May 2025 Market Commentary

Wrecking Ball

I came in like a wrecking ball
I never hit so hard in love
All I wanted was to break your walls
All you ever did was wreck me
Yeah, you wreck me

https://www.youtube.com/watch?v=rk7p2kPqm_c

The first hundred days of the Trump administration have certainly felt a bit like a demolition site. The last several decades of globalization have been hit squarely in the face with a wrecking ball. It is rare for a President to come into office with a blitzkrieg of new policy initiatives, usually they tend to work on one or two at a time. Not this time.

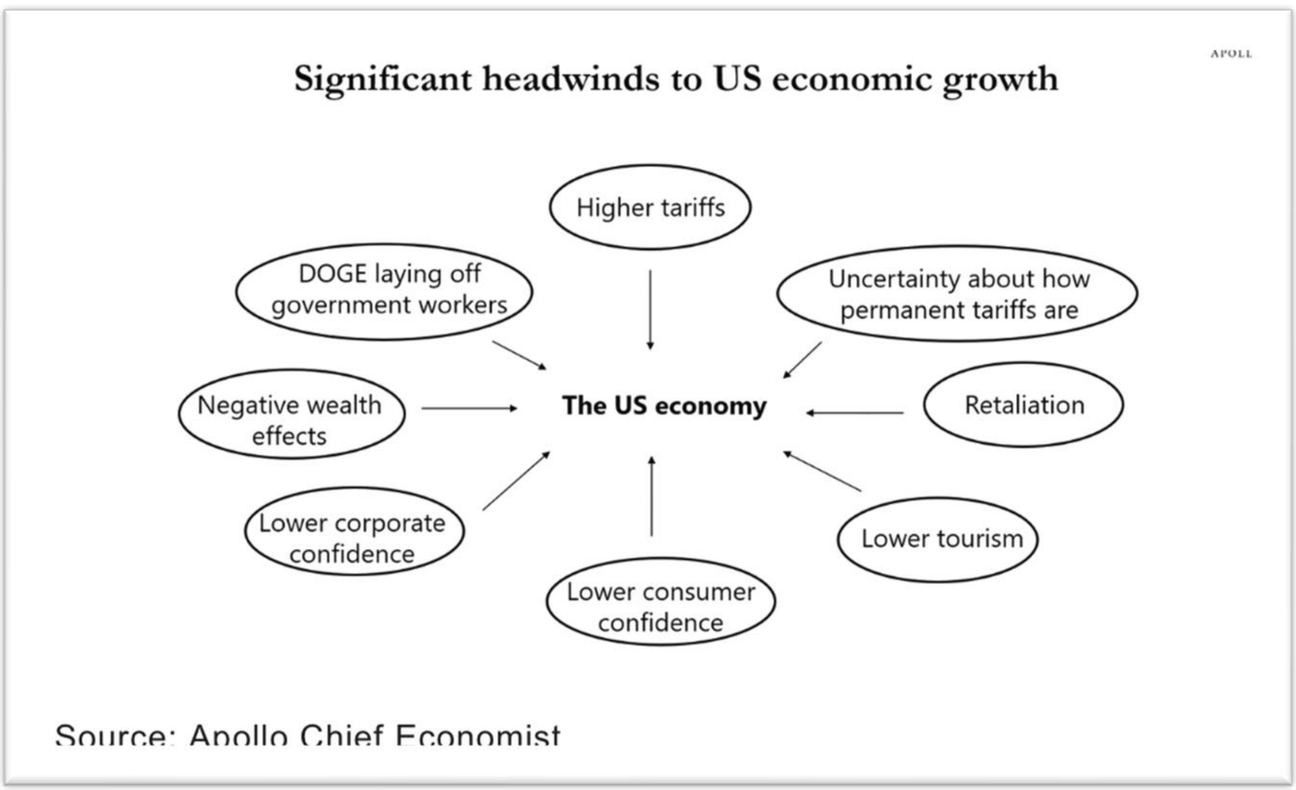
A blitzkrieg is a military tactic of surprise and speed, which aims to confuse and overwhelm the enemy – to wreck them. This seems to be an apt analogy for the Presidents trade war. Here are some of Trumps purported goals from tariffs:

- Support U.S. manufacturing
- Encourage exports
- Discourage imports
- Shrink or eliminate trade deficits
- Make supply chains more secure by onshoring
- Deter unfair trade practices
- Generate revenue for the U.S. Treasury

While these are all admirable goals, there is one big problem...in the real world of economics there are unpredictable second and third-order consequences to every action. Economics is a soft science, unlike physical sciences where if you do A, then B happens. As theoretical physicist Richard Feynman said, **"imagine how much harder physics would be if electrons had feelings."**

In economics, when you do A, you really don't know how others will react, or how others will react to those reactions. Predicting the future is always a dangerous endeavor, but in the fog of war it is particularly fraught.

