

Tariff Wars: Counting Small Victories

Market Insights

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Counting Small Victories

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Well, its official. The market opened today, and the S&P 500 officially entered bear-market territory, down 20% from its most recent high.

We have seen a lot of big corrections since 2000 — the Tech Bubble, the global financial crisis and the Covid pandemic jump immediately to mind. The self-induced nature of this correction is unprecedented, but it also means a policy U-turn is possible, and likely once the pain threshold becomes too high. It could come from multiple sources: market drops, widening credit spreads or lower approval ratings. Multiple countries have voiced willingness to talk and, aside from China, there's no sign of any Asian nation deploying retaliatory measures.

U.S., Canadian and global companies are coming into the crisis with strong fundamentals. Further, many asset prices that had extreme moves overnight have somewhat reverted, indicating that the panic-selling and margin calls may, for the most part, be behind us — at least in Asia and Europe. So far, there haven't been any catastrophic events, and the banking and financial system is working as intended. In times like this, small victories need to be counted.

In this issue of *Market Insights*, we consider the current market correction through the following four lenses:

1. Amygdala hijacking:

Knowing that the innate desire to flee can come at a high and permanent cost.

2. Extreme social media:

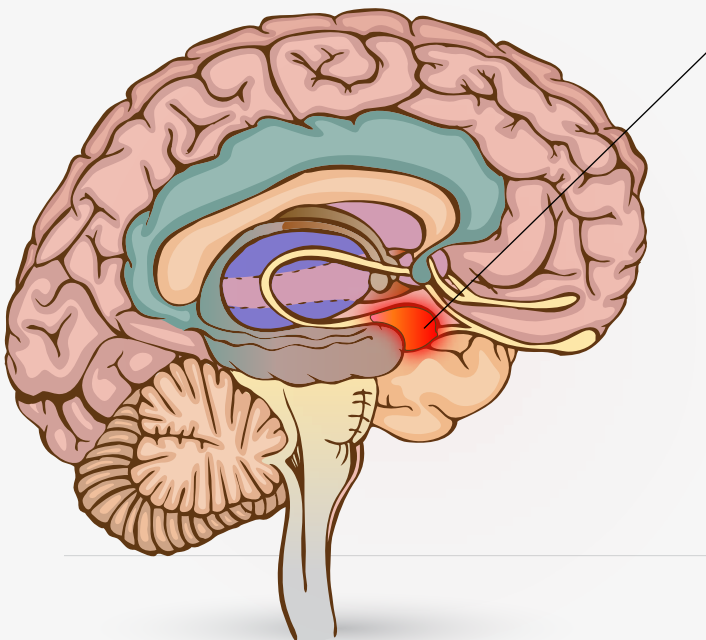
There's lots of technology out there designed to inflame your biggest fears.

3. Market and economic context:

The market crisis has been less intense than others in recent history, and countries with the biggest economies are going into this in pretty good shape.

4. Event-driven bear markets:

No one wants a bear market, but if you have to have one, this is the best kind.



1 | Amygdala hijacking

Clearly, we are in the middle of a market correction, and many investors are beginning to feel the fear that environments like this bring. For many of us, when faced with a great threat or uncertainty — such as the ultimate impact of a tariff war — it's our emotions that are in charge. Author Daniel Goleman coined the term "amygdala hijacking" to describe what happens in times of stress, when this tiny, almond-shaped region deep inside our brain gets triggered. Think of it as the brain's fire alarm; its primary purpose is to keep us alive when confronted by threats, real or perceived.

Although the “fight or flight” response, hardwired in all mammals, is a wonderful evolutionary mechanism that has kept our species alive for the past half million years or so, they’re highly counterproductive when it comes to financial threats. The same response that can keep us alive when facing a predator or natural disaster can be detrimental to our wellbeing in modern society. High blood pressure, dilated muscle fibre, a rush of adrenaline — these may protect us from predators, but they do little to shield us from market corrections. Relying on this primal response could be detrimental to your long-term financial health.

Neuroscientists have shown that the amygdala sidesteps higher brain functions, including the ones we usually associate with reason. The key to being a disciplined investor, then, is the ability to override that fear response, which is easier said than done, especially in the current environment where everything is so extreme.

