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What federal budget, regulatory, and trade decisions could mean for investors **May 6, 2025**

The challenge to U.S. exceptionalism from U.S. policies

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Full steam ahead: Rapid policy change in first 100 days of Trump 2.0

As President Trump marked his first 100 days in office on April 30, his administration's economic-policy reforms appear well underway with an unusually rapid sequence of policy changes, including tariffs front and center. Markets welcomed the 90-day pause on most reciprocal tariffs with a relief rally, but signs continue to emerge that tariff uncertainty will persist as we detail below.

Beyond tariff negotiations, tighter border controls and deportations of undocumented immigrants have been moving full steam ahead. Economic headwinds from trade and immigration policy changes may ease later this year or early in 2026 as we expect tax-cut extensions and deregulation to help offset them. For now, the combined threats of higher inflation and slower growth raise the risk of recession.

Short-term pain, long-term gain

President Trump initiated his revised trade policy by imposing a 25% tariff on steel and aluminum imports followed by a March 26 announcement of 25% tariffs on imported automobiles. On April 2, he announced a universal 10% levy coupled with reciprocal tariffs varying by country, prompting several trade partners including the European Union (EU) and China to counter with retaliatory tariffs. A week later President Trump ordered a 90-day pause of reciprocal tariffs for most countries — excluding China. The S&P 500 Index bounced 9.5% on the news; the EU announced its own 90-day pause against the U.S. Meanwhile, U.S. tariffs against China were raised to 145%; China retaliated with a 125% levy.

We continue to watch for signs of an easing of the high-stakes tariff strategy, especially where Europe and China are concerned. Despite the talk of U.S.-European negotiations, not much has transpired yet. Regarding China, there are some tentative, early signs that talks will commence. However, even if the U.S. and China reduce their tariffs after some negotiation, we expect some levies to stick. China is likely to remain a main target of U.S. tariff policy, and that will bring higher prices to U.S. consumers and businesses that rely on supply chains from China.

It's unclear how negotiations will play out, and there remains a prospect for additional sectoral tariffs, starting with pharmaceuticals and semiconductors. Given President Trump's propensity as a dealmaker, we might expect talks to linger. A protracted trade war would likely increase costs for consumers and businesses, prompting shifts in spending habits or delaying purchases. We believe the longer trade-policy uncertainty persists, the greater the likelihood that inflation ticks up and growth slows down. The settled tariff policy could determine the recession or no recession outcome.

Immigration policy 2.0

Immigration policy has also been an early focus for the White House. Since January, the administration has arrested more than 30,000 people living in the U.S. illegally, mainly those with criminal records or gang affiliations (the actual number of arrests of those whose only violation is lacking legal immigration status remains undisclosed).[1] Deportations of migrants have been facing court challenges.

The electorate appears to support deportations of undocumented offenders. Pew Research Center has found that most Americans agree with deporting undocumented immigrants who have committed violent crimes (97%) and

1. Bloomberg. March 22, 2025.

nonviolent crimes (52%).[2] Tighter immigration controls may pose a threat to a vibrant U.S. labor market. Yet, we still see encouraging signs in economic data, including positive job and wage growth.

DOGE tackles spending ahead of budget reconciliation

The Department of Government Efficiency (DOGE) is an advisory board tasked with cutting government waste, fraud, and abuse to reduce the national debt (which stands at $36 trillion) through workforce reductions and programmatic spending cuts. DOGE aims to cut $1 trillion (15% of total federal expenditures) in federal spending by fiscal year-end in September. Through March 30, DOGE has claimed to save $140 billion, though this figure has been challenged by some lawmakers as only $7.7 billion are verifiable through receipts.[3]

The House and Senate have settled on the same budget blueprint, agreeing to just $4 billion in spending cuts over the next decade. While budget reconciliation does not stipulate specific policies, the House fiscal-year 2025 resolution mandates deeper spending cuts of up to $2 trillion in exchange for tax-cut extensions, a yawning difference between the two chambers that will have to be resolved as the bill works its way through the appropriations process.

Market implications of economic policies

The organic strengths of current U.S. economic growth — including solid labor markets, steady income growth, low borrowing rates, adequate liquidity, and households' heavy preference for services (not subject directly to tariffs) — lead us to believe a 2025 recession is not the base case. The prospective benefits from deregulation, tax-cut extensions, and potential interest-rate cuts that we expect later this year or next reinforce this view.

