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INVESTMENT SERVICES

Weekly Relative Value

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WEEK OF FEBRUARY 3, 2025

The Trump Trade War Begins

"America is harmless as an enemy but treacherous as a friend."
– Bernard Lewis, Historian

The new president has overtaken Federal Reserve Chair Powell as the key source of uncertainty for investors, with questions swirling about what policies he will enact. How those changes impact the Fed, markets, and the broader U.S. economy is at the center of the current market moment.

Of course, the latest concern is the new trade war that commenced over the weekend.

See the following *Wall Street Journal* Op-Eds: "The Dumbest Trade War in History" and "The Dumbest Trade War Fallout Begins." Also have a read of **"**The Absurdity of Donald Trump's Trade War" in today's *Financial Times*.

President Trump announced that all goods imported from Canada and Mexico will be subject to a 25% tariff, except Canadian energy products, which will face a 10% hike. China will see an additional 10% tariff on EXISTING tariffs from the last Trump trade war.

"We don't need the products that they have…We have all the oil you need. We have all the trees you need, meaning the lumber."- President Donald J. Trump

THIS WEEK

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SUBORDINATED DEBT: (SIMPLIFIED)
Partnership has its perks.
Hand over the hard parts.
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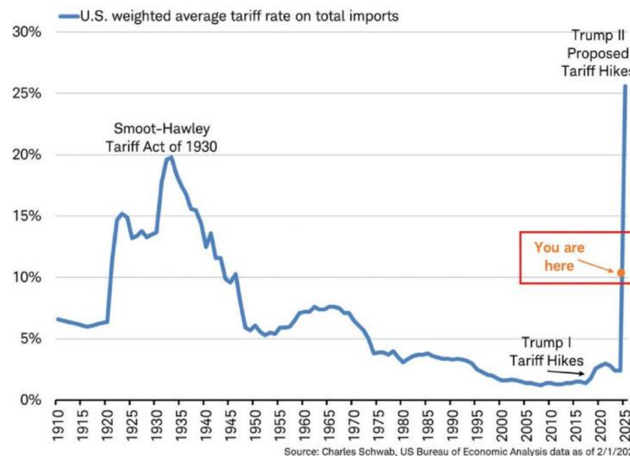
The countries are the largest three sources of U.S. imports accounting for roughly 40% of U.S. imports, worth more than $1.3 trillion.

Bloomberg estimates that the average tariff rate will rise to nearly 26% — its highest since the 1930s. On February 4 at 12:01 am ET, these tariffs will go LIVE.



Leaving China aside, Trump's justification for this economic assault on our neighbors is that Canada is an unfair trader and endangering American lives because of the fentanyl and criminals coming from Canada. Effectively, President Donald Trump has declared Canada not just an economic enemy but a security threat to the United States. It pits two long-time, democratic allies with one of the world's largest and most successful trading relationships, against one another.

This is what newly appointed Commerce Secretary Howard Lutnick had to say:

"Shut your border and end fentanyl coming into this country."

What exactly is Lutnick talking about? Last year, U.S. Customs and Border Protection agents intercepted about 19 kilograms of fentanyl at the northern border, compared with almost 9,600 kilograms at the border with Mexico. In other words, ONLY 1% of fetanyl came in from Canada. Bizarre! The amount of fentanyl crossing over the northern border no way, no how, fills the "emergency" requirement that the President needs to launch this unilateral trade action (normally under Congressional purview).

Moving on. Apparently, Trump believes that tariffs will make us rich. If tariffs made countries very rich and very strong, then every country would respond in kind. Since tariffs are a tax on consumers, the logical assumption is taxes make us rich and strong.

"I think there could be some temporary, short-term disruption and people will understand that… ***The tariffs are going to make us very rich and very strong.****" – President Donald J. Trump*

The ultimate result of everyone being rich and strong would be no one importing or exporting anything they could conceivably make or grow themselves. Trump sounds as if the U.S. shouldn't import anything at all, that America can be

a closed economy making everything at home. This isn't the world we live in, or one that we should want to live in, as we may find out soon.

