HILLTOPBANK
Trust and Wealth Management

QUARTERLY MARKET INSIGHTS – FIRST QUARTER 2025

To the Clients and Friends of Hilltop Bank Trust and Wealth Management:

Just one short quarter ago, I was writing to you about the expensive nature of the market, with the hope of providing some useful context that might be drawn upon in the event of any coming correction. Unfortunately, that guidance proved timely. The S&P 500 has begun the year with its worst quarterly performance since 2022, now down 10% as I write this.

As a general rule, it's most often a mistake to attribute a specific cause to overall market fluctuations. There are just too many disparate narratives, covering thousands of individual firms and an even greater number of variables, to attribute causation in such a manner. That being said, when a development is significant enough to change the path of global macroeconomic conditions, it will also have an impact across a broad swath of asset prices. We now have just such a development in the first quarter of 2025, in the form of trade policy.

As a primer, the broad thrust of trade policy over the past thirty years has been toward more universal free trade. That is, fewer barriers such as tariffs, quotas, and subsidies. The theory behind these developments is straightforward market economics – if Wyoming is able to produce more natural gas than it uses, and does so more cheaply than Montana, which can produce a surplus of lumber more cheaply than Wyoming, it makes sense to trade some natural gas for some lumber. In fact, both Wyoming and Montana will be richer from the benefit of utilizing the other's marginal advantages.

Extrapolating this example to a nation-state scale is obviously a little trickier. If Montana was worried about Wyoming milling that lumber into baseball bats, and storming across the 45th parallel, there's a good argument to be made that they should limit how much lumber they trade. This is a rational reason for the U.S. to limit trade, in certain goods, with certain geopolitical rivals.

While such a trade restriction may be a laudable goal under some circumstances, it is not cost-free. If you apply the trade restriction to all goods from everywhere, that cost will only multiply. Further, in today's world of globally-integrated supply chains and just-in-time inventory management, those costs can be significant and unpredictable.

First, and the most immediate cost to discuss, is who pays the tariff? Frankly, in most circumstances, it will be consumers that pay in the form of higher prices. A tariff, after all, is simply a tax on imported goods. As with any other tax, who ultimately bears the cost will depend on where the pricing power lies in the economic relationship. Since the pandemic, firms have been able to push much of their cost increases onto consumers, with consumer prices up about 24% since 2020, and S&P 500 net profit margins growing from about 10% to about 12%. Firms may have lost some of this pricing power now that pandemic-era savings are spent, and the wealth effect of higher markets is deteriorating, but until we see an actual decrease in consumption we can't assume that's the case. In addition, shielding domestic producers from foreign competition only increases their pricing power. If a foreign manufacturer has to raise its price ten percent to pay for the tariff, a profit-maximizing domestic manufacturer will simply raise their price slightly less to capture more of the surplus. Foreign competition stokes efficiency, whereas coddling domestic industry does not lead to innovation.

Second, while another predominant argument for tariffs is that they will protect domestic manufacturers, this is not reflected in the economic literature. For one, we do not trade in only finished products, and the current tariffs are also a tax on the intermediate components and machinery that manufacturers use to build their products. Taxing components and equipment makes domestic manufacturing more expensive, and makes US products less competitive in a global marketplace, since foreign manufacturers don't pay it. This was observed as recently as 2018-2019, when the U.S. imposed duties on washing machines, steel, aluminum, and a wide variety of Chinese imports. In that experiment, sectors exposed to the tariffs experienced significantly slower growth, even before factoring in retaliatory tariffs. This makes sense. If the choice is between a t-shirt produced in the US at $39 because we have tariffed sewing machines, or a t-shirt produced abroad that is now $40 due to tariffs, the likely response is not a preference for the domestically produced shirt. It will be to consume fewer t-shirts.

Third, while targeted tariffs can lead to a small increase in employment in specific industries, broad tariffs come at the expense of the jobs market overall. When the U.S. experimented with the 2018-2019 tariffs, it was possible to identify a few thousand more jobs, at specific washing machine manufacturing plants, as a result. However, overall manufacturing employment was reduced by the tariffs 245,000. Again, due to the increased costs for intermediate components, lower exports, and the introduction of retaliatory tariffs. Those few thousand jobs in washing machine manufacturing came at the cost of an even greater number of manufacturing jobs elsewhere in the supply chain.

