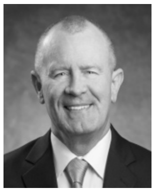
April 17, 2025

MARKET SIGHT*LINES*



Unpacking the Market Dynamics of Tariffs, Inflation, and Recession Fears

By Michael O'Keeffe, *Chief Investment Officer*

Many investors have been shaken in 2025, with some gauges signaling "extreme" policy uncertainty. People are worried that tariffs will drive inflation higher and trigger a recession. Forward estimates of inflation have risen, yet fed funds futures are signaling interest rate cuts. The stock market has fallen, yet market interest rates remain elevated. In this week's Sight|Lines, we unpack how the market has reacted to the current environment and look at the data to understand where we might go from here.

THE TAKEAWAY: MARKET REACTIONS ARE ACTUALLY REASONABLE, BUT INTEREST RATES DESERVE SOME ATTENTION

Despite the uncertainty in the environment, most market dynamics are not that unusual, and yet some warrant careful focus. In summary:

- The Economic Policy Uncertainty Index, which gauges uncertainty based on news headlines and policy changes, is at levels last seen at the peak of the pandemic.
- In the last couple of months, actual inflation has been cooling, with the consumer price index (CPI) and producer price index (PPI) results coming in below the Federal Reserve (Fed)'s target.
- Many are worried about sustained inflation, with the break-even inflation rate and the New York Fed's consumer survey of one-year inflation both well above the Fed's 2% target.
- Popular forecasting models show an increased probability of recession.
- Fed officials are wrestling with the increased uncertainty of the economic outlook, and market participants have interpreted that to mean the Fed will cut rates this year.
- The stock market is down given increased worries about tariffs, inflation, and recession.
- But market valuations are still reasonable, and the year-to-date return is reasonable given our approach to modeling long-term expectations.
- Market interest rates, such as the 10-year Treasury yield, which would typically fall in this type of environment, have instead risen modestly.
- This modest disconnect deserves some attention, as it may be an early signal that investors will be demanding higher yields to hold U.S. Treasury bonds going forward, which has implications for the cost of debt for consumers, businesses, and our government.

IN-DEPTH: UNCERTAINTY AROUND THE PATH FOR INFLATION, THE ECONOMY, AND MONETARY POLICY IS LEADING TO INVESTOR FEAR, AND INTEREST RATE MOVES DESERVE SOME ATTENTION

While policy uncertainty is high and extreme fear is driving investor emotion, many of the market dynamics are not all that unusual, even as others warrant some additional focus. Going deeper:

- The Economic Policy Uncertainty Index is elevated:
  - This index now sits at 434, a level last seen during the peak of the pandemic and above the average of 118 over the last 25 years.
- February and March inflation readings showed inflation is cooling to the Fed's 2% target:
  - The CPI was 0.2% in February and declined 0.1% in March, the first monthly decline since May 2020. Core CPI, which excludes food and energy, rose 0.1% in March.
  - The PPI actually fell 0.4%, and core PPI fell 0.1% in March.
- Both investors and consumers though are projecting inflation above the Fed's 2% target:
  - From investors, the 12-month inflation breakeven rate is currently 3.1%.
  - From consumers, the New York Fed's consumer survey of one-year inflation rose to 3.6%.
- Forecasting models are signaling an increased probability of recession:
  - The New York Fed's probability of U.S. recession in the next 12 months is at 30%,
  - The Bloomberg Recession Probability forecast is now 30%, up from 20% in 2024.
- With the Fed worried about increased uncertainty and the economy, investors are expecting Fed rate cuts:
  - Fed funds futures are forecasting four 0.25% cuts by December.
- The stock market is down given increased worries about tariffs, inflation, and recession, but market levels and behavior are in line with historic valuations and long-term expectations:
  - The S&P 500 is down 7.9% year to date through April 15.
  - The S&P 500 forward P/E ratio, though, is in line with its 10-year average, reflecting fair valuation.
  - Our capital market assumptions (CMAs) estimate there to be a 17% chance of a -8% return (or worse) in any given year, indicating such a move may happen once every six years.
- The 10-year Treasury yield, which would typically fall in this type of environment, has instead risen:
  - This yield rose from 4% to 4.5% from April 4 (tariff "Liberation Day") to April 11 (before the announcement of a 90-day tariff pause). Since then, the yield has fallen to 4.3%.
- This modest shift of the 10-year Treasury yield to move higher deserves some attention:
  - Normally, with heightened uncertainty and the expectations of Fed cuts, rates usually fall.
  - Investors may be demanding higher yields to invest in U.S. government bonds, reflecting possible worries about growing debt and the economic impact of significant tariffs going forward.

CONCLUSION

Investors have been shaken in 2025, and popular gauges are signaling heightened uncertainty around policy. Forward estimates of inflation have moved higher, but the building worries of a recession have investors still expecting Fed rate cuts. Despite investor worry, equity market results are within expectations, and the data that deserves perhaps more attention are market interest rates, especially Treasury yields.

Michael P. O'Keeffe, CFA
Chief Investment Officer
michael.okeeffe@stifel.com
www.stifelinsights.com

The information contained herein has been prepared from sources believed to be reliable but is not guaranteed by us and is not a complete summary or statement of all available data, nor is it considered an offer to buy or sell any securities referred to herein. Opinions expressed are subject to change without notice and do not take into account the particular investment objectives, financial situation, or needs of individual investors. There is no guarantee that the figures or opinions forecasted in this report will be realized or achieved. Employees of Stifel, Nicolaus & Company, Incorporated or its affiliates may, at times, release written or oral commentary, technical analysis, or trading strategies that differ from the opinions expressed within.

Asset allocation and diversification do not ensure a profit and may not protect against loss. There are special considerations associated with international investing, including the risk of currency fluctuations and political and economic events. Investing in emerging markets may involve greater risk and volatility than investing in more developed countries. Due to their narrow focus, sector-based investments typically exhibit greater volatility. Small company stocks are typically more volatile and carry additional risks, since smaller companies generally are not as well established as larger companies. Property values can fall due to environmental, economic, or other reasons, and changes in interest rates can negatively impact the performance of real estate companies. When investing in bonds, it is important to note that as interest rates rise, bond prices will fall. Investing involves risks, including the possible loss of principal invested. Past performance is no guarantee of future results. The Standard & Poor's 500 index is a capitalization-weighted index that is generally considered representative of the U.S. large capitalization market. The Dow Jones Industrial Average (DJIA) is a price-weighted average of 30 significant stocks traded on the New York Stock Exchange (NYSE) and the NASDAQ. The DJIA was invented by Charles Dow back in 1896. The MSCI EAFE index (Europe, Australasia, and the Far East) is a free float-adjusted market capitalization index that is designed to measure the equity market performance of developed markets, excluding the U.S. and Canada. VIX is a trademarked ticker symbol for the Chicago Board Options Exchange Market Volatility Index, a popular measure of the implied volatility of S&P 500 index options. Index returns include the reinvestment of dividends but do not include adjustments for brokerage, custodian, and advisory fees. Indices are unmanaged and are not available for direct investment.

Stifel, Nicolaus & Company, Incorporated | Member SIPC & NYSE | www.stifel.com

0425.7869949.1