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A Very Different Investment Order

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Commentary around financial markets can confuse catalysts with causes. Many point to Trump's tariff war as the source of this year's turmoil across US equities. It seems clear that many underestimated the commitment of the resurgent Trump presidency to radical change. How else to explain why the consensus outlook for 2025 has not survived the first quarter?

The distribution of the turmoil in early spring reveals the essential problem: the overvaluation, over-optimism, and overexposure across America's largest-cap growth stocks. The collapse of the momentum factor in March—one of the fastest unwinds in 40 years[1] —highlights the danger of overstaying the party, or "dancing as long as the music plays."[2]

If Wall Street has lost the leadership of the Magnificent Seven, investors must grapple with a very different future. The conditions that have long attracted investors to these stocks are being challenged at a time when these companies dominate portfolios everywhere. These are global businesses that are compromised in a reordered world economy.

This positioning crisis across the investment industry has symmetrical logic. The counterpart of everyone's overweight to US growth equities has been a corresponding underweight outside of America and to cyclical value. The comparative resilience of equities in Europe, Canada, and Mexico—all targets of Trump's tariffs—is telling.

The obsession with Trump generates the impression that his pronouncements are the most significant influence. Yet, it is an accident of history that Trump's second presidency coincided with the moment when America's growth equity assets had attained unsustainable levels. US equities entered 2025 from a position of vulnerability, and a catalyst for reassessment was inevitable.

From this perspective, the correction in equity values in 2025 should be unsurprising and is not especially material. That said, the acceleration of the equity correction into April requires an explanation, starting with tariffs where Team Trump makes the case for some short-term pain as Main Street is prioritized over Wall Street.

But investors have much more to consider. The strategic rivalry with China is intensifying, the policy linkages to economic activity are complex and contradictory, and the direction of US fiscal policy is still to come. In short, we believe the signals for a reordering of the investment landscape are everywhere.

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[1] The relative gains of the momentum factor of the past two years have been unwound (i.e., reversed) in just three weeks in Q1.

[2] "When the music stops, in terms of liquidity, things will be complicated," Chuck Prince said on the eve of the 2008 financial crisis. "But as long as the music is playing, you've got to get up and dance."

A Brutal Reordering of Global Trade

Amid today's polarization of the political landscape, it can be challenging to calmly assess the US administration's tariff policies absent the context of its stated objectives, internal preferences, and negotiating style. Without these inputs, one is left with an analytical void. In our view, public statements converge toward three clear and rational objectives.

First, tax revenues are imperative in the context of a historical budget deficit, which the administration acknowledges is unsustainable. Tariffs are one policy tool for addressing this and can offset the tax cuts that Trump campaigned on. Equally, tariffs carry a political message of real appeal: tax cuts can be paid for by foreigners.[3]

Second, the reshoring of industry is a priority of strategic and economic value. Some infrastructure is vital and must be produced domestically for national security reasons. The fragility of supply chains was revealed during the pandemic. Such strategic recklessness was laid bare by the crisis in Ukraine: Europe had outsourced its economic growth to China, its energy policy to Russia, and its security to the United States.

The economic value of reshoring is straightforward. Taxes on incremental incomes generated domestically underpin the first objective and message support for such priorities as healthcare and social security. Longer term, robotics and AI rather than cheap labor will drive the next wave of industrialization. We believe a strong manufacturing base will be critical for embracing new automation technologies.

Finally, the ambition of disciplining trade partners should not be discounted. China is the priority here, but the effectiveness of policy toward China depends on partner economies' cooperation. More generally, the Trump administration believes that access to the US market is not "free" and is partly beholden to other US aspirations such as security and border control.

These objectives are well defined, yet they embody internal conflicts that generate angst and confusion. Combined with Trump's personality and negotiating style, there is a concern that these policies conflict with the universal objectives of economic growth and public approval. Naturally, this is why few US political figures have taken up this challenge—until Trump.

