Economic & Market Outlook

Executive Summary

~ The U.S. is coming off a period of prolonged economic and financial dominance, marked by superior GDP growth, corporate profits, and equity returns. This American Exceptionalism has cemented the U.S. as the world's capital magnet, but it has also widened domestic divides and fueled backlash against globalization.

~ For the first time in years, ex-U.S. assets are outperforming across the board, including in equities, fixed income, and currency markets, underscoring shifting sentiment and growing uncertainty around U.S. policy.

~ In April, the U.S. enacted sweeping tariffs. While anticipated in theory, their size and scope stunned markets and marked a sharp rupture from the country's decades-long commitment to free trade.

~ U.S. equities fell ~15% and Treasury yields surged in response to the tariffs. The administration has since softened its stance, revealing a pain threshold, but the damage to market confidence and the real economy continues amid ongoing policy uncertainty.

~ Annandale's diversified approach has helped us weather the market's volatility. While unsettling, drawdowns of this magnitude are historically common, and enduring them is required to earn equity like rates of return.

Introduction

This was one of the harder commentaries we've written in recent memory.

From the postwar era to the 1990s, the U.S. led the effort to build a global system rooted in free trade - founding institutions like the World Trade Organization, crafting major deals like NAFTA, and steadily lowering tariffs. The result was global integration, with supply chains, capital flows, and economies becoming increasingly intertwined.

The new tariff regime represents more than just a policy shift, it's a philosophical rupture with that decades-long tradition. And it's hard to assess what this rupture means, because we haven't seen tariffs of this scale in over a century.

Markets are grappling not only with the magnitude of the changes, but also with their ambiguity. As one economist put it, "I've gotten used to not knowing what tariffs are going to be in the near future, but not knowing what tariffs are, in the present, is an interesting plot twist."

While the policy direction and uncertainty are unlikely to benefit the real economy or financial markets in the near term, it's also fair to say this moment was a long time coming. Rising wealth inequality - real or perceived - has fueled populist angsts, and globalization often becomes the target. A more direct confrontation with China, a world superpower, also seemed inevitable.

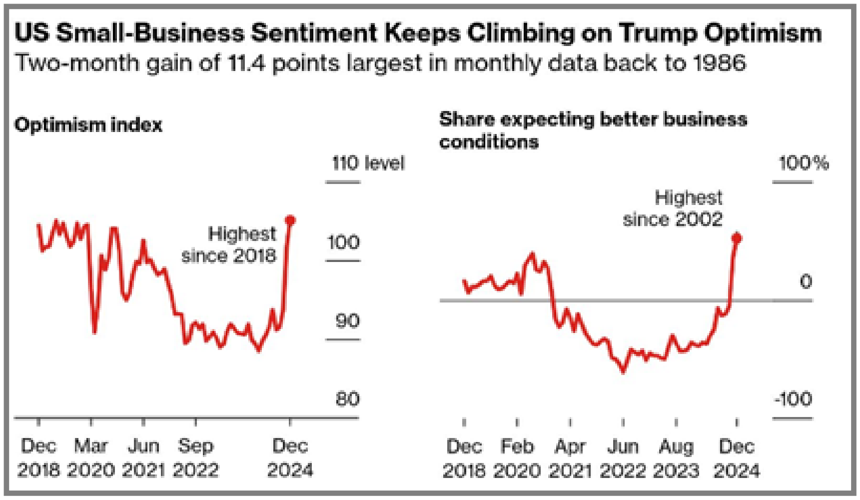
Highly diversified portfolios have helped Annandale weather the volatility thus far, and we hope that continues, but this is a good time to remember that enduring volatility is the price investors pay for equity-like returns.

Setting the Stage

It's difficult to visit Davos, Switzerland in mid-January. Most hotel rooms are reserved for heads of state, Fortune 500 CEOs, and the occasional celebrity, all eager to shape the global policy landscape. Needless to say, Annandale didn't make the World Economic Forum's guest list, but America's winning streak, and Europe's inability to get out of its own way, were popular topics of conversation.

As Huw van Steenis put it, “U.S. exceptionalism has been a driving force in markets for years. The dominant theme at Davos was whether the new administration would amplify and diverge even more from Europe and Asia.” Even President Trump dialed in virtually, declaring: “My message to every business in the world is very simple: Come make your product in America… Under the Trump administration, there will be no better place on Earth to create jobs, build factories, or grow a company than right here in the good old USA.” With the benefit of hindsight, we can say he was being quite literal.

Small Business Optimism Surged After the Election



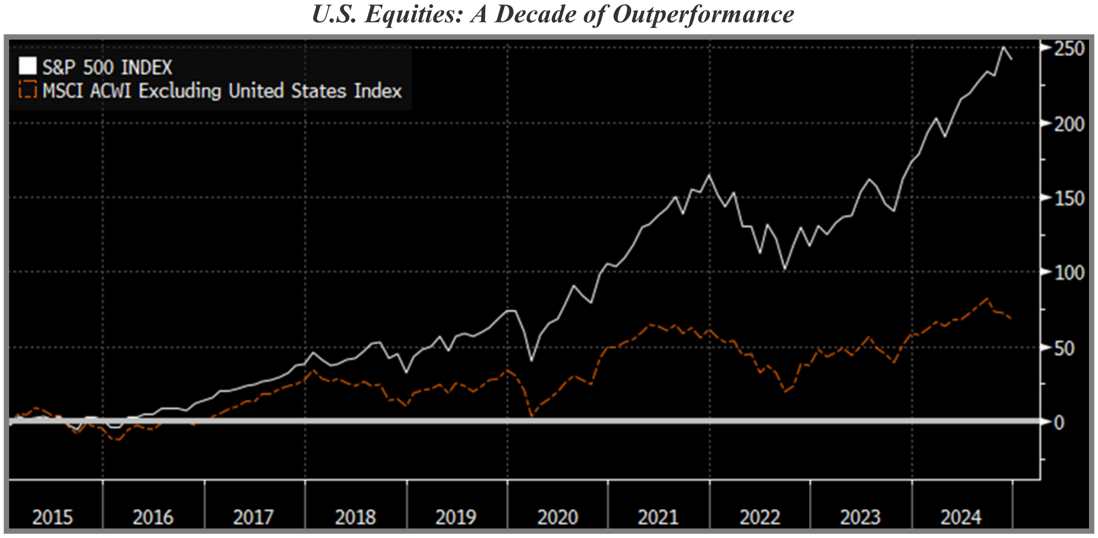
National Federation of Independent Business

American exceptionalism is real.