2 | Extreme social media

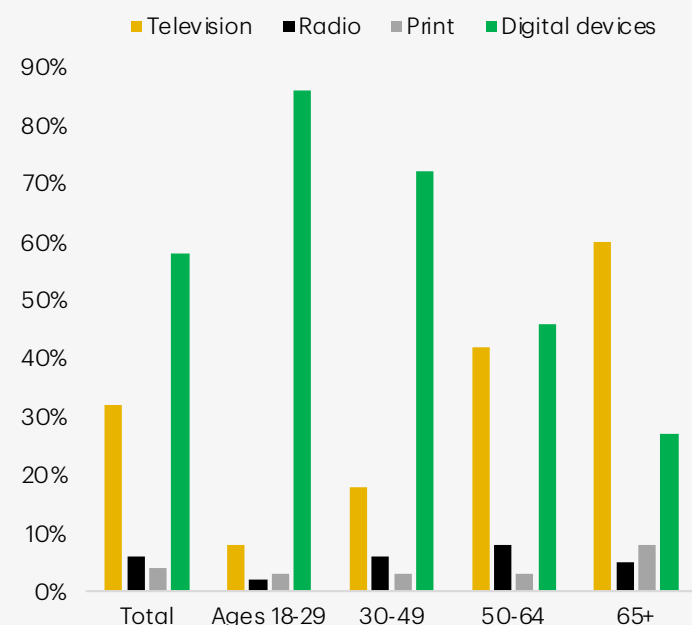
One example of our current extreme environment is the tendency for investors — professionals and lay people alike — to find an anchor from the past to inform our current and future state. In the current environment, this approach may be deeply flawed. Never in the past has so much biased information been so readily available, targeted and tailored to investors in bulk.

Figure 1 highlights this relatively new phenomenon, which became entrenched during the Covid era, when we were isolated in our homes all day living through monitors and screens. Almost 60% of Americans use social media to get their information, a number that unsurprisingly skews higher the younger you are. We live in an age where you can do a Google search based on your worst fears, and an algorithm is sure to feed you something to reinforce those fears, via comments and “news.” There is an enormous amount of this going on right now. We live in a world where more and more clicks are worth more and more money. The key for us as investors is to realize this and make sure that we do not end up losing our wealth because of it.

3a | The market environment

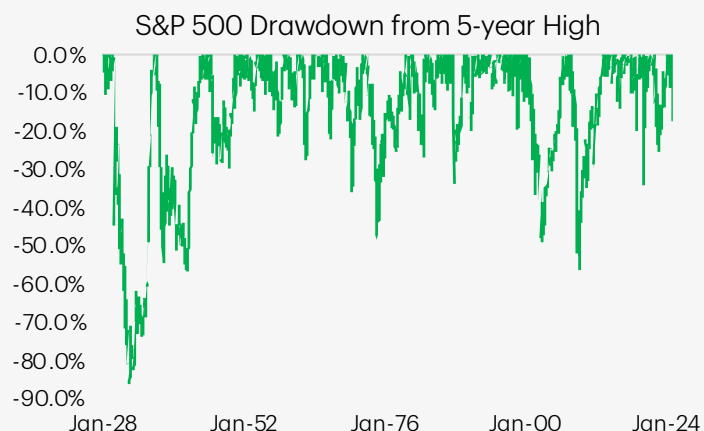
The result is an environment like this one — where the “news” is all about the market crash and concern that we are headed into a recession. Figure 2 puts this current correction into some context, highlighting the drawdowns in the S&P 500 over almost 100 years.

Figure 1: Where Americans get their news



Source: PEW Research, Wealth Investment Office as of April 2025
* Survey of U.S. adults in 2023

