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A Turning Point in History?

Dear Investors

We are writing at a potential turning point in history. It has become increasingly clear to market participants that the ushering in of the new Trump administration will have significant ramifications for assets and the economy. As the policy mix has become clearer with time, it seems that a recession may be the likely price to pay for achieving Trump's goals. This note examines these developments and explains why we believe a recession is probable.

A Historic Shift Begins

The second Trump presidency differs significantly from the first. Instead of appointing traditional conservative Republicans to moderate his views, this time he has chosen department heads who are committed to implementing his vision. For example, Commerce Secretary Lutnick has been a close friend of Trump for 40 years, and Special Advisor Navarro even served jail time after defying Congress in connection with Trump's efforts to overturn the 2020 election. The administration is now populated by individuals who are fully aligned with Trump's objectives and will carry out his directives.

It is becoming increasingly evident that the goal of this Trump administration is to reshape the world order. The post-World War II framework established at Bretton Woods is being dismantled. The objectives of the World Trade Organization, International Monetary Fund, NATO, and the United Nations – institutions that were largely shaped by the US – are being fundamentally challenged by their creator.

The Domestic Fallout of Globalization

The old system was premised on the idea that free trade would bring the world peace and prosperity. The free trade consensus pointed to Asian countries like Singapore and South Korea as examples of their theory. However, it now seems that these countries have become too successful for the system's comfort. The cost has largely been borne by US manufacturers and the employees who once thrived in industry.

The hallmarks of the old system were as follows: Free trade encouraged companies to manufacture goods in China and Southeast Asia, where labour and overall costs were significantly lower, resulting in higher profit margins. Today, China's manufacturing capabilities are unmatched, making it difficult for many goods to be viably produced elsewhere due to the expertise and infrastructure involved. This system allowed American consumers to purchase goods at lower prices. In turn, China reinvested the proceeds from its trade surplus back into US bonds, creating a cycle that benefitted both sides.

For many years following China's ascension into the World Trade Organisation, the system delivered low inflation, higher corporate profitability and improved real wages for the majority of Americans. There was no reason for the US democratic system to change when, under one person one vote, the net number of winners outweighed the losers.

Change has, however, occurred over time. The first signs of political shift emerged with the rise of the Tea Party movement. Presidential candidate John McCain remarked that, unexpectedly, vice-presidential candidate Sarah Palin was drawing larger crowds at her rallies than he was. Following Obama's election, came Brexit and then Trump. The dissatisfaction with the system has been building since the Global Financial Crisis, with these events marking key moments of unrest.

Underlying this political shift was the stark reality that many people had been left behind, despite the overall economic prosperity being created. Many lost their jobs as it became cheaper to produce goods in China, Mexico, or Canada. As the documentary *American Factory* highlights and the book *Janesville* shows, entire towns were devastated by China's rise. Shops closed or were boarded up, and as hope dwindled, fentanyl spread throughout much of the Midwest and upper Mid-Atlantic, exacerbating the sense of decline.

The number of people whose livelihoods have been destroyed by the Bretton Woods system has now become politically significant. Trump recognized an opportunity to tap into a Republican message that could resonate with union members and traditionally Democratic voters. In contrast, the Democrats offered more of the same, and Kamala Harris had little appeal in the Midwest swing states. The old system was no longer working, and the American people have called for change.

Trade is the backbone of our entire economic system. Domestically, we exchange our time and skills for the goods and services others produce and provide that we need and want. Money simply acts as the medium facilitating this exchange. Similarly, on the international stage, countries trade with one another in the same way. Trade underpins our system, and now the US seeks to change the rules governing the international part of that system.

