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What You Need to Know – March + Tariffs

Month of March: Equity markets faced a challenging month, driven by the uncertainty surrounding U.S. trade policies. Growing recessionary fears and policy uncertainty led major equity indices lower, led by US technology stocks. Gold hit repeated record highs on risk aversion, while bonds weren't sure whether to worry about the growth outlook or the potential for an inflation shock and traded sideways.

Tariffs – Worse than Expected: in early April US President Trump announced sweeping tariffs against many US trading partners, potentially raising the average US import tariff rate from 2.5% to over 20%—a level not seen since the 1920s. The scale and scope of the tariffs, including a 10% universal tariff and country-specific measures based on trade deficits, were broader and more aggressive than markets expected. This significantly worsens the outlook for both inflation and economic growth.

Not priced: Leading into the event, markets had treated tariffs as a temporary negotiating tool, not a lasting policy shift. Introducing a universal tariff signals a more ideological stance from the Trump administration. Hopes for quick resolution are fading, especially given strong retaliatory responses from countries like China and the difficulty in addressing non-tariff barriers, such as subsidies and domestic tax policies.

US Corporate Earnings Expectations Reset: Earnings forecasts have fallen from 13% annualised growth at the start of the year to low single digits. The upcoming earnings season will be key for market sentiment, with many companies likely to pull or revise forward guidance and defer investment.

Our Portfolio: Our underweight to equities is preserving client's capital. In the lead-up to this market shock, we further increased our positioning to Gold and US Treasuries. This, along with our existing positions in credit with duration exposure has cushioned the blow to risk assets. Our exposure to USD was initially a hindrance, but that has since reversed. We are very well placed to re-enter the equity market when we have stronger conviction that we have seen the worst of tariff policies.

Outlook: We could be at a turning point in global trade policy. The economic outlook is now uncertain, and analysts are struggling to pinpoint where US growth and inflation land. In short, we believe that US Core PCE (inflation) will head back up above 4%, economic growth for this year will go to zero or we see a technical recession.

How to Position: This is not a "healthy pull-back" where valuations become too stretched with a correction of 5% to 10%. In a recession, the US market has dropped on average ~30%. In crisis events, like the tech bubble, the S&P500 fell nearly 50% and the GFC nearly 60%. It is difficult to say where this type of global shift in trade may end up sitting, but we believe that it could be somewhere between a negative growth shock and a recession, with a ~20-30% drop in US equities from their peak. It is difficult to pinpoint an attractive entry point for equities as the impact of tariffs is evolving, but valuations remain expensive by historical standards and earnings downgrades have a way to go.

We can see a path to lower bond yields as the market focuses on the shock to growth, a further widening in credit spreads is likely and an extended period of cross-asset volatility is almost certain as markets second guess what might be next. This is where alternative and uncorrelated assets are invaluable.

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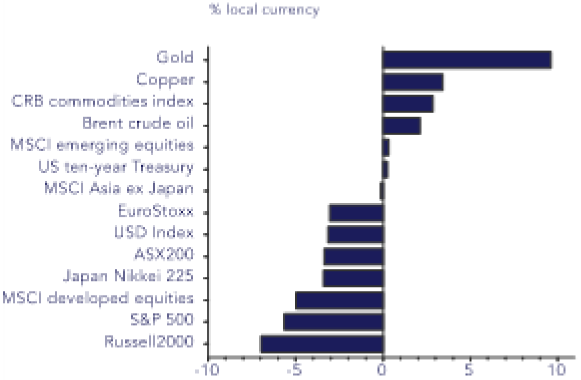
Markets in March

Equity markets faced a challenging month, driven by the uncertainty surrounding U.S. trade policies. Growing recessionary fears and policy uncertainty led the S&P 500 to a 6%+ decline in March. As markets waited hopefully for some clarity on the April reciprocal tariff announcement, the MSCI World index declined 5.0% over March, while the MSCI Emerging Market was flat at 0.3% as Chinese equities outperformed.

