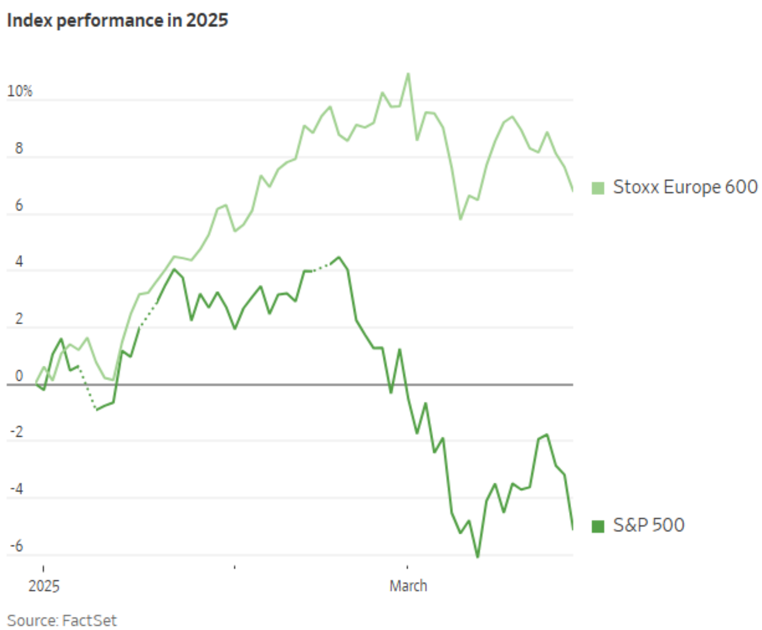
Pull Over?

" it's not an everyday 'forecasting is hard' type of fog. It's a zero visibility, pull over and turn on your hazards type of fog."– **Tom Barkin** (Richmond Fed President)

Markets faced significant headwinds in the first quarter as the S&P 500 fell 10% from its February high and ended the quarter down 4.6%. Tariff fears and the unwinding of the Tech AI trade were the two primary catalysts for the volatility. Markets hate uncertainty and as Mr. Barkin states above, we are looking into a dense fog with some of the new regime policies.

As interest rates moved lower, bonds fared well, earning 2.74% for the quarter and provided good diversification to falling US Stocks.



Foreign markets were the shining star for the quarter, up 8% as measured by the MSCI EAFE. After years of underperformance, European stocks did particularly well and were up almost 12% through March. This is the largest quarterly outperformance by international stocks since the beginning of 2015. Much of this outperformance can be attributed to very large jumps in the European defense sector as those countries look to boost their military spending.

Below we discuss the new tariffs, our understanding of the administration's goals and portfolio strategy for the balance of the year.

Tariffs

At the end of 2024, investor sentiment was through the roof as hopes of deregulation and lower taxes dominated the headlines. As we discussed in our outlook, excessive optimism is never a great sign and historically the first year of the presidential cycle tends to get off to a rocky start. We were also worried about market valuations and the forecasted earnings for the next couple of years. Although, it is impossible to know the ultimate catalyst, risk was certainly higher than most realized. In the end the Tariffs provided the catalyst to send markets into a tailspin to start the second quarter.

On April 4th, President Trump announced the new tariff plan that would go into effect on April 9th. During the speech the futures markets were positive as the new 10% baseline tariffs were explained and then the

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administration pulled out a chart of the new reciprocal tariffs that ultimately sent the market into a tailspin. Although the President walked through the chart and explained that in most cases, we were charging each country half of the tariffs that they charge us, that is not the case, and the tariffs are not reciprocal. The new tariff rates are based on the trade deficits with each underlying country. Like most investors and economists, we believe the higher level of tariffs are not productive and if left in force could cause a global recession. Thus, we hope the tariffs have to be a giant negotiation.

Over two days, the S&P 500 declined by nearly 11%, which is the 5th largest decline since 1950. Only Covid, the Financial Crisis and Black Monday had such large and quick declines. Over that weekend, negativity continued to mount, and markets were down another 4.5% to start the week before rallying to finish nearly flat. April 9th saw a major bounce back as the higher-level tariffs were delayed by 90 days. This was one of the single best days in stock market history. Although we may have bottomed in the short term, we are probably in for a few more months of volatility.

S&P 500 Change

	Day	Day 1 %	Day 2%	12 Month Return
1	10/19/1987	-5%	-21%	22%
2	11/6/2008	-5%	-5%	15%
3	11/20/2008	-6%	-7%	45%
4	3/12/2020	-5%	-10%	55%
5	4/4/2025	-5%	-6%	??

What is the Administration Doing?