Still, there are clear risks that, if not avoided, could tip the global economy into contraction. For example, deportations have not had a perceptible effect on the labor market yet but could increase firms' labor costs if they accelerate. Most of all, we view the U.S.-China tariffs as sufficient mostly to stop bilateral trade. U.S.-European tariff exchanges are also a risk. Some tariff relief seems critical, whether unilateral or through negotiations. And any additional sectoral tariffs likely would undercut the U.S. and international economies further. The weight of these uncertainties is clear in the reluctance of many U.S. firms to provide forward earnings guidance in their first-quarter earnings reports.

A natural question then becomes: Can the U.S. remain our favored global region for investment? U.S. exceptionalism has been a cornerstone of our investment guidance, and the balance of this report tests this key assumption. We find that the case for U.S. exceptionalism still looks solid, and the report concludes with specific investment guidance.

Inflation, the economy, and immigration are the top three issues for voters with 43% of voters saying inflation is their top concern. 79% want the government to balance the budget by reducing expenditures.

Source: Harris/Harvard, March 31, 2025

As of March 31, 2025, the 12-month federal deficit stands at $1.31 trillion.

Source: U.S. Treasury

2. Pew Research Center, March 26, 2025.

3. Doge.gov.

U.S. exceptionalism: Are we at an inflection point?

Douglas Beath
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Global impact of tariffs

Year to date, international stocks have significantly outperformed U.S. equities. That was following a 15-year stretch when the S&P 500 Index outperformed both developed and emerging markets[4] by 6.2% and 9.2%, respectively, (as of April 23, 2025) on an annualized basis and a composite index of the U.S. dollar against a group of major developed-market currencies appreciated by 38%.[5] This section considers whether stronger international market trends will downgrade the U.S. in our outlook.

A closer examination

As a result of the aggressive tariff scenarios discussed in the previous section, we downgraded our 2025 U.S. economic growth forecast on April 4 from 2.5% to 1% and raised our year-end consumer price inflation target from 3.3% to 3.5%. To reiterate, we continue to believe that a U.S. recession is avoidable but the addition of more tariffs likely will raise the recession risk.

Yet, we believe China and Europe are two key regions that should suffer more than the U.S. under a global tariff fight. At a high level, Europe and China suffer from unique structural weaknesses, such as declining working-age populations and heavy regulation — and in the case of China an extended property slump and lingering uncertainties about the competitiveness of its tech sector — that should continue to hinder economic growth. We next consider each in some detail:

China

China's economy began this year on a strong note as the economy expanded by a more-than-expected 5.4% in the first quarter from a year earlier. However, several major U.S. banks have downgraded their forecasts on China's growth this year to 4%, or lower, as a result of U.S. tariff announcements, well below Beijing's published goal of 5%. Consensus forecasts available on Bloomberg put expansion this year at 4.5% with a base-case scenario of a U.S.-China tariff agreement that clearly will limit future tariffs. During previous periods of economic stress, we have observed Chinese corporations accept lower profit margins, rather than lose market share, and believe this is likely again if high tariffs persist. In addition, Bloomberg consensus currently indicates roughly flat Chinese price levels in 2025, but persistently high global tariffs should tip China back into deflation, which has been a chronic problem and the result of China's debt overhang and slow economy.

So, we see the tariffs coming at a time when China's economy is vulnerable. Its real-estate sector is experiencing a multiyear downtrend, cramping consumer spending, which has led to a period of prolonged deflation. In addition, any attempts from Beijing to remake its economy in response to global tariffs will likely face headwinds. For example, finding new export markets to replace the U.S. will be difficult as other countries could be reluctant to accept a flood of low-priced goods from China. Europe already has reacted against the flood of electric vehicles onto the continent. In addition, pivoting toward expanding domestic markets will be difficult for China. Household consumption accounts for less than 40% of China's economy versus nearly 70% for the U.S. And efforts to boost China's consumption in past global downturns have had limited success as the central government focused on its usual remedy of increasing investment spending.

4. Indexes used for Developed Market and Emerging Markets: MSCI EAFE and MSCI Emerging Markets versus the S&P 500.
5. From April 28, 2009, through April 25, 2025, the ICE U.S. Dollar Index appreciated by 38%. The index is a weighted average of the value of the U.S. dollar relative to a basket of U.S. trade partner currencies, composed of the euro, Japanese yen, pound sterling, Canadian dollar, Swedish krona, and Swiss franc. A higher index value indicates dollar appreciation.

