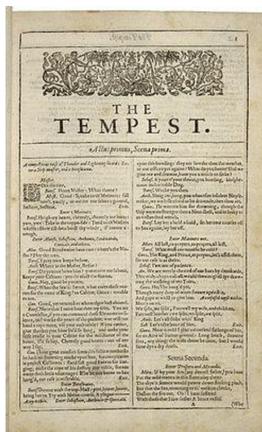
Knightsbridge
WEALTH MANAGEMENT

April 9th, 2025

Spring Quarterly Commentary


THE TEMPEST.

"The clouds methought would open and show riches
Ready to drop upon me, that when I waked,
I cried to dream again."

William Shakespeare
Playwright, poet and actor
1564-1616

Last July, our letter led with the quote, "Winter is Coming", as we warned of potential investment risk. The stock market didn't cooperate, as it rallied a further six percent over the next six months. We then wrote our most bearish letter of the past twenty-five years, urging readers to shift investment allocations to more stable assets such as private lending. Eleven days later, the S&P 500 Index peaked, dropping 18% to Monday's closing level, far below its level when we penned both aforementioned missives. As the old saying goes, "The market takes the escalator up and the elevator down."

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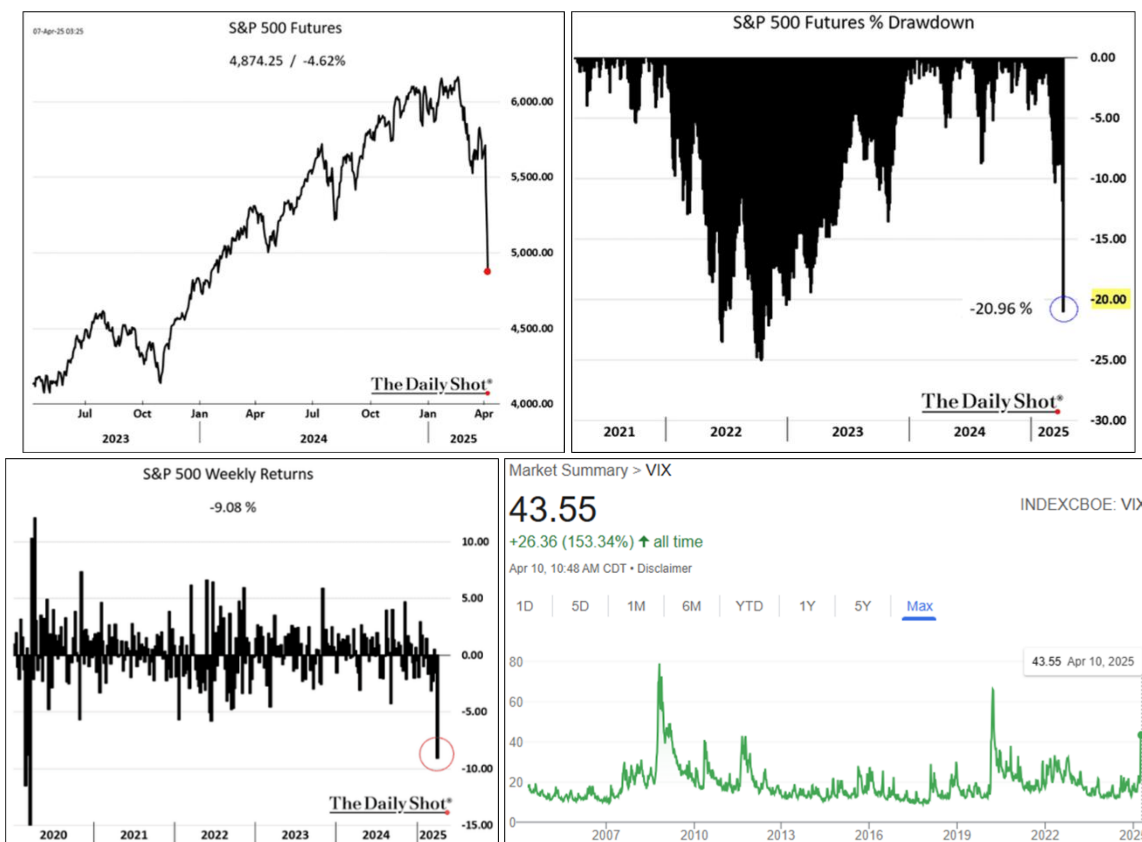
So far, the magnitude of the current decline parallels that of the slow meltdown of 2022. Its speed and ferocity, however, more closely mirror the COVID and 2008 financial crisis panic periods[1], as evidenced by the below "VIX" spike, a measure of stock market volatility as implied by the options market, sometimes called "Wall Street's Fear Gauge".



