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The following contains a brief discussion of the equity markets from Senior Quantitative Analyst, Charles Clavel, CFA.

Tariffs Shall Set Us Free

When the latest wave of globalization emerged in the early 1980s, economists and policy makers theorized that it would free us from low pay, tedious jobs – in their minds, jobs in factories— so that we could focus on more advanced, high-skilled tasks. In other words, we'll make airplanes, they'll make tee shirts. **This naïve view of globalization was supported by a shallow understanding of the theory of comparative advantages,** whereby the West would maintain a stronghold on intellectual property while the countries of outsourcing would benefit from their cheap labor. Unfortunately, as is often the case, reality has deviated substantially from the predictions of economic theory. Many of those countries– chief among them China – were able to move up the value chain through long term strategic planning, government subsidies, barriers to entry for foreign products (like tariffs or intricate norms), sharing of intellectual property as a condition for foreign investments etc….to the point when they can now compete against the US and Europe on advanced goods and services like EVs or telecom equipment.

A more predictable consequence of globalization has been the destruction of many manufacturing jobs in developed countries. In the US, manufacturing employment declined from 19.6 million in June 1979 to 12.8 million in February 2025. These jobs were not replaced in similar numbers with positions in advanced occupations. Western societies responded by creating many service and administrative jobs – which anthropologist David Graeber referred to as "bull**** jobs"– of questionable economic value. The extent of the phenomenon was incidentally revealed when Elon Musk took over Twitter and let go of 80% of the workforce without any significant service disruption - some would even argue that it is even better/faster than before. In addition, **Western governments started incurring substantial deficits to provide benefits and job programs that could help offset the negative impact of globalization, which over time led to the large debt and deficits we now have.**

Thomas Jefferson famously warned his contemporaries about the dangers of excessive debt (see https://www.forbes.com/quotes/9232/) but those have been largely ignored by successive administrations, which kept adding on to the debt pile. Excessive debt not only makes us dependent on our creditors and shackles our policymaking, but it also makes the country vulnerable to a rise in interest rates, for example one that is caused by a resurgence of inflation as is the case currently. **When Trump talks about liberation day, this is the real burden his administration is trying to free the country from**, by reducing the amount of government debt and rebalancing the US economy towards more manufacturing.

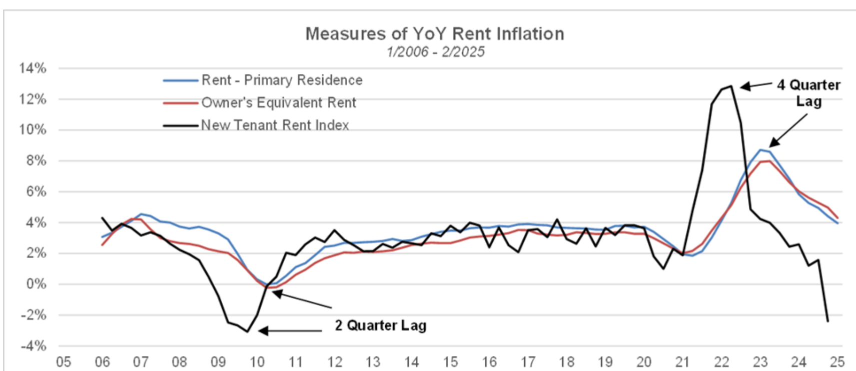
Trump's plan to revitalize US manufacturing relies on tariffs (or the threat thereof), which would make imported products less competitive and incentivize manufacturers to produce domestically rather than rely on imports. On liberation day, he proclaimed reciprocal tariffs that are meant to penalize the countries that apply much higher tariffs and trade barriers to American products and services than the US applies to theirs. **In addition to the tariff rates being well above expectations, Wall Street seems to have mis-understood what Trump meant by reciprocity**. What intuitively seems fair is that for a given product or service, tariff rates applied by countries should be similar. For example, one can argue for raising tariffs on European cars, since the EU charges much higher tariffs on American cars than the US charges on theirs. However, the formula for the reciprocal tariffs, which are based on the size of the overall trade deficit with a given country, is rather puzzling and may suggest that the administration's tariff strategy has not been carefully thought out.

