BlackDiamond
Financial

INVESTMENT INSIGHTS

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Mount Fuji is a sacred symbol of Japan.

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Tariff Uncertainty and Recession Concerns Drive Sentiment

The S&P 500 declined by 4.3% in the first quarter, driven largely by renewed tariff uncertainty and growing concerns about a potential recession. Investor sentiment weakened as trade tensions raised questions about the durability of corporate earnings and broader economic momentum.

From its February peak, the S&P 500 fell 10% in just three weeks — meeting the definition of a market correction. This underscores that volatility is a normal and expected aspect of equity investing, even during strong years. For example, the last correction occurred in 2023, a year in which the S&P 500 ultimately returned 24%.

Since 1980, the S&P 500 has experienced an average intra-year decline of 14%. Despite these fluctuations, the index achieved positive annual returns in 34 of the past 45 calendar years — a powerful reminder of the long-term resiliency of stocks.

International equities, by contrast, gained 5.2% this quarter. While this divergence is noteworthy, it is important to recognize that U.S. equities have significantly outperformed international markets over the past two decades. Periodic outperformance abroad is not surprising and underpins the value of portfolio diversification.

In fixed income, 10-year Treasury yields declined by 0.4%, finishing the quarter at 4.2%. This move provided a tailwind for bond prices (bond prices rise when yields decline), helping the Bloomberg U.S. Aggregate Bond Index gain 2.8% this quarter. For balanced portfolios, fixed income played its traditional role — helping cushion equity volatility.

As always, we emphasize the importance of maintaining a disciplined, long-term investment strategy focused on thoughtful asset allocation, broad diversification, and prudent risk management — rather than reacting to short-term market noise.

Comparative Returns

		Annualized Performance			
	Q1 2025	2024	3 Years	5 Years	10 Years
Large Cap U.S. Stocks[1]	(4.3%)	25.0%	9.1%	18.6%	12.5%
Small Cap U.S. Stocks[2]	(9.5%)	11.5%	0.5%	13.3%	6.3%
International Stocks[3]	5.2%	5.5%	4.5%	10.9%	5.0%
Real Estate[4]	0.8%	7.5%	(1.8%)	10.0%	4.0%
U.S. Bonds[5]	2.8%	1.3%	0.5%	(0.4%)	1.5%

1 S&P 500 index. 2 Russell 2000 index. 3 MSCI ACWI ex-U.S. index. 4 MSCI U.S. REIT index. 5 Bloomberg Barclays Aggregate Bond index.

Tariffs and Tradeoffs

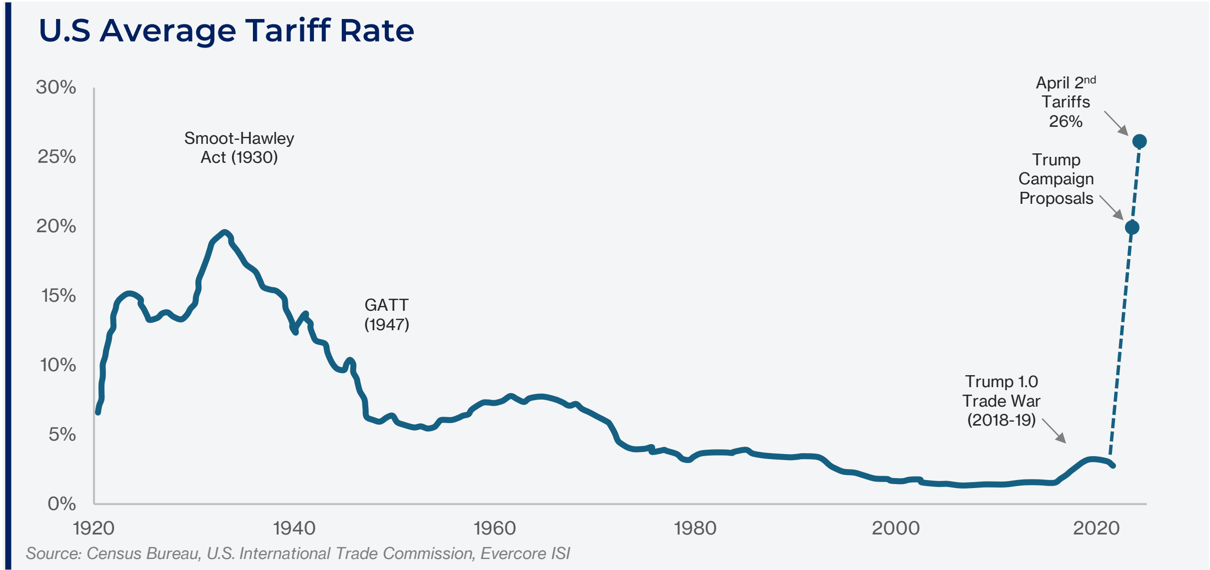
What Investors Need to Know

The Role of Tariffs in Economic Policy

Tariffs have emerged as a defining feature of the U.S. policy landscape, and investors are weighing both the risks and the rationale. On one hand, higher tariffs raise input costs, reduce trade flows, and can dampen consumer demand — heightening the risk of a growth slowdown or even a recession. On the other, as the current Administration has argued, when tariffs are implemented alongside reduced government spending, deregulation, and a reordered international trade model, they may accelerate economic growth, increase overall government revenue — even with lower tax rates — and reduce fiscal imbalances.

