2025

INVESTMENT OUTLOOK

Chemung Canal Trust Company

CAPITAL BANK
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Bank Anywhere, Anytime.

ALBANY
132 State St., Albany
65 Wolf Rd., Albany
581 Loudon Rd., Latham
1365 New Scotland Rd., Slingerlands

BRADFORD
5 W. Main St., Canton
159 Canton St., Troy

BROOME
127 Court St., Binghamton
100 Rano Blvd., Vestal

CAYUGA
110 Genesee St., Auburn
185 Grant Ave., Auburn

CHEMUNG
One Chemung Canal Plaza, Elmira
628 W. Church St., Elmira
100 W. McCann's Blvd., Elmira Heights
29 Arnot Rd., Horseheads
602 S. Main St., Horseheads
951 Pennsylvania Ave., Southport

CORTLAND
1094 Highway 222, Cortland

ERIE
5529 Main Street, Williamsville

SARATOGA
25 Park Ave., Clifton Park
3057 Route 50, Saratoga Springs

SCHENECTADY
2 Rush St., Schenectady

SCHUYLER
303 W. Main St., Montour Falls
318 N. Franklin St., Watkins Glen

SENECA
54 Fall St., Seneca Falls

STEUBEN
201 Bath Plaza, Bath
149 W. Market St., Corning

TIOGA
203 Main St., Owego
405 Chemung St., Waverly

TOMPKINS
909 Hanshaw Rd., Ithaca
304 Elmira Rd., Ithaca

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Second Quarter
2025 Investment Outlook

It's often said that the markets hate uncertainty. If that is so, then they must *abhor* chaos, which is a fair description of the current investment climate.

After back-to-back years of more than 20% gains, some correction should have been expected, and that is exactly what occurred in the first quarter. But almost all of the sell-off was concentrated in the same, few technology stocks that had risen dramatically during the market's 2023-24 rise. Investors and analysts knew that the new President was committed to the idea of implementing tariffs in an attempt to protect American businesses and jobs, but few were alarmed at the prospect.

When the additional tariffs were announced on April 2nd, their size and scope were well beyond what analysts had imagined, and the markets suddenly took notice - in a very big way. The S&P 500's 10.5% plunge over the ensuing 2 days was its 4th worst such decline in the last 75 years. Then, when the President announced a "pause" in the announced tariffs on April 9th, the S&P rose almost 10% *in less than 2 hours*, and had its best day since 2008. And since the April 9th announcement was only a pause, investors are in limbo waiting for what comes next.

The issue of tariffs has suddenly gone from background noise to being all that matters. And as expected, there is a lot of confusion and misinformation about what tariffs are, who pays them, and what they're intended to accomplish.

Most of this *Outlook* will be devoted to tariffs, their history, what they're purported to achieve vs. what they actually have achieved, and what the unintended consequences of implementing them now may be.

We'll also discuss why we think tariffs are bad for the economy and the markets, and some of the steps we have taken to protect our clients' portfolios from what we think will continue to be a volatile market environment.

Trade Deficits and Tariffs – Fact vs. Fiction:

Fiction: Trade deficits are bad and are a sign that our trade policies are failing.

Fact: Trade deficits and surpluses are neither bad nor good. They are simply the difference between what a nation exports and what it imports. And they have far more to do with factors within our domestic economy than they have to do with trade policies, per se – either ours or our trading partners. A trade deficit (or surplus) is the result of many things – but it is not the *cause* of anything.

Part of this fiction is the fault of the media, which often refers to an increase in our trade deficit as a "worsening" of the deficit, and a shrinking of the deficit as an "improvement." Neither characterization is helpful, or true.

The fact is that the trade deficit is not driven so much by a country's trade policies as it is by a country's *internal* level of savings and spending, and the U.S. has one of the lowest savings rates in the world. A March 12th report by the Cato Institute puts it simply:

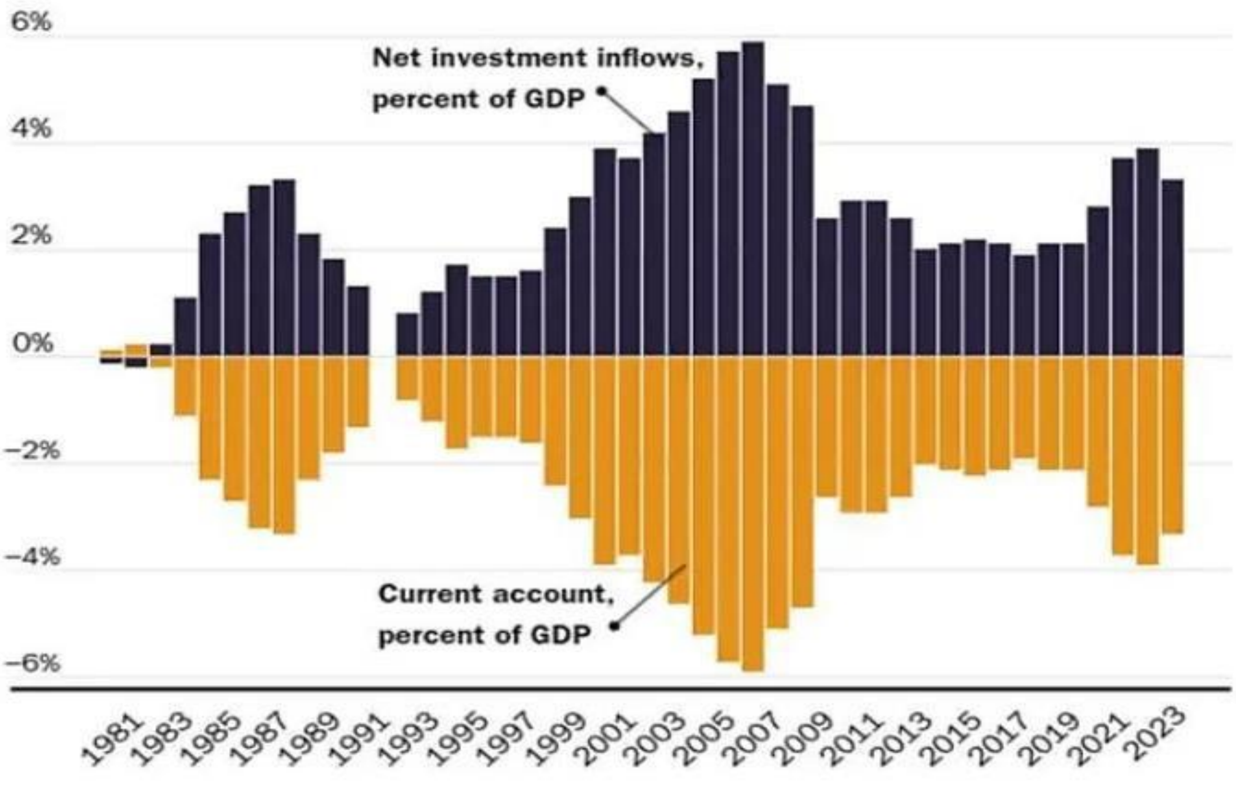
> National income – created by investment, production of goods & services, and exports – is used either to consume/invest or to save. Nations that, in the aggregate, spend more than they save will import more than they export (i.e., run a trade deficit), and will finance this consumption with capital from abroad. Trade surplus nations face the opposite situation.

This is clearly reflected in the following chart of the U.S. government's "balance of payments" data, which records all international transactions with the United States. The "current account" reflects trade and income flows between the U.S. and the rest of the world (mainly the trade deficit), and the "capital account," measures foreign investment in the U.S. These two measures are virtual mirrors of each other – a current account (trade) deficit will always be accompanied by a net inflow of foreign investment capital.

In other words, the trade deficit will shrink if our savings rate increases and/or our federal budget deficit shrinks. Our savings rate matters and our budget deficit matters, the trade deficit does not.

