Citi Wealth

Investment Strategy *Bulletin*

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Hitting the Tariff Button

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Key Takeaways

- A 10% drop in US equities has not dissuaded President Trump from announcing escalating tariffs on particular imports from Canada, the EU and others. However, with US equities dropping 0.7% on average per day since peaking on February 19, we suspect that a near-term peak in trade policy uncertainty will be reached by the President's deadline for a "reciprocal tariff" announcement on April 2.
- While complex to measure, we expect reciprocal tariffs to be significantly smaller in absolute size than the 10%-25% tariff increases across a range of North American and Chinese imports. This does not prevent future rounds of tariff uncertainty or "trade wars" from recurring.
- Even in a hypothetical "best case" in which US tariffs are dropped as foreign tariffs decline in negotiations, the rise in trade uncertainty is likely to result in a net weakening of the US economy in the next couple of quarters as production and investment slow. With this said, the drop may not be as severe as peak market fears to come. As an example, in 1Q to date, US small business confidence has fallen less than 5%, pointing to a moderate slowdown.

Potential Portfolio Implications

- US large cap tech shares have fallen 20% from their peak, but merely to September 2024 levels. With the "Magnificent 7" as a group up 160% over the two years ending 2024, they won't look "cheap" unless one takes a very robust view of future EPS growth. Nonetheless, investors should consider the grouping's historic EPS growth rate of 16% compounded.
- Last year, the software group rose 19% after Trump's election, with the idea that they would contribute more to AI solutions, but also that software trade was less susceptible to tariffs. Software maker shares have erased all of the gains and more, matching the decline in retailers, despite less tariff exposure.
- US healthcare has acted as a defensive trade as we had hoped, with a 7.5% year-to-date gain. Non-US equities have broadly stayed on their late 2024 recovery track, rising 7% YTD. China is showing global investors that US firms are not the sole innovators.
- US tariff and immigration policies are more fundamental to the outlook than last August's "yen carry-trade" driven market pullback. We don't see signs of extreme "capitulation" in markets. Nonetheless, future returns improve as values drop. We also see 1Q EPS estimates as unusually weak in advance of results. High quality balance sheets and dividend growth may be the first place to add for investors who are below their benchmark allocations to equities.

Rising Apprehension, Potential for Exaggeration

"Tariffs are going to be the greatest thing we've ever done as a country. It's going to make our country rich again." President Donald Trump in comments to reporters March 10, Wall Street Journal.

Perhaps we were putting it too nicely last week: "the world is waking up to a torrid pace of change in US policies under the new administration" (Please see Investment Strategy Bulletin Mar 8, 2025). After Ontario's decision to slap a 25% tax on US electricity exports, US President Trump said he would raise Canadian steel and aluminum tariffs to 50% from 25%. The tariffs, of course were put on pause for further negotiations. But are tariffs, as an idea, negotiable? From the President's comments, it doesn't sound like it.

Tariffs to protect US industry from competition and collect tax revenue would generally move the US toward an economic model most prevalent in Emerging Markets economies. These are generally not known for their economic success. While the tariffs won't dominate all that matters in the US and world economy, in the present case, there's also a transition cost to consider in the form of retaliation. We suspect losses of US exports, higher input costs for domestic producers and the pass through to consumer demand will, when all is tallied, weaken US manufacturing employment compared to where it would otherwise be.

As we discussed last week, tracking data point to downward revisions in our forecast for US growth in the first half of this year, with uncertainty beyond. We are somewhat reluctant to quantify this before actual tariff announcements from the US administration, currently set for April 2. Those details and market reaction may help us understand both the *depth and duration* of economic impact.

Tariff Turmoil- How to Invest Amid Heightened Uncertainty

Market prices are attempts at predicting the future. They constantly adapt to incoming information that influences the prediction. Bull and bear markets tend to *exaggerate* the ultimate reality. We believe the Trump administration's April 2 "reciprocal tariff" announcement date in just over two weeks, coupled with negative market dynamics, will lend itself to high levels of apprehension, possibly exaggerated apprehension. If so, opportunities will present.

