Q1 2025 MARKET COMMENTARY

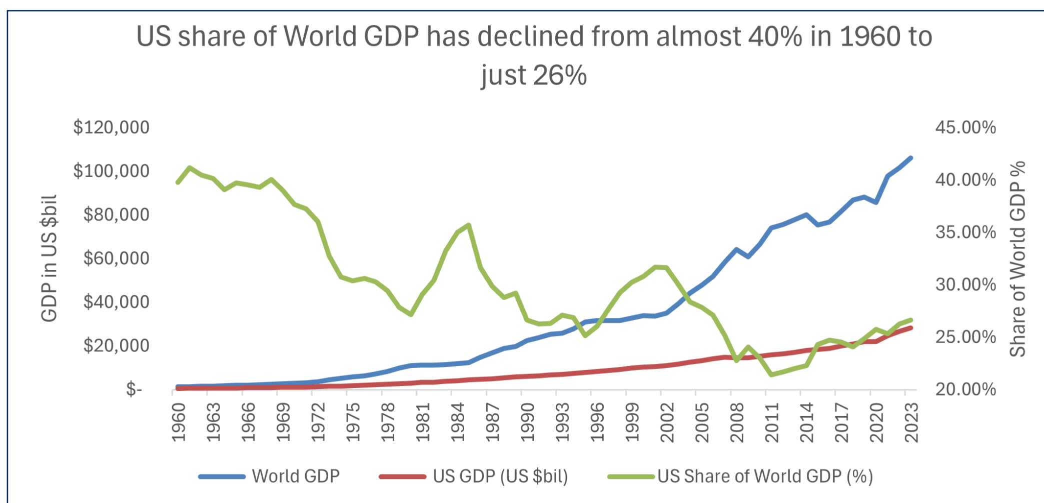
Liberty One Investments Team

In our previous commentary, we emphasized that although near-term market risks are manageable and long-term prospects remain attractive, we posit that the existing state of financial markets remain vulnerable- stemming from stretched valuation multiples, high earnings expectations, concerning rise in long term interest rates, and a middling fundamental backdrop. Additionally, we believed that policy decisions (eg: trade, immigration, regulations, monetary) are likely to further drive investor sentiment and volatility in 2025. Since then, US equity markets have experienced further weaknesses as high expectations have moderated and recessionary fears due to policy impacts (tariff, spending cuts, immigration crackdown) have resurfaced. Initially, it was our belief that the recent weakness was primarily driven by negative sentiment due to policy impact uncertainty rather than significant deterioration in the fundamental backdrop. However, financial markets may be starting to discount a potential recession in 2025 after "Liberation Day"- in which the Trump Administration launched a sweeping tariff initiative on all US trading partners in an attempt to remedy perceived unfair trade practices. Investors should demand higher risk premiums for holding longer duration assets due to the wider range of potential outcomes and a less stable environment moving forward.

The Motivator for Drastic Policy Actions

It can be argued that the US has been taken advantage of by both allies and enemies, particularly in the unfairness to international trade and the cost burden by the US in providing a security shield to its friends and allies. Americans are frustrated with international trade, where the US has consistently run a quarterly current account deficit since 1982, except for two quarters in 1991. They see imports replacing domestic production and Americans losing jobs to foreigners. This threatens US national security, as manufacturing is hollowed out- quoting President Trump, "If you do not have steel, you do not have a country". Additionally, carrying the cost of global financial system stability through the provision of the US dollar being the reserve currency creates an inelastic demand for US dollars, which frequently leads to an overvaluation of the dollar, making exports less competitive and imports cheaper, further widening the trade deficit. This feeling of unfairness can be illustrated in Chart 1.