The annual size of the US current account deficit is mirrored by the annual net inflow of foreign investment

Share of GDP



Sources: "Table 1.1. US International Transactions," International Data, Bureau of Economic Analysis, updated June 20, 2024; and "Table 1.1.5. Gross Domestic Product," National Data, US Bureau of Economic Analysis, updated July 25, 2024.

Notes: Net foreign investment includes direct investment, portfolio investment, and other investment assets. In 1991, the current account balance was a positive $2.9 billion, or 0.05 percent of GDP; GDP = gross domestic product.

Fiction: A trade deficit with a country means that the U.S. is being disadvantaged.

Fact: Bilateral trade balances exist for any number of reasons, and few of them reflect cheating or unfair trade practices by the countries involved.

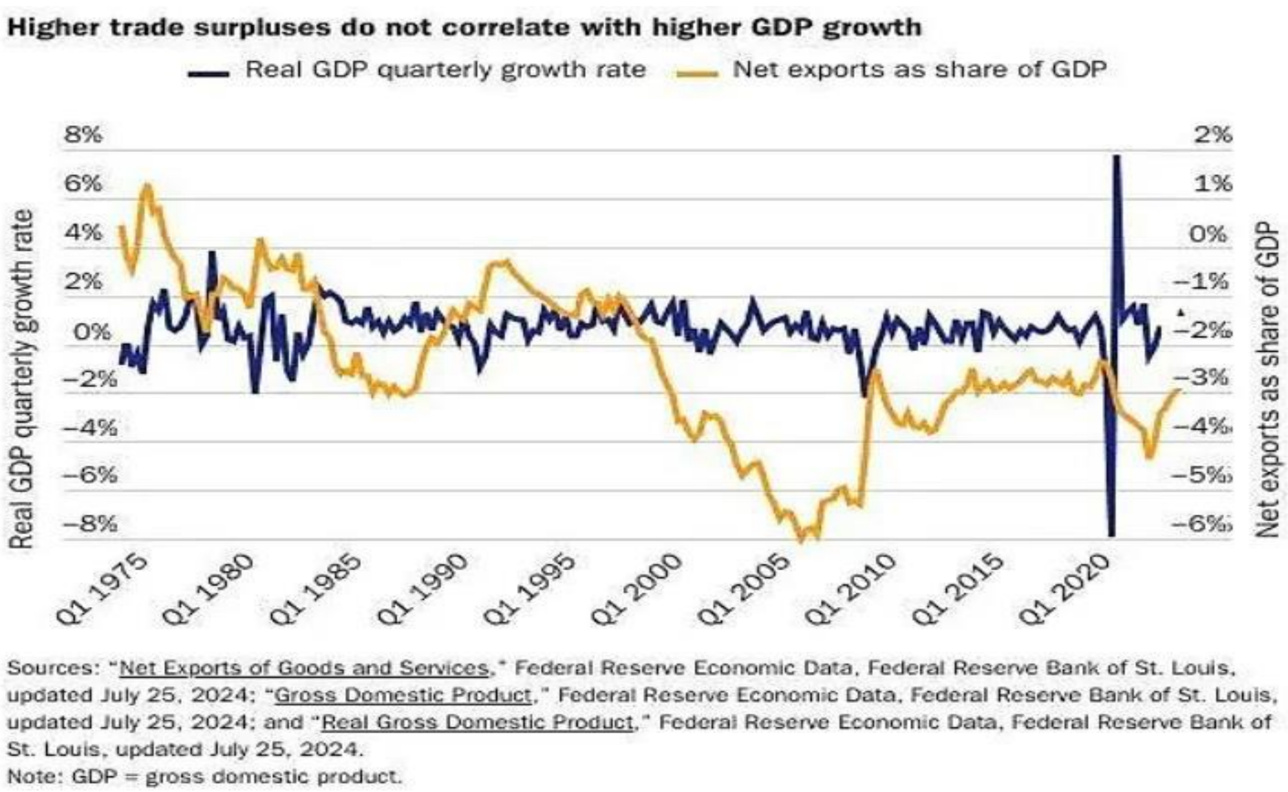
For example, we import vanilla from Madagascar and chocolate from Switzerland, among other things, and have trade deficits with both countries. Madagascar can't buy any more goods from us because their average annual income is about $400/year, about 1/150th of what Americans earn. At the other end of the economic spectrum, Switzerland returns the dollars earned from their exports in the form of investment. The Swiss rank 6th in foreign investment in the U.S. and first for investment in research & development, mainly through pharmaceutical giants Roche and Novartis.

Neither Madagascar nor Switzerland imposes any tariff at all on imports from the U.S., but because the U.S. has trade deficits with these countries, they are subject to the proposed retaliatory tariffs.

Fiction: Trade deficits are a drag on economic growth.

Fact: There is no evidence that the U.S. trade balance has any effect on GDP growth. The chart (below), which plots real GDP growth in blue and net exports in gold, shows that the relationship between higher trade surpluses (or smaller deficits) and higher GDP growth is non-existent.

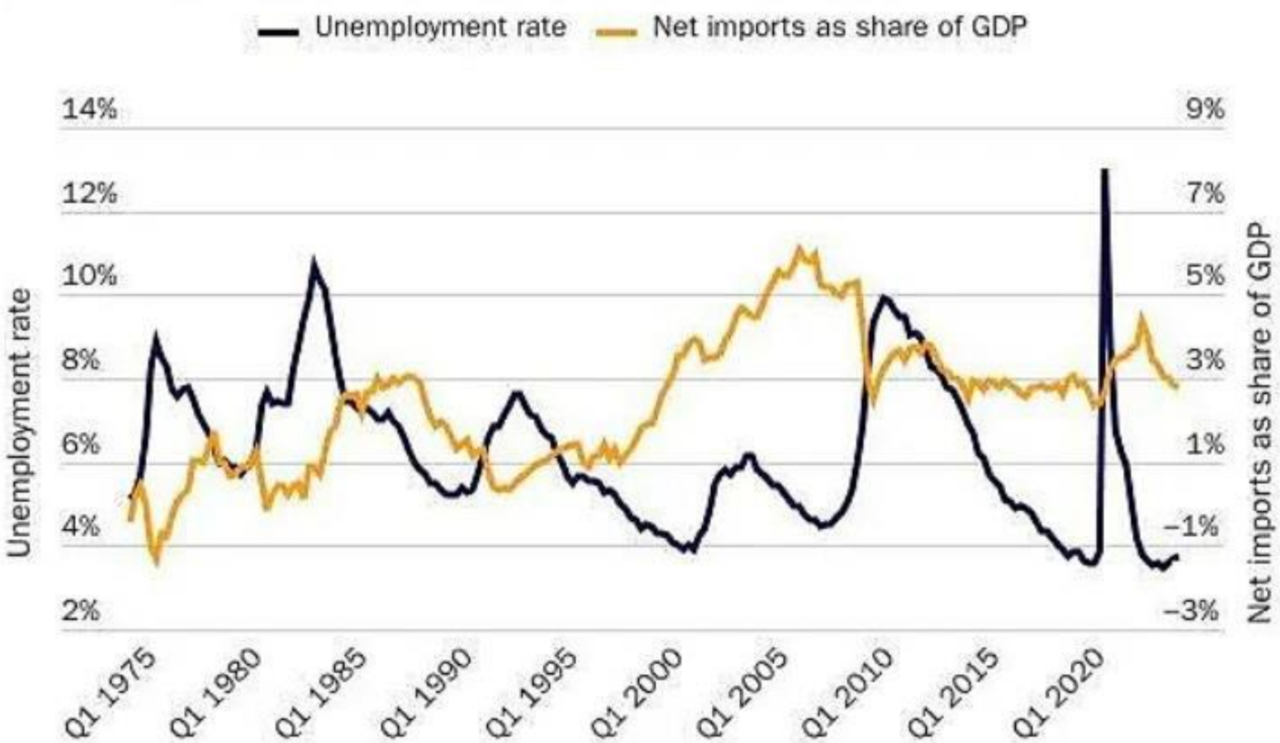
Economist Donald Boudreaux, an economist with the Mercatus Center at George Mason University, and former Senator Phil Graham, conducted a study of U.S. trade between 1890 and 1994. Their conclusion, which was published in a recent Wall Street Journal column, was that "It is impossible to find a statistically significant correlation between America's trade balance and its economic growth."