Last October, The Economist published a piece titled The American Economy Has Left Other Rich Countries in the Dust. A few highlights: In 1990, the U.S. made up about two-fifths of the G7’s total GDP. Today, it's closer to half. On a per-person basis, U.S. economic output is now 40% higher than Western Europe and Canada, and 60% higher than Japan - roughly twice the gaps seen in 1990. Mississippi, the poorest U.S. state, has higher average wages than Britain, Canada, or Germany. And America’s lead is widening. Since the start of 2020, U.S. real growth has hit 10% - three times the average for the rest of the G7. According to the IMF, the U.S. is the only G20 economy where both output and employment have exceeded pre-pandemic expectations.

Nowhere is that outperformance more visible than in equity markets. Over the last decade, the S&P 500 has delivered a return on equity of 14%, compared to just 5% for the rest of the world. U.S. corporate profits have grown at 9% annually - three times the rate of Europe. This shouldn’t surprise anyone. Nvidia, Microsoft, Apple, Amazon, Meta, Tesla, and Alphabet, the so-called “Magnificent Seven,” all call the U.S. home.

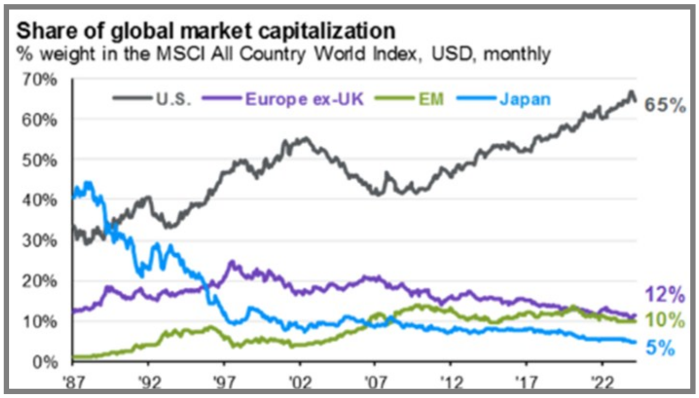
U.S. Equities: A Decade of Outperformance



Bloomberg

The return differentials are stark. Over the last ten years, the S&P 500 has returned 242%, compared to only 69% for ex-U.S. equities. The Magnificent Seven has returned 384%, in just the last five years. That's a 29.1% annualized return. As a result, the global equity market has become the U.S. equity market. And the U.S. equity market has effectively become an index tied to a handful of mega-cap tech giants.

The U.S. Market Was The Global Equity Market



JP Morgan

Large-Cap Tech Was the U.S. Market

JP Morgan

The Haves and Have Nots

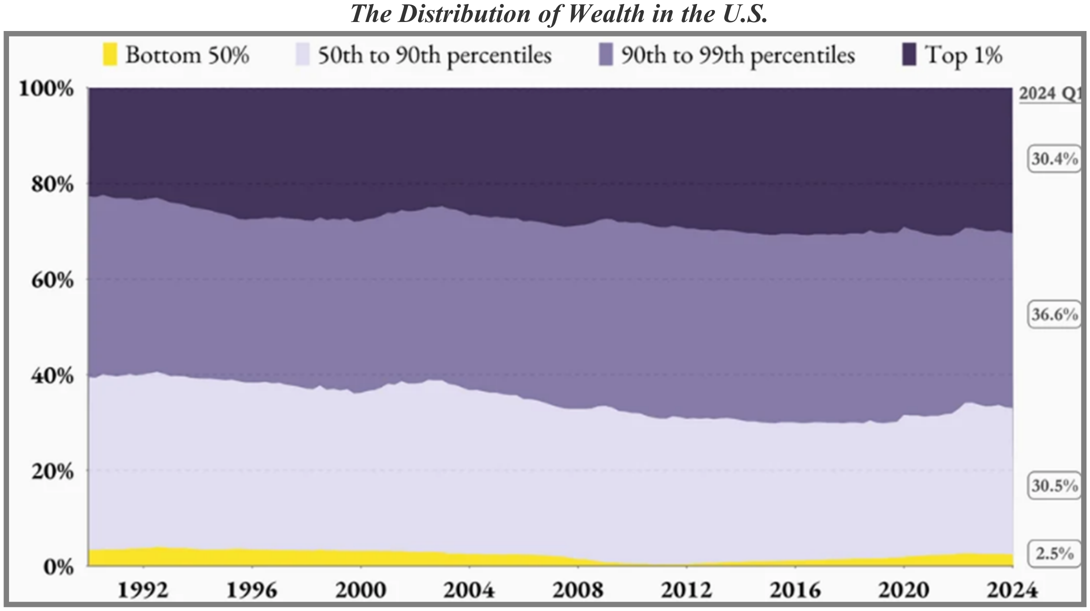
One byproduct of America's prolonged economic prosperity is the widening gap between the "haves" and the "have nots."

Wealth, by its nature, compounds. Those with excess savings can invest in income-producing assets, like real estate, public and private equity, and let time do the heavy lifting. The more assets and the more time, the better. And over the past decade (or two), there's arguably been no better place to invest than the United States, private or public.

For those without assets, economic mobility depends almost entirely on wages, a route that is more constrained, and more vulnerable to inflation, automation, and broader economic shifts.

To be clear, wealth inequality is not new. It has been a feature of every civilization, including those that have attempted to eliminate it. But the public's sensitivity to it feels heightened today. One way to observe this is by looking at the share of wealth held by the bottom 90% of Americans. In 1990, they held 40% of national wealth; today, that figure is just 33%. Meanwhile, the top 0.1% of earners now control 14% of wealth. The top 1% and top 10% control 31% and 67%, respectively.

The Distribution of Wealth in the U.S.