Chart 1

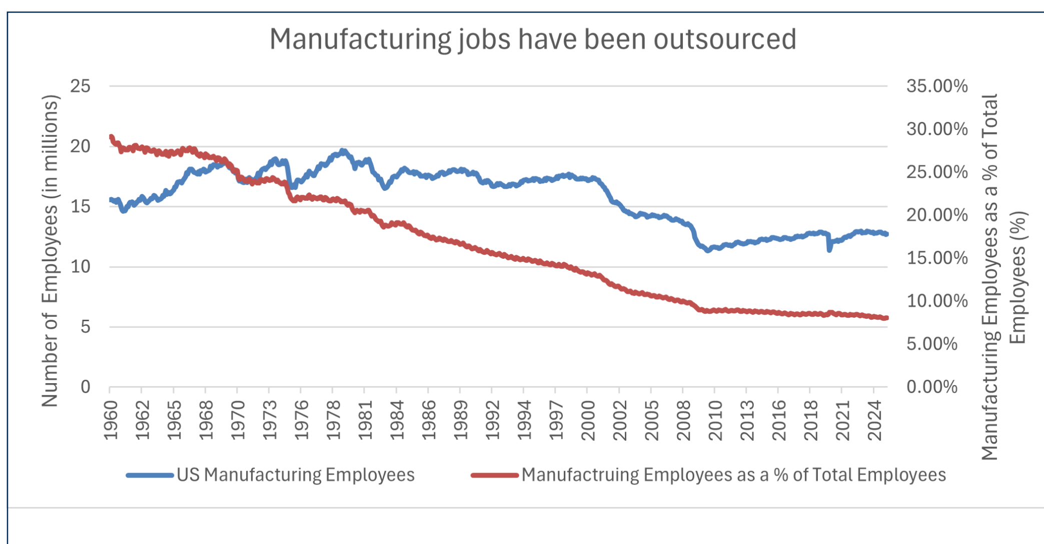


Source: US Bureau of Economic Analysis, FRED Economic Data, Liberty One, Q4 2024.

Since 1960, the nominal GDP for the world has grown by a CAGR 7.5% while US GDP grew at a CAGR of 6.4%. Consequently, the US share of the world's GDP has declined from almost 40% to 26% today. Advances in energy production, technological advancements, globalization, policy reforms, population growth, and economic liberalization led to such rapid global economic advancement over the last 60 years. And within that environment, the US played a significant role in powering global economic growth by being the world's primary customer.

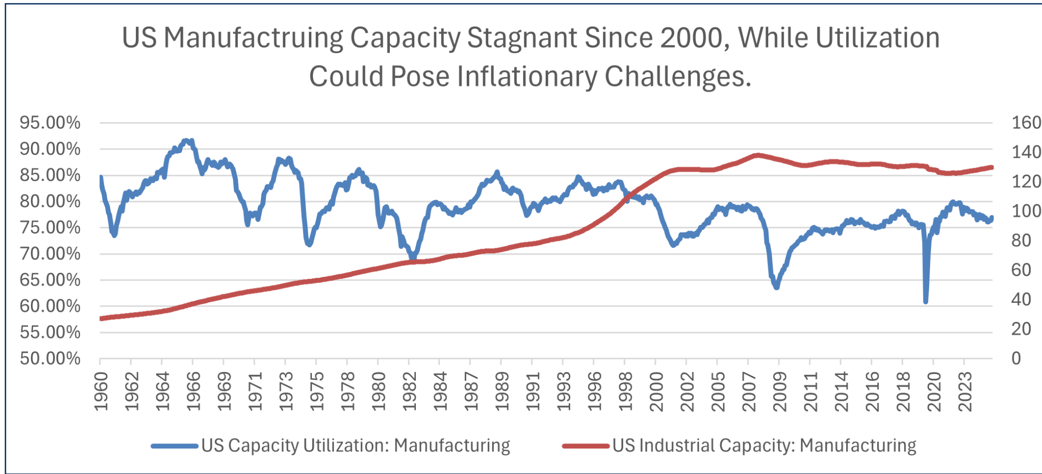
What Chart 1 does not capture is the extent to which global production capacities have shifted. Growth in US GDP is largely driven by consumption, and a larger proportion of this consumption is being supplied by foreign nations where goods are produced at far lower prices than in the US. This can be seen as creating jobs in foreign nations at the expense of jobs in US factories. Such a trend is highlighted in Chart 2, where the absolute number of manufacturing jobs in the US has declined since 1980 (and even more as a percentage of total employment).

Chart 2



Source: US Bureau of Labor Statistics, FRED Economic Data, Liberty One, Mar 2025.