Fiction: Trade deficits result in lost jobs and higher unemployment.

Fact: If there is any correlation at all between trade balances and unemployment, it is that unemployment runs weakly *counter* to the trade deficit. When the trade deficit rises, the unemployment rate tends to go down. That doesn't mean that a higher trade deficit causes lower levels of unemployment; it just means that this claim isn't supported by facts.

Higher trade deficits do not correlate with higher unemployment



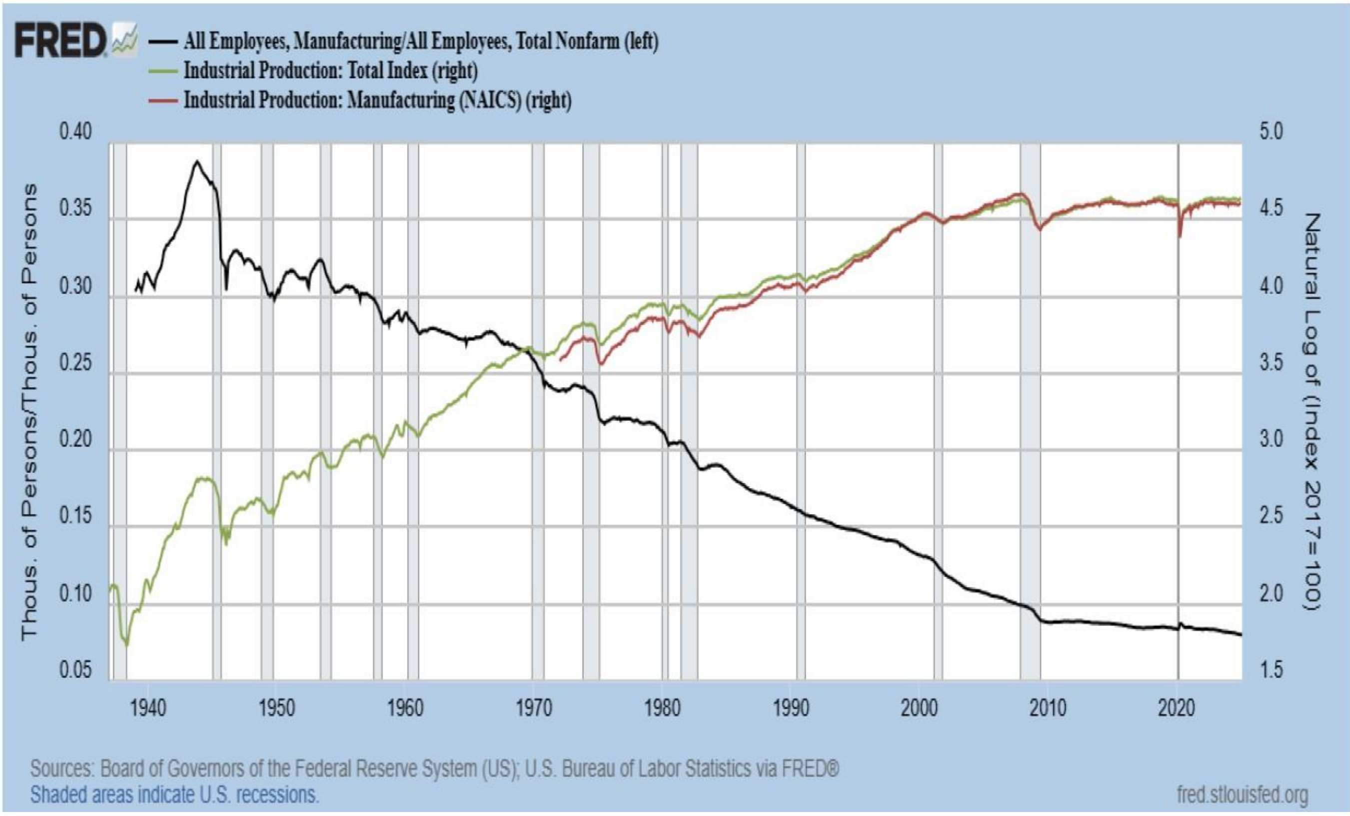
Sources: "Net Exports of Goods and Services," Federal Reserve Economic Data, Federal Reserve Bank of St. Louis, updated July 25, 2024; "Gross Domestic Product," Federal Reserve Economic Data, Federal Reserve Bank of St. Louis, updated July 25, 2024; and "Unemployment Rate," Federal Reserve Economic Data, Federal Reserve Bank of St. Louis, updated August 2, 2024.
Notes: Net imports (imports − exports) is the flip side of net exports (exports − imports); GDP = gross domestic product.

The fact is that more jobs are lost to advances in technology and increases in productivity than are outsourced to foreign workers due to free trade. Economists call it creative destruction, a concept in which new innovations make older innovations obsolete. It is also called progress.

It's true that manufacturing now accounts for less than 10% of all non-farm payrolls in the U.S., down from 38% during the post World War II peak and 20% when globalization gained pace at the end of the Cold War. But industrial nominal production and manufacturing output are at all-time highs – due to increases in productivity – and would be well above previous highs were it not for the devastating effects of the COVID-19 recession.

At the same time, **jobs in trade-related industries have grown to 41-million, and now account for more than 25% of all non-farm payrolls,** more than offsetting the losses in non-competitive manufacturing jobs.

Manufacturing employment vs. industrial production.



Fiction: Tariffs will bring manufacturing jobs back to the United States.

Fact: History has not borne this out.

As we have pointed out previously, most manufacturing job losses over the last 40+ years have been due to stunning advances in technology, which in turn have created better, higher paying jobs in new industries.

In a radio address to the nation in April 1987, President Reagan had this to say about tariffs:

"Throughout the world, there's a growing realization that the way to prosperity for all nations is rejecting protectionist legislation and promoting fair and free competition. For those of us who lived through the Great Depression, the memory of the suffering it caused is deep and searing. And today, many analysts and historians agree that high tariff legislation passed back in that period called the Smoot-Hawley tariff greatly deepened the depression and prevented economic recovery.

When someone says let's impose tariffs on imports, it looks like they're doing the patriotic thing by protecting American products and jobs. And sometimes, for a short while, it works – but only for a short time. What eventually occurs is, first, homegrown industries start relying on government protection in the form of high tariffs. They stop competing and stop making the innovative management and technological changes they need to succeed in world markets.

