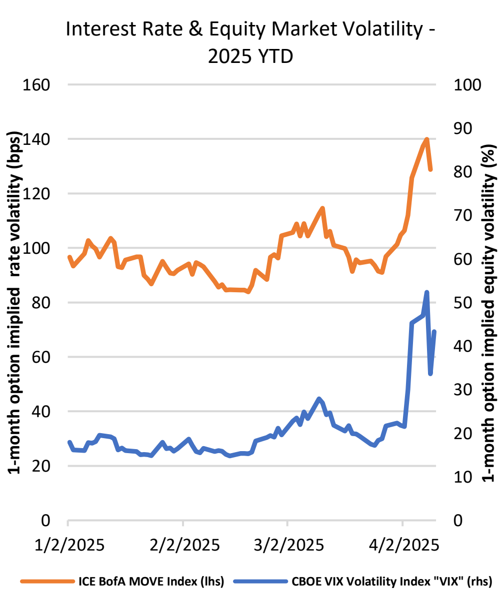
Turn Signals | Cues for Q2:

April 2025

A quarterly newsletter with cues and views covering capital markets

INSIDE



Source: Bloomberg L.P., BofA Merrill Lynch Research

360° Policy Review, 77 Days of Volatility and Counting

By Tim Senechalle, CFA

"No longer will shower heads be weak and worthless…make America's showers great again." – President Trump (April 9, 2025)

Liberation Day has led to surging equity and interest rate volatility, as financial markets estimate the impact to global capital flows and regional economies. The 90-day reprieve from reciprocal tariffs, applicable to imports from most countries, delays but does not eliminate the challenge that investors face in estimating and pricing for the immediate impact of uncertainty and the still present long-term impact of a higher tariff regime.

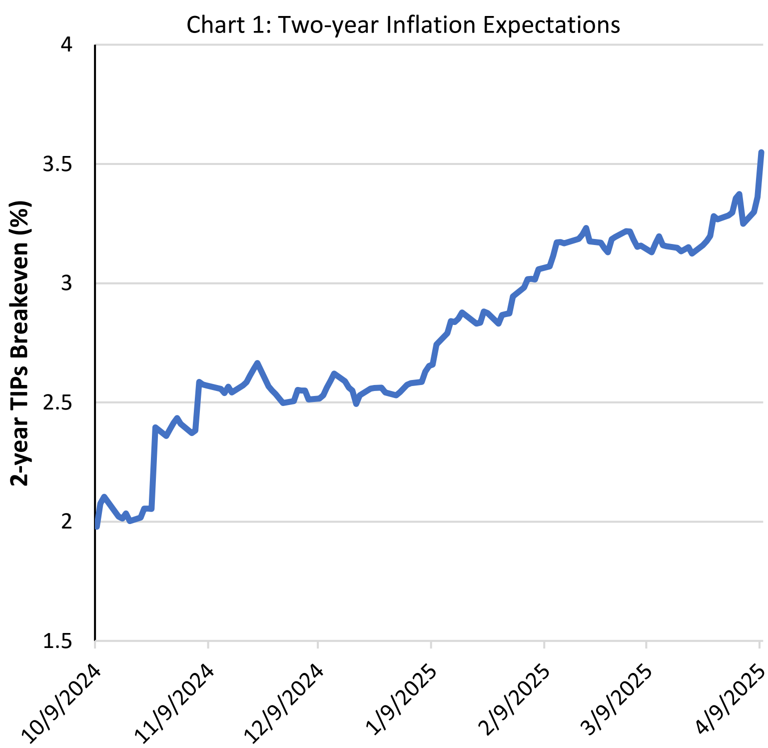
We anticipate tariff headlines will remain a source of ongoing volatility in the quarters ahead, as the Administration negotiates amended trade deals. But we are reminded by yesterday's Executive Order, liberating us from low-flow showers, that a 360-degree review of policy remains in full swing.

Among the items that we are closely monitoring are fiscal developments in Washington as the House and Senate work to advance policy through the budget reconciliation process. Moving past the headlines, the path to an agreement on the tax and spending cuts and the debt ceiling will be points of contention in the quarters ahead. The slope of the US Treasury yield curve, which has steepened dramatically in recent trading sessions, will be telling as investors process incoming fiscal and monetary policy cues on the horizon.

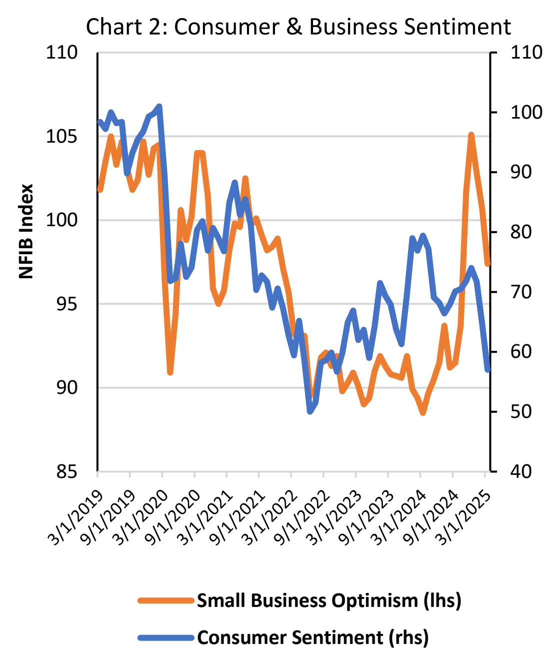
What's a Fed to Do?

