Monthly Equity Market Topics

Equity Insight
May 2025

Growth Risks: Navigating the Air Pocket Amid Tariff-Induced Economic Uncertainty

Author

Ross Cartwright
Lead Strategist
Strategy and Insights Group

In Brief:

- There are serious macro risks ahead, particularly on the growth front, with signs of a slowdown under way.
- Tariff-induced distortions are complicating the interpretation of economic data, potentially masking underlying growth vulnerabilities.
- Equity markets may be mispricing risks given weak sentiment and elevated valuations.
- To help navigate the current uncertainty, investors may be encouraged to prioritize resilience by focusing on high-quality investments, adopting a defensive approach and maintaining strict valuation discipline

1. Market Backdrop

Following a period of economic resilience post-pandemic, the United States is potentially facing an economic 'air pocket' — a temporary slowdown triggered by growth-depleting policy shocks such as tariffs, immigration restrictions and budget cuts. Some of these measures may initially be inflationary due to a one-off price shock but are likely to be moderated by lower energy costs and potential demand destruction.

2. Decoding the Signals

Emerging signals may suggest caution in the period ahead. A sharp decline in freight traffic from China and a record trade deficit indicate front-loaded demand and preemptive stockpiling. Forward-looking indicators such as consumer sentiment and manufacturing PMIs are notably negative. The record trade deficit suggests that the robust economic data may be a result of demand being pulled forward in anticipation of future higher prices.

The full impact of these policies on services and other economic sectors remains uncertain pending further clarity from policymakers.

3. The Unwanted Supply Shock

The worst-case scenario for the US may be a major supply shock. Supply shocks tend to be more economically disruptive than demand-side shocks as they ripple through supply chains. Companies are now withdrawing earnings guidance, a euphemism for “we have no idea,” or are providing alternative scenarios. This conservative approach does not necessarily reflect pessimism but rather a realistic adaptation to an unpredictable environment. This is important because profits drive employment and capital expenditure, both of which are required to generate economic growth. Corporations ultimately need clarity on the rules of engagement before committing to meaningful capital investment and hiring.

Decades of financialization and supply chain optimization have supported record corporate profitability. Importing cheap goods has raised living standards while exporting financial assets from those recycled dollars. All of this is now potentially under threat, and a fundamental recalibration is unlikely to come about without significant consequences.

4. A Market Pricing in Optimism Amid Uncertainty

The market seems to be pricing in a tariff u-turn. Despite the uncertainty over the duration and scope of tariffs, the S&P 500 has nearly returned to its pre-April 2 levels, and while earnings growth expectations for 2025 have been revised downward, they remain robust at around 9%. However, high market multiples, deteriorating sentiment and reactive (rather than strategic) policy shifts pose market risks, in our view. Historically, weak sentiment typically presents buying opportunities, but only when valuations are also low, which is currently not the case. The risk of retaliatory tariffs beyond China remains and even a retreat from much of these policies may leave some scar tissue in the near term, which does not seem to be properly priced in at this juncture.

The weaker dollar, however, is supportive for some as approximately 40% of the S&P 500 earnings come from offshore and we are yet to see the pro-growth aspects of the reconciliation bill like the mooted ability to write off new plant, equipment and buildings in year one rather than deprecated over their lifetime.

Given the potential range of outcomes, the market seems somewhat sanguine about what can happen and confident about what will happen from here. While waiting for more policy clarity, unemployment is a key indicator to watch, and any meaningful rise is likely to be a concern for equity investors as that could signal falling consumer demand for goods and services. Another area to watch is widening credit spreads as a sign of deteriorating corporate health.

5. Strategic Positioning: Own What You Can Explain

Our base case is a range-bound market and continued volatility in the absence of elevated policy clarity. However, that could change for the positive or negative with a tweet. Admittedly, the market outlook is uncertain in the near term. On this basis, we suggest a shift in focus from conjecturing about what the US Federal Reserve or the White House may do next to focusing on assessing corporate resilience and evaluating what companies can withstand. Investment should probably be directed towards companies with strong pricing power, robust balance sheets and operational flexibility, in our view. We believe that leverage, especially in cyclical sectors, is best avoided. Investors may consider using market volatility to enhance the quality of their portfolios and stress-test their investment assumptions, including earnings projections, margin sustainability, debt servicing and capital expenditure plans.

6. Conclusion: Embrace Uncertainty, Don't Fear It

Current market conditions do not signal an impending collapse. This is not COVID or the Global Financial Crisis, but investors need to contend with a recalibration of earnings expectations, supply chain operations and the definition of corporate resilience in a less globalized, more contentious economic landscape. In our view, embracing uncertainty — rather than fearing it — is the cost of compounding wealth. Investors may want to approach this environment with disciplined investment strategies, focusing on long-term growth through quality and stability rather than short-term gains. To us, equity investing was never about certainty; it was always about conviction in the face of uncertainty.

Equity Insight

May 2025

The views expressed herein are those of the MFS Strategy and Insights Group within the MFS distribution unit and may differ from those of MFS portfolio managers and research analysts. These views are subject to change at any time and should not be construed as the Advisor's investment advice, as securities recommendations, or as an indication of trading intent on behalf of MFS.

Keep in mind that all investments carry a certain amount of risk including the possible loss of the principal amount invested.

Diversification does not guarantee a profit or protect against a loss. Past performance is no guarantee of future results.