April 2025

Known Unknowns

The current investing climate is dominated by attempting to analyze the rapidly changing economic and geopolitical climate and repositioning portfolios – ostensibly to reduce risk in the short term while setting them up to prosper over time. The simplicity of this statement ignores several harsh realities. The first that comes to mind is Newton's third law of motion, "every action has an equal and opposite reaction." The significant changes being proposed and taken by the new administration, both at home and abroad, are unlikely to be accepted without pushback. This pushback can take many forms and occur over time. Most, at the time of this writing, can best be politely described as known unknowns.

In risk management, proactively identifying known unknown situations and developing plans to mitigate or respond to them is most important. It is essential because the outcome of the known action is variable and uncertain. **The current environment, in our opinion, is opening up outcomes that are outside of the normal range of variability and thus require significant attention.** For example, President Trump is working publicly to bring an end to the conflict between Russia and Ukraine. That is the known action, how the rest of the world responds to that deal, if and when it happens, is unknowable. As a recent article published on March 21, 2025, in the Wall Street Journal by Greg Ip describes below, the reactions to date have potentially altered the course of large economies.

Europe Comes to Life as U.S. Stumbles

Germany's defense buildup is one of several signs Europe might be shaking off stagnation
By Greg Ip

At the World Economic Forum in Davos two months ago, the mood around Europe was funereal. Its economy and markets had underperformed the U.S. for years. Now, a newly inaugurated President Trump promised to sledgehammer Europe with tariffs while juicing U.S. growth with lower taxes, less regulation, and cheaper energy.

As usual, the Davos consensus got it wrong. Since then, the moods across the Atlantic have switched places. European stocks are up nicely, while the American market has had a correction (a 10% drop). On Wednesday, Federal Reserve officials revised their outlook for inflation up and for growth down. The dollar, which shot up after Trump was elected, has sunk.

Some perspective is in order. A market reversal was overdue; the valuation gap between European and American stocks was becoming absurd. Even with revisions, the U.S. is still likely to grow faster than the European Union and Britain this year. Business activity indicators in Europe remain weak.

Yet a more fundamental reappraisal of the two regions' prospects might be in order, and it has a lot to do with Trump -- though not the way most expected.

U.S. growth prospects have actually slipped since Trump's arrival. In January, economists expected growth of 2.2% annualized in the current quarter. Now, estimates are around 1% to 1.5%. On Wednesday, Fed officials lowered expected growth this year to 1.7% from 2.1%.

The exact reasons for the downgrade are unclear; the first-quarter slowdown reflects data that predated Trump's first full month in office. Still, his trade war has taken a toll on business and consumer confidence.

Moreover, the risk that tariffs keep inflation above the Federal Reserve's 2% target means the central bank is for now keeping interest rates at 4.25% to 4.5%, though it hasn't ruled out later cuts.

European growth prospects haven't changed much. In fact, the threat of tariffs led the European Central Bank earlier this month to mark down expected growth in the eurozone this year to just 0.9%.

But several positives are pushing in the opposite direction. Though European leaders are nervous about Trump's eagerness to strike a peace deal in Ukraine with Russian President Vladimir Putin, the prospect has brought European natural-gas prices down.

And with underlying inflation lower in Europe than the U.S., the ECB has cut rates twice this year, to 2.5%, and will likely cut them again, a useful tailwind to consumers.

Meanwhile, European leaders have been galvanized to act on their stagnant economies, nowhere more than in Germany. This week, its legislature amended its constitutional "debt brake" to effectively permit unlimited defense spending. Evercore ISI, an investment bank, estimates that defense and infrastructure spending will rise by the equivalent of 3% of gross domestic product. The equivalent in the U.S. would be nearly $1 trillion a year.

In a memo Tuesday, the conservative party that won last month's elections and spearheaded the move (on which the legislature's upper house will vote Friday) said: "We are defending ourselves against attacks on our open society and freedom. At the same time, we are strengthening Germany's investment opportunities to an unprecedented extent."

The European Commission, the European Union's executive arm, is pushing in the same direction, proposing to exempt defense from the bloc's deficit caps. On Wednesday, it proposed a defense fund of 150 billion euros, the equivalent of $164 billion. Participation by U.S. weapons suppliers would be limited unless America signs a security agreement with the EU.

