

The bad, ugly, and good of President Trump's Tariffs

Executive Summary

Five years ago, we watched as President Trump made the difficult decision to shut down the economy as the coronavirus spread. Last Wednesday afternoon on “Liberation Day,” he put another freeze on the global economy, announcing tariffs that shocked investors, economists, and global leaders. Five years ago, we were largely adding exposure with excess cash during a dramatic and sickening decline. The economy and stock markets recovered quickly, and we were rewarded for doing so. This time we expect to be more patient with excess cash. While there is certainly a path to a similar, quick recovery, there are important differences to highlight.

Five years ago, the economic shock came from external sources, today it comes from an internal, self-inflicted force. The pandemic was a global issue that largely united global leaders, today's tariffs pit the U.S. against the rest of the world. During the pandemic, a deeply divided Congress acted quickly with unprecedented fiscal stimulus. While Congress is controlled by the Republicans today, deficits already stand near record highs. The appetite for additional stimulus that could reignite inflation is limited. Similarly, during the pandemic, the Federal Reserve engaged in unprecedented monetary stimulus with little fear of inflation. Today, despite Trump's cajoling the Federal Reserve sits sidelined as tariffs have increased inflation expectations and their appetite to cut rates.

The Bad

So, we can end with some of the potential positive aspects of the Trump tariffs; we will start with the bad. U.S. stocks lost \$6.6 trillion in value on Thursday and Friday, falling 10% in short order. This was, in fact, the 4th worst two-day loss for markets in modern history. The other three instances occurred during World War II, 1987 and the pandemic. Volatility often begets volatility, fear builds on fear, margin calls roll in and U.S. futures are wildly fluctuating between gains and losses as of this writing.

While some areas like gold, real estate and even international equities held up well relative to U.S. stocks on Thursday, they each came under increasing pressure on Friday and Monday. Bonds, which provided a buffering 0.5% return on Thursday, gained just 0.1% on Friday as the market digested the Federal Reserve's stated reluctance to cut rates in the face of potentially higher inflation. On Monday, the 10-year bond yield this morning is pushing higher back above 4% and thus providing no ballast to global stocks. Bitcoin, which fell 6% during Trump's tariff announcement on Wednesday, stabilized on Thursday and Friday but has since fallen another 8% as of this writing. Even the dollar, the world's “safe haven,” lost nearly 2% on Thursday in extraordinary volatility. Gold, which often rallies during crises, is off 5% since Trump's speech. As fear grows contagious, there are very few places to hide other than cash where we remain overweight.

While we generally get more interested in putting cash to work as investor fear grows, we are concerned with fear in other areas of the economy. Consumers report near record low sentiment and expect inflation to be over 4% over the next 5-10 years, the highest expectations we've seen since 1993. While consumer expectations can be skewed by political affiliation, we are seeing similar concerns from economists. 87% of economists raised their inflation expectations while 92% raised their recession odds since Trump's “Liberation Day” speech. CEO confidence, which reached nearly a decade level high just months ago, now stands near a decade level low.

For now, both investors and businesses are taking a wait-and-see approach, akin to a hibernating bear. To wit, the private market showed signs of reawakening with the acquisition of Wiz and the IPO of CoreWeave. We saw nearly a half dozen smaller deals in our own private portfolio close in Q1 with solid results. But now private firms, StubHub, Klarna, Medline, and Circle, are all now delaying recent plans to IPO. They, along with many others, are willing to wait and see how far this goes.

Finally, while valuations have cheapened, they have not reached the screaming bargain levels seen in previous market routes. For example, the S&P 500 now trades at 18X next year's expected earnings. In 2008 and 2011, valuations dipped to and even below 10X earnings. More recently, during Trump's 2018 tariffs and the 2020 pandemic, valuations dipped below 14X. We will be watching earnings closely, but given both the reduced sentiment and heightened uncertainty, it is likely earnings expectations will fall and guidance may be cloudy. For all these reasons, we will be very patient in investing excess cash.

The Ugly

The ugliest part of the tariffs, in our opinion, is their delivery. President Trump likens the U.S. economy and market to a sick patient. Yet, instead of operating with a modern surgical scalpel, he has elected to operate with a hack saw like a Civil War surgeon not far in time from the McKinley tariffs of 1890 that he admires. The tariff rates were delivered on a board resembling the showmanship of a game show. The equation used to calculate the tariffs has caused confusion and consternation and bears little semblance to the actual tariffs and even non-tariff trade barriers other countries place on the U.S. The tariffs shocked the markets, as they were higher than expected, surprising economists, investors, and global leaders. They were not coupled with the pro-business, deregulatory measures that may have softened the blow. They were placed on uninhabited islands, Nauru, and both allies and adversaries alike.

The purpose of the tariffs themselves is confusing. We've been told they are a national emergency needed to raise revenues and reduce our deficits, to stem the flow of fentanyl, and to revive a moribund American manufacturing sector, but they cannot be for all three at once. If they are used as a negotiating tactic to reduce trade barriers and stem the flow of fentanyl, they will do little to raise revenues. This leaves everyone confused as to whether the tariffs are part of Trump's maximalist negotiating style or a true push to reorder the world economic order.