There is a popular objection that Trump's tariffs are poorly planned and avoidably antagonistic. Yet, the signals amid the noise are unmissable. The US will use its full leverage to reset the baseline of trade relationships in its favor. Most countries understand this, and many are responding by offering to renegotiate. In simple terms, the world's #1 customer will get a 10% discount.

This narrative is rapidly unfolding, and Trump has a limited window to produce results, perhaps a few months at most. Trump must show the world and his supporters that there can be an upside to this brutal realignment of the global trading order, albeit one that US leadership across much of the political spectrum believes is necessary.

[3] There is a notable difference between a tax that takes away your income directly versus a tax that encourages you to choose different goods and, thus, impacts your welfare. Those are two very different incentives that commentators often ignore.

The likely outcome is that the US “wins” the trade war, where the heart of the matter is the confrontation with China. The latter has indisputably benefited the most from “free trade” of the past 30 years; it has the most to lose. By resetting its tariffs on a country basis, the US undermines the MFN[4] principle that fueled China’s manufacturing rise after its WTO entry in 2001.

Any language around “winning” must be carefully qualified. The US does hold the best cards among its trading partners. However, this does not equate to “getting someone to behave” who does not wish to behave. In essence, the US tariff strategy is a surrogate form of conflict with China that many believe is long overdue and inevitable.

This strategy could work well with most countries - but not with China where there is no viable path[5] to truly balanced trade. The result will be intensified economic decoupling and its corollary, a new investment order. In these circumstances, we can imagine a more tightly integrated US-led bloc of economies *that could enjoy more sustainable economic growth*.

The Economics of Trade Chemotherapy

Academic literature describes free trade as positive for all. Yet, there is no historical precedent for a large mercantilist economy generating the trade imbalances of China’s magnitude—a transfer of wealth that wears on the economic fabric of open societies. *This is the cancer that the US administration seeks to address, with no precedent to help frame the medicinal value of tariffs*.

For China, today’s trade embargo[6] is a deflationary shock at a time when its economy is struggling with a historic bubble in real estate and debt, reinforced by a declining working-age population. China may be confronting its own version of the Minsky moment[7] as the decline of its enormous trade surplus ripples internally.

China is not in a good place for this. It has been structurally unable to sufficiently boost its domestic consumption to overcome the collapse in property investment. China’s constraint is partly political: A consumer-led economy implies the CCP must loosen its domestic control. For all the excited talk around rebalancing, the consumption share of China’s GDP declined[8] in 2024.

The best one can say about the Chinese position is that its political structure can absorb immense pain, as it did with its punishing approach to the pandemic. The meaningless label of “strategic patience” is overused here. Given its reactionary instincts, China will turn inward, promote self-sufficiency, and hope to “buy out” the non-aligned countries of the global south. The latter will struggle with the exported deflation of China’s excess capacity.

[4] Under the Most-Favored-Nation (MFN) rules of the World Trade Organization, any country that accedes a special tariff rate to the US normally has to offer that same rate to its other trading partners. This is unlikely, which points to the end of the MFN or open trading system that was so beneficial to China’s dominance in goods trade.

[5] As opposed to a “truce deal” to help contain the rivalry.

[6] Beyond tariffs, there are parts of the US policy structure that aim to curb China's rise, particularly in technology and in terms of economic influence.

[7] Named after economist Hyman Minsky (1911–1996), this refers to a collapse of asset values after a long period of stability or growth sparked by a liquidity shock, often debt or currency pressure. The label gained popularity in the US during the 2008 financial crisis.

[8] It took Japan 17 years (1991-2008) and GDP rates barely above zero to boost its consumption share of GDP by 10 percentage points. There is little reason to think China will do this much more quickly.

For the US, an improved trade balance is an asymmetric reflationary stimulus amid a complex sequence of inflationary and deflationary impulses. Fortuitously, all of this comes at a time of considerable resilience across the US private sector. Gauging the interaction of this resilience and an expected pause in business spending amid declining sentiment[9] is inherently difficult.

