TWO POLICY RISKS IN THE SPOTLIGHT

There are two significant policy risks looming in the weeks ahead: U.S. domestic policy risk and global policy risk. Overall, financial markets believe that these two policy risks could limit economic growth and cause inflation. However, we continue to believe that the optimal way to navigate these risks is through a tactical and flexible approach. As more details of policy changes emerge, we could witness substantial market moves in either direction. For example, meaningful progress in trade negotiations with Canada and Mexico could provide quick relief to markets and lead to a risk-on environment. On the contrary, a prolonged period of intense negotiations with all U.S. trading partners could cause investors to lose patience and exert downward pressure on risk assets.

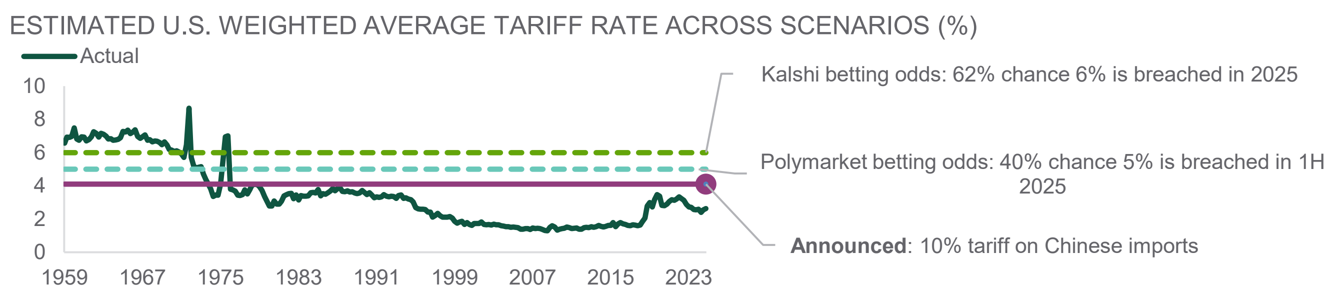
Domestic Policy Risk: The current federal government funding expires on March 14th. To avoid a shutdown, Congress needs to pass new spending legislation or extend the current funding. There are significant disagreements between Democrats and Republicans over the Trump Administration's actions, such as dismantling government programs and agencies, and freezing government grants. Some Democrats are willing to use the threat of a shutdown as leverage to force changes in the Trump Administration's decisions. Given the slim majority in both the Senate and the House, it will be very difficult to pass funding bills without Democratic support. If a potential shutdown were to continue into the month of April, this could create further downside risks to growth.

Global Policy Risk: As expected, the Trump Administration started the process of renegotiating trade agreements with its major trading partners. While this did not come as a surprise, it happens at a time when the geopolitical landscape is in flux, with high-stakes diplomacy and potential shifts in trade policies creating uncertainty. The trade discussions between the EU and the U.S. are likely to intensify in the coming weeks. We believe that there are positive paths for both sides to agree on a deal which would involve greater EU imports of liquefied natural gas (LNG) and increased military spending. However, discussions about non-tariff trade barriers are unlikely to be resolved quickly. In summary, markets are priced for an increase in U.S. tariff rates last seen in the 1960s. While some of the benefits may show up in increased domestic capacity to produce certain goods (e.g. cars, steel, aluminum), this could be a slow process and could be undermined by pressure on consumer spending as prices for many consumer goods are likely to reflect higher tariff costs much sooner.

In conclusion, the financial markets are facing a period of heightened uncertainty driven by policy risks, slower growth, and inflation concerns. The combination of domestic political gridlock and ongoing global trade tensions requires investors to be disciplined about portfolio strategy and maintain flexibility to adjust their risk stance as new information emerges.

TARIFFS EXPECTED TO INCREASE FROM THE CURRENT LEVEL OF AROUND 2.5%

The baseline market expectation seems to be for the average tariff rate to increase towards ~5%.



Source: Northern Trust Asset Management, Macrobond, U.S. Bureau of Economic Analysis, Kalshi and Polymarket betting odds as of 2/18/2025. 1H = First half. Actual tariff rate from 1959 through 2024. Polymarket and Kalshi betting odds defined on page 5. Historical trends are not predictive of future results.

BASE CASE EXPECTATIONS

Soft Landing

Global growth will settle around trend, supported by ongoing U.S. economic strength and labor market/ consumer resilience. Inflation will settle at lower levels, but tariffs could cause some bumps along the way.

Central Bank Easing

Lower inflation has allowed major central banks to start cutting policy rates. We expect central bank easing to continue, though the timing and trajectory could be complicated by tariffs.

RISK CASE SCENARIOS

Reflation

Policies of the incoming U.S. Administration have a net stimulative effect, leading to above-trend growth, persistent inflation and a pause in the Fed rate-cutting cycle.

Supply Restraint

Supply-side disruptions from immigration restrictions and higher tariffs weigh on economic activity and halt the disinflationary process until a recession takes shape.

DEFINITIONS:

Polymarket betting odds: Polymarket users can create prediction markets around any real-world event that they choose. To do so, they propose an event, such as "Will [Event] occur by [Date]?" The market creator defines the possible outcomes (e.g., Yes or No) and adds details to clarify conditions for resolution. Other users can then participate by placing bets on the outcome they believe is most likely. As bets are placed, Polymarket automatically adjusts odds based on the market's activity. If more users bet on one outcome, the odds will reflect a higher likelihood of that event happening.

Kalshi betting odds: At the core of Kalshi's pricing system is the concept of market-assigned probability. The platform continuously assesses the collective sentiment of its users regarding the likelihood of an event resulting in a "Yes" or "No" outcome. This probability is expressed as a percentage, ranging from 0% (certain to not happen) to 100% (certain to happen). The contract price for a particular event is directly tied to this probability. As the perceived likelihood of a "Yes" outcome increases, the contract price for "Yes" will rise, while the contract price for "No" will correspondingly decrease. Conversely, if the market believes a "No" outcome is more probable, the contract price for "No" will increase, and the contract price for "Yes" will fall.