# CIO Letter | Worse than the worst case – April 07,2025

***The tariffs announced by the Trump Administration last week are worse than the worst-case scenarios that investors predicted. Tariff rates are now higher than in the 1930's and their impact on global trade and the world economy will be significant – if they stay in place.***

***Equity markets reacted negatively to the announcement, particularly US equities with the S&P 500 down around 13%, the Nasdaq down 15% since the announcement. The USD fell sharply versus the EUR and the JPY, while US Treasury bonds rallied.***

***What makes this event very challenging for investors is the mercurial approach of President Trump and the unclear goals he pursues as well as the fact that there will be hardly any winners and many more losers. A cool head and a steady hand will be crucial to navigate this trade war.***

President Trump's announcement on tariffs marks a stunning departure in US trade policy that was the basis for world trade since WWII, its reach and dimensions are startling. Tariff rates are now higher than in the 1930's: A "baseline" tariff of 10%, plus "reciprocal" enhancements on a country-by-country basis results in a cumulative 54% for China, 24% for Japan, 20% for the European Union and so on. Clearly, it's a more aggressive package overall than financial markets had expected.

**"The Art of the Deal", or are we beyond that?**

The goals stated by the Trump Administration remain contradictory, and the question is if tariffs will stay in place for longer or if they are more of a negotiating tool.

If "Liberation Day" was a way for Trump to place the US in a favorable position in future trade negotiations, tariffs would eventually be reduced again, and the world could then move on. That would be consistent with Trump's cherished negotiating tactics – as described in his book "The Art of the Deal", where he initiates talks asking for extremely unfavorable terms.

The other possibility is that Trump acts from a more ideological point of view, where he sees a closed US economy as fundamentally good. In that case not much is up for negotiation and heavy tariffs will persist.

No matter what, it seems likely that uncertainty will persist as the real intentions of the White House are debated and because foreign governments might now retaliate. That could trigger a cycle of tariff retaliation and counterretaliation that makes everybody, including the US, much worse off.

While drafting the letter, President Trump signaled that he would not retreat from his aggressive trade policies, despite increasing concerns about a global recession. In either scenario you would probably not expect him to blink just yet.

While the goals of the tariffs remain unclear, **their longer-term costs**, if they remain in place, **are much clearer**:

- higher prices in 2025 and 2026
- structurally higher long-term inflation rates as there will be less competition
- less innovation
- lower living standards

The disruptions to supply chains and the continuing uncertainty increase the risk of recession in the US and many of the tariffed countries, significantly. It is going to be hard for companies to invest in new plants or rearrange their supply chains without knowing how long tariffs will remain in force and how high they might be next month or next year.

## Dealing with the ongoing uncertainty and U-Turns

The situation is difficult to deal with for the average investor. The mercurial behavior of President Trump, which makes yearly forecasting and modelling close to impossible. Any decision or tweet can change the situation in a heartbeat.

As we always do in such a period of stress, we take a step back, look at the facts, stay away from conjecturing and lean on the quality of the business we own. **One of the first reasons to own strong businesses is that they allow for calm actions at a time where others start to wonder whether they will be able to survive the next day.**

We are making sure that none of our companies are exposed to an obliteration of their business model in any of the likely scenarios ahead of us. We are also identifying which businesses find themselves relatively advantaged and disadvantaged in a world that is more fragmented, more transactional and less open.

We also believe a step-by-step approach in investment decision making and developing a **structured approach to process information** is helpful to navigate these stormy waters.

We are looking at the following **three elements** in that process:

1) Tariff negotiations and economic growth scenarios
2) Government and Central Bank measures
3) Reaction of financial markets, particularly credit spreads and oil prices as indications of a recession and stress in the system

Finally, a structured approach to stock selection by building categories of stocks (winners, losers, unclear cases) has already helped us to navigate Covid well.

## 1a) Tariff negotiations and economic growth scenario

**Scenario 1: Tariffs reduced through negotiations, still negative impact on growth**

President Trump himself invited negotiations, and Treasury Secretary Bessent said in a Bloomberg interview that the announced tariffs are "the high end of the number" and that countries could take steps to bring tariffs down. However, this process will likely take time and companies, and financial markets will not just sit tight and wait, neither will tariffed countries.

Even if tariffs are ultimately reduced by year-end, the near-term shock and associated uncertainty is likely to drive a near-term slowdown in the US economy and reduce full-year 2025 growth. We note that heightened uncertainty before the announcement has already been feeding through into weaker business and consumer sentiment. The Atlanta Fed's GDP now forecast for Q1 growth is currently running at -1.4% (adjusted for gold imports). The key question remains how much leeway the FED will have to cut rates.

