Quarterly Commentary

Q1 2025

Tariff Games

When thinking back over the last several months, memories of the children's games we played in kindergarten came flooding back. Perhaps it was the relative disorder the world suddenly found itself in that prompted the connection. Or maybe it was the fact that each child seemed to have their own understanding of the rules—and those rules weren't really going to impact how some played the game anyways! One game in particular kept coming to mind: Duck, duck, goose.

If we flash back to November 8, 2024, Donald Trump was elected to a second Presidential term in a decisive victory over Kamala Harris. The market reacted as it did in 2016, quickly pricing in a more lenient approach to regulation and a pro-growth bent that would surely be positive for corporate earnings. Although a prominent feature of Donald Trump's campaign, tariffs largely ended up in the back seat, with concerns more focused on the effect they might have on inflation, but not a big enough factor to hold back the stock market. Indeed, the S&P 500 powered to new record highs through February 19th, 2025. Perhaps it was ignorance, hubris, inertia—or even the recollection of the relatively mundane tariffs of Trump's first term—that allowed for the collective blinders to be put up.

The world's first jolt into the inconvenient reality that, this time around, things may not be so mundane, came on February 1st, when President Trump announced that he would follow through on his promise to implement widespread tariffs on Canadian and Mexican imports. Canadian and U.S. markets quickly took a negative turn. That is, until a few hours later when Trump announced a 30-day grace period to allow the two countries to demonstrate meaningful progress on tightening border security (the thinly vailed pretense used to justify the tariff measures). Since that time, it has been a seemingly constant barrage of on-again, off-again tariff announcements, with anyone—and anything—being on the table. Duck, duck, goose.

Tariffs have a long history in trade. They are one mechanism, among many, that countries use to attempt to safeguard domestic industries or goods from competitive foreign pressures. In a very simplistic form, tariffs are a tax that increase the cost of foreign imports. The goal is to make comparable domestic products cheaper and, therefore, more attractive to domestic purchasers. Tariffs have been on a downward trajectory since the Great Depression in the 1930s. After the Second World War, international cooperation on trade was formalized with the General Agreement on Tariffs and Trade (GATT). Even with Cold War dynamics in play, average U.S. tariff rates fell from a level of approximately 10% at the end of the Second World War to less than 4% in the early 90s. The formation of the North American Free Trade

Agreement (NAFTA) in 1994, along with the World Trade Organization (WTO) in 1995, saw U.S. tariff rates drop below 2% up until 2018. Thirty years on, the WTO is now the world's largest international economic organization, with 166 members representing over 98% of global trade.

The formation of these agreements and organizations reflected an extensive and concerted international effort towards the globalization of free trade and economic cooperation. Over the past thirty years, these efforts, combined with expanding populations and economic & technological advancements, have led to a highly complex network of supply chains and manufacturing. Economies have become increasingly intertwined in a complex and delicate balance of crisscrossing trade. In the past, tariffs could be relatively simplistic; in a world where car parts cross international borders over 20 times, tariffs become much more complex. This was indeed one of the intents of globalization: Align the national economic interests of many countries and all are less likely to enter conflict with one another due to the detrimental impacts it would have on their own national interests.

Another economic argument for globalization is that the distribution of resources is not inherently equal among nations. From a high level, if one country can produce a product or develop a resource more efficiently, it makes sense to outsource that process rather than invest energy and capital into trying to compete from a place of relative disadvantage. In this way, such energy and capital can be focused on industries where a country has a comparative advantage, thus promoting more efficient overall use of each countries' resources.

Of course, this is a very simplistic and idealistic view. The world is a competitive place, with some industries being more desirable than others, while also creating more wealth than others. Over time, competing national interests, strategic priorities, changing economic advantages, and security considerations inherently create imbalances. Additionally, some countries skirt the rules or take advantage of the system; there should be steps taken to combat such abuses.

Not many, however, would point to the world's leading economy and say they have been a victim of globalization. Nevertheless, President Trump's justification for tariffs is just that. His general assertion is that the U.S. has a relative disadvantage in the world of trade due to the value of the U.S. dollar (USD) and its status as the global reserve currency. He further claims that nations around the world have been taking advantage of this for decades, exporting goods to the U.S. and accepting high-value U.S. dollars in return. He points to the large trade surpluses many countries have with the U.S. as evidence of America's disadvantaged position. The result, it’s claimed, has been a hollowing out of U.S. manufacturing and the jobs that go with it.

If there is an overarching strategy to Trump's trade war it appears to have been defined within a whitepaper published by Dr. Stephen Miran, Chair of the Council of Economic Advisers, in November 2024. The basic theme is that tariffs can serve as a mechanism to realign trade imbalances in favour of the U.S., make the world less dependent on the USD as a reserve currency, and therefore make U.S. exports more competitive, thus bringing back jobs to America.