While Trump will argue that foreign countries will pay the tariff, the reality is that consumers of products from Canada and Mexico and China will pay higher prices. To wit: In his first term, Trump placed tariffs on Canadian lumber, which

"You campaigned on lowering prices for consumers. Which executive order lowers prices?" - Vice President JD Vance, Interview with Margaret Brennan on Face the Nation

drove up costs on furniture and home construction. There were also tariffs on aluminum and steel, ultimately increasing the costs of some household appliances by hundreds of dollars. According to a study by the Tax Foundation, the tariffs first imposed by Trump and continued by Biden cost American families more than $300 per year.

Now that tariffs have increased and been applied across more products, it's estimated that new tariffs could easily cost families more than $2,000 a year, and in effect, saddle middle-class families with the largest tax increase in history. Again, is this what America wants?

Take the U.S. auto industry, which is really a North American industry because supply chains in the three countries are highly integrated. In 2024, Canada supplied almost 13% of U.S. imports of auto parts and Mexico supplied nearly 42%. Question: Is Trump really prepared to destroy the North American motor vehicle industry?

More than a quarter of General Motors' U.S.-sold cars come from Mexico or Canada. Tariffs would overturn the past three decades of the auto industry using free-trade rules and building a vast and highly integrated supply channel across the U.S., Mexico and Canada. According to Wolfe Research, this would add up to car buyers facing price increases of roughly $3,000. Do Americans really want higher vehicle prices on top of ridiculously high prices today?

The same chaos will occur in the agricultural sector. In fiscal year 2024, Mexico and Canada exported approximately 23% and 20% of total U.S. agricultural imports. Many top U.S. growers have moved to Mexico because limits on legal immigration have made it hard to find workers in the U.S. Also, Mexico now supplies 90% of avocados sold in the U.S. So, the avocados I get at Aldi for $1.00 will go up to $1.25. If I recall, one of the reasons Trump was reelected was because of soaring food prices. Americans are going to get a big shock once they park their car and head into the grocery store. How exactly does this help?

And let's not forget about oil. Over 60% of U.S. crude imports comes from Canada, so a 10% tariff on oil imports will lead to a prompt increase in the price of gasoline and diesel, which is the backbone of the U.S. economy. The Pacific

Northwest and Northeast are deeply reliant on electricity or gas flows from Canada. And oil industry advocates have warned against even a 10% increase in the cost of crude inputs into midwestern refineries that have few near-term options to substitute with U.S. supplies. American drivers are about to get a big shock when they fill up the tank. Does this make sense? Is this what Americans voted for?

"Tariffs are the most beautiful words to me in the dictionary."
- President Donald J. Trump

Let's see how U.S. consumers react to a cut in their real take-home pay. What makes this different than Trump 1.0 is that back then, the tax relief came first, and the tariffs (which were more targeted — solar panels, steel and washing machines — and far less radical in terms of size) came second. This time, the order has been reversed. And that is a problem for the U.S. economy, not just Canada and Mexico. Cost-push inflation is coming our way. The only question is how much and for how long, and layoffs in the industrial sector are sure to mount as North American supply chains confront a major and unnecessary disruption.

And more tariffs are likely to be announced on other Asian countries, which will have tariffs imposed on computer chips and semiconductors. It's not like we can get advanced chips anywhere else. Thus, U.S. customers will pay more than anyone else in the world for chips, and computers too. How exactly is that supposed to help the U.S.?

And then, of course, we have retaliation tariffs.

Canada and Mexico have already responded with counter tariffs on various U.S. goods. Canada placed a 25% counter-tariffs on $155 billion CAD ($107 billion USD) worth of American-made products, with items including *beer, wine, bourbon, fruits, fruit juices, vegetables, clothes, perfume, household appliances, plastic and lumber*.

"We need to be very targeted, very surgical, very precise…We need to look through and say who is supporting Trump and how can we make them pay a price for a tariff attack on Canada."
– Chrystia Freeland, Former Canadian Finance Minister

In the above quote, Freeland is threatening to apply a 100% tariff on Trump ally Elon Musk directly by applying a 100% tariff on Tesla cars. That will hardly help de-escalate what is now officially the first trade war of Trump's second term.