Against all these economic challenges, the Chinese central government could announce new and large stimulus, likely in the form of new credits to the economy. Beijing has used these measures in the past but has avoided them since growth started to slow, we think mainly because officials do not want to increase the economy's overall debt. It remains to be seen if tariffs will slow the economy enough to encourage new stimulus.

Europe

Before President Trump's barrage of tariff announcements, Europe was set to recover from last year's anemic pace supported by the lagged impact of the European Central Bank easing cycle, the EU's rearmament stimulus, and the pull back of Germany's debt restrictions. Europe's tenuous energy security and heavy regulation add to our skepticism that most EU governments can afford new defense-spending commitments.

More importantly, the U.S. is Europe's top export destination — accounting for more than 20% of EU exports last year — and we believe global tariff uncertainties will most certainly be a headwind. Germany is more vulnerable to tariffs than other EU members[6] with the potential to shave close to 1% from its annual economic growth rate. We also expect euro-area inflation to fall as the economy slows. We believe Developed-market ex-U.S. earnings forecasts have been accelerating with expectations of low double-digit growth for Europe in 2025, but this outlook also could be at risk as the euro-area economy slows.

In contrast, the U.S. benefits from less regulation with a more efficient financial market and a projected 5% working-age population growth over the next 15 years — the highest in the developed world and China by far.[7]

Most importantly, U.S. exceptionalism is primarily related to the technology sector, which we expect to remain a disruptive force in the global economy, led by the U.S. We base this expectation on the following:

- Artificial intelligence (AI) — the U.S. economy is more service-oriented versus the rest of the world with a more dynamic economy, which should equate to more productivity gains from AI.
- U.S. new technology absorption rates — these are higher than in other global regions and provide another advantage to AI development in the U.S.
- Energy — energy independence should make the U.S. less vulnerable to shocks and benefit the growing energy needs of AI and data centers.

We believe the U.S. equity outperformance should resume and benefit from the significantly higher allocation to technology in the S&P 500 Index compared to developed ex-U.S. and emerging-market equities, which are heavily weighted to their financial sectors. Earnings per share since the Great Financial Crisis show a cumulative gain of nearly 200% for the S&P 500 Index versus just 10% for MSCI Emerging Markets Index and essentially flat for MSCI EAFE Index.

What it means for investors

We believe the U.S. is better prepared both for a global economic growth recovery and to adjust to higher tariffs. In addition to the adverse structural issues that China and Europe face, greater exposure to foreign trade there and in most other economies abroad leaves them more exposed to fallout from increased global protectionism: Eurozone exports are 29% of gross domestic product (GDP) versus 20% for China and 11% for the U.S.

A trade war should negatively impact global economies with China being the most vulnerable.

Despite a significant downward revision to economic growth this year, the U.S. economy's exports as a percent of total output is relatively low, making it less vulnerable to global tariffs.

6. PIPER SANDLER. April 17th, "Quick Take: Lagarde's 7th Cut Amidst Trump-Induced Uncertainty, page 9.
7. Source: Global, Economic, Inflation, and Market Outlook, February 2025, page 29, Alejandra Grindal.

U.S. exceptionalism and the future of the U.S. dollar

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Despite volatile policy, American exceptionalism likely will remain

We believe that large and broadly applied tariffs will reduce but not eliminate the preeminent role of the U.S. economy and the U.S. dollar. The foundation for the U.S. economy remains the importance of U.S. companies, securities, and government on a global level.

U.S. still firmly in the driver's seat of the global economy

The U.S. has been a key incubator of invention and innovation with a more accommodative regulatory framework supporting a more entrepreneurial culture than those in other advanced economies. European regulatory reforms have been discussed,[8] accelerated recently by concerns over the future relationship with the U.S., but political changes of this magnitude do not come easily. Beyond these proposals, structural disadvantages ranging from less efficient financial markets and industrial structures, declining populations, and a smaller, less dynamic technology sector in other advanced economies (particularly in Europe) help explain lagging growth abroad compared to the U.S. in our outlook. Moreover, global-trade concerns likely will weigh on more export-oriented economies in China, Europe, and other advanced economies overseas.