By Marco Bravo, CFA

Federal Reserve Chairman Jerome Powell is facing a challenging situation. Tariff policies coming out of Washington are heightening the risks of both rising inflation and slower economic growth. On the inflation front, potential retaliation from other countries could lead the U.S. into a trade war, pushing prices higher. This risk is reflected in the market for Treasury Inflation-Protected Securities (TIPs), where short-term breakevens – used to gauge market-based inflation expectations – have increased, as shown in Chart 1 below.



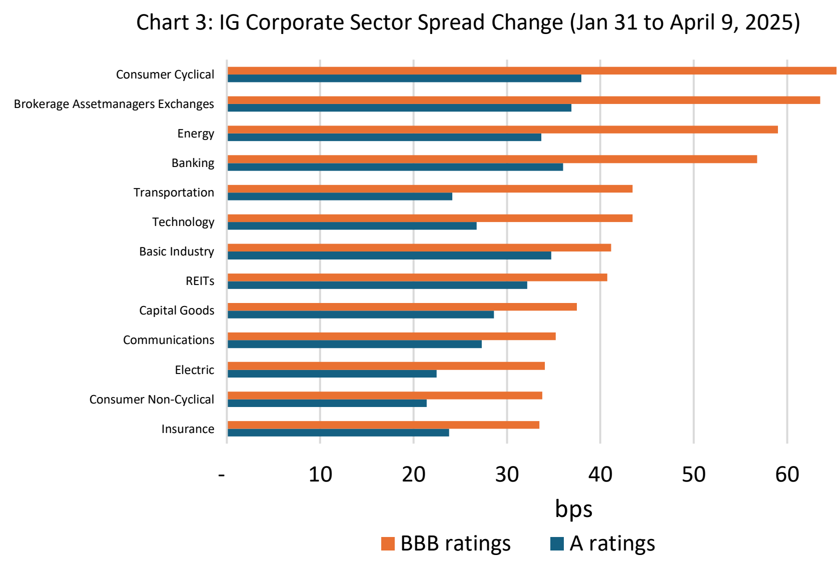
Rising inflation expectations would usually prompt the Fed to increase the Federal Funds rate in order to prevent those expectations from becoming entrenched. But wait – the Fed operates under a dual mandate and is also responsible for ensuring full employment. The uncertainty caused by tariffs is weighing heavily on both consumer and business sentiment (as shown in Chart 2). This decline in sentiment could lead to reduced consumer spending and business investment, which in turn may slow economic growth and push the unemployment rate higher.



Futures markets are currently pricing in three rate cuts (totaling 75 basis points) for 2025. So far, the decline in sentiment has not led to a slowdown in economic activity. Unless we see an uptick in the unemployment rate, it's unclear why the Fed would cut rates in response to rising inflation. We'll closely monitor weekly unemployment claims data and employment surveys for any signs of a cooling labor market.

A Wider, More Typical Corporate OAS Target

By Elizabeth Henderson, CFA



Markets remain volatile as governments, investors, consumers, and businesses worldwide react to the uncertainty and near-term risks of the Trump Administration's new trade policy. We entered this year anticipating increased volatility and with low risk premiums, positioned portfolios defensively and with enhanced liquidity to take advantage of opportunities because of the volatility. Spreads are wider in all sectors, as the probability of recession increases, interest rate volatility has increased, and investors require greater payment for this volatility and uncertainty. AAM's expected OAS range for Investment Grade (IG) Corporate Bonds in 2025 has widened to 95-150 with a year-end target of 120. This reflects an environment where recession risk is elevated. For context, OAS has been 95-125, close to 40% of the time over the last ten years, with most of the time in a range of 115-125.