So far, the market's very negative reaction lends credence to this interpretation and reveals some similarities with the aftermath of Lehman Brothers' collapse. Part of the motivation for letting the bank fail was to put an end to the bailout culture that had been developing over the prior 20 years. However, **drastic decisions can have powerful adverse unintended consequences on complex systems**. The near seizure of the global financial system that followed Lehman's failure led the Treasury and the Fed to implement extraordinary measures which ended up strengthening the bailout culture considerably (as we saw with the rescue of Silicon Valley Bank in 2023). Similarly, **the global economy is another complex system, and the reciprocal tariffs could have serious unintended adverse consequences, as market action over the past few days seems to suggest.** There is a non-trivial chance that the economic effects of Trump's tariffs are so negative that a broad bi-partisan consensus against those tariffs forces Trump to reverse course.

However, there may be more method to the madness than it appears. **Trump's approach to negotiation typically involves hardball tactics that are meant to obtain quick concessions** or even capitulation from his opponents. The just announced 90-day pause on reciprocal tariffs for most countries lends credence to this interpretation. So far, China seems to have chosen confrontation, but the EU and other Asian countries like Vietnam seem to have a more measured reaction so far. In addition, as Scott Bessent said, **those reciprocal tariffs represent the worst-case scenario (provided countries don't retaliate), which reduces market uncertainty to a meaningful extent** since investors can now price in a floor for companies' future earnings.

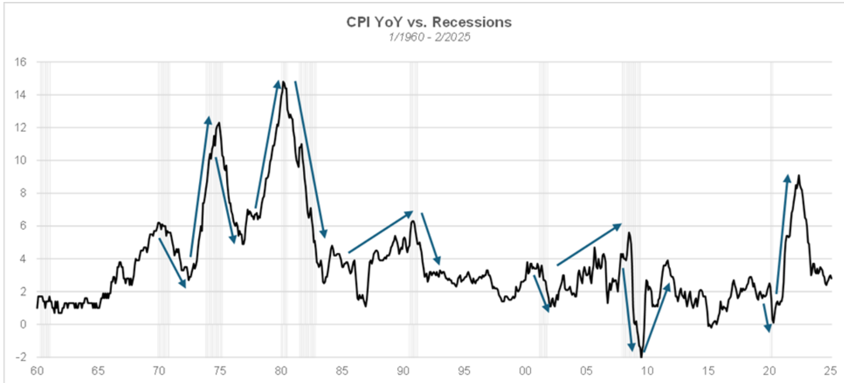
While the tariff strategy may be beneficial in the long term, the current macro-economic backdrop is not conducive to its implementation. While inflation has declined materially from its peak in the summer of 2022, it remains well above the Fed's target. Real time measures of inflation do suggest that inflation is rapidly declining - for example, Truflation pegs the YoY inflation rate at 1.35% as of April 4th https://truflation.com/marketplace/us-inflation-rate. However, **consumers still perceive inflation as sticky, and the inflation data from the Bureau of Labor Statistics seems to provide confirmation**. Though misguided those expectations may be, they are a key driver of future inflation. The fact that inflation has become a politicized topic – with Democrats expecting inflation to get out of control and Republicans expecting near deflation – has made it more difficult for policy makers to gauge consumer expectations. However, University of Michigan data show that inflation expectations over the next 12 months among independent voters (i.e. the least politically biased) is above 4%. **Official CPI numbers' stickiness is primarily due to the shelter component, and especially owner's equivalent rent**, which is not a price measure, but is based on a survey of how much homeowners would expect to get if they were to rent their dwelling. As shown below, it is slow moving and it significantly lags the Cleveland Fed's new tenant rent index, which declined by 2.4% YoY in Q4 2024. The lag between the peaks in new tenant rent inflation and CPI rent inflation is 4 quarters, twice the amount of time between the two troughs in the depth of the financial crisis. The substantial lag could be explained by tenants signing longer leases in exchange for modest cuts in rent, which would increase the time it takes for rental rate declines to filter through the overall measure of rent inflation. In addition, the increased implementation of return to the office policies is causing geographic disparities in terms of rent inflation, which muddy the overall picture. As a result of those policies, large population centers that were deserted during COVID are seeing rent increases - Manhattan apartment rents just reached new highs - while the areas where people fled to during the pandemic are now experiencing rent deflation.