Federal Reserve

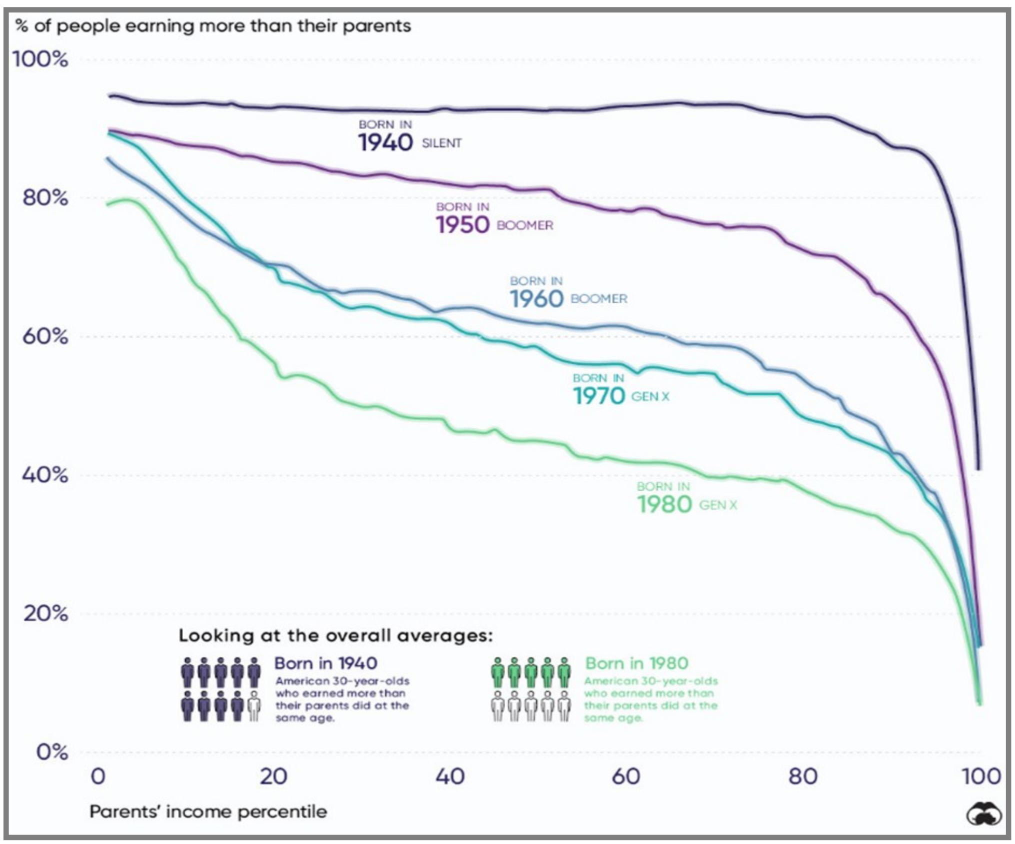
An insensitive economist might point out, correctly, that even amid this growing disparity, most Americans are better off than they were a generation ago. Between 1979 and 2023, the top 10% of earners saw real wages grow by 46%, while middle-income earners experienced growth between 17% and 24%. Even the bottom decile saw a 17% gain in purchasing power. So while inequality has increased, the standard of living has improved across the board.

It's also worth considering the counterfactual. Would the U.S. have seen the same pace of innovation or economic dynamism under a different model? Likely not. Advances in technology and productivity like air conditioning, refrigeration, broadband, and medical care have delivered tangible benefits that extend well beyond financial metrics.

Still, perception matters. A rising standard of living may not feel like progress if the gains are unevenly distributed, and upward mobility appears out of reach. Elon Musk's reported net worth of $362 billion might symbolize opportunity to some, but to others, it may reinforce a sense that the system is skewed and that they're stuck on the same rung of the economic ladder.

The history of American capitalism is one of extraordinary progress, but also of uneven distribution. And in a system where ownership is rewarded more than labor, those who hold capital naturally pull further ahead.

Are You Earning More than Your Parents?



World Economic Forum

The Rise of Populism & Globalism, the Fall Man

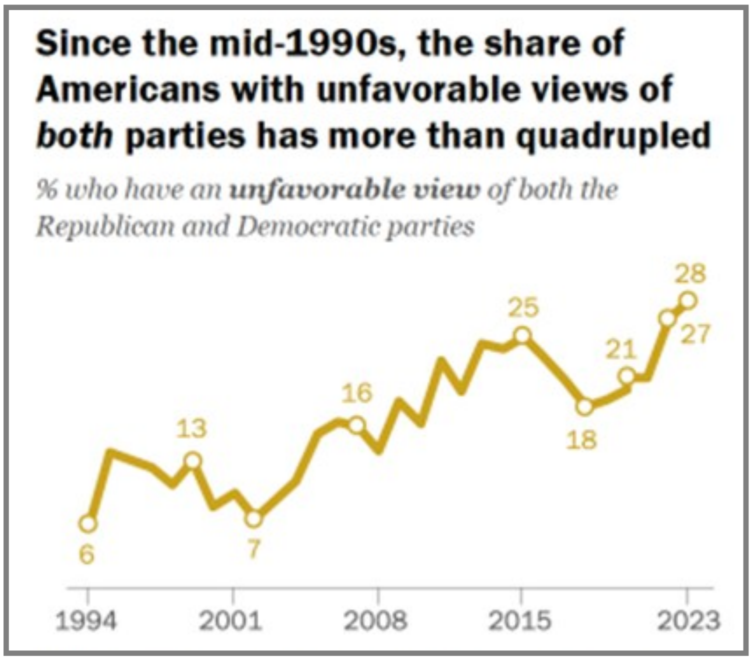
"When a particular model of capitalism is working successfully, material progress relieves political pressures. <u>But when the economy fails – and the failure is not just a transient phase, but a symptom of deep contradictions capitalism's disruptive social side effects can turn politically toxic…</u>

If we are witnessing this kind of transformation, then piecemeal reformers who try to address specific grievances about immigration, trade, or income inequality will lose out to radical politicians who challenge the entire system. And, in some ways, the radicals will be right.

The disappearance of "good" manufacturing jobs cannot be blamed on immigration, trade, or technology. But whereas these vectors of economic competition increase total national income, they do not necessarily distribute income gains in a socially acceptable way. To do that requires deliberate political intervention…"

Whether you believe in American exceptionalism or not, voters have grown increasingly dissatisfied and have been for the better part of a decade. One possible explanation, the widening gap in wealth and opportunity. "Since the mid-1990s, the share of Americans with unfavorable views of both political parties has more than quadrupled." For politicians, electoral survival increasingly means moving to extremes. MAGA Republicans have displaced traditional conservatives; progressive Democrats have sidelined moderates. Populism, on both the left and right, has become the main political beneficiary of America's unease.

