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This Time It's Different

At BCWM, we are fond of saying that the president of the United States gets way too much credit when the economy is good and way too much blame when the economy is bad—that there are much larger forces at work determining our financial fate (demographics and geopolitical issues, to name a couple).

The 47th President (DJT) seems bent on testing that aphorism. Trump seems to have decided he is not going to be a passive president, just letting the #1 economy in the world continue to hum along as the #1 economy in the world.

No, Trump campaigned on a promise of dramatic change, and he appears to be trying to deliver on that in spades in the first ninety days. The phrase "this time it's different" is almost never true, but the new president has us wondering.

At the very least, there seems to be the *potential* for Trump to make an impact because his changes are so extraordinary and are happening so quickly. There are a few keys areas we consider worthy of attention.

Virtually everyone has heard or read about "tariffs" over the last month, so let's start there.

A tariff is a tax placed on an imported good, which makes foreign products more expensive when they enter the U.S. The importer pays the tariff to U.S. Customs and Border Protection, and the revenue collected goes into the U.S. Treasury, where it can be used for government programs.

While tariffs may seem like a modern political buzzword, they have historically been a major tool of U.S. economic policy. Tariff revenues played a significant role in funding the government until the modern federal income tax system began in 1913. But since the end of World War II and the expansion of free trade, tariffs have not really been a relevant factor for our trade policy and economic development.

They quickly became relevant again during Trump's first term, primarily in the trade war with China. Surprisingly, Biden kept most of Trump's tariffs in place, even increasing some against China (one of the few shared polices of the two).

Now that Trump is back for round two, he has come out swinging.

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On Saturday, February 1st, Trump surprised no one when he announced an additional 10% tariff on all Chinese imports. What did surprise everyone was the simultaneous announcement of 25% tariffs on goods from America's two largest trading partners, Canada and Mexico. When the stock market opened Monday, it was down about 2%, and shortly thereafter Trump agreed to delay the tariffs by a month.

This tactic has become synonymous with Trump. Shock with an unexpected threat, then try to negotiate. A recent example: Trump used tariff threats to pressure Colombia into accepting deported migrants on military planes.

The tariff push didn't stop there. Trump soon unveiled a 25% levy on steel and aluminum imports and directed his administration to develop "reciprocal tariffs" tailored to offset perceived disadvantages for U.S. manufacturers. Last week, he went even further, floating the idea of 25% tariffs on the import of automobiles, semiconductors, and pharmaceuticals.

The tariff man is back, bolder than ever. This blitz of announcements happened so quickly, Trump's pick for Secretary of Commerce and U.S. Trade Representative had yet to be sworn in.

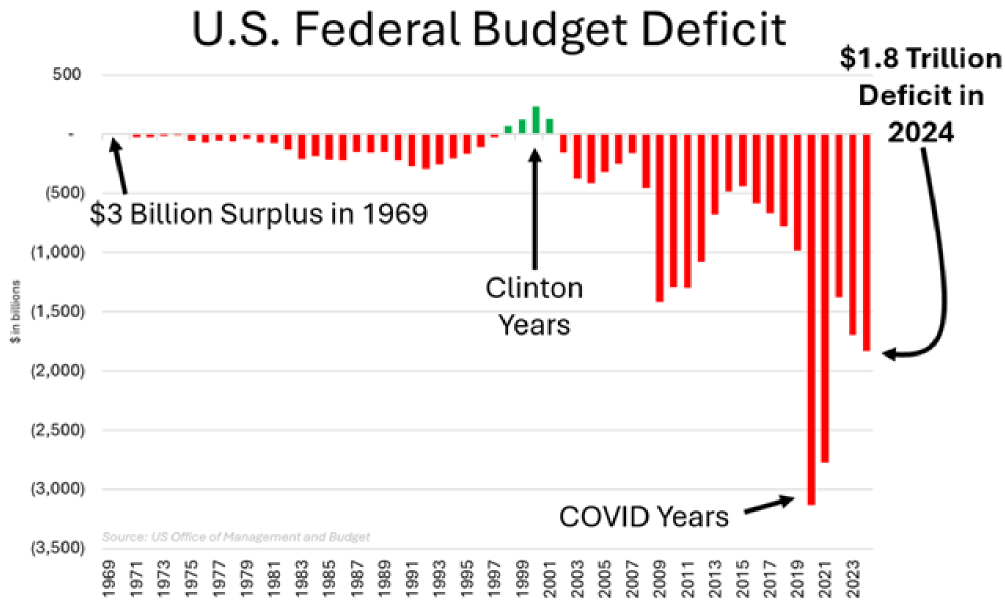
The impact of Trump's tariff strategy will depend on several factors, including how other countries respond. Is Trump's bark louder than his bite? Do other countries bend to his demands? If not, how long do the tariffs stay in place?

Typically, tariffs create inflationary pressures. Companies pass on the higher cost of imported goods to their consumers. U.S. manufacturers that rely on foreign materials—such as steel and semiconductors—may see production costs increase, potentially leading to job losses or reduced competitiveness. On the other hand, American companies in protected industries will likely benefit from reduced foreign competition.

Now onto the budget cuts . . .

We've written countless times about our national debt and budget deficit and their threat to long-term economic growth. The good thing is that our debt problem isn't anywhere near as bad as the rest of the world's. The bad thing is . . . it's still a huge problem with no easy solution in sight.