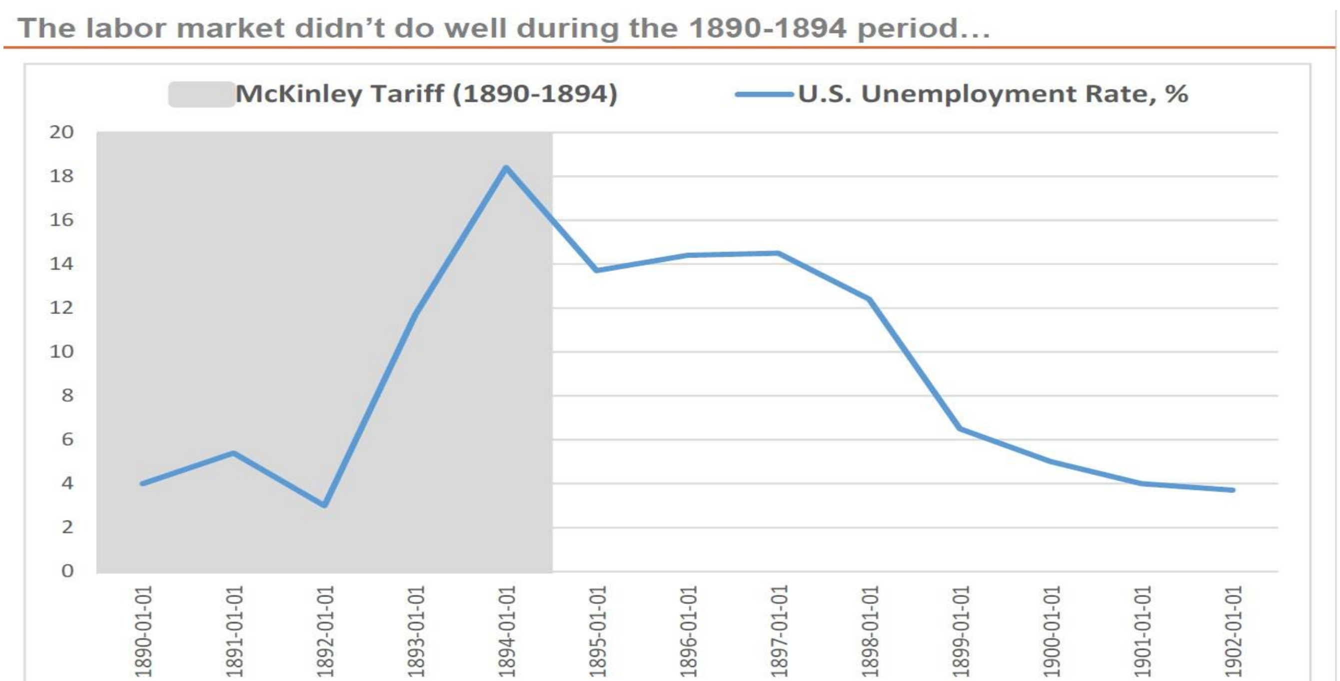
And then, while all this is going on, something even worse occurs. High tariffs inevitably lead to retaliation by foreign countries, and the triggering of fierce trade wars. The result is more and more tariffs, higher and higher trade barriers, and less and less competition. Soon, because of the prices made artificially high by tariffs that subsidize inefficiency and poor management, people stop buying.

Then the worst happens. Markets shrink and collapse, businesses and industries shut down, and millions of people lose their jobs."

One of our associates likes to cite the example of Apple, now the world's largest company. The box the iPhone comes in states, "Designed by Apple in California, assembled by Apple in China." This is our economy today – the U.S. is unmatched in exporting innovation, information and ideas. But only the assembly is counted in the trade deficit. The President's goal is to bring the assembly back to the U.S. as well. But do we really want to bring the manufacturing of iPhones back to the U.S., driving the price up to $3,500 from $1,500, leaving $2,000 fewer dollars to spend on food, rent, Netflix subscriptions, airline tickets and other products and services?

The Mckinley Tariff of the late 19th century is often cited as a model for what the President is trying to achieve. William McKinley, then a congressman, framed a tariff that passed Congress in 1890, raising the average duty on imports to almost 50% in an effort to protect domestic industries and workers.

But the fact is that the McKinley tariff failed miserably, driving the unemployment rate from 4% to 18% in less than 4 years, before it was repealed in 1894.



Source: Historical Statistics of the United States

Facts and More Facts:

With apologies to the "Gilded Age" of the late 19th and early 20th centuries, the last 80 years following the end of World War II have been the greatest in our history in terms of economic stability, productivity gains and wealth creation. That much of these gains are attributable to more open trade is undeniable.

With just 4% of the world's population, the U.S. accounts for more than 26% of the world's GDP, and approximately 60% of the world's total stock market capitalization. By comparison, China, the world's 2nd largest economy, accounts for just 6% of the world's market capitalization. The fact that American financial assets are so highly valued is hardly evidence of a nation in decline.

Facts, common sense and history all evidence the notion that free and fair trade keeps prices low and creates jobs and wealth - no matter which side of the trade imbalance the country is on – while tariffs drive up prices and destroy wealth.

A nation's trade deficit isn't a bad thing to be fixed, just as a trade surplus isn't a good thing to be encouraged. After all, the U.S. had trade surpluses throughout the Great Depression, as the unemployment rate ran between 15% and 25% and Americans had less money to spend. Tariffs do nothing that affects a country's trade balance one way or another, while undermining our attractiveness as a reliable trading partner and a safe haven for foreign investment.

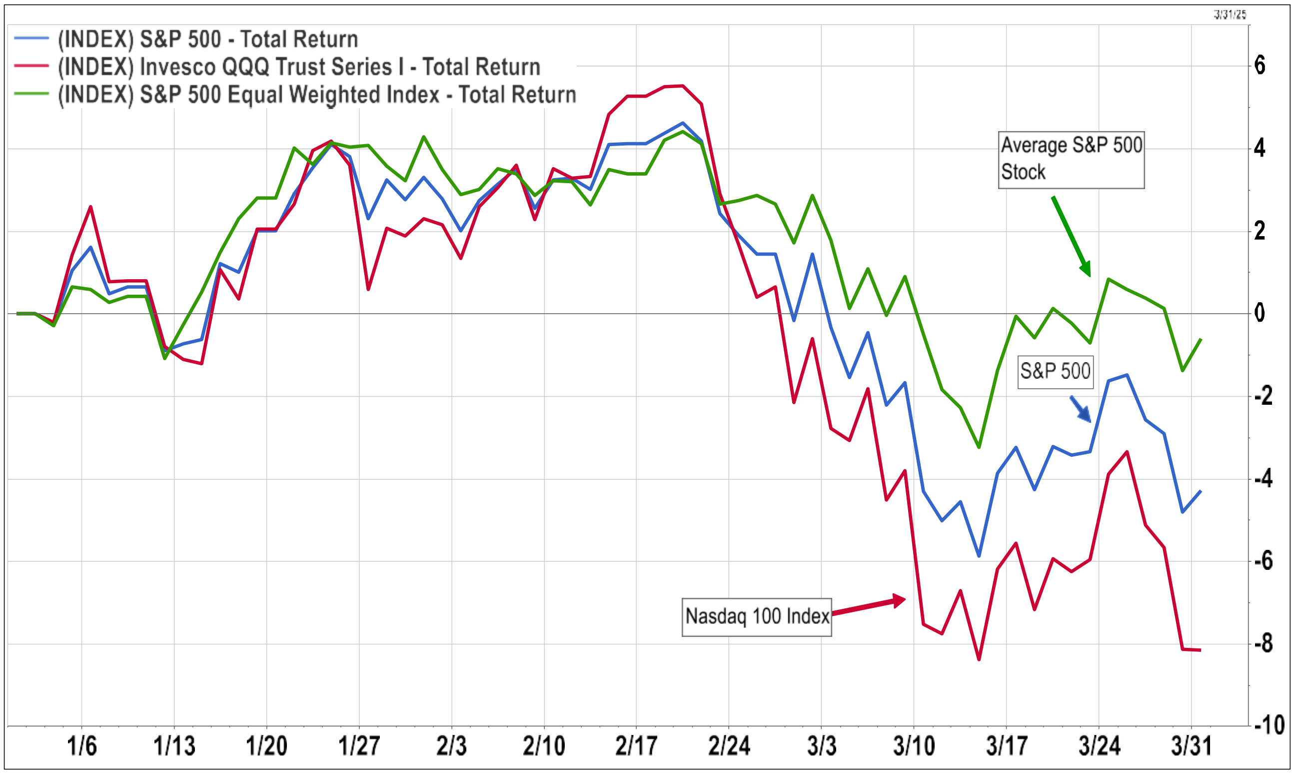
Finally, even if tariffs on goods were to succeed in bringing manufacturing jobs back to the U.S., there would still be a couple *practical* questions that so far have gone unasked. The first is, would it even be feasible to build the factories to manufacture these goods if building costs rise from the weight of the tariffs being proposed? And the second is, where are we going to find the workers with the skillsets to build the products, when the biggest problem cited by most Human Resource executives is finding qualified workers to fill the open jobs that already exist, but are unfilled?