As we've discussed, the US trade policy uncertainty index has risen to all-time highs (see **Figure 1**). Lasting tariffs of 25% on Canada and Mexico alone are larger than "reciprocal" tariffs on the rest of the world, subject to one's definition and interpretation. (The US administration will define).

Where asset prices are in two weeks, what the administration announces, and how the US and world economies respond, will help determine opportunity and risk. We can't pre-judge this yet. It is true, however, that valuations of some desirable long-term assets are lower now than at recent peaks. US software shares – with light tariff and retaliation exposure while providing key ingredients for the future of AI and cybersecurity – have erased all of their late 2024 rise. Their roughly 20% drop is equal to the drop in US retailers. Yet US retailer profits are far more impacted by tariffs on consumer goods imports and any related economic weakness to come (see **Figure 2**).

Unrelated factors have weakened both US tech shares and cyclicals this year (such as Consumer Discretionary shares). As we've highlighted in our Outlook, we've been underweight US large cap equities all year on concern for concentration risk for the Magnificent 7 which collectively rose above $18 trillion in market cap late last year. The world's most profitable handset and consumer technology maker is among the firms most dependent on Chinese production and demand. The US's largest electric vehicle maker is having its sales eclipsed by Chinese producers (Please see Investment Strategy Bulletin Feb 22, 2025). But all of the Magnificent 7 have now fallen 20% collectively. This bears watching as *individual shares* for investors with below target exposure.

FIGURE 1: US Trade Policy Uncertainty Index

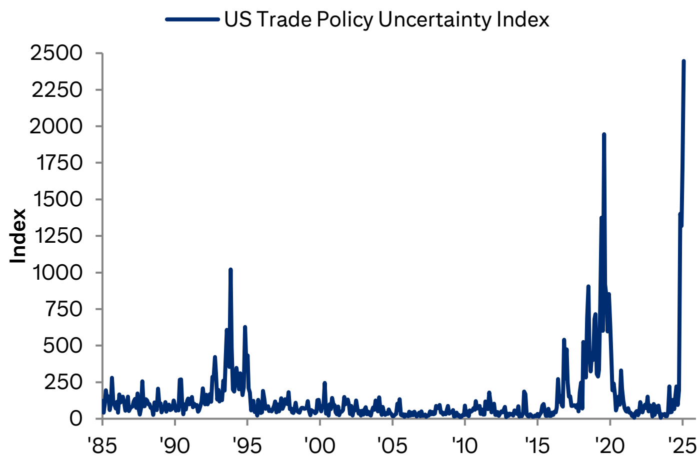
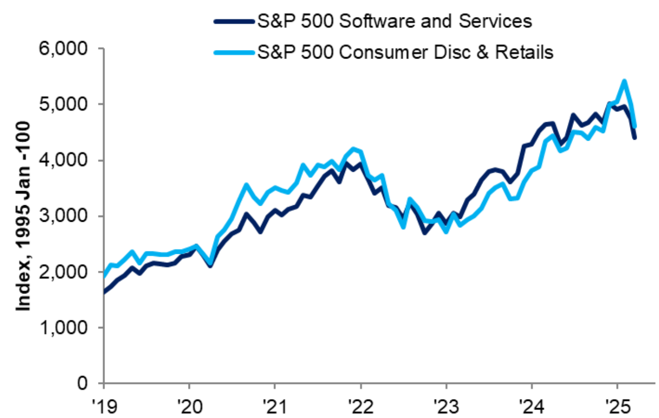


FIGURE 2: US retailers vs US Software



Source: Haver Analytics, Bloomberg, as of March 13, 2025. Indices are unmanaged. An investor cannot invest directly in an index. They are shown for illustrative purposes only and do not represent the performance of any specific investment. Index returns do not include any expenses, fees or sales charges, which would lower performance. Past performance is no guarantee of future results. Real results may vary.