Chart 1: March Asset Class Performance



Source: LSEG Datastream/Fathom (Note: Past Performance is not a reliable indicator of future performance)

The ASX 200 fell 3.4% in March. Despite recovering some losses mid-month due to soft employment and inflation data, which added hopes for a May cut, it was not enough to offset the negative sentiment from U.S. tariff headlines. Technology (-9.7%) was down the most, while all other sectors except for Utilities (1.5%) lost ground.

The MSCI World index continued its decline in March, falling by 4.4% in USD terms. Developed markets underperformed with a -5.0% return, dragged by the U.S. Europe also gave back earlier gains, falling -3.5%. Emerging markets outperformed developed markets in March, returning 0.3% in local currency terms.

Equity valuations declined over the month but are still well above historical averages, with the ASX 200 reaching 17.5x forward price-to-earnings (P/E) ratio and the S&P 500 at 20.1x, while Europe (14.0x) and Japan (13.9x) continue to trade relatively cheaper.

Chart 2: Selected Equity Markets Relative Performance (0 = 1 Jan 2025)

Source: LSEG Datastream/Fathom (Note: Past Performance is not a reliable indicator of future performance)

10-year yields on Australian government bonds rose 9 basis points in March to 4.39%. U.S. 10-year Treasury yields also rose 2 bps to 4.21% as markets continued to digest the on-and-off tariff threats and firmer inflation data. As expected, comments from various Fed speakers including Chair Powell suggest that the Fed is looking through any inflation risk from tariffs as transitory and focusing more attention on growth concerns. Spreads on U.S. investment-grade bonds were stable but widened on global high-yield bonds suggesting credit markets are starting to worry about growth.

Commodities were broadly higher in March. Gold prices surpassed USD 3000 per ounce on March 14, driven by policy and economic uncertainties that increased demand for safe-haven assets, ending the month 9.9% higher. The USD dropped sharply in early March and the DXY index ended the month down 3.2%. The euro surged on Germany's agreement to increase defence and infrastructure spending, rising 3.9% over March.

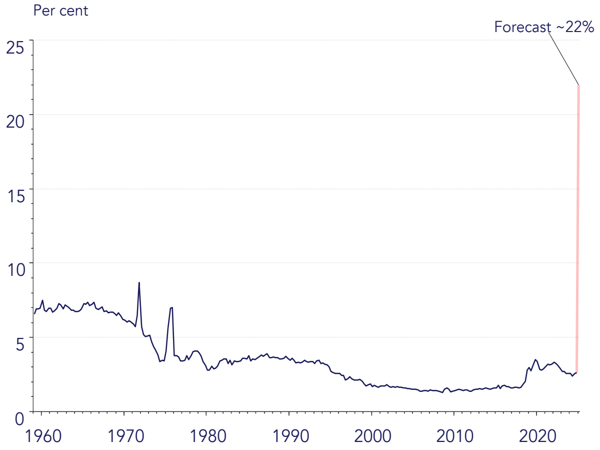
Key Themes

Tariffs – Worse than Expected

In early April US President Trump announced (on "Liberation Day") a wide range of retaliatory tariffs against a lengthy list of US trading partners. The "reciprocal" tariff rates have been calculated to effectively offset the trade deficit that the US has with each country, rather than countering respective tariff rates.

Trump's proposals are likely to raise the weighted average tariffs on US imports from 2.5% as of the end 2024 to over 20%, levels not seen since the 1920s. Both the magnitude of 'reciprocal' tariffs imposed per country and the set of countries they were imposed on were larger than many had reasonably anticipated. That they come on top of a 10% universal tariff is an added shock. This has the potential to considerably worsen the growth vs inflation equation in the US and the global economy.