A more simplistic view is that the U.S. has been running incredibly large budget deficits since the pandemic, and interest on aggregate U.S. national debt is becoming increasingly burdensome. If one wants to cut taxes and not increase the deficit, those cuts need to be offset with other sources of revenue. Tariffs are a source of revenue for the government, and one that can be claimed to be a tax on foreign nations. Whether or not they are additive depends on the impacts tariffs have on demand for foreign imports and overall economic activity. We will point out that, if this is the goal, all things being equal, trade imbalances would be desirable, as they would correlate with higher tariff revenue.

The third option is tariffs are a broad negotiating tactic designed to improve the terms of trade for the U.S. or provide leverage to achieve other strategic objectives important to this administration.

We will not venture to guess what the ultimate strategy of President Trump is, nor will we debate the legitimacy of the above claims or the mechanisms proposed. Suffice to say, global trade is a very complex system, with the current balance a reality of many decades of nuanced trade relationships and economic development. To fundamentally change this balance over one Presidential term is a tall ask, and it will not be achieved without considerable impacts on the global economy, international geopolitical relationships, and markets.

The Current Tariff Reality (as at the time of writing: April 7, 2025)

Subsequent to the quarter-end, on April 2nd—a day self-titled as 'Liberation Day' by President Trump—broad-based tariffs on all U.S. imports were announced via Presidential Order and implemented under the International Emergency Economic Powers Act (IEEPA). The tariffs included a blanket 10% levy on all imports, with 40 countries plus the EU being charged a further increase over and above as a so-called 'reciprocal' tariff. Additionally, President Trump indicated further targeted sectoral tariffs would be forthcoming, with 25% tariffs on automobiles taking effect that day. Canada and Mexico escaped further escalation to previously announced tariffs, with US-Canada-Mexico Agreement (USMCA) exemptions remaining intact, broadly sheltering much of Canada's trade relationship with the U.S. from tariff impacts. The nations hardest hit were those with the largest trade imbalances with the U.S. For example, China was targeted with a reciprocal tariff of 34% (resulting in an effective tariff rate of 54%), Europe 20%, while Cambodia, Laos and Vietnam will be faced with levies of 49%, 48% and 46%, respectively.

China announced retaliatory tariffs of 34% on all imports from the U.S. on April 4th. At the time of writing, additional sector-specific tariffs were expected to be announced by Donald Trump and his team over the coming weeks. Other nations may also put retaliatory tariffs in-place, risking further escalation of tensions. Governments globally will be working hard to negotiate exemptions—either broadly, in the form of new or revised trading agreements, or more specifically in areas deemed strategically important to national interests.

Looking forward, further retaliatory tariffs or additional sectoral tariffs are likely to enhance negative sentiment. On the other hand, announcements regarding negotiated exemptions or revised trading agreements will likely be positive for markets. Additionally, trade negotiations and cooperation between nations outside the U.S. will no doubt be a strategic focus, and may be positive for those markets.

Below, we outline some of the higher-level impacts the tariffs may have:

- Uncertainty makes it very difficult for corporations and individuals to plan. If costs and economic conditions are unclear, corporate capital programs may be delayed and consumers' discretionary spending reduced until they can be more confident in their environment. This means corporations may delay growth plans, aim to cut costs, and potentially cut jobs. Individuals may delay spending and thus drive slower economic growth. Retaliatory tariffs from other nations against the U.S. will serve only to exacerbate this uncertainty.
- Tariffs will increase the cost of products imported into the U.S. Such cost increases will directly affect any businesses that utilize foreign products. Companies will attempt to pass these costs directly through to consumers. Where they are successful, they will push inflation higher. To the extent they are not, they will result in compressed profit margins for corporations. It is important to note that tariffs have the potential to push prices up on products produced solely within the U.S. as well. If competing foreign products are 10% higher (or more), domestic producers face less competition and are less incentivized to keep their prices low.
- The above effects risk an environment where inflation is high but economic growth is low. This is a condition known as stagflation.

Stagflation presents considerable challenges to traditional economic policy. When inflation rises, central banks typically raise interest rates to reduce inflationary pressures by cooling aggregate demand. However, tighter monetary policy can push unemployment rates up and slow economic growth; not a desirable outcome in an already slow economy. On the other hand, when economic growth is slow, central banks typically respond by cutting interest rates, while governments often elect to increase fiscal spending to promote growth. Both solutions can push inflation higher—again, not a desirable outcome if inflation is running hot. Thus, stagflation presents a policy dilemma, leaving central banks and governments hemmed-in by competing economic objectives.

- The budding trade war has shaken the confidence of many nations in terms of long-held geopolitical allegiances. One of the first objectives outlined by Friedrich Merz, Germany's Chancellor-in-waiting, was to increase defense and infrastructure spending in response to what was interpreted to be an uncertain outlook for the U.S.'s commitment to defending Europe under its NATO obligations.
- Countries are also evaluating how best to diversify their trading relationships in the context of shifting global balances. South Korea and Japan recently held talks with China—historically not the most harmonious relationship—to promote a trilateral free trade agreement. Canada and Europe have made overtures about increasing economic alignment and cooperation. These efforts will continue in response to an uncertain outlook for trade with the world's leading economy.