The global U.S. role extends to the size and liquidity of U.S. financial markets. The U.S. government-securities market is by far the largest globally, and almost $9 trillion of U.S. Treasuries (roughly one-third of marketable Treasury debt) are held internationally.[9] U.S. equities make up almost 65% of some global equity indexes.[10]

We have observed nothing to suggest that foreign nations are undertaking a wholesale move away from the U.S. In fact, U.S. Treasury data indicate that official buyers have slowed their purchases but private buyers have increased their share of Treasuries held abroad over the past 10 years. The U.S. also has global leadership through global payments systems, especially the SWIFT system (vital for international payments between financial institutions), and through financial institutions like the International Monetary Fund, using its influence to achieve policy goals through both.

The U.S. dollar is a key building block of the global financial system. On average, the dollar holds a 57% share in the foreign-exchange reserves of all other countries, according to the International Monetary Fund. That share has eroded slowly over the past four decades as broadening global trade made holding other currencies useful. However, the dollar also remains solidly above 50% in all international transactions, not just in goods trade but in all foreign-exchange traffic, which includes investment flows around the world.[11] Beyond the dollar's key role in financing investments, many commodities, including oil, continue to carry prices in dollars.

Some weakening in the dollar's value is consistent with at least some tariffs remaining in place. Yet, the dollar's value as of April 24, 2025, was still significantly above its average for the past 35 years as shown in the chart on page 7. However, we believe that there is no global currency with so much support from depth and breadth of financial markets that could replace the greenback as the world's premier reserve currency.

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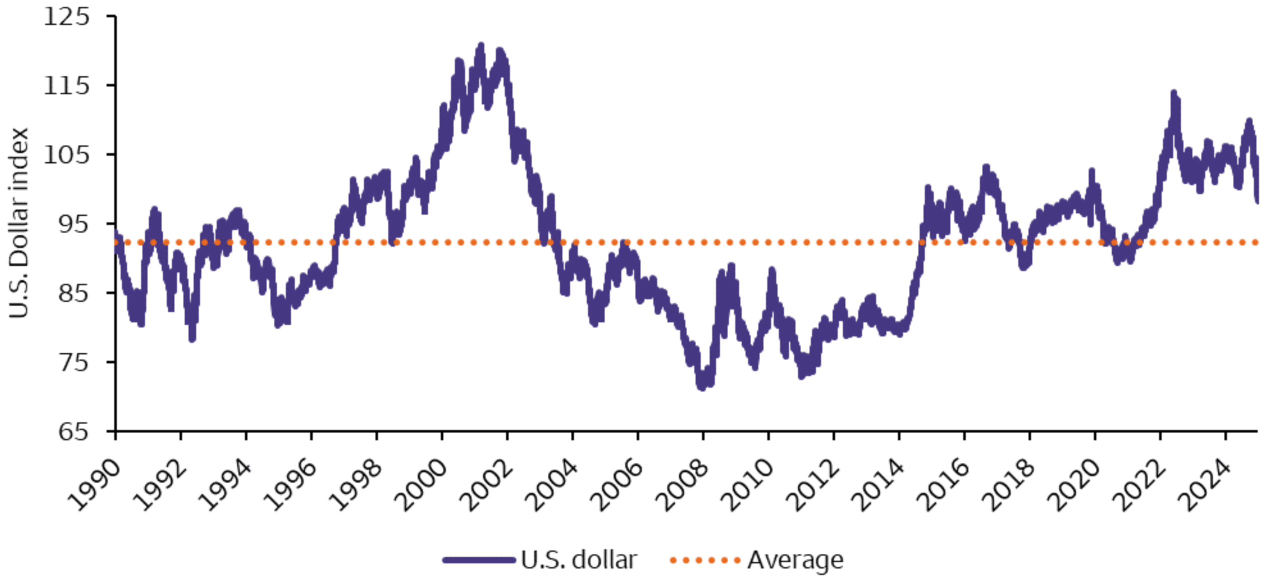
8. European Commission, "Better Regulation: Taking Stock and Sustaining Our Commitment," April 15, 2019.
9. Treasury International Capital Data as of February 2025.
10. MSCI All Country World Index as of March 31, 2025.
11. Carter Johnson, "U.S. Dollar's Use in Global Transactions Tops 50%, Swift Says," Bloomberg, February 20, 2025.

Chart 1. Value of the U.S. dollar from 1990 – 2025



Sources: Bloomberg and Wells Fargo Investment Institute as of April 24, 2024. U.S. dollar represented by the DXY Index, an average of exchange rates between the U.S. dollar and major developed trade partners of the U.S. Average from April 24, 1990, to April 24, 2025. An index is unmanaged and not available for direct investment. **Past performance is no guarantee of future results.**

How to invest for continued American exceptionalism

To summarize this and the preceding two sections, tariffs and deportations exact material costs on the U.S. economy. Nevertheless, American exceptionalism rests, in large measure, on deep-seated structural advantages that are unlikely to change quickly, even accounting for far-reaching policy changes of recent months.