Chart 3: US Effective Tariff Rate



Source: LSEG Datastream/Fathom (Note: Past Performance is not a reliable indicator of future performance)

Not priced

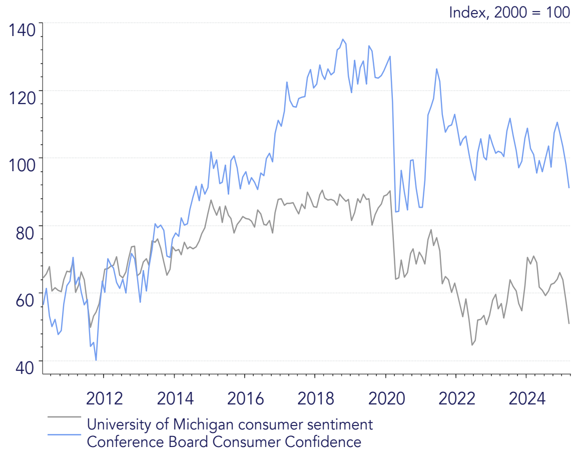
Essentially, markets were thinking of tariffs purely as a negotiating tool, not an ideological one. While there is a chance that rates of tariffs do come lower as trading partners negotiate with the US, that is unlikely to happen quickly. Regardless, the 10% universal tariff suggests the Trump Administration firmly believes tariffs are the policy needed to fundamentally alter trade and economic relationships with the global economy.

Hope for tariffs being immediately negotiated lower has been further dashed by the strong retaliation from US trading partners - such as China, and the difficulty of countries negotiating lowering of non-tariff barriers which, according to the US administration, includes policies like subsidies, domestic 'Goods and Services' or 'Value Added' taxes.

Came at a bad time

There is never a good time to have a major shock, but this one comes on the back of the US Economy already slowing. The US consumer was already showing clear signs of fatigue. Economic data has been worsening as two drivers of strong growth; fiscal spending and immigration, have both faded. Even before this policy move it was likely that the US economy was due to revert to something more like trend growth this year. Recession probabilities are now rising quickly, and many pundits see a recession coming later in the year.

Chart 4: US Consumer Confidence



Source: LSEG Datastream/Fathom (Note: Past Performance is not a reliable indicator of future performance)

Expectations around US corporate earnings have gone from 13% annualised growth at the beginning of the year, to more like low single digits. The upcoming corporate earnings season will be critical to sentiment with many companies likely to withdraw any formal guidance or give outlooks that is focused on uncertainty or suggest capex and spending plans will be shelved.

Positioning and valuation exacerbated the extreme moves

As of the end of March US investors were long equities, with low allocations to bonds and cash. At the same time equity market valuations were expensive versus historical standards. With bearish sentiment hitting historical highs in a very short period, the unwind has been large and it has been quick.

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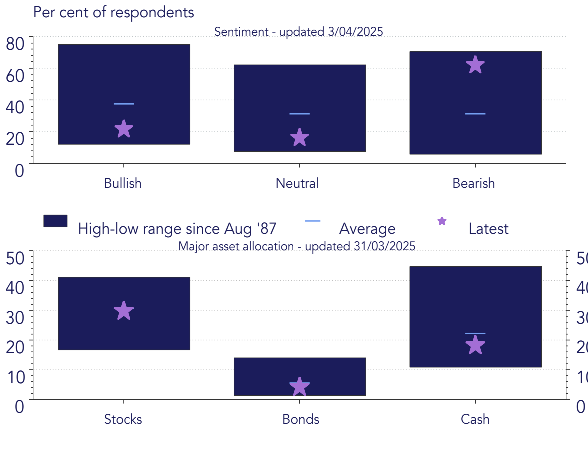
Chart 5: AAII US Investor Sentiment Surveys



Source: LSEG Datastream/Fathom (Note: Past Performance is not a reliable indicator of future performance)

Outlook

We believe that we could be at a turning point in global trade policy. For decades, the U.S. has benefited from the principle of comparative advantage—a foundational economic theory that suggests that countries should specialise in producing goods and services they can produce relatively efficiently, and trade for the rest.

