April 7, 2025

A Note on Volatility, Diversification, Trade Wars, and Inflation

Dear clients:

Below are our thoughts with respect to economic developments last week and the market reaction.

The Painful Process of Pricing-In a Recession

We have just concluded the worst week for U.S. equity markets since March of 2020, with the S&P 500 down -10.5% on Thursday and Friday, and this on top of a decline of -7.7% from the all-time high on February 19th to Wednesday, April 2nd. This volatility is wholly attributable to public policy, specifically a pattern of on-again/off-again threats of new tariffs, including tariffs on some of our closest allies and trading partners. The dramatic losses at the end of last week followed President Trump's "Liberation Day" announcement of new and historically high tariffs on nearly all the United States' trading partners. While the market disdains limitations on free trade and has begun pricing in a substantial risk of recession by year end, we believe it is the vacillation and uncertainty that is predominantly driving this short-term volatility.

A Brief History of Trade

The wide consensus among economists is that free trade is a net positive for economic growth and is not a zero-sum game of winners and losers. On the contrary, a demonstrable fact of economics is that when countries specialize in areas in which they have a comparative advantage and trade with other countries for goods and services in which they do not, all parties gain from trade and overall economic output increases.

The global economy has greatly benefited from a concerted effort by the U.S. and other advanced economies to liberalize trade since the end of World War II. This was primarily done via various multilateral and regional trade agreements. One objective was to help Europe and Japan rebuild their economies. Another was to help the developing world to grow and prosper for *everyone's* benefit. In the process, the free world would advance the spread of democracy.

Those objectives have largely been met. The Western European and Japanese recoveries are well documented. The developing world has experienced dramatic growth in per capita income and improvements in standards of living, substantially narrowing the wealth gap between rich and poor nations. Today the U.S. remains one of the most open economies in the world. Despite a sharp reduction in trade barriers over the past 80 years, global trade is neither fully free nor fair. Most of our trading partners' economies are relatively more protected and less accessible than ours.

The Trump Administration's stated position on this is that the United States has been "ripped off" by its trading partners, who have reaped more than their fair share of gains from trade over the last 80 years. To address this President Trump has resorted to levying tariffs on imported goods entering the United States. During the campaign, he described tariffs as a tool to bring manufacturing and jobs back to the United States while simultaneously raising new revenue from foreign exporters to balance the budget. Foreign companies should pay for the privilege of

accessing the U.S. consumer market, and to make them do so would make U.S. producers more competitive.

A Short Primer on the Economics of Trade

Markets have reacted dramatically to the announcement of the Liberation Day tariffs. To help understand why we offer a brief lesson from Macroeconomics 101. Two fundamental concepts in Keynesian[1] macroeconomics are Aggregate Supply and Aggregate Demand, both of which are often stylistically expressed as the linear relationship between price and quantity on the y- and x-axes (respectively) of a graph. The Aggregate Supply curve represents the total amount of goods and/or services an economy is capable of producing (that is, real GDP) at any given price level; Aggregate Demand is the total amount an economy is willing to consume (also real GDP) at each aggregate price level.

The Aggregate Supply curve slopes upward, because in the short run producers are able to profitably produce more goods at higher prices, and the Aggregate Demand curve slopes downward, because consumers generally are willing and able to consume more when prices for goods and services are lower.

Below, in *Figure 1*, the intersection of the Aggregate Supply and Demand curves represents the equilibrium GDP and equilibrium price level in an economy.

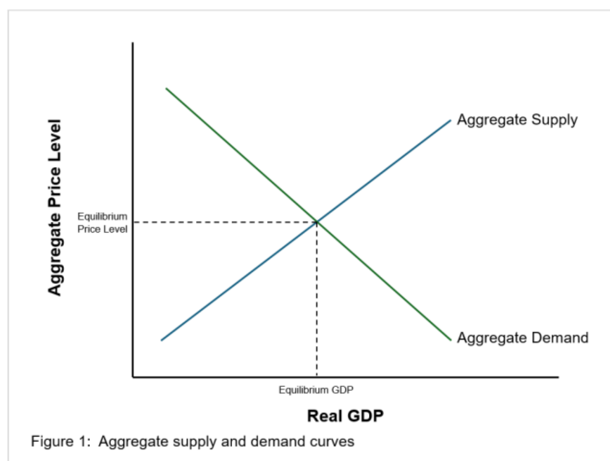

Figure 1: Aggregate supply and demand curves

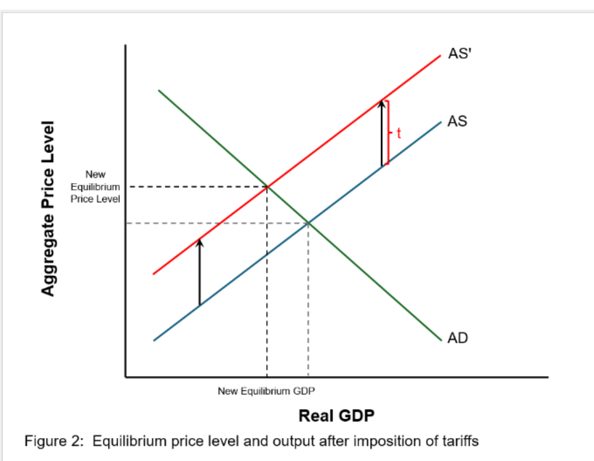

Figure 2: Equilibrium price level and output after imposition of tariffs

Figure 2 shows the effect of tariffs within this framework. The Aggregate Supply curve shifts parallel upward in the amount of *t*, to reflect the additional levies. *t* is equal to the sum of tariff rates multiplied by the values of each imported good across the entire economy. The new Aggregate Supply curve, AS', intersects the Aggregate Demand curve at the new equilibrium price level, which is higher than before, and the new equilibrium real GDP, which is lower. This is the outcome of essentially reversing gains from trade, as inferred from this Keynesian model of aggregate supply and demand.

