Our apologies in advance for the length of this month's letter. But it's very difficult to address what is happening without sufficient elaboration to alleviate linguistic confusion. We feel compelled to clarify precisely what we mean when we write "inflation" or "tax" for example. To make things more digestible, we've broken the note this month into four parts. Simply ignore parts 3 and 4 if you want a little less of the explanation about what's happening:

1. **What exactly happened when Trump announced his tariff plan?**
2. **What is most likely going to happen going forward/what should we do in accounts right now?**
3. **Why did the markets react the way they did? Why was the market reaction so strong and immediate?**
4. **What can you likely ignore despite the talking heads making it sound super alarming?**

As your read, please keep in mind that we wrote this note on Sunday April the 6th – but these communications must work through a review process before they are published. This situation is highly likely to be fluid when the markets open Monday morning; please forgive us if anything seems dated by the time you receive it. On the bright side, if you make it through this particular month's dissertation, our hope is you will understand more about what is happening right now and why.

1) What happened?

Let's start by directly addressing the market's reaction to the April 2nd "Liberation Day" tariff announcement. As you are likely already aware, the US stock markets fell in excess of 10 percent across a two-day span Thursday and Friday April 3rd and 4th in response to the tariff announcement – among the largest two-day declines in market history. Year-to-date through the close on Friday April 4th, US equity markets have declined as follows:

S&P 500: down 13.4 percent
Nasdaq: down 19.1 percent
Dow Jones: down 9.5 percent
Magnificent 7: down an average of around 24 percent

Conversely, bonds as measured by the Barclays Aggregate Bond index have risen by about 3.7 percent so far this year. Interest rates fell and short-term inflation indicators such as commodity prices rapidly declined last week.

Diversified portfolios have held up much better. Why? The threat currently is recessionary; stocks and bonds normally move in the opposite directions when there are threats to economic growth. It's partly why all our communications the last several months have touted bonds. The Mag 7 stocks in particular were oversubscribed and heavily sold last week – that's partly because those stocks are what people actually own, and you cannot sell what you do not already own. But it's also true that the largest multi-national global corporations are more affected by changes in trade policy than more domestic enterprises like healthcare.

2) What do we think is going to happen going forward/what should we do in accounts right now?

Had we known that the Trump administration planned to announce the single largest tax increase since the 1960s, in retrospect we would have simply done a lot more of what we were already recommending. We'd have been at max policy allocation limit in long-term government bonds and at minimum equity allocations. But hindsight is always perfect.

As Lisa Shallett, Our Chief Financial Officer, put it, "At face value, the announced "Liberation Day" tariffs increase the effective rate on imports to as much as 17%–22%, the highest in history. If we knew this was the end game, we would be aggressively selling equities and calling for a recession-induced bear market. In fact, our new 2025 base case does reflect deterioration, with recession and stagflation odds rising and soft-landing prospects falling. While earnings are also at risk, the problem with "making the call" right now is that there is time before implementation on April 9, and the administration appears open to bilateral negotiations. We also don't yet fully understand the end game, as maximum revenue collection, reshoring investment and leveling the playing field for US exporters are mutually exclusive. We are convinced that for the average consumer, inflation and demand disruption outweigh any immediate opportunities for new middle-class jobs. That said, with at least a 50% chance that policy will change in the next 90 days, we are taking a wait-and-see approach."

Ultimately, we do think markets are probably oversold in the short term. After the 10 percent declines last week and the likelihood of another 4-5 percent decline Monday morning from capital calls, it's no time to sell anything. Nevertheless, we are not recommending jumping in full tilt either. Our best guess is that tariff concerns do moderate for many countries quickly this next week – Vietnam, Taiwan, and the UK seem to already be trying to create a zero-tariff and zero-barrier model with the Trump Administration. If that's the only news, markets may rally. Monday morning will be tough for sure because of margin calls. It's also true that trade negotiations take time, are incredibly complex, and there are a lot of countries with which to negotiate. Correctly timing the rallies will likely prove to be an impossible task in these circumstances. Some countries, especially China, may dig in and escalate matters in the trade war scenario many people fear. Each time there's a ratchet up in that regard, expect market action similar to Friday's. The EU's response might also cause further declines. If Trump responds with another increase in tariffs on Chinese goods this week, there's a good chance you'll see more downside volatility.

