Uncertainty Around Tariffs

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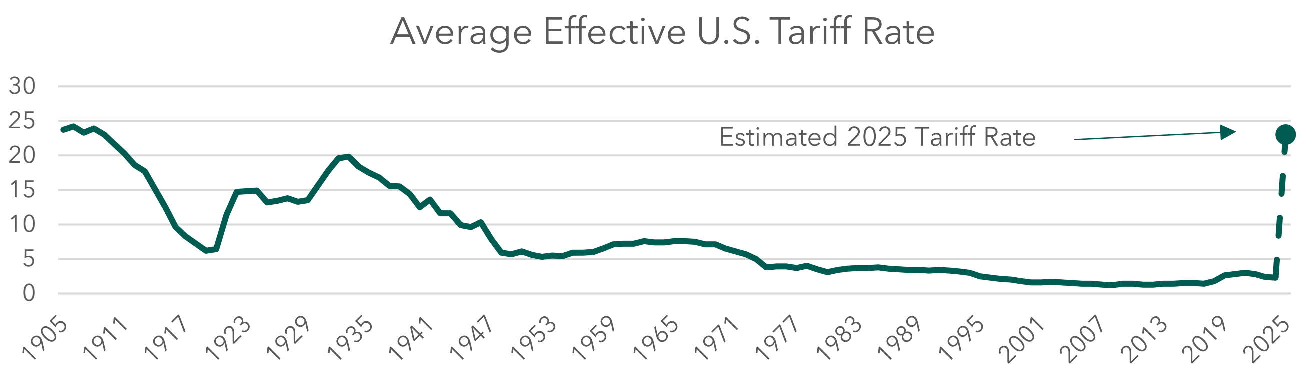
DAVIDSON INVESTMENT ADVISORS

Markets were rocked last week by the announcement that the United States would impose higher-than-anticipated tariffs on trading partners across the globe. While most had come to believe that tariffs would be announced and enacted early in the new administration, both the breadth and magnitude of the new levies surprised investors and introduced new worries about how businesses will operate and generate earnings in the new environment. Economic uncertainty is no friend to business or consumer confidence, business investment, or hiring; in our view, this accounts for the markets' sharp pullback as investors parsed the effects of these new policies.

Our team has spent considerable time researching, discussing, and processing what these new tariffs mean for the companies in which we invest and our clients, and we are pleased to share a few thoughts here.

For most of the past century, tariffs on goods imported into the United States have fallen. This coincides with a globalizing economy and a domestic shift from a manufacturing to a service-based economy.



Source: Bloomberg Finance L.P. 2025

The combination of globalization and lower taxes on imported goods has resulted in a prolonged period of prosperity for the American economy - GDP has grown, goods have become cheaper, domestic companies have continued to innovate, and the US consumer has become the envy of the world. However, these changes have also been accompanied by higher trading deficits, the dislocation of the manufacturing sector of the domestic economy, and a dependence on global supply chains to satisfy domestic demand.

The stated objectives of the new tariff policy are to raise revenue, bring manufacturing jobs back to the cities and towns that were affected by globalization, and shore up national security by making our supply chains more secure and robust. While these objectives carry obvious benefits, investors and economists seem to be weighing the relative likelihood, and resulting costs, of attaining them. Many of the plants and factories likely to be built in the U.S. would be highly automated and therefore bring back fewer jobs than likely intended by policymakers. Further, since 2018, services wages have been higher than manufacturing wages, and that gap has only grown since – meaning it may be difficult to find workers willing to work in these plants if they have a better alternative.

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Before President Trump's announcement, economists at the Federal Reserve ("Fed") estimated tariffs would add roughly 0.5% to inflation and subtract roughly the same amount from GDP growth. This was expected to put stagflationary pressure on the economy, but nothing it couldn't overcome, given its healthy condition. All else equal, the economy was still expected to grow, and inflation - although sticky - would still not be burdensome. However, since the announcement of the tariffs, Fed models point to a more severe increase in prices of 1.6% and a reduction in GDP growth of 2.8%, making a potential recession and bout of stagflation a real possibility.

Not only were the tariffs much larger than market participants expected, but given the high likelihood for retaliation or capitulation from other countries, uncertainty remains elevated. Some countries are already promising to lower their tariffs on the U.S. to 0% in order to get their reciprocal tariffs reduced or removed; conversely, other countries have responded by escalating their tariffs on U.S. goods. China already has struck back, implementing a 34% retaliatory tariff on all U.S. imports beginning this week.

Companies can respond in a variety of ways to the imposition of tariffs. To maintain their short-term margins, they can reduce hiring or lay off workers, they can try to pass on the higher prices to consumers, or they could try to find cheaper or lower quality parts for their products. Companies whose products are easily substituted will likely have more trouble raising prices in the short run, which makes it more likely for them to pursue layoffs or cheaper inputs. Conversely, companies whose products have no good substitutes will likely raise prices because they need to protect their margins and business. This is likely to lead to the outcome described above where the aggregate price level rises, and economic activity slows.

In the longer run, they could re-shore their means of production back to the United States, or they could reset expectations about the price of their goods to end consumers. This scenario could see companies bring back the production of goods to the United States. This is the Trump administration's stated preference, but it is not a certain outcome.

If the hit to growth turns out to be of a greater magnitude than the upward pressure on prices, it is likely the Fed will adopt a more significant rate-cutting bias moving forward in an attempt to bolster the labor market and avoid the more negative possible outcomes. Already, Fed funds futures are pricing in more than 100 basis points of easing by the end of this year, with the next rate cut fully priced in for the June meeting. With the announcement of these tariff rates, the probability of a recession has risen, though it is far too early to say that it is a done deal or to know how deep or long one would be if it did happen.

Over the near-term, the market is likely to be volatile as the outlook for growth, investment, and consumption changes alongside any negotiated agreements or announced retaliations. Such volatility provides investors opportunities to invest in quality franchises with solid management teams at attractive valuations. Whether or not the recent declines and volatility in markets have created a buying opportunity or not is dependent on just how much earnings are likely to be hit. Remaining invested in times like these is important, especially given the speed at which things can change - markets could bounce back as fast as they have fallen. Knowing your portfolio and sticking to your plan are paramount, and we believe that our long-term, actively managed, risk-aware approach will continue to serve clients well.

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