% in March. Only materials, energy, and utilities remained in positive territory. Gold prices reached record highs and supported the materials sector amid heightened geopolitical uncertainty. Broader market weakness reflected investor concerns over global trade uncertainties and the ongoing impact of US policy, particularly tariffs, which continued to weigh on growth expectations for Canadian exporters.

Latin American equities posted mixed results in Q1. The MSCI Latin America Index rose largely due to Brazil's performance. The MSCI Brazil Index gained 15.7%. Brazil's market strength was fueled by rising commodity prices, especially gold, which benefitted the materials sector. Brazil's economy stands at a crossroads, balancing between the headwinds of inflation, high interest rates, serious fiscal concerns, and the tailwinds of a strengthening domestic equity market and a stabilizing currency.

Mexico's MSCI Index gained 10.7% in Q1, supported by the strong performance of the industrials and energy sectors, as global demand for energy resources picked up. While domestic growth slowed, the Mexican market benefitted from its integration with U.S. trade flows and stable foreign investment, making it an attractive destination amidst regional uncertainties. Mexico's government sees its economy growing between 1.5%-2.3% this year, down from a prior estimate of 2.0%-3.0%. The downward revision was attributed to weaker residential investments and supply shocks.

Argentina's MSCI Index posted a significant decline of 12.1%, driven by persistent inflation and economic instability. The country's high debt burden and the challenge of implementing effective fiscal reforms dampened investor sentiment. Despite government efforts to stabilize the economy, political uncertainty and a lack of structural change left the market underperforming compared to regional peers.

Focus On: Mr. Trump Riffs on Tariffs

Tariffs serve as both sword and shield in foreign trade policy. Import duties defend domestic industries from foreign imports and can be wielded offensively to influence the policies of foreign governments. When used well, tariffs underpin a nation's economic security and stability. Or, tariffs can incite a revolutionary war that sets off the crumbling of an empire.

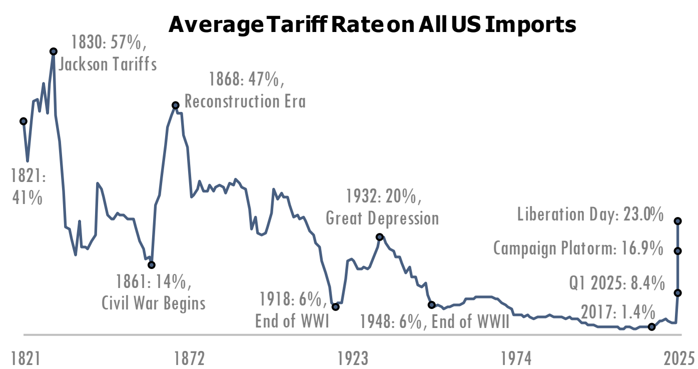
The basic cause and effect of tariffs is straightforward: the federal government collects an additional tax (dollars per unit or a percentage of the sales price) on an imported good or service at the time of purchase. By making imported goods more expensive, tariffs encourage consumers and businesses to shift their purchases to domestic alternatives. This allows domestic producers to charge more and possibly sustain a business that would otherwise close. Tariffs can create or preserve jobs and wealth domestically, improving the economy; however, the resulting price inflation can offset these benefits by subduing demand. Although the purchaser pays the tariff, the seller may choose to absorb some of this added cost by lowering the price they charge. This is unlikely if the seller can attract customers at a higher pre-tax price in other regions.

Tariffs generate both winners and losers. It is a trade-off with a net loss according to classical economic theory. Free trade is efficient, maximizing resource allocation and consumer benefits. When governments impose tariffs, they shield specific domestic industries at the cost of higher consumer prices and reduced product variety. This protective approach distorts market signals and leads to inefficient resource allocation, resulting in deadweight losses that underscore the net economic cost of such policies. Ideally, productive tariff policy finds a way to generate a domestic net benefit by:

- Converting foreign sellers' profit into local government revenue
  - ✓ This may happen if foreign sellers have excessive profit margins and are able and willing to absorb the tax
  - ✗ This often does not happen because the seller shifts sales to another region or sells less at a higher price
  - ✗ Sometimes tariffs make foreign goods non-competitive, so the result is higher prices and zero tax revenue
- Protecting local producers to maintain or grow an industry
  - ✓ For industries sustainable without tariffs after a jump start, providing upward mobility, or strategically critical
  - ✓ Works when the appropriate resources and labor are readily available and cannot be put to better use
  - ✗ Often, the industry is not thriving domestically because the right ingredients for this are constrained

A Return to Original Form

Before the Declaration of Independence, British-imposed tariffs restricted colonial trade to benefit the empire. These measures forced the colonies to rely on British ships and goods, stifling local enterprise and fueling resentment that ignited revolution. After independence, the new nation faced a pressing financial challenge. Alexander Hamilton, the first Secretary of the Treasury, recognized that strategic tariffs would help the United States become self-reliant and sustainable. In 1789, he helped introduce tariffs to raise revenue for the federal government while protecting emerging American industries from overwhelming foreign competition.