History has taught us that free markets work best when they are free. Unnecessary government meddling has seldom, if ever, accomplished its intended purpose.

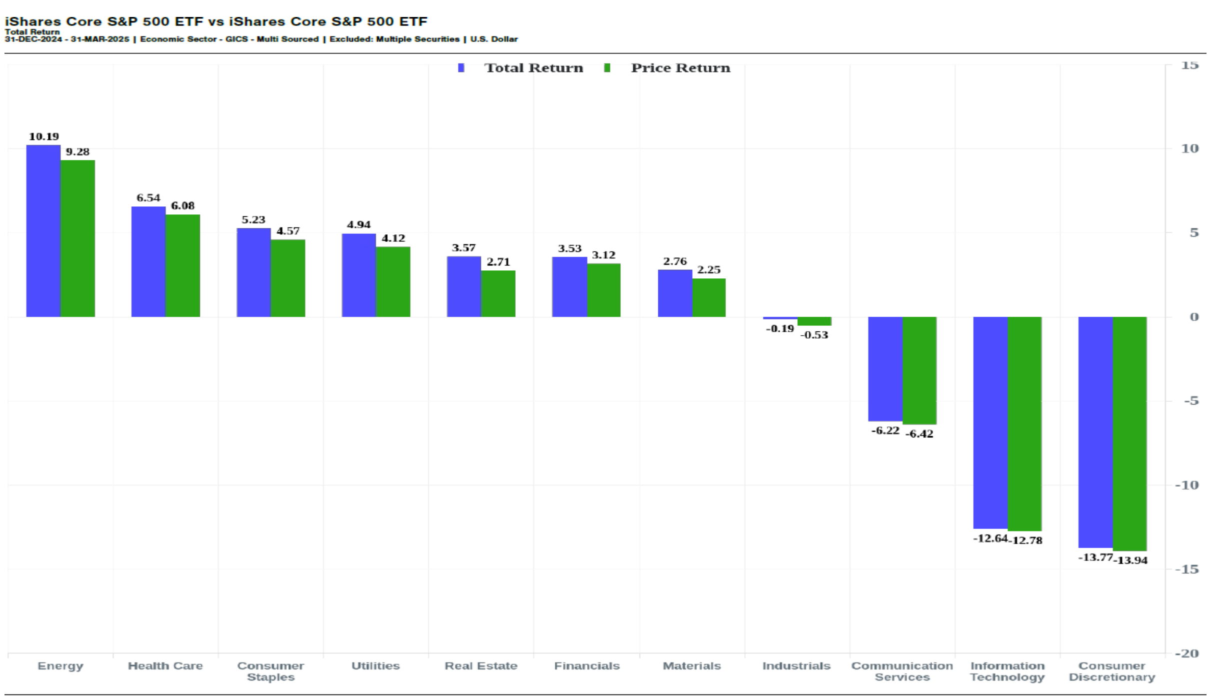
The Stock Market – A Normal, Healthy Correction, Then Chaos Ensued

Major stock market indices posted their first quarterly loss since the third quarter of 2023, as investors grappled with high valuations. The prospect of tariffs almost certainly loomed over the market, but valuations were a bigger concern as higher multiple stocks bore the brunt of the decline. The S&P 500 index fell by 4.3% and the technology-heavy Nasdaq 100 index declined by more than 8%.

After two years of extraordinary gains, a correction was not exactly unexpected. And just as the "Magnificent 7" stocks generated the lion's share of the market's gains over the last two years, they also bore the brunt of the first quarter's market's decline. As a group, the Mag 7 fell by almost 15% and every constituent of the group generated negative results through the end of March. Meanwhile, an equal-weighted index of S&P 500 stocks declined less than 1%, and if the Magnificent 7 stocks were removed from the S&P 500, the other 493 stocks actually posted modest gains.

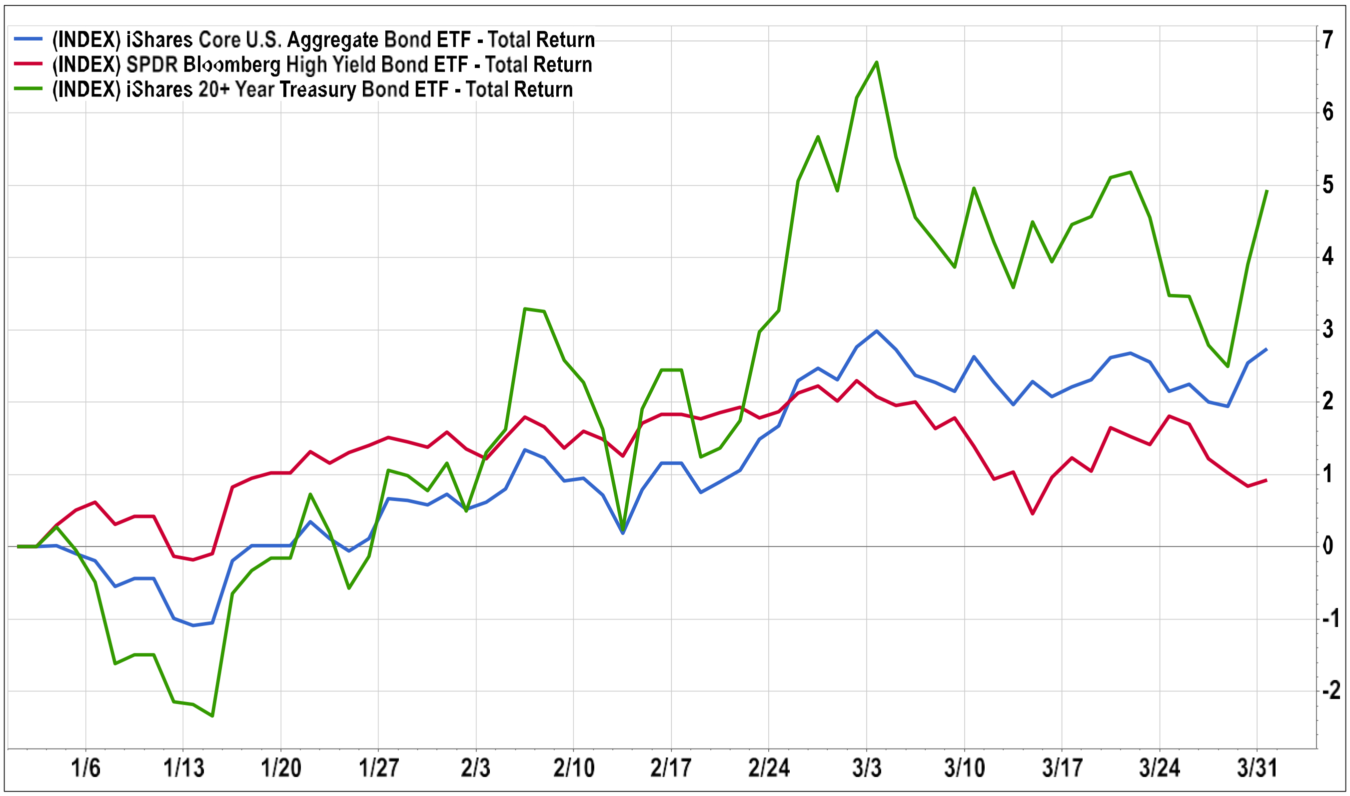


It’s not surprising to see that the only three S&P 500 sectors that materially declined during the quarter were the sectors that housed the Magnificent 7 stocks. Consumer Discretionary was the worst performing sector due to the inclusion of Tesla, which declined by a staggering 36% in just three months. Seven of the eleven sectors generated positive results during the quarter, despite the headline index suffering losses. Generally, the more defensive areas of the market performed the best.