Figure 2: Market corrections over a century



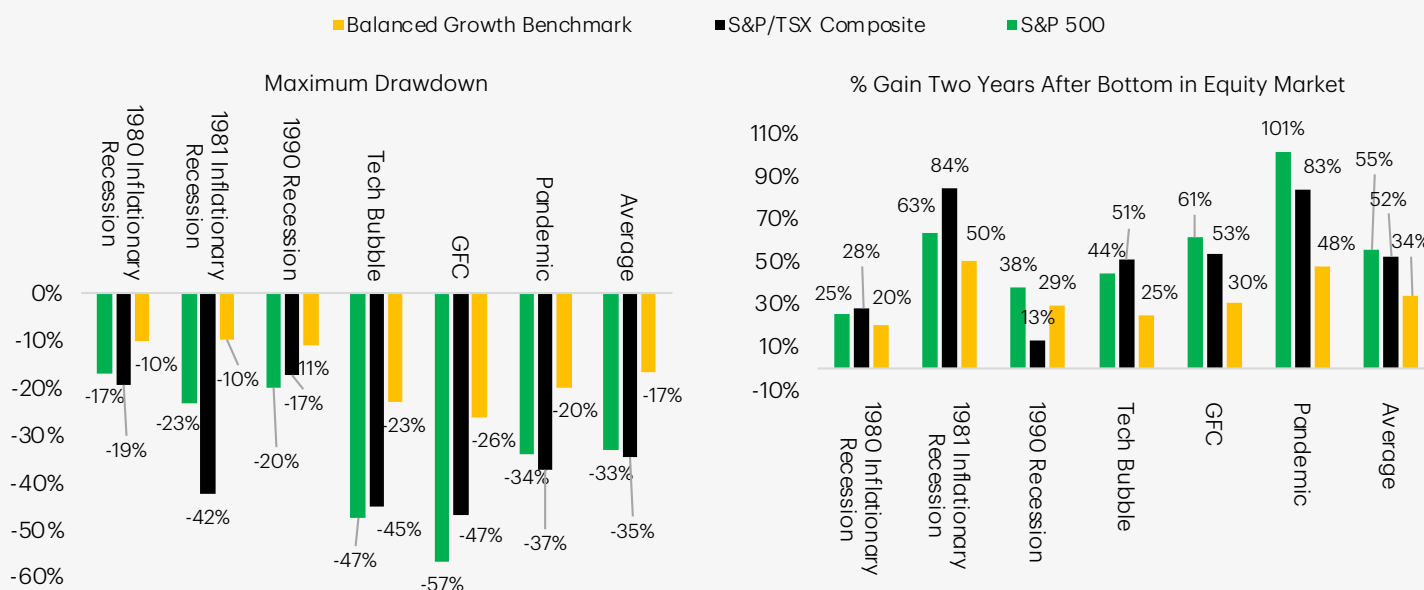
Source: FactSet, Wealth Investment Office as of April 7, 2025

Interesting, isn't it? The dot-com bubble had a 49% drawdown, the global financial crisis 57% and the Covid crash 34%. The current drawdown is around 20% so far. I shudder to think of what the social media environment of today would look like back in the days of the dot-com bubble.

While headlines scream and sentiment swings, the current drawdown so far is more muted than past crises. Since the U.S. left the gold standard in 1971, monetary policy based on fiat money has always been able to stimulate the economy whenever it grows below trend rate or a systemic crisis occurs. The market bottom often coincides with the announcement of policy stimulus. The equity market has weathered worse — and recovered. Every single time. Yes, short-term pain stings. But over the long term, growth tends to revert to its historical mean. That's what markets do. They price in fear, overshoot and then recalibrate.

Of course, most investors do not have all their money in the equity markets. In Figure 3, we looked at the returns for the three largest market corrections since 2000 – the tech bubble, the global financial crisis and the Covid pandemic — of investors fully exposed to U.S. and Canadian equities, and compared their returns to investors who were well diversified. This changes the perspective a great deal.

