ADVANCED ASSET MANAGEMENT ADVISORS

# Many Very Large Moving Parts

Market Update From Advanced Asset Management Advisors

March 31, 2025

The media is teeming with economic and political headlines. Those most significant for the financial markets are: Fiscal policy, tariffs, tax policy, consumer confidence, inflation, and Artificial Intelligence.

Bear with us as we touch on all of these.

## Topics

**Fiscal policy**, and the potential impact of planned spending cuts.

**Tariffs**, and how consumption and global trade may be affected.

The potential for changing **tax policy** as provisions are set to expire in 2025.

Falling **consumer confidence** and potential weakness in future spending.

The economic impact of massive investment in **Artificial Intelligence**.

The many **moving parts of the economy**, and the increasing odds for a recession in 2025.

**Inflation** and the impact on **interest rate policy** in the near-term.

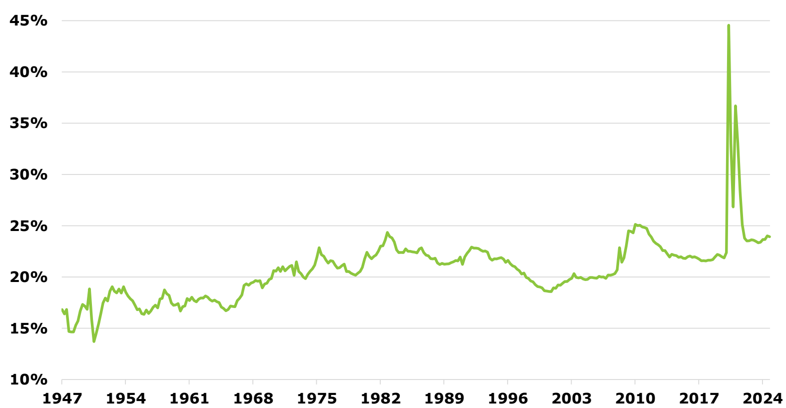
Current **stock market valuations**.

## Fiscal Policy

From 1947 through 1970 federal outlays ranged between 15% and 20% of nominal GDP. From 1970 to date, that range has been higher, between 20% and 25% (except for the pandemic response). Outlays currently stand at 24%[1]. Current headlines suggest a target of cutting spending to between 20% and 15% of GDP. Cutting federal outlays to 20% would require a $278 billion reduction… 15% requires a $634 billion cut. If government spending were to drop to 20% of GDP, the economy could suffer a 1.4% decline. A drop to 15% could develop into a 3.2% decline.

Spending cuts would reduce the current fiscal deficit, but would be partially offset by lower tax revenues. Reduced federal spending would be a short-term negative and long-term positive for the economy.

**Federal Expenditures as a Percent of GDP**




Source: Federal Reserve Bank of St. Louis

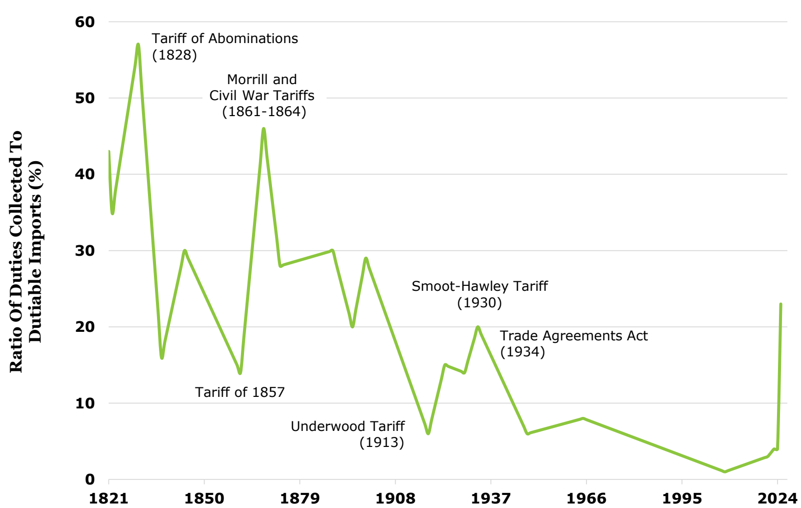
# Tariffs

Many economists express concerns that a tariff war could precipitate economic weakness. That is because tariffs are a tax on the consumption of goods.

When taxes on goods are increased, the burden can be borne in several ways. First, price increases could be passed on to the consumer. In this case, the consumer will consume less of the good in the long run – either by a change in behavior or by finding a substitute. Second, the manufacturer (or exporter) could "eat" the cost of the tariff. This increases costs of manufacturing, reduces capital, and ultimately penalizes shareholders of the company.

It is unclear at this time whether recently announced tariffs will be modified. What we do know is that we are in a world economy. Of course, many of the pitfalls of a global supply chain were exposed during the pandemic (or in times of war). However, the globalization and specialization of trade has led to more domestic productivity and a better overall (economic) quality of life.

