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# Charts and Smarts®

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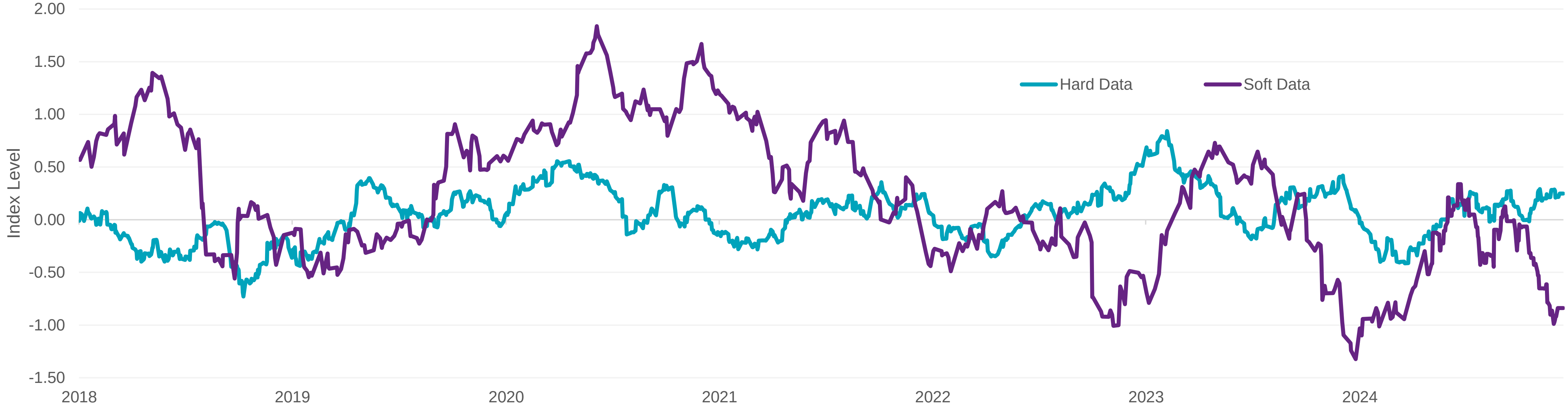
# Riders on the Storm