Asset Allocation to Mitigate Range of Outcomes, Risks

Much more broadly, asset allocation should be set for investors on the basis of a wide set of potential outcomes. A 100% bond allocation will have none of the benefits of generating real returns from economic development and technological progress. A 100% equity portfolio will be subject to bull and bear market volatility extremes. If risk-adjusted returns are the target, a mix of equities and negatively correlated high quality bonds is the right approach (see **Figures 3**). This year, for the first time since the early 2000s, non-US equities are contributing positively to diversification and returns as we have hoped (Please see Wealth Outlook 2025).

As we are all attempting to understand the new Trump administration's policies and whether or not they will adapt and change, we need to be open minded to the risks and opportunities, humble in what we don't yet know. Tariffs are one fundamental policy change. Deregulation is another. But the scope of the setback in overall US equity market has been less than one annual standard deviation (-12%). The spike in implied volatility and other metrics does not suggest a collapsed equity market (see **Figure 4**). At the same time, credit markets haven't suggested a break down in the capacity of firms to service debt. This would come if markets believed tariffs set in motion a self-reinforcing collapse in the economy. The absence of such a dynamic remains our base case view, but one that is challenged if the international trade discord develops into a much more severe supply shock. We will keep this in mind as we calibrate new policies and the market reaction.

FIGURE 3: Regional Equity Returns % YTD

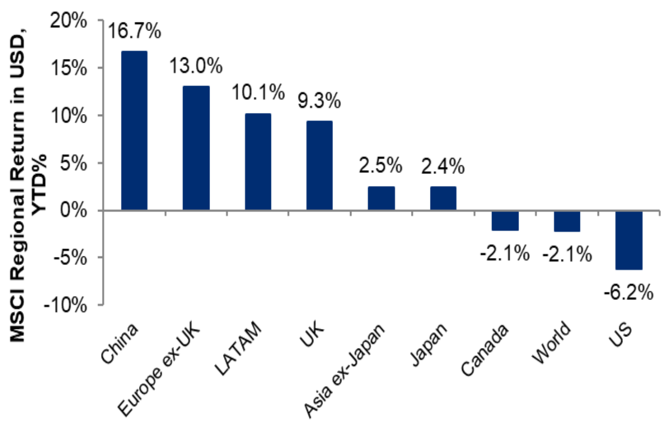


FIGURE 4: VIX Index

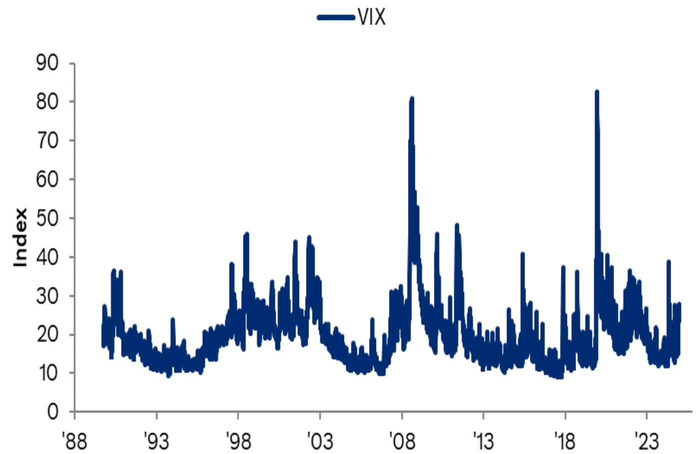


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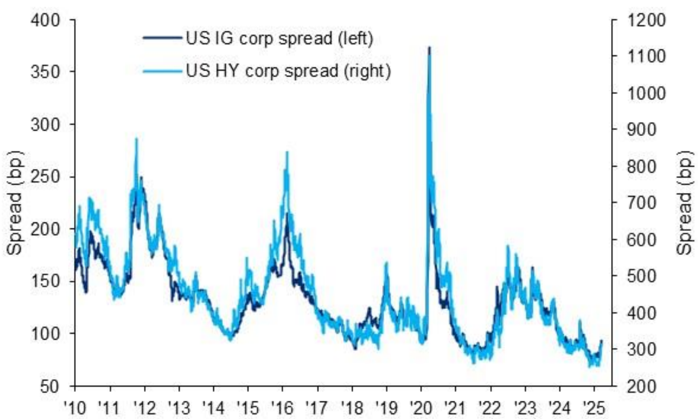
FIGURE 5: US High Yield and High Grade Spreads



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Future EPS Is the Key