We don't have a crystal ball, and didn't predict *why* the market would drop. We did, however, early this year call out the fact that the stock market was expensive, and investors were overly optimistic, both of which made stocks vulnerable to severe declines should something go wrong. Fortunately, both of those factors have now changed for the better. The charts atop the next page reflect a market reset - radically lower investor sentiment and the typically promising investment returns following plunges in value like we just experienced. While not giving the "all-clear" signal, we have begun shifting our stance from defensive to neutral. Further drops may well prompt us to become more aggressive buyers.

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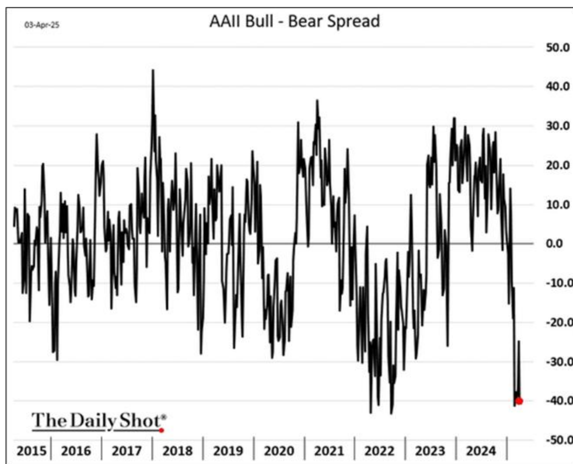
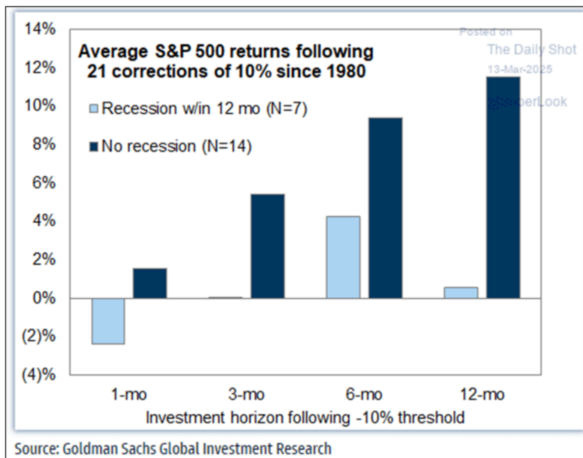
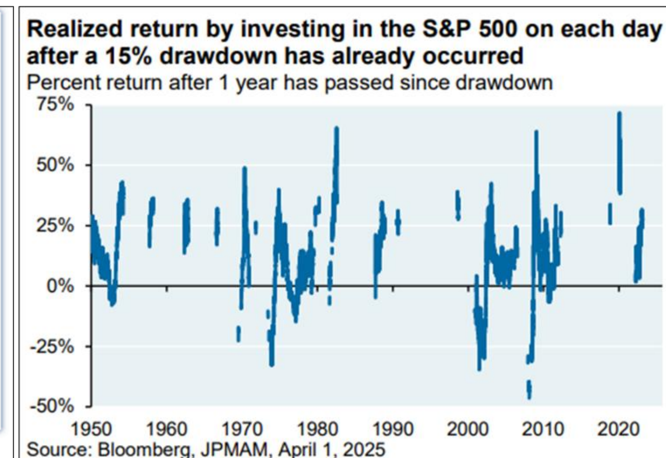
[1] As we wrap up this letter, a 90-day pause on reciprocal tariffs above 10% for most countries was just announced, driving an equally ferocious *single-day* rally of 9.5% by the S&P 500 Index. To deliver our investment reporting in a timely manner, we have chosen to leave this letter unchanged aside from a few postscripts. The thrust of this letter remains illustrative of our thinking and likely remains relevant for the situation we will apparently face in 90 days.