But since Trump's orders also included retaliation clauses that would increase U.S. tariffs if the countries respond in kind, that means we are now locked in a tit-for-tat escalating prisoner's dilemma, one where it progressively gets worse before it gets much worse.

Trump likes to talk about "law and order," but his decision to violate the United States-Mexico-Canada Agreement – a deal that his own administration negotiated – runs contrary to a rule-based global trading system that the U.S. helped create after World War II.

"USMCA will be the best and most important trade deal ever made by the USA. Good for everybody — Farmers, Manufacturers, Energy, Unions — tremendous support."- President Donald J. Trump

Other countries are no doubt asking themselves what bogus reason Trump will come up with to raise tariffs on them in the future.

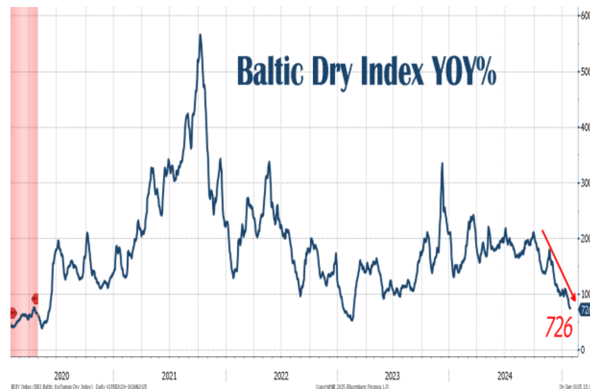
The net effect of Trump's actions will be to reduce U.S. political influence in the world and push more countries into China's arms. It will also undermine the U.S. dollar's hegemony while increasing risk premia associated with owning U.S. assets.

Bottom line: It's hard to decide if this is worse economic policy or foreign policy. In any event, the die is now cast, Pandora's box is opened, and the laws of unintended consequences are soon to arrive. We are truly in uncharted territory unless we want to dust off the 1930s playbook. Whatever the case, history tells us that nobody wins in a global trade war; it is only about the magnitude of the pain! There is nothing beautiful about tariffs. All Trump's trade policy is going to do is create headaches for everyone. It is likely to backfire. Let's hope this is resolved quickly.

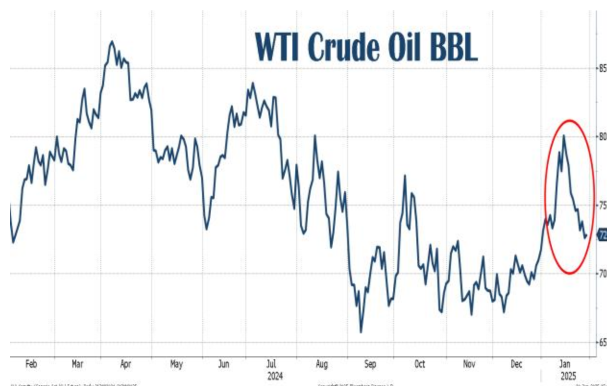
INFLATION WAS HEADING LOWER!

There are opinions, and then there are facts: Do you see "inflation" in the following charts?

The Baltic Dry Index (measures the cost of transporting various raw materials, such as coal and steel) to little fanfare, has plunged over -40% since early December to a near-two year low.

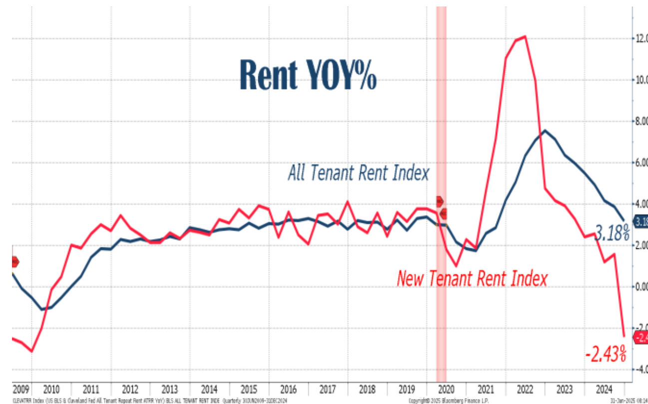


The oil price rally has stalled out. After trading to just over $80 per barrel, the price of West Texas Intermediate crude oil has receded to $72.00.