As we discussed in Wealth Outlook 2025, the weakness in cyclical industry profits across the world in 2023 allowed for broadening gains across industries and regions in 2024. Yet following last year's 10% EPS gain for the S&P 500, an 11% EPS gain for 2025 seemed excessive. A gain that large was not completely out of reach, but required some acceleration in economic growth in our view. Our own estimate of the S&P 500 EPS gain for 2025 was 7.6%. With very strong 4th quarter results now reported, it seems possible to achieve our $262 estimate for the EPS level this year, but not the "bottom up consensus" of just over $270.

With the bulk of tariff impact to hit US profits in 2Q 2025 and any negative economic impact in that period and beyond, we expect many exposed firms to guide down future profit forecasts. At the same time, that's what falling share prices anticipate.

As noted, EPS gains in 4Q 2024 were much stronger than expected. And in 78% of years since 1997, calendar first quarter "upward surprises" were larger than fourth quarter surprised for the S&P 500 overall (see **Figure 6**). Analysts, meanwhile, have cut calendar first quarter EPS estimates far below the likely profit level of the unfinished first quarter (estimates show a 7% quarterly drop from the end of 2024, see **Figure 7**).

"Beat and raise" guidance is usually what's needed to drive bull markets ever higher. Yet with plenty of policy uncertainty and share price declines to scare investors over the past month, the first quarter EPS results in April should temper downward earnings revisions for 2025. If the Trump administration could also "finish" announcing its intended tariff targets, it's more likely markets will come to grips.

With this said, we don't believe investors should be betting on unpredictable trade developments. If investors are underweight equities relative to their target allocation and take a long-term time horizon, both domestic and international dividend growers have demonstrated balance sheet capacity to withstand shocks (see **Figures 8-9**).

