The Palos Perspective

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More of the Same

Last week, I wrote that: "A shift in sentiment from euphoria to recession fears within a month 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 infrastructure. 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."

What Went On Last Week:

On Monday, the S&P 500 struggled to generate a 0.6% increase. Nonetheless, it rallied nicely if one adds Friday's positive action. It was the first time in a month that the equity market had closed higher for a second trading day. From a contrarian perspective, this reaction jibed with extremely bearish sentiment readings compiled by Investors Intelligence and AAII, even though a flurry of bad data points for the economy, like retail sales, a manufacturing survey in the Empire State, and homebuilders' moods were sour and below estimate. In addition, the net share of respondents who manifested pessimism rose the second-most ever, according to data going back 31 years.

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On Tuesday, there was a reality check, with the Atlanta Fed's NowCasting model estimate for Real GDP in Q1 coming at -1.8%, without a corresponding decline in inflation. The cost of imports rose faster than usual in February as well, rising 0.4% m/m for the second month in a row, with economists not expecting this because tariffs were not yet included. The S&P 500 then tumbled 1.1% in spite of good hard numbers on construction of new homes and industrial production, suggesting in turn that the Fed won't budge. Perhaps, however, the real cause for the drop might have been related to Trump's suggested impeachment of federal judges who stand in the way of his sundry diktats. Some say that this kind of interference leads to a constitutional crisis.

On Wednesday, with so many elements in flux and millions of Americans holding off on spending, in addition to foreigners boycotting purchases of US goods and postponing their travelling plans to the U.S. - all while inflation expectation is on the rise - there wasn't much the Fed could have done at the moment. The sensible thing to do was to pause until the ambiguity over tariff policies was cleared up, which is due on April 2 - Liberation Day for America. Indeed, the Fed held its policy rate at 4.375%, while its economic projections expect 2 rate cuts, even though the officials expect inflation to rise to 2.7% in 2025 from 2.5% in January, and gross domestic product to decrease to 1.7% from 2.2%.

What is important to note here is that in spite of a cornucopia of risks, the Fed did not panic: the Administration said that it could live with the decision for now, and public prospects were high that rate cuts were likely as the economic effects of the tariff kick in. Overall, the Fed lifted the mood sufficiently over tariffs by downplaying mounting growth concerns and classifying tariffs as transitory to drive the S&P 500 up 1.1%. Perhaps what was most important was the surprise Fed announcement of a dramatic slowdown to the pace of quantitative tightening (QT), having allowed only $5 billion of securities to roll off its balance sheet from $25 billion, suggesting they were sunsetting their program sooner than originally anticipated. This means that the Fed would no longer take liquidity out of the banking system, reducing the threat of a looming credit crunch. The stock market loves added liquidity as much as it likes lower interest rates.

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On Thursday, traders who had recovered from their short positions decided to stay put, avoiding taking on new risks as trading volume was very low. U.S. equities traded sideways as investors digested a batch of much better than expected economic prints, but remained worried about talks of recession. The benchmark closed only 0.2% lower.

On Friday, the market headed into the so-called "triple witching" which can be a big quarterly event that often stokes volatility when sentiment is fragile. An estimated $4.5 trillion of options contracts expired. Despite this drag, however, the S&P 500 rose modestly, snapping a 4-week losing skid to book a weekly gain of 0.5%. It remains that 3 in 5 investors said tariffs were the largest policy risk to the economy, according to Goldman Sachs.

Trump's Trade Wars are Tipping the World Toward Slower Growth:

Trade wars and the end of U.S. exceptionalism crashed global growth expectations and hopes for lower inflation. Indeed, the OECD has warned that the trade war is taking a significant toll on the global economy, reducing its world growth forecast to 2.3% this year, well below trend and down from 2.9% last year, and to 2.2% in 2026 with a serious downside scenario if retaliatory trade barriers between countries become the norm. Indeed, the footings supporting the thesis that the economy is not entering a recession are weakening. Fragmentation of the global economy, however, is something that cannot last forever. In a report produced by Fitch, the U.S. effective tariff rate (ETR) has already risen to 8.5% from 2.3% in 2024 and is likely to rise further. It assumes a 15% ETR will be imposed on Europe, Canada, Mexico and others in 2025, and 35% on China, which will push the U.S. ETR to 18% this year, the highest rate for 90 years.

Unsurprisingly, the Bank of America's latest global fund manager survey (FMS) showed that 71% of respondents expected below-trend and above-trend inflation over the next 12 months, which brought about a sharp decline in overall equity exposure and a big jump in cash holdings. The bank lowered its US GDP forecast for the first half of 2025 to 1.5% from 2.5% and raised core inflation to 3.0%.

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Will the Federal Reserve Lose its Independence?

This is a very important question. My readings on the subject tell me that the Supreme Court has historically limited the ability of a President to remove commissioners at will. I trust that precedent to hold, which would therefore eliminate, or at least reduce, the threat to the Fed's independence. There is no precedent for getting rid of Fed officials, since the Constitution of the U.S. expressly grants to Congress the power to create money and regulate it. The President can appoint officials when there are vacancies; but it still remains that the Fed's monetary policy functions are a delegation of legislative power, rather than of executive branch power. The simple quick answer, therefore, is no - otherwise a constitutional crisis would erupt.

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