First Trust
Monday Morning OUTLOOK

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Tariffs, the Economy, and Stocks

The Federal Reserve started raising short-term interest rates three years ago and the M2 measure of the money supply – what Milton Friedman said to focus on – soon started declining, hitting bottom in late 2023.

One of the great mysteries of the past two years is why, given tighter money, economic growth didn't slow down, much less hit a recession. One reason was that the federal government was engaging in the most reckless deficit spending in our lifetimes. Don't get us wrong, we don't believe government spending is good for the economy in the long-run. But, in the short-run, it can make things feel better.

The federal deficit was north of 6.0% of GDP in both Fiscal Year 2023 and 2024. To put that in perspective, during the 1980s, President Reagan was consistently criticized for running overly large budget deficits. And yet the largest deficit of the 1980s was 5.9% of GDP in FY 1983, even as Reagan was fully funding the Pentagon at the height of the Cold War and the unemployment rate was 10%, meaning spending on unemployment and welfare were elevated.

There were no similar excuses for the past two years, when the jobless rate averaged less than 4% and we aren't at war. We think the enormity of these deficits, relative to economic conditions, temporarily masked or hid some of the pain from the tightening of monetary policy.

But now fiscal policy has gone in reverse, unmasking that economic pain. The Trump Administration is cutting government spending, via DOGE and otherwise, while simultaneously raising taxes via higher tariffs. According to the Tax Foundation, the Trump tariffs – those recently announced plus those already implemented – would raise revenue by 0.85% of GDP, making them the largest peacetime tax increase since 1982, even larger than the Bush tax hike of 1990, the Clinton tax hike of 1993, or the tax increases enacted under Obama. Note that the Tax Foundation's score is static, in the sense that it assumes no major shift in the location of production or buying habits back to the US, so that 0.85% estimate could easily be too high, but only time will tell.

Regardless, at least in the short term, these new tariff increases could more than fully outweigh an extension of the 2017 Trump income tax cuts, because most of what gets enacted later this year is likely to just be an extension of current policy. In other words, unless the income tax law enacted later this year includes a substantial deepening of the 2017 tax cuts, the total burden of taxes will be higher in 2026 than in 2024.

Hopefully the new US tariffs are a prelude to lower trade barriers against US products abroad, in which case our tariffs can come down, as well. We are hopeful on that front. But the formula used to calculate the new tariffs – based on our trade deficit with each country rather than the level of their tariffs – suggests that other countries simply reducing their tariffs might not be enough for the Trump Administration to relent on higher tariffs.

In the meantime, the economy has suddenly shifted from being artificially held up by overly large budget deficits to being exposed to temporary pain. Right now, it looks like US Real GDP will be roughly flat to down in the first quarter (initial release on April 30). And now consumers have to pay more for foreign goods, at the same time that businesses that might think of avoiding tariffs by putting or expanding operations in the US have to worry about how long the new tariff policies will stay in place. Why build a new plant here if the tariffs might be gone by the time you finish? As a result, recession risk is rising and we already thought a recession was overdue earlier this year.

Obviously, the tariffs have been the catalyst behind the recent drop in stock prices. And stocks may go lower from here. But stocks were overvalued even before the tariffs and if tariffs weren't the trigger for the drop in stocks, something else would have been. That's why we were willing to stick our necks out late last year and forecast 5,200 on the S&P 500 for this year while the rest of the industry was telling their clients stocks were headed higher.

Depending on the outlook for earnings, the S&P 500 is now *basically at fair value*, a major change from where it's been for the past few years.

Date/Time (CST)	U.S. Economic Data	Consensus	First Trust	Actual	Previous
4-7 / 2:00 pm	Consumer Credit – Feb	$15.0 Bil	**$10.0 Bil**		$18.1 Bil
4-10 / 7:30 am	Initial Claims – Apr 5	223K	**221K**		219K
7:30 am	CPI – Mar	+0.1%	**+0.1%**		+0.2%
7:30 am	"Core" CPI – Mar	+0.3%	**+0.3%**		+0.2%
4-11 / 7:30 am	PPI – Mar	+0.2%	**+0.2%**		0.0%
7:30 am	"Core" PPI – Mar	+0.3%	**+0.4%**		-0.1%

Consensus forecasts come from Bloomberg. This report was prepared by First Trust Advisors L. P., and reflects the current opinion of the authors. It is based upon sources and data believed to be accurate and reliable. Opinions and forward looking statements expressed are subject to change without notice. This information does not constitute a solicitation or an offer to buy or sell any security.