In many cases, the trade negotiations will require other countries to remove trade barriers, not just tariffs. Barriers, because they are generally imposed by laws and regulations, may significantly slow negotiations even if a foreign country desires that outcome. For example, the EU simply bans hormone-treated meat which essentially bans US beef. A reduction in tariff rates will not rectify that. Basically, there is likely to be months of large up and down moves to come based on trade negotiations. Markets are going to favor anything that increases free trade and disfavor anything that decreases it; the news flow is not something we can systematically time for you.

Therefore, we are not calling, and Morgan Stanley is not calling, for clients to rush back into equities just yet. If you are a long-term investor, it's never wrong to buy the dip. If you're dollar cost averaging into the markets, this is probably a pretty awesome scenario for you – everything's on sale 20 percent off. If you are contributing to your 401k each week, the same applies.

We will likely rebalance sometime this week – which is the lightest version of buying we do. If you were 50 percent stocks and 50 percent bonds, now you are something like 43 percent stocks 57 bonds after last week. So where appropriate, we will likely recommend selling some bonds, buying some stocks, and bringing you back to 50/50 in your account.

But we are not taking accounts that are normally 50% stocks up to 70% stocks like we did in March of 2020 – at least not yet. We simply expect more volatility to come – big swings both up and down as the situation progresses over the next several months. Markets are more resilient and quicker to adapt than most people believe possible – who would have thought the corporate Covid response would have gone as well as it actually did? But stocks are also more expensive in relation to bonds than they were in 2020 – and profits are far more likely to suffer from suddenly evaporating economic transactions than interest payments. It's just a different scenario that favors bonds in a lot of ways over the short term. We may miss a rally or two in stocks but can live with that outcome in service of protecting clients from extreme volatility.

Do we think 2025 is still salvageable as a year of decent returns? Yes. Are we suddenly uber pessimistic? Not at all. Diversified accounts have held up very well. If you had a meaningfully diversified portfolio, your returns are likely down 2-7 percent for the year depending on your specific allocation as of Friday the 4th. It's only if you were loaded up on the Magnificent 7 that you have experienced truly concerning declines year to date.

The main thing we want to get across is that that we are here to help you through this. If you have questions or concerns, worries or fears, you should feel free to put those on our shoulders at any time. The very process by which we operate our team and care for our clients is intentionally constructed to contend with the wildness of the world that lies in wait – that's why we diversify, have target asset allocations, run financial plans. It's why we don't try to pick which thing will be "the best" thing and instead focus on managing risk. The markets have not stopped going up for forever. They just don't like tariffs. Regardless of where tariffs settle out, we are hopeful once the reset is over, trade barriers will generally diminish over time to everyone's benefit. While we doubt we'd have to try very hard convince someone of the wisdom of our approach to wealth management this week, we also know sometimes it just helps to hear a friendly voice when times are tough. Don't hesitate to call us if we don't call you first.

3) Why did the markets react the way they did? Why was the reaction so strong and so immediate?

In short, markets were surprised by the magnitude of the tariffs. As we noted last month, tariffs are taxes by another name. All tax increases -- no matter the form or type -- stifle economic activity by reducing the number of voluntary transactions among individuals.

For example, if we were to raise marginal income taxes on revenue from lawn mowing to 100 percent, it's highly unlikely you would find a young person in your neighborhood still willing to perform that work. You'd be worse off because you would then have to mow your own law; the neighbor kid would be worse off too (now he has no job or income at all). The transaction itself – the trade between you and the neighbor kid – is what made both parties wealthier. The actual money changing hands is not so important to the economist. Whether the transaction is settled in bitcoin, shells, shares of stock, a home-cooked meal, or dollars, the value to an economist lies in the exchange itself. Voluntary transactions occur only when both parties believe they're winning; the economic value measured in this sense is not the $100 you pay the neighbor kid. Rather, it's the amount you don't have to pay them (you would have gladly paid $120, but only had to pay $100, so you were better off by $20) added to the value the neighbor kid receives in excess of the minimum he would have required to undertake the task (he might have done it for $85, but you paid him $100, so he gained $15). To an economist, the exchange improved the world by the $35 -- the sum "earned" by each party in excess of the amount that physically changed hands.