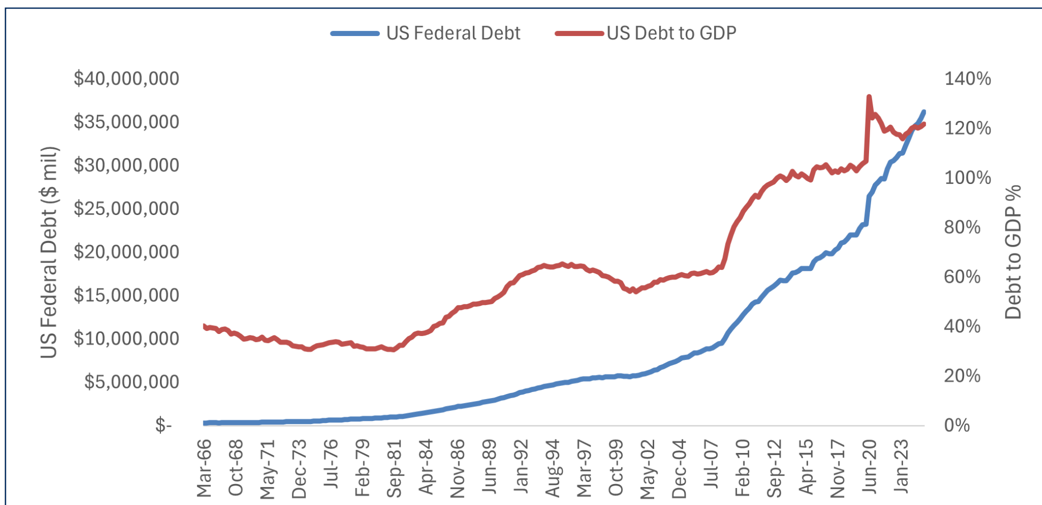
Of course, more jobs have moved from manufacturing to services as one would expect when economies graduate into more developed, advanced, and rich nations. However, the loss of manufacturing jobs has emptied out towns, degraded infrastructure, and increased unemployment in several parts of the country. Trump's goal to bring manufacturing back to America is to revitalize and reindustrialize these badly affected towns in the country while protecting American national security interests, in which tariffs are a tool to incentivize such transformation. In his March 5th address to the joint session of the US Congress, President Trump said that "tariffs are about making America rich again and making America great again. And it's happening. And it will happen rather quickly. There'll be a little disturbance, but we are okay with that. It won't be much." As a result, tariffs can be seen as a tool to bring manufacturing back to America, substitute imported goods with American made goods and raise tax revenue to be directed towards lowering corporate taxes to stimulate domestic investments and infrastructure building. However, one could argue that the window of success to pulling that off is slim, as it would require continuity in government policy making beyond the next 4 years, other nations to cooperate and not escalate trade conflicts (reciprocal tariffs or boycotts), convince global corporations that US manufacturing can be as competitive, find the necessary talent and investment to build manufacturing capacity, and not overwhelm near-term manufacturing utilization which could lead to outsized inflation.



Source: US Department of the Treasury, FRED Economic Data, Liberty One, Q4 2024.

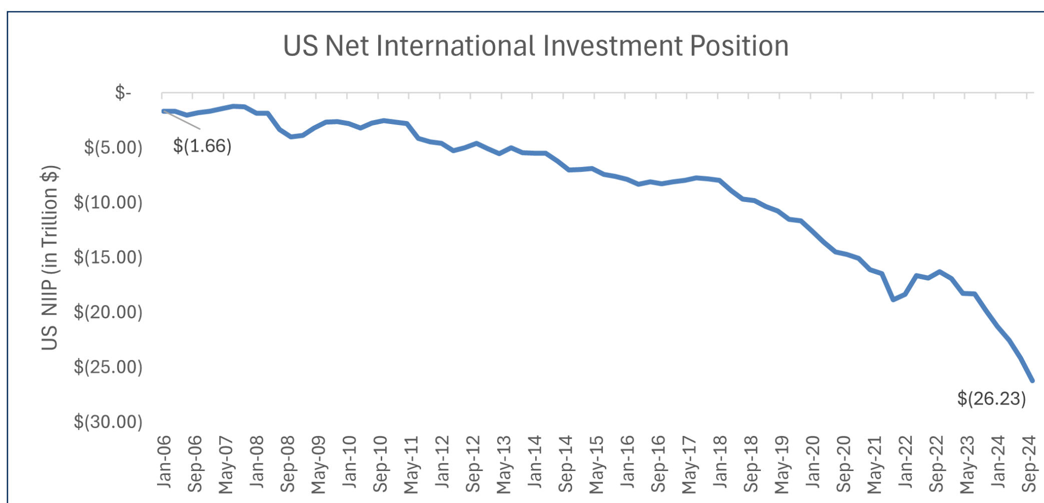
Tariffs Are Only A Means To An End

Contrary to mainstream media, we do not believe that tariffs are the endgame of Trump's economic and political agenda. The endgame is to secure US exceptionalism in a unipolar world for a long time to come. To do so, it requires the US to protect its national security interests, project its military and financial powers, reshape its security and defense alliances, and recreate a new global trade and economic order- one in which the US can dictate terms to and benefit for itself. To protect its national security interests and livelihood of its citizens, the US must revitalize its manufacturing sector, rebuild its crumbling aging infrastructure, and increase its relative competitiveness to export more and import less. This requires higher domestic and foreign investments into the US, more research and development, more innovation, and better education systems (especially in critical areas like AI, computing, and robotics). Reducing inflation is also critical via supply-side deregulation, cutting bureaucracy, excessive regulatory oversight, and lower energy prices. It must improve its trade balance, create jobs with increasing wages, increase the US share in global trade, and increase its share of global wealth. Finally, it must do so in a fiscally sustainable way by getting its finances and indebtedness in check.



Source: US Bureau of Economic Analysis, FRED Economic Data, Liberty One, Q4 2024.