Trump's New Economic Strategy

How does the new Trump administration seek to change the system? Two recent interviews offer valuable insight into the rationale behind his strategy – we encourage readers to listen to them (here and here), as they are particularly illuminating. The administration's plan to replace the old system with a new one centres on three core pillars:

- **Rebalancing global trade**: The US will pressure trade-surplus nations to reduce their reliance on exports and boost consumption. At the same time, the US aims to produce more and consume less, using tariffs as a key tool to shift the balance.
- **Balancing the federal budget**: The administration intends to close the fiscal gap by implementing $1 trillion in spending cuts alongside $1 trillion in new revenues.
- **Redesigning tax policy to reward key voter groups**: Tax cuts will be restructured to support working-class Americans who align with Trump's agenda – for example, by reducing taxes on tips, overtime, and car leases, provided those cars are made in the US.

Much of what the Trump administration is doing bypasses the need for Congressional approval – it operates largely through executive action, making it difficult to block. The legal foundations for these actions are likely to be upheld by a conservative-leaning Supreme Court, which increases their staying power. This administration has already demonstrated a willingness to sidestep legal norms, as evidenced by its continued deportations to Venezuela despite legal and humanitarian concerns.

On top of the reordering of global trade, this administration is heavily shaped by the mindset of businessmen. They see government as a business and a budget deficit as a loss. Commerce Secretary Howard Lutnick, for instance, is a vocal critic of debt, crediting his company's survival after 9/11 mainly to its debt-free position. As a student of Stanley Druckenmiller, Treasury Secretary Bessent has long argued that America needs to cut back on entitlement spending to ensure its long-term prosperity. It was Lutnick who first proposed pursuing DOGE (Departmental Operational Government Efficiency), and he successfully convinced Elon Musk that the federal government could be run with 80% fewer employees. Musk agreed, pointing to the fact that only 800,000 federal workers were deemed essential during the COVID-19 pandemic. He has now been tasked with identifying $1 trillion in expenditure cuts.

Under the administration's logic – however flawed – cutting the wages of so-called "unproductive" federal workers doesn't reduce what they consider "productive" gross domestic product. Driven by this belief, Lutnick is on a mission to eliminate the budget deficit entirely.

The Recession Case Builds

What are the likely implications of this policy mix? Overall, the likely consequence from these changes is a recession. There are a few lenses we can use to provide us with perspective.

One lens with which we can view the impact of these changes is through corporate profit margins. It's hard to see how corporate profit margins don't come down. Under the old system, corporate America was a major beneficiary – able to outsource production to lower-cost countries like China and capture the resulting spread. For example, Elon Musk's most profitable factory is located in Shanghai, not Texas or Nevada. Reshoring production will reduce equity returns in two fundamental ways: first, it will require higher capital expenditure to produce the same amount of goods as before; and second, the cost of production will rise due to more expensive labour and inputs. On aggregate, returns on capital for the corporate sector will come down in a structural way.

This dynamic is also true of the returns on capital of foreign companies. If reshoring is successful foreign manufacturers will be hit on two fronts: they'll lose part of their margin to U.S. tariffs and face a shrinking customer base in the world's largest consumer market.

Furthermore, the average company listed on the US stock exchange doesn't tend to make a large net profit margin. The S&P500 averages a net profit margin of around 8%. Theoretically, the net profit margin can't be much higher than wage growth. If, say, the cost of goods sold and labour costs rise by around 2-3% from reshoring, then this would have a major impact on corporate profitability.

Another way we can put the impact of tariffs into perspective is through the lens of taxation. Even in a scaled-back form, the tariff will represent the largest tax hike in the last 75 years of US history. The tax hike will be borne by a mixture of participants in the world economy (mainly US consumers), and the overall impact will be to dampen growth. It's a lot of revenue to suck out of the system.

We can also view these changes from the lens of supply chain disruptions. COVID was such a turbulent period largely because global supply chains were thrown into disarray. However, while the post-pandemic recovery saw supply chain chaos alongside a surge in spending, today we're facing similar disruptions but with a negative income shock. We can see how we get disruptions to supply chains similar to the post-pandemic recovery. The scale of the disruption might end up being larger because the tariffs are a big enough hit to corporate profits to cause *permanent* change.

