That Fog we talked about last quarter? It turned into a disastrous storm as the New Administration in Washington implements tariff levels not seen since 1909.

On April 2, 2025, President Trump announced sweeping global trade tariffs that are expected to have wide-ranging implications for economies and markets around the world.

As of this writing, the tariff plan consists of two parts. A 10% baseline tariff, scheduled to take effect on 5 April, would apply to imports from all countries – excluding Canada and Mexico, which already face tariffs of 25% for goods that don't meet the US-Mexico-Canada USMCA trade agreements rules of origin.

A "reciprocal" element, which was initially described as being based on a foreign country's outward tariff and other non-tariff trade barriers. Instead, this has been set at half the ratio of the U.S. bilateral trade deficit with the country, divided by U.S. imports from that country. This second component is scheduled to take effect on April 9.

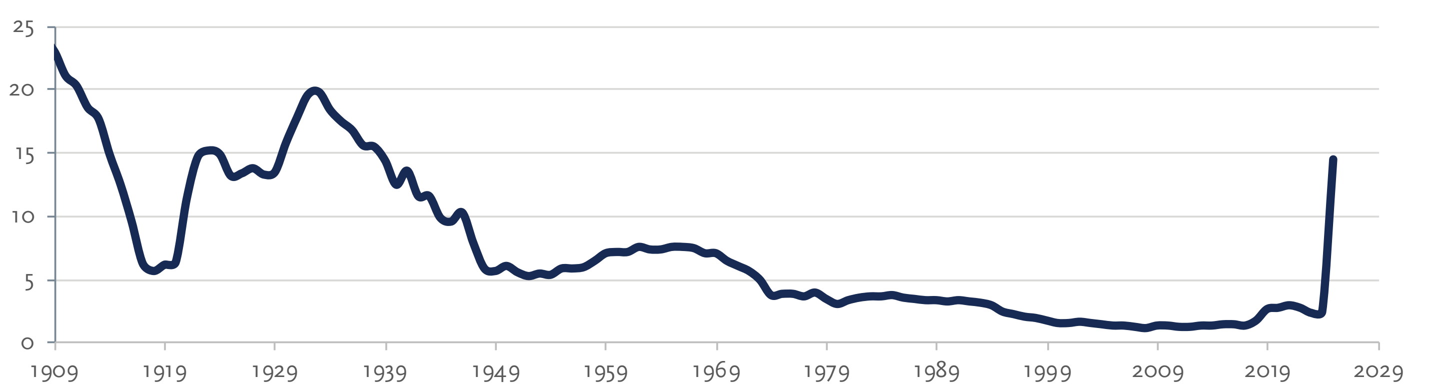
Around one third of imports will be exempted from these additional tariffs, including those goods subject to the Section 232 tariffs such as autos, auto parts, steel, aluminum, semiconductors and pharmaceuticals, where tariffs have already been raised this year. Energy and selected minerals are also excluded. Estimates of the effective average tax rate increase are around 11 to 13 percentage points. This brings the average effective tariff rate to around 15%, which are levels last seen in the 1930s after passage of the Smoot-Hawley Tariff Act.

The Fed kept interest rates steady, adjusted the dots in the Summary of Economic Projections for modestly lower growth, modestly higher inflation, modestly higher unemployment and an unchanged path for the Fed Funds rate, expecting two 25 basis point cuts in 2025. The Fed also reduced the pace of balance sheet runoff, aka quantitative tightening, from $25 billion per month to $5 billion. All was as expected. The press conference, as usual, gave greater insight into the thinking at the Federal Reserve Board. Powell downplayed the importance of the dots as guidance for the path of interest rates this year and suggested that they were in "no hurry" to cut and "well positioned to wait for greater clarity".

During the press conference, tariffs were a focus. Powell acknowledged that the impact from tariffs is beginning to be incorporated into Fed forecasts. A significant increase in U.S. tariffs should result in higher inflation and lower growth. Inflation will rise because importers, who pay this tax, will attempt to pass this cost along to their customers and growth will slow as consumers will demand less as prices rise. Core PCE inflation, the Fed's preferred measure, last peaked at 5.6%, on a year-over-year basis, in February 2022. Since then, the measure fell to a low of 2.6% in June 2024, but has since gradually risen to 2.8% in February 2025, still well above the Fed's target of 2.0%. Powell indicated during the meeting that the Fed would be willing to tolerate higher tariff-induced inflation, reviving the tainted term "transitory"; however, their task will be complicated by the difficulty of distinguishing what is a result of tariffs and what is a reacceleration of the underlying rate of inflation.