The US federal government indebtedness has grown since the 1960s and is currently at its highest point relative to its GDP in modern history. Although one argument can be made that American citizens living beyond its means can be blamed for such indebtedness, another argument attributes this indebtedness to the dilemma of the US dollar being the world's reserve currency. The demand for dollars increases as it facilitates global trade. Meanwhile, they are held for investments and reserves for large funds, central banks, and citizens of foreign nations that have a trade surplus with the United States. Therefore, the dollar as a reserve asset forms part of the global money supply. As the global economy grows, the global pool of assets and savings expands along with it, and the world's demand for dollar and Treasuries rise. The US run fiscal deficits and supplies dollars and Treasuries to fund its deficits, increasing its indebtedness for the benefit of global wealth accumulation. As we mentioned previously, the United States' share of World GDP has shrunk from 40% in 1960 to 26% today. Consequently, a greater amount of US wealth is shifting into foreign hands. The US net international investment position (NIIP) has gone from a deficit of - $1.6 trillion in 2006 to -$26 trillion in 2024 (almost 90% of its entire GDP in 2024). The net international investment measures the amount of assets that the US owns abroad minus the amount of assets foreigners own in the US. A negative number means that foreigners own more US assets (stocks, bonds, real estate, ports etc) than Americans own abroad. A persistent negative NIIP typically implies vulnerability to foreign capital flight risks or shifts in global risk appetites, but the US has been able to sustain a larger and more persistent negative NIIP due to its world's reserve currency status.



Source: US Bureau of Economic Analysis, FRED Economic Data, Liberty One, Q4 2024.

Persistent negative NIIP could eventually lead to a hollowing out of US ownership of US-based assets into the hands of foreigners. In other words, increasing foreign control over US companies, land, housing, and infrastructure could result in the loss of economic sovereignty of the United States. This could distort domestic priorities and create political vulnerabilities, especially if adversarial nations own strategic US assets. Furthermore, as foreign ownership of US assets grows, more income (dividends, interests, and rents) flow out of the US each year, meaning that more American capital is flowing out of the country , and as the balance of payments deteriorates, Americans would increasingly rely on debt or asset sales to fund its deficit, leaving its future generation responsible for meeting those liabilities with fewer income-producing assets as assets continue to be sold off to fund deficits.

Bottom line, protecting future American economic sovereignty begins with fiscal sustainability, which can only be achieved through lowering fiscal deficits, trade deficits, and increasing US share of Global GDP growth. And the urgency to address these issues is finally coming to the forefront at Capitol Hill. This is where the Trump Administration believes tariffs, government spending cuts (Department of Government Efficiency DOGE), and deregulation are interlinked and self-reinforcing, enabling a positive feedback loop to achieve this goal. The idea is that tariffs will raise revenue for the government, lower the fiscal deficit, and pay for a part of the tax cuts. High prices from tariffs will lower the trade deficit and reduce the supply of Treasuries. Lower taxes, tariffs, and deregulation will encourage more investment in the US over time and will lead to even higher investments and domestic production, create jobs, increase wages and productivity, and thus drive economic growth. It appears that tariffs are a means to an end to kickstart the chain of events aimed that reducing deficits, manage fiscal indebtedness, revitalizing economic growth, and recreating an economic order that is more beneficial for the US over the long term. Additionally, tariffs can also be used as a negotiation tool for concessions that stretches beyond trade- such as sharing the cost burden of defense alliances, immigration control, and technology transfers. We have witnessed some effectiveness of this through the first round of tariffs announced. Germany increased its defense contributions within NATO by approximately $500 billion while Canda and Mexico vowed to improve its border security to stem the flow of illegal immigrants into the United States. The interconnected complex web of economic, military, and political factors stretches beyond the imposition of tariffs, and tariffs appear to be the First Act.

The Imposition of Tariffs

One of the prevailing debates about the imposition of tariffs is its impact on inflation, especially at a time when the state of the consumer is vulnerable. This vulnerability could eventually lead to a recession. Whether tariffs will translate into higher prices and recession depend on a variety of factors. Most economists believe that it will be highly unlikely that in a globally competitive marketplace, the exporter can absorb the entire tariff. And to the extent that both the exporter and US wholesale importer are not able to absorb the tariff, price increases will happen. What can help mitigate the increase in prices is for the US dollar to appreciate to offset the after-tariffed price of the import. This happened in 2018-2019 when the effective tariff rate imposed on China was 17.9% but the US dollar appreciated 13.7% against the Chinese Renminbi, resulting in a 4.2% net increase in prices. Inflation averaged 2% during that time and was not an issue. Nonetheless, if the tariff is large enough and there is no currency offset, consumers will likely pay higher prices, and the tariffs will be borne by them. This is especially true if the tariff uncertainties persist and if tariffs were to remain in place for a long time. In that scenario, the odds of a recession are likely to rise more significantly due to the demand and supply imbalances that tariffs bring out. Demand shocks from tariffs are likely to happen first as prices rise and demand falls in the near term. However, supply chain adjustments and factory build up take longer to implement, causing a demand-supply imbalance gap which could temporarily lead to a stagflationary environment. (High prices but weak economic growth). The risk of stagflation increases if other countries were to retaliate and impose retaliatory tariffs on the US, which would hurt US exporters and US growth. We believe that this awkward period is probably what President Trump refers to as “the adjustment period”. The duration, magnitude, and risks of this potential “adjustment period” is also dependent upon other policy actions that could temporarily help mitigate its impact (eg: targeted fiscal support, incentives for supply side investments, temporary tax relief, price controls or subsidies etc)