Strong economic and earnings growth fostered by these advantages supports our preference for domestic over international in both equities and fixed income. We recognize that tariff and trade policy does still have the potential to cause volatility in the short term. Our preference is generally for higher-quality investments, large and mid cap over small cap and emerging markets in equities, and investment grade over high yield in fixed income, which we feel may be better positioned to weather policy-driven short-term volatility. From a sector standpoint, our preference has been for Information Technology, Communication Services, Financials, and Energy in equities.

The U.S. government securities make up roughly 35% of all global, long-term debt securities, more than three times the next largest individual country.

Source: Bank for International Settlements as of December 21, 2023

An indication of a U.S. industrial structure more dynamic than Europe: None of the top five American companies predate 1975 while a top European conglomerate dates back to the 1700s.

Source: Bloomberg as of April 17, 2025. Measured by market cap.

Risk considerations

Forecasts are not guaranteed and based on certain assumptions and on views of market and economic conditions which are subject to change.

Different investments offer different levels of potential return and market risk. The level of risk associated with a particular investment or asset class generally correlates with the level of return the investment or asset class might achieve.

Equity securities are subject to market risk, which means their value may fluctuate in response to general economic and market conditions and the perception of individual issuers. Investments in equity securities are generally more volatile than other types of securities. The prices of small and mid-cap company stocks are generally more volatile than large company stocks. They often involve higher risks because smaller companies may lack the management expertise, financial resources, product diversification and competitive strengths to endure adverse economic conditions.

Sector investing can be more volatile than investments that are broadly diversified over numerous sectors of the economy and will increase a portfolio's vulnerability to any single economic, political, or regulatory development affecting the sector. This can result in greater price volatility.

Investments in fixed-income securities are subject to interest rate, credit/default, liquidity, inflation, and other risks. Bond prices fluctuate inversely to changes in interest rates. Therefore, a general rise in interest rates can result in the decline in the bond's price. Credit risk is the risk that an issuer will default on payments of interest and principal. This risk is higher when investing in high-yield bonds, also known as junk bonds, which have lower ratings and are subject to greater volatility. If sold prior to maturity, fixed-income securities are subject to market risk. All fixed-income investments may be worth less than their original cost upon redemption or maturity.

U.S. government securities are backed by the full faith and credit of the federal government as to payment of principal and interest. Unlike U.S. government securities, agency securities carry the implicit guarantee of the U.S. government but are not direct obligations. Payment of principal and interest is solely the obligation of the issuer. If sold prior to maturity, both types of debt securities are subject to market risk. Although Treasuries are considered free from credit risk, they are subject to other types of risks. These risks include interest rate risk, which may cause the underlying value of the bond to fluctuate.

Investing in foreign securities presents certain risks not associated with domestic investments, such as currency fluctuation, political and economic instability, and different accounting standards. This may result in greater share price volatility. These risks are heightened in emerging markets.

Currency risk is the risk that foreign currencies will decline in value relative to that of the U.S. dollar. Exchange rate movement between the U.S. dollar and foreign currencies may cause the value of a portfolio's investments to decline.

Definitions

ICE U.S. Dollar Index is a weighted average of the value of the U.S. dollar relative to a basket of U.S. trade partner currencies, composed of the euro, Japanese yen, pound sterling, Canadian dollar, Swedish krona, and Swiss franc. A higher index value indicates dollar appreciation.

MSCI All Country World Index (MSCI ACWI) is a free float-adjusted market capitalization weighted index that is designed to measure the equity market performance of 23 developed and 26 emerging markets.

MSCI EAFE Index is designed to represent the performance of large and mid-cap securities across 21 developed markets, including countries in Europe, Australasia and the Far East, excluding the U.S. and Canada.

MSCI Emerging Markets Index is a free float-adjusted market capitalization index that is designed to measure equity market performance of emerging markets.

S&P 500 Index is a market capitalization-weighted index composed of 500 widely held common stocks that is generally considered representative of the U.S. stock market.

U.S. Dollar Index (DXY) is an average of exchange rates between the U.S. dollar and major developed trade partners of the U.S.

An index is unmanaged and not available for direct investment.

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