Outside of the U.S., equity markets fared much better. The MSCI EAFE Index of international developed market stocks rose almost 7% for the quarter. In addition to geographic diversification, the composition of the EAFE index is skewed towards more defensive and value-based companies, which helps explain the outperformance relative to domestic markets. Emerging Markets also outperformed the S&P 500, gaining 3% to start the year.

The bond market also provided support to portfolios during the equity market sell-off. The Bloomberg U.S. Aggregate Bond Index increased by almost 2.8%. High yield bonds, the riskier area of the bond market, performed the worst during the quarter, returning roughly 1%. This was the first quarter since June of 2022 where investment grade bonds generated better returns than high yield bonds. High yield bonds tend to have a higher degree of correlation with equities than traditional bonds, so the equity market weakness filtered into lower rated bond performance. Long-dated treasuries performed the best during the quarter, gaining almost 5% as long-term interest rates fell.

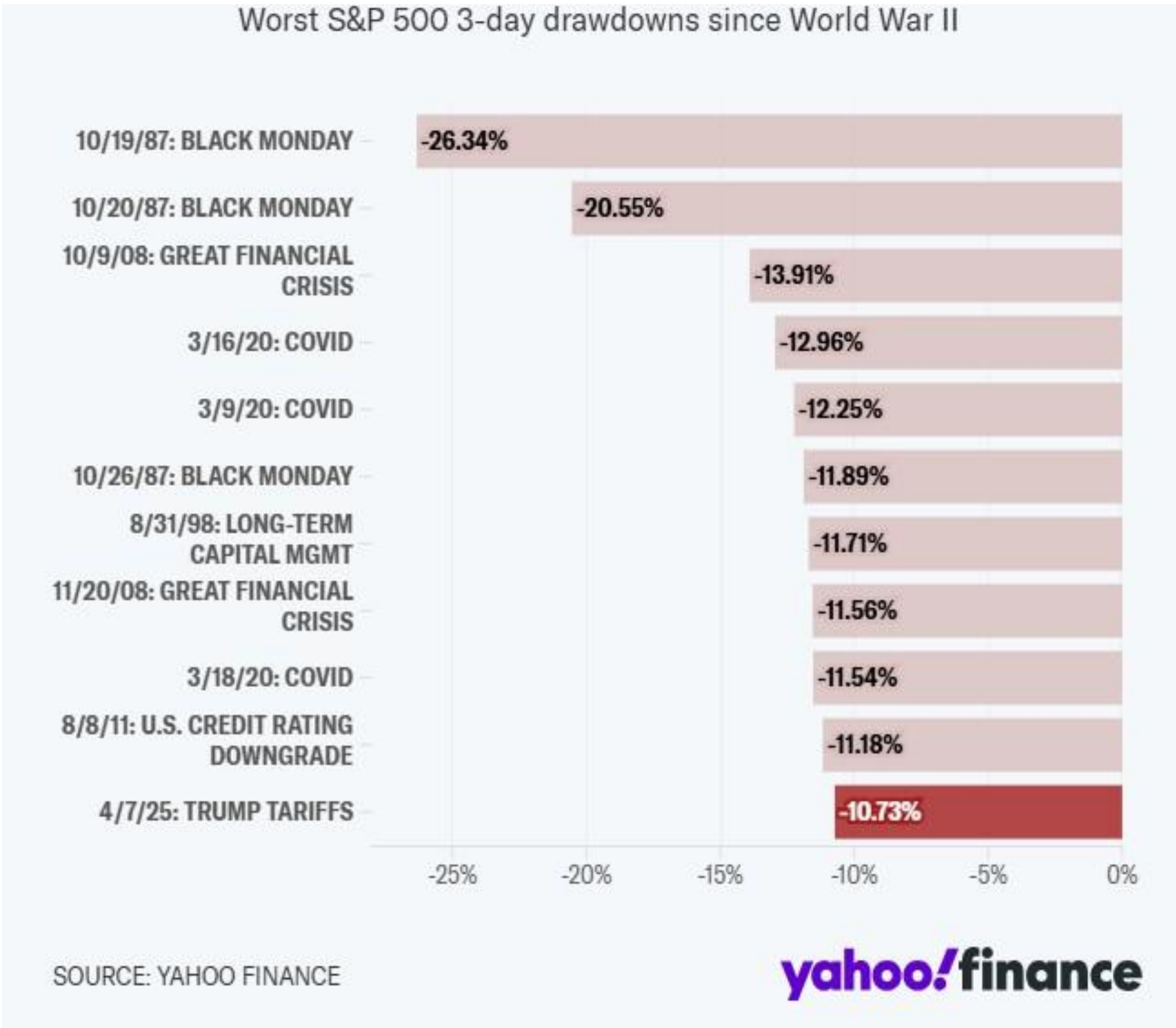


<u>Everything Changed on "Liberation Day"</u>

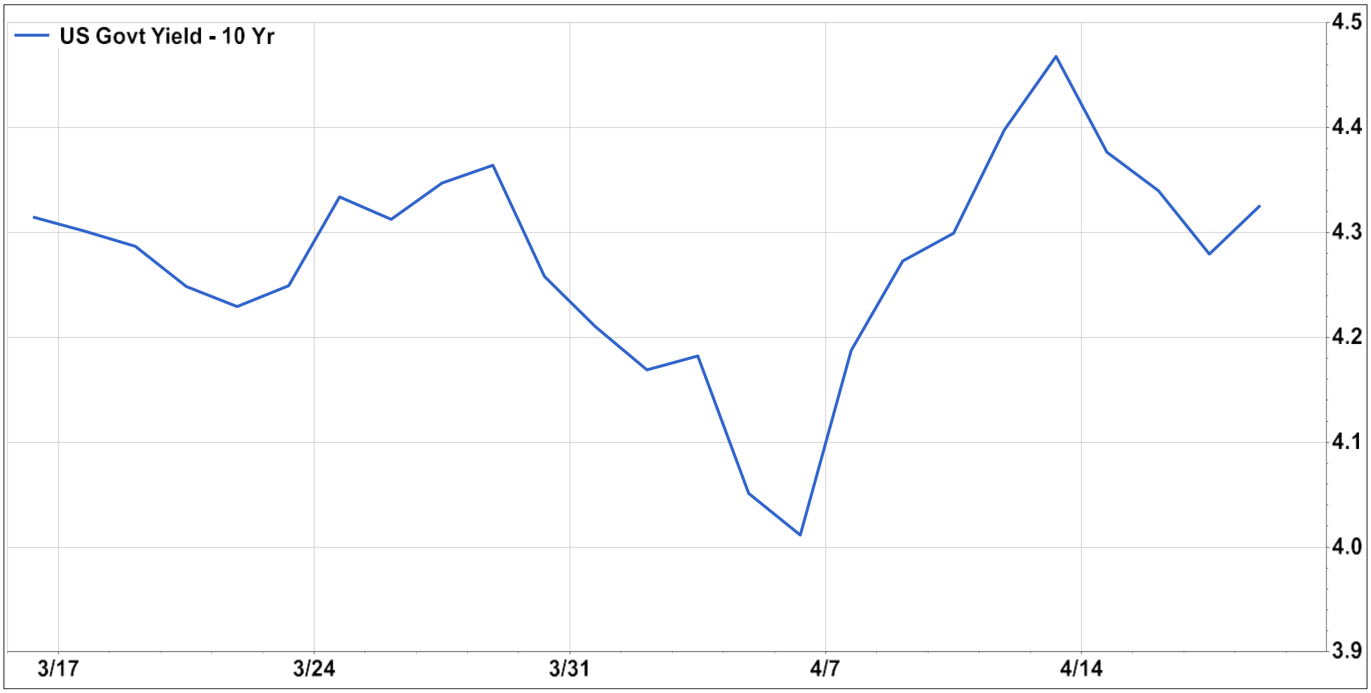
The market decline suddenly became broader and deeper when the President made his tariff announcement on April 2nd. The announcement itself wasn't a surprise, but the size and scope of the proposed tariffs was beyond anything even the most bearish analysts had expected. Furthermore, while the tariffs were described as "retaliatory", the calculations themselves had nothing to do with any tariff rates imposed on U.S. exports, but were simply based on the absolute level of each country's trade imbalance with the U.S. This led to "retaliatory" tariffs being imposed on countries open to U.S. products free of tariffs, as we noted earlier.

