

By Prabhu Palani (Chief Investment Officer)

Wars can come in many different forms. A trade war is one of them. Prof Jeremy Siegel of Wharton calls the current trade war, “the biggest policy mistake of the last 95 years.” Of tariffs Warren Buffett has said, “they’re an act of war, to some degree.”

The Smoot-Hartley Tarriff Act of 1930, signed into law by President Hoover set tariff levels around 20%. This Act, which levied tariffs on over 20,000 imported goods, was designed to protect American industries from foreign competition at the onset of the Great Depression. The markets didn’t respond well. At its lowest level in July 1932, the market had fallen a staggering 89% from its peak. The tariffs did not cause the Great Depression, but they did not make things easier.

One could persuasively argue that we are in a different era now than during the Great Depression. Central Banks have more tools; monetary policy has been built on failures and successes of the past. Chair Powell said today that it is “too soon to say what will be the appropriate path for monetary policy.” In other words, don’t look for an interest rate cut yet.

Can tariffs push the economy into a recession? The answer is not clear, though Siegel and Powell seem to think so. Most of the large investment banks have increased their odds of a recession. I’m not a fan of economic predictions, though the science has its uses. If we are indeed in an era of regime-change, we have no idea how this drama will unfold. We have let loose a torrent of tariff missiles at the world, and we need to wait and see how they respond. Will China’s tariff response hold? How many countries will come to the negotiating table? Will the US’s reciprocal tariffs be permanent policy? And even if not, will this be the beginning of a new order? Only time will tell. What is more relevant for us is the potential impact to our portfolio and the way forward.

Bear market studies are interesting. Though technically defined as a 20% pullback in the market, start and end dates influence how we calculate bear markets. For example, in a prolonged bear market there can be intermittent bull markets. A broadly accepted version is that there have been about a dozen bear markets in the last 100 years with an average drawdown of about 35%. The Covid bear market fell exactly at the mean, though the two prior bear markets of the Great Recession and the Dotcom bubble saw pullbacks of 50% and 45% respectively. Of greater interest though, is that bear markets tend to be much more short-lived than bull markets and market gains in bull runs are often significantly higher than market losses in a bear market. Hence the adage, “stocks for the long run.” We’re of course talking averages here and this data is more instructive than predictive.

Market timing is a hazardous game. In a perfectly efficient market, timing the market will be futile (this is when assets are always perfectly priced). However, studies have shown