Americans Are Fed Up With Both Parties



PEW Research

And even though 62% of Republicans view the Democratic party as "very unfavorable" and 54% of Democrats hold the same view of Republicans, the populist camps in both parties attribute wealth inequality and the erosion of the working class to globalization.

"Since 2001, the US has lost more than 3 million manufacturing jobs. Why? Because disastrous trade deals have encouraged corporations to move jobs to low-wage countries." Senator Bernie Sanders

"We were told that if we let the biggest companies get even bigger through trade deals, their wealth would trickle down. That was a lie. What trickled down were lost jobs, lower wages, and broken towns." – Senator Elizabeth Warren

"Globalization has made the financial elites who donate to politicians very wealthy, but it's left millions and millions of our workers with nothing but poverty and heartache – our towns and cities with empty factories and plants… we're fighting for Main Street, not Wall Street. We have rejected globalism and embraced patriotism." President Donald Trump

"For 40 years, this country has made… a bipartisan mistake. It has allowed our manufacturing might to get offshored and to get outsourced while simultaneously increasing the commitments that we have all over the world." Vice President JD Vance

The Original Trump Economic Agenda

A week before "Liberation Day," we hosted a client webcast to discuss rising volatility in U.S. equity markets. At the time, investor sentiment remained relatively calm - international markets were in positive territory, and U.S. equities were only 7% off their recent highs. It's always tricky to assign a clean narrative to market movements, but the drivers year-to-date were straightforward. The AI trade had cooled, and President Trump's economic agenda, if implemented in full, promised short-term pain, even if proponents believed it could deliver long-term gain, a reality the administration was happy to disclose.

"There's going to be a natural adjustment as we move away from public spending to private spending. The market and the economy have just become hooked…" - Treasury Secretary Scott Bessent

"There's no (Trump) put." - Treasury Secretary Scott Bessent

Our assessment of that agenda was simple. Curtailing illegal immigration is contractionary. Economic growth is a function of population and productivity, and reducing the former puts a cap on potential. The Department of Governmental Efficiency's planned layoffs would further tighten the labor market and ripple into the private sector, given that government spending is, by definition, someone else's revenue. Over time, it's possible that leaner and more efficient private-sector spending could backfill that gap, but not without a timing mismatch.

And then there were the tariffs, the market's primary concern. These are, in effect, tax hikes. The only real question was one of magnitude: Were these tariffs a tactical reset in the terms of trade, or a reflection of deeply held views about global commerce?

President Trump the Tariff Man

President Trump's support for tariffs spans several decades. Long before his political career, he was outspoken about what he saw as the unfair trade practices of other nations. In a 1989 interview, Trump told Diane Sawyer, "So many countries are just ripping off America left and right and down the middle." He wasn't afraid of a trade war and proposed imposing 15 to 20 percent tariffs on Japanese imports. While his frustrations initially centered on Japan in the 1980s, his grievances grew over time to encompass a broad range of U.S. trading partners. He consistently framed tariffs as a necessary tool to secure America's economic strength. In 2011, he wrote, "A nation without tariffs is a nation without jobs." Trump has often romanticized the Gilded Age, stating, "We were at our richest from 1870 to 1913. That's when we were a tariff country. And then they went to an income tax concept." His favorite president, William McKinley, once declared, "I am a tariff man running on a tariff platform," and Trump has repeatedly aligned himself with that legacy, insisting that he would never back down from a trade war so long as the U.S. was running a trade deficit.

Pre-WWII the U.S. Derived Most of it's Revenue from Tariffs

Unknown

While we knew the President had a long-standing aversion to past trade policies, April 2nd, 2025, "Liberation Day," was a revelation. It wasn't just the practice of unfair trade that Trump despised; it was the trade deficit itself. He declared, "Deficits are no longer merely an economic problem; they are a national emergency that threatens our security and way of life." He further explained that for nations that "treat us badly," the U.S. would calculate the combined rate of all tariffs, nonmonetary barriers, and other forms of trade imbalances. In an attempt to be "very kind," the U.S. would charge these countries "approximately half of what they had been charging the U.S."

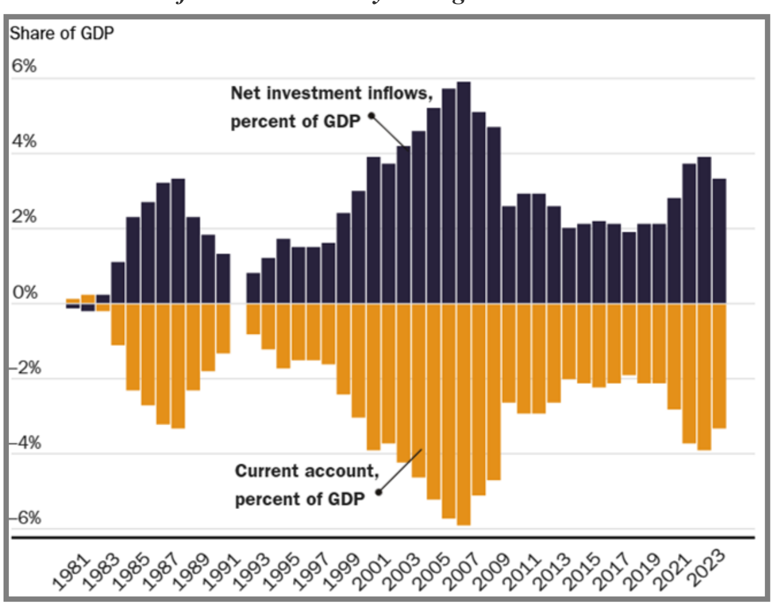
The tariffs announced on "Liberation Day" were far steeper than anyone had expected, and far greater than the "tariffs, nonmonetary barriers, and other forms of cheating" that these countries were imposing on us. It quickly became clear that rather than calculating actual damages, the administration had simply divided the U.S. goods trade deficit with each country by total trade and then halved that number. In cases where the U.S. had a trade surplus with a country, a flat 10% tariff was applied.