The Limitations

The challenge with tariffs is that they are not designed to be as effective as a permanent tool. Higher prices may lead to lower demand for imported goods initially, but as the marginal costs of tariffs rise, the marginal benefit of tariffs falls. For example, global supply chains may adjust or decouple from the United States, reducing the US’ relevance in global value chains and causes its economy to become more isolated. Furthermore, US domestic industries that benefit from tariffs may become less competitive by relying on tariffs. They may not have the incentive to innovate, reduce costs, or benefit from technological know-hows from other nations. Moreover, the US manufacturing sector may not have the capacity or ability to create substitutes for imported goods, depriving its citizens of improved choice

and standards of living. Additionally, the design of tariff policies may be flawed. The poorly designed nature of policies makes it hard to have confidence that the current form will prevail, leading to increased uncertainty which would delay investment in domestic manufacturing capacity. Finally, any gains from imposing tariffs disappear when the tariffed nation or nations retaliate by imposing their own tariffs on US exports. The breakdown in global trade would be a lose-lose situation for both the US and the world. This could be especially detrimental when protectionism policies like tariffs are implemented at a time when the global economy is fragile. For example, global trade shrank by over 60% between 1929 and 1933 when the Smoot-Hawley Act of 1930 was implemented to protect American farmers and manufacturers from the Great Depression. This led to a cascading effect of retaliatory tariffs where every country tried to help itself at the expense of others, but all became worse off as a result. More importantly, financial system stress could resurface given how interconnected our global financial systems are today. Export-dependent countries like Argentina and Vietnam could be particularly impacted by tariffs, which may undermine their international debt repayments that could contribute to banking crises and currency devaluations. Its impact would be felt beyond the borders of affected countries, as global investors and banks who hold their debts would also be negatively impacted.

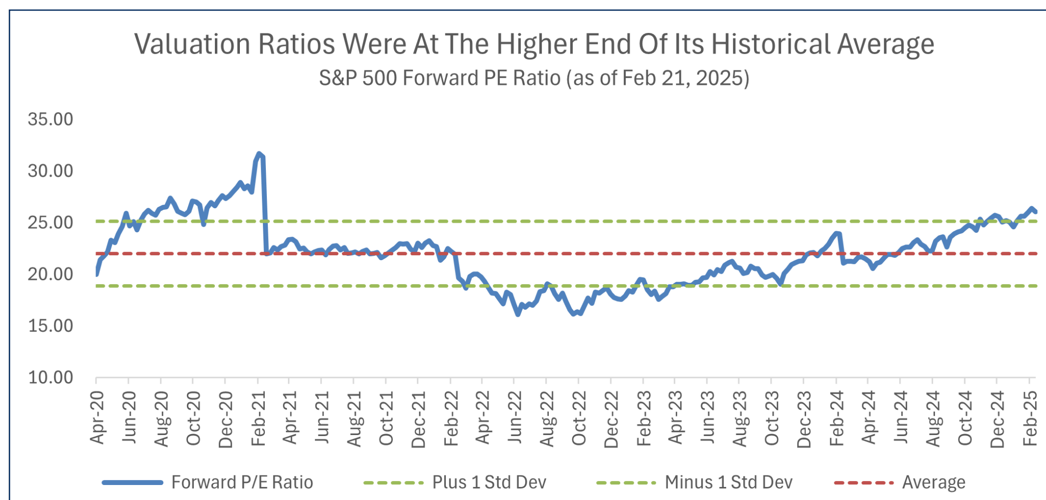
Furthermore, many of tariffs' intended benefits are paradoxical. For example, one perceived benefit of tariffs is to increase tax revenue AND bring manufacturing back to the US. However, tariffs only increase tax revenue if goods are still being imported from foreign countries. If those goods are now being manufactured in the United States, import of those goods would decline substantially and so would the tax revenue collected from tariffs. It would be a challenge to both increase tax revenue and reshore global manufacturing supply chains back to the US considerably over the long term from the imposition of tariffs.