Over the past three decades, China's opening has been the most important factor in producing the Great Moderation in the developed world. Accordingly, the closing of America to China should lead to a degree of "immoderation": somewhat higher and more variable inflation and interest rates in the US due to less elastic supply curves. This is the key debate.

Some of this inflation will be positive. To the degree that tariffs portend higher prices and cost pressures, this is better for incomes and balance sheets than the reverse. The *prima facie* evidence of this positive impact is the current health of US private sector balance sheets in the wake of the pandemic inflation. The greater threat for equities is always deflation, not inflation.

In contrast, "rebalancing" implies that high-surplus countries are threatened with deflation unless they can introduce fiscal stimulus. Europe and Germany have the rearmament alibi. However, China's constraint is fundamental, and in all likelihood, its deflation will be exacerbated by its excess manufacturing capacity. No other country besides America can absorb this.

US Slowdown, Not Recession in 2025

Tariffs, the scare of policy uncertainty, and the bursting of the AI bubble—all have coalesced to produce fears of a stall in US consumer demand. We see parallels with the Silicon Valley Bank (SVB) crisis in spring 2023, when economic fears intensified but abated quickly. Today as then, labor markets appear firm, consumer balance sheets remain pristine, and real wage growth is positive[10].

In the near term, any liquidity turmoil of stalling trade and the foreign liquidation of Treasuries[11]must be addressed, much as the Fed responded to the SVB crisis. Elsewhere, repo markets have been fine with no sign of funding stress. On April 15, Treasury Secretary Bessent outlined his toolkit response,[12] which aims to ease financial conditions at the long end of the curve, if necessary.[13]

Trump's admonitions of Chair Powell make good entertainment but are a sideshow because *we* no longer live in a world of monetary dominance. Fiscal policy has been the decisive factor[14] that allowed

[9] A sharp slide in business sentiment is a necessary but not sufficient condition for recession, particularly with profit margins close to record highs.

[10] The decline in oil prices is estimated to add 0.4% to real consumer incomes in Q2.

[11] Unconfirmed whispers suggest that China has been using sales of its US Treasuries to gain advantage in the trade battle. This asset selling appears to have had its intended impact.

[12] The Treasury Secretary give a glimpse of his proposed toolkit in a Bloomberg interview with Annmarie Hordern. The Treasury could purchase securities in the disrupted longer-duration areas of the yield curve while increasing the issuance of T-bills. There would be no monetary policy impact of these actions.

[13] Of course, the Federal Reserve could co-operate with some "common sense" actions of its own. Trump appears to be 'softening up' Chairman Powell in this direction.

[14] The coming changes in trade may be less impactful for the US economy than those related to deregulation and fiscal policy. Total imports of goods and services account for 15%, while taxes and deregulation affect the remaining 85%.

the private sector to absorb such shocks as the Russian invasion of Ukraine and an unprecedented, synchronized tightening of global monetary policy.

To summarize, we believe investors are incorrectly judging today's trade shock as deflationary for the US when it is a different sort of shock versus the past 30 years. As we write this note, there is little macroeconomic data that points to an impending economic stall. Few have offered tangible linkages between today's tariff policies and a material hit to US consumer income or employment.[15]

Although today's headlines diminish our confidence, we see expansion as the most likely path ahead because the key drivers of recession are not yet in place. Sentiment matters, but fundamentals matter more. High levels of uncertainty do not equate to the certainty of recession. Of course, all this bears monitoring as the tariff salvos fire overhead.

Importantly, market behavior appears to confirm this. Bond yields have been stable, and credit spreads have not moved decisively. Domestic US cyclical stocks have remained resilient. Some commodity prices have weakened, but primarily those driven by Chinese demand. For now, our diagnosis is a severe correction of equity values, not a bear market.