Figure 3: Managing risks with time and diversification



Source: FactSet, Wealth Investment Office as of April 7, 2025

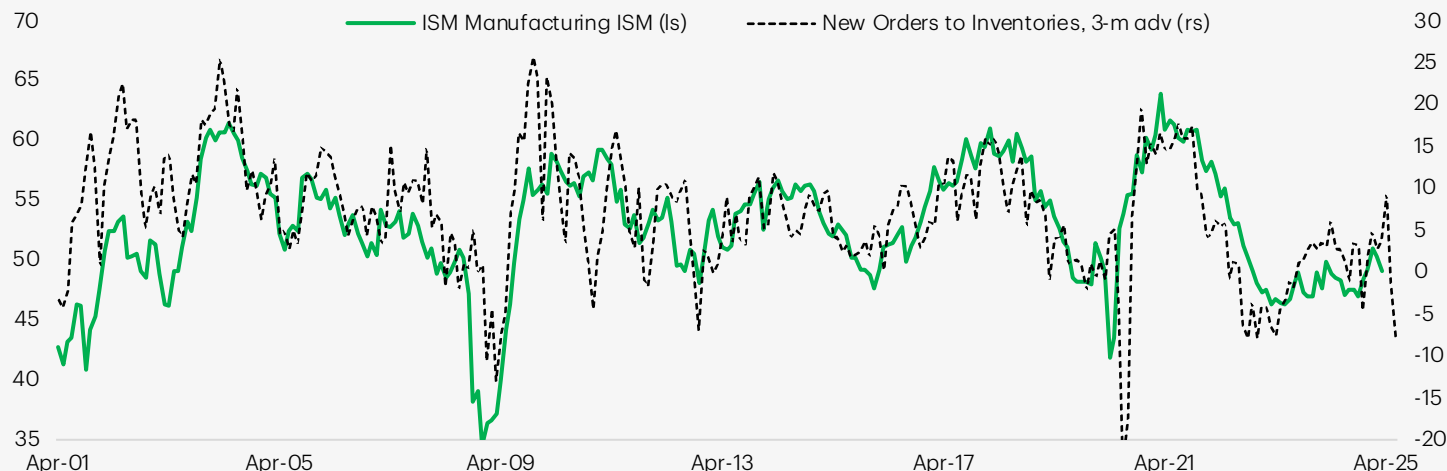
The balanced-growth benchmark, in the three significant correction periods, was down 23%, 26% and 20%, respectively, during the burst of the tech bubble, global financial crisis and the pandemic — with an average loss of 23%. In the following two years, the upside for the balanced-growth benchmark was 25%, 30% and 48%, which averages out to around 34%. The upside is not as good as being in all equity, but correspondingly, the downside was way less painful.

3b | The economic environment

Prior to the tariffs announcement, there was some hope that the U.S. and other developed economies were going to see an upswing in the business cycle as the lagged effect of monetary-policy easing became a tailwind for the economy this year.

The potential for an escalation in the trade war, however, has kept businesses from making large capital expenditures, with many having hoarded inventories in anticipation of the import tariffs — essentially pulling forward demand (Figure 4).

Figure 4: Manufacturers saw depressed new orders amid front-running of tariffs



Source: Macrobond, Wealth Investment Office as of April 7, 2025

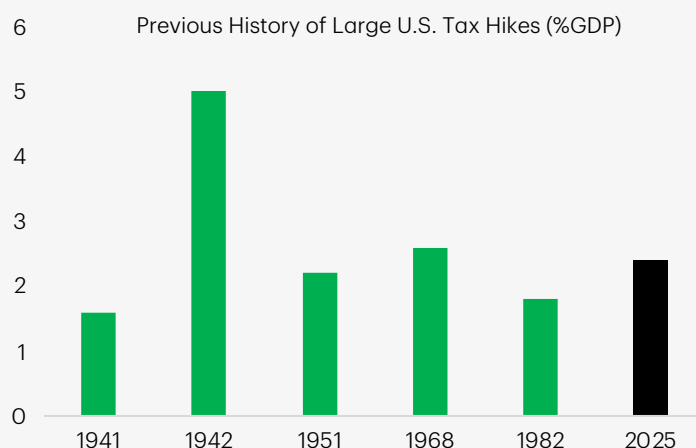
Barring a climbdown on tariffs from the White House, goods manufacturers in the U.S. will face a tough year as demand destruction from higher prices materializes. This could lead to a significant headwind, especially in the industrial and consumer discretionary sectors. Despite the intention to bring manufacturing to the U.S., U.S. tariffs have in fact made it more expensive to build and operate a factory due to higher import costs for raw materials and unfinished goods.

The good news is that U.S. private-sector layoffs have remained relatively muted despite the uncertain demand outlook, as highlighted by the fact that initial and continuing jobless claims are still below pre-pandemic averages. Most of the recent layoff announcements in the U.S. have been dominated by the federal government, amid DOGE efforts to reduce government spending.

The U.S. economy has enjoyed the fastest growth compared to other Western developed economies post-pandemic, thanks to the generous fiscal stimulus, which is now set to reverse course given that tariffs are essentially a tax on consumers (Figure 5). Again, it's clear that U.S. consumers are the ones paying for the increase in tariffs. Inflation could be 1% to 2% higher in the coming year, and GDP could fall below zero.

Consumers had already pulled back on their spending prior to the recent volatility, due to deteriorating outlook on jobs and income, as well as prices.