[1] Keynesian economics, named after British economist John Maynard Keynes, is a macroeconomic theory emphasizing government intervention through fiscal and monetary policies to stabilize the economy and manage aggregate demand, aiming to control inflation and prevent recessions.

In the stylized demand curves above, the cost of the tariff is split between producers and consumers—that is equilibrium prices increase by less than t. The proportion that is absorbed by consumers is a function of price elasticity of demand, a measure of sensitivity of demand to changes in price. For goods which are "wants" rather than "needs" or for which there are abundant substitutes (price elastic demand), the majority of the tariff will be absorbed by the foreign producer, who won't be able to raise prices to maintain margins. For goods which are necessities, or which cannot be substituted (price inelastic demand), more of the tariff will be paid by U.S. consumers, because the foreign manufacturer will raise prices to compensate for the tariff.

The Modern Economy

While this analysis is simplified, the global economy is incredibly complex. Decades of initiatives to liberalize trade as well as to attract foreign direct investment have resulted in a highly interdependent global economy with sophisticated multi-border supply chains. Modern U.S. manufacturers build their products from imported raw materials, component parts, and partially completed products. Their input costs will be adversely impacted by tariffs. In the auto industry, parts and sub-assemblies may travel to and from Mexico and Canada many times before final assembly. Untangling these relationships will be costly and complicated, and could lead to unintended consequences. One example: a current U.S. manufacturer who relies on exporting may find it more profitable to move its factory entirely out of the U.S. into a jurisdiction where it can lower manufacturing costs and avoid retaliatory tariffs if the trade war escalates.

Implications for the Economy and Markets

The bottom line is that trade wars entail multiple risks, and if the Administration carries on with this policy we should prepare for higher prices and perhaps an economic contraction. There is the risk of second and third order unintended and undesirable effects.

There is the risk of foreign governments retaliating by placing new tariffs on U.S. exports. On Friday, China raised tariffs on U.S. goods by 34% and also placed duties on rare earth mineral exports. Escalating protectionism such as this contributed to the Great Depression 95 years ago.

There is also a risk of isolation. Other nations are already establishing new trade agreements with one another, leaving the United States out. A prolonged trade war could lead to the permanent loss of export markets, such as for American agricultural products, as countries like Brazil ramp up production to fill the void with our former foreign customers.

One argument for protectionism is to regain lost U.S. manufacturing jobs which have moved overseas in the last 35 years. Profit-maximizing firms will move production into America if and only if the cost to produce elsewhere is increased (by imposition a tariff) to exceed the cost to produce here. Moving production into the U.S. will lead to either lower profit margins, or higher inflation, or both—neither of which are good for investors in stocks or bonds. And a recession that coincides with inflation is particularly difficult to address. The monetary cure for high inflation is raising interest rates, whereas the approach to a recession is to lower interest rates. On Friday, Federal Reserve Chairman Jerome Powell warned of the possibility the Liberation Day tariffs could sustain above-target inflation, which could preclude lowering interest rates to stimulate the economy.

A manufacturing renaissance in the United States, notwithstanding higher prices, would be positive to the extent that we can be assured that goods are produced responsibly here with respect to both labor and environmental standards, which is definitely not always the case with imported products. However, another potential problem with reindustrializing the United States at this particular moment is the economy is already running at or above capacity. Unemployment is relatively low—4.2% in March. All those factory workers who lost their jobs to the "giant sucking sound" after NAFTA was passed in the 1990s have moved on, finding new employment in the service and knowledge economy.

Likewise, we are doubtful that all those closed factories remain mothballed, waiting for someone to restart them—much of that real estate has been repurposed for productive use in the modern economy. One of the strengths of the American economy, which remains the largest and wealthiest in the world, has been its dynamism and efficiency at allocating resources. If a firm were to build a new factory in the United States, we suspect they would strongly consider automation, staffing the factory floor with robots empowered with artificial intelligence, which could diminish the number of new manufacturing jobs created.

We continue to track public policy closely with client portfolios in mind and we expect the volatility to continue. This is a time when diversification is particularly important, and volatility nearly always presents an opportunity to rebalance portfolios to their long-term strategic asset allocation. Change also creates opportunities, and we and the managers we have partnered with to steward client assets are always on the lookout for those opportunities. As always, the best course of action is to diligently follow your thoughtfully-crafted Investment Policy Statement.

As always, please do not hesitate to contact us if you have any questions or concerns.

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