In a context when both inflation expectations and official CPI numbers remain significantly above the Fed's target, further price increases may create popular discontent, especially since inflation was a key topic in the last presidential election. The tariff rates, if implemented, would likely cause some price increases, at least in the near to medium term, since it would take time for companies to shift their supply chains towards domestic production. Some companies with high profit margins may be able to absorb most of the tariffs, but many won't be able to. For example, it is hard to imagine that car producers can absorb a 25% tariff.



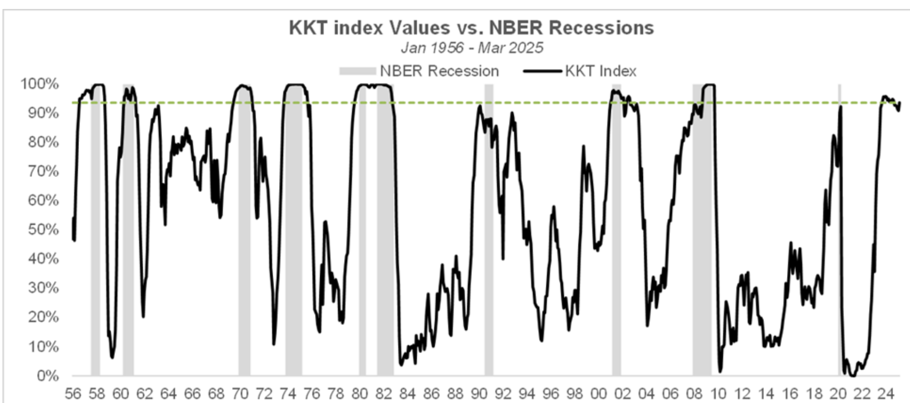
Source: Bureau of Labor Statistics, SIMG Analysis

Some market commentators have theorized that the Trump administration may try to engineer a recession to bring inflation and long-term interest rates lower. However, the economy is not like a light bulb that one can switch on or off. The administration could enact policies that push the economy into a recession, but it has no control over how long or intense that recession may be. In addition, while historically, recessions have led to significant drops in inflation, the subsequent recovery has brought the inflation rate back up.



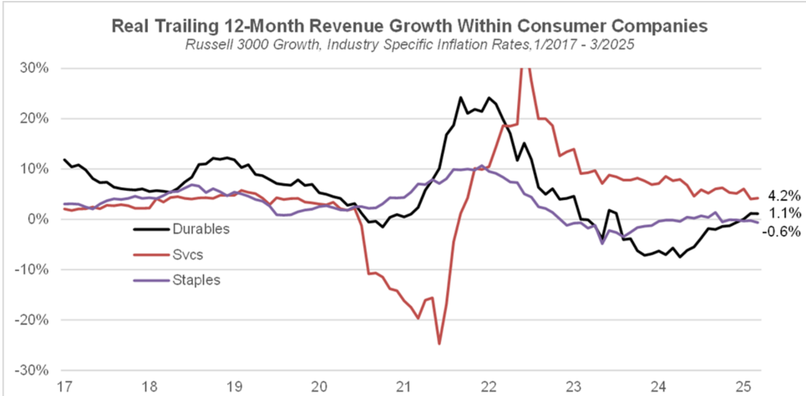
Source: Bureau of Labor Statistics, SIMG Analysis

Price increases resulting from tariffs could further dampen consumer sentiment and negatively impact the economy. After a post-election rise in optimism and a surge in economic activity in anticipation of tariffs, consumer sentiment has returned to lackluster levels. **The low savings rate, the rise in delinquencies, along with the end of government stimulus suggest that US consumers' buying power has been substantially reduced** vs. the past couple of years. **The KKT index, which has been on a declining trend over the past 6 months, has spiked to 93.7% at the end of March**, because of the recent market decline and of the drop in long-term Treasury yields. **The model suggests that current economic conditions are much more consistent with a recession than with a period of robust growth**, so its indication is now in line with the prevailing economic consensus. The three main engines that have sustained economic growth over the past two years are now being turned off. First, not only is there no new government stimulus package on the horizon, but some meaningful cuts could occur if DOGE's recommendations get implemented. Second, the wealth effect from rising asset prices, which has fueled robust spending by top income earners and asset owners (recent analysis from Moody's shows that the top 10% wealthiest Americans account for about half of total consumer spending) is now reversing as markets decline, which could have a detrimental impact on consumption in the months ahead. Finally, the release of DeepSeek's latest AI models has shown that AI providers could make a more efficient use of their existing compute power, which may curb enthusiasm for future spending on AI infrastructure.