As economist John Kenneth Galbraith once remarked, “The only function of economic forecasting is to make astrology look respectable.” That reminder is particularly relevant here: while policy tools like tariffs may carry theoretical benefits, their real-world outcomes are often clouded by complex interdependencies and unpredictable changes in behavior.

Tariff uncertainty has caused investors to lower their confidence in the future earnings growth of corporate America, thereby leading to recent market declines.



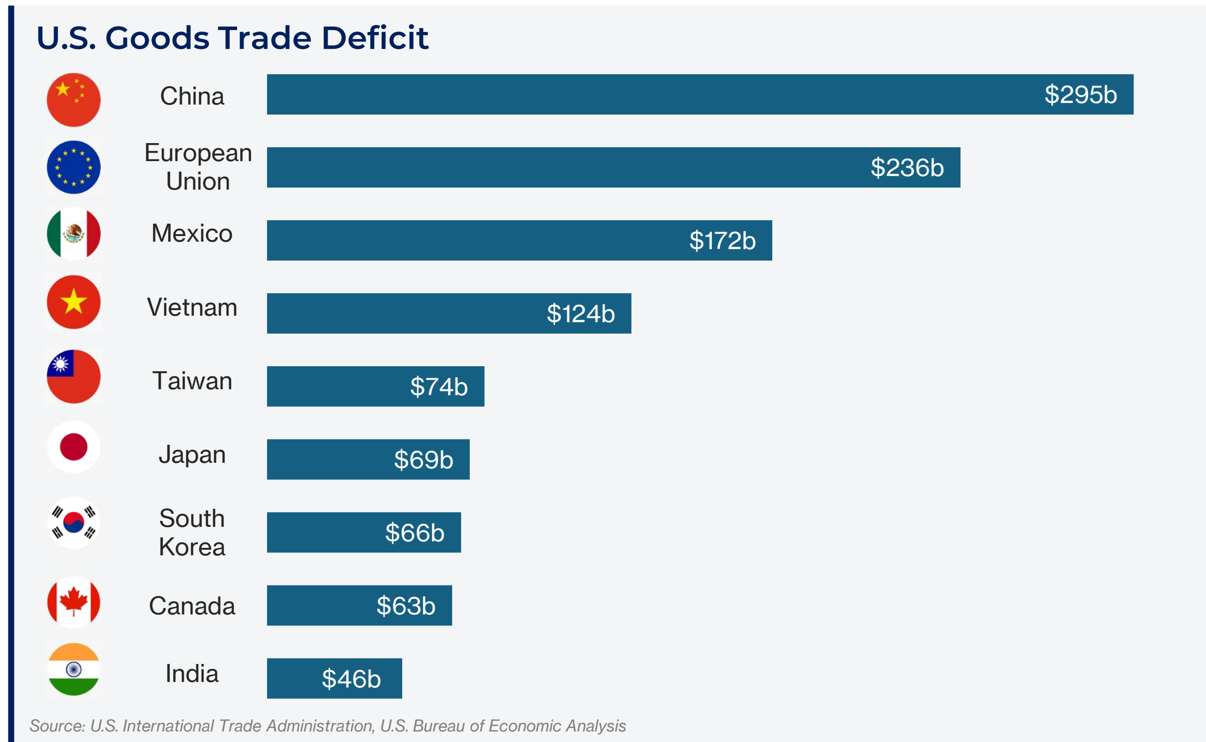
Source: Census Bureau, U.S. International Trade Commission, Evercore ISI

Tariffs in Historical Context

The U.S.’ commitment to liberalized global trade goes back to the post-WWII period. During the late 1990s — when many of us at Black Diamond were in business school — free market theories became even more prominent, both in academic circles and economic policy. We learned that tariffs create economic inefficiencies, distort comparative advantage, and ultimately reduce consumer welfare. This free trade consensus framed open markets as the most effective means to promote growth and productivity with lower prices, increased efficiency and greater market access.

This free market policy has led to significant trade deficits. In 2024, The United States' trade deficit in goods exceeded $1.2 trillion with the key imbalances highlighted in the chart below.

