Commerce Trust Market Brief with Scott Colbert

March 31, 2025 – Current Market Correction and How Tariffs Impact Inflation

Scott Colbert: Good morning. It's Monday, March 31st, and the markets are open. As you're well aware, domestic stocks have largely posted negative returns for the year. The S&P 500 (Index) is down 4.81%. The tech-heavy Nasdaq market (Nasdaq 100 Index) is down 8.06% year to date. Smaller cap (capitalization) stocks have not done very well either. The S&P 400 (Index) mid-cap down 6.29%, and the Russell 2000 (Index), a measure of small stocks, down 9.02%.

There has been a bit of positive news, though, when it comes to the international markets. Large cap international markets are up 9.11%, as measured by the EAFE (MSCI EAFE Index), an index that focuses on large, developed international corporations. And even emerging markets (as measured by the MSCI Emerging Market Index) are positive 4.73%.

Why the disparity between domestic stocks and international stocks? Well, number one, the (United States) dollar has fallen, which boosts international returns. Number two, those foreign stock markets have underperformed for nearly 13 years relative to the U.S. market. And finally, there's a spark overseas with regard to defense spending, particularly as the United States prods the European countries along a bit to spend more on their own defense spending.

The fixed income markets have been mixed, with taxable bonds doing quite well, up 2.5% (as measured by the Bloomberg U.S. Aggregate Bond Index), just a bit more than that. But the muni (municipal bond) market (as measured by the Bloomberg Municipal Bond Index) is still flat to down on the year because there are worries that in order to raise revenues, the government is considering suspending, or at least lowering, the tax-exempt threshold and the returns those provide to high-net-worth individuals.

Despite the fact that the S&P 500 and all segments of the stock market are down, there has been a slight broadening to the market. When we look at the equal weight S&P 500 Index (S&P 500 Equal Weight Index) dating back to when the market was very certain that the Fed (Federal Reserve) would be reducing rates, you can see that the equal-weighted S&P 500 is actually a positive 1.63% versus the S&P 500 index, down about three-quarters of a percent. Showing you that slight rotation away from those mega-cap seven (magnificent seven) stocks towards the rest of the market.

This is even easier to see when you take a look at broad sector returns, where seven sectors in the S&P 500 are positive and only four are negative year to date. With the worst performing being what? Information technology and consumer discretionary. This is where Apple (Apple Inc.) and most of those technological stocks are focused.

And as you're well aware, the market is in corrective territory with the S&P 500 having fallen 10%. But when we look back in history since 1980, as long as there is no recession on the horizon, the market is positive 86% of the time six months later. And even if there's a recession, the market has still been positive three-quarters of the time over the next six months. So we're using this correction not to get more defensive, but are looking for pockets of opportunity to take advantage of this market's decline.

And of course, the markets are very focused on all of the additional tariffs likely to hit the market. We know that the president (President Trump) has proposed tariffs on Canada and Mexico at 25%. He's proposed 20% tariffs on China. He's proposed 25% tariffs on all imported cars coming from outside of North America. There are 25% tariffs on steel from around the globe and on aluminum. And of course, we're likely to also see this week reciprocal tariffs put in place as the administration attempts to counter foreign trade policy that they deem unfair.

What are all the implications for these tariffs? Well number one it's likely to drive of course inflation higher. But this works through a five-channel mechanism. We've posted this for you to see.

First off, you have the simple accounting effect that it will raise the price of any good that we're (the U.S.) importing. But those import prices will not get entirely passed through, as the importers probably try to reduce the amount of the tariff and lower those prices in an attempt to maintain market share. The importer of that good or service is also likely to take some of the tariff in their margin in an attempt, again, to maintain their market share.

Unfortunately, there's also likely to be a domestic market price rise, taking advantage, if you will, of all these import price rises. And then finally, there will be a mixed effect where consumers rotate towards cheaper goods. If that means imports are more expensive, they (consumers) may buy more domestic product.

So, while we think the impact to inflation is ultimately a positive 1.3% to 1.6% given all of the tariffs. That doesn't mean that the CPI (consumer price index) is going to rise on a year-over-year basis by 1.3 to 1.6%, because all of this is cumulative over time. You will see a gradual increase in the CPI and then a gradual decline as all of these tariffs work through.

On the final chart, we've tried to model this out. If there's no change in economic activity and inflation was going to stay the same regardless of the tariffs, we would see the CPI peaking at about 4%, say 6 to 9 months from now and then gradually declining over 2026 back to where it is today. But we do think these tariffs are likely to slow economic activity. And as such you won't see a cumulative rise in the CPI quite as dramatic as that. And we're likely to see the CPI gradually rise this year, but then begin to fall next year as the slowdown in economic activity starts to push back on some of the import price pressures that we get from the tariffs.

With an economic slowdown, we would assume that the impact of these tariffs is about half what it might have been. And of course, then we would end up with a CPI eventually lower than where it is today, but not as low as it would have been had no tariffs been in effect.

This, of course, puts the Federal Reserve in a bit of a box. They're going to see the economy slow while they see inflation rise. And we (Commerce Trust) think this likely puts the Federal Reserve on hold for a material period of time as they both have to adjust to the higher inflation and the slower economic activity.

That's an awfully lot of news to digest. And of course, we have nothing but economic news coming at us that will likely move the markets on a going forward basis. And we'll be back in several weeks to discuss how they are impacting your portfolios.

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