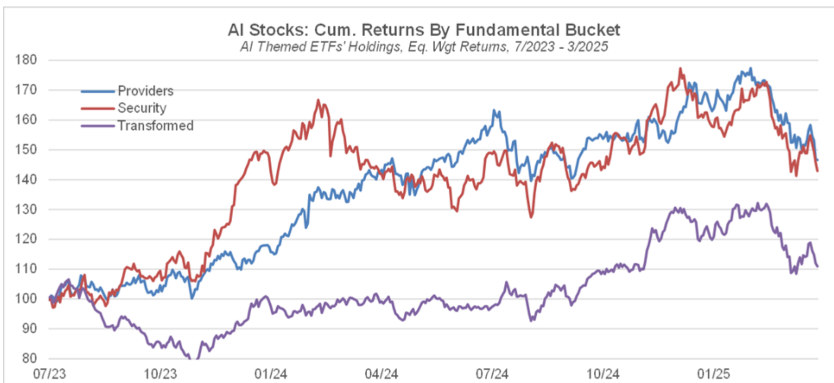
Source: St Louis Fed's ALFRED database, Robert Shiller's data (http://www.econ.yale.edu/~shiller/data.htm), Bloomberg, SIMG Analysis. The methodology behind the KKT model is explained in the research paper below: A NEW INDEX OF THE BUSINESS CYCLE by William Kinlaw, Mark Kritzman, and David Turkington

A substantial deceleration in real (adjusted for inflation) consumer spending has been evident since 2022 in the aggregate revenue numbers reported by consumer-oriented companies, suggesting that the US economy has been slowing for quite a while. The chart below shows the median real YoY sales growth rate for consumer durables, services and staples companies in the Russell 3000® Growth, where nominal revenue growth is adjusted using an industry specific inflation rate. Spending on durables has been in recession territory since 2023 and has barely rebounded since then. Consumer services have fared much better, first because of revenge spending following months of COVID lockdowns, but also thanks to the newer generations' (Millennials and Gen Z) preference for spending on experiences. However, even spending on services has slowed markedly over the past 3 years. Such weakness in consumer spending suggests that it wouldn't take much of a negative shock to push consumer spending into recession territory.



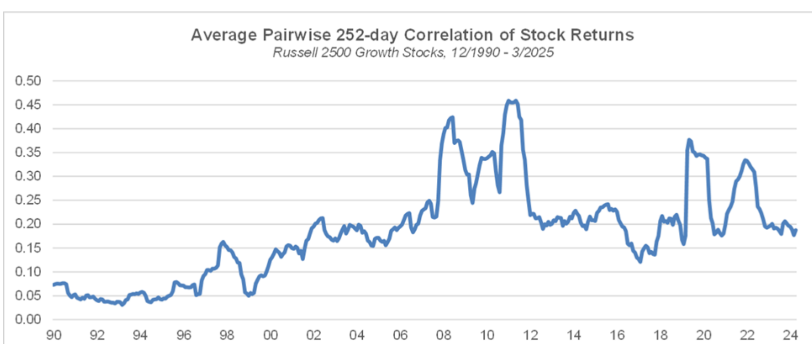
Source: Bureau of Labor Statistics, FactSet, SIMG Analysis

Sentiment on AI stocks seems to have soured following the release of DeepSeek's model in late January. While AI is not a recognized sector of the market, one can identify AI stocks by looking at the membership of AI themed ETFs. The chart below shows the cumulative equally weighted returns since July 2023 of three subsets of AI stocks: the major AI providers (Microsoft, Google and Meta), AI security companies (that are members of both an AI and a cybersecurity themed ETF), and companies that are not involved in building AI but are likely to be transformed by it (such companies are identified as members of AI themed ETFs that are outside the tech sector). **All three subsets have declined markedly since mid-February. So far, companies that are supposed to be transformed by AI have materially lagged the rest of the pack**, as investor attention has concentrated on the companies building the AI platforms and infrastructure, but this may change as/if capex spending on AI slows down.