The current Administration's tariff policy represents a significant departure from the long-standing free market consensus. Critics of free trade argue that it has contributed to the hollowing out of U.S. manufacturing, discouraged investment in advanced domestic production, weakened critical supply chains, and left the defense-industrial base vulnerable to foreign adversaries.



Sweeping Tariffs Imposed on Imports

On April 2nd, the Administration unveiled a comprehensive set of tariff measures aimed at addressing trade imbalances and promoting domestic manufacturing.

The announcement included a universal 10% tariff on all imported goods. Additionally, higher "reciprocal" tariffs have been imposed on specific countries with which the U.S. has significant trade deficits. Reciprocal tariffs were set at half of the current tariff rates imposed by U.S. trading partners based on the Administration's calculations. These tariffs will remain in effect until the President determines that the threat posed by the trade deficit and underlying nonreciprocal treatment is satisfied, resolved, or mitigated.

The tariffs also contain modification authority, allowing the President to increase the tariff if trading partners retaliate or decrease the tariffs if trading partners take significant steps to remedy non-reciprocal trade arrangements and align with the United States on economic and national security matters.

To determine the level of reciprocal tariffs, the Administration applied a formula based on bilateral trade imbalances. For each country, the U.S. trade deficit was compared to the value of that country's exports to the United States. That ratio was then halved to arrive at the final tariff rate — subject to a floor of 10%, even in cases where the U.S. runs a trade surplus. This approach is designed to reflect what officials describe as an imbalance in treatment, imposing higher tariffs on countries whose exports to the U.S. far exceed their imports from it.

> *"Virtually all economic behavior is governed by the interplay between fear and greed, and by incentives."*
> Howard Marks – Founder of Oaktree Capital

Economic Impacts are Difficult to Predict

Tariffs are often justified on three grounds: correcting unfair trade practices, supporting domestic industry, and reducing the trade deficit. By raising the cost of imported goods, tariffs aim to incentivize domestic production and job creation while simultaneously creating negotiating leverage with international trading partners.

Yet these benefits come with economic trade-offs. As Howard Marks of Oaktree Capital has emphasized, "Virtually all economic behavior is governed by the interplay between fear and greed, and by incentives." Tariffs may offer immediate political appeal and short-term benefits to targeted sectors, but they can also lead to retaliation and trigger inflationary pressures — which increases uncertainty for businesses and investors.

This skepticism echoes the views of economist Milton Friedman, who argued that while the benefits of protectionist measures may be highly visible and concentrated, their costs are broad, diffused, and often hidden from public view.

There are also behavioral considerations. If companies believe tariffs are temporary or politically motivated, they may delay investment decisions, hedging against regulatory or pricing risk rather than committing capital to domestic expansion. This kind of policy-induced hesitancy can erode the very job growth and capacity-building that tariffs are intended to support.

Negative Trade Deficits Drive American Assets into Foreign Hands

Some observers have also pointed to the long-term national wealth effects of persistent trade deficits. When the U.S. imports more than it exports year after year, it must finance the gap by selling financial assets — like treasury bonds, corporate equity, or real estate — to foreign investors. This inflow of foreign capital helps fund domestic consumption, but it also means that more and more U.S. income-generating assets are owned by entities abroad. The United States now has a negative international investment position of $23.5 trillion as evidence of this dynamic. Over time, the earnings from these assets flow out of the U.S. economy and into the hands of foreign investors.

While this process unfolds gradually, its effects are cumulative. It represents a quiet but steady transfer of national wealth and future income streams. Critics argue that this dynamic weakens U.S. economic sovereignty and leaves the country more vulnerable to external shocks. The Administration contends that tariffs, when used strategically, can help reverse this pattern by reducing the trade gap and encouraging domestic investment. In their view, a revised trade policy is not just about economics — it's about regaining control over the nation's industrial base and long-term financial independence.

> *In 2024, debt servicing costs surpassed spending on both national defense and Medicare, highlighting the growing challenge of sustaining our nation's debt.*
> – Black Diamond Financial

Fiscal Policy Context: A Broader Strategy Emerges

What makes today's tariff strategy distinct is its integration into a broader fiscal agenda. The federal deficit totaled $1.8 trillion in fiscal year 2024 equating to 6.4% of the nation's Gross Domestic Product (GDP).

In this context, tariffs are being positioned as part of a broader strategy that includes reducing discretionary spending, enacting pro-growth tax reforms, and seeking additional, politically viable revenue streams. Unlike direct tax increases or entitlement reform — which face significant political resistance — tariffs are seen by some as a more acceptable, indirect means of raising revenue.