**U.S. Tariff Inflection Points and Trends**




Source: Statista (Bureau of Economic Analysis, Census Bureau, Bureau of Labor Statistics)

Prior to the enactment of income taxes in 1913, tariffs provided a significant source of funding for the U.S. Government. High tariff rates contributed to north-south tensions leading up to the civil war. Smoot-Hawley tariffs are cited as contributing to the depth of the Great Depression. Since 1940, tariff rates had declined and remained below 3%. Because the recently announced tariffs include very high rates against countries with whom we have significant trade deficits, the current projection for average tariff rates in 2025 is 23%, the highest since 1900.

News reports about tariffs have created an immediate impact on the value of stock prices for importers. It is ironic that General Motors and Ford may be more negatively impacted than Honda and Toyota, as GM and Ford manufacture a lot of vehicles outside the U.S., while Honda and Toyota have extensive manufacturing facilities within the U.S. What is clear is that any tariff, like any tax, is a transfer of income and economic productivity away from the private sector and to the government.

Tariffs will likely have a short-term negative impact on the economy with unknown long-term consequences.

## Tax Policy

Several provisions of the current tax law are set to expire at the end of 2025. If the provisions are not extended, income taxes would increase for individuals and corporations. Higher tax rates would likely help reduce the fiscal deficit, but negatively impact the economy in the near-term.

## Consumer Confidence and Spending

The economy has been solid due to a resilient consumer (70% of GDP), so recent reports of flagging consumer confidence certainly raise a question about whether the economy may be negatively impacted in the near-term.

## Artificial Intelligence

What does AI have to do with the economy? The segment has dominated financial headlines and explains a lot of the enthusiasm for the stocks of certain companies. Hundreds of billions of dollars have and will continue to be spent to develop power sources, data centers, data bases, and software capabilities.

These investments are positive for near-term economic growth. The long-term impact will not be known until the benefits of AI are measurable and measured.

## The Economy — The Bottom Line

There are lot of very large moving parts in the equation and there is significant interaction between the parts. The average economists' forecast for first quarter GDP is for growth of 1.6%. The Atlanta Federal Reserve GDP Now Model forecasts a decline of 2.8%. (the GDP Now model is updated as each relevant economic report is released). In late February/ early March the forecast dropped from +2.3% to -2.8%... a change of -5.1% in two days. On February 28, personal spending statistics were released and on March 3, construction spending was released. Both contributed significantly to the forecast decline.

We had consistently maintained a constructive forecast for economic growth as every historically reliable recession predictor had turned negative over the last three years. Last summer, we established that the window for economic slowdown would start to open early in 2025. If the GDP Now forecast is correct with a first quarter decline and it is followed by weakness in the second quarter, the technical definition of a recession would be met.

There is a lot of economic data to be reported between now and June 30. The conclusion is uncertain at this time (as always) but we have now must recognize the potential for a recession, or at least near-term economic weakness.

## Inflation

Inflation remains a problem today, as differing components of the PCE and CPI indices take turns in leading the rise in prices. While we have commented extensively on the varied, yet stubborn inflation readings over the last three years, the takeaway can be boiled down to this — the inflation fight is not over. The Federal Reserve's favorite measuring stick (PCE Services ex Housing & Energy) has averaged 4.1% over the last three months and 3.6% over the last six months[2]. The 4.1% rate is the worst over the last year.

## Interest Rates

The Federal Reserve policy for short-term interest rates is on hold at the moment and recent inflation reports do not suggest they will change their stance. It is unlikely the Fed will drop short-term rates significantly unless there is a major negative shock to the domestic or global banking system. The ten-year Treasury Bond yield has ranged between 3% and 5% over the last three years – currently at 4.2%[3].

**Ten-Year Treasury Bond Yield**


Source: Morningstar

The market fight is between the prospects for longer run inflation and near-term economic weakness. The supply of bonds from funding a fiscal deficit equal to 7% of GDP does not help bond prices rise (and yields fall). The ten-year rate is a good report card on how well the Fed's inflation fight is progressing. The rate is currently ½ percent higher than when the Fed cut rates in September, expressing a less than stellar grade.

## The Stock Market

The 10 largest companies had represented as much as 35% of the capitalization-weighted S&P 500 Index. These stocks also carried relatively high valuations as enthusiasm for AI-driven growth prospects drove prices upward. Valuations are moving lower for these market leaders, as well as the overall market. However, the S&P 500 forward P/E ratio still stands in the 82nd percentile of its historical range. Given the "many very large moving parts" within the economic landscape, we are maintaining a relatively more conservative allocation within equity portfolios, concentrating on more defensive sectors such as health care and consumer staples.

We will continue to monitor the economic statistics and earnings profile of segments of the market and position portfolios accordingly.

## Disclosures

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[1] The Federal Reserve Bank of St. Louis [2] Bureau of Economic Analysis [3] Morningstar


engage@aamamail.com
aamaweb.com
4995 Bradenton Avenue, Dublin, Ohio 43017
614-717-4451