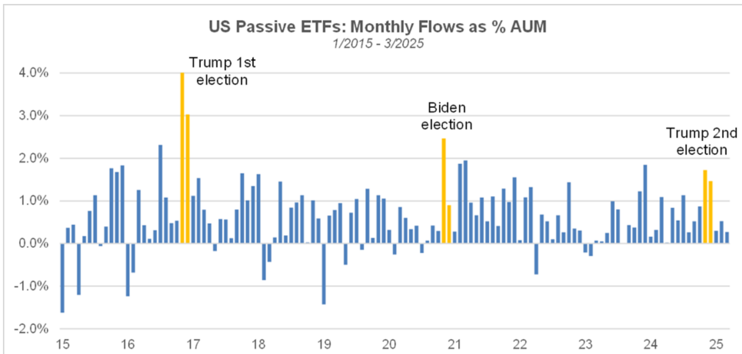
Source: FactSet, SIMG Analysis

Our long-term measure of investor sentiment, the average pairwise correlation of stock returns, has ticked up at the end of March, but is far from levels that would indicate significant risk aversion. We will have to see whether the sharp downturn that has been developing in the past week leads to a substantial shift in sentiment.



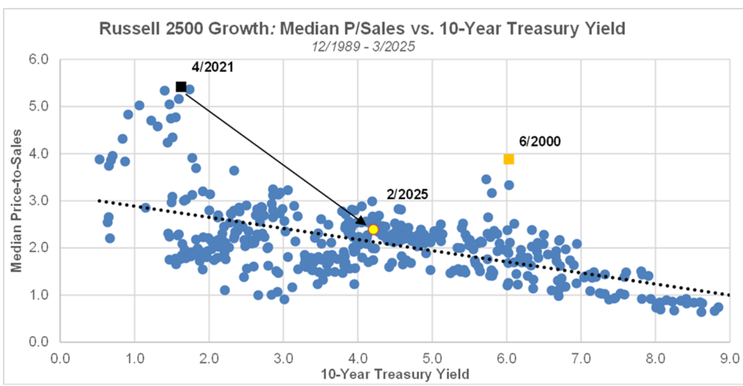
Source: FactSet, SIMG Analysis

The strong market returns observed in 2023 and 2024 seem to be at odds with the rather moderate economic growth rates observed during those years, suggesting that factors unrelated to the economy, and more specifically liquidity flows may be impactful drivers of market returns. As mentioned in prior notes, three sources of inflows may have contributed to the US equity market's strong recent performance: share repurchases, capital flows from foreign investors (who have seen the US as the most attractive geography to invest in) and flows into passive ETFs. The tariffs' impact on the US economy and corporate earnings may lead corporations to scale down their buyback programs and may alter foreign investors' views of the US as an investment destination. However, **US passive ETFs have continued to experience inflows so far this year, even though the pace of those flows has slowed down since the election. Like in 2022, passive inflows, if they are sustained, may help cushion the developing bear market.**



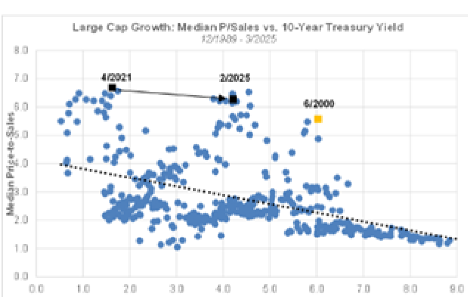
Source: FactSet, SIMG Analysis

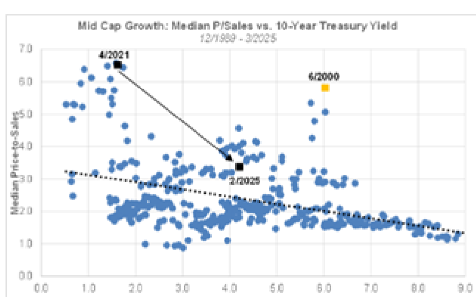
The market decline in March has brought the median price-to-sales multiple of small & mid cap growth stocks to a level that is consistent with the 10-year Treasury yield, suggesting that **SMID growth stocks are now fairly valued.**