Therefore, despite the well-intentioned nature to use tariffs as a starting point to secure US exceptionalism for a long time to come, the potential destructive force that economic nationalism brings could consequentially make the US and the world poorer. Whether we like it or not, the US needs the world just as much as the world needs the US. This symbiotic relationship led to some of the greatest wealth creation, stability, peace, and inter-cultural exchange in human history. How the future consequences of tariffs play out will be highly dependent on how other countries react to these tariffs. There is still a possibility that the tariffs announced by President Trump could lead to the intended beneficial effects that we discussed previously in the commentary, but that would require international coordination, negotiations, and compromises to be made. Without that, the current global economic order that we know of today is at risk of unraveling, being replaced by more protectionist regimes globally which would heighten the risk of global conflicts.

With that said, how are financial markets pricing these inherent risks? Are they pricing them? What if inflation picks up again while growth stalls due to tariffs? How should investors think about navigating that environment? We intend to hopefully answer those questions in the next section.

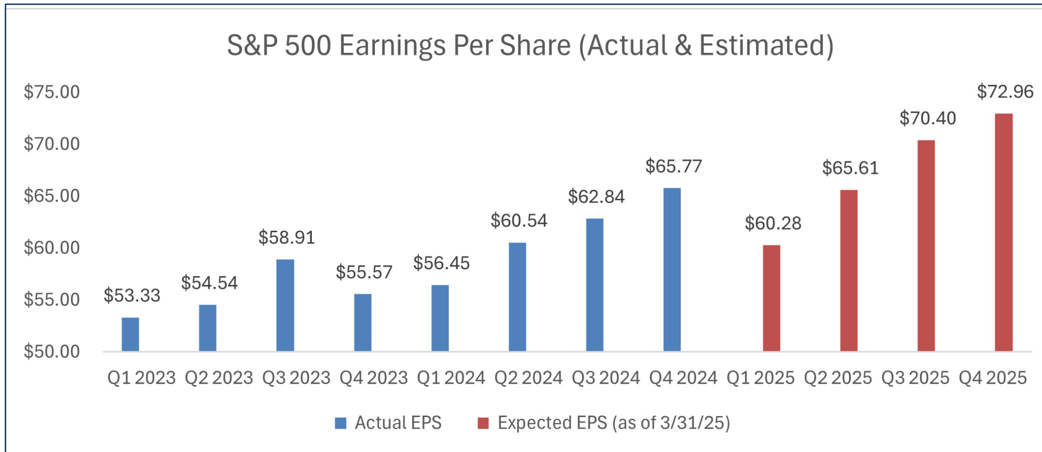
Are Markets Pricing Inherent Risks Appropriately?

Prior to "Liberation Day", we believed that the S&P 500's pullback of -7.3% after peaking on February 19th, 2025, was primarily due to negative investor sentiment compressing high valuation multiples, and not necessarily due to recessionary fears. Credit spreads, earnings guidance, and leading economic indicators were not foreshadowing recessionary signals. However, we still cautioned that equity risk premiums at a 22-year low meant that stocks were vulnerable to a selloff should negative sentiment and uncertainties persist. In our opinion, investors were simply not being compensated adequately for taking on equity risk.



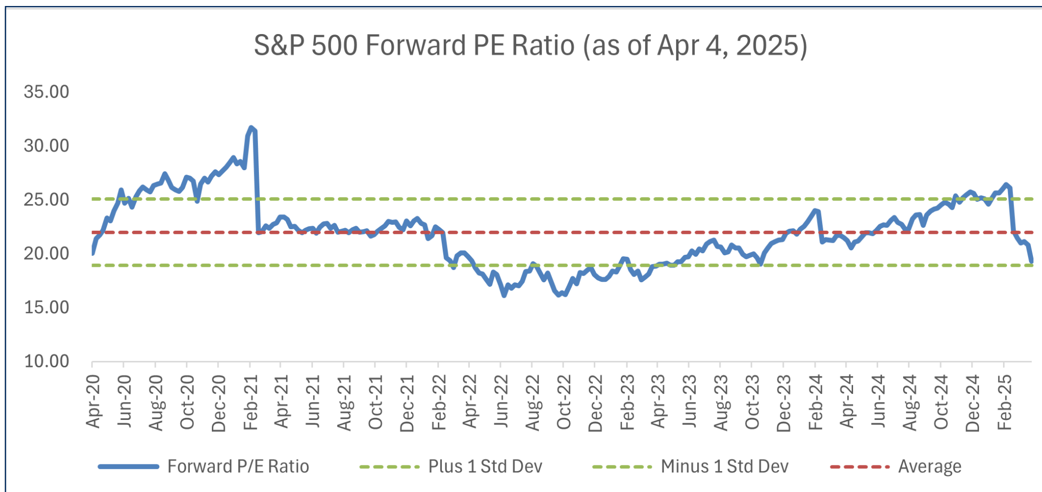
Source: Bloomberg, Liberty One, Feb 2025.