We can also think of the economy as a single person – someone who receives income from both the government and a private sector job, saves, invests in assets, and spends. When this person's income and investment returns rise, spending typically increases, driving economic growth. In today's case, however, our person-economy is about to see a roughly 5% drop in government income, while the value of their investments has already declined sharply. On top of that, tariffs may raise the cost of living by another 2–4%. Taken together, it's not a difficult forecast to make: this person's spending power is set to decline. And recessions happen when people spend less.

Market Signals and Fragility

As the policy picture has become clearer, market participants are now responding in force. A recession that occurs while inflation rises has, throughout history, been particularly unfriendly to stocks. The reason is because price earnings multiples tend to contract more severely under such conditions. If the Trump administration doesn't change course, then we believe there could be another 15-20% decline in the S&P 500 to come over time.

Falling collateral values will also act as a drag on spending, particularly given that a significant portion of recent consumption has been funded by sources other than income. A similar phenomenon was present during the dotcom period, and declining tech stocks (AI stocks today) was the first driver of the recession. The broader indices followed and the decline in collateral values had a notable impact on the ability of consumers to either borrow or spend.

AI, too, is starting to run into problems. As we've monitored the course of events, it's become clear that the supply of infrastructure has begun to exceed the demand for it. For instance, Microsoft has begun to terminate contracts to build data centres across the world – something we wouldn't expect to see if AI demand were still significantly exceeding supply. There is still compute rationing in some parts of the system, but growth rates have likely peaked. The start of the dotcom crash coincided with higher interest rates and a peak buildout of the infrastructure needed to run the internet.

One factor we're actively considering is the potential speed of the decline. While we're not yet certain how quickly it will unfold, several elements are contributing to the current market downdraft. The strong conviction with which investors now view the outlook – combined with the need to unwind highly concentrated stock positions—is accelerating the pace of the initial sell-off. That said, it's unlikely the broader economic downturn will match the speed of the COVID crash or the GFC. The trajectory may be slower and more drawn out, but it's something we're continuing to monitor closely.

What Might Change the Outlook?

The key question now is: when might policy change course? And relatedly, where could the recession thesis be wrong?

For us to shift our positioning, we would need clear signs that the Trump administration is reconsidering its approach in response to political pressure. Already, it's become clear that his agenda is deeply unpopular. In recent special elections in Florida, Republican candidates suffered swings of around 20% against them. Similarly, in the Wisconsin Supreme Court election – a state Trump carried in the presidential election just six months ago – there was a 10% swing against the conservative candidate. These results suggest that the electorate may be having second thoughts about the Trump agenda and may not be willing to bear the economic costs of aggressive trade reform. Many moderate Republicans in the House are likely feeling increasingly uneasy. If the administration begins to soften its stance in response to this pressure, it could be a meaningful catalyst for a shift in market sentiment.

Another potential turning point could come from signing trade deals with the EU, China, Canada and Mexico. These four countries make up the large portion of American imports. Some smaller nations, like Vietnam, have strong incentives to eliminate tariffs entirely, given that they're unlikely to import much from the US regardless. But the incentives for larger economies are far more complex. China, for instance, has the capacity to cushion a couple of years of economic pain through fiscal stimulus, and its political system gives it an edge in absorbing hardship – unlike democracies, it doesn't face the same short-term electoral pressures. The European Union, while likely eager to preserve trade advantages, faces significant domestic constraints. Reforming its VAT system – one of the Trump administration's core grievances – would be politically difficult. Meanwhile, the EU is moving forward with its digital services tax, set to be passed by the end of this month, further straining negotiations. Canada and Mexico have much more to lose given that up to 25% of their economy relies on exports to the US. Already, Canada is in recession and job cuts have been deep. Deals might get struck much earlier than the others. The willingness of trade partners to strike deals, particularly as a response to domestic political pressure, is a key development we're watching closely.

