To subscribe to our Newsletters, please send an email to info@palos.ca with subject line "Newsletter"

PALOS

The Palos Perspective

Issue No. 11 | March 14, 2025

CONTENTS

From Euphoria to Recession Fears Within a Month 1
Disclaimer & Contacts 6

A Macro Market View by Hubert Marleau

From Euphoria to Recession Fears Within a Month

Last week, I ended my note to readers saying: "With almost every company reporting, earnings for the S&P 500 in Q4/25 have risen by a fat 18% year-over-year, increased revenues having accounted for 5% of the increase, while fatter profit margins accounted for 13%. There is no way this can be repeated if tariffs are actually fully implemented; and the standard measure of retail investor sentiment, the AAII Survey, has undergone a remarkable crash as a result. Whether the tariffs are tactical negotiation tools or strategic priorities, earnings may not be able to save the day as they have, leaving the nightmare behind us. Unfortunately, some of the damage has already been wrought, because the prospect of recession is the all-consuming talk on Wall Street, reducing reliance on the "Trump put". In this connection, the Polymarket probability of a U.S. recession in 2025 is now a troublesome 38%, making the probability of particular concern, given that the debt burden is large and the fiscal deficit huge. In other words, if the Administration cannot get spending under control or derive revenues from duties on imported goods, it may become difficult to deliver its promised corporate tax cuts. As a result of all this, a lot of money is leaving town for alternatives abroad, especially Europe and - yes - even Canada; an outflow that could get worse because a significant negative effect looms if the trade war were to persist. What does that tell you? It may be the untold reason why Yardeni Research has raised its subjective odds of what-could-go-wrong for the economy and the stock market from 20% to a startling 35%, simultaneously reducing the likelihood of a melt-up scenario from 25% to 10%."

Trump Confirms the Possibility of Recession:

On March 9, President Trump revealed on Fox News that he refused to rule out the U.S. entering a recession in 2025. He said: "There will be a period of transition, because what we are doing is very big." I think he came up with this line, having sensed that equities had failed to respond favourably

to tariff delays; but the argument continues to hold. He told Bartiromo on Fox: "What I have to do is build a strong country. You can't really watch the stock market," thereby saying for the first time, with a straight face, that his objectives were going to cause pain.

All of sudden, there was no more confusion about the implementation of tariffs, which would be: 1) a permanent weapon to force companies to produce in the U.S., especially goods that he views as essential to national security like steel, aluminum, pharmaceuticals and semiconductors; and 2) that his tariffs would extend globally, in an effort to fix the U.S. trade deficit.

In this connection, the NY Fed's Survey of Consumer Expectations pointed to inflation a year from now being at 3.1%, while unemployment, delinquency, and credit access were bound to deteriorate notably. Additionally, the word "uncertainty" came up no less than 47 times in the Federal Reserve's latest Beige Book, which gathers evidence on economic conditions around the country - about 3 times as often as it mentioned in January. Meanwhile, the NFIB Survey of Small Business Owners includes its own uncertainty index, which has rebounded to a near record high, reflecting a near-term drop in capital spending plans. Interestingly, the soft data has not only undercut sentiment, but has started to affect the performance of monetary and financial data, in which the velocity of money has declined, while corporate spreads - corporate bond yields less Treasury yields - have widened, suggesting that the economic train might be veering off the tracks.

What intrigues me here is that the US budget deficit for the first 5 months of fiscal 2025 hit a record $1.147 trillion, making it very disconcerting to see outlays continue to outstrip revenues. This should not happen when the economy is expanding; but according to the WSJ, Americans of all income levels are cutting back on pretty much every type of purchase, including necessities Consumer sentiment nosedived to a 29-month low.

All of this was enough to change the outlook: BCA Research concluded that policy uncertainty engendered by DOGE, coupled with tariffs would provide the nudge to tip the economy into recession; Yardeni Research did not rule out that the odds of a recession had increased conspicously; while Goldman Sachs downgraded its forecast for economic growth below blue-chip consensus

A Macro Market View by Hubert Marleau

because trade policy assumptions were adverse. For its part, Morgan Stanley trimmed expectations for economic growth with Bruce Kasia, JPMorgan's chief global economist, asserting a 40% probability that a recession would take place this year and could potentially exceed 50%, if reciprocal tariffs were imposed in April.

Meanwhile, the hand-wringing by the NowCasting model of the Atlanta Fed over the current quarter's growth at -2.4% is certainly exaggerated; however, the fact remains that growth will take a beating, and the Q1 forecast growth range is wide. Economists at Capital Economics, who are among the most pessimistic, are predicting a -1.9% rate while the more optimistic ones at Nomura see a positive 1.1%. The Economic Outlook Group, however, gave a 60% chance of recession, in which a poll by Chief Executive magazine showed the C-suite's outlook for the next 12 months is now the worst since 2012, with fully half its respondents expecting a recession or a material slowdown.

This shift in sentiment has priced the idea of a "hard landing" at the same odds as "no landing" just a few weeks ago. The reality is setting in that if the US is going to do everything on its own while the rest of the world does not, the relative cost of production will tilt away and things will be a lot more expensive. This is compounded by the fact that corporate earnings will also be hurt pro rata - so much so that GS predicts that per-share earnings among companies in the S&P 500 could drop by roughly 1% to 2% for every 5-percentage-point increase in the U.S. tariff rate.

