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Brian Gardner
Chief Washington Policy Strategist
bgardner@stifel.com

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Potomac Perspective

We think the market's recent decline is due in part to a recalibration of geopolitical assumptions, especially regarding tariffs. When some investors initially looked at President Trump's economic agenda, they saw only desserts (low taxes and deregulation) but ignored that they might have to eat their veggies (tariffs) first. Some seemed to have thought they might get to skip most veggies altogether. Not only does Mr. Trump seem more committed to imposing tariffs than previously anticipated, but he also seems committed to using them to restructure the U.S. economy in a way that has led investors to adjust their expectations for future growth. Simultaneously, Europe has been forced to reconsider its economic and military relationship with the U.S. We might be at the end of the post-World War II economic order and at the start of new economic alliances. Markets are trying to decide what these changes mean.

As we try to decipher the market's recent performance, we think one of the factors that needs better understanding is the political/policy dynamic and how investors are interpreting actions being taken by Washington. Regardless of peoples' policy preferences and whether they support the current administration; we think investors have started to realize some of their earlier assumptions about the Trump administration's trade agenda were overly optimistic or wrong. In addition, the world seems to be at an inflection point. The political order (both military and economic) that has prevailed since World War II has been evolving for some time, and it now seems that a new system might be emerging. This, too, has long-term ramifications and could be impacting markets.

Following President Donald Trump's election in November 2024, equity markets rallied because investors expected a de-regulatory, low tax agenda would be pro-growth and positive for the economy and markets. Even though President Trump promised to increase tariffs, investors seemed to discount the market impact of the trade agenda. This view appears to have been based on several assumptions which have recently been called into question. This has, in turn, negatively impacted markets. The prior assumptions now being called into question include:

- *This term would be similar to the first term*. sIn Trump 1.0, Mr. Trump backed off some tariff threats either by granting numerous exemptions to them, which diluted their impact, or accepted modest concessions from trading partners. It is still early, and things may change, but tariffs are being implemented more or less as promised, and there are fewer exemptions this time. The economic impact is likely to be greater than previously expected.
- *Tariffs are a negotiating tool that won't actually be imposed*. In his confirmation hearing, Treasury Secretary Scott Bessent said tariffs are used to: 1 provide negotiating leverage; 2. raise revenue; and 3. counter unfair trading practices.
    - Investors apparently thought the first reason meant the administration would use tariffs as a means to an end. Trading partners would presumably act rationally and reach a negotiated settlement – any trade war would be brief. Trade wars, however, are like hot wars – they are easy to start and can be hard to stop. Leaders in other countries have their own domestic political considerations, which could prevent them from reaching agreements with the U.S. We believe that investors are now factoring in a protracted trade war.
    - The justification that tariffs can be used to raise revenue has been misunderstood, in our view. Mr. Trump has said tariffs paid at the border raise revenue, but there seems to be another explanation for this argument. Mr. Trump

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has spoken admiringly of President William McKinley. He views the McKinley administration as a model and thinks his tariffs (which were actually passed when McKinley was in Congress and watered down over time) led to an economic boom at the end of the 19th century and beginning of the 20th century. In our view, the administration thinks high tariffs will lead to massive capital investments in the U.S., thus leading to high-paying jobs and higher revenue for the federal government. Regardless of what one thinks of the merits of this policy, it would require a gigantic restructuring of the global economy, which will take several years to achieve. As businesses think about changes to the current system, they will be cautious about making long-term plans until they know what the future system will look like. This, in turn, could negatively impact economic growth – at least in the short term. It appears the administration understands the potential for short-term, pain which is why they have been preemptively predicting near-term disruptions. These warnings have contributed to the recent selloff.

- ***The "Trump put" means the administration will eventually react to market selloffs***. We think this assumption is flawed for several reasons.
    - There is a sense of urgency with the administration because Mr. Trump cannot run for president again. He and a few of his key advisors seem to believe they have a limited amount of time to restructure the American economy. They are therefore not going to be easily moved by a market selloff.
    - Some administration officials also seem to believe the equity markets sold off in 2017 and 2018 in reaction to tariff headlines but eventually recovered and that history will repeat itself. As we noted above, the current situation appears to be different from Mr. Trump's first term because of the speed by which the administration is acting and because there are few exemptions to this round of tariffs. Markets will eventually recover but they may do so at a different pace than eight years ago.

Not only are optimistic trade policy assumptions being questioned, but American foreign policy is also being questioned in ways that could impact international trade and the economy longer term. American governments have been warning European allies about their insufficient defense budgets for decades, but the U.S relationship with Europe has not been seriously questioned (at least not by the Europeans) until now.

The White House meeting between Mr. Trump and Ukraine President Zelensky was a shock to the European system. In combination with the current trade war, it might be a catalyst for Europe to reconsider its alliance with the U.S. The post-World War II military and economic system seems to have reached a critical juncture, and a new order may be emerging in which the U.S. and Europe could have a more adversarial relationship than they have had since 1945. Again, we take no position on the prudence of American or European policies, but changes in a 70-year-old alliance will have economic consequences as business leaders try to adapt to a new system. There might be benefits to the U.S. economy but in the near-term, it could cause businesses to delay long-term investments as they decide how to best deploy capital in a changing world. This uncertainty could be weighing on markets.

The geopolitical situation does not necessarily portend a bear market. Markets should ultimately recover, but we think investors need to consider that the international economic system is being recalibrated. Mr. Trump entered office as a disruptor. Technological disruptions have advanced societies throughout history, but that does not mean that they always went smoothly. That could also be the case in the current political situation. The ongoing changes could lead to additional volatility in the markets as investors question many of their assumptions about the Trump trade agenda and the global economic system. The idea that Mr. Trump would react to a market selloff when he is apparently trying to rearrange the U.S. economy seems to have been refuted, at least for now.

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