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Reprieve Sans Relief - The Tariff-Stock Market

I ended last week's Commentary by saying that the stock market has taken a second breather in the wake of a flurry of rapid-fire statements, pronouncements, and executive orders devoid of clarity on tariffs, which has since triggered such extreme uncertainty that the Global Economic Policy Uncertainty Index rose above 400 - as high as it was when Covid struck in 2020.

As a result, the S&P 500 fell 1.0% to 5955 in the week ended 28, while Bitcoin declined a full $14355 to $84,220. Significantly, both these price corrections were generally attributed by market strategists who stressed their unpopularity to tariffs on Mexican and Canadian imported goods.

While I understood what made the market react, I was as confused about its direction as the next guy because pronouncements surrounding tariffs were just too erratic and frequent to predict: anyone who said they weren't was just fooling themselves. Thus the odds of being right on any given forecast are now much lower than they once were.

In this connection, the best place to look for some guidance was in the bond market. Up until a few days ago, its message was that tariffs were deflationary because they would likely depress global economic activity, and were widely presumed to be a one-shot price-rise shock. Bond yield behavior attested to such these observations. Indeed, when the talk of the town was that tariffs were coming, bond yields fell, but rose when they were postponed. Expressed differently, during recent episodes of tariff turmoil, bond yields fell as well as the stock market, but reacted oppositely when tariffs were temporarily paused. It follows that these incidents more or less guarantee a choppy stock market for as long as tariffs continue to dominate the narrative.

From these observations, two important lessons have been learned: 1) Despite the hard-headed ideas of the Trump administration on tariffs, it demonstrated on Wednesday last that it can still listen to

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reason to a certain extent, if only by responding intelligently to the legitimate desperation of the US auto industry, which stands to be particularly harmed by protectionism; and 2) Despite the Administration's acknowledgment that it’s OK with the rough effects its tariff policies will have initially on the economy, the President still cares about the market, suggesting that stocks will retain a veto over his economic policy.

Up until Wednesday, Donald Trump was able to engineer recoveries in market sentiment 7 times this year, either by announcing tariff reprieves or dialling down his adversarial rhetoric, thereby changing the temperature. This kind of worked because there was a strong consensus that the economy was just too solid to fail. Unfortunately for him, however, the stock market pattern of bouncing up and down in response to news about tariffs - falling on impositions and rising on pullbacks - broke down on Thursday last week. The on-again, off-again, North American trade war became simply too exhausting, and investors lost it, figuring that maybe the economy might be weaker than presumed earlier.

The U.S. Economy Heading South:

On the economic front, the ISM headline numbers were mixed. On the one hand, US manufacturing decelerated sharply while the readings on factory input costs were blazing hot. On the other hand, the service sector masked growing uncertainty among senior executives showing that the U.S. economy is still growing, but at a much slower pace than previously believed, according to new data on the employment situation. First, the latest ADP survey revealed that the US private sector’s hiring rate ran way below expectations in February to 77,000, falling well short of the 140,000 consensus. Second, the Challenger Report showed an alarming jump in February’s announced job layoffs to 172,017, a third of which were related to the activities of the DOGE Boys. In retail, too, technology and consumer products were also hit pretty hard. And third, the US economy created 151,000 jobs in February: not horrendous, but falling short of expectations, while the unemployment rate rose to 4.1%.

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If the economic bull run is to continue, it is imperative to have government policies that are both stable and predictable, if the market is to take advantage of where comparative advantages reside. Raising tariffs on steel, aluminum, energy, lumber and fertilisers is not going to do anything good to industries that are integrated across international borders, other than increase input costs, ill-allocate resources, and direct savings in uncompetitive industries. Americans are becoming aware that the rest of the world is either reducing or eliminating tariffs that would merely move exceptionalism abroad.

What is Going on Right Now:

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. If one assumes that these tariffs are more tactical negotiation tools than strategic priorities, earnings may once again save the day, leaving the nightmare behind us. Unfortunately, however, 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”.