**Scenario 2: Downside scenario: A prolonged tariff scenario could increase the risk of a recession in the U.S. and globally.**

A downside scenario is that the tariffs announced today remain in place for an extended period or potentially increase with rounds of retaliation from trading partners. We believe this could push the US and the World Economy into recession. As the inflationary pressure will likely be higher for the US than others, this would limit the scope of rate cuts from the Fed, which would be the normal reaction to a slowdown in normal times.

The retaliatory tariffs imposed by China over the weekend have made that scenario much more likely to play out. In fact, as things stand, **we assign the highest probability to this scenario at the moment**.

**Scenario 3: Upside scenario: Tariffs reversed quickly**

An upside scenario is that tariffs are reversed relatively quickly. Previously announced tariffs on Mexico and Canada in February were reversed in a matter of days following lobbying from businesses. Nevertheless, the political capital invested in "Liberation Day" and the breadth of the announced tariffs makes a wholesale reversal less likely on this occasion.

We also note that the tone of the Trump administration's rhetoric on tariffs had shifted to be significantly more hawkish in recent weeks. At the beginning of March, President Trump said: "There will be a little disturbance, but we're OK with that...it won't be much." On 30 March, in contrast, President Donald Trump said, "I couldn't care less if they raise prices, because people are going to start buying American cars." He also described the auto tariffs as "permanent, 100 percent,"

In sum, the situation remains fluid, making any predictions difficult, if not impossible. One of the main questions is how much of an ideological element there is in Trump's view on trade and how much is transactional resp. negotiation tactics. Many commentators and strategists have so far assumed it to be more of a bargaining tool. We are not so sure of that, in fact we more and more lean towards assuming a significant element of ideology, which would mean that the room for negotiation would be limited. The defiant tone of the Trump Administration following the market turmoil point in the same direction, which is bad news. Therefore, we give scenario 2 the higher probability than scenario 1, while scenario 3 get the lowest.

### 1b) Tariff negotiations and economic growth scenario – Economic and inflationary impact

**Impact on the US**

According to Bloomberg Economics, the newly announced tariffs could raise the effective U.S. tariff rate to around 22%, up from 6.6%—an estimated increase of roughly 15 percentage points since April 1, and nearly 19 points since the start of the Trump administration. A 2018 Federal Reserve model offers some guidance on potential macroeconomic effects, suggesting that a 19-point tariff increase could lower GDP by 2.8% and push inflation up by 1.6%. The model indicates that most of the inflationary impact would likely be front-loaded in the first year, tapering off in the second, and falling below baseline by the third year—implying a largely temporary effect. Nonetheless, a more protectionist economy could lead to structurally higher inflation over the long term.

Following Trump's Rose Garden event several Wall Street firms warned of a recession— and inflation returning to pandemic levels — with some saying it's now their base case. "The risk of recession in the global economy this year is raised to 60%, up from 40%," JPMorgan Chief Economist Bruce Kasman said Thursday in a note to clients, calling the tariffs the largest tax hike on US households and businesses since 1968. We share those views.

Overall, the U.S. may experience higher inflation rate increases, which could limit the Fed's ability to reduce interest rates. Meanwhile, exporters might face a slowdown in economic growth, while their central banks could have more flexibility to lower rates.

**Impact on exporters:**

Europe: Bloomberg's early estimate is that the announced tariffs might reduce European exports to the US by something in the region of 50% in the medium term, putting 1.1% of GDP at risk. We think Brussels will try to negotiate a deal while readying retaliatory measures. Protecting the economy and staying cohesive will focus and challenge at the same time.

China: Bloomberg Economics' trade team's earlier estimates suggest that 60% tariffs could cut China's direct exports to the US by up to 80% over the medium term, putting 2.3% of GDP at risk. China vowed to take countermeasures to protect its interests and called for talks to deal with disputes. Beijing's responses to US tariffs so far this year were measured and targeted, but Friday's announcement of 34% tariffs on imports from the US **is a significant escalation** and it is an indication that patience on the Chinese side could be stretched.

Japan: "reciprocal" tariff of 24% on Japanese goods, alongside a 25% levy targeting autos, poses significant downside risk to Japan's growth. Our very early estimate is that Japan's exports to the US could fall by a quarter over a year, putting about 0.9% of GDP at risk. The impact could be larger if US tariffs on other trading partners reduce global trade flows, which seems likely.

### 2) Government and Central Bank measures

**Central bank and fiscal policy reactions:**

While the economic impact of the tariffs will be outright negative, government and Central Bank measures can have a significantly positive impact on equity markets, as the example of Covid showed. We will be watching out for them carefully. However, other than during Covid, due to the existing inflationary pressures and the different ways the announced tariffs will impact pricing, not all central banks and governments have the same leeway to support their economies.