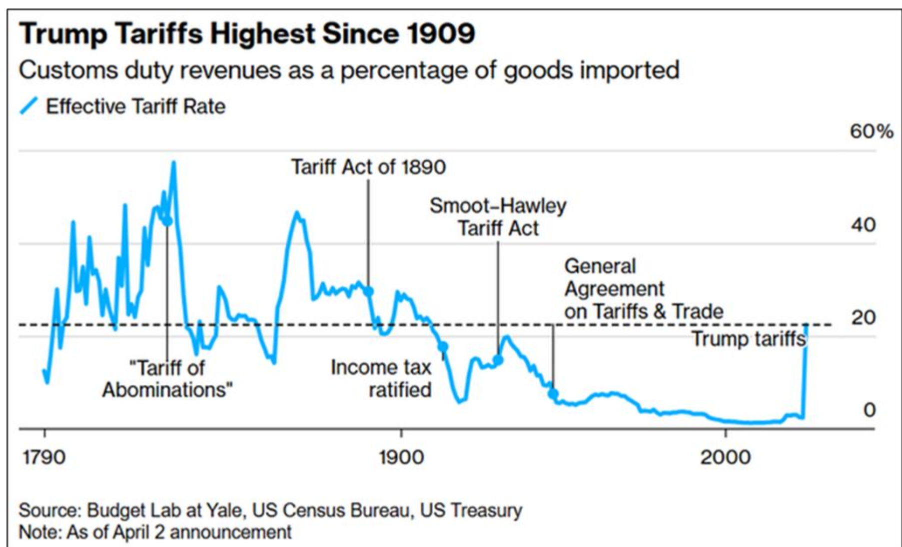
The recent market turmoil is, of course, due to Trump's larger-than-expected "Liberation Day" tariff announcements. We will do our best to leave aside any discussion of whether these tariffs are good or bad for the country, and focus instead on what has happened, how it affects markets, and what the future may hold.

Last week, the President unveiled a plan to impose an additional round of "reciprocal" tariffs on all U.S. trading partners, starting with a minimum charge of 10% and rising as high as 50%. Despite the name, these tariffs are not assigned according to proportionate tariff barriers other countries impose on us[2], but rather represent a rate equal to half of the trade imbalance in goods with that country (i.e. the European Union receives a 20% barrier because our EU trade deficit is 40% of total goods traded[3]). The 10% "baseline" tariffs went into effect Saturday and the "reciprocal" ones went into effect midnight Wednesday.

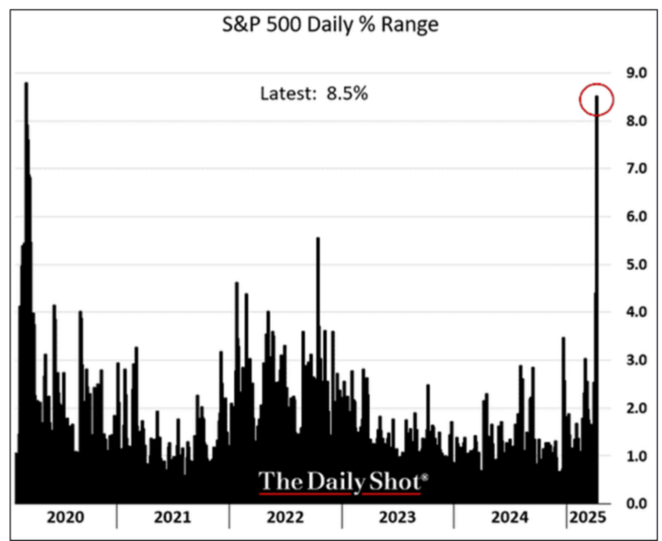
[2] The administration would argue that trade deficits are an approximate reflection of the trading restrictions other countries impose on us.

[3] Left out of the calculation is the fact that we run a services surplus with the EU. A retaliatory tax on U.S. services could be a very damaging outcome and one we are concerned about, especially for U.S. tech companies which sell their services abroad.

This rockets the U.S. effective tariff rate from what was ~3% all the way up to an estimated ~25%, substantially higher than that imposed in the 1930s[4]. However, there's more. If countries choose to retaliate, Trump has promised further tariffs in an escalation of the trade war. A primary focus is China, where Trump has doubled down and slapped additional tariffs, bringing the total rate to 125% in response to counter-tariffs imposed by them.