Trade Deficits

The trade war waged by the United States wasn't simply about ensuring fair trade. "Liberation Day" marked a clear shift: the administration was explicitly targeting all bilateral trade deficits, even with countries that engaged in fair and open trade. The goal was to reverse the trade policies pursued by the U.S. dating back to 1944 Bretton Woods agreement. Our best explanation for this is that Trump views trade as a zero-sum game: either you're the exporter, the winner, or you're the importer, the sucker. But that's not how trade deficits work. Trade deficits aren't meaningful numbers when viewed without context.

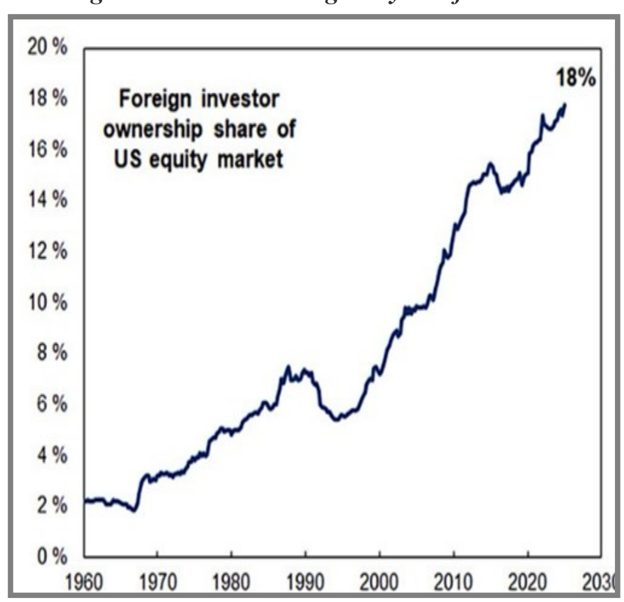
When a country imports more than it exports, it sends its local currency abroad. The dollars received by foreign countries can either be reinvested into the country of origin or, in some cases, parked under a mattress. This is known as the balance of payments. To some extent, the U.S. trade deficit has played a crucial role in what's been termed "American Exceptionalism." The dollars sent abroad are the same ones that fund U.S. investments, which in turn support the growth of companies like Amazon, Microsoft, Apple, Nvidia, Meta, and Alphabet. Foreign capital competes to invest in the U.S., which lowers our cost of capital, fosters economic growth, and helps ensure that the U.S. dollar remains the world's reserve currency. Here's a random example, a U.S. manufacturer imports raw materials from an Australian company. In this simple example, there is a deficit, because the trade is one way. That Australian company now has US dollars, which they loan to a U.S. based property developer. The property developer uses those dollars to fund the construction of a new multi-family complex. "A trade deficit is a symptom, not a disease"

The Trade Deficit is Mirrored by Foreign Investment in the U.S.



CATO Institute

Foreigners Have Been Large Buyers of U.S. Stocks

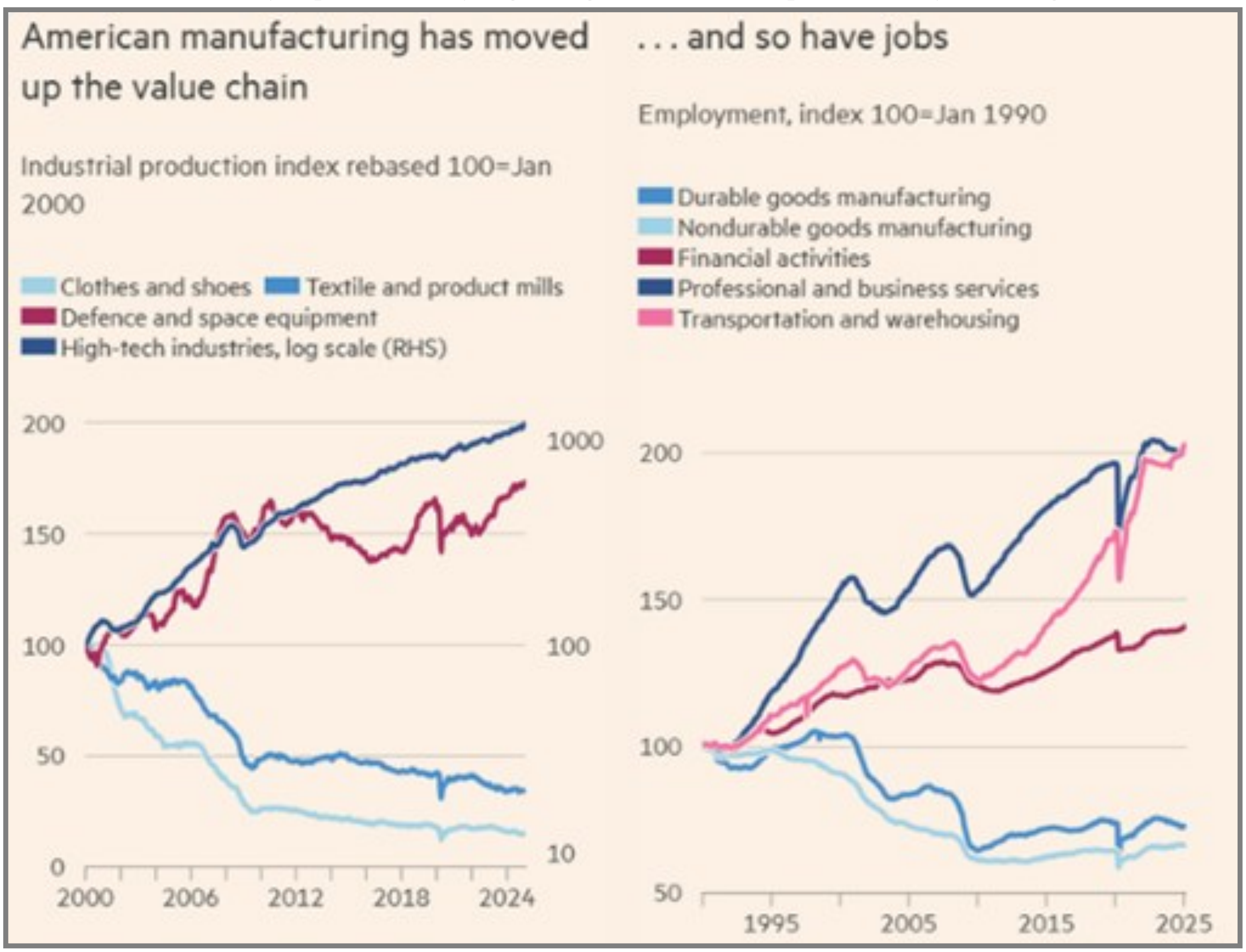


Goldman Sachs

There are more nuanced ways to frame the issue. The U.S. runs a $918 billion trade deficit, which sounds alarming without context. However, this deficit represents only 3-4% of our nation's gross national income. To put this into further perspective, U.S. households hold over $170 trillion in net assets - 185 times the size of the trade deficit. While trade deficits can sometimes be problematic, this situation isn't one of them. Many of the goods we import are productive assets that will generate income. For example, capital goods, such as machinery and equipment, make up 31% of imports. Industrial supplies, which will eventually turn into finished products, account for 35%. Isolating the trade deficit is like accusing someone with gray hair of being unhealthy without considering the broader context.

