PERSPECTIVES ON THE US EQUITY MARKET SELLOFF

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Presidents like to get painful policy measures put in place early in their term of office so that voters can forgive and forget by the time midterm elections roll around. That seems to be what is happening with President Trump focusing on tariff hikes and DOGE-based government restructuring at the very beginning of his term. Both of these policies are likely to slow growth and dent consumer and business confidence, and the tariff hikes are expected to add at least a one-time boost to inflation, too.

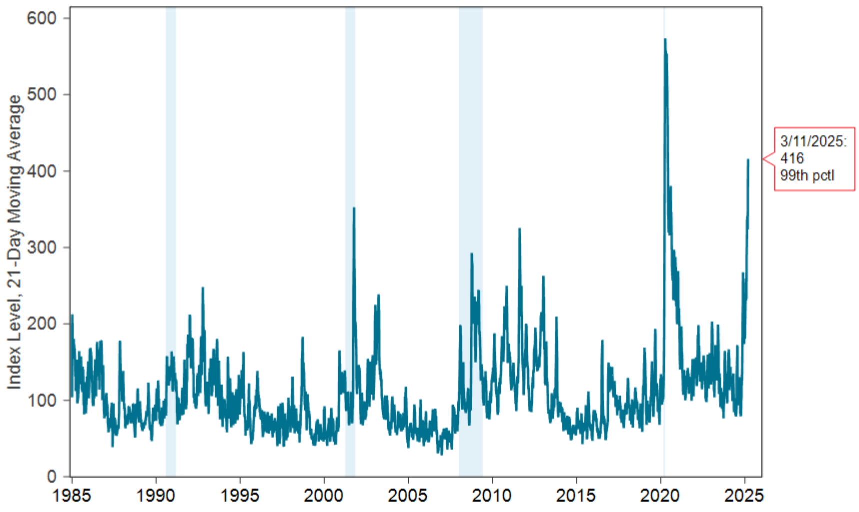
IMPACT OF TARIFF HIKES AND GOVERNMENT RESTRUCTURING

The chaotic nature of the off-again, on-again tariff rollout, with proposed tariff rates changing dramatically on an intraday basis, is also creating extremely heightened anxiety among business leaders, investors, and consumers. We track a news-based measure of economic policy uncertainty created by academic economists, which has reached an extremely high level typically associated with periods in or around recessions (**Figure 1**).

A news flow-based measure of economic policy uncertainty has recently spiked to levels normally associated with periods in or around US recessions.

FIGURE 1

US Policy Uncertainty Has Surged:
US Economic Policy Uncertainty Index



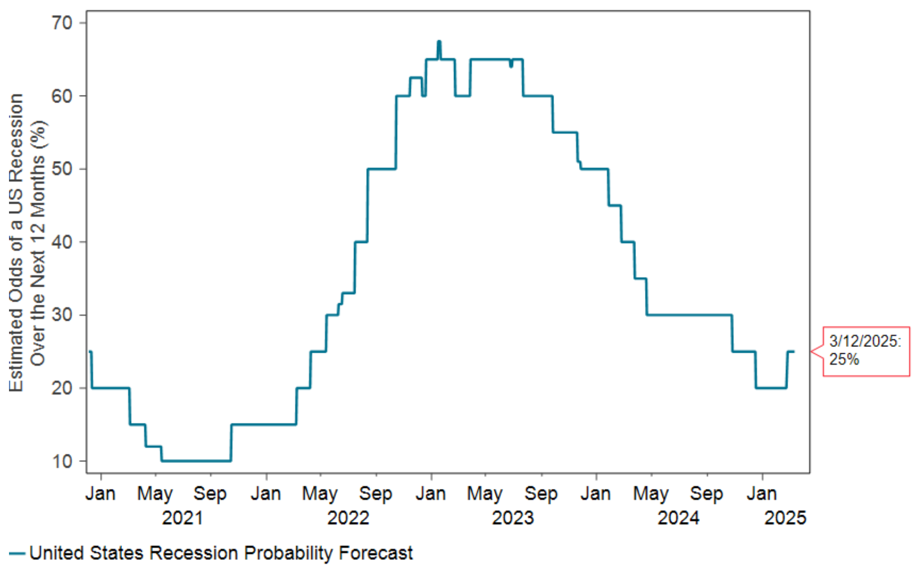
Note: Shaded areas denote NBER recession periods.
Sources: GW&K Investment Management, Baker, Bloom & Davis, and Macrobond.

A SLOWDOWN...OR SOMETHING WORSE?

The economic concern is that when such uncertainty is so elevated, business leaders and consumers will delay making investments or decisions about large purchases. If such delays become widespread and prolonged, the result can be a slump in investment, which could potentially result in a recession — and a painful bear market for stocks. Indeed, some prominent economists have been warning of increased recession odds this year. For example, JP Morgan's economics team has put the odds of a global recession at 40%, and Harvard economist and former US Treasury Secretary Lawrence Summers puts the odds at 50%. However, a Bloomberg survey of economists puts the odds at only 25%, up from 20% at the start of the year (**Figure 2**).