By outsourcing lower-paid, labour-intensive manufacturing roles to lower-cost regions, the US has been able to focus on high-value sectors such as technology, finance, and advanced manufacturing. This has driven economic growth, lowered consumer prices, and boosted national income over the long term. On the global stage, trade liberalisation has had a profound impact on lifting millions of global citizens out of poverty.

Despite the US being in the top 5 of wealth per capita in the world and enjoying an unemployment rate of 4.2 per cent, the income benefits from trade liberalisation have not been shared equally and the recent tariffs tap into a sentiment that manufacturing jobs can be returned to the middle American heartland without a loss in living standards.

Positioning to get "the best deal"

In our view, investors have until now, and maybe still do, assume that tariffs will be used as a negotiating tool. But Trump is a long-term believer that the US is getting a "bad deal" going back decades, and even if some measures get wound back a return to "normal" looks incredibly unlikely. We believe this will have a material impact on growth and inflation.

Even if some countries—reportedly Japan, Vietnam, and Israel—are willing to negotiate, reaching agreements will be difficult. The tariffs target complex issues like domestic taxes, subsidies, and currency manipulation, making meaningful progress unlikely, in our opinion.

Potential Impact on the US economy

The economic outlook has grown increasingly uncertain, leaving analysts unsure about the trajectory of US growth and inflation. In our view, Core PCE inflation likely climbs back above 4%, while economic growth stalls—potentially hitting zero or slipping into a technical recession.

We believe that the onshoring of labour to the US either does not happen or does not happen for at least 3 years. The more likely outcome is that corporates cut spending and knuckle down until the political environment changes. In this environment, unemployment rises, whilst consumer and business confidence drops further. In response, retail spending drops, and prices rise higher.

In our view, central banks are not sure how this will pan out; they will need to wait for hard data to move. The Fed faces an increasingly difficult trade-off as both sides of its mandate will move in opposite directions – with inflation likely to rise with a one-off hit to prices, but also the potential of longer-term impacts through onshoring, if that happens. Its action will depend partly on the speed of deterioration in activity/inflation data and in our view rate cuts are unlikely to come until later in the year in the US and may be shallower than what the market is currently pricing. Comments from Fed officials suggest they are reluctant to cut aggressively in this environment where there is an upside risk to inflation.

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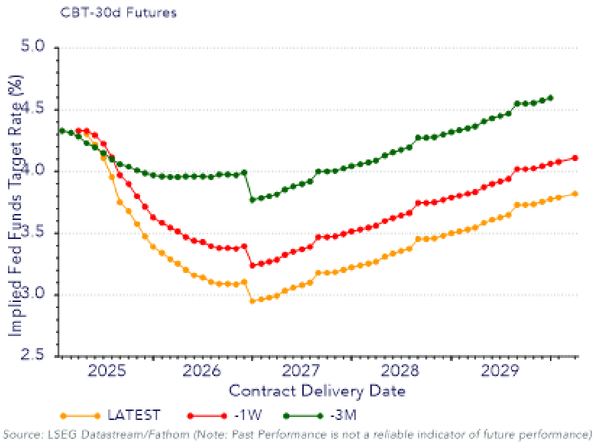
Chart 6: Fed Funds Futures Curve



How to Position

Our underweight to equities is preserving client's capital. We further increased our positioning to Gold and US Treasuries in the lead-up to this market shock. This, along with our existing positions in credit with duration exposure has positioned us well. Initially, our exposure to USD was a hindrance, but that has since reversed.

We are very well placed to re-enter the equity market when we have stronger conviction that we have seen the worst of tariff policies.

Equities: Where is the bottom?

With a 10% baseline tariff regime and from a valuation and technical perspective we thought the US S&P500 looked more interesting at 5300, but the current situation is much worse than that.

Leading into this year consensus was for ~13% year-on-year earnings growth, which has now dropped below 10% and has further to fall. We are about to enter US quarterly reporting season, and while backward-looking results will be solid, they will be almost meaningless. Focus will be on outlook commentary and guidance which in many cases will either be removed altogether, focused on the impact of tariffs, or just on "uncertainty".