Additionally, there are structural reasons behind the U.S. running a trade deficit. We recently imposed reciprocal tariffs of 49%, 46%, 44%, 39%, and 38% on countries like Cambodia, Vietnam, Sri Lanka, Iraq, and Guyana. The common thread among these countries is that they are relatively poor, developing economies. For instance, the richest of the group, Iraq, has a per capita GDP of just $5,565. In Sri Lanka, 73% of exports to the U.S. consist of apparel products, the largest being underwear. How could a country like Sri Lanka, with an average household income of $1,422, ever expect to run a trade surplus with the U.S.? In a globalized economy, manufacturing and services migrate to the countries that can produce most efficiently, expanding the economic pie for everyone. Think about it this way: in your daily life, you likely run a trade deficit with your local grocery store, because it's far more efficient for you to purchase their goods rather than attempt to produce them yourself. A recent FT poll found almost 80% of Americans think the country would be better off if it had more manufacturing jobs, but fewer than a quarter of those polled thought they would be better off if they worked in a factory. Are U.S. citizens better off trying to sew their own garments or assemble iPhones, or would it be more productive to outsource these jobs to countries where they have a comparative advantage?

The U.S. Economy Exports Relatively High Margin Services and Imports Relatively Low Margin Goods



Financial Times

The final point we want to emphasize is governments don't dictate trade deficits (or surpluses). They "are the product of billions of transactions by millions of individuals and firms acting independently of each other… Put simply, the trade balance isn't really about one nation trading with others, even though that's always how it is described."

The Fallout

On April 2nd, 2025, it became clear that the administration wasn't merely aiming to level the playing field, it was fundamentally altering the structure of global trade. Some believe the administration was attempting to dismantle globalization, and to achieve that, it was willing to impose prohibitively high tariffs. JP Morgan's research highlighted the potential consequences, noting that, "if sustained, this year's ~22% tariff increase would represent the largest U.S. tax hike since 1968." And this estimate didn't even factor in retaliatory measures, supply chain disruptions, and other economic shocks. The very next day, the S&P 500 embarked on a sharp decline, ultimately experiencing a roughly 15% peak-to-trough drop within a week.

Liberation Day Welcomes Market Volatility

Bloomberg

The New Narrative: Walking it Back

Since Liberation Day, U.S. trade policy has been in constant flux. On April 3rd, Trump's previously announced auto tariffs took effect, prompting Canada to retaliate. On April 4th, China responded by imposing a 34% retaliatory tariff on all U.S. goods, along with additional export controls on rare earth minerals. April 5th saw the implementation of Trump's 10% threshold tariff. By April 9th, the tariffs announced on Liberation Day were set to take effect, but the president paused them for 90 days (excluding China). In response, China raised its tariffs on U.S. imports to 84%, and Trump retaliated with a 125% duty. The following day, the White House clarified that tariffs aimed at China would total 145%. By April 11th, China raised its retaliatory tariff to 125%, and Trump issued an order exempting all cell phones, computers, and chips made in China from his 125% tariff, leaving a 20% tariff in place.

As confusing as it was to track, the key takeaway is that on April 9th, the day of the tariff pause, markets began to turn a corner, despite ongoing escalations with China.

The new narrative emerging suggests that the administration is walking back its hardline stance on trade deficits, with China being the notable exception, and is now looking to strike deals. Whether this was the plan all along remains unclear, but one thing became evident - the financial pain was simply too much for the administration to ignore. As Trump himself noted, "Over the last few days, it looked pretty glum… people were getting a little queasy… you have to be able to show flexibility and I'm able to do that."

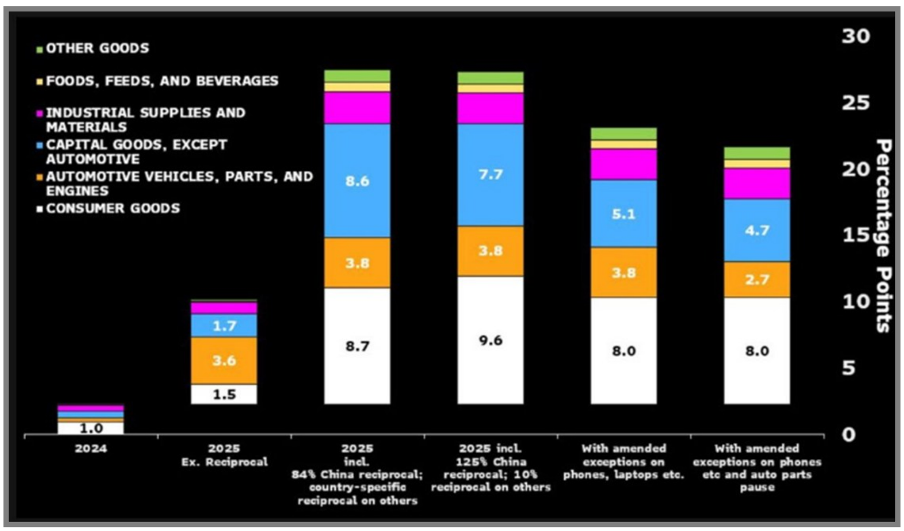
The economic stress was no longer limited to stocks; U.S. Treasuries were also feeling the pressure. The yield on U.S. 10-year bonds surged from 3.9% to 4.6%, and 30-year yields jumped from 4.3% to 5.0%. This spike in yields created an additional challenge for an administration already grappling with a $36 trillion federal debt load – a problem that does need to be addressed.