Unsurprisingly, investors were in a very bad mood as a result for three reasons. First, the strike price on the "Trump Put" had turned out to be much lower than originally thought and perhaps even below the 200-day moving average. Second, the "Fed Put" was not likely to bail out investors until next June, while they waited for evidence that a downturn was certain. Third, the "C-suite Put", in the form of share buybacks, was now difficult to envisage, given that the whole idea behind the tariff policy was to encourage business to reshore and build infrastructures. Accordingly, the stock market was stuck in an ominous pattern and couldn't figure out how it was going to get out of its rut, thereby brutally removing the shine from American exceptionalism.

A Macro Market View by Hubert Marleau

What Is Going On Now:

Given the prevailing narrative of unsettling uncertainty, stock traders have pushed the stock market into correction territory, discounting a scenario of a pull-back on consumer spending and business reluctance to invest. On Monday, the S&P 500 fell savagely; on Tuesday, it edged closer to correction; on Wednesday, in the wake of the BLS release, which showed both headline and core CPI had increased only 0.2% m/m, the news was sufficient to stop the stock market carnage and generate a 0.6% rise; but on Thursday, inflationary and growth worries resumed, amid escalating tariff concerns over alcohol, demonstrating that investors had not put much weight on Wednesday's inflation report. Stocks swooned 1.4%, as a result, putting the S&P 500 in correction. Only on Friday was the market up, as it normally is after brutal attacks.

Time to Load Up on Stocks? Perhaps

We could see a period where hypothetical sharp rallies get sold. Trump has an unchallenged liquidation approach to the economy - a laissez-faire notion to leave things alone, allowing damage to the economy early on to make things better later with little upside for investors. Yet there are three good reasons why this potential nightmare may not occur any time soon, even though there is little hope that the S&P 500 will return quickly to its record high of 6144. For example, Goldman Sachs and Yardeni Research have reduced their 2025 targets for the benchmark to 6350 and 6400 respectively. A few weeks ago, I also reduced my own target to 6300 from 7000.

First, the CBOE Volatility Index, known as Wall Street's Fear Gauge and CNN's sentiment indicator viewed from a contrarian perspective are both signalling buy flashers, and are essentially bullish when they both show extreme fear; while the Skew Index, a measure of where the tail risk sits, has declined of late.

Second, the Fed can't put off dealing with what the levies mean for monetary policy much longer. Expectation is rising at an alarming speed, such that it will have to deliver very soon the first set of rapid-fire reductions in its policy rate. Moreover, the Administration will likely start to promote its

much-anticipated tax package very soon: the November 2026 midterms elections are already looming.

Third, corrections are uncommon, and they don't last all that long. Paul La Monica cited some important context in the Barron: “Fortunately market corrections are usually a short term event, occurring an average of once a year and lasting 3 to 4 months.” He went on to say that the average loss during a correction is 13% and, historically, that loss is recovered over a period of about 4 months. Indeed, if one counts one year from the start of the last 15 corrections, the S&P 500 has been up 13 times, and has seen an average gain of 15.3%, according to Dow Jones Market Data.

Fourth, at the Yale CEO Caucus, there was universal revulsion against Trump economic policies, with particular horror expressed over Canada, to the point where I strongly suspect that the C-suite will rebel. How business leaders talk about the Trump administration in private has been markedly different than what they are game to say in public.

Fifth, Congress may be to do whatever it takes to force the government to pivot away from reckless policies that could leave the U.S. on its own.

This is a correction, not a bear market. If my S&P 500 target of 6300 proves right, it will be 12.0% higher in one-year’s time.

Disclaimer:

This publication is proprietary to Palos Management Inc. (along with its affiliate Palos Wealth Management Inc., “Palos”) and no part or its contents may be copied, downloaded, stored in a retrieval system, further transmitted, reproduced, disseminated, and/or transferred, in any form or by any means without permission from Palos. The views and opinions expressed herein are solely those of the author(s) and do not constitute investment advice, and they should not be relied upon on as such. The information has been compiled from sources believed to be reliable; however no representation or warranty, express or implied, is made as to its accuracy or completeness. The information is current as of the date of publication and is subject to change without notice.

This publication may contain certain forward-looking statements that are not guarantees of future performance and future results could be materially different. Commissions, trailing commissions, management fees and expenses all may be associated with mutual fund investments. Please read the offering documents before investing. The indicated rates of return are the historical annual compounded total returns including changes in unit value and reinvestment of all distributions and do not take into account sales, redemption, distribution or optional charges or income taxes payable by any unitholder that would have reduced returns. Mutual funds are not guaranteed, their values change frequently and past performance may not be repeated. Palos Funds are not available for non-Canadian residents.

Palos Funds and certain separately managed account advised by Palos may have investments in the securities discussed or referenced in this publication. These investments are made based on the funds and managed account’s investment policies and may change over time as market conditions evolve.

L'infolettre Palos Perspective est un aperçu hebdomadaire de la situation macroéconomique disponible uniquement en anglais. Si vous avez des questions sur l'infolettre ou des demandes générales sur Palos, veuillez nous contacter à info@palos.ca