The Administration's proposed measures could potentially generate hundreds of billions in new revenue. This dovetails with the broader theory that deregulation and fiscal discipline can unlock faster economic growth, which, when paired with stable or rising revenues from tariffs, can reduce deficits without politically painful entitlement reforms.

One question worth considering is what level of fiscal deficit is sustainable over the long term. While there is no single optimal target, many economists view a sustained federal deficit in the range of 2–3% of GDP as a prudent benchmark— one that allows for investment and economic flexibility without triggering debt instability. When deficits consistently exceed this level, especially in non-recessionary periods, the risks compound: higher interest costs, reduced fiscal flexibility, and increased vulnerability to future economic shocks.

Included on the next page is a table highlighting Federal Agency spending, revenue sources and resulting deficits. The scale and scope of federal fiscal expansion over the past five years is notable. From fiscal year 2019 to 2024, spending outpaced revenue, widening the federal deficit by nearly 86%. This fiscal trajectory underscores the growing challenge of managing long-term deficits, reinforcing the strategic interest in policy tools like tariffs to supplement revenue without direct tax increases.

Key Takeaways for Investors

As long-term investors guided by a strategic asset allocation philosophy rooted in diversification and discipline, we believe tariff policy — while important — should not drive wholesale changes in portfolio construction. Tariffs are just one of many macroeconomic variables influencing capital markets, and history shows that reacting to a single policy shift can lead to missteps.

That said, the reemergence of tariffs, especially at elevated levels, raises recession risks by increasing input costs, tightening financial conditions, and potentially curbing investment by businesses and consumer spending. These developments could contribute to further market volatility in the near term. Rather than repositioning portfolios tactically based on any one policy trend, we advise investors to remain focused on long-term goals while ensuring that portfolios are stress-tested for a range of outcomes — including elevated volatility and slower growth scenarios.

SPENDING, REVENUE AND DEFICIT

(In Billions)

Agency Spending	FY2019	FY2024
Department of Health and Human Services	$1,213.8	$1,720.6
Social Security Administration	1,101.8	1,519.7
Department of the Treasury	689.5	1,311.9
Department of Defense	654.0	826.3
Department of Veterans Affairs	199.6	325.0
Department of Education	104.4	268.4
Department of Agriculture	150.1	203.4
Office of Personnel Management	103.1	126.2
Department of Transportation	80.7	117.4
Department of Homeland Security	56.3	89.3
Independent Agencies	19.6	77.8
Other Defense Civil Programs	60.9	66.2
Department of Labor	35.8	65.7
Department of Housing and Urban Development	29.2	52.0
Department of Energy	28.9	49.3
Department of Justice	35.1	44.0
Department of State	28.0	37.0
International Assistance Programs	23.6	35.8
Small Business Administration	0.5	33.2
National Aeronautics and Space Administration	20.2	25.0
Department of the Interior	13.9	17.1
Department of Commerce	11.3	14.7
Environmental Protection Agency	8.1	13.7
Corps of Engineers	6.5	11.3
Judicial Branch	8.0	9.5
National Science Foundation	7.3	9.4
Legislative Branch	5.0	6.8
Executive Office of the President	0.4	0.6
General Services Administration	(1.1)	(0.2)
Undistributed Offsetting Receipts	(247.8)	(330.6)
Total Spending	**$4,446.7**	**$6,746.5**

Revenue Sources	FY2019	FY2024
Individual Income Taxes	$1,718.0	$2,426.0
Corporate Income Taxes	230.0	530.0
Social Insurance Taxes	1,243.0	1,709.0
Excise Taxes	99.0	101.0
Estate and Gift Taxes	17.0	32.0
Customs Duties	71.0	77.0
Miscellaneous Revenue	85.0	43.0
Total Revenue	**$3,463.0**	**$4,918.0**

Federal Deficit	**($984.4)**	**($1,830.0)**

Source: Department of Government Efficiency, U.S. Department of the Treasury as of September 30, 2019 and September 30, 2024.
Due to rounding, individual figures may not add up precisely to the total displayed.

ABOUT US

Black Diamond Financial, LLC is a fee-only registered investment adviser with a unique and holistic focus on preserving and enhancing wealth. Our mission is to help you achieve your financial goals through the use of low cost, tax-efficient investment strategies. We create individualized investment portfolios for each client that are risk-appropriate, return optimized, and tax-efficient. Where appropriate, we incorporate institutional quality private investments to capture illiquidity premiums or yield opportunities. Furthermore, we believe cost is a critical factor in any successful investment strategy and therefore offer fully transparent pricing that is below industry standard. As an employee-owned firm focused on our fiduciary duty, we make our clients' interests our highest priority.

CONTACT US

info@blackdfinancial.com

Baltimore

Bend

Park City

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