Given the already existing inflationary pressures, the Fed will have significantly less room to maneuver than back in 2020. Fed Chair Powell already hinted that. Therefore, the strike price of "Fed put" that investors still hope for, is likely be a lot lower and would only come into play in case of severe market distress, particularly on the credit side.

The European Central Bank has much more flexibility to lower interest rates, and we think the scale of the hit to demand will be too big for them to ignore. What's more, the risk posed by EU retaliatory measures to inflation looks fairly modest. More forceful retaliation by the EU could yet change that assessment, but we think the EU will focus on negotiations to soften the blow to their economies, while the ECB can cut rates more aggressively than the Fed. The recent strength of the Euro will give the ECB even more leeway. In addition, lower rates will come in handy to finance Europe's re-armament.

China will probably boost fiscal and monetary policy support to shield the economy from the blow to external demand. The government has lined up a big budget this year, with a substantial increase in the deficit. The focus now will be to deliver the fiscal stimulus quickly. The People's Bank of China has signaled it will ease policy and lower the reserve requirement ratio for banks in April and cut rates in May — and deliver more easing over the course of the year.

### 3) Reaction of financial markets, particularly credit spreads and oil prices as indications of a recession and stress in the system

The reaction of financial markets, particularly equity, credit and oil markets has been outright negative. Equities are down significantly (particularly US-equities), credit spreads have widened, and oil has fallen sharply. While the equity sell-off was broad-based and maybe in part a reaction to the strong performance before, the widening of credit spreads and a fall in oil prices are first warning signals of economic trouble ahead. While said trends are concerning, particularly the widening of credit spreads is not at recession levels yet. However, we will be watching them closely.

### Implications for stock selection:

Investors should adopt a highly selective approach rather than just buying the index as the impact from this dual re-set of global trade and the world security fabric will be long-lasting and have a large impact on inflation rates, trade and government finances, with the risk of many unintended consequences.

More challenging than the attempt of re-wiring of the current economic and political world order are the constant U-turns and the confusing messaging around it, which makes forecasting nearly impossible, at least short- to mid-term. Therefore, we think focusing on the long-term consequences of what is happening, and the long-term fundamentals of our holdings is the most appropriate approach. Currently, we can see only very few obvious winners, while the obvious losers list is only focused on the most obvious ones in any scenario. For the more dire scenarios outlined earlier, the list will get a lot longer.

At the same time, investors should not forget that volatility also always means opportunity. While we think that for the majority of companies, the impact of the tariffs will remain unclear for some time, indiscriminate selling might push stocks of solid companies to bargain levels. We will try to identify those bargains as the picture clears up. Past experience suggests that markets tend to recover over time, with resilient companies often leading the rebound and emerging stronger.

**The winners:**

- Beneficiaries of the re-armament of Europe, such as defense contractors and selected industrial companies, particularly in Europe.
- US domestic companies that are not dependent on imports, are not very cyclical, have low debt and a strong market position.
- Tech and data providers that are mission critical and/or help generate efficiencies to off-set the rising costs of more complicated business structures that will be required irrespective of the outcome of this trade war.

**The losers:**

- US importers with low profit margins (retailers) and limited pricing power, as they may not be able to absorb resp. pass on price hikes.
- Car manufacturers and other industrial companies with global supply chains that export resp. import to the US and that rely on volumes for efficiency.
- Companies with weak balance sheets and low margins. Many small caps fall into that category.
- Many more sectors if current tariffs stay in place for an extended period.

## Conclusions

Clearly, the full implementation of announced policies would be a substantial macroeconomic shock that has largely not yet been incorporated in market forecasts. If sustained, those policies would likely push the US and possibly global economy into recession this year and inflation in the US would rise well above 4% for the next two years. Over the weekend, the probability of this more dire scenario has grown significantly after the retaliation by China. Also, President Trump's defiant comments suggest difficult negotiations.

A key determinant of market direction will be for how long the announced tariffs will remain in place. If they remain for longer, the high risk of recession is likely to push markets lower.

While the fall in equity markets is the steepest in any three-day period since 1987, they have further to fall if a recession scenario plays out. Typically, a recession (without a financial or real estate crisis), leads to a drop top-to-bottom of 20-35%. Currently the S&P500 is down 21% from it's peak.

Despite all these risks and the potential for more immediate downside in equity markets, investors should take the long-term view and focus on strong companies with strong balance sheets. Since 1970, every time the market was at least 25% down, buying stocks resulted in above average returns in the following 10+ years.

Also, indiscriminate selling tends to drive stocks of high-quality companies to bargain levels. One of the main benefits of owning strong businesses is that they not only offer the best protection for our clients' wealth long-term but also provide a certain peace of mind at times like these. That is how our portfolios are positioned.

With kind regards,

**Lloyd Capital LLC,** Investment Office

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