Our concern over the consequences of raising tariffs was confirmed by the market. The S&P 500 fell almost 11% in the 3 days following the President's announcement, ranking just outside the "top 10" worst 3-day sell-offs in the market since World War II. Nearly $7-trillion in wealth was lost, even if temporarily.

Then when the President announced a "pause" on April 9th, the S&P 500 soared 9.5% in one day, the largest percentage gain since 2008, and the 8th largest percentage gain in its history. The stock market couldn't have sent two clearer messages.



Bond yields soared, as well. The 10-year Treasury yield rose from just under 4% to 4.5% in the days following the tariff announcement, then eased when the pause was announced. Rates have settled at slightly lower levels since the pause, but it's safe to say that investors are (understandably) on edge as they wonder what awaits at the end of the pause, or in the interim, for that matter.



Finally, the performance of the stock markets of the U.S. and some of its major trading partners leading up to – and in response to – the April 2nd announcement is interesting. Note that while the U.S. market experienced one of the steepest sell-offs in the group, the best performer during this period has been China.

Notes: Data as of 3:30 a.m. Eastern time on Friday. Percentage change in daily closes since Jan. 17 of major stock indexes for each country: Germany's DAX; China's Shanghai SE Composite; the United Kingdom's FTSE 100; Canada's S&P/TSX Composite; the United States' S&P 500; Japan's Nikkei 225. · Source: LSEG Data & Analytics · By Karl Russell and Pablo Robles

What Others Are Saying

We follow the thinking of many analysts and economists and listen in on numerous webinars and podcasts, and not one of them have expressed optimism – short term or long term – over the course the U.S. appears to be on. The thinking on the "street" has gone beyond consensus to near unanimity in voicing their concerns over the consequences of a trade war.

Fed Chairman Powell, in an April 16th speech at the Economic Club in Chicago, said this:

"The level of tariff increases announced so far is significantly larger than anticipated. The same is likely to be true of the economic effects, which will include higher inflation and slower growth. Both survey and market-based measures of near-term inflation have moved up significantly, with survey participants pointing to tariffs."

Powell also said that the Fed might find itself in "the challenging scenario in which our dual mandates are in tension." He means that if unemployment rises and the economy slows, the Fed will want to lower rates further to stimulate the economy. But this risks raising inflation further at a time when it has already gone up due to tariffs. The Fed is caught in a catch-22 situation, and we are increasingly at risk of a stagflationary environment, where growth stalls, and prices and unemployment both rise.

Jamie Dimon, Chairman and CEO of JPMorgan Chase, had this to say:

> Dimon: "There are many uncertainties surrounding the new tariff policy: the potential retaliatory actions, including on services, by other countries, the effect on confidence, the impact on investments & capital flows, the effect on corporate profits & the possible effect on the U.S. dollar"

@TheTranscript_

Howard Marks is the co-founder and co-chairman of Oaktree Capital Management. His essays, which he calls memos, are widely read and respected in the investment community, and even Warren Buffett says, "When I see memos from Howard Marks in my mail, they're the first thing I open and read. I always learn something, and that goes double for his books."

Marks said this following the tariff announcement:

> "This is the biggest change in the environment that I've seen probably in my career. You know, we've gone from free trade and world trade and globalization to this system, which implies significant restrictions on trade in every direction and a step toward isolation for the United States... I believe that the last 80 years since World War Two have been the best economic period in the history of mankind. And one of the major reasons was the growth of trade." (Oaktree Capital Co-Chairman Howard Marks)

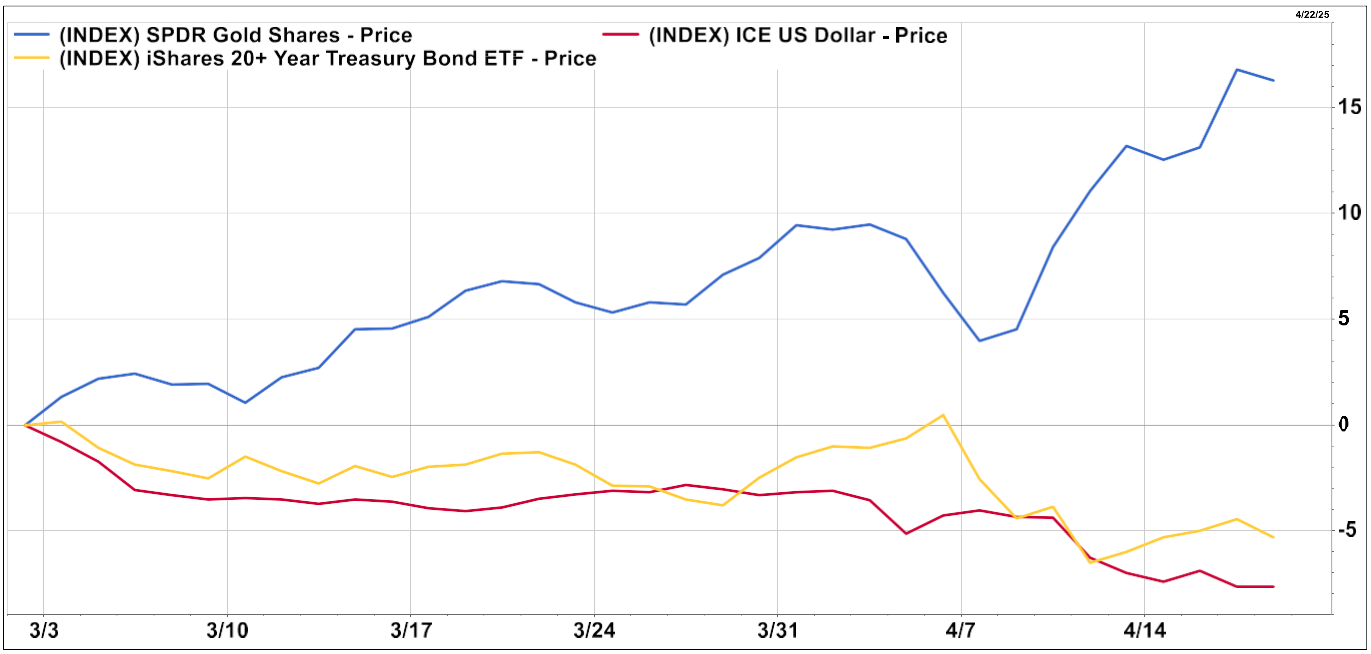
The Transcript

Laurence Fink, Chairman of BlackRock warned that “The economy is weakening as we speak. Most CEOs I speak to would say we are probably in a recession right now.”

Goldman Sachs has said that it will raise its recession probability to more than 50% if the White House does not back down from the announced tariffs.

Home Depot CFO Richard McPhail has said that “customers’ hesitation to take on larger projects has not been this frozen since the great financial crisis.”