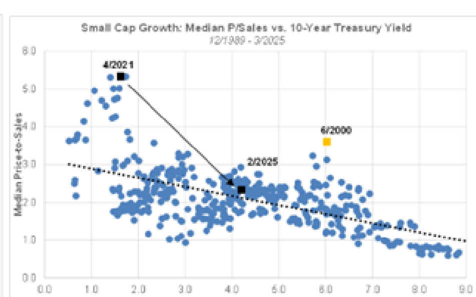


Source: FactSet, SIMG Analysis

The charts below split the Russell 3000® Growth constituents into three market cap cohorts: small caps (members of the Russell 2000® Growth), mid-caps (members of the Russell Midcap® Growth) and large caps (members of the top 200 that are in the Growth universe). Given the current long-term rate, small cap growth stocks appear to be fairly valued, mid cap growth stocks seem mildly over-valued while large cap growth stocks are still clearly overvalued despite March's market decline.







Source: FactSet, SIMG Analysis

Within the factor space, top ranked stocks in terms of forward P/E, price-to-sales, FCF yield, and ROE have out-performed so far this year, consistent with **an investor tilt towards high profitability companies with robust cash flow generation and reasonable valuations. By contrast, stocks with high revenue growth expectations have continued to under-perform materially in March**. High momentum stocks have also under-performed for the second month in a row.

Alpha Factor Performance, Top Quintile vs Market
Russell 3000 Growth Universe, Through 3/31/2025

	Fwd P/E	Price/Sales	FCF Yield	ROE	Gross Profit	Total Yield	Sales Growth (T12M)	Sales Growth (FY2/FY1)	12-M Price Mom.	1-M. Mom. Reversal	Earnings Revisions
Jan 2025	0.7%	1.4%	0.7%	0.1%	1.8%	(0.6%)	2.2%	(1.3%)	1.0%	0.1%	(0.3%)
Feb 2025	0.7%	2.0%	2.0%	2.7%	1.6%	1.2%	(1.1%)	(4.0%)	(1.5%)	0.4%	0.9%
Mar 2025	2.3%	(0.3%)	1.6%	2.0%	0.6%	2.4%	(0.1%)	(2.7%)	(0.5%)	(4.2%)	(0.4%)
2025	3.7%	3.0%	4.3%	4.9%	4.1%	3.1%	1.0%	(8.1%)	(1.0%)	(3.8%)	0.2%

Source: FactSet, SIMG Analysis

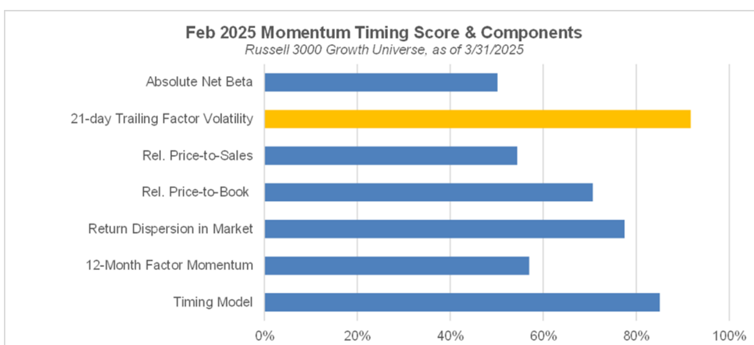
Regarding styles, **the best performing cohorts year-to-date continue to be large caps, low volatility and high-quality stocks, consistent with stock pickers positioning their portfolios towards an economic slowdown/ recession**. By contrast, small caps, high volatility, and junk stocks have underperformed materially. **Interestingly, stocks with high passive ownership have been able to hold their own while those with low passive ownership have materially underperformed**, consistent with the idea mentioned above that stocks that benefit from passive inflows are better able to weather macro-economic uncertainty.