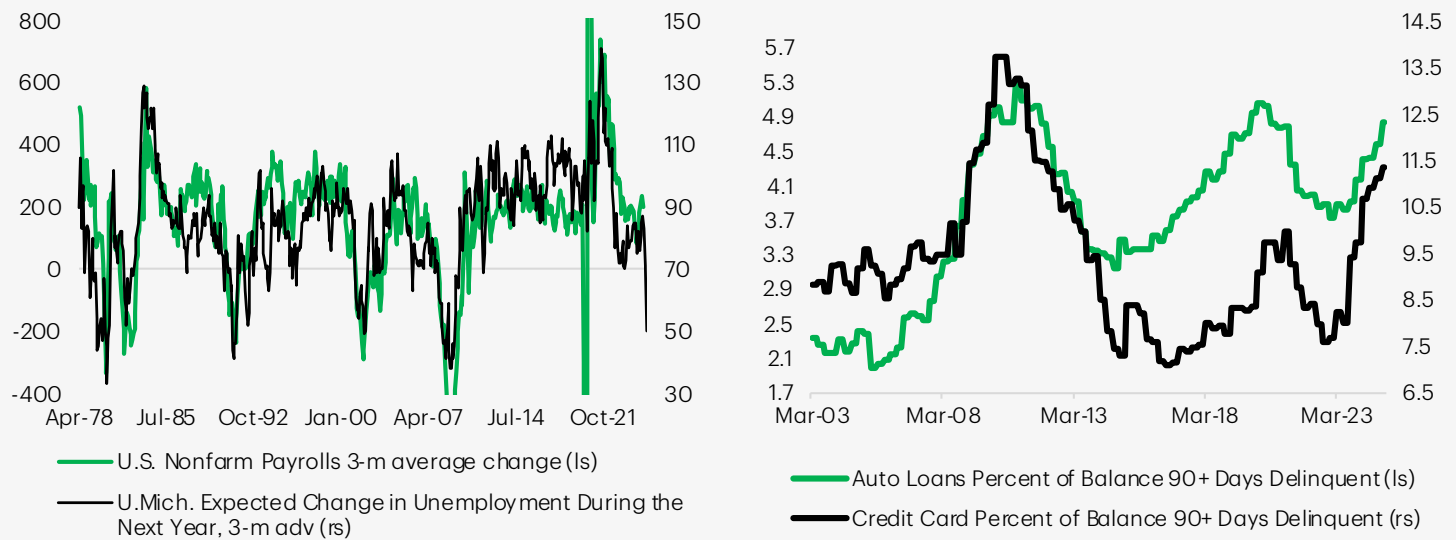
Figure 5: Tariffs are a tax on consumers



Source: Macrobond, Wealth Investment Office as of April 7, 2025

The University of Michigan consumer sentiment survey shows an elevated fear among households of losing their job in the coming year (Figure 6).

Figure 6: U.S. consumer outlook is deteriorating

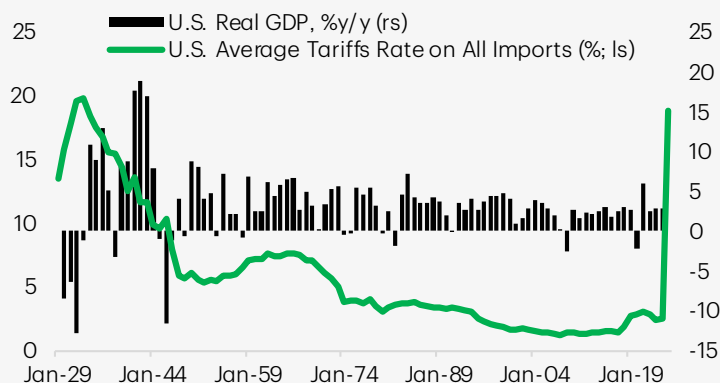


Source: Macrobond, Wealth Investment Office as of April 7, 2025

Worryingly, credit delinquencies are also increasing, with credit-card default rates at their highest level since the global financial crisis. Low- and middle-income households have been suffering, with consumer spending increasingly dominated by high-income households. The negative wealth effect from the decline in equity and house prices could accelerate the slowdown in consumer spending going forward.

The bottom line is that a prolonged trade war would ultimately send the U.S. economy into a recession, leading to a much higher unemployment rate and lower growth. Given that inflation and the economy are among the top concerns among Americans, this could lead Republicans to lose their seats in the mid-term election. Consider that the increase in U.S. tariffs in this round is the largest since the Smoot-Hawley tariffs in 1930 that worsened the depth of U.S. depression (Figure 7).