Aside from a few years during the Clinton administration, the U.S. government spent more money than it took in for over fifty years!



Regardless of political leanings, we think most people would agree that this problem, that was created by BOTH parties, needs attention.

Enter Elon Musk and the Department of Government Efficiency (DOGE).

There is a lot one can say about Elon Musk. On the one hand, he is a highly successful (world's richest) businessman who continues to be a pioneer in industries shaping the future: electric cars, self-driving cars, space travel, artificial intelligence, putting satellites into space to provide internet access to remote areas of the world . . . and an implantable brain chip to help people with disabilities and "unlock human potential." A true visionary.

On the other hand, he is a highly polarizing figure with a knack for controversy—often provoking strong reactions by pushing buttons on sensitive topics, leading his critics to paint him as racist. . . or antisemitic . . . or misogynistic.

Musk has been tasked with cutting wasteful government spending, which is quite ironic considering his companies have received billions of dollars in government money in the form of aid, contracts, and tax incentives. Even more ironic is the use of the name "DOGE" (Musk's reference to a joke cryptocurrency with a total value of $35 billion and a real economic abomination) for the department in charge of fixing what is arguably the most serious problem facing our economy.

Adding to the drama, the constitutionality of DOGE is being disputed. We suppose this should come as no surprise, given the divisiveness of our politics and Musk's penchant for working within the gray areas of what is legal.

Stranger than fiction, but stay tuned. There will surely be more drama as this story unfolds.

Meanwhile, DOGE is busy at work, trying to trim the fat in the federal budget. There is a real risk of collateral damage, where important and necessary programs get eliminated, especially if the cuts are made too hastily. But in the long term, reducing the budget deficit is a good thing for the economy. However, in the short term it could be some hard medicine to take. It could be very disruptive even if DOGE cuts only the most wasteful spending.

How much is the department going to cut? Who knows! Musk initially said $2 trillion, but then walked it back, saying maybe $1 trillion of spending cuts is a more realistic goal. The DOGE website claims the department has already trimmed $55 billion, but after correcting for an error and adding up its itemized list, the actual number seems to be *only* about $8 billion — a huge sum of money but only a small fraction of the $6.8 trillion federal budget.

Let's put those numbers into perspective. For the 2024 fiscal year, the government spent $1.8 trillion more than it took in (the budget deficit), so if DOGE cuts spending by $2 trillion, guess what? We balanced the budget! However, that giant chunk of government spending would be missed by the economy. If $2 trillion of economic activity disappears (and isn't made up elsewhere), Gross Domestic Product (GDP) would shrink by about 7%, which translates to a massive recession. A $1 trillion cut would translate to a 3.5% cut to GDP, which is still a sizeable recession—about the same as the 2020 pandemic-induced recession.

Yes, in the long term we think it would leave the economy in a better position. But a quick and sizeable cut that isn't offset by other factors has the potential to be very disruptive. A more methodical and gradual approach could dampen the blow. It seems highly unlikely that DOGE can deliver on its promises so quickly, but you never know . . . it is Elon Musk.

Another area that is experiencing a similar upheaval is immigration.

Trump's policies notwithstanding, our job is to understand how it might affect the economy to better position client portfolios. Regarding immigration, the formula is quite simple. More people = more economic activity (a.k.a. economic growth).

From a labor market perspective, immigrants (especially illegal immigrants) tend to have the largest impact in areas such as agriculture/farming, construction, and some service industries, such as restaurants and hotels. Mass deportations could leave companies in these sectors scrambling to find workers. That could lead not only to disruption (delays in getting food onto shelves or longer lead times in home building) but also wage pressure, as these companies pay more to recruit enough workers. In turn, that added cost would likely get passed on to the consumer, meaning higher inflation.

Every new president has an agenda. Typically, the effect a new set of policies has on the economy is overhyped by the talking heads on CNBC, and the actual result is rather muted. Said policies might take a long time to go into effect. Or they may be offset by other factors.

In the Trump 2.0 case, there is the potential for a lot of things to change in a big way and fast. The net effect is still uncertain. Do DOGE spending cuts just get offset by tax cuts? Does tariff revenue fill that gap to balance the budget? Are the tariffs strong enough to drive meaningful inflation quickly? Or can American-produced goods quickly meet demand, allowing prices to remain steady? Is the Trump administration able to follow through with its immigration promise, and will it push up labor costs and inflation? What about deregulation in other areas such as energy? Does that meaningfully push economic growth?

How effective is one policy going to be versus another? It's hard to say. But what we do know is that all these massive potential changes have generated a lot of uncertainty.

In fact, the chart below shows how small business uncertainty is currently at its highest reading ever. Higher than during the pandemic. (As an interesting side note, uncertainty was very low during the Great Financial Crisis of 2008. Times were very, very bad, but not uncertain. Everyone knew it was going to be rough.)

Like we said during Trump's first term—and Biden's, and every other president's—too much credit/blame is placed on the president when things go well/bad in the economy and stock market. What is different with Trump's second term is the <u>magnitude</u> and <u>speed</u> at which new policies are going into effect. So, for the first time, we find ourselves pondering that dangerous phrase . . . is this time different?

Our guess? Probably not.

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