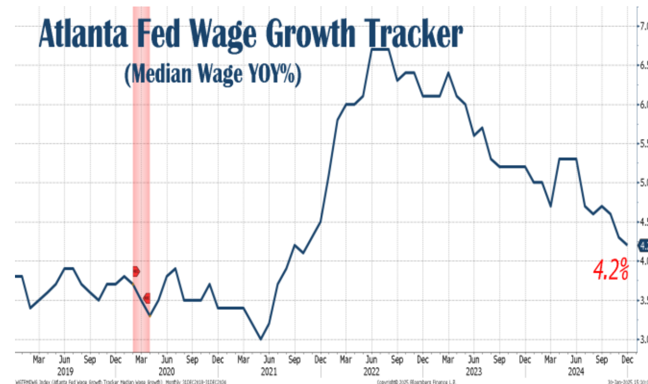


Transportation costs have declined, and believe it or not, a thaw is taking hold in health care costs, especially prescription drugs (Have a good look at "Drugmakers Show Restraint on Price Increases in New Trump Era" in the *Wall Street Journal*.

The "All" Tenant Rent Index has cooled to the weakest trend since 2021. "New" Tenant rents are now actually plummeting. Remember: Shelter commands a 37% share of the Consumer Price Index (CPI), and 46% of the core index.

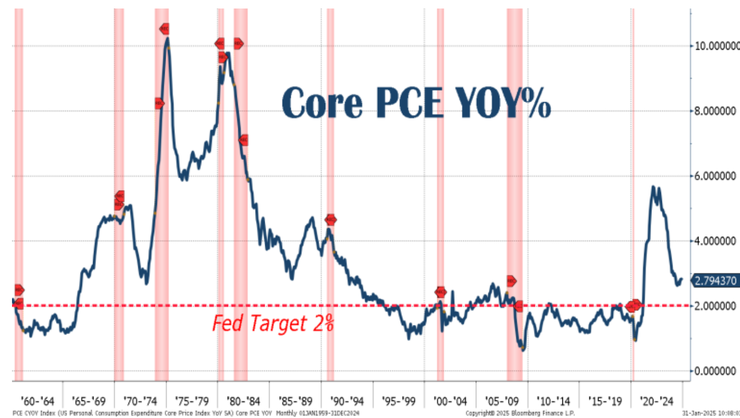


In addition, several measures of wage growth have softened to levels seen more than three years ago.



The Fed does pay close attention to the Employment Cost Index since it includes all forms of labor compensation (wages, salaries, and benefits). The +0.9% quarter-on-quarter increase in the fourth quarter was well off the 2022 inflationary boil. The year-over-year trend eased for the eighth quarter in a row to below +3.8% as of Q4.

The personal consumption expenditures (PCE) deflators are the most important from a market standpoint. The headline deflator came in as expected at +0.3%, and the core index matched expectations as well, at +0.2% sequentially. So, no surprise in either direction. As the consensus projected, the year-over-year trend in the core deflator held at +2.8%.



As you can see below, core PCE inflation ended 2024 with a whimper.

- 1 month: 1.9%
- 3 months: 2.2%
- 6 months: 2.3%
- 12 months: 2.8%

Bottom line: What's not to like? This inflation report was pretty stellar from an interest rate perspective. The only question is whether the onset of Trump's Trade war upset the apple cart and cause inflation to reassert itself.

THE FRUGAL CONSUMER?

> *"**Companies figured out they do like to raise prices**. But we also hear a lot from companies these days that **consumers have really had it with price increases**."*
> *– Fed Chairman Jerome Powell*

Now have a look at this article in the *Wall Street Journal* – "The Americans Pledging to Buy Less—or Even Nothing."

To wit**:**

> *"Instagram, TikTok and other social-media sites are usually overwhelmed by people showing off what they bought. **This year, people are pivoting to something else: displaying how they're buying nothing**."*

This dovetails very nicely with the consumer confidence report, where spending plans took a hit right across the board from autos to housing to travel. The share of households intending to buy a motor vehicle dropped to 11.8% to the lowest level since last August. Home buying plans eased to a five-month low of 5.2%.