## Bloomberg Economic Surprise Index (5/31/18–5/14/25)

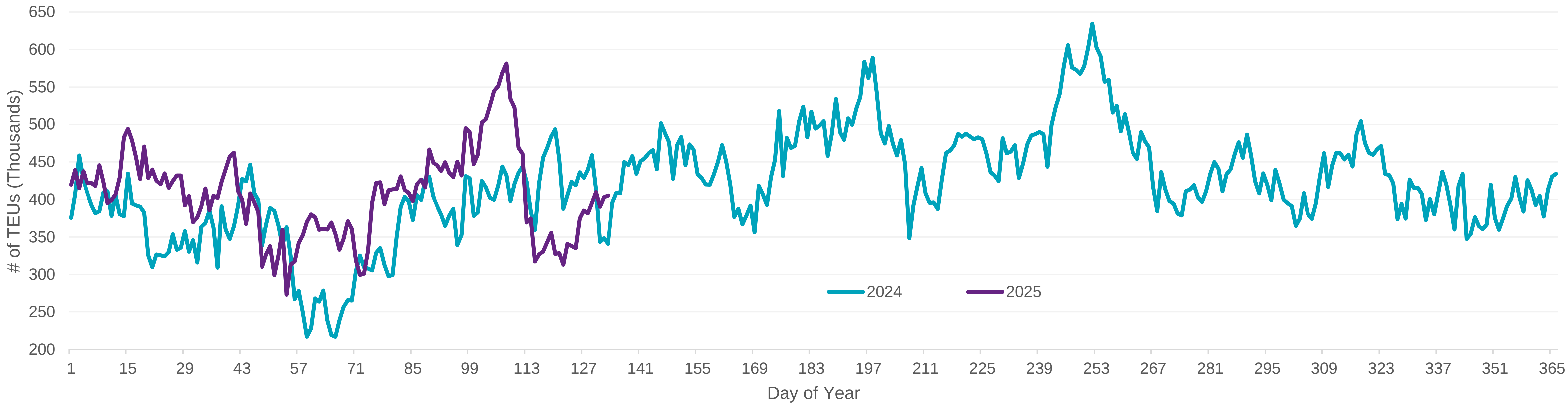



Markets are impatient and that is particularly the case today. Confidence has collapsed in the wake of the Liberation Day shock dragging down soft survey-based data, but that confidence recession has yet to manifest in the hard economic data. As much as the market may like to see the data shift quickly, this shock is not of the sudden stop variety that remains emblazoned in investors' minds from COVID. While some impacts are likely to be felt more rapidly, namely reduced capex spending and slower hiring, even those have yet to show through in the data as activity has been pulled forward as businesses rushed to front run the tariffs. Reduced policy volatility and uncertainty in recent weeks as rhetoric has softened has also spurred firms to cautiously resume activity, all helping to keep the hard economic data supported. As markets have powered higher, reversing all of the post-Liberation Day plunge, the resilience in the data has predictably led to a notable improvement in investor sentiment, and raised questions as to whether the soft data may once again be a head fake as it has been over the past few years. But the resilient data in addition to still-looming. upside inflation risks is also keeping the Fed sidelined, serving to passively tighten policy on an economy that continues to organically cool. While it's encouraging that growth has remained relatively solid, red flags continue to mount as the policies being pursued–and the manner in which the administration has implemented them–has only added to headwinds that were growing for the economy. The jury remains out as to how the divergence between the hard and soft data resolves this time. Should the hard data converge to the soft data, it may take longer than many expect, keeping open the potential for a wide-range trade as a tug of war between de-escalatory optimism and elevated recession risks plays out in markets.

Source: Portfolio Analysis & Consulting, Bloomberg. Hard data represents data releases covering Housing and Real Estate, Industrial Sector, Labor Market, Personal/Household Sector, and Retail & Wholesale sector. Soft Data represents data releases covering Surveys & Business Cycle Indicators.

# Ship of Fools

## Laden Container Ship Count from China to US (1/1/24–5/13/25)




Speaking of front-running activity, one need look no further than container-shipping counts to see evidence of both front loading of import activity ahead of tariff implementation, as laden container counts ran well ahead of 2024 levels, followed by a collapse as order cancellations took hold. The de-escalation we've already seen, paired with the expectation of further softening of the de facto Chinese trade embargo, has had a visible effect, not only in corporate commentary, but again in that same shipping data as laden container counts from China to the US appear to have bottomed and are inflecting higher. Nonetheless, fears of looming supply shortages continue to circulate. While we sympathize with the fact that some of the toothpaste can't be put back into the tube, PTSD may be playing a role in these persistent fears of supply shortages and bullwhip effects. To be sure, container counts remain below 2024 levels and the disruption is likely to have some effects on product availability, but those disruptions may be more limited in scope than feared. While the magnitude of shock has certainly been larger than expected, tariffs have been looming for months, providing sufficient time for firms to build inventory in advance. And although the surging trade deficit in Q1 was fueled largely by pharmaceutical and nonmonetary gold imports, domestic inventories remain fairly healthy, providing firms a buffer to wait out the storm. In short, the economy can likely withstand universal tariffs of 10%. The obvious risk is where tariff rates for China settle and how long it takes to get there. Markets are clearly expecting cooler heads to prevail sooner, but should that fail to materialize, the fallout to fear from empty shelves isn't an inflationary impulse as it was with the COVID bullwhips, but rather the drag on real growth and revenues that still elevated tariffs pose.

Source: Portfolio Analysis & Consulting, Bloomberg. Based on 2024 trade.



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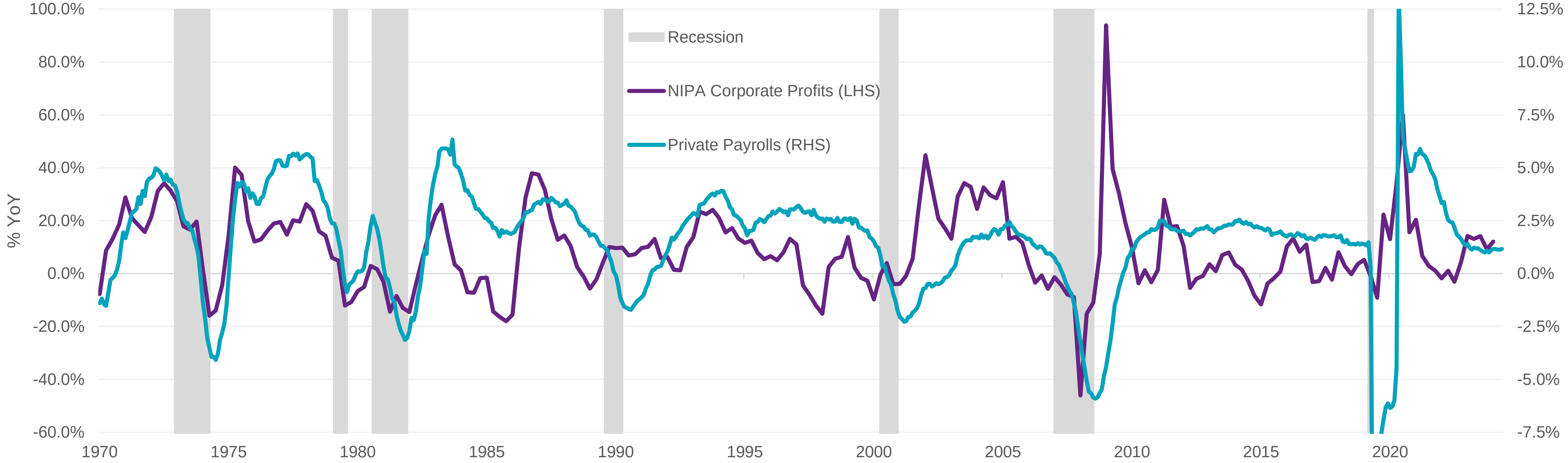
# Light My Fire

