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Capital Markets Commentary – May 2025

If only it were that easy. Trade imbalances and less than fair (sometimes downright predatory) trade practices have vexed the US from the very beginning. Today, given our outsized share of global GDP, you'd think owning the bully pulpit would be enough. However, the problem is that the global economy is infinitely more interdependent than it was in the 50's, 60's, or 70's. Today, the global economy is a closely integrated ecosystem where even an apex species relies upon the contribution of seemingly minor players to survive and thrive.

Furthermore, our financial markets rely on this interdependence, and to be blunt about it, US financial markets like it just fine when global businesses and markets depend on us to be the responsible adult….steady, reliable, and predictable. We imagine, that on April 2^{nd}, when the administration announced the largest tariffs imposed in over a century, that the world's dependence upon our leadership would necessarily force tariffed countries to rapidly capitulate. Not an entirely unreasonable assumption, but that's not what happened. We didn't get capitulation. What we got instead was a war and that's when things got ugly. When that war quickly began to hammer the dollar and US Treasury markets, two things that almost always go up, not down, during periods of global instability, the administration was forced to hit pause. We'll talk about why the dollar and the Treasury might have headed the wrong direction and why that scared markets silly in a moment, but first, let's look at the numbers for April.

You'd be forgiven for thinking that returns this month would be a train wreck. Dramatic and at times traumatic as the month was, indices were not much worse for the wear. The NASDAQ actually managed to pull off a teeny gain of 0.9%, and the S&P lost just 0.7%. The Dow, where the components tend to be more tariff sensitive, closed down 3.1% - down, but far from tragic. Europe, on the other hand, did very well indeed. The broader Eurozone STOXX 50 gained 3.9% and the German DAX ended the month up 6.6%. Returns in Asia were mixed, as one might expect. Whereas the Japanese Nikkei 225 added 6.3% in April, China's Shenzhen lost 4.5% while the Hang Seng lost 3.7%.[i]

Bonds as measured by the US ten-year Treasury, were wilder still. The ten-year started April at a yield of 4.15%, then the yield plunged to a low of 3.8% following the tariff announcement. But then things quickly went sideways. Yields began to rise sharply on April 7^{th}, and continued surging through the 11^{th}, when the benchmark bond hit 4.6%.[ii] Let's talk about why that might have happened and why it made markets nervous (heck, not going to lie…it made us nervous, too).

The US Treasury, and the dollar, are the Swiss army knives of the global economy. The Treasury is not just a way for the US to finance operations or for Treasury bond buyers to generate income. Treasuries can be bought by foreign companies who plan on making purchases or investments in the US. They can be bought by foreign governments who may want to redeem them for dollars with which to buy other currencies, particularly their own. Treasuries can also be held by people, institutions, and investment vehicles to hedge risk. These hedges can be more complex than a post-graduate physics class at M.I.T., but the strategy mostly boils down to the fact that when things get dicey in the economy, and equity markets stumble, the value of safer stuff like Treasuries is ***supposed*** to rise. The increasing value of that Treasury position can serve to offset some of your losses in stocks. And yet, in the aftermath of the tariff announcement, while many, if not most, analysts were projecting increased odds for recession and stocks were, day after day, heading alarmingly lower, Treasury (and dollar) prices were not rising….they were falling. On April 4th, the ten-year Treasury was yielding 3.88%. Just one week later, it kissed 4.6%. What broke?

There are a few reasons Treasury prices might have been falling, none of them good:

- The market may have feared that tariffs would cause a spike in inflation and with it, rising interest rates. When interest rates rise, bond prices fall, so traders could have been trying to unload Treasury positions before the bottom fell out.
- Investors (very large ones) could have been facing margin calls and selling Treasuries in order to raise cash to meet those calls.
- Foreign governments and companies could have been dumping Treasuries and dollars to pressure the US (kind of a conspiracy theory, but it's out there so we mention it), or more likely because they were suddenly less inclined to make investments in US businesses or dollar-denominated securities, or,
- Investors world-wide may have begun to wonder if the Treasury's safe-haven status might be in jeopardy.

Any or all of these things could have been true at the same time, but the result was that the bond market was falling at a time when it should have been rising. At Graystone Charleston, we've been around the block a bunch of times and in our experience, while downdrafts in equity markets can be alarming, downdrafts in debt markets can be downright dangerous. On the morning of April 9th, as Treasury yields continued to fall, to be perfectly honest, we were concerned. Apparently, and thankfully, so was the administration. Early that afternoon, the announcement came that most of the tariffs would be paused for 90 days. Equity markets exploded upwards with joy, posting the highest point gain and the 3rd highest percentage gain in index history.[iii] Bonds prices rose, too, but not by much. Equity markets tend to be emotional things, but bond markets are more likely to take a more circumspect approach. Equity markets are happy to assume something good will happen. Bond markets want proof.

