Conversations with Commerce Trust Podcast
Earnings and Tariff Impacts – April 18, 2025

David Hagee: Hello, and welcome to Conversations with Commerce Trust, our show about the markets, investment themes, and economic insights that matter to you. I'm David Hagee, Chief Investment Officer with Commerce Trust.

Today we're discussing equities and tariff impacts with KC Mathews, our Chief Market Strategist, and Don McArthur, our Director of Equity Research and Senior Investment Strategist. Welcome to the podcast, gentlemen.

Don McArthur: Hi, David.

KC Mathews: Hey, David.

David: There have been no shortage of news stories coming out of the new administration, but I think the one that has captivated financial markets the most over the first 100 days or so of the new administration has been tariffs. We saw a ceremony in the Rose Garden on April 2nd that announced wide-ranging tariffs and also a universal tariff of 10% on all goods coming in the U.S. with selective countries receiving higher tariffs.

And then we've been in a bit of a trade-off with China where, at this point, I'm not sure more tariffs would even matter. As you've seen this sort of grow a little bit out of control, I think the last number I saw was 145% tariff on Chinese goods. This has been a very fluid situation, moving around, and we've seen a pause as of April 9th of the tariffs on countries outside of China, so certainly a dynamic situation where we're trying to get our arms around it.

The markets have had a negative reaction to that, as we saw sharp sell-offs and then a little bit of a rebound on the pause news. Don, you know, earnings drive markets, and so what were the earnings expectations coming into 2025?

Don: It seems like a long time ago, but it was only a few months, David. But as we came into the year, the S&P 500 (Index) was investors were looking for EPS (earnings per share) of 16% to 17% up versus the prior year, which seemed really high to us.

We were thinking more 9% to 12%, and that's based off of real economic growth, inflation, and our margin outlook. Earnings expectations started to come down in the first quarter, and then the tariffs hit.

David: So yeah, that's a good recap that as we sit today, we saw, you know, a really, really strong economy as well as earnings growth anticipated for 2025. They have come down, but we're yet to feel the impacts. You know, given this idea that earnings drive markets and that the earnings are driven by the economy to some degree, KC, how are we interpreting all these tariffs on the U.S. economy?

KC: Well, fluid is probably the best descriptor. Every day it seems to change, but what we do know is President Trump is executing on one of his campaign promises to try and level the trading playing field. So what's the U.S. impact on our economy?

What we do know is it will slow economic growth along with having higher inflation and a weaker dollar. So, last year, 2024, we had robust GDP (gross domestic product) 2.8%. And here at Commerce Trust, we were anticipating growth to slow long before tariffs appeared, something like 2% GDP growth this calendar year.

But now with tariffs, even if we meet in the middle, we do think that perhaps the worst-case scenario is off the table as the President pauses and makes exemptions and things along that line. But nevertheless, if they meet in the middle, we know economic activity will slow, and we're thinking closer to 1% for calendar year 2025. And the risk is to the downside. That if there's more negotiations that do not go the President's way, the economy will just slow further.

We are not in the recession camp. We do think we'll avoid a recession, but economic growth somewhere around 1%, or like I said, the risk could be lower.

David: So let's unpack that for a second here. So, assuming the 10% universal tariffs, we assume that there's going to be roughly a 50% pass-through to consumer, i.e., the consumer will have to pay about half of the tariff. And that the businesses and suppliers will eat the other half of the tariff.

What does that do for inflation, and what does that do for the U.S. economy, with the consumer or consumption being around 70% of the U.S. economy?

KC: All right. Well, what we do know is it will increase inflation. I think that is the consensus. I know that is the consensus among many of the economists out there. And core PCE (personal consumption expenditures) for the last couple of quarters has been in this range between 2.6% and 2.8%.

This is the Fed's (Federal Reserve's) favorite inflation measure. And of course the Fed target is 2%. So we've been quite a ways away, coming down, but quite a ways away from the Fed's 2% target at 2.6%-2.8%. And with tariffs, if we meet in the middle, that inflation, at least for the next year, would go north of 3%.

So consumers will end up paying more, and that's how you get slower growth down to that 1%. So consumers, which represent 68% of economic growth, they've been robust, they drove GDP in the last two years. But there's no doubt, with the uncertainty, that consumers will sit on their hands and slow consumption.