Figure 7: The largest increase in U.S. tariffs since 1930



Source: Macrobond, Wealth Investment Office as of April 7, 2025

Countries that are hit the hardest by tariffs will likely be among the first to reach out to the U.S. government to negotiate, as we have seen over the past week, with Vietnam and Cambodia. Meanwhile, governments around the world will try to cushion the shock to their economies and domestic exporters by providing fiscal stimulus.

Finally, given trading partners' declining trust in the U.S., and their desire to lower dependency on the world's largest economy, developed Western countries will likely strengthen their relationships and become less U.S.-centric over time.

4 | Bear market

Okay, the last thing we wanted to tackle is this concept of a bear market. A bear market is defined by a prolonged drop in investment prices — generally, a bear market happens when a broad market index falls by 20% or more from its most recent high. Today, we officially entered that bear market, but the good news is that the type of bear market we're entering is typically less painful than others.

Let me explain. There are three types of bear markets, each with its own triggers and distinct characteristics.

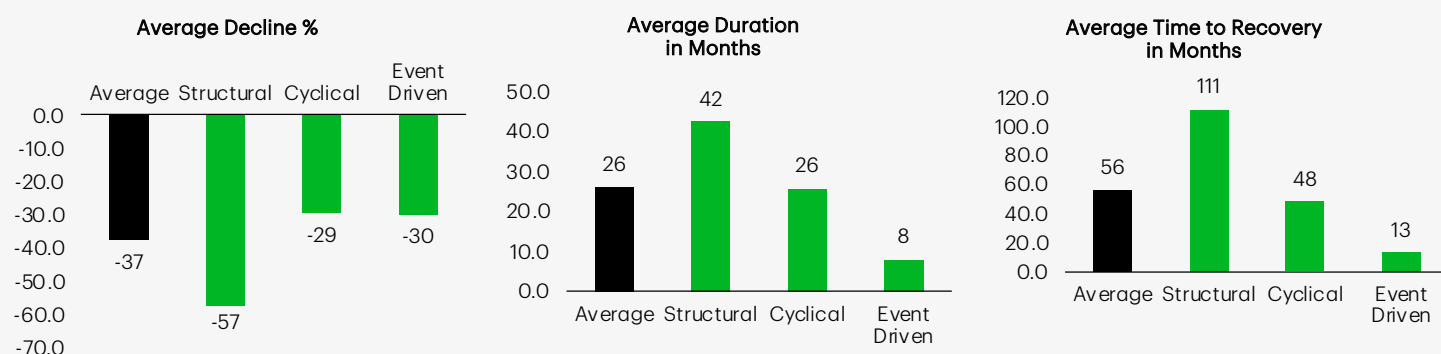
- **Structural Bear:** This version is the result of structural imbalances in the economy and often comes with financial bubbles. More often than not, there is a pricing mechanism, such as deflation, that follows.
- **Cyclical Bear:** In this variety, rising interest rates are the culprit, leading to an impending recession and declining profits. They are a natural function of the economic cycle.
- **Event-driven Bear:** This type of bear market begins with a shock to the system, something that you didn't see coming. Trade wars, collapses or dislocations — the “Black Swan” events, so called for their rarity.

We think it's pretty safe to say that the primary driver behind the current market volatility is the fear surrounding the trade war, which would classify this as an event-driven bear market.

So how do event-driven bears behave? We're going to be looking at data from the U.S., which is cleaner, older and more telling. If we examine the long-term data (Figure 8), we find that the main difference between a standard interest-rate-led, cyclical bear market and an event-driven bear market is less the severity of the fall itself but more the speed of the fall, and of the recovery.

Both the fall and the rise in the markets tend to be faster in an event-driven downturn. Indeed, event-driven bear markets, on average, tend to reach their bottom in about eight months, compared with over two years for a cyclical bear market and nearly four years for a structural bear market. On average, event-driven bears are back to their starting point in about a year, compared to four years for a cyclical bear market and nearly a decade for a structural bear market.

Figure 8: U.S. bear markets and recoveries since the 1800s



Source: Robert Shiller, Data Stream, FactSet, Wealth Investment Office as of April 7, 2025

Markets have bears, businesses do not

It's also important to distinguish between financial markets, which can be volatile, and the stable underlying businesses that they represent, which collectively account for their aggregate market capitalization. Put another way, *investors are more volatile than their investments*.