## NIPA Corporate Profits vs Private Payrolls (12/31/70–12/31/25)

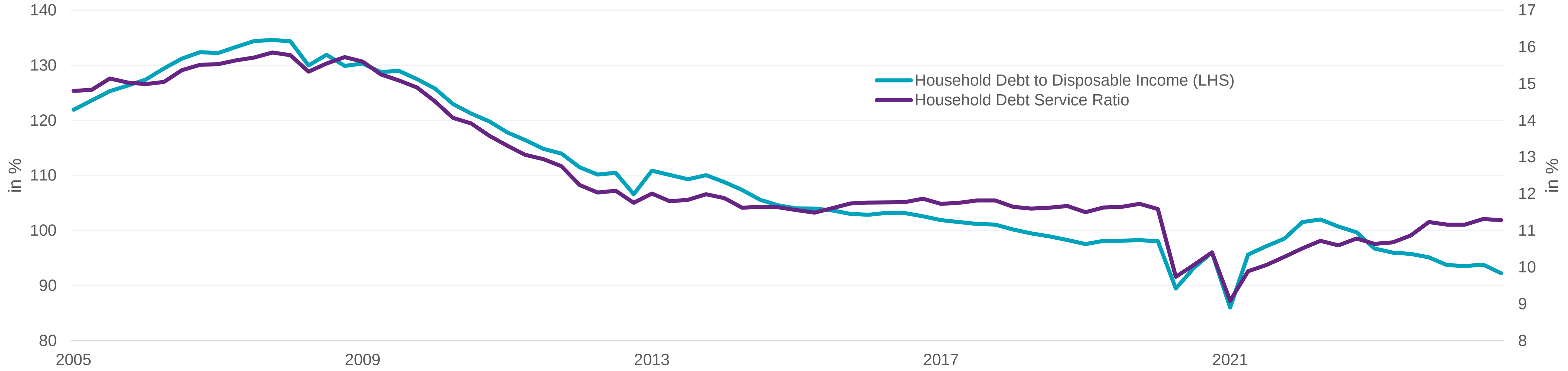



On the topic of inflation, let's clear something up. Tariffs don't raise prices, they raise costs. Those costs, of course, may be passed along to consumers in the form of higher prices, but that's not necessarily a given. And that's particularly questionable now for a handful of reasons. First, given how haphazard the rollout of tariffs has been and Trump's track record of blinks, why would firms risk giving up market share in the short run by passing along increased costs when it's common knowledge that the current state of tariffs is unsustainable. But perhaps even more critical is the fact that the nominal economy is in a very different place than just a few years ago when we faced the last inflationary episode. Taking the outlook back to the basics: the nominal engine for the economy, income growth, continues to cool, with wage and salary disbursements growing 3.7% over the past year. Any increase in price simply translates to a reduction in quantity. Cooling nominal income + higher prices = lower real growth and lower revenues. Growth is slowing and static policy rates and trade policy are only adding to those headwinds. The debate about how the divergence between the hard and soft data resolves will, in large part, be dictated by how quickly and how far the administration de-escalates and how firms decide to respond to those cost increases. Either raise prices and risk lower revenues or accept margin compression. While that may not be enough to push us over the edge into recession, economic and earnings growth likely cools further from here, which will weigh on hiring and capex intentions for the foreseeable future.

Source: Portfolio Analysis & Consulting, Bloomberg.