FIGURE 6: Firms Attempt to Embed Negative EPS News in 4Q Periods

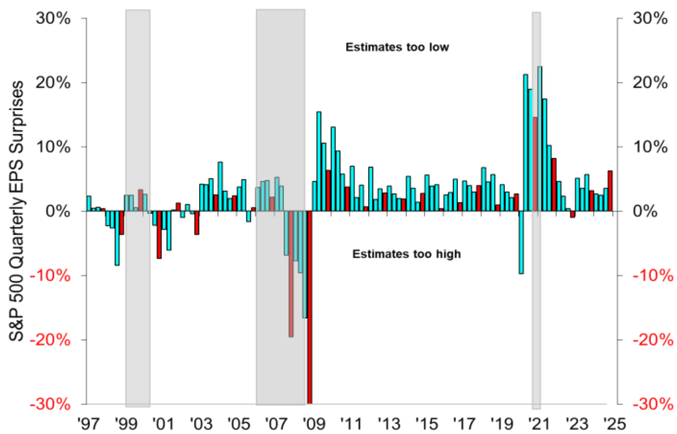

FIGURE 7: S&P 500 EPS Estimates Too High for the 2025, but Too Low for 1Q 2025

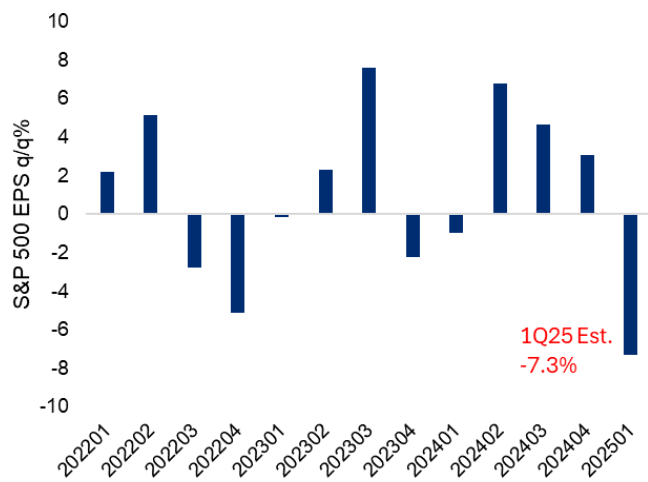

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FIGURE 8: S&P Dividend Aristocrats vs S&P 500 Y/Y

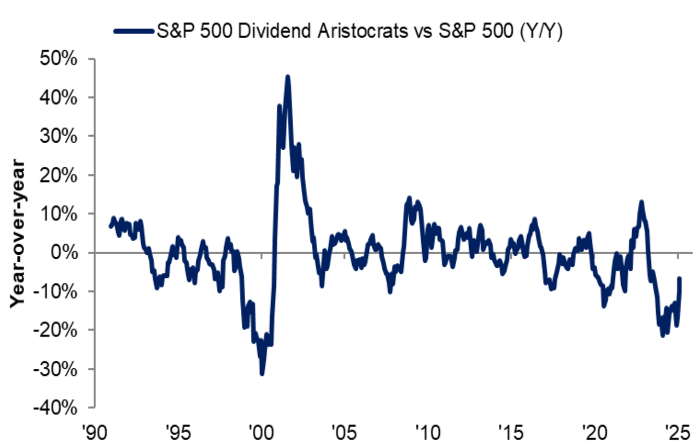
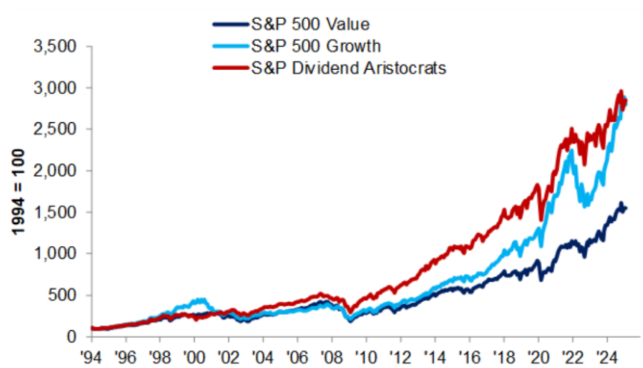


FIGURE 9: S&P Aristocrats, Growth and Value Index



	Value	Growth	Div Growers
Avg Ann. Return	10.1%	12.2%	11.8%
Avg Ann. Volatility	15.6%	15.9%	14.0%
Sharpe Ratio	0.65	0.77	0.84

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High quality (very strong)	Aa	AA	AA
Upper medium grade (Strong)	A	A	A
Medium grade	Baa	BBB	BBB
Not Investment Grade			
Lower medium grade (somewhat speculative)	Ba	BB	BB
Low grade (speculative)	B	B	B
Poor quality (may default)	Caa	CCC	CCC
Most speculative	Ca	CC	CC
No interest being paid or bankruptcy petition filed	C	D	C
In default	C	D	D

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- lack of liquidity in that there may be no secondary market for the fund and none is expected to develop;
- volatility of returns;
- restrictions on transferring interests in the Fund;
- potential lack of diversification and resulting higher risk due to concentration of trading authority when a single advisor is utilized;
- absence of information regarding valuations and pricing;
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- less regulation and higher fees than mutual funds; and
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