So far, it's clear that there hasn't been enough pain for the administration to change course. Reports by the Washington Post from administration staffers suggest that Trump is keen to change the world order, and he's only got 2 years to do it before the mid-term elections:

> *"He's at the peak of just not giving a f*** anymore. Bad news stories? Doesn't give a f***. He's going to do what he's going to do. He's going to do what he promised to do on the campaign trail."*

Secretary Bessent often references the economic pain that accompanied the sweeping changes introduced by Paul Volcker and Ronald Reagan – arguing that while the short-term costs were significant, they paved the way for a long period of prosperity. Aside from Vice President Vance, the key figures in the administration – Trump, Lutnick, Navarro, and Bessent – do not have future elections to contest, giving them more freedom to pursue long-term structural change. According to Bessent, the goals of reshoring production and rebalancing global export economies are multi-year efforts. The administration believes it holds the stronger bargaining position in global trade negotiations, given its role as the world's largest debtor nation. It also views its mission as being for Main Street, not Wall Street. From their perspective, stock market performance is an irrelevant metric – particularly since the bottom 50% of Americans own very few equities. It's for these reasons the administration may be willing to endure an inordinate amount of pain in pursuit of its goal to fundamentally rewrite the rules of the global economic order.

The other potential flaw to the thesis is if the Supreme Court strikes down the tariffs, which are based on executive action rooted in the International Emergency Economic Powers Act. This legislation has never before been used to impose tariffs of such a broad and systemic nature, making the legal basis somewhat untested A lawsuit challenging the tariffs has already been filed. However, it's worth noting that Trump significantly shaped the Supreme Court during his previous term, appointing a solid conservative majority. That same Court recently allowed Trump to proceed with his changes to DEI policies, suggesting a general deference to executive authority.

What seems likely at this point is that the mechanisms for a recession are already in motion, even before the Trump administration might change course. In other words, timing is crucial. If the tariffs remain in place long enough, the economic chain reaction – starting with job cuts – will be set in motion, eventually triggering a recession. While the administration may try to adjust its policies later, the longer these changes persist, the more likely the downturn becomes.

Additional Risks on the Horizon

There are also risks that could accelerate the onset of a potential recession. One such risk has already begun to play out, with China adopting a sort of "honey badger" approach to retaliation – unfazed and willing to push back aggressively. Any further escalation in tariffs would only intensify the pressure, compounding the economic damage and hastening the downturn.

We're also cognisant of the risk that rising nationalism and protectionism could begin to restrict the free movement of capital globally. For example, President Macron has urged EU companies and investors to reduce capital flows to the United States. In Japan, institutions often align closely with government policy, and the Economy Minister has recently warned the US about potential capital repatriation during trade negotiations. China has already taken steps to reduce its holdings of US Treasury bonds. Meanwhile, anti-Trump and anti-American sentiment is increasingly pervasive in Canada. These developments could undermine the U.S.'s ability to finance itself easily – adding yet another layer of pressure to an already fragile economic backdrop.

We're open to the idea that the US can't get all of the funding it needs. If capital flows are re-wired faster than the trade deficit is eliminated, then the US economy may need to ration capital. It's likely that such a shortage might show up most clearly in equity markets. In response, either the government, businesses, and consumers will need to increase savings, or we could see higher interest rates, falling asset values, or a scenario where the Federal Reserve is compelled to print money to bridge the gap.

Our Positioning: Waiting for Clarity

So where does that leave us? Stock prices were already elevated to begin with, and we believe that, in the event of a recession, a much larger decline would ensue. The Fed is prevented from saving the stock market because inflation could rise to 4% or more from a fully-fledged tariff program. In our view, gold stands to benefit during this attempt to reshape the world order, as we've outlined in previous notes. While bonds have traditionally provided downside protection in recessions, we believe they will serve as only a partial and relatively ineffective hedge this time due to persistent inflation. Once markets settle, we expect gold to fill that defensive role more effectively than fixed income.

If we see the administration significantly change course, we'll begin to re-enter the market and buy the individual stocks we've researched. However, the lesson from past downturns – such as the dotcom crash, during which a young Amazon lost 90% of its market value, and previous episodes of stagflation – is to exercise extraordinary patience. After a long period of stability and excess, the world is heavily exposed to US stocks and assets. But the proverbial penny is starting to drop – and we believe it's prudent to wait for clarity before stepping back in.

Kind Regards,
Fawkes Capital Management

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