FIGURE 2

Recession Fears Have Ticked Up This Year: Bloomberg Survey of Economists' Recession Odds



Sources: GW&K Investment Management, Baker, Bloom & Davis, and Macrobond.

After declining steadily since mid-2023, economists' odds of a US recession over the next 12 months have recently ticked up from 20% to 25%, with very recent market turmoil potentially pushing the odds higher.

Put differently, that means that the base case of most economists — at roughly 75% odds — is for no recession this year. And that includes the fact that most economists have already had time to factor in substantial tariff hikes, leading to lower growth and higher inflation. Reasons for economists' relative optimism include the strong momentum of the economy coming into this policy "transition period," with real consumer spending having grown by 2.8% last year, with growth of 2.6% expected by the Bloomberg consensus for this year. Such views are predicated on the labor market remaining solid and unemployment staying in the low 4% range, while household balance sheets remain strong as well.

To be sure, the risk is that tariff hikes along the lines currently proposed could erode consumers' purchasing power by $1,600 to $2,000 (**Figure 3**). That said, the hit to GDP growth from numbers in that range is expected to be on the order of 0.5% of GDP — not enough to trigger a recession. At the same time, inflation is expected to jump by about 1% or slightly more for the first year of tariff implementation. But that is already factored into US Treasury bond prices, with the 1-year "breakeven" inflation rate yields currently at about 4% (this is the difference between 1-year nominal yields and 1-year TIPS (Treasury Inflation Protected Securities). Based on the experience of many countries that have implemented consumption taxes, the hit to prices is expected to be a "one-off" hit and not a trigger for ongoing higher inflation.

FIGURE 3

Impact of 20% China + 25% Mexico & Canada Tariffs on Average Real Disposable Income per Household

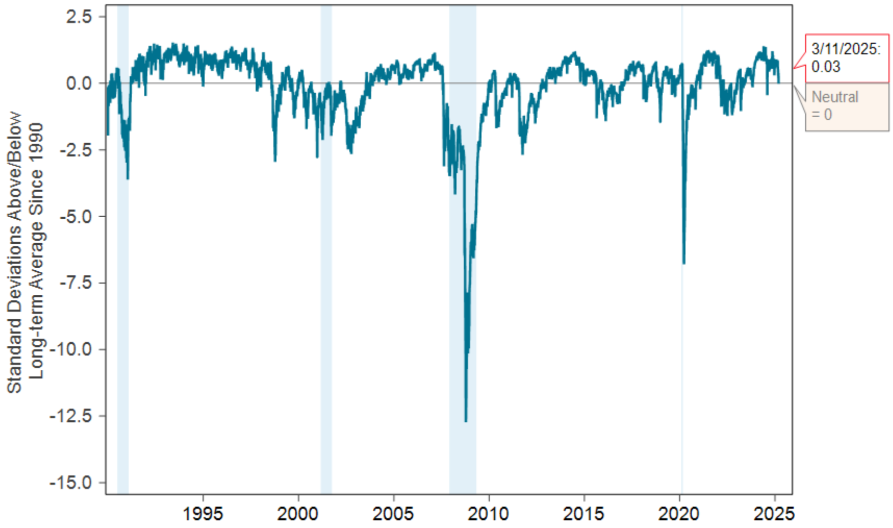
Sources: GW&K Investment Management, The Budget Lab at Yale University, and Macrobond.

The hit to consumers' purchasing power from tariff hikes could be substantial, but most economists do not believe it will be large enough to trigger a recession.

It's also instructive to look at measures of financial conditions when considering recession risk, since recessions are typically preceded or accompanied by extreme tightening of financial conditions, which include not just equity market movements, but also various measures of money market and credit market distress like spreads between commercial paper and T-bills, or spreads between investment grade or high yield debt and US Treasuries. Many of those measures continue to signal business as usual in US money and credit markets. As a result, an overall measure of financial conditions, the Bloomberg Financial Conditions Index, is currently giving a neutral reading, suggesting that recession odds are not particularly elevated (**Figure 4**).