The Core PCE inflation rate has been above the Fed's target for about four years now. Market-based and consumer survey-based measures of inflation expectations have been fairly well-anchored over this time, but have risen significantly recently. Market-based one year ahead inflation swaps have risen from a low of 1.70% in September 2024 to 3.25% at the end of March. The University of Michigan's consumer survey of one year inflation expectations similarly has risen from a low of 2.6% in November 2024 to 5.0% in March. Markets and consumers are losing faith that the Fed will tame inflation in line with its mandate. The risk is that this becomes a self-fulfilling prophecy. If businesses expect higher inflation, they will likely raise prices to preserve profits and, similarly, workers will demand higher wages. Powell's comments around inflation expectations were perhaps the most surprising, and dovish, comments coming out of the meeting. He pointed to various longer-term measures of inflation expectations, which he described as still well anchored, and dismissed the University of Michigan's five-year expectation (at 4.1% - the highest in 34 years) as an outlier. This

Tariffs Back to their Highest Level Since 1909



Source: Taxfoundation.org

Monetary Policy:

Journalist Edward R. Murrow once quipped about the Vietnam War, "Anyone who isn't confused really doesn't understand the situation." Fed Chairman Jerome Powell seemingly understands the situation perfectly. "Uncertainty" was the word of the day, uttered eleven times during the FOMC March 19 press conference and Q&A, for a Fed meeting occurring amidst a strong, but slowing, economy subject to the combined effects of significant policy changes including: threats of a trade war, an immigration crackdown, DOGE cuts, geopolitical turmoil, deregulation, and budget negotiations, including potentially significant tax cuts.

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combined with the dots showing the Fed cutting into an above target and rising inflation forecast, led most observers to evaluate the meeting as dovish, with Powell more concerned about the growth outlook than inflation.

The Fed is in a difficult position. With inflation and inflation expectations higher than desired, they will likely be reluctant to cut rates until a negative impact to growth shows up in the economic data, which is reported on a lag. The unemployment rate will be the key indicator and it should be expected that the Fed will cut aggressively if this measure begins to sharply rise. If growth remains steady with inflation continuing to trend higher, with perhaps a boost from tariffs, it's likely we won't see any interest rate cuts for some time.

The Fed has now cut the overnight rate by 100 basis points (bps) and has signaled that it expects to cut this rate by another 50 bps in 2025. However, a lack of progress on inflation over the second half of the year and some stronger than expected payrolls numbers have the markets second guessing this forecast. In fact, in a highly unusual move, longer-term interest rates have risen while the Fed has cut short-term rates. This is contrary to historical experience.

Interest Rates: While markets remain volatile, our position based upon all the information available as of this writing is the Fed will continue to closely monitor the hard data for signs of a recession developing and then cut rates. The economic data from Q1 was solid, particularly as employment was firm, however, as we move into Q2 it can turn very quickly especially given the uncertainty and volatility in the equity and fixed income markets.

Investment Grade Corporate Bond Outlook: As CEO's are losing confidence and reconsidering or downgrading revenue outlooks for 2025, we expect corporate spreads versus Treasury bonds to widen from their past tight levels. Given strong balance sheets, corporate credit fundamentals and rating trends that remain strong, we will continue to stay up-in-quality. We believe credit selection will be paramount in both investment grade and high yield, as the focus will shift toward fundamentals and the ability of corporates to navigate this macro uncertainty with U.S. economic growth slowing.

High Yield Bond Outlook: All of the comments we made about our investment grade corporate outlook are applicable to the high yield bond market. We expect an increase in both defaults and spreads during 2025 versus the record setting lows of 2024. Given our consistent tilt to quality, higher rated high yield bonds, we anticipate our total return in this asset class to be less favorable in 2025 relative to the past year. However we remain confident that coupon payments will be realized and opportunities will present themselves to put those funds back to work in the asset class.

Investment Grade Corporate Bond First Quarter Performance:

U.S. investment-grade bonds returned +2.3% during the quarter as policy uncertainty out of Washington led to a flight to safety driving Treasury yields lower. This downward move in rates more than offset 14 bps of corporate spread widening in the quarter, which ended the quarter at 94 bps per the Bloomberg U.S. Credit Index. The Bloomberg U.S. Credit Index measures the investment grade, U.S. dollar denominated, fixed-rate, taxable corporate and government-related bond markets. In our opinion, the securities are well positioned to weather the current market cycle.

High Yield Bond Sector First Quarter Performance:

High yield fixed income bonds had a return of +1.0% in the first quarter. High yield spreads started the quarter at 287 bps and ended at 347 bps, as markets grappled with the potential impacts of trade policy headlines on the global economy. The quarterly return was comprised of +0.6% from income and -1.6% from changes in price. From a quality perspective, BBs understandably outperformed at +1.5% given the flight to quality, single-Bs returned +0.7% and CCCs underperformed at -0.7%. High yield bond data is representative of the U.S. High Yield Corporate Bond Index which is designed to track the performance of U.S. dollar-denominated, high-yield corporate bonds issued by companies whose country of risk use official G-10 currencies, excluding those countries that are members of the United Nations Eastern European Group (EEG).

Thank You

Wow, welcome to 2025! Michael and Leo started working as an investment team in October of 1999. In that nearly 25 years, we have seen many different markets conditions. Entering into 2025, our economy was in very good shape. However, current U.S. Administration tariff and global relationship decisions have weighed heavy on our leading stock and bond indices. This volatility has added vulnerability to our economy in a rapid manner and caught many off guard. We suspect our economy likely entered into negative growth during the first quarter as we await the GDP release. Recession probabilities have increased and how deep and long it will endure is oddly enough up to one person, our current president. One thing we do know through our market experiences, rash decisions are never good decisions. As you would expect, we are well positioned to withstand significant volatility in your portfolios.

If you have any questions on strategy, performance or business development, please do not hesitate to contact us.

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