Overall, if a global trade war leads to some combination of higher prices, slower growth, and increased unemployment, it begs the question, why are we doing this at all? Why not target specific industries and final goods? Unfortunately, as near as I can tell, it stems from a misunderstanding of Gross Domestic Product (GDP) and trade deficits.

In economics, we pay a lot of attention to GDP. That is, the total amount of goods and services produced in a given economy. One way we calculate GDP is GDP = Consumption + Investment + Government Spending + Exports – Imports (popularly, C+I+G+NX where NX stands for net exports). Because imports follow a subtraction sign, it's an easy mistake to make, thinking that they subtract from GDP, but as I'll explain, that's not the case.

The most popular way we measure all production in an economy is to simply add up all the expenditures within it. In other words, how much is spent on final goods and services within that economy? Obviously, adding up all those sales is going to capture sales of items purchased in that economy, but made elsewhere. We need to back those products out of our formula to get an accurate estimate of domestic production. As we said above, importing a t-shirt from abroad doesn't mean one less t-shirt is produced domestically. Simply put, the "– Imports" identity is an accounting adjustment. Not an actual drag on GDP.

As for trade deficits, they arise because U.S. consumers buy more stuff from other countries than other countries buy from us. Intuitively, that is predictable. U.S. consumers are the richest group of people to ever walk the face of the earth. The most recent data shows us as having spent $22.5 trillion on consumption in 2023. The next highest-consuming country was China at $9.9 trillion, and they outnumber us 4-to-1. Add to that the fact that goods can be produced cheaper elsewhere, and that we prefer cheaper alternatives, and a trade deficit in goods is a natural outcome. (We are also ignoring trade in services, which is the U.S.'s comparative advantage, 76% of our economy, and from which we export $278 billion more of than we import.)

Is this a problem? It depends. As another simple formulation, when we buy a semiconductor lithography machine from Taiwan, we can either give Taiwan, say, a ton of soybeans or an IOU. If the machine and the soybeans cost the same, there is no trade deficit. We exchanged equal goods for equal goods. If Taiwan doesn't need the soybeans, they can instead take an IOU from us in the form of a Treasury bond. We get the machine, they get a Treasury, and the trade deficit is the cost of the machine. We know imports don't directly subtract from GDP (and neither does issuing a Treasury), and now we have acquired a machine capable of producing the very best semiconductors in the world. Producing those semiconductors adds to GDP, and so when the IOU comes due, we will be richer and it will be even less burdensome to pay. Seems like a good trade.

Alternatively, if we buy a tank from China (or a baseball bat from Montana), we still get the tank (bat), but neither produces much GDP. Do it long enough, and we may forget how to build tanks or bats at all. That's an obvious example that makes clear there are specific instances where protectionist trade policy may be necessary to protect a larger national interest, despite its costs.

Unfortunately, even after the recent, partial pause, with broad tariffs on intermediate goods, allies, and everything in between, we cut off our nose to spite our face. We will pay the costs of all the tariffs for an uncertain, and likely much smaller benefit.

What is more, by changing our trade policies almost daily, we have frozen firms' and consumers' ability to plan and budget. The response to that uncertainty is not to invest more in the U.S., but rather to pause investment altogether. That adds yet another layer to the detrimental costs of the policy. We already see hints of a resulting slowdown in soft-data measures like consumer confidence and capital expenditure plans. It remains to be seen how much that will translate to the hard data, such as GDP.

In sum, the longer broad tariffs remain in place, the greater the damage they will do to our economy. Even if they are cancelled tomorrow, the uncertainty around them has already significantly increased the chances of a recession. As for the markets, they detest such uncertainty. As the range of possible outcomes grows, the discount rate applied to future cash flows will also rise, and the present value of assets will fall. Until our trade policy is at least predictable, volatility will continue. Now more than ever, when trillions of dollars are changing hands based on social media posts, I must again advise against trying to time the market.

Best,

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