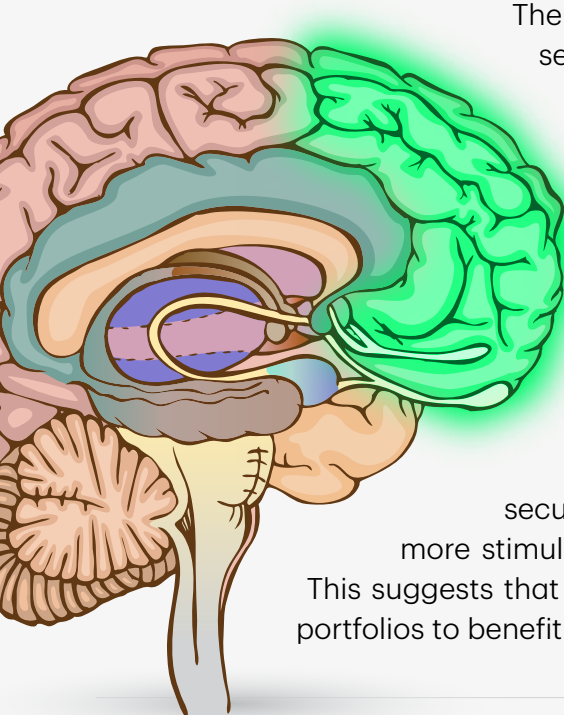
At times like this there are too many speculators and not enough investors. Back in the day, markets would correct in a big way and then investors would take advantage of prices that, based on fundamentals, suggested there was a bargain to be had. Today, liquidity often comes from high-frequency trading activity, algorithms that aim to exploit inefficiencies in the market, and passive index (ETF) rebalancing. While a hard number is hard to figure, I would ballpark that 80% to 90% of trading is being done this way.

This can cause strange accelerations and dramatic swings that become self-perpetuating as the algorithms compete with one other, pulling and pushing the markets with greater intensity as outcomes are achieved in ever shorter increments of time. We still rely on market fundamentals to create narratives, but I would contend that few investors, in the short term, are buying and selling securities based on these measures.

Conclusion: Keeping it in perspective

While none of us want to hear this right now, we do need to acknowledge that financial-market volatility has been incredibly low and stable for much of the past few years. This era of stability caused investors to underestimate the odds that anything could go wrong. This is an example of representativeness bias, where investors tend to predict future outcomes based on present information. So, investors start to feel good about the economic news they're reading, and they project today's good news into a belief that tomorrow will be great. It's a "kernel of truth" principle where one takes a partial truth and converts it into a full, and often brighter, truth.

Investors have been doing this for a good deal of time now. There had been 29 months without a 20% market correction, despite growing pressures on the system. The rise of protectionism in the U.S., ballooning tech valuations — these were largely shrugged off by complacent investors.



The converse, however, is also true for bad news, which is what we're currently seeing. Bad news is being reflected by the incoming data, which becomes representative and leads to a belief that things are going to go from bad to terrible to catastrophic. These are the two ends of a pendulum swing that we've been oscillating between for time immemorial.

We are at the end of the roaring bull market that began following the pandemic, thanks in no small part to the Magnificent 7 and momentum stocks, and the promise of AI. The fear of the trade war has led market participants to think with their amygdala instead of their frontal cortex. Capitulation leads to the next move higher. There are compelling arguments for longer-term investors to start moving further into equities, but clearly this is not a race. The next leg of the secular bull market likely requires fiscal and monetary policy becoming more stimulative again, as had been the case in previous business-cycle upturns. This suggests that once the markets stabilize, investors will likely need to reposition their portfolios to benefit from the potential new bull market.

To be clear here, having some constructive fear is prudent. The fear of losing money will rationally cause investors to manage their risks actively and in proportion to their expected reward. That's the reason we diversify in the first place. Extreme fear, however, can cause investors to quickly sell all their risk assets at fire-sale prices in exchange for government bonds and cash, which may not serve their longer-term objectives. If we allow our amygdalas to drive our reaction to a market correction, we may eventually regret these decisions. As always, strategic asset allocation remains the principal driver of portfolio performance and is paramount in helping investors achieve their objectives.



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