Volatility in a Very Broad Range

Entering 2025, we anticipated two scenarios for US equities: volatility or a bear market. By April, equities stood at the threshold of a bear market. However, it is too early for this because the US economy is confronting a slowdown, not a recession. This favors the scenario of volatility rather than outright bear—for now.

Through the first quarter, we assumed that the downside for the S&P 500 Index would be contained to the 5300 level. The rapid deterioration of financial markets in the early days of April, with the S&P 500 declining briefly to the 4800 level requires explanation. Here, we think the market is signaling two fundamental risks.

First, the escalation with China is moving too fast. Beijing has reacted vociferously to US tariffs because it has limited leverage and its economic back is against the wall. Perceiving an encircling trade alliance to its disadvantage, China's leaders interpret today's conflict in a historical context: Westerners imposing reparations and public humiliation.

It is impossible to know if China is ready for a nasty showdown. But Trump has every reason to de-escalate: His administration's bandwidth is stretched with multiple proposals for new trade arrangements. Some kind of 'trade truce' with China would minimize the risk of another leg down in equities in a highly financialized US economy.

What China wants is a structured process for dialogue with a US point person who can credibly represent Trump's endgame. It is unclear if Trump is ready to commit to this. He may prefer simmering

15 In the simplest sense, any policy that redirects US consumption to domestic participants rather than foreigners is an immediate and positive stimuli to economic activity.

tensions as a roadblock for China's economy but a tailwind for reshoring back to the US. All said, he needs to minimize his vulnerability to disruption in US financial markets.

In any case, investors need to see that the confrontation is limited to China, and that the tail risk of acute escalation can be minimized. The question is whether this ship has sailed.

The second risk is inflation. The bond market's message is that inflation is percolating in the backdrop and thus, the real safe haven is gold rather than bonds. The inflation problem will become serious if the market begins to believe that the Fed will hike rates – but investors are not there yet. Inflation can be good for equities *until the Fed's position becomes untenable*.

If these risks are contained, the major equity benchmarks can avoid a new leg lower: April 7 could represent the lows for 2025. In our view, equities need "another shock" for the recession call to become credible.

What emerges from this will be influenced by our structural perspective.[16] Although a degree of investors' over-optimism has been removed, the obstacle of over-ownership is unresolved. Investors are likely to reduce risk into any revival, which implies recovery cannot be V-shaped. In other words, the best outcome for equities will be a setting of three steps forward and two steps back.

The riposte to the Invincibility Syndrome and its implications for prolonged disturbance is this: Has the world that produced the decade-plus outperformance of US growth equities really changed that much? After all, these businesses have substantial profitability and security attributes. Could this not simply be a temporary setback rather than a more strategic turning point?

Dogmatism about the future is rarely a productive investing quality. And yet, two arguments stand tall over the question of sustained American financial supremacy. First, asset valuations matter, at least when they are extreme and especially when considerations of sentiment and positioning back them. The comparison with the year 2000 can be qualified, but not entirely dismissed.

Second, the exceptionalism of US financial markets was enabled by America's ability to attract capital for competitive returns and security from all parts of the world. Today, few doubt the narrative of a more fragmented world economy with greater restrictions on trade, capital flows, and direct investment. Disruption implies that financial capital can go home.

In this version of the new global order, it is hard to believe that capital flows will not be affected in some fashion. Although the US economy is less vulnerable to Trump's policies than its major trading partners, the unintended and indirect effects upon portfolio capital flows may be more disruptive than many can imagine today.

This is a future where Main Street leads, but Wall Street struggles. It is an investment landscape where active and alternative solutions win at a time when clients have too much passive equity exposure. In this sense, the first quarter may be an overture for what is to come: the aspirations of many will struggle if the Magnificent Seven becomes decidedly less magnificent.

[16] This was described last autumn in our market commentary as the Invincibility Syndrome.

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