First Trust Portfolios Canada®
Monday Morning OUTLOOK

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416-865-8065 • www.firsttrust.ca March 10, 2025

It's Not All About Tariffs

It is true that tariffs are a tax. It is also true that tariff policies have been volatile…on and off again…different carve outs…different countries…phone calls that change things. All of this clearly has an impact on the market. So, we are not surprised to see stock market volatility.

However, it isn't all about tariffs. Many major models of overall stock market valuation show that the market is expensive. The so-called Buffet Indicator, which measures the market cap of the S&P 500 as a percent of GDP, says the market is overvalued. The Shiller CAPE PE Ratio, which measures stock prices compared to trailing 10-year inflation-adjusted earnings, shows the market is overvalued. In other words, compared to history, stock prices are on the high side.

Some argue that it's different this time. That AI, and technology in general are moving so fast, and so powerfully, that historical measures don't work. One way to deal with this is to compare stock values and earnings to a discount rate…in other words compare the stock market to the bond market.

The Fed Model, which compares the earnings yield of the S&P 500 (the inverse of the PE ratio) to the 10-year Treasury yield or to a corporate bond yield, shows that stock returns relative to bond returns are the lowest since 2000 – the dot-com bubble.

Our Capitalized Profits Model, which discounts current profits by the 10-year Treasury yield, shows the same thing. We are overvalued relative to past relationships of earnings and interest rates. (To view all these charts, see our latest Three on Thursday by following this link.)

However, as the saying goes, it is a market of stocks and not a stock market. Just because these models say the market as a whole is over-valued does not mean all stocks are over-valued. But because the S&P 500 is so top heavy, with just 10 stocks making up over 1/3rd of its total capitalization, it is hard for the other 490 stocks to offset declines in these very large cap companies.

Back on January 6th, we published our forecast for 2025. Our expectation was for the S&P 500 to finish this year around 5,200. We have not changed our forecast. For the record, unless earnings grow much faster than the consensus expects (around 10% this year), or the 10-year Treasury falls to 3% or below, even at 5,200 the market would remain over-valued.

We think the policy changes that are underway will be positive for long-term growth. Keeping tax rates low, cutting regulations, and reducing the size of the government bureaucracy will boost the underlying growth rate of the economy in the future.

Unfortunately, the US economy has been artificially boosted in recent years by massive deficits and a very loose monetary policy. Reducing that artificial stimulus is like having morphine wear off. We expect the economy to grow more slowly this year, which means corporate profits are unlikely to grow faster than the consensus expects.

In other words, what is good for the long-term makes the short-term look worse. This is much like what happened with Ronald Reagan in the early 1980s. Even though his policies led to a boom in the economy, the fix (especially for inflation) was a painful process.

So we are not surprised to see the stock market reaction of the past few weeks. Investors have been so used to "buying the dip" because the stock market has been a one-way trade, that seeing it fall toward or into correction territory feels worse than it really is. This compounds negative feelings and people start looking for scapegoats.

We get it. But tariffs are just the catalyst, not the full explanation. Don't forget, when Reagan moved into the White House, the PE ratio of the S&P 500 was about 8. When Donald Trump moved back into the White House it was 28.

This doesn't mean investors should abandon stocks altogether. The valuation models we mentioned are not meant for trading. They are indications of value. And when valuations are high, there are still opportunities. To find them, we suggest reading Dave McGarel's Market Minute. As we said a few weeks ago, "the era of easy everything is over." And as McGarel says in his Market Minute, "when you break stride it's hard to win the race." Clearly the market has "broken stride," which shouldn't be a surprise to anyone looking at heady valuations.

Date/Time (CST)	U.S. Economic Data	Consensus	First Trust	Actual	Previous
3-12 / 7:30 am	CPI – Feb	+0.3%	**+0.3%**		+0.5%
7:30 pm	"Core" CPI – Feb	+0.3%	**+0.3%**		+0.4%
3-13 / 7:30 am	Initial Claims – Mar 8	225K	**223K**		221K
7:30 am	PPI – Feb	+0.3%	**+0.4%**		+0.4%
7:30 am	"Core" PPI – Feb	+0.3%	**+0.4%**		+0.3%

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