David: So, another major input into equity prices is going to be the rate environment that we're in. It occurs to me that the Fed is in a bit of a box right here.

So, they have a dual mandate of full employment and low inflation, typically targeting around 2%. Where do we think the Fed is headed with things given these tariff impacts?

KC: Yeah, you're spot on that the Fed clearly is in a pickle. They have two mandates. To stabilize inflation and maximize employment. And they had a strategy where they were, they had high interest rates to curb inflation, which appeared to be working.

Inflation was coming down, but here we are, with inflation being stuck, and the Fed now is on hold. Clearly, Chairman (Jerome) Powell has said we're going to wait for new data to see if inflation comes down. But as we just cited, tariffs will increase inflation. So again, it causes the Fed just to sit tight and watch the data.

Now, the futures market, the Fed (Federal) Funds futures market, is suggesting that we see three additional cuts this calendar year. We're perhaps a little bit more conservative given the fluid nature of this and the uncertainty that we expect two more Fed cuts. So we'll go from 4.5% Fed Funds where we currently are, down to 4% by the end of the year.

Now we don't expect any activity until the second half as we get some clarity on tariffs and other fiscal policies. Then the Fed will analyze the data and take some actions, like I said, in the second half of the year.

David: So, I think an interesting point adjacent to Fed policy has been that our rates are continuing to be somewhat high, but we've seen the dollar have a pretty dramatic sell-off here of down about 3% inside the month of April versus a large basket of currencies.

As we're unpacking that, you know, what does that mean for investments? And then, is this a shift in sort of American exceptionalism, where our economy was the envy of the world and we drew in a lot of foreign investments?

KC: I think that is the case, that it is changing rapidly. You mentioned U.S. exceptionalism. You know, we had the best companies with artificial intelligence. We had unique companies and technologies, and that has clearly changed, and because of that our markets demanded a valuation premium. But now the President (President Trump) is talking about protectionism and nationalism. And that changes things.

So first, with the dollar, we saw foreign investors, foreign central banks really selling treasuries because if you want dollar, if you're foreign investor and you want dollars, you buy treasuries. It's the largest market, the most liquid market out there. And if foreign investors are going to sell treasuries, yields are going to go up, which they have. And you're going to see dollar weakness, which you have.

This year to date the (U.S.) Dollar Index is off 7 to 8%. And you could continue to see weakness, which would be bad for the U.S. and yields on the rise if you see more selling pressure of dollars slash treasuries.

What that means for markets, financial markets like I said, if yields are on the rise, that's not a good thing for total return investors in the bond market. And it also would lead you to more foreign investments if you're a U.S. investor. For decades, the U.S. market has outperformed. It would lead you to invest more in foreign markets.

David: Okay, given this unsettled picture on the economy and a very fluid situation, Don, what have we seen so far as we sit today? We're about a week or so into first quarter earnings season. What have we seen so far in terms of earnings?

Don: Yeah, earnings so far are actually coming in pretty good. We're expecting earnings to be up 6%, 7% for the quarter, because remember, tariffs kind of dribbled in at the end of March with tariffs on Canada and Mexico, but Liberation Day wasn't until April. So people had already closed out their books for the quarter.

And as we sit here today, about 10% of companies have reported. Most of those are financials, but they have their hand on the pulse of the economy, and they're doing pretty well. Credit's good. Interest margins are good. Trading's great because of all the volatility. We're not seeing a lot of M&A (mergers and acquisitions) or deals made in the capital markets. But overall earnings are coming in pretty well for the quarter.

David: I think right now we can, we can say the first quarter is definitely yesterday's news as the environment has clearly shifted. As we mentioned before, you know, people have been moving forward some of their purchases. You've seen a surge in used car prices here. You've seen, you know, I had to go out and pick up some phones for the kids. Things like that to try and beat the tariffs.

What are we anticipating for the earnings environment moving forward into this into this new paradigm?

Don: Yeah. Well, David, at least you didn't have to go buy a car to get ahead of tariffs and the only damage was the iPhone.

David: That’s right. That’s right. Small gifts.

Don: Yeah, so we're seeing a lot of pull forward in demand as people get ahead of tariffs. Already happened in the first quarter, likely happens in the second quarter as you're trying to get ahead of that. What we might see is a pull forward of inventory and then maybe a[n] air pocket of demand in the second half of the year.