Torsten Slok, Apollo Groups Chief Economist, believes that while the trade war may result in some of Trump's goals being achieved in the long run, in the near-term the U.S. economy faces many headwinds that will slow growth to such an extent that a recession is almost a certainty.



Another fact that Slok points out is that historically trade negotiations are long and arduous affairs, lasting on average 18 months. Trade negotiations involve discussions about non-tariff barriers, tax differences, rules of origin discussions, IP rights, labor standards, environmental standards, anti-dumping, dispute resolution, digital trade and e-commerce, government procurement, and sometimes security and defense considerations. Hence, they are tedious, and we supposedly have 90 different countries to negotiate with.

This is the world we currently live in. A world of increased uncertainty and a wide range of possible outcomes. Can we skate by without a recession? Sure, if the President reverses course quickly and settles the largest of the trade disputes (especially China). But the longer this process drags on the higher the probability of a recession.

What kind of bear is that?

For any of you who have been hiking or fishing in the backwoods of National Parks, you are probably aware of the importance of being able to tell the difference between different bear species. Park rangers usually advise visitors to wear little bells on their clothes, so they make noise when hiking. The bell noise allows bears to hear them coming from a distance, so they won't be startled by a hiker accidentally sneaking up on them, which might cause a bear to charge.

Visitors are told they should also carry a pepper spray can just in case they encounter a bear. Spraying the pepper into the air will irritate the bear's sensitive nose and it will run away.

It is also a good idea to keep an eye out for fresh bear scat, so you have an idea if bears are in the area. People should be able to recognize the difference between black bear and grizzly bear scat.

Black bear droppings are smaller and often contain berries, leaves, and possibly bits of fur.

Grizzly bear droppings tend to contain small bells and smell of pepper.

Another common refrain is: **"If it's black, fight back. If it's brown, lie down. If it's white, say good night."**

These rules are also handy for investors when trying to determine what type of bear market we are in. Not all bears are created equally, and neither are all bear markets.

From a technical perspective, a bear market is defined as a market that falls 20% or more from its high. This occurred on April 8th when the S&P 500 had an intraday low of 4910.42, which equates to a decline of -20.12%.

The question now becomes, what type of bear market is this?

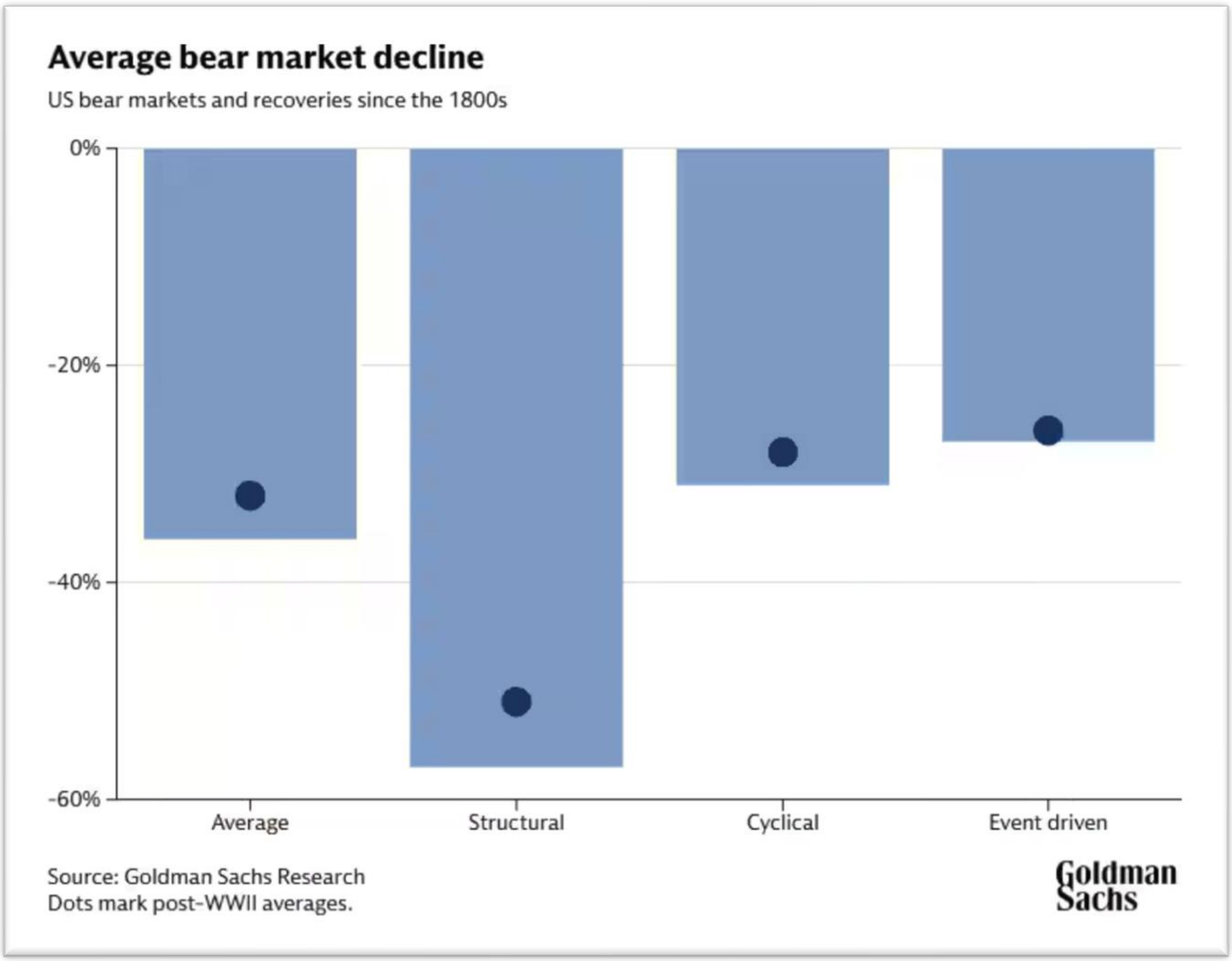
The fine folks at Goldman Sachs have defined three distinct types of bear markets: event-driven, cyclical, or structural. The first two have about the same severity, about a 30% average decline, but the cyclical bears are much more painful because they tend to last about three times as long – 27 months compared with just eight months for event-driven. Structural bears (aka polar bears) are by far the most severe, with average declines of about 60%, that last about three years and take a decade to recover.