The United States national debt is currently over $36 trillion and has been growing rapidly since Covid. Although we were through the worst of the pandemic, policymakers continued to pour stimulus into the economy in 2021 and beyond. In addition, we haven't had a balanced budget in any single year, since 2001. The massive increase in the money supply combined with supply chain disruptions created the highest inflation in decades, which then forced the Fed to raise rates. In 2025, the United States will pay approximately $1 trillion in interest on our debt, which eclipses our national defense budget. Something has to give, as this path is simply not sustainable in the long term.

We believe the administration believes it has a generational opportunity to fix some of these systemic problems. Although they have done a poor job in laying out the strategy, we have pieced together what we believe is their intent:

1. Reduce Government Spending – DOGE was created to reduce the size of the federal workforce and make the government more efficient. The stated goal of savings is $1 trillion.
2. Increase Revenues – The primary source of revenue today is income taxes. The administration wants to add more sources of revenue through Tariffs and the new Gold Card. This card will cost $5 million and provide a fast track to US citizenship. The stated goal of new revenues is also $1 trillion.
3. Balanced Budget – Increased revenue and reduced spending should help to have a more balanced budget, which will slow the massive growth of the US debt.

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4. Reduce Trade Deficits – There have been unfair trade practices for decades and the administration believes now is the time to address them and provide incentives for companies to reshore operations to the United States.
5. Competition of US Exports – As a result of current tariffs and value added taxes, many of our products are not competitive abroad. The administration wants to level the playing field. An example of our auto exports is below:

USA: US products are more expensive overseas

Model	Price (USA)	Price (Germany)	Germany vs. USA	Price (China)	China vs. USA
Tesla Model Y	$48,990	$59,616	22%	$42,895	-12%
Jeep Wrangler	$44,145	$81,223	84%	$68,412	55%
Ford Mustang	$31,920	$65,383	105%	$53,334	67%

Will Tariffs Work?

The market has spoken, and the answer is no, at least not at the proposed levels. Global trade has been built over the last 30 years and the technological efficiency and cheap labor simply can't be equaled in the short-term. Below are the basic problems with these tariffs, which again is why we are hopeful that this is part of a larger negotiation.

1. Inflation – Tariffs are a consumption tax. Although they can ultimately raise significant revenue for the government, they are inflationary as much of the price increase will be passed on to the end consumer.
2. Reshoring – Reshoring is a great thing for some goods. However, reshoring sneaker production and textiles is in no one's best interest and we cannot compete with foreign manufacturers. Also, are those the jobs that Americans really want?
3. Growth – Both GDP growth and corporate earnings will both be greatly reduced as a result of tariffs at least in the short term and the long term is unknown.
4. Imports – 11% of the US economy (GDP) is made up of imports. 40% of those imports are parts that are ultimately used in the final production of goods here in the US. Many of these parts can't be produced in the US competitively and many are simply inferior. This is ultimately hurting our manufacturers and increasing the cost to our consumers.

What Happens from Here?

We believe we are getting close to a short-term bottom as the market was essentially down 20% over a month. As a comparison, in Covid, the market was down 30% in March of 2020. There are three primary outcomes to the tariffs; Tariff resolution, the Fed comes to the rescue, or we go into a recession.

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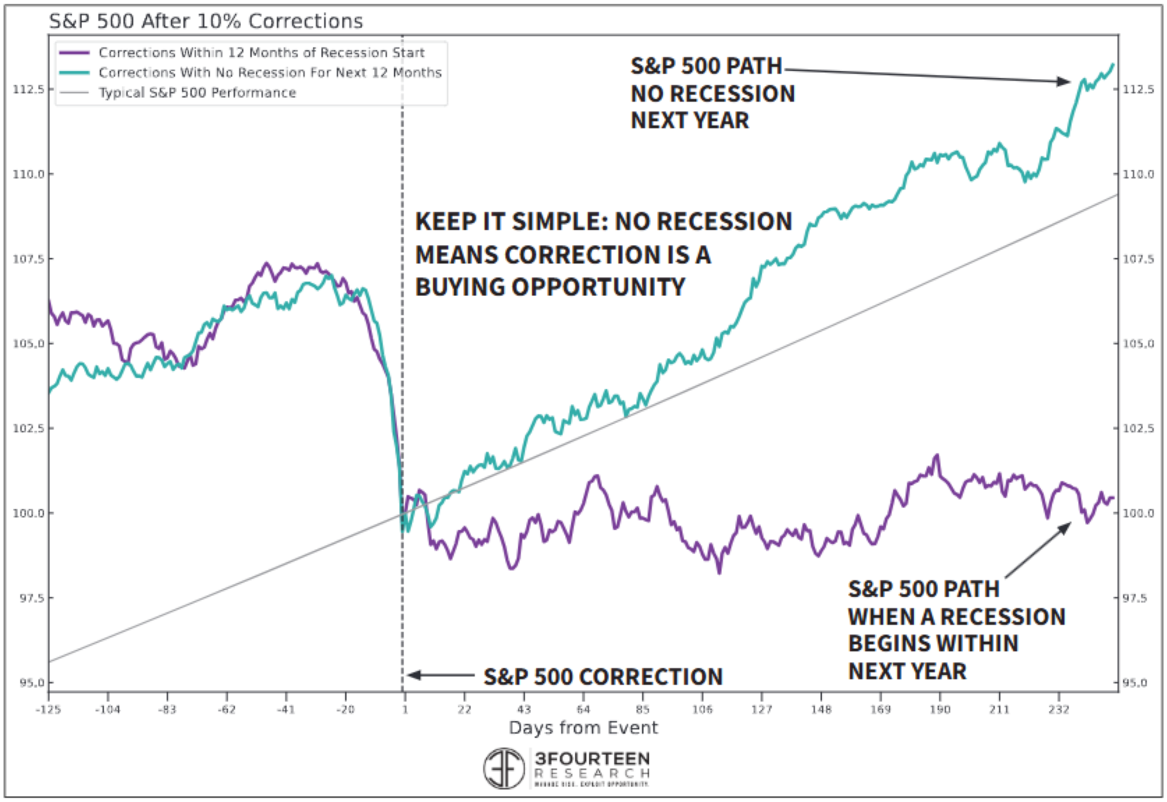
If the tariffs ultimately end in negotiation and the higher-level tariffs are removed, we could see a significant market recovery. The problem with this outcome is the timing. Can you negotiate with 70+ countries quickly? Probably not, which may be part of the reason for the 90 day delay. In the end, there are 6 countries that really matter, and we believe that they will be in front of the line. Even if the higher tariffs are removed, the baseline 10% tariffs could be here to stay, remember the government needs more revenue.

Many investors are relying on the Fed to bail markets out again. This will not be easy as the Fed typically doesn't make policy changes on hypotheticals. They will need to see higher unemployment, which probably won't be in the actual numbers for months. They will also need to see lower inflation, which is very probable in the short term, but harder to assess long term if the tariff policy is constantly changing.

The third outcome is hopefully the most unlikely and would probably mean more downside for markets. In this scenario, the tariff resolution takes months, and the Fed does not react. As a result of the uncertainty, consumers stop spending and businesses slow down their capital investments which ultimately leads us into a recession. Over the past 2 weeks, recession odds have risen from around 25% to 60% and now back to 40%. At this point, we still believe we will not have a recession. As the chart below shows, non-recessionary market corrections typically recover very quickly. However, recessions can take months for markets to find resolve and can ultimately lead to much larger declines. The administration knows that a recession would essentially shut down their agenda in its tracks, so we believe they will do their best to steer clear of recession. Nevertheless, we will be watching for any signs in the coming months.



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Road Map for Investors

While uncertainty and volatility are not fun for any of us, it is part of investing. The volatility is the price that we all pay to ultimately have higher returns over time. Our most important advice is don't panic and don't let politics influence major investment decisions. This is a great time to think about your overall allocation to stocks and reflect on how you have handled the recent volatility. For example, let's assume you have 60% in stocks and 40% in bonds. Stocks go down 20% and bonds go up 2%, then your portfolio will go down by 11%. If this gives you heart palpations, then you may have too much in stocks. If you don't worry about it, then you might want to be more aggressive. We are all different and there is no right answer!

Below are some of the actions that we have taken thus far and things that we thinking through for the coming weeks.

1. Rebalancing – We adjusted our strategies to start the year to get the closer to our benchmark weighting. In hindsight, we wish we had underweighted stocks, but these events happen quickly.
2. We have adjusted stock holdings in our portfolios in anticipation of the new administration and now we are adjusting based on opportunities we see from quality companies that have had large declines.
3. We have taken tax losses where appropriate and will use those to offset future gains.
4. We have dollar cost averaged for many clients and if applicable, used money market holdings to increase stock exposure at the lower prices.
5. Bonds have performed quite well to start the year and have provided good diversification.
6. Our Alternative Investments have also performed well and provided stability.
7. We are assessing whether we should increase our allocation to stocks and the potential market levels that such an increase would make sense.

We don't want to make large strategy changes in turbulent times, but we do believe we can be proactive and that will be accretive to the ultimate rebound. Just remember, this too shall pass.

Resources

What We Are Reading:

Annual Letters: Below are the letters that we always look forward to reading this time of year:

1. Jame Dimon (JP Morgan) Chairman & CEO Letter
2. Warren Buffett (Berkshire Hathaway): Annual Report
3. Tom Gayner (Markel): Shareholder Letter

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Conclusion

Thank you for taking the time to read this letter. As always, please let us know if you have any questions related to your investments, taxes, or general planning or if there have been any changes to your overall plan or risk tolerance. This is a great time of year to set up a review meeting.

Sincerely,

Canal Capital Management

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