Trump is a famous negotiator and thus there is some question as to whether these tariffs will stick. Things are moving fast as this letter goes to print and it may be outdated by the time you read it. The administration has alternately broadcast they are not making exceptions while also saying they are ready to make deals. Just what kind of deals they might be looking to make is anyone's guess, as blanket 0% tariff proposals with both Vietnam and the EU have apparently been rejected. The market has gyrated wildly, with vast intraday swings as rumors fly and different administration officials speak. We recently witnessed four straight days where the S&P had a trading range greater than 5%, a sequence only seen in the years 1987, 2008, and 2020.

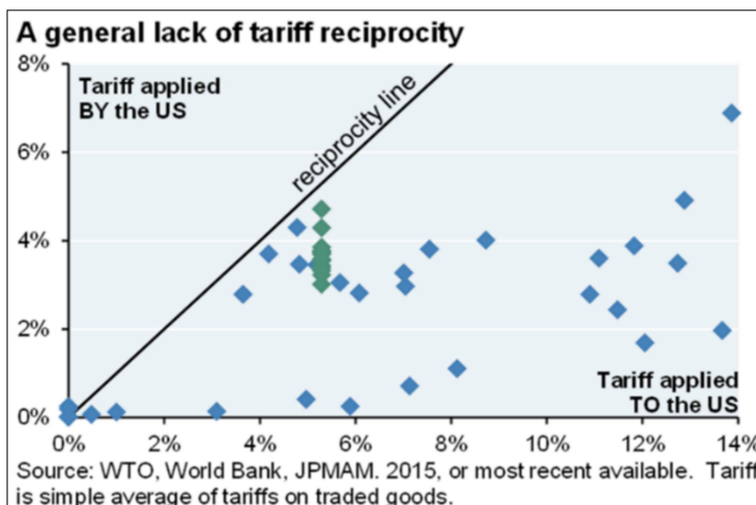


While the power to implement these "emergency" tariffs rests on somewhat shaky legal ground, courts are unlikely to take the extreme step of

[4] Postscript: even after the Thursday afternoon reprieve, the effective tariff rate will still be much higher than at any time in the last 100 years. All countries will be subject to 10% tariffs and China, one of our largest trading partners, will be subject to 125% tariffs.

issuing injunctions to stop them any time soon. Any opposition in Congress will likewise probably go nowhere. Even with scattered Republican defections, it is unlikely there would be enough votes for the two thirds majority needed to override an expected Trump veto. For now, any changes are up to the Executive alone. Our view is that one month from now and six months from now, there absolutely will be a new (higher) tariff regime in place. The President would lose too much credibility to completely back down. We do, however, expect substantial revisions and exceptions, and a final level substantially lower than what has been proposed.

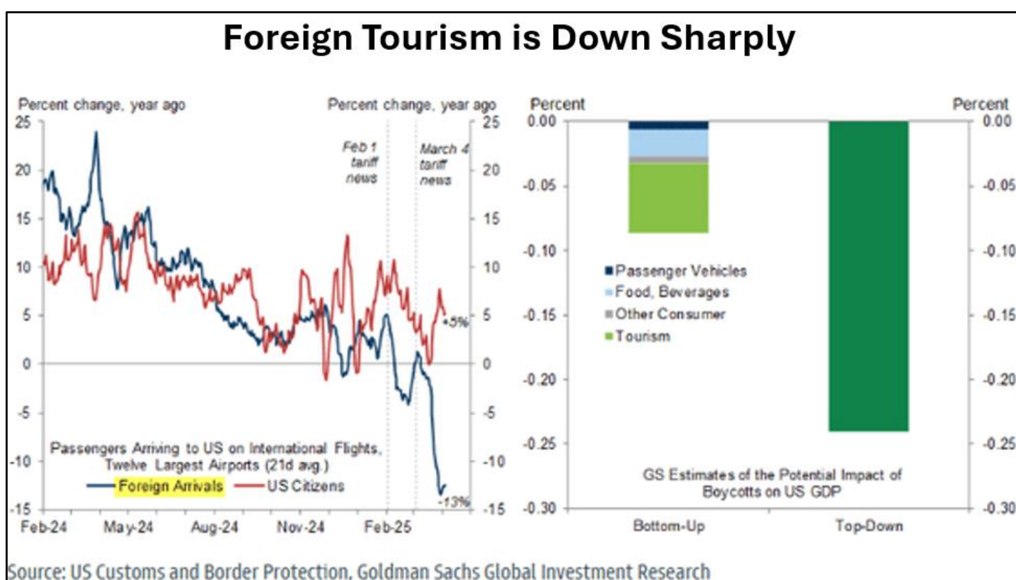
There are two theories as to what Trump's ultimate goal is. The first is that he truly believes trade deficits are unfair, a threat to the country, and that serious measures need to be taken, whatever the consequences, to rebalance trade and bring manufacturing back home. The chart to the right demonstrates his point that other countries have imposed higher tariffs on the U.S. than the U.S. has on them.