We felt that the -7.3% pullback was quite healthy as expectations were beginning to reset to more reasonable levels. This was particularly prevalent with the Magnificent 7 stocks, which together collectively accounted for 30% of the S&P 500's overall market cap. The forward PE ratios of the Magnificent 7 stocks compressed at a faster pace than the broader index, highlighting their normalizing earnings growth and valuation multiples on which investors were willing to pay for the group. The Magnificent 7 posted another impressive earnings season in Q4 2024, with total earnings reaching a record $131.2 billion—up 31.7% year-over-year. This growth significantly outpaced the S&P 500's 16.9% gain (or 13.0% excluding the Mag-7). However, despite the strong showing, the 31.7% increase marks the group's slowest growth rate since Q1 2023 and is projected to slow further in Q1 2025, with a forecasted growth of 18.5%. This coincided with a downgrade in earnings expectations for the overall market in calendar year 2025 when cautious corporate guidance due to the anticipation of tariffs and declining consumer confidence led to lower earnings revisions for Q1 and Q2 2025. Despite the compression in multiples, equity prices were still expensive on historical standards, and we believed that investors were underpricing inherent volatility risks stemming from fiscal policy agendas that could result in a wider possibility of outcomes.



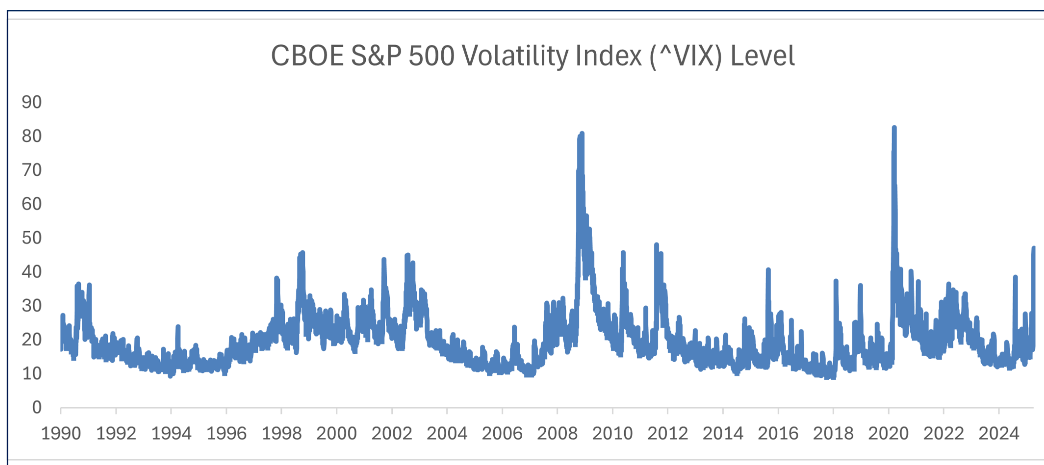
Source: Standard & Poor's, Bloomberg, Liberty One, Mar 2025.

Since "Liberation Day", the S&P 500 corrected by another -10% in two days, and markets have now appeared to discount at least some possibility of a recession in addition to weak sentiment compressing multiples even further. The current S&P 500 forward PE ratio is now trading at the lowest levels since 2023. Although this may appear relatively attractive, forward earnings estimates have yet to be revised from the potential adverse impacts of the tariffs. According to various industry experts, analysts are projecting that earnings could decline by about 8-10% from its initial expectations due to the tariff impact, which would lead to little to no earnings growth in 2025. Nonetheless, we believe that the risk reward profile of US equities is more attractive today than they were one quarter ago, despite the ongoing uncertain economic outlook.



Source: Bloomberg, Liberty One, Feb 2025.

For starters, many market sentiment metrics are at panic levels historically associated with market bottoms over the last 35 years. For example, the CBOE S&P 500 VIX Index reached an intraday high of just under 60 before closing at 47 on Monday, April 7th. For historical context, the VIX hit 66 during the unwind of the Japanese Yen carry trade in August last year, 85 during the COVID pandemic selloff, and just under 90 during the Great Financial crisis. Those periods coincided closely with market bottoms when fear was at its peak. Although the current VIX Index is nowhere close to those levels, it is also worth mentioning that today's spike in the VIX is primarily due to unexpected policy changes and not a fundamental breakdown in key areas like tech in 2000, housing in 2008, and the shutdown of the economy during the COVID pandemic. Fundamentally, the economy is still relatively healthy despite economic leading indicators pointing to further weakening.