As the nation evolved, so did its approach to tariffs. President Jefferson advocated for lower tariffs to support an agrarian economy, where farmers depended on affordable imported goods. He believed in free trade over protectionism, a contrast to Hamilton's economic strategy. Yet, as the country expanded, the desire for stronger protective measures reemerged.

This tension reached a critical turning point under Andrew Jackson's presidency with the Tariff of 1828, derided as the "Tariff of Abominations." Designed to shield burgeoning American manufacturing, the tariff dramatically increased import duties. While this measure acted as a powerful shield for domestic industries, it also served as a sharp sword that cut deeply into regional interests. The high tariffs sparked anger and resentment in the agrarian South, which refused to abide. US tariffs have waned and waxed, but with a decisive downward trend correlated to US economic development and prosperity.

Tariff-ic or Tariff-ying?

The market impacts of tariffs are multifaceted and depend on the coordination (or lack thereof) between government fiscal policy and central bank monetary policy. In the short term, industries receiving protection from tariffs may experience a boost, as reduced competition allows them to increase prices and profits. However, industries reliant on imported materials will face rising costs, squeezing margins and impeding growth. Companies with the pricing power to do so will pass on the higher prices; inflation cascades through the economy, interrupting smooth, prosperous growth.

In the 1800's foreign imports were often luxury goods and tariffs were straightforward. Transportation costs often added more frictional cost than tariffs. Now transportation is comparatively cheap and tariffs can be levied several times over as complicated, interconnected supply chains routinely cross borders. One real-world example depicts a car transmission crossing the US border (with Canada or Mexico) seven times from raw material to finished product and taxed three-fold.

Modern, interconnected, global supply chains complicate the targeting of tariffs, as do retaliatory actions. Trade wars can destabilize global markets, disrupt supply chains, dampen international investment flows, and curtail economic growth. Understanding the implications of tariff policies is crucial but difficult even for expert policymakers and professional money managers. It is not only the consequences of tariffs but uncertainty that grips investor sentiment and spurs market volatility.

Rife with Rifts

Mr. Trump's first term tariffs levied taxes mainly on steel, aluminum, and Chinese goods. The impact was a 1-2 percentage point increase in overall US tariffs. In his second term, the President came ready for more aggressive policy. On inauguration day, Mr. Trump authorized tariffs under the International Emergency Economic Powers Act ("IEEPA") and Section 232.

Detailed actions soon followed. Canada and Mexico were assigned a 25% tariff rate on specific imports before temporary exemptions were granted for auto imports and USMCA-compliant goods until April 2nd. Longstanding exemptions for steel and aluminum were ended and their tariffs raised to 25%. China was hit with an initial 10% tariff on all imports, which was then raised to 20%. Tariffs targeting the European Union were announced, with product-specific tariffs slated for sectors including autos, copper, semiconductors, pharmaceuticals, timber, lumber derivatives, and agricultural products.

These preliminary announcements led up to "Liberation Day" on April 2nd. With pomp and circumstance, Mr. Trump unveiled universal 10% tariffs on all imports and higher rates for many countries. Canada, Mexico, and Afghanistan were a few exceptions to receive harsher treatment, while Russia escaped tariffs entirely. S&P 500 index futures quickly declined roughly 3.5% on the announcement.

The President presented his tariffs so that it seems he is acting with fairness and restraint. "They charge us, we charge them, we charge them less. So how can anybody be upset?" His "discounted reciprocal tariffs" appear to be half the rate imposed on US imports by each partner. Yet, World Bank data shows only 4 instances where the actual weighted rate is 10% or more.

	Tariff Rates on US Exports		"Reciprocal" Tariff
Country	Actual	Claimed	on US Imports
Malawi	18%	34%	17%
Haiti	14%	10%	10%
Zimbabwe	13%	35%	18%
Bangladesh	11%	74%	37%
...	World Bank	White House	
Vietnam	5%	90%	46%
India	3%	52%	26%
China	3%	67%	34%
Singapore	0%	10%	10%

What Mr. Trump misrepresented as "tariffs charged to the USA" is the ratio of US trade deficit to US imports for that country (floored at 10%), not their tariff rate. In essence, he oddly treats the entire trade deficit as a foreign tariff. Actual tariff rates don't sell the story that foreign trade partners are to blame for the trade deficits.

According to the World Bank, Vietnam charges an effective tax rate of 5% on imports from the US but Mr. Trump claims the rate is 90% based on US exports of $11.7 bn to Vietnam and $124.8 bn of imports from Vietnam. A 90% tax on Vietnam would recapture the trade deficit via tax revenue if imports were static and absorbed entirely by foreign sellers. Neither assumption is valid – imports will plummet and taxes will be paid mostly by US consumers.