Meanwhile, the new reality of higher domestic prices and weaker growth is creating havoc. The Atlanta Fed’s NowCasting model has a 2.4% GDP decline estimate for Q1/2025, partially caused by companies' front-running tariffs in stockpiling imported goods. This may seem temporarily negative; nonetheless 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 will become impossible 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. Indeed, overseas, investors have already been dumping U.S. government bonds. Think on this one: adjusted for changes in the exchange rate, the ratio of the TSX/S&P has still risen to 3.01times from 2.89 a few weeks ago, even though the Canadian dollar and oil prices have been down considerably. 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%.

I've reduced my S&P 500 2025 target to 6350 from 7000. In this regard, buying the dips cautiously may still be a good strategy, given that the benchmark ended the week at 5770, registering at 3.1% decline.

The S&P 500 Tests a Line in the Sand:

On March 4, the benchmark for stocks fell to 5778 while its counterpart for cryptocurrencies hardly rose, even though it was promised officially to become a strategic reserve, thereby wiping out all the gains made earlier. Some say the resistance level for the S&P 500 is 5700, with $85,000 for Bitcoin, illustrating graphically there was a real need for an up-day. In other words, even for Trump, enough might have been enough. He then activated his "Trump Put," believing that it would work by granting a 30-day tariff reprieve for North America car manufacturers, which led in turn to a full-blown rally in cryptocurrency and stocks, snapping a 2-day skip and avoiding what could have turned into a merciless correction. But on Thursday he got a reality check: the market once again lost it, with the S&P 500 falling 1.8%, 6.9% below the all-time high of 6144 registered on February 19.

Canada is in the Eye of the Tariff Storm:

Canadian public officials remain in Washington, hoping to prove that they are on the case to secure her borders from illegal drugs and migration, while US border data itself shows a 97% decline in fentanyl seizures coming from Canada from December to January. In that time, Canada began deploying its $1.3 billion border security package, appointing a fentanyl "czar," and reducing illegal migration by 90% in recent months per Bloomberg.

I devoutly hope that all these efforts will be positively received in the end. It is very hard to find any obvious benefits for Americans to reduce Canadian imports for national security purposes; and generally, goods that the U.S. buys from Canada are neither high-profit, associated with high paying jobs or overpriced.

Everything Is an Emergency:

The editorial board of the WSJ declared that Trump's tariffs have nothing to do with emergency, doubting if he has the power to impose them and hoping that his afflatus gets a legal challenge. The Journal went on to say that the President has explicit power to restrict imports, but only for specific reasons like threats to national security; in response to large and serious balance-of-payment deficits; a surge of imports that harms U.S. industry; or discriminatory trade practices. The article, which was posted on March 6, ends with the following: "Presidents of both parties are now declaring everything to be an emergency to achieve their policy goals without having to deal with a frustrating Congress. If Mr. Trump succeeds in unilaterally imposing tariffs as he sees fit, a future Democratic President will use "emergency" power for climate change and much more. Mr. Trump's order needs a legal challenge."

The Case Against Tariffs Is Getting a Hearing:

Tyler Cohen wrote an opinion posted by Bloomberg this week arguing that tariffs do not always deliver their intended purpose. The truth is that tariffs do not, in general, reduce trade deficits. Global data show that countries with higher tariffs actually have higher trade deficits. "The simplest problem is that many US exporters - Boeing, GM, Caterpillar, to name a few - rely on foreign inputs. So if a tariff has to be paid on foreign steel or aluminum coming into the U.S., American exporters who use those materials face higher costs. That will hurt their international competitive position and in turn

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increase the US trade deficit." Indeed, the spin that tariffs will reduce the trade deficits is hard to swallow. He added: "The most important factors behind trade balances include savings decisions, fiscal policy, economic growth, wealth levels and demographic characteristics." Indeed! Again, trade barriers tend to misallocate human resources and business capital to inefficient industries rather than allocate them to industries with comparative advantages. If the Administration wants to believe that trade deficits are a problem, it would be smarter to introduce policies that would increase the national savings and productivity.

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