"WWII got the US out of the Great Depression; Europe's rearmament should do wonders for Europe's cyclical outlook," Stephen Jen and Fatih Yilmaz of Eurizon SLJ Capital wrote this week.

More important than the numbers is the change in mindset. Germany enacted its debt brake in 2009 when its leaders were determined to avoid the instability that excess debt had wrought on its European neighbors.

They succeeded, but at a cost. An aversion to borrowing kept German demand depressed and its trade surplus high while starving the military and infrastructure. Marking the shift in mindset, Defense Minister Boris Pistorius said ahead of Tuesday's vote: "The threat situation comes before the financial situation."

Germany isn't the only place where pro-growth policy is in fashion again. U.K. Prime Minister Keir Starmer is rolling out permitting reforms to speed up the construction of houses, infrastructure and nuclear power plants. Chancellor of the Exchequer Rachel Reeves vowed this week to ease restrictions on mergers.

France, meanwhile, signaled that it would approve loans to finance six new nuclear reactors, estimated in 2022 to cost EUR52 billion.

These steps could take years to bear fruit, and there's no guarantee execution will match intent. Still, it's notable that political leaders have mustered the intent. Why now? Trump can take some credit, though not in the way Europe would want. His overtures to Russia, ambivalence toward the North Atlantic Treaty Organization and promised tariffs have created in Europe an urgency around rearming and breaking down internal barriers to investment and innovation.

German conservative leader Friedrich Merz, likely the next chancellor, said last month that it is clear Trump "does not care much about the fate of Europe. My absolute priority will be to strengthen Europe as quickly as possible so that, step by step, we can really achieve independence from the U.S.A."

French President Emmanuel Macron last month cited Trump's mantra "drill, baby, drill" to tout his own agenda of boosting nuclear-generated electricity: "Here there is no need to drill, it is plug, baby, plug."

Trump isn't just changing the policy calculus in Europe. In China, his tariffs are easing the way for more fiscal stimulus. Andrew Batson of Gavekal Research estimates that China will run a budget deficit of 10.9% of GDP this year, its largest ever, bringing additional stimulus equal to 2.4% of GDP.

These figures "run counter to the popular narrative that China's deep-rooted fiscal conservatism is preventing it from responding appropriately to an economic slowdown," Batson wrote.

There is an irony here. If Europe and China succeed in firing up internal engines of growth, that could, along with the weaker dollar, help narrow their trade surpluses with the U.S. Tariffs would have achieved Trump's goal of reducing the trade deficit, but not the way he expected.

Write to Greg Ip at greg.ip@wsj.com

Best practices for risk management would involve identifying the known unknowns and then developing contingency plans and mitigation strategies. Comically, the first mitigation strategy is avoidance, which isn't really an option today. We are where we are.   **Understanding that avoidance is not an option, the most realistic course of action is acceptance of the risk**. This requires that we must plan for both the probable and possible impacts of the known actions. Given the wider range of outcomes, both good and bad, the complexity of planning for probable, let alone possible, has been ratcheted significantly higher.

When complexity increases, decision-making slows. This is true for governments, companies, and individuals. It also acts as a deterrent to long-term investment as the long-term remains uncertain. If this uncertain environment persists, then as capital investment grinds to a halt, economic activity will slow as individuals and businesses collectively pause to continue evaluating changing conditions. This continuous evaluation is the last step in managing any risk.

We have written for some time about embracing volatility and positioning portfolios for the long term. This has occurred in fixed-income portfolios, taking advantage of higher interest rates to lock in real rates of return for longer timeframes. We have also previously noted that regarding equity portfolios, "we would expect to find opportunities in that choppiness to exit some positions that have reached full value while also investing in new ideas that will benefit from a refreshed and extended economic cycle." **While the macro environment presently appears as clear as mud, over the long term, we remain resolute in our belief that over any reasonable timeframe, the economy and earnings grow, enabling equity markets to move higher.** This remains our viewpoint and a vital part of our continuous evaluation of client portfolios.

As always, if you have any questions or simply want to catch up, please give us a call.