Caron's Corner Transcript – 3.31.2025

We Are Past Peak Tariff Uncertainty, not Volatility

- We believe that the **uncertainty surrounding tariffs has peaked**.
- The market now understands that it is not just a bargaining chip for coercive foreign policy, but instead a realignment of trade and economic policies.
- The President and U.S. Treasury Secretary let market prices adjust to a new reality that **tariff policy is more ideology than a bargaining chip.**
- This awakening led to a 10% drawdown in the S&P 500 peak to trough.
- While peak tariff uncertainty is now likely behind us, this does not mean that markets will not be volatile. **<u>There is a different between uncertainty and volatility</u>,** lest anyone conflate the two.

Jim Caron: Hello, this is Jim Caron, CIO of the Portfolio Solutions Group. Welcome to another edition of Caron's Corner powered by The BEAT. The BEAT stands for Bonds, Equities, Alternative and short-term Transitional investments, and is our asset allocation framework.

Today we're going to talk about peak tariff uncertainty, and I believe that we are past peak tariff uncertainty, but not volatility. We believe that the uncertainty surrounding tariffs has peaked in that the market now understands that it is not just a bargaining chip for coercive foreign policy, but instead a realignment of trade and economic policies. April 2nd is well advertised to be the date when a lot gets revealed. Now, this was misunderstood in the first half of the first quarter, but it's been better understood since then. President Trump and U.S. Treasury Secretary Bessent were willing to let markets market prices adjust to the new reality that tariff policy is more than just ideology, it's actually what they're trying to do for the longer term. It's not just a bargaining chip. This awakening led to a 10% drawdown in the S&P 500 peak to trough. Uncertainty became evaluated, in other words. Now that peak tariff uncertainty is likely behind us, it does not mean that markets will not be volatile. There is a difference between uncertainty and volatility, lest anyone conflate the two. So let's get into it.

Uncertainty versus volatility, what's the difference? Well, simply put, mathematically speaking, uncertainty cannot be priced, but volatility can. If we think of volatility as the shape of a normal distribution of outcomes, then we can assess the probability of ranges that come with it. Which then get translated into asset prices and expectations. Conversely, uncertainty is a flat horizontal line, which means any outcome is equally probable. This cannot be priced efficiently. Now clearly I'm taking the contrast to the limit, but it makes the point. It also represents a difference in the market's reaction function. It's no wonder when in early March the market entered into a period of uncertainty over tariffs that it had its 10% drawdown. It's also no wonder that it happened so fast, with a 10% drop in just 22 days - the sixth fastest correction in 75 years. This is what happens when the market enters into a period of uncertainty. The good news is that peak uncertainty is now likely behind us.

Let's move on to volatility, which will likely still be with us for awhile. Markets will now learn what tariffs may look like, the response from other countries and which sectors may get impacted more and those

that may be less impacted. From here, one can start to make a probability assessment and establish a range of outcomes for prices within a degree of confidence. The market will take that price adjustment and then hand the baton back to economic fundamentals such as GDP growth, inflation, labor markets, etc. In other words, back to business as usual.

Now let's talk about our portfolio positioning. As we like to say, diversification is our first line of defense, but of course there are nuances to be discussed. We like bonds - high quality, but with a shorter duration. We also think that the curve is likely to steepen, and we do not find longer-duration exposures as attractive. We have reduced from an overweight, higher yielding, lower credit quality position to more neutral to slightly underweight because we think that the outcomes are asymmetric, meaning that spreads may have more room to widen than narrow. In equities, we were positioned at the start of the year with an overweight in materials partly because a large component of that is metals, which offers a hedge under higher tariff risk scenarios, and partly because we thought valuations were attractive. We still like the more domestic-heavy mid-cap sectors because deregulation policies may benefit them most, plus it has less trade related exposures. Regionally we moved to an overweight in Europe in early February as signs for European policy turned more pro-growth. Reindustrialization policies emerged and fiscal stimulus came with that.

If there's a silver lining to the confusion around tariff policies today, it is that we're moving away from the difficult-to-price period of peak uncertainty, moving to a period of volatility which Wall Street and the markets are really well equipped to handle. In other words, uncertainty can't be managed well, but volatility can be. So our goal is to find the investment opportunities as we make this transition.

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