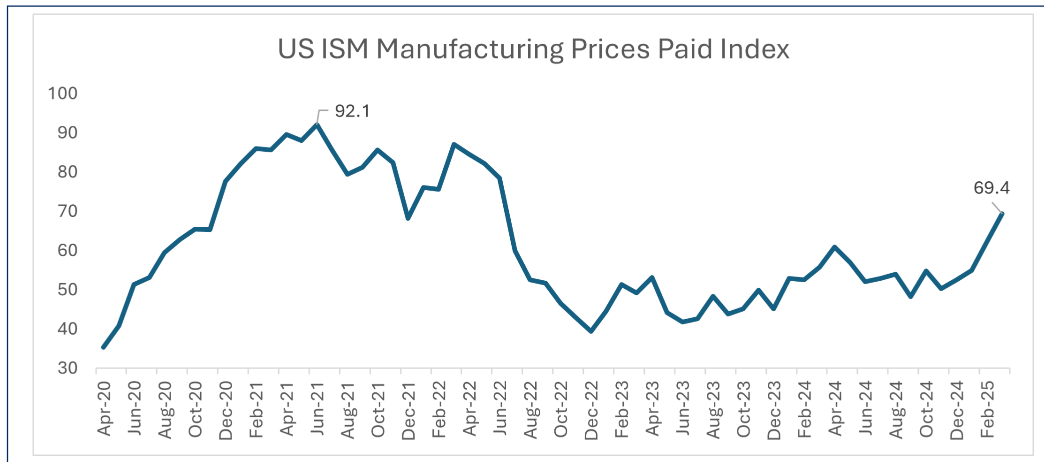


Source: Chicago Board Options Exchange, YCharts, Liberty One, Apr 2025.

However, it is still impossible to gauge whether we have hit a market bottom as of this writing. Markets are likely to remain volatile in the near term until tariffs are negotiated and reduced, fundamental outlook improves, or valuations fall to very compelling levels to encourage dip buyers. Additionally, tariff news cycle is likely to drive market direction in the near term, so we would expect volatility to persist for a while.

Outlook

At the start of the year, our investment theme for 2025 was to "plan for growth, but prepare for volatility". That continues to hold true as we are one quarter into the year. We still believe that most US corporations and businesses are still exceptional and will continue to do well over the long term. However, recent policy changes have clouded the outlook for many corporations. These policy changes have also increased the risks of stagflation- a scenario characterized by stagnant economic growth coupled with inflation. Prior to the broad-based tariffs announced by the Trump administration on "Liberation Day", the March 2025 US ISM Manufacturing Prices Paid Index was already rising at its fastest pace since June 2022.



Source: Institute for Supply Management, Liberty One, Mar 2025.

The recent rise was largely attributed to the tariffs imposed by the Trump administration on imports from Canada, Mexico, and China. These tariffs have led to increased costs for raw materials such as steel and aluminum, directly impacting production expenses. As a result, the overall ISM Manufacturing PMI declined to 49.0% in March, signaling a contraction in the manufacturing sector after two months of modest expansion. The combination of rising input costs and contracting manufacturing activity raises concerns about potential stagflation. Under this scenario, weaker economic growth could prompt the Fed to cut interest rates to support the economy, but we believe that the Fed would be more limited than what the markets may be hoping for, especially because the Fed will be tasked with anchoring long-run inflation expectations in a tariff-induced inflationary environment. So they would likely be more reactive than proactive in its policy decisions which increases the likelihood of policy missteps. Currently, CME markets are pricing Fed Fund rates to be approximately 1% below today's level (equating to 4 interest rate cuts) for 2025. We'd argue that this seems overly optimistic and therefore reaffirm our stance to remain neutral on duration despite the potential for weaker growth on the horizon due to inflationary risks. The objective for investors during stagflationary periods would be to preserve their purchasing power, avoid duration risks, and position for pricing power and defensiveness. In such an environment, we'd prefer quality dividend stocks with strong pricing power and resilient cash flow properties. The dividend growth received from these companies can help maintain investor income even as real growth struggles. Treasury Inflation-Protected Securities (TIPS) and inflation-hedged REITs would also be viable attractive alternatives to help investors to achieve those objectives. Although stagflation is not the baseline scenario currently, we believe that the longer tariffs remain in its current form without additional fiscal support or re-negotiated deals, the higher the likelihood that we could encounter stagflation.

Due to the possibility of wider outcomes in financial markets, it is extremely challenging to ascertain with confidence which investment style or strategy would outperform in the near to medium term. This is where the benefits of diversification shine- to position portfolios in various non-correlated investment styles or strategies to help navigate an uncertain environment. The key to diversification is concentration-concentration in different non-correlated investment styles, whose asset characteristics differ from one another. What we are trying to emphasize here is that diversification does not mean investing in hundreds of different stocks, mutual funds, or ETFs that overlap significantly. Diversification is stronger in portfolios invested in 5 different investments that have a low correlation to one another than 100 investments that are highly correlated to one another.

With the future economic outlook and financial conditions likely to remain volatile, actively managing for risks could help clients navigate the current environment while helping them remain invested over the long term.

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