Even if the President backs off from his course (not a certainty by any means), many are raising the question of whether too much “reputational” damage has already been done. The dollar is falling as are U.S. Treasuries, while gold prices, which had been rising steadily since January, have surged even higher.



Countries which have long treasured their “special” relationship with the U.S. (Canada, eh) have good reason to question the wisdom of relying on the U.S. as a trading partner and may look elsewhere. The EU is already reaching out to China, which would be eager to expand its trading arrangements outside the U.S. The U.S. risks being left out as new alliances are explored and supply chains are re-formed.

Surveys of CEOs are showing that they have gone from trying to convince the President to abandon his course, to trying to protect their companies from the uncertainties of what may lie ahead. Capital expenditures and hiring plans are being re-examined, and banks will no doubt be more cautious in their lending practices. Swollen building costs due to tariffs are causing companies to kill or delay projects, resulting in confusion and job losses.

To illustrate the challenge now being faced by a manufacturer as a result of the proposed tariffs, consider the example of an air conditioner made in the U.S. It may require wire from China, steel from Canada, pipes from India, coils from Mexico, motors from Germany, copper from Peru, and electronics from South Korea. Costs of all of these inputs will rise when they are subjected to tariffs, killing the very manufacturing jobs the President is trying to bring back to the U.S.

And let's not forget that the largest industry in the U.S. is agriculture. The following was written in the New York Times a couple days after the President's announcement:

> The American Soybean Association noted in a statement that soybeans would face a 60 percent tariff in China starting next week, double what was levied in the 2018 trade war. The association estimates that American soybean farmers will lose $5.9 billion annually. Brazilian soybean farmers, who gained greater access to China during the 2018 trade war, will be the beneficiaries, the statement said.
>
> "A.S.A. strongly encourages the administration to swiftly negotiate and address tariff and non-tariff barriers for U.S. agriculture exports," the organization said.
>
> China imported almost $13 billion worth of soybeans last year, along with more than $1 billion each worth of cotton, sorghum, beef, pork and seafood, according to the U.S.D.A....
>
> China's retaliatory tariffs, which are supposed to go into effect on Thursday, could be just the beginning of pain for the industry. American farmers already operate on slim margins, and the possibility of other retaliatory tariffs from the European Union and other major trading partners will make finding alternatives to China's market challenging.
>
> "We will lose more market share in China," said Ian Sheldon, a professor of agricultural marketing, trade and policy at Ohio State University, "and the potential to divert that elsewhere in the world will be stymied by the fact that the tariffs implemented yesterday were so broad and across so many potential export markets." He was referring to the global tariffs announced by President Trump on Wednesday.
>
> "Farmers won't just be losing market share," Dr. Sheldon added. "Their revenue will fall because commodity prices will fall, and farmers are already facing a margin squeeze right now."

NYTimes

Our Thoughts

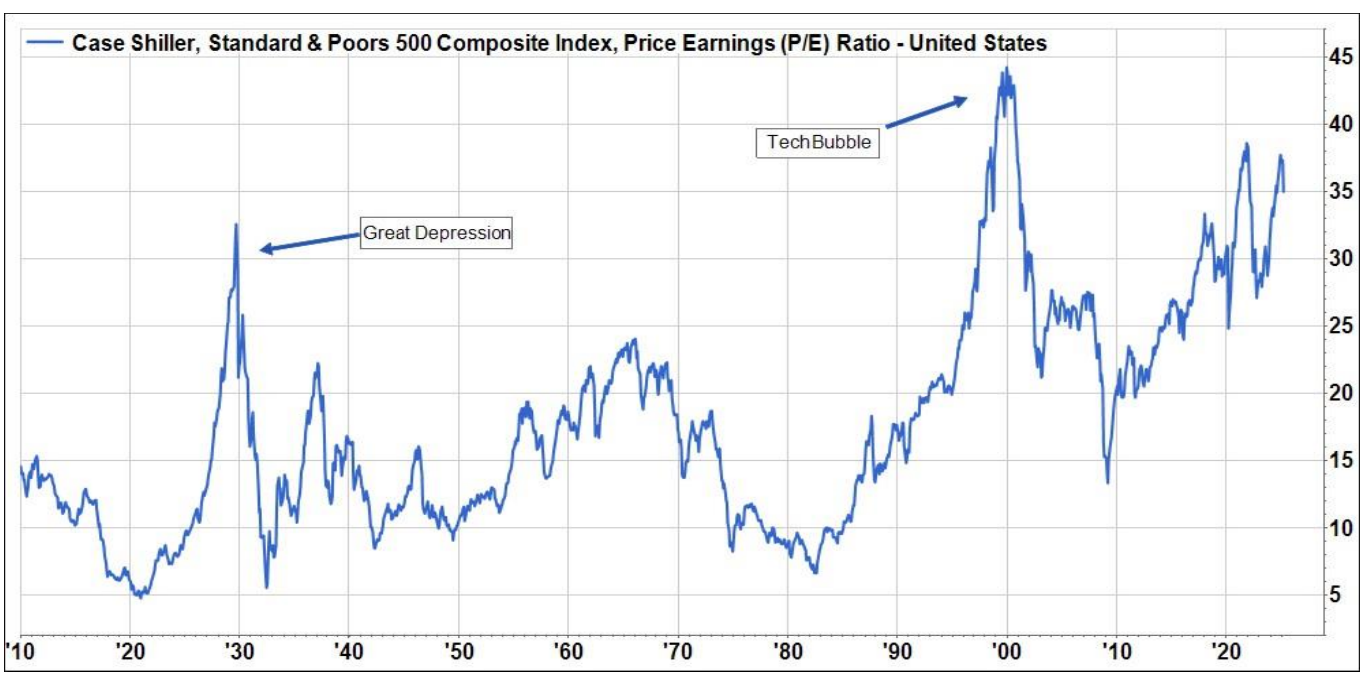
It's often said that one shouldn't talk about politics, money or religion. The religion part is easy, but preserving our clients' wealth is our business, and money and politics in the current environment intersect to the point where neither can be discussed while avoiding the other.

We have tried to cite facts and history to describe what has happened in the past when isolationist or protectionist policies have been used in defense of America's industries and workers. And in a truly global economy that is inter-dependent as never before, the negative consequences of our current course are more likely to be greater than in the past, not less.

We don't have to guess whether or not the imposition of tariffs will drive the economy into recession, since there is no real definition of what a recession is. But tariffs will almost certainly drive up prices, stall investment and increase unemployment. S&P 500 earnings forecasts still reflect a consensus that

2025 earnings will be 10% above last year's results, which we regard as unrealistic in the current situation.

At the same time as this secular change threatens to disrupt trade growth that has worked to our benefit for more than eight decades, longer term U.S. equity valuations remain extremely elevated relative to historical norms. While the market's current price/earnings ratio has declined slightly as a result of the recent sell-off, longer term valuation measures like the market's total stock market value relative to GDP (the Buffett Indicator), and the market's price relative to its long term "normalized" earnings (Case Shiller) are at or near all-time highs.



In view of everything we've discussed, we don't believe that adding risk to portfolios is prudent at this time. Where we were not constrained by capital gains taxes or other account considerations, we moved over the 1st quarter to make our equity portfolios more defensive and less volatile, by focusing on utilities, consumer staples and health care, and reducing positions in economically sensitive areas and over-priced technology stocks. And more recently, we have taken additional steps to lower risk by lowering U.S. equities and increase our cash holdings and diversify into other asset classes.

Whether or not this will be proven to be the right response to the situation is unknowable. So whether an action will ultimately be proven to be right or wrong can't enter into our thinking. Our only consideration is whether or not an action is prudent, and we think caution is the most prudent course at this time.

Until the cloud of uncertainty is lifted, we are clinging to Churchill's famous observation, which has been borne out time and time again, that "You can always count on Americans to do the right thing, after they've tried everything else."

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