Style Performance, Top or Bottom Quintile vs Market
Russell 3000 Growth Universe, Through 3/31/2025

	High Volatility	Low Volatility	Most Shorted	Least Shorted	Large Caps	Small Caps	Quality	Junk	High Rate Sensitivity	Low Rate Sensitivity	High Passive Ownership	Low Passive Ownership
Jan 2025	(2.6%)	(0.2%)	0.1%	(0.6%)	3.1%	(3.0%)	0.3%	(2.4%)	0.3%	0.6%	(0.1%)	(1.7%)
Feb 2025	(3.5%)	5.0%	(3.8%)	4.7%	2.6%	0.8%	4.3%	(2.6%)	0.3%	1.2%	(0.8%)	(1.8%)
Mar 2025	(5.8%)	4.7%	(1.9%)	2.1%	1.9%	(4.4%)	4.3%	(5.0%)	(1.5%)	2.8%	2.4%	(2.3%)
2025	(11.9%)	9.5%	(5.6%)	6.2%	7.7%	(6.6%)	8.8%	(10.1%)	(0.9%)	4.5%	1.5%	(5.8%)

Source: FactSet, SIMG Analysis

At the end of February, our momentum timing model indicated that high momentum stocks were at risk of under-performing in March, which they did. The model continues to indicate a high risk of under-performance for those stocks in April. Note that the timing model's indication for April is primarily driven by the high recent volatility of the momentum factor, with the other 5 variables having more moderate values. This observation suggests that the model's negative indication is less robust than in the prior 3 months, when at least 2 of the individual variables were beyond the 80th percentile.



Source: FactSet, SIMG Analysis

The table below shows the average relative 1-, 3- and 12-month performance of industries following a month-over-month transition to a different tertile or the observation that it remains in the same tertile. **Industries that maintain themselves in the top tertile or transition from tertile 2 to tertile 1 from one month to the next tend to perform best**. Industries that transition from tertile 3 to tertile 1 also tend to outperform in subsequent months. Within consumer discretionary, retail and durables have both transitioned from T3 to T1, in 12/2024 for the former and in 2/2025 for the latter. The model scores of industry groups within consumer discretionary have improved notably in recent months.

Average Relative Returns Post Industry Tertile Transition

Russell 3000 Growth Stocks, 1/2000 - 3/2025

1-Month Horizon

Previous Month Tertile	Current Month Tertile T1	T2	T3
T1	0.36%	0.24%	(0.74%)
T2	0.26%	(0.06%)	0.14%
T3	0.15%	(0.24%)	(0.35%)

3-Month Horizon

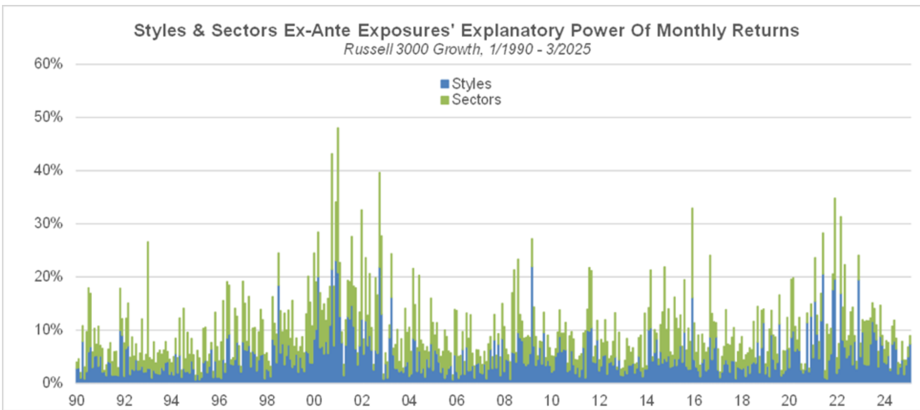
Previous Month Tertile	Current Month Tertile T1	T2	T3
T1	0.97%	0.47%	(0.95%)
T2	0.78%	(0.28%)	(0.15%)
T3	0.43%	0.00%	(0.92%)

12-Month Horizon

Previous Month Tertile	Current Month Tertile T1	T2	T3
T1	1.22%	(0.26%)	(1.36%)
T2	1.53%	0.58%	(0.31%)
T3	0.51%	1.07%	(1.90%)

Source: FactSet, SIMG Analysis

The percentage of cross-sectional monthly return dispersion (within Russell 3000® Growth stocks) that is explained by exposures to styles and sectors has risen in March but remains near the historical median. This percentage tends to spike during periods of macroeconomic stress or high market volatility and tends to be low when investors are in risk seeking mode.



Source: FactSet, SIMG Analysis