So we think overall earnings for the 2025 likely come down from the expectations that were actually really high coming into the year and continue to be moderated lower.

David: So, that's very broad strokes here that we continue to see maybe a deceleration of earnings growth. So, not negative growth, but just less growth for corporate earnings this year. In terms of how we're approaching that from a market point of view, what sectors do we anticipate to have maybe more weakness or areas of strength areas of weakness?

Don: Yeah, I think that the clear one that's going to have weakness is consumer discretionary. We import a lot of goods that we sell to consumers from China, and that's where the focus of the trade war is. So that would be weak if demand declines, and that would hit the need for energy, gasoline, et cetera.

But we're seeing strength in technology as people continue to buy and reinvest in artificial intelligence and some other just secular trends. We're seeing growth in healthcare as people still get older. We're seeing communications services continue to grow.

So, there's areas that likely do really well through this entire year. So, we think earnings come down, but they're still going to grow over 2024.

David: So, you know, similar to the macro picture, as we look at the sector level positions, there's a lot of uncertainty out there as to what earnings will shake out to be, similar to the economic impacts that we are forecasting. But generally, a more subdued environment in terms of your positioning inside some of the processes that you're responsible for. How are you thinking about that right now?

Don: Yeah. So clearly, we have uncertainty, so we think, you know, broad diversification is very important in managing position sizes. But our stocks in general have more visibility, greater cash flow, or are generally higher quality, which we think is very appropriate right now.

And then we also have to be cognizant that we're one tweet, one Truth Social (post), one lawsuit away from things changing one direction or the other. Or likely back and forth more than once over the coming months.

David: And then, KC, how is Commerce approaching asset allocation?

KC: Well, what we believe is when you have uncertain times and stormy weather, you stay close to shore. We create a long-term strategic portfolio based on our capital market assumptions.

And given the data we cited, we do think there will be more opportunities in foreign markets, so something that we are watching very closely.

David: Yeah, I think that's a great point that you know, while we're always looking for opportunities in the markets, we continue to hold to our core belief that asset allocation is the driver of returns. Of course, asset allocation is a reflection of our clients' unique goals, circumstances, and characteristics. Rebalancing and reevaluating portfolios remains our path to investing success.

Gentlemen, thanks for the interesting discussion today.

For more on this topic, please visit www.commercetrustcompany.com for additional commentary on earnings. If you've enjoyed what you've heard today, you can subscribe to our show on Apple Podcasts, Spotify, Amazon Music, or wherever you get your podcasts from.

Thank you for joining us on Conversations with Commerce Trust. I'm David Hagee, we'll talk again soon.

Important material disclosures regarding the content of this program follow. Commerce Trust is a division of Commerce Bank. Generally, non-depository investments offered in connection with Commerce Trust and its affiliates are not guaranteed, are not FDIC insured, and may lose value.

Opinions and other information provided are effective as of the date of the recording and presented for the purpose of general education, information, or illustration only. This material provided should not be construed as a recommendation to buy, hold, or sell securities or as advice relating to the profitability of any investment product, strategy, or plan. You, as the investor, are fully responsible for any investment transaction you choose to enter into, including determining whether such investment is appropriate in light of your investment objectives and personal circumstance, and you shall not have relied on the preceding information from Commerce as the basis for any investment decision.

This material is not intended to replace the advice of a qualified attorney, tax advisor, or investment professional. In considering whether to trade or invest, you should inform yourself and be aware of the risks. Past performance is no guarantee of future results, and the information in the commentary provided is subject to change based on market or other conditions. Diversification does not guarantee a profit or protect against all risk.

Commerce Trust does not offer tax, legal, or specific estate planning advice. And while we may provide information or express general opinions from time to time, such information or opinions are not offered as professional tax or legal advice.

Commerce Trust does not provide advice relating to rolling over retirement accounts. Commerce Trust is not a Municipal Advisor under Section 15B of the Securities Exchange Act and does not offer advice or recommendations concerning bond proceeds or other municipal advice subject to this section.

Any data contained herein from third-party providers is obtained from what we considered reliable sources. However, its accuracy, completeness, or reliability cannot be guaranteed.

April 18, 2025
Commerce Trust is a division of Commerce Bank.