Costs of Radical Uncertainty

Markets take risk in stride. They are after all continuously discounting changing circumstances and attaching probabilities to unknown future outcomes. Markets are less adept, however, at coping with radical uncertainty, unknowns which cannot be characterized probabilistically.

Markets are attempting to cope with unprecedented levels of radical uncertainty concerning the scope, magnitude, timing, and persistence of tariffs. The magnitude of the proposed tariff changes, the suddenness of their implementation, and the repeated abrupt reversal of policy are compounding the difficulties markets face. The daily vacillation of U.S. tariff policy is not the only factor fueling uncertainty. The extent of retaliation by other countries is also unknown.

Nor is uncertainty limited to trade policy. The continued independence of the Fed is also in doubt, undermining confidence in the dollar as the preeminent global reserve currency and U.S. Treasuries as the ultimate safe haven. Uncertainty is further heightened by suggestions by the Chair of the Council of Economic Advisors that it might be advantageous to convert all or part of the existing stock of outstanding U.S. Treasury securities into zero coupon century bonds. Escalating uncertainty on multiple fronts is likely to have a profound impact on economic activity and increase financial fragility.

Tariffs Pose a Massive Supply Shock

The level of tariffs being imposed, if they persist, would represent a supply shock that would push inflation higher while slowing growth. Tariffs of the magnitude envisaged would disrupt existing supply chains and longstanding patterns of consumption and production, raise input costs to firms and the prices paid by consumers, and reduce the markets open to firms and the products available to consumers.

According to estimates by the Yale Budget Lab, the U.S. tariffs and foreign retaliation as of April 15 would cut the disposable income of the average U.S. households by $4,900, a supply shock equivalent to doubling the price of gas. Once households adjust their consumption patterns, the long-term annual decline in disposable income is estimated at $2,600 in 2024 dollars.

Faced with the possibility of a massive supply shock, consumer and business sentiment has plunged. Households expect their employment and financial prospects to fall as the prices they pay for necessities soar.

The prospect of wild swings in input costs and declining demand for their products has led firms to put new hires and capital expenditure on hold, and to raise their sales prices. Others, faced with a sudden increase in input costs, are renegotiating existing contracts. Many small businesses face the prospect of going out of business.

Firms and consumers are front-loading purchases of goods likely to be subject to tariffs, distorting economic signals. The inventories being built to avoid tariffs will pose a drag on growth as they are drawn down. This inventory drag will compound the eventual tariff-induced hit to growth caused by higher prices and reduced supply.

A supply shock of this magnitude would pose a dilemma for the Fed in fulfilling its dual mandate. The Fed would have to choose between preserving price stability and countenancing economic contraction or prioritizing growth and allowing inflation to become entrenched.

Survey data from the University of Michigan point to a sharp rise in household long-term inflation expectations. Once entrenched, expectations for price increases are projected forward in contracts, creating a self-fulfilling cycle. Breaking this cycle typically requires shock therapy to reset expectations. The Volker shock of the 1980s, which sent 3-month T-bill rates to over 15% and resulted in a prolonged economic contraction, is a case in point.

An erosion of Fed independence would undermine confidence in its ability to restore price stability. This in turn would allow inflation expectations to become deeply entrenched, thus raising the ultimate cost of restoring price stability.

Uncertainty Increases Financial Fragility

In normal times, markets can adjust to changing perceptions of risk in an orderly fashion. Faced with radical uncertainty, however, there is no reliable probability distribution of future outcomes. Risk becomes more difficult to measure and risk premiums can be highly volatile, undermining the orderly functioning of markets and increasing financial fragility.

So far, markets have remained orderly. Although most U.S. asset prices have declined and equity, bond, and currency volatility has spiked, these moves have not risen to crisis extremes. While rising long-term bond yields, a depreciating dollar, and soaring gold prices suggest some movement out of the dollar, there does not yet appear to be a concerted restructuring of foreign holdings out of dollar assets.

Part of this orderly market response reflects the possibility that tariffs of the magnitude now being imposed will prove short-lived as negotiations with trading partners bear fruit. While a hopeful prospect, the result of ongoing negotiations is itself unknowable, adding a further element of radical uncertainty.

In this environment, the best portfolio strategy is a focus on bottom-up strategies aimed at strengthening portfolio resilience and exploiting pricing anomalies across individual securities. Heroic top-down positions have no place in the face of radical uncertainty.

Note: Opinions expressed herein are current as of the date appearing in this material and are subject to change at the sole discretion of Strategic. This document is not intended as a source of any specific investment recommendations

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