The cause of the Treasury sell-off remains unclear. Some analysts attributed it to the unwind of a basis trade, while others speculated foreign countries were dumping U.S. Treasury holdings. It's also possible that investors were hesitant to hold long-duration assets amid the uncertainty of a price shock. Regardless of the cause, what's most important is that the 90-day tariff pause occurred. The administration, which had previously claimed that a "Trump put" didn't exist, showed its hand, revealing that there is indeed a pain threshold it is unwilling to cross. Notably, long-term U.S. Treasury yields remain higher than they were on Liberation Day, signaling the lasting impact of these policy shifts.

What's Next

Despite the administration's softer approach, the tariffs set to go into effect are unprecedented in over a century, and we won't fully understand their impact until/if they are implemented. Brad Setser, a senior fellow at the Council on Foreign Relations, estimates the "just pay it" cost could amount to 2.2% of GDP, roughly equivalent to a $90-per-barrel oil price shock.

Estimating Our Effective Tariff Rate



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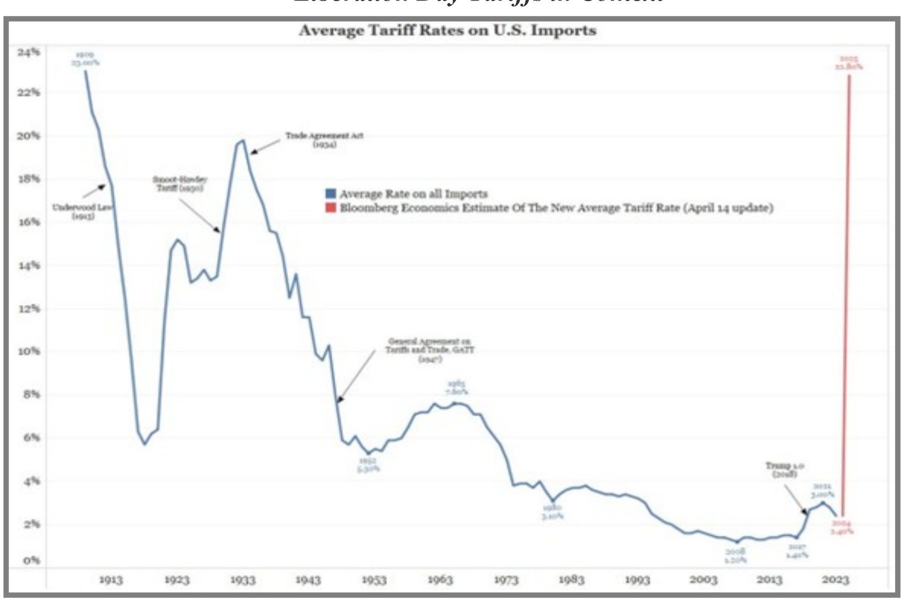
Liberation Day Tariffs in Context

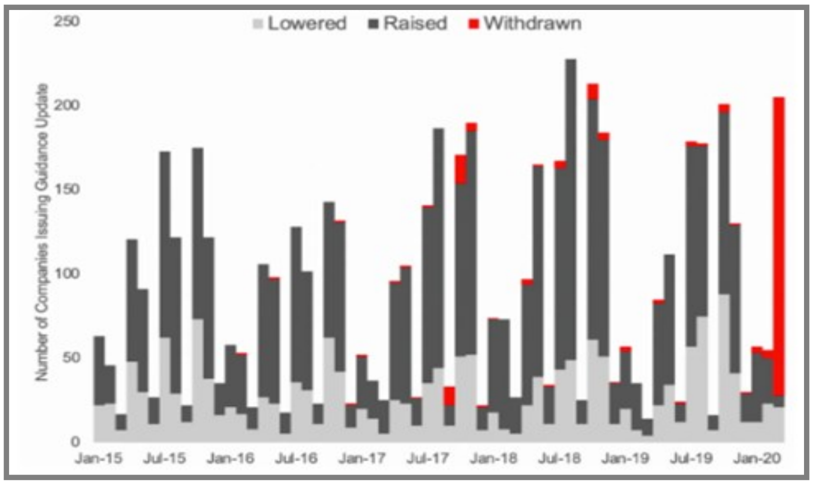


Bianco Research

For financial markets and business owners, the outlook remains uncertain. Will a flurry of trade deals materialize, or are we entering an era of permanently higher trade barriers? The uncertainty is unmistakable, and the longer it persists, the more damaging it will be for the economy.

Uncertainty, for obvious reasons, stifles corporate investment. Would you relocate a manufacturing plant to the U.S. if you thought the tariffs might ease soon? Every time a tariff is introduced or rescinded corporate finance teams are re-calculating the net present value of their capital expenditures. These aren't trivial calculations. According to the National Association for Business Economics, 57% of firms cited trade policy uncertainty as a key factor holding back capital expenditures as far back as 2019. That hesitation is likely even more pronounced today. As Goldman Sachs recently noted, "Policy-driven uncertainty tends to have longer-lasting effects on investment than standard macroeconomic shocks," because it forces companies to delay or cancel projects with multi-year payback horizons. This stop-and-start approach to planning is corrosive to long-term growth, especially in capital-intensive industries like manufacturing, energy, and semiconductors, where clarity on input costs and market access is crucial.

U.S. Companies Pull the Plug on Guidance



S&P Global

Reporting from Business Insider

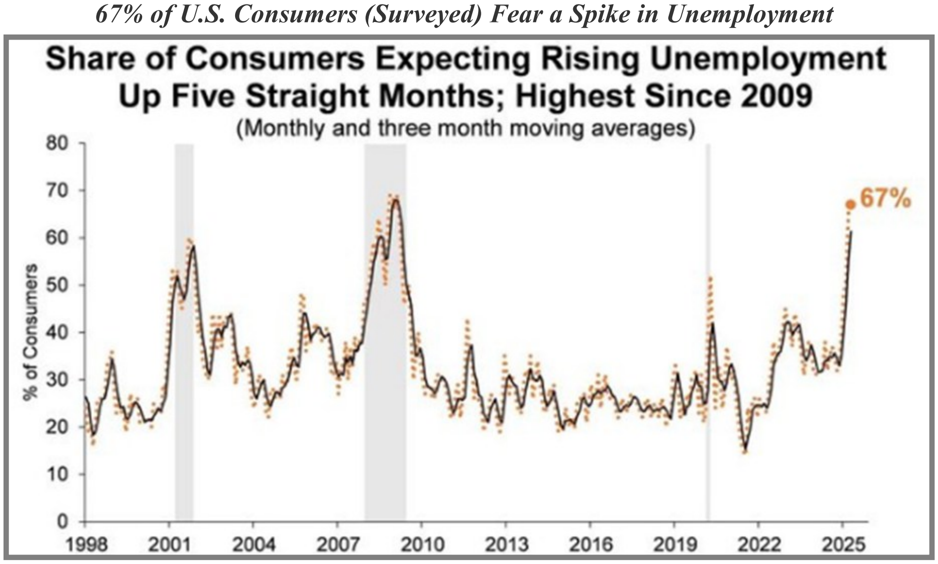
Forecasting, for example, has become nearly impossible for some teams. One of Amazon's largest supply chain units recently warned about the challenges of making its second-quarter projections due to tariffs, according to an internal email obtained by Business Insider.