# Five to One

## Household Balance Sheet (3/31/05–12/31/24)

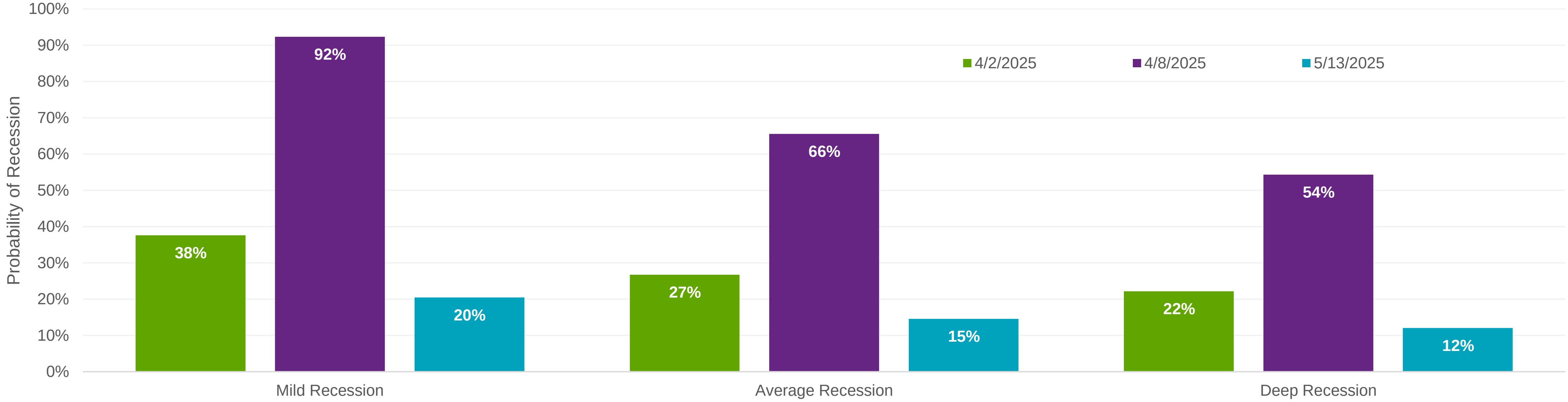



While recession may not be the base case, given scope for further de-escalation, the outlook certainly seems to be one of slowing growth and rising unemployment before conditions get better. But not all recessions are the same, and when attempting to decipher what fallout financial markets have priced in, one needs to consider what that potential recession looks like. Recessions can generally be divided into two types: a balance sheet recession or an income statement recession. In a balance sheet recession, a highly leveraged economy is forced to shift from spending and investment to saving and deleveraging. The result is a prolonged period of balance sheet repair where monetary policy is less effective, given the myopic focus of consumers and businesses alike to save and pay down debt as opposed to borrow and spend. See the Global Financial Crisis. An income statement recession, on the other hand, tends to be less pernicious as there's less imbalances in the economy to recess. In this environment, a slowing labor market typically gives way to slower income growth, softer consumption and shrinking margins, setting off a negative feedback loop that begets contraction. And critically, monetary policy tends to be more effective in these recessions, helping to limit the depth and duration of the contraction. The key to determining which recession we might be contending with is largely a function of our starting point. Initial conditions matter and with household leverage at near record lows and corporate balance sheets rock solid, those initial conditions are simply too strong for a deep and protracted balance sheet recession to take hold. Instead, an income statement recession remains the more likely outcome if we do indeed slip into recession. And while that recession would likely prove fairly shallow, the risk is that the recovery may be slower and more protracted than the typical income statement recession, given the ongoing potential for confidence shocks from the administration. One thing, however, is clear: should the hard data catch down to the soft data, the Fed will likely adjust quickly to defend against the growing threats to the labor side of the mandate.

Source: Portfolio Analysis & Consulting, Bloomberg.

# When the Music's Over

## S&P 500® Market Implied Recession Probabilities (As of 5/13/25)




Markets are forward-discounting mechanisms, with investors voting with their dollars on the expected path of economic and earnings growth. In that regard, while both earnings estimates and hard economic data have yet to reflect any material fallout from the tariff shock, markets are certainly anticipating some degree of impairment. A mild recession certainly remains the odds-on favorite should the economy slip into contraction, and at the lows, equities were almost fully discounting that outcome. Since the reciprocal tariff pause and the administration's pivot to China, the market has priced out crisis odds as the extreme left tail has been severed and compressed. This is no longer about a fundamental rebalancing of the trade deficit and markets have better clarity as to where the pain point is for the administration. The question now is about whether markets are accurately pricing in a more normal left tail. Through all the trade turmoil, we have frequently redirected the focus to the underlying cooling taking place in the economy. That has been and remains the key risk for the economy. The market has rallied considerably on resilient hard data and a steady trickle of de-escalatory rhetoric. But with markets now pricing in under 40% odds of a mild recession, the skew may be starting to flip in the opposite direction. De-escalation remains the clear direction of travel, and the hard data indeed continues to hold up, but at current levels, markets are potentially vulnerable to underwhelming "deals" and unexpected softening in labor market data, as the market seemingly continues to overlook the organic cooling that continues in labor markets and growth. While the lows may be in, the tug of war between de-escalation optimism and persistent recession risks looks set to continue manifesting in a wide-range trade.

Source: Portfolio Analysis & Consulting, FactSet. Probability of recession based on the average peak to trough recessionary drawdown between 1948–2020. Mild recessions defined as earnings decline of less than 15%. Deep recessions include all recessions with 15% or greater earnings declines. Average recession is an average of all recessions.

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