

Market Note:

In a continuation of last week, U.S. financial market sentiment has continued to weaken, largely due to the headline news about the administration's tariff policy, and uncertainty about possible side effects, although there are some other factors.

Stocks have fared poorly so far again this week, as the deadline for the tariffs on Canada and Mexico was reached, which was a disappointment to investors hoping for a further extension or deal in the meantime. Specifically, this week sprung a 25% tariff rate for all imported goods from Canada and Mexico (the exception being 10% on Canadian energy), with an additional 10% rate imposed on China (bringing the total to 20%). All three of these nations applied retaliatory sanctions on the U.S., as would be expected, with China imposing a 10-15% tariff rate on U.S. exports that included chicken, cotton, wheat, and soybeans. (Part of China's explicit retaliatory policy has been targeting the economies of U.S. 'red states' that represent the base of the President's support.)

As we've discussed before, much of the confusion about these tariffs is how serious (or not) the policy might be, and if it's merely a negotiation tactic to elicit further concessions, such as for national security/narcotics (Mexico) or fairer trade terms (Canada and China). Or, if this represents the beginning of a more McKinley-like foreign trade policy of the late 1890s-early 1900s that featured tariffs as a tool to wield foreign power and raise revenue (the U.S. Federal income tax wasn't added until 1913). While the administration has mentioned the appeal of tariff revenue to supplement and perhaps replace portions of revenue earned from income taxes, to better reduce fiscal deficits, the amount of expected tariff revenue earned would be far too small to make a dent. In fact, if tariffs were raised high enough to make more of a revenue impact, the economic damage caused by higher prices, business disruption, and reduced economic activity is assumed to more than offset any benefits, bringing the argument full circle. That is perhaps why financial markets haven't taken the tariff threats as seriously as they normally would.

What is the worry about tariffs specifically? The immediate concern is higher prices, which could take the form of a one-time price level spike, which is indistinguishable to many consumers from ongoing inflation. As companies import goods to which tariffs apply, they have the choices of absorbing the cost (which would damage profit margins) or pass it on to consumers (that many companies have noted they're inclined to do, at least per comments in many recent Q4 earnings calls when asked). Because of this effective transfer, economists argue that foreign governments/companies wouldn't be the ones bearing the brunt of most negative tariff impacts as implied by politicians—it would be U.S. consumers. On the other hand, selected U.S. companies shielded from foreign competition could benefit to some extent from specific tariffs, in the examples of automakers and metals processors, among others, although supply chain dynamics become a lot more complicated. (A typical U.S.-manufactured vehicle and/or its parts allegedly moves back-and-forth several times across the Canada or Mexico border for a portion of the factory process to happen before completion. How tariffs help or hurt in that case is very unclear.) The administration has also noted the goal of 're-shoring' more manufacturing activities from abroad back to the U.S., for national security, supply chain logistics, and competitive purposes, but this is not immediately possible in most cases. China's rise as a goods producer to the world ramped up around the time of their entry to the World Trade Organization in 2001, and has progressed upward since, with a hiccup around the pandemic. Not only changing supply chains but building manufacturing facilities is a multi-year effort. This becomes even more complicated in the high-tech area where semiconductor chips have become increasingly complicated and much of global strategic and military competition is oriented.

Although tariffs are the most headline-worthy reason for recent market volatility, side effects have also soured sentiment, seen in rising inflation expectations, and continued pessimism in consumer sentiment surveys. The latter are seen as a threat to the personal consumption-driven economic growth of the last few years. Firms such as Walmart noted this pessimism as a potential threat in a recent earnings call. While that represents a 'softer' behavioral form of economic data, a shift from carefree spending to non-spending can spiral into a decline in economic growth, that can lead to recession if it were to continue long enough. Also, hopes for a near-term resolution of the Ukraine-Russia war have turned less positive after the recent White House visit, in addition to what appear to be U.S. equity markets that have been described by some as 'priced for perfection' in some sectors. That vulnerability was brought to light after the Chinese DeepSeek artificial intelligence announcement raised

questions about the viability and productivity of immense spending on U.S. AI software, hardware, data facilities, and infrastructure.

Following the recent weeks of negative U.S. equity sentiment, the S&P 500 is down roughly -7%, approaching correction territory (usually defined as a drop of around -10%), and erasing gains since the election. From a technical side, current index prices have also fallen to just above their 200-day moving average, which has long been used as an indicator of the market's trend direction. The AAll Individual Investor survey turned bearish, in fact, by three standard deviations, to within the top 10 most bearish readings since it began in 1987.

This also makes the Federal Reserve's job especially challenging. Inflation numbers remaining elevated compel a continued hawkish stance, while a slowing economy and labor market could push the FOMC toward further easing. As it stands, an assumed one cut in 2025 a few weeks ago has grown to a weighted average of three cuts currently.

We know inherently that corrections are a natural part of the equity investment cycle. We know that another correction is inevitable, but we just don't know when, and what the catalyst will be. It could be a false alarm again, which could be hinged on any given day's tariff announcement. For investors, that's not much consolation, of course. We are always on 'borrowed time' in a sense, with the last official -10% drop having occurred in the summer of 2023, and the last more severe decline of -25% taking most of 2022 to unfold. Per historical precedent, -10% corrections have tended to occur once every 1-3 years since the 1945 end of World War II. In environments where stock earnings growth remains positive, these can be seen as a 'pause that refreshes,' with forward-looking returns over the next 1-2 years historically positive. In the more severe case, say a -20% drawdown that has often coincided with a change in the business cycle historically (every 6-7 years), such a point has actually been a productive time to deploy risk assets, based on future returns from that point. As an indicator of retail sentiment, extremely bearish AAll sentiment readings have tended to be bullish for stock market recoveries—tied to above-average forward 12-month returns. Of course, that is based on history, and the future could always be unique.

One last irony is that foreign stocks (represented by the MSCI EAFE Index as well as Chinese equities) have sharply outperformed U.S. stocks year-to-date. Despite no shortage of political and economic concerns abroad, lower valuations, easing central banks, and perhaps some signs of 'maximum pessimism' have reached a point of capitulation. This has certainly lessened the negative impact on those utilizing diversified global asset allocation portfolios.

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Sources: Capital Group, CME Group, Morningstar, FocusPoint Solutions calculations.

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