Regardless of what we may think politically is the right thing to do, whenever a free exchange is stopped by government policy under any name (taxes, regulations, tariffs, price controls, sanctions, etc.), you can safely assume at least two individuals somewhere suffered economically because they are no longer exchanging something. That does not mean all government action is bad. Many times, the juice is worth the squeeze and the government does good things with the revenue it collects. Nevertheless, the economic value of the missing transaction is lost to the world. It's also true and intentional in this example that the government would not collect any "tax" revenue since no one would ever mow someone else's lawn in these circumstances (see Laffer curve.) But to understand what is happening right now in markets, all you need to know is that the economic "tax" on the whole system is the collective sum ($35) lost when our 100% income tax policy stops lawn mowing exchanges altogether.

In reality, governments long ago sorted this out, so taxes and tariffs are always less than 100 percent of true economic value. Consequently, they eliminate some unknown proportion, but not all, of the economic transactions from occurring. That's because some people would pay a lot more than $100 to get their lawn tended, and therefore and won't care if the price goes up a bit. Some neighbor kids might also be happy to take so $80 to mow your lawn; others might not. Unfortunately, the reality is so incredibly complicated, it creates a bit of a linguistic mess. The "tax" most people have in mind is not the aggregate value of the loss of economic activity, but rather what the government actually charges the kid, say 20 percent, on his lawn-mowing earnings. So, the kid mows your lawn for $100, pays $20 in taxes, and keeps $80. But the "tax" on the system to an economist is the thousands of transactions that stop happening altogether because of the new policy. Or if you prefer, you can think of it as the thousands of lawns that don't end up getting mowed because many people would have paid $100, but won't pay $125 so that kid can net his required $100. Basically, tax sort of means three things all at once, color coded for convenience here: the tax policy imposed by the government, the tax revenue collected by the government, and the economic tax impact on the whole system.

When we are discussing the effects tariff policy we mean the word tax mostly in the economic sense – the cumulative effect of eliminating millions of transactions. It's what is suddenly **NOT** going to be happening in the future that concerns markets. It is true that the government will collect tariff revenue on whatever transactions still occur and get to spend it. Whether that ends up being worth the cost of some number of transactions that no longer occur depends entirely on how much you value the political goal ostensibly achieved. But our purpose here is not to make political value judgments; nor are we interested in relaying our personal politics in these missives.

It’s also true that consumers ultimately pay all taxes regardless of whether they’re first applied to corporations or nations. While a corporation can make a tax or tariff payment and be subject to a tax policy, only human beings can ultimately suffer from scarcity and work to alleviate it and thus pay taxes; that’s because only human beings want things and suffer the burden of being sufficiently conscious to negotiate with their future selves and others (delay gratification, save, trade, etc.) in an effort to maximize their own long-term utility. This is why AI is almost, but not quite, conscious in the way we are. Rest assured, tariffs fall equally on Americans just as they do other nations because we were also benefiting economically from every exchange the higher tariffs suddenly arrested.

From a purely economic perspective where taxes are measured as the total value of economic activity eliminated (the millions upon millions of $35s that no longer occur), we submit for consideration that the tariff announcement on April 2nd was the single largest tax increase by the Federal government since at least 1968 when Lyndon Johnson applied a [10% surtax on all income] to fund the Vietnam War effort – but that tax policy was designed to last only 6 months. In dollar revenue terms, these tariffs might be the [largest US tax hike] in history. The surprising magnitude of the tax increase last week made market participants instantly believe three things: first, a US recession and global recession was much more likely than previously thought because a great many transactions would soon evaporate; second, further retaliation (trade wars) from other nations was more likely than previously feared; and third, that at least some countries (China) would choose to immediately retaliate rather than negotiate – which was contrary to what market participants had previously believed was most likely. China’s reaction on Friday morning confirmed issues 2 and 3 and prompted a broader and deeper sell-off in stocks. Basically, the market realized just how many voluntary transactions were about to stop occurring, did some quick math on how that would translate to a very large decline in corporate profits, and immediately fell 10 percent.