The administration intends to boost federal revenue, protect domestic production, and enhance its negotiating position in trade talks. However, Mr. Trump will have to pick and choose between political sword and economic shield in each battle. To be effective generators of tax revenue and domestic production, tariffs must be predictably adamant. To be effective negotiating chips, tariffs must be flexible. Regardless of the tack, deploying tariffs carries a cost. Early models forecast pre-April tariffs (8.4%) to drop US economic output 0.4%, and 0.3% more for announced retaliatory tariffs [Tax Foundation].

Tariff Skirmishes

The sweeping US tariffs have sparked a trade war with retaliatory actions targeting Mr. Trump's political support in red states. Canada imposed 25% tariffs on $108 bn of US exports in March. The European Union announced tariffs to take effect in April on $28 bn of iconic American goods, from Harley Davidson motorcycles to blue jeans and bourbon. China initially marked $14 bn in US exports for tariffs of 10% to 15%, then added many US agricultural exports to the list. In response to Liberation Day, China reciprocated with a matching 34% tariff on all US imports.

Investors were already sensitive to every new inflation number printed and to every tremor in the geopolitical landscape. An extended trade war will compound inflationary pressures, and may prompt the Fed to adjust its stance on interest rates.

Central banks were already in a precarious position to balance the risks of inflation and unemployment. Now, as they globally cite disruptions in international trade as a major risk for their economies, monetary policy decisions have become increasingly cautious and tenuous. Mr. Trump has prioritized reducing the trade deficit over these economic concerns.

The Economics of Trade Deficits

Trade deficits and tariffs are not the same thing; the latter is just one small factor. Exports and imports are ruled by relative production costs, exchange rates, relative savings rates, the vagaries of consumer preferences, and investment flows more than tariffs. US goods tend to be less competitive because of issues such as high costs of labor and US dollar strength. These are as much results of domestic policies as actions by foreign governments.

Trade Partner	US Trade Deficit $ Billions	% Total
China	$ 270	51%
Mexico	$ 157	20%
Vietnam	$ 113	83%
Germany	$ 76	35%
Japan	$ 63	30%
South Korea	$ 60	33%
Canada	$ 55	8%
India	$ 42	35%

Trade Partner	US Trade Surplus $ Billions	% Total
Netherlands	$ 51	44%
Hong Kong	$ 21	70%
Australia	$ 18	38%
UK	$ 10	8%
Brazil	$ 7	8%

However, campaigning for lower pay and a weaker dollar doesn't win many votes. Tariffs will push US residents to purchase domestic goods, but won't encourage anyone outside the US to do so. Many retailers abroad have pulled US goods from their shelves in outrage.

Trade deficits are analogous to consumer loans or credit card spending. The US finances a net deficit in trade with foreign capital. When the cost of this capital is low, US businesses can benefit from cheap financial leverage and consumers can enjoy greater rates of consumption. The US, in particular, attracts massive foreign investment in its financial markets.

Commodity-exporting countries, and EM countries in general, tend to run trade surpluses. Reducing the trade deficit weakens the US politically by shrinking the carrot of US demand for foreign exports (and the base on which import taxes are assessed). Mr. Trump's trade agenda is littered with inconvenient contradictions. The White House projects tariff revenue of $700 bn/yr; this assumes no drop in imports, but Mr. Trump assumes huge declines.

Rational use of tariffs as a shield requires strategic targeting of vital domestic industries, but few such industries depend on tariffs to survive. Most sectors are economically viable on their own or protected by regulatory barriers. Sugar tariffs and government-subsidized minimum prices have existed for decades, though motivated more by politics than genuine strategic need. While preserving American jobs seems purely positive, over-romanticizing honest labor can hinder modernization that improves quality of life and has elevated the US economy to its enviable leading position.

Jobs are good, but some are much better than others. If we could seamlessly relocate mega-factories from emerging market economies to the US, who would fill these low-paid, straining jobs? Where could we locate them so no one minds the pollution? How would these jobs instill the skills needed for upward mobility? The economic impact of these trade wars is unclear because the rationale for them is unclear. What is not difficult to discern is the direction the stock market is heading.

We Have Met the Enemy and They are Us

Upon closer inspection, tariffs are a double-edged sword and an imbalanced shield, dangerous both to wielder and target, providing at best incomplete and imprecise protection. As in warfare, the scale and speed of impacts have risen dramatically. Tariffs once nurtured infant industries, bolstered national security, and provided vital tax revenue. In developed markets, their effectiveness today is limited by complex, interdependent, global supply chains and service-centered economies.

Populist leaders need broad support to survive and thrive. However, tariffs and other restrictive trade policies in fact pit Americans against Americans – consumers at large against special interests, primarily labor and business groups in obsolescing or less competitive industries. The Administration appears to be trying to recast trade as a conflict between the US and foreign powers.

Conflict between US consumers and special interests is inevitable and centuries old. Whether high labor cost is good or bad is a matter of opinion, an issue which should be subject to civil debate in a functioning political system. Policymakers can work to responsibly mediate competing interests by building coalitions to serve the broader public good. But it is much easier to casually invoke foreign adversaries as boogeymen to justify regressive and isolationist policies.

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