The market has already traded through the typical "healthy pull-back" where valuations become too stretched and you see a short and sharp correction of 5% to 10%.

In a recession, the US market has dropped on average ~30% - the S&P500 fell 34% during COVID-19 but bounced back on the back of government stimulus and immediate rate cuts. We are not going to get either this time around. In recent crisis events like the early 2000s tech bubble the S&P500 fell nearly 50% and the GFC nearly 60%.

It is hard to say where this type of global shift in trade may end up sitting, but we believe that it could be somewhere between a negative growth shock and a recession resulting in a ~20-30% drop. We temper this though, given we are yet to see the full extent of retaliatory tariffs, but if the Chinese response is anything to go by it is likely to be strong. Then we face the risk of Trump responding with further escalation.

Chart 7: Mag 7 S&P500 Weighting

We have seen those stocks with elevated valuations and earnings growth assumptions get hit the hardest, along with small caps which typically get sold first given their lack of liquidity. At an index level on a valuation basis, the equity market is yet to look "cheap" versus historical measures given the uncertainty around earnings.

While it is still early days, we may have seen some of the extreme positioning and leverage get washed out of the system. US equity markets recorded their largest volume day ever on Friday 4 April, as recorded hedge fund leverage fell dramatically and assets like Gold were sold.

What recovers first?

It depends. If tariffs remain at their current levels companies that are entirely reliant on domestic demand and production are likely to be more protected in our view – these are more likely to be small caps. But these will still suffer from a demand shock due to dropping consumer and business confidence.

While there is currently a carve-out for semiconductors, the magnificent seven and large-cap tech have global supply chains and customers will still be impacted negatively. Some, not all, technology companies will be better placed to absorb a hit to margins. If sentiment turns as tariffs are wound back, this part of the market likely recovers first in our opinion.

Regardless, we expect markets to remain volatile for not weeks, but months as investors second guess what might happen next and try to work out what "fair value" may be for a market with enormous uncertainty of earnings.

Cash Rates: RBA to cut multiple times?

The RBA may be forced to cut interest rates in May and at subsequent meetings to counteract a shock to global growth. The RBA has more "room to move" than many other central banks should the crisis deepen. Given the small trade relationship between the US and Australia, any tariff-related inflation is likely to be very minor. Instead, we could see cheaper goods from Asia come to our market, diverted from the US giving further downward momentum to inflation. This would give the RBA a little more comfort to move.

Bonds: Credit Spreads are now widening and have further to go, Government bonds negatively correlated again

Credit spreads have widened but arguably have more to go, in our view. The widening in physical corporate bonds in Australia has from all reports been orderly and not panic selling. Fixed coupon bonds will be sheltered somewhat should the bond market continue to price in lower growth, however, if inflation becomes the primary concern, we could see losses magnified by a rise in yields and a selloff in spreads. We see the risk to growth being more significant than inflation and advocate clients add duration.

Alternatives: Time to shine

This is where non-correlated strategies come into their own. While some of our alternative strategies have taken a short-term hit in the brutal and indiscriminate sell-off of everything, we expect them to perform strongly in this environment. We continue to believe that small to mid-cap private equity will perform given these types of businesses are typically domestically focused.

Currencies: The USD behaving badly

The USD is behaving slightly differently from past episodes. It is too early to say that this is the beginning of a move away from the US Dollar as a reserve currency or anything extreme like that. The weakness in the USD and strength in currencies like the Euro is more so a reflection of growth differentials given the fiscal spending planned in Europe.

The Australian Dollar did its best to hold up in the face of a trade war but has capitulated to trade below 60 cents for the first time since March 2020. While it may languish here for some time, those clients who have not hedged part of their equity exposure should take advantage of this now.

Luke Hansen, James Wright, and James Marchetti
Sayers Investment Solutions Team

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