Plus, bond markets may still have been getting a strong whiff of inflation. Tariffs, after all, hadn't been cancelled, only "suspended," and the tariff on China had been raised to 145%. The 10% across-the-board tariffs left in place for the rest of our trading partners were still much larger than investors had anticipated. Markets had baked in broad tariffs in the neighborhood of 2.5%[iv] so the reduced tariffs were still four times larger than the 2.5%, folks had planned for. Nevertheless, the partial rollback was enough to stabilize the Treasury market.

Then, just when we thought the situation couldn't get more chaotic, it did. If the US is viewed as the responsible adult of global markets, the US Federal Reserve is viewed as the responsible adult of the American financial system. The Fed is designed to be an independent body, not beholden to the whims and desires of politicians. To insulate the board from political pressure, the Board Chair is appointed to a four-year term, removable only for cause. The rule is intended to allow the Board room to make decisions they feel are in the best interest of the financial system, even if those decisions are not politically expedient. Jay Powell was appointed by President Trump in 2018 and retained by Biden in 2022. His current term will not expire until May 2026, but on Monday, April 21st, the President launched a series of broadsides against Powell on social media. The S&P promptly tanked. Luckily, the White House did an about face, assuring investors that no attempt would be made to remove the Fed Chair. This assurance was, thankfully, enough to nip that round of selling in the bud.

So where does this leave us? While we hope that the worst of the volatility is behind us, these tariffs are so new that we're not yet seeing the impact bubble up through the hard data with the exception of a mildly negative GDP print for the first quarter. Nevertheless, we believe those impacts will soon become evident. We can expect to see, at least temporarily, a spike in inflation and a pronounced drop in spending not only because folks may be more circumspect about opening their wallets, but also because there may be less stuff to buy. According to a spokesman for the Port of Los Angeles, arriving cargo will be down 35% by next week, adding "essentially all shipments out of China for major retailers and manufacturers have ceased." This could in turn lead to softening employment. Apollo Global Management estimates that we could begin to see empty shelves within four to eight weeks.

Even if tariffs were reversed tomorrow, it'll take time for manufacturing and ship lading to come back on-line. Then, there's transit time. It takes a heavily loaded container ship about three weeks to travel from Hong Kong to LA,[v] so all in, we're talking about five weeks to two months, maybe more, before inventories reappear on store shelves. Global trade can't restart, though, until some sort of rapprochement is reached. That could happen tomorrow, or it could take months; and the longer it takes, the harder it's going to be on the economy and US markets.

So what does this mean for markets going forward? Alas, while we have decades of experience in trying to anticipate how economic Policy A should result in Outcome B, what happens next is not a market question but a political one. Since the question is political and without precedent, we aren't even going to venture a guess as to what happens next. CEO's apparently feel the same way with some companies either issuing two versions of their earnings guidance, each dependent upon how long tariffs last, or suspending guidance all together.

But there is good news. Although consumer confidence is at record lows, CEO confidence is declining, and we're seeing the sharpest decline in the earnings outlook since 2020[vi]……wait, this is the good news? It is! Look, April was a rough month and commentary on the Street is very, very dark, and yet, year-to-date the S&P is down just 4.9%. For the trailing twelve months, the S&P is still *up* 12.1%. Despite the heavy mood, we're holding up pretty darn well.

Regular readers of this letter will know that we've been preaching caution for months now, and positioning for a correction. No, we did not see this coming. We did not guess that the *reduced* tariff menu would be of a magnitude four times greater than markets had baked in. But, based on valuations alone, we've adopted an increasingly defensive posture. We do believe we're appropriately positioned to mitigate downside capture, but we warn you that markets may remain volatile and perhaps range-bound for the foreseeable future. While we can speculate as to what some of the knock-on effects will be, we can't possibly anticipate them all. None of this is normal. If we were tempted to feel inadequate *because* we don't know what's going to happen, we can be consoled by the fact that nobody else knows, either, and anyone who claims they do know is lying.

It bears repeating: Trailing 12-month returns are still solid despite the whirlwind that was April. If you spent a single long night last month staring at the ceiling, we need to talk. Now. It's been a very long time since markets were this challenging. When they seem to do nothing but go up, it can be easy to assume more risk than we should. If you lost any sleep in April, let us help you sleep better in May.

Should you have specific questions or concerns, please never hesitate to call. We always look forward to hearing from you.

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[i] Source: Morgan Stanley Wealth Management GIO, Bloomberg, FactSet
[ii] Source: Morgan Stanley Wealth Management GIO, Bloomberg, FactSet
[iii] Source: msn.com/en-us/money/markets
[iv] Source: Morgan Stanley Wealth Management GIC
[v] Source: searates.com/distance-time/
[vi] Source: Federal Reserve Bank of Philadelphia, Macrobond, Apollo Chief Economist

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