The "volatility and uncertainty" from the new round of tariffs were simply too high to derive any meaningful numbers, the email said.

Business Insider

Similarly, uncertainty ripples through the economy via U.S. consumers, who account for 68% of GDP. When consumers are uncertain about their future prospects, they tend to pull back on spending in preparation for potential hard times. Currently, 67% of individuals surveyed by the University of Michigan expect unemployment to rise. A common counterpoint is that the top 10% of earners, who now account for over half of U.S. consumer spending, are less affected by tariffs. While this is true, keep in mind that this cohort has just experienced a 20% peak-to-trough decline in their U.S. equity portfolios, which could dampen their outlook as well.

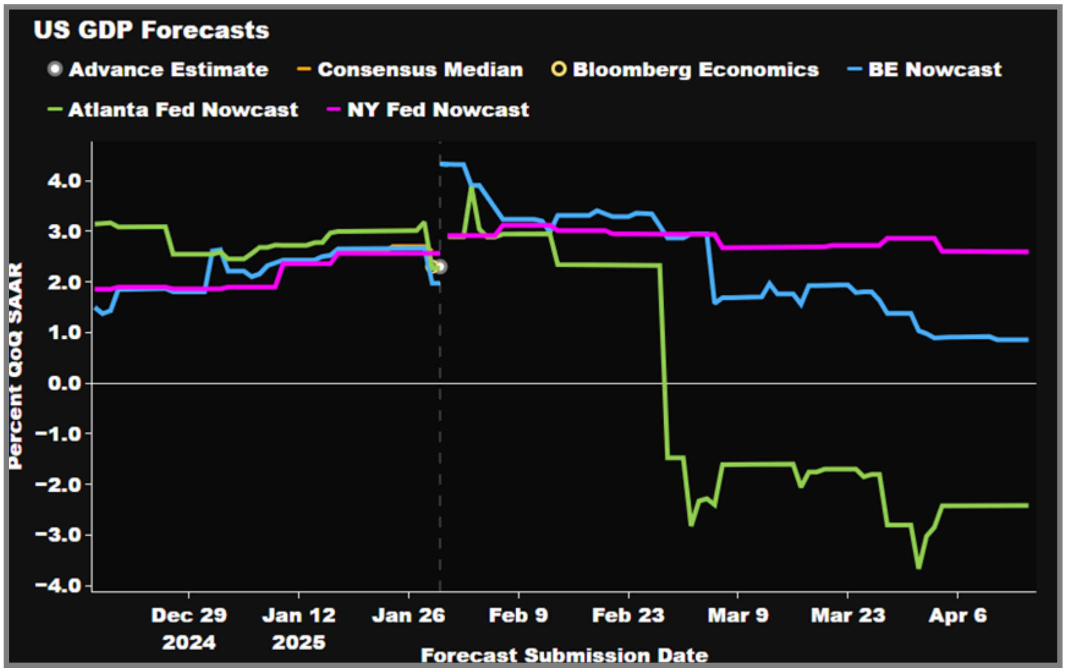
67% of U.S. Consumers (Surveyed) Fear a Spike in Unemployment



JP Morgan

It would be misleading to say we aren't concerned about the economy. Before the surge in "tariff talk," the U.S. economy was strong, but there were reasons for caution. Unemployment stood at 4.2%, but hiring and job openings were down. Other indicators, such as corporate layoffs and federal unemployment claims, suggested that unemployment could rise significantly if a negative economic shock were to occur—which, as we now know, has happened. The consensus is that the U.S. economy will slow, but the big question is: by how much? The answer will depend on the administration's policies, foreign reactions, and how other factors, like the Tax Cut & Jobs Act, play out moving forward.

GDP Nowcasts Are Signaling an Economic Deceleration



Bloomberg

It's understandable to be concerned or even scared. You can't attempt to reroute global trading patterns without causing some casualties along the way. The fear you and every other investor are battling is the price of admission.

Since 1950, U.S. equities have delivered an 11–12% compound annual return, about 70% of which came from price gains and 30% from dividends and dividend reinvestment. Throughout that journey, there have been numerous ups and downs, some more daunting than what we're experiencing now. During the Great Financial Crisis, equities dropped 57%, and during the dot-com bubble, they fell 49%. By our count, there have been sixteen bear markets, defined as a 20% or greater decline. Drawdowns happen regularly, but for some reason, people often fail to notice. Since 1980, the S&P 500 has averaged an intra-year drawdown of -14%. As an equity investor, short-term turbulence should be expected, and if you can't weather those storms, you won't be able to reap the excess returns that equities offer.

The good news is that we manage diversified portfolios. Our exposure to overseas equities, bonds, and certain private investments has softened, and in some cases, countered the market's declines. Our private holdings in natural gas minerals should have a standout year, with spot prices comfortably above $3 per foot. Committing to a diversified portfolio isn't always easy, especially when "American Exceptionalism" is at its peak and investors are questioning whether they should own anything other than U.S. equities. By most accounts, overseas equities are currently inexpensive, and recent declines in U.S. equities have made their valuations more attractive. While broad diversification may ultimately prove to be the wrong strategy, we remain hopeful that it will position us to capitalize on opportunities as they emerge.

As always, we appreciate the trust you place in us.

Update (4/23/25) - President Trump & Secretary Bessent walked back tariffs on China. Updated tariff rates have not been published, but WSJ is reporting tariffs in the range of 50-60%.