FIGURE 4

Bloomberg's Financial Conditions Index: Tighter But Not Extremely Tight



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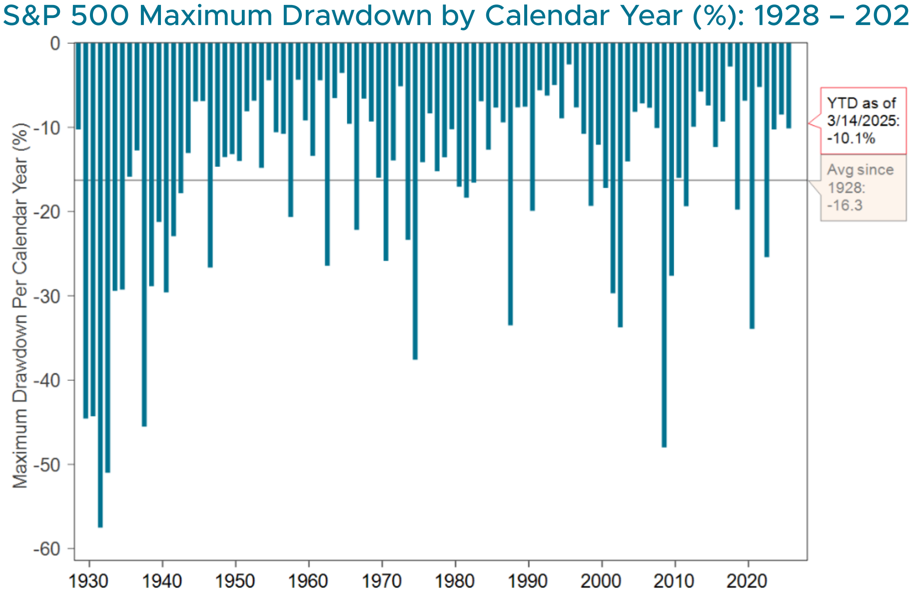
Sources: GW&K Investment Management, Bloomberg, and Macrobond.

STOCK MARKET SLUMPS ≠ RECESSION SIGNALS

We favor such broad-based measures of financial conditions because stock market swoons tend to have weak predictive power for recession forecasting. The joke among economists is that "the stock market has predicted nine out of the last five recessions" and that is worth keeping in mind. Stock market volatility is just a fact of life, with the average annual drawdown from peak-to-trough in the US stock market going back to 1928 being -16.3% (**Figure 5**).

FIGURE 5

S&P 500 Maximum Drawdown by Calendar Year (%): 1928 – 2025



Double-digit peak-to-trough declines in the stock market historically have been very common, with the average year since 1928 experiencing a -16.3% drawdown.

Another perspective on stock market corrections is to understand how common they have been. Since 1928 there have been corrections in the -5% to -10% range in 95% of all years, while corrections of -10% to -20% have occurred in roughly two thirds of all years (**Figure 6**). Fortunately, crashes of -30% or more have been relatively rare, happening in less than 10% of all years.

FIGURE 6

Stock Market Losses: 1928 – 2021

Losses	% of Years
5% or Worse	95%
10% or Worse	63%
20% or Worse	26%
30% or Worse	10%
40% or Worse	5%

Source: Ben Carlson, "How Often Should You Expect a Stock Market Correction?", January 20, 2022.

Stock market declines of 5% or worse have been exceedingly common, occurring historically in 95% of years. Corrections of 10% or worse have been experienced in nearly two thirds of all years.

STIMULUS TAKES TIME AND INVESTORS SHOULD STAY THE COURSE

A significant downshift in US growth was not what most investors were expecting at the beginning of this year. But the jury is still out on whether current market volatility will turn out to be just another "growth scare" as opposed to the beginning of a more serious economic downturn. We need to keep in mind that the stimulative aspects of the new administration's economic policy, including tax cuts, deregulation, and lower energy prices, will take more time to put in place. We also need to keep in mind that despite the one-time bump in inflation from tariff hikes, the Fed is not out of the picture indefinitely. In fact, Fed funds futures now suggest three rate cuts this year, with the first most likely to come in June, followed by cuts around the September and December FOMC meetings. If realized, that should provide a positive tailwind to stock and bond markets.

Finally, investors should keep in mind how counterintuitive stock market movements can be. Yes, this is a time of extreme policy uncertainty and that cannot be helpful to the economy in the short run. But let us finish by going back to the Economic Policy Uncertainty Index we mentioned earlier. Just out of curiosity, we went back and asked the following simple question: When that Index reached extreme levels (>90th, >95th, and >99th percentile since 1985), how did the S&P 500 Index perform over the next 3, 6, and 12 months? The answer is, on average, very well indeed, with 12-month returns ranging from 20% to 39%, and positive hit rates of 90% or better (**Figure 7**).

FIGURE 7

S&P 500 Future Returns Following Economic Policy Uncertainy Spikes*

Percentile	3m Mean	% Positive	6m Mean	% Positive	12m Mean	% Positive
>90th	6.0%	84.0%	12.0%	88.5%	20.3%	90.0%
>95th	7.3%	84.5%	15.2%	93.0%	26.0%	92.9%
>99th	12.0%	97.8%	20.1%	100.0%	39.0%	95.5%

*Based on 21-day moving average of the Economic Policy Uncertainty Index.
Sources: GW&K Investment Management, Baker, Bloom & Davis, Bloomberg, and S&P Global.

Following periods when the US Economic Policy Uncertainty Index has been notably elevated, the S&P 500 has frequently delivered strong double-digit returns.

Of course there are no guarantees this time around. But this history provides important food for thought about how extreme uncertainty can be followed by surprisingly positive stock market returns.

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