And what is with this? Vacation plans slid to 40.8% from 45.4% to stand at the weakest reading since October 2022.

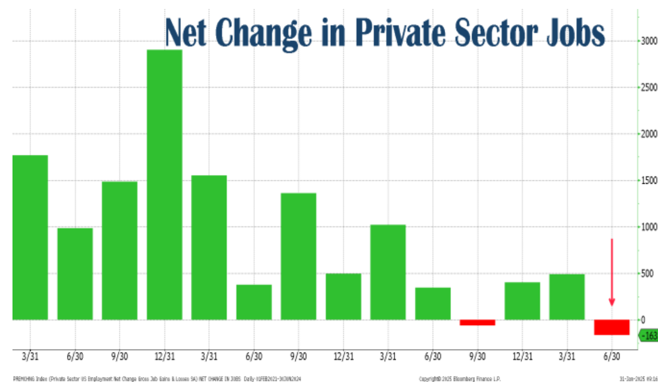
While domestic travel plans hung in relatively well (39.6% from 42.8%), intentions to travel abroad sunk to a mere 16.0% from 24.1% in December — the lowest level since December 2022. This is a little surprising given the strength in the U.S. dollar, which makes European trips cheaper. Then again, if you are more nervous about your job, you're not likely going on a vacation anytime soon.

Bottom line: The Fed has stepped up its concerns over inflation even though we are on the precipice of seeing back-to-back very tame prints on the core PCE deflator. This clearly looks to be more Trump tariff related than connected to anything resembling the true underlying trends in pricing power and the broad labor market.

THE BLS JOBS REPORT IS BS!

I've said this for years. It's crazy people who trade the non-farm payroll numbers every month. They are just made-up numbers. Here's one more example: The 2024 Q2 Business Employment Dynamics Survey (BED) was released last week to little attention. Economists know that this BED report is far more accurate than the monthly non-farm payroll report (aka establishment survey) that the financial media clings to. The establishment survey is done in a hurry, polling just 670,000 employers. Those results are then extrapolated across the population, seasoned to taste and then reported to the public. The BED report is done quarterly and polls 9.1 million employers. There is no doubt about which of these reports is more accurate.

Contrary to the non-farm payroll report, this report showed employment declining -163,000, the steepest decline since 2020. Historically speaking, declines of this magnitude have only ever happened in a recession.



The number of job gains fell from 7.60 million in Q1 to 7.59 million in Q2; meanwhile, job losses rose to 7.75 million from 7.11 million. While the number of layoffs is still low, that is not the story. The story is about hirings that have already fallen below firings. This is not yet reflected in the government birth-death model, which artificially (more like fictitiously) added +320,000 jobs in Q2 of last year.

The “official” non-farm payroll report showed that the economy magically added +442,000 jobs in last year’s second quarter, when clearly that did NOT happen. The Bureau of Labor Statistics BED report provides further confirmation the BLS birth-death jobs model is seriously screwed up.

Bottom line: Powell doesn't see it, but U.S. employment is actually shrinking**.** Further, most of the job gains have been in part-time employment and hiring rates have absolutely plummeted. The backlog of continuing claims has been on a visible upward path, and the consumer surveys have revealed a substantial loss in labor market confidence.

It amazed me that Powell kicked off his post-meeting press conference with the comment that we have “a healthy job market” on our hands and the latest Fed statement upgraded the labor market to “solid.”

A NEW TRADE DEFICIT RECORD

The U.S. goods trade deficit boomed to near-record levels in December, to -$121.1 billion from -$103.5 billion in November.

In a signpost of weak demand abroad, and the super-strong U.S. dollar, exports sagged by -5.0% month over month and have been down now in three of the past four months (outbound shipments of consumer goods were down -8.4%; capital goods were down by -4.3%) while imports surged in anticipation of the tariffs (+3.7% month over month after a +4.3% jump in November).

Trump will howl over this report, but the reason why the U.S. has such a big trade deficit is because it is an economy built on consumerism. It is virtually the only major country in the world without a federal sales tax of some sort, and one of the few countries with a single-digit personal savings rate.