A stock’s value is the sum of all its future expected profits valued as of today -- the collective sum of millions of little profits on millions of transactions expected in the future from whatever each company builds or does. Companies can’t make profits on exchanges that don’t occur. Furthermore, profits decline even faster than transactions at the margin because of economies of scale, financial leverage, and operational leverage. That’s what happened on Thursday and Friday. Stocks traded at substantially lower prices instantly as market participants realized there would less voluntarily exchanges and less profits than anticipated. The more a stock’s profits relied on voluntary exchanges with laborers in other countries, the harder they were hit. That’s one of the reasons the Mag 7 in particular was at risk and why we and Morgan Stanley have been recommending diversification away from those stocks.

If you take the time to read this letter each month, you already know that our team, while surprised along with everyone else by the magnitude of the tariff announcement, had decided to take the Trump administration’s tariff plans literally rather than as simply bluster or a negotiation tactic. We were worried about tariffs. Furthermore, we had correctly guessed the directional response of both stock and bond markets – the mistake made by many others was to think that interest rates would rise immediately because of tariff-related inflation fears (inflation is another word that can mean vastly different things at times.) What we said last month with regard to tariffs remains relevant. We have not changed our minds much at all:

As it has been, our guess is tariffs (this is a great paper on the history of tariffs in the US) are here to stay. Whether we agree with the political goals of protectionist policies or not, we feel confident the Trump administration plans to use tariffs in an effort to raise revenue for the Federal government, protect US industries in the hope of spurring more domestic manufacturing, and achieve more reciprocity in trade policy. The administration ultimately hopes to create higher-paying jobs for Americans with these policies in an effort to offset a 65-year-long trend downward in the share of GDP accruing to wages – from about 51.6 percent in 1969 to 42.2 percent in 2024. What matters to us with regard to your portfolio: any investor hoping for a quick end to the tariff issue will likely be disappointed until at least 2028. We also expect significant volatility in the application of tariffs over the rest of 2025.

We'd also guess the growth/recessionary implications of tariffs sublimate to some degree the inflation concerns – i.e. inflation may very well continue to fall for the full year despite the tariffs as the global economy cools down and slack in the system largely offsets the direct price effects of tariffs. We worry our saying this will make someone think we are denying the inflationary effects of tariffs – which are simply tax increases – and we are not. We are not making a political statement here. All else held equal, tariffs increase prices just like any other tax on a good or service would. We do mean to say that the linear analysis offered by most pundits considers the direct price/inflation effect, but not the residual growth and monetary effects (declining equity markets also lower inflation as they stifle liquidity). With regard to portfolio construction, we must consider all the angles. In the net analysis, a slowdown in global growth as a consequence of increased protectionism and decreased government spending (DOGE) portends a decline in long term US interest rates and a difficult environment for mega-cap multinational US stocks. It that environment, it would also not shock us if international investments and bonds continue to buoy diversified portfolios despite declines in the major US market-cap weighted stock indices.

What can you simply ignore despite the talking heads discussing it?

First, we hope you will simply disregard Great Depression worries. While it is absolutely true that the Smoot-Hawley tariff bill you are hearing so much about was passed in 1930 after the market crash of 1929 and before the worst years of the great depression, it's a stretch to make it more than a contributing factor. Tariffs do reduce growth; Smoot-Hawley no doubt made the depression worse than it otherwise might have been. Tax increases during recessions are bad policy. But, in our opinion, the primary and proximate cause of the Great Depression was the sudden destruction of the money supply caused by bank failures which led to a deflationary debt spiral. There simply was not enough money in a very literal sense for everyone to pay their bills because banks are the money, they don't actually have it. When banks failed in succession, people lost their money and could not pay their debts. Then the person to whom they defaulted had to default on his or her debt, which made the next guy write down his, and so on and so forth until everyone had nothing left. Anyone with any money at all was infinitely wealthy on a relative basis by the time World War II broke out. This is why the Greatest Generation never wanted to spend any money for their whole rest of their lives. That scenario is also what almost happened during the financial crisis in 2008 when markets fell 50 percent and no security was left unscathed. While the Fed may be slow to lower rates this year now – partly because they also do not like tariffs and will want to wait to assess the fallout before acting – they are highly unlikely in our view to behave again as they did in in the 1930s. If anything, all else held equal, the Fed is now much more likely to lower interest rates than they were before, and the market is already pricing that reality in bond markets. The liquidity situation is also very different today and the banking system is much healthier than it was in the 1930s or 2007. Furthermore, we were not already in a recession on April 2nd – and they likely were when Smoot-Hawley passed.