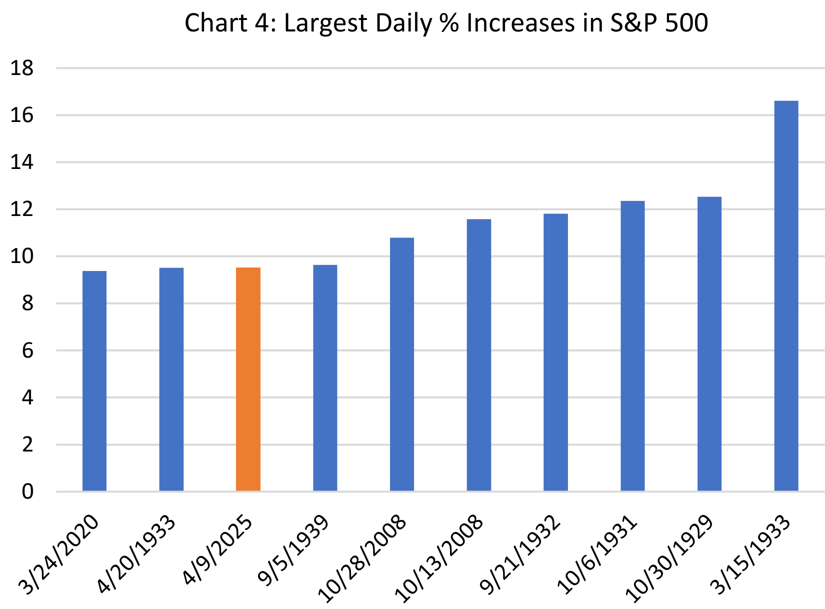
Importantly, as it relates to IG fixed income, fundamentals are strong for the average corporation and consumer, as debt leverage was reduced and liquidity was enhanced after 2020. As AAM analysts adjust their fundamental estimates given current events, our base case includes the expectation for tariff-related negotiations over the next 90 days and economic activity falling due to heightened uncertainty, pressuring GDP growth while circumventing a recession. While the Fed is expected to cut rates, we also expect some fiscal support (i.e., tax policy and deregulation).

Changing Sector Risks Require Recalibration of Relative Value

As we seek to maximize risk-adjusted income opportunities, the critical variable is the denominator or risk measure. Analysts run estimates and recalibrate fundamental outlooks in this environment, incorporating various macro and micro possibilities. The sector that has suffered the most in this environment is Consumer Cyclicals, as industries like Autos face headwinds from both tariffs and weaker economies around the globe.

Since much of the North American auto manufacturing base is in Mexico and Canada, tariffs would substantially increase the cost of manufacturing vehicles sold in the US. For example, Mexico accounts for roughly 30% of GM's North American production while Ford is relatively less exposed at 16%. Volkswagen has the majority (75%) of its North American production in Mexico. Furthermore, while the US does not import vehicles directly from China, the international supply chain is vulnerable to tariffs on Chinese exports and retaliation worsens the situation. While higher tariffs are disruptive for the entire industry, it is particularly ill-timed for the supplier base, which is already dealing with challenging market conditions in Europe and China.

Source: Bloomberg, AAM



Tariffs – The Short and Long of It

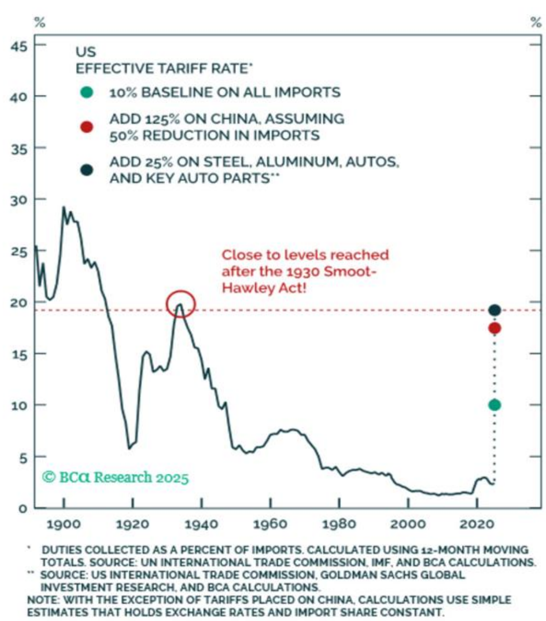
By Peter Wirtala, CFA

As I type this the S&P 500 has just had its largest daily increase since 2008, shortly after having its largest 4-day drop since 2008. This was caused by a single social media post pausing US tariffs on most countries for the next 90 days. What does this episode tell us about the outlook for equities for Q2?

First, expect headline risk to remain elevated. When new developments have wide-ranging impacts (think Covid in 2020, or inflation in 2022, and now tariffs in 2025) markets stay closely attuned to each new twist and turn of the saga, rising and falling on sentiment shifts while giving less weight to fundamentals. "Buy (or sell) now and ask questions later" becomes the norm. In the near term the tariff theme likely has more surprises in store for us. The 90-day pause may create a cooling-off period, but until the White House signals a new status quo has been achieved we can expect more seismic tweeting in the months ahead.

Once the acute "headline risk" phase ends, expect tariffs to become an important talking point in earnings revisions and investor calls for multiple coming quarters, with impacts on pricing, cost structures, and long-term capex plans. The fiscal impact will also be important: if the government collects substantial tariff revenue, does that mean tax cuts? Stimulus payments? Subsidizing domestic industrial development? Any of these could become a future source of market-moving headlines, just as the 2017 tax cut negotiations drove markets higher for months before being finalized.

From Halloween 2023 to Valentine's Day 2025 equities rose 50% with barely any volatility on the way; those periods of meteoric low-risk returns are the reverse of the coin from this year's tariff turmoil. Patience and a long-term perspective remain the equity investor's best defenses against both reactive anxiety in down markets and complacency during advances.



Source: Wikipedia – list of largest changes in S&P 500