Bottom line: This cuts two ways for the bond market: The widening trade gap is a deadweight drag on gross domestic product (GDP) growth, but this does raise the risk that the President’s ire will be raised even further (in that everyone in the world only exists to rip off the U.S.).

THE SPUTNIK MOMENT

"DeepSeek's artificial intelligence (AI) model is one of the most amazing and impressive breakthroughs I've ever seen and a profound gift to the world"
– Marc Andreessen, Technology Investor

After assuming for years the U.S. was far ahead of the rest of the world on AI, comes a Sputnik realization that perhaps the U.S. is behind despite China having to use rented computers and/or lower-grade chips to develop their AI.

DeepSeek's model reportedly required as few as 2,000 Nvidia chips (some estimates at 10,000 chips) to develop versus Meta's expectation to need 1.3 million advanced chips by the end of this year.

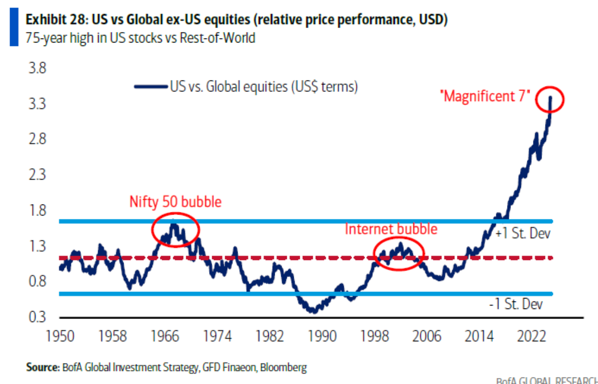
The company said it spent just $5.6 million training the base model behind its AI (a fraction of the experience of the past year, where the expenditure range on such spending on new models was in the $100 million to $1 billion range). No one should be surprised by this. It was probably a mistake to downplay China's ability to get creative when it comes to technological developments, not to mention the fact that the country is home to some five million engineers, about double the talent pool in the U.S.

Is DeepSeek as good as the U.S. model? We don't really know, but we do know that the free downloadable version is very good, perhaps as good or better than ChatGPT, which costs $200 a month (well, not for long)!

Remember: The anticipated strong earnings growth and high stock valuations were based mostly on AI-related spending assumptions. The emergence of DeepSeek's cheaper AI alternative is certainly going to challenge those assumptions. If DeepSeek is what it is built up to be, then it is cheaper and faster, and it will require less spending on chips than what the U.S. stock market had embedded.

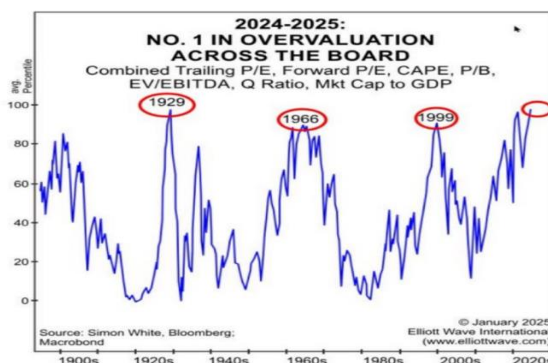
Perhaps the sanest thing anyone has said of late came from none other than Ray Dalio:

*"Where we are in the cycle right now is very similar to where we were between 1998 and 1999. In other words, **there's a major new technology that certainly will change the world and be successful**. **But some people are confusing that with the investments being successful."***
– Ray Dalio, Founder, Bridgewater Board



Big picture: For an exceptionally long time, the equity market has been fueled by price momentum alone**.** To wit: For all of 2025, the bottom-up analyst community is currently at $271 for earnings per share. The peak was $277 on June 2024. That is a -1.9% haircut. Yet, the S&P 500 "price" has expanded +10% over this period. It's quite uncommon to see investors (robots?) paying a higher multiple for a declining earnings growth outlook, but that is what we have today.

And this leaves us with valuations that are needless to say… exceedingly high.



Heck, even Vanguard, the vendors of all things bullish and the pioneers of the passive index fund, has just turned "cautious" over the U.S. equity market. The firm is forecasting that U.S. stocks will barely keep up with inflation over the next decade. Practically no return in real terms. It is also predicting what many feel is the impossible — that the U.S. equity market will lag the Treasury market over the next ten years.