This volatility has been the result of a fundamental change to policy. It is possible, therefore, that a policy U-turn, or a series of 'off-ramps', leads to a more constructive environment. We anticipate the latter is more likely than an abrupt U-turn. Even if tariff rates are pulled back, many of the above impacts are likely to persist to some extent as individuals, corporations, governments, and nations recalibrate prior assumptions around potential risks.

Borger Griffiths Wealth Management's Strategy

As highlighted in our communication to clients on April 3rd, this remains a very fluid and evolving situation. Our team's strategy has been one defined by more conservative positioning, beginning in earnest in the lead-up to the U.S. election last year. Specifically, our strategy has been focused on the following:

- Pulling forward allocations to fixed income given strong yields and the expectation interest rates would continue to fall in Canada and globally
- Reducing exposure to large-cap U.S. technology and associated securities that had benefited from significant Artificial Intelligence-driven momentum over the prior two years
- Increasing exposure to value-oriented securities, including Canadian companies that have strong track records of paying dividends and non-tech U.S. equities with more favourable valuations
- Increasing allocations to strategies with downside-mitigation and volatility-reducing mechanisms built-in, including active hedging and long-short strategies
- Increasing exposure to developed-market international equities given record discounts to U.S. equities

Though we cannot predict how this will ultimately settle-out, we believe these themes will remain relevant, and we will continue to adjust positioning as new information comes available. We will also be looking to take advantage of opportunities provided by this volatility, though we will do so strategically and—as much as reasonably possible—from an informed perspective. Additionally, a majority of client portfolios have fixed income maturities throughout the year which will provide access to capital.

We believe the volatility will eventually subside, and we will emerge on the other side with more positive days ahead. In the meantime, our team will be highly engaged, working hard to support you and your family as we navigate through the uncertainty.

Q1 Market Performance

American stocks carried momentum through the start of 2025 with positive anticipation for a pro-business agenda under President Trump and ongoing momentum in Artificial Intelligence-related stocks. AI momentum was rattled significantly with the release of Chinese company DeepSeek's advanced AI model. The model rivaled the most advanced American models in many ways, but cost far less to develop, utilized far fewer advanced chips, and required far less power to operate. This raised fundamental questions about America's lead in the AI race and the enormous capital being invested by the U.S. tech giants.

Despite some short-term volatility, the broader U.S. market quickly moved past the DeepSeek phenomenon and climbed to record highs on February 19th. However, as rhetoric around proposed tariff policies began to escalate, markets retreated from their highs. The S&P 500 officially entered correction territory in mid-March after falling more than 10% from the February 19th peak. This 10% drop occurred over just 16 trading days, making it the sixth-fastest correction since 1950. The drawdown was led by the same 'Magnificent 7' mega-cap technology stocks that propelled markets higher over the past two years. Overall, the S&P 500 finished the quarter down 4.6% in Q1. Collectively, the Magnificent 7 declined approximately 14.8%. Excluding the Magnificent 7, the rest of S&P 500 posted a positive 0.4% return during the quarter. The NASDAQ Composite Index finished down 10.4%.

A similar performance dichotomy played out in international equities, with European and Chinese indexes outperforming the U.S. by a wide margin. European markets gained momentum in anticipation of increased defense and infrastructure spending, with the MSCI Europe Index posting a +10.6% return. In China, the DeepSeek revelation proved to be a shot-in-the-arm for Chinese technology stocks and broader equity markets as investors recalibrated their assumptions around global tech leadership. Government stimulus measures targeting increased consumption and support of the broader economy also contributed to the momentum. The MSCI China Index finished the quarter up 14.6%.

In general, value-oriented stocks broadly outperformed their growth peers in the first quarter. The MSCI World Value Index posted a +5.0% return, compared to the MSCI World Growth Index falling 7.7%, as mega-cap tech heavily weighed on growth equities.

Closer to home, the Canadian S&P/TSX Composite Index posted a positive +0.8% return in the first quarter, with materials (predominantly gold), utilities, and energy leading the way year-to-date. Canadian fixed income yields continued to fall as the Bank of Canada cut interest rates for the 7th consecutive time in March. The U.S. Federal Reserve held rates steady during the quarter in response to inflation uncertainty related to tariffs. The U.S. Aggregate Bond Index eked out a +2.75% return during the quarter.

Subsequent to the quarter, global stocks fell significantly following the 'Liberation Day' tariff announcements on April 2nd. As at the time of finalizing this letter on April 7th, markets had recorded the following year-to-date returns:

- S&P 500 Index: -13.9%
- NASDAQ Composite Index: -19.2%
- S&P/TSX Composite Index: -7.6%
- Euro Stoxx 50 Index: -4.9%
- Japan's Nikkei 225: -22.0%
- Shanghai Stock Exchange (SSE) Composite Index: -6.9%

The Borger Griffiths Wealth Management team thanks you for your business and continued trust in us. We look forward to continuing to work with you and your family as we help navigate your financial journey with deep knowledge, diverse experience, and commitment on your side. If you have any questions or issues you would like to discuss, we would be happy to receive your call.

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