This does not mean we think the market is going to shoot right back up like it did in April of 2020 after the covid stimulus began. More on this below. But we do feel comfortable telling you we are not concerned this the beginning of the second Great Depression – though you will certainly hear many such predictions over the next few weeks. We may very well get a recession now depending on how things shake out with trade negotiations – that's not Morgan Stanley's base case but they acknowledge it as a possibility. But we feel pretty confident Great Depression or even Great Recession is a stretch comparison considering the overall situation.

Second, we think you'd be wise to focus a lot less on the inflation talk. Yes, tariffs make prices going up in a literal sense. They are taxes just like sales taxes or VATs or corporate taxes. But this is another linguistic issue where it's difficult for us to explain what we think is going to happen without precisely explaining what we mean when we say "inflation." When we use the phrase "increase in inflation" what we mean is an acceleration of the average rate of change in the average price level over time. So, if inflation were on average 2.5 percent per year for the next decade and because of a new policy it was now going to be 3.5 percent per year for the next decade, that is an increase in "inflation." This kind of "inflation" to quote Milton Friedman is "everywhere and always a monetary event." Meaning, if the growth of the money supply exceeds the growth of real goods and services derived from voluntary exchange, prices on average will trend up. For example, during Covid everyone stopped making things (no transactions) but in concert all the Central Banks printed money and all the governments borrowed money and freely distributed it – money supply went way up. Asset production down; money quantity up. So, we confidently predicted there would be inflation – especially of asset prices.

After the Smoot-Hawley tariff was passed in 1930, you'd have been tempted to predict inflation. But it turned out the money supply shrunk even faster than the Smoot-Hawley tariffs eliminated voluntary transactions, so the economy experienced massive deflation from 1930 to 1933. For the record, we don't predict that now either.

Ultimately, it's simply not obvious right how things will play out with regard to inflation. It's true that all else held equal, voluntary transactions will decline and that's inflationary to a degree. But all else is not going to hold equal. Market declines themselves are quite disinflationary as are recessions. It's also literally true that the price of many imported goods will rise. But that's not all the goods that people buy; consumers can substitute other goods and they can simply defray purchases altogether. Both acts likely shift some of the increased costs to corporations who will be forced to lower profit margins. That's one of the reasons stocks are falling on this news.

We worry that when people hear Morgan Stanley or an economist on TV saying "inflation" they think it mean prices are going up right now. In this case, that may not occur right away. As we pointed out in our March note, oil prices fell on the original tariff news about Canada and Mexico. Almost all commodities including oil declined more than stocks last week after the Liberation Day announcement. We suspect March CPI will be flat. If we had to guess, if nothing changes in the next couple weeks to alleviate the new tariffs, the global economy may enter a recession later this year, probably pretty quickly too. Morgan Stanley has the odds at of 2025 recession at 35% now, up from 25%. Our team would place the odds higher than that.

Don't be shocked if interest rates and prices fall in the very near term as investors seek safety from the carnage by lessening spending, increasing savings, and shifting toward safety in portfolios. This does not mean you won't see interest rate volatility as other nations holdings US Treasuries (especially China) may very well sell them in response to the tariffs. The best we can say is what we have said already: immediate price increases are likely to be more muted on average than people expect because of recessionary concerns; but over time, tariffs and all other taxes are not good for "inflation" in the long run economic sense. Again, we are not weighing in on the politics of inflation. We are just making sure clients understand why bonds might do better than expected in this environment and prices at the gas pump and grocery store may not react the same way they did in 2021 and 2022. In a prolonged trade war, the inflation and stagflation concerns do get progressively worse as the tariffs escalate over time -- but the word inflation means very different things all at once.

As always, if you have any questions or concerns or need anything at all, don't hesitate to reach out to any member of our team.