We also see that Warren Buffett has bolstered his cash position even more to an unheard-of $325 billion. The world's pre-eminent value investor apparently cannot find value. Yet, the new "fast money" seems to think the Oracle is out of touch and irrelevant.

I'm guessing that Warren will once again be proven right when all is said and done.

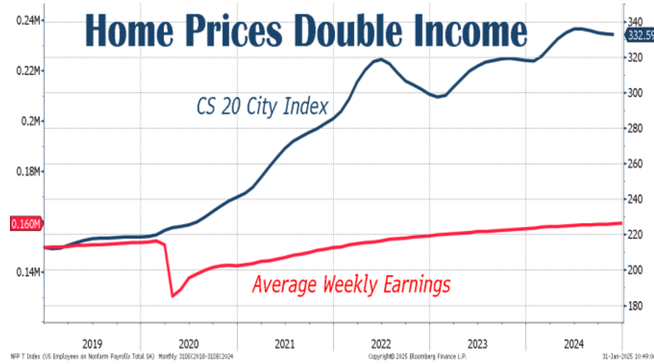
Bottom line: With so many moving parts and uncertainty now entering the equation, the DeepSeek news further underlines the need to diversify away from the Magnificent 7 given their hefty valuations and risks to their profitability that didn't exist just a few weeks ago.

HOME PRICES

The 20-city home price index rose by +0.41% month over month in November and a tad firmer than the +0.35% month-over-month uptick in October. Not too hot, but definitely not cold.

You have to go all the way back to January 2023 to find the last time that this closely watched home price series suffered any setback. While the year-over-year trend moderated to +4.4% from +5.7% a year ago, this is still a fairly good showing in view of sub-3.0% headline CPI inflation.

As shown below, the average home price in the U.S. is up over 53% in the last five years, more than double the increase in wages.



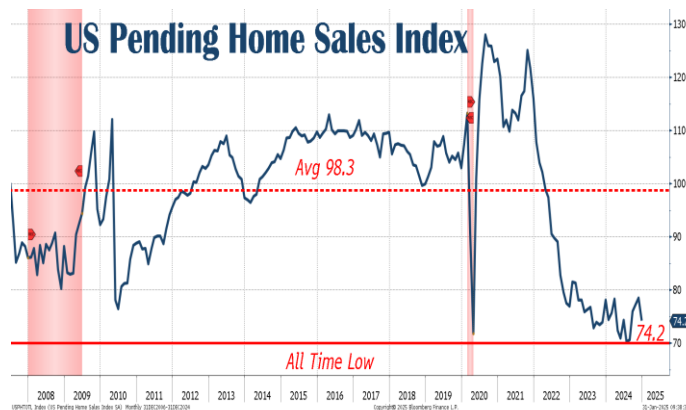
Bottom line: Residential real estate continues to bolster household wealth alongside the equity bull market. There is nothing here to get the Fed to do anything but remain on the sidelines — all the more so with all the uncertainty pertaining to the trade and fiscal policy outlook.

BUYERS' STRIKE CONTINUES

While homeowners have benefited from the sharp appreciation of homes, the widening gap between prices and incomes has led to the least affordable housing market in history.

Pending home sales, the gold standard in terms of being a leading real estate barometer, felt the sting from higher mortgage rates — slumping -5.5% month over month in December in the first setback since July.

Smoothing out the monthly wiggles, the year-over-year trend swung from +4.9% to -2.9%. At 74.2, the index level is lower than it was in September 2008 (90.7), when Lehman collapsed, and the recession was ten months old. That tells you a thing or two right there. Nothing much here for the homebuilders to be cheering for.