Source: WTO, World Bank, JPMAM. 2015, or most recent available. Tariff is simple average of tariffs on traded goods.

The second view is that Trump needs to apply the threat of tariffs to bring other countries to the table to make deals to lower their respective trade barriers and make other concessions. We believe that when the dust is settled, we will have a new tariff regime but, as deals are made, barriers to trade won't be as high as initially advertised.

At the risk of stating the obvious, implementation of these tariffs will be incredibly disruptive to the global economy, corporate profits, and asset prices. Some manufacturers may well be celebrating but others, reliant on imported parts, are idling plants and cutting back overtime while they evaluate the situation. There will be other unintended effects. Foreign tourism, for example, has already declined precipitously, as shown below.



Though the stock market has retreated, we believe it is behaving as if the tariffs will not, in fact, be implemented as advertised (at least not for long). The economic results will continue to play out over the coming weeks and months, as the ultimate policy direction becomes clearer. The standard rule of thumb on tariffs is that for every 1% increase in the tariff rate, GDP growth and inflation both move 0.1% in the wrong directions. This relationship suggests the new tariffs could have a two percent impact on each measure. Substantial, but not the end of the world.

Importantly, the inflation hit is supposed to be one time in nature, not recurring. If this is true, the Federal Reserve will not be inclined to raise rates to head off a transitory inflation bump. Financial markets appear to agree with this prognosis. Bond markets are currently pricing in rate cuts in May or June to boost growth and normalize policy, which is still restrictive (i.e. the Fed's short-term rates are still on the high side and slowing the economy, so they will be lowered).

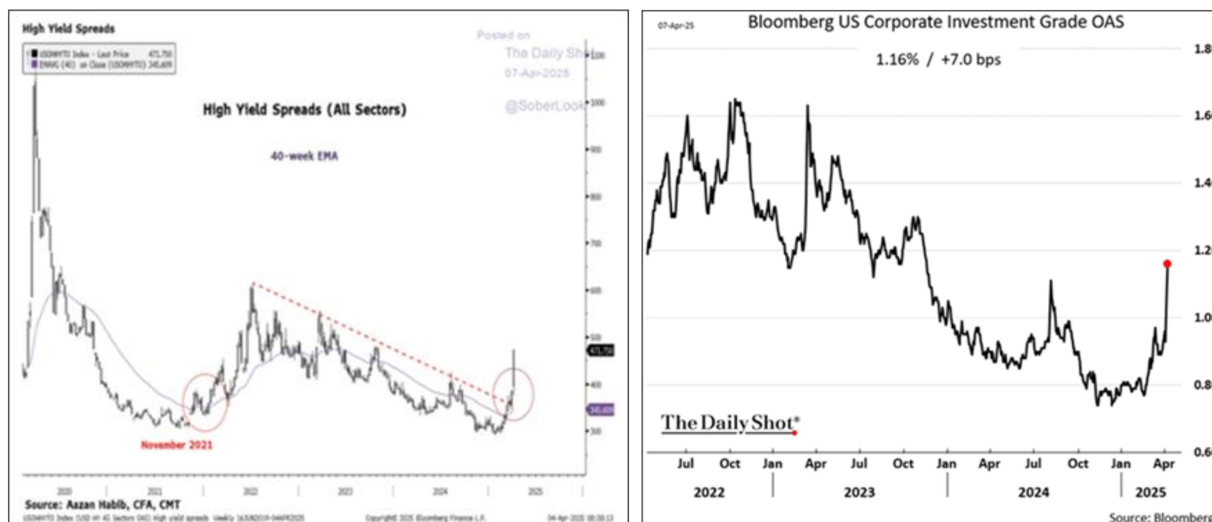
The bigger fear is not inflation, but growth. With tariff levels potentially so high, and on all trading partners, the result could be worse than the rule of thumb would indicate. Wall Street banks are actively increasing their forecasted recession probabilities.