Countries like Japan, Canada, Mexico and Vietnam that have tried to negotiate have not been spared. Vietnamese, who earn \$330/month on average, see the tariffs as cruel and wonder why Americans would want their low-paying textile jobs. Trump seems to question the 250-year-old economic theories of David Ricardo that it is generally a win-win for the Swiss to make watches while the Italians make Ferraris and trade based on their comparative advantages. Trump went so far as to repost a fictitious social media post that Warren Buffett supported his policies. In fact, Buffett is on record earlier this year noting that "we've had a lot of experience with them" and tariffs are "an act of war to some degree" and "a tax on goods". While both Trump and US Secretary of Commerce Howard Lutnick look back fondly on the McKinley tariffs of 1890 and the Smoot-Hartley tariffs of 1929, voters at the time agreed they were bad policy choices. Most economists believe the Smoot-Hartley led to retaliatory, beggar-thy-neighbor policies that slowed global growth, worsened the Great Depression and eventually contributed to World War II. To date, we've already seen China retaliate with 34% tariffs and the US respond with threats of additional tariffs.

Buffett is now joined by other famed investors, CEOs and politicians warning against tariffs. Trump supporter Bill Ackman just called for a 90-day pause to avoid “a self-induced, economic nuclear winter.” Rumors that Trump was considering this pause briefly led to a remarkable intraday rally before the White House dismissed the news as “fake news.” Stanley Druckenmiller, who was Secretary Scott Bessent’s boss, just posted that he does “not support tariffs exceeding 10%.” JP Morgan CEO Jamie Dimon just noted the proposed tariffs “will slow down growth” and expressed concern that the tariffs may lead to retaliatory actions and potentially harm America’s standing in the world. Republican Senators Ted Cruz and Rand Paul have both spoken out about the risks of tariffs. Iowa Republican Chuck Grassley is pushing for legislation that would require congressional approval for tariffs. While it is currently unlikely the House will pass this bill, the chorus calling against current tariffs is growing. While Trump, Lutnick, and Bessent appear to be listening to these concerns, they largely doubled down on tariffs over the weekend. If they are serious about reordering the global economic supply chain, uglier markets are likely to lie ahead. We intend to preserve cash and other safe haven assets should this occur.

The Good

In order to not end on a bad note, there is certainly some good that can come out of all of this. Trump may well be on the path for the grand “Mar-a-Lago Accord” he has long wanted. Decades ago, President Truman and Eisenhower noted that the US was unfairly on the hook for our allies’ defense budgets. Now after decades of neglect, we are beginning to see Germany and others more willing to also run deficits to fund “their fair share” of defense spending.

While Trump has taken a maximalist approach that may anger and alienate our allies and adversaries alike, tariffs applied to the U.S. were generally greater than those applied by the U.S. Some fifty countries have reportedly already reached out to make a deal. Vietnam is reportedly willing to drop its tariffs completely. European countries have made overtures. President Trump’s adviser, Elon Musk, has floated the potential for a 0%, free-trade negotiation with the EU. While China has, as noted, worryingly reciprocated with higher tariffs on U.S. goods, there is also a potential for some grand bargain here. TikTok, the Panamanian ports, the reshoring and technological transfers of batteries and solar capabilities from China to the US and even Taiwan are all on the table for a potential major, lasting resolution. Even without a major accord, as much of the damage has been self-inflicted, it could at least be partially unwound through a set of more minor deals and face-saving measures if cooler heads prevail.

Finally, turning to markets, there are also some positives, but still more uncertainty and questions than answers. The two biggest questions we are getting from investors are “Is this a buying opportunity?” and “Should we be selling more?” On a positive note, we raised cash at the end of November and again in February, given the levels of ebullience, valuations, and rising uncertainty. We continue to generally maintain a diversified portfolio, including excess cash, high-grade bonds, gold, and uncorrelated hedge funds, which have all weathered this storm with positive returns year-to-date as of this writing. A basic, diversified, liquid portfolio of 60% global stocks and 40% U.S. bonds is, in fact, off just 5% year-to-date after gaining 11% last year. In private assets, our portfolio had seen an uptick in realizations at good prices before these events. Recent investments in early-stage American defense companies have shown significant unrealized appreciation. Our private funds broadly also often focus on cutting-edge, asset-light, domestically focused businesses that are more insulated from global trade.

Finally, and as noted above, whereas valuations were relatively rich very recently, they have cheapened considerably since. The S&P traded at 22X estimated earnings just 30 days ago and now stands at a more

normal 18X. Like everyone else, we don't know what will happen next and are okay taking the wait and see approach for now. We aren't likely to buy hand over fist given these valuations and the extraordinary uncertainty. We, however, are more likely to patiently put our excess cash to work overtime. Although recent events are concerning and carry considerable risks, we remain long-term investors and focused on finding attractive opportunities. Paraphrasing the late, great Charlie Munger a bit, the pie counter may not be open just yet, but when it is we will look to take a good helping.

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