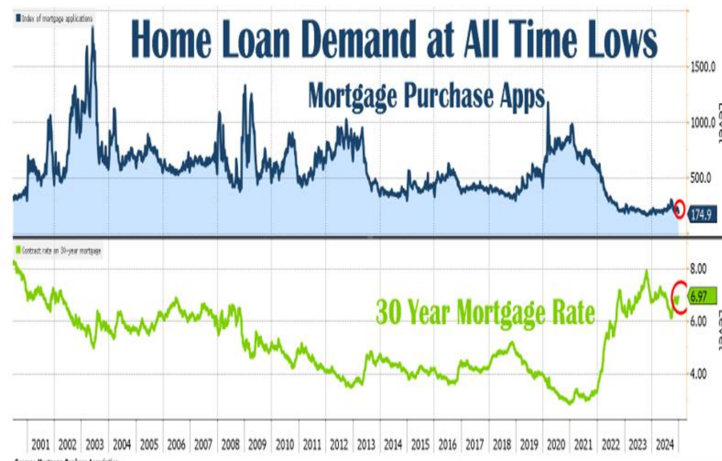


All regions were down:

- West: -10.3%
- Northeast: -8.1%
- Midwest: -4.9%
- South: -2.7%

Pending sales are based on contract signings and track deals that haven't closed yet and could still fall apart or get canceled. There have also been a lot of deals falling apart or getting canceled because buyers cannot afford the homeowner's insurance or cannot even get it. This is a big issue in states where homeowner's insurance has spiked in recent years.

Likewise, applications for mortgages to purchase a home are an early indication of home sales: like pending sales, up only a smidgen from rock bottom.



Bottom line: The Buyers' Strike continues because prices are too high! Why does anyone still believe anything a realtor says about housing? *"There is now crazy demand"* is the same copy-and-paste propaganda they always say.

MARKET OUTLOOK AND PORTFOLIO STRATEGY

Lat week, the Fed stood pat (holding rates at 4.25-4.50%) as everyone expected. That said, the hawkish shift in the wording within the press statement hinted that no more rate cuts are coming for a long time. Perhaps a not-so-veiled message to President Trump.

More importantly, there were three key takeaways from the Powell press conference: the funds rate is substantially above neutral; the rental data are soon to take inflation down to target; and the labor market seems solid only because firing rates have remained low.

The Q4 GDP data confirmed that the U.S. economy is cooling off. The +2.3% headline GDP number missed estimates even with the hot consumer. But after stripping out the post-hurricane spending effect on housing/home improvement, and autos, real GDP growth in Q4 was a little better than a +1.3% annual rate.

In any event, what is most important, especially from an inflation perspective, is whether the economy is expanding above, at, or below potential. And, according to the Census Bureau's index of economic activity, it was the latter in Q4 for "*only the fourth time in the past five quarters.*"

Despite the discussion above regarding Trump tariffs, the evidence is mounting that inflation was heading to target, the labor market is in balance, and that is consistent with a Fed funds rate around 3%, not the current 4.3%.

Because of the news over the weekend the bond market is no longer assuming any rate cuts. But this means that if the Fed does decide to cut earlier if the data disappoint and inflation recedes more quickly, the Treasury market stands a

good chance of rallying. As it stands, the 10-year yield is still almost -30 basis points below the nearby peak of 4.8%. The market talk of 5%+ or even 6% has died down.

Bottom line: The economy is slowing, and inflation was heading towards the Fed's target of 2%, but because of all the uncertainty surrounding policy initiatives (trade, fiscal, tax, etc.) VOLATILITY is the name of the game. Thus, until there is greater certainty, focusing more on the front and intermediate parts of the curve is likely to prove to be a prudent risk-reward strategy. Any significant sell-off is an opportunity to invest new funds.

MORE INFORMATION

For more information about credit union investment strategy, portfolio allocation and security selection, please contact the author at tom.slefinger@alloyacorp.org or (630) 276-2753.

As Alloya's Market Strategist, Tom Slefinger leverages nearly 40 years of investment strategy expertise to deliver insightful commentary on the economy and market events to optimize balance sheet performance at the credit union level. With thousands of subscribers, Tom's daily and weekly publications are widely read amongst credit union executives.

Prior to becoming the corporate's Market Strategist, Tom served as the Senior Vice President of Institutional Fixed Income Sales at Alloya Investment Services, a division of Alloya Solutions, LLC. In this role, Tom developed and managed operations associated with institutional fixed income sales in addition to developing investment portfolio strategies, identifying appropriate sectors and securities, and optimizing portfolio performance at the credit union level.

Tom holds a B.S. in business administration from the University of Maine. In addition, he holds a Series 7 and 63 through ISI.

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