Covid was a great example of an event-driven bear market, characterized by a sudden unforeseen drop and an equally sudden recovery. Other good examples are foreign wars and oil price shocks.

Cyclical bears are usually a function of economic cycles, triggered by rising interest rates, recessions, and declining profits.

Structural bear markets often result from significant capital market imbalances that lead to banking crises. Examples include the late 1990s internet bubble, and the Global Financial Crisis of 2007-2008.

Unlike a real life ursine, financial market bears are hard to identify in real time. The event driven bear may evolve into a cyclical bear, which may eventually trigger a much more severe structural decline.



Our current bear market has all the characteristics of an event driven bear since it was intentionally started by a trade war. It could end just as quickly as it started if the President reverses course. But if President Trump sticks to his stated goal of restructuring international trade, it appears that this very high level of tariff uncertainty will continue, and this event driven bear will probably evolve into a cyclical bear market recession.

The next question then becomes whether it evolves into a full-fledged structural bear market. Will we see a major realignment in global trade that isolates the United States from many growing markets? Will we see the United States lose its reserve currency standing?

I'm hoping this is a black bear, or even a grizzly, but not a polar bear...polar bears are just relentless. The great thing about financial bear markets is that we have always adapted to the new economic reality and survived, sometimes it takes a while and the pain can be intense, but the beauty is that mankind finds a way.

As I write this on April 23rd, the markets are rallying after President Trump stated he is not going to fire Federal Reserve Chairman Powell, that the tariffs with China are too high and he looks forward to "nice" negotiations. Then in the afternoon markets gave up about half of their gains as Treasury Secretary Bessent said that a new trade deal with China could take 2-3 years. Such are the times in which we live.

This may turn out to be a simple event driven bear, where new trade deals are quickly struck and global trade restarts. If that is the case, then buying the dip might make sense. If this drags on into a prolonged trade war then we are probably looking at a more drawn-out cyclical decline, buying can be postponed. Hopefully this will not evolve into a structural decline that last years, but if it does, we should continue to look for opportunities to upgrade our portfolios into the new names that will emerge stronger.

As investors, should we fight back, lie down, or say goodnight? Unless the world ends, we should probably focus on a combination of fighting back and lying down. For us that means taking advantage of the volatility to look for opportunities to upgrade the quality of our portfolios. Bear markets create opportunities to purchase companies that have been trading at nosebleed levels that are now more reasonably priced.

You don't buy dips in bear markets, you sell rips. You want to keep cash on hand both as a cushion against further declines, and as a facilitator to add to quality names when they decline.

Unlike real life bear attacks, financial bears are totally survivable, just stay calm and take advantage of others panic.

As always, be careful out there.

Chris Wiles, CFA

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