What we have for certain is a lot of uncertainty, which is bad for business. Even before "Liberation Day", professionals like us were having a hard time keeping track of all the tariffs that have been implemented or repealed. When businesses are faced with uncertainty, they tend to hold off on investment plans. This lack of business investment is part of what traditionally causes recessions.

Due to all the uncertainty already endured, even if all the tariffs are called off, there is no scenario where this doesn't hurt corporate earnings. If tariffs do stick, companies that cannot pass price increases along to their customers will take a hit to their margins and/or

revenues. We will learn more about this next week when companies start reporting earnings and potentially pulling or lowering their guidance. Wall Street analysts will then get busy lowering their own earnings targets. Beware of demonstrations on how "cheap" the market is based on forward earnings estimates... before those estimates are updated.

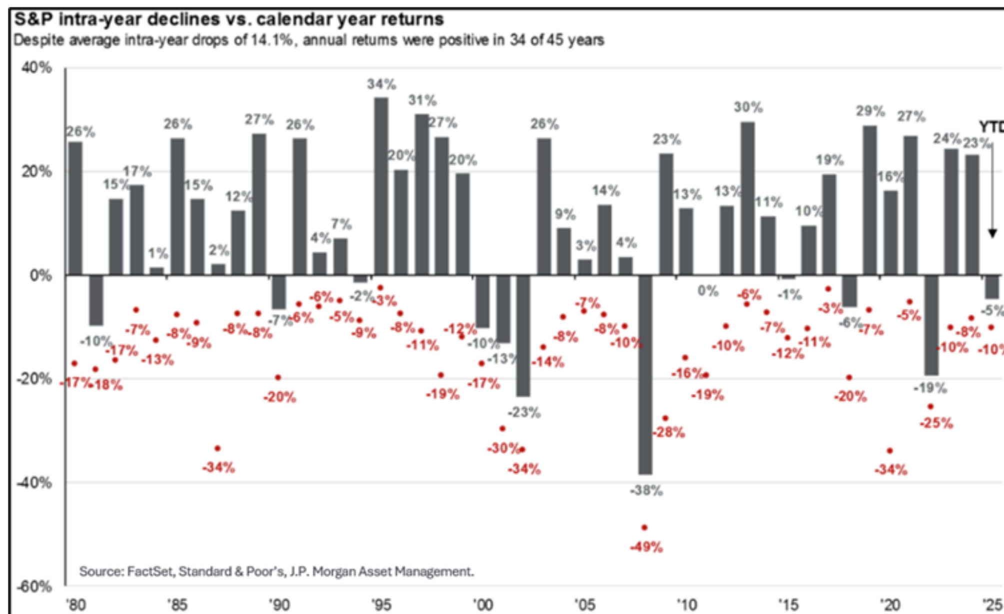
Budding economic concerns are already visible in corporate credit spreads (how much more companies must pay to borrow money over and above what it costs the government). The higher spreads go, the greater the concern.



Perhaps the most concerning market reaction to the tariff announcements are the rising long-term U.S. Treasury yields. Usually in times of turmoil, investors flock to the safety of U.S. Treasury bonds, sending their yields down. Right now, yields are *rising*, indicating Treasury selling[5]. In times of trouble, people generally run towards safety. This time, you see people running *away* from traditional sources of safety, which is concerning.

We wonder if this could be the first sign of financial markets' discontent with U.S. financial policy. James Carville once commented that he wanted to come back as the bond market, because it scares everyone. Us too.

[5] Unexpectedly rising borrowing costs are a classic recessionary ingredient.



With markets swinging violently day-to-day, it's natural for the mind to drift toward contemplation of doomsday scenarios. Yet, we are contrarians by nature and note that the long-term Treasury rate increase has been modest thus far. Further, market pullbacks are normal, routine, and healthy. The S&P 500 Index is *already* down close to 20%. 30% declines, much less 40% declines, are exceedingly rare. When they do happen, they are the result of large, world-changing events like COVID or the Global Financial Crisis. Unlike those previous economic catastrophes, the current situation is fully reversible with the stroke of a pen.

Moreover, because of the market moves, we are seeing companies that we've been wanting to own finally become cheap enough for consideration. Even if the policy changes and economic repercussions are in the early innings, the equity price drops we've already seen have set the table for more attractive returns in the long run going forward.

We appreciate the trust you place in us.

Sincerely,

John G. Prichard   Kurt Beimfohr   Miles E. Yourman

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