Kennedy Capital Management®

NAVIGATING A RAPIDLY SHIFTING LANDSCAPE

Unexpected Reaction to an Anticipated Action

While the recent implementation of significant tariffs was arguably foreseen given the current administration's widely discussed and distinctive approach to trade, the ensuing reaction has been notable. The market reaction underscores the challenges of navigating through volatile policies and a shifting geopolitical landscape. While some may view the sizable tariffs as unexpectedly high, our President's affinity for such mercantilist tools is well documented. While he espoused and implemented some tariffs during his first term, evidence emerged during February 2024 that he would consider a substantial 60% levy on Chinese goods, underscoring this policy direction.

Tariffs? Or Perhaps Taxes?

These tariffs seem to us an indirect mechanism of corporate taxation. Tariffs on imported inputs effectively raise costs for US companies, mirroring a tax increase without directly altering corporate tax rates. One might speculate whether this is a deliberate attempt to generate government revenue under the guise of trade policy, perhaps to avoid the political unpopularity of direct corporate tax hikes. This trompe-l'oeil has likely not fooled astute market observers.

Investing Amidst Unpredictability

The imposition of tariffs, while perhaps anticipated given the current administration's stated trade policies, introduces a significant layer of complexity to the investment landscape. Beyond the direct impact on specific industries and trade flows, these measures contribute to a broader environment of policy uncertainty. For investors, this translates to increased difficulty in accurately forecasting future cash flows and assessing risk. In our role as asset managers, we recognize that such unpredictability can deter capital investment in long-term projects, which are essential drivers of employment, productivity, and sustained economic growth.

China as a North Star

Over the past half-century, China has emerged as a major global economic power. The current administration's trade policies, including the recent tariffs, may be, in part, a response to this shift in the global balance. China's strategic initiatives, such as the Belt and Road Initiative, investments in global resources, and the provision of technology to developing economies, have fostered economic interdependencies. The concern among some policymakers is that these dependencies could translate into undue influence, potentially challenging the existing geopolitical order. From this perspective, the tariff policies, while applied broadly, may be aimed at recalibrating trade relationships and mitigating potential risks associated with this evolving global dynamic.

Powell: "Should I Stay or Should I Go Now?"

A critical consideration in this shifting landscape is the potential predicament facing the Federal Reserve. While some debate the inflationary impact of tariffs, the prevailing view acknowledges this risk. Simultaneously, the likely economic headwinds generated by these policies could lead to GDP deceleration. Historically, such slowdowns prompt the Fed to ease monetary policy to support employment, a key component of its dual mandate. This creates a conflict with the Fed's recent efforts to combat inflation through rate hikes. A conflicted central bank may erode market confidence, often triggering selling pressure or discouraging investment.

Adding to this uncertainty is the President's public pressure on the Federal Reserve to lower interest rates. The perceived independence of the Fed is a cornerstone of America's attractiveness as a destination for global capital, insulating monetary policy from potentially volatile political influences. While fiscal policy can often be counterbalanced by monetary policy, direct political intervention in the Fed's decision-making process risks undermining decades of established confidence in our financial system, potentially leading to capital flight and a cascading series of negative consequences. For instance, reduced confidence in the government's fiscal management could prompt foreign investors to divest from US Treasuries in favor of nations perceived as having more stable and predictable governance. Similarly, declining faith in the stability of US financial markets may lead both foreign and domestic investors to reduce their allocations to US equities, as decreased demand with unchanged supply naturally results in lower asset prices.

Historical Precedents and Potential Market Dynamics

In navigating this uncertain terrain, historical precedents offer valuable, though not deterministic, insights into potential market behavior. A common reaction to heightened uncertainty is an increase in selling pressure in equity markets. Sharp market declines can trigger loss aversion, causing investors to liquidate holdings to protect accumulated wealth perceived as increasingly vulnerable. This behavior can amplify downward momentum. Over the past century, the equity market has delivered an average annual return of approximately 10%[1]. However, investor psychology often leads to market extremes during periods of significant disruption. The subsequent recovery, fueled by a return to a more rational outlook, often manifests as a more pronounced rebound than the historical average would suggest, reflecting the unwinding of those emotionally driven extremes.

Therefore, while the confluence of tariffs, policy changes, and geopolitical risks presents significant challenges and undoubtedly creates a disorienting environment, it is crucial to remember the underlying strengths inherent in the US economy. These foundational elements, built over time, have historically demonstrated an ability to absorb substantial shocks. While the immediate future may feel precarious, our experience suggests that the inherent resilience of the US economy provides a basis for eventual recovery and a return to a more stable trajectory. Our focus remains on active risk management, rigorous analysis, and the identification of opportunities we believe may offer sustainable long-term value to our clients.

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[1] S&P 500 Returns since 1925 https://www.officialdata.org/us/stocks/s-p-500/1925?amount=100&endyear=2025
The S&P 500® is widely regarded as the best single gauge of large-cap U.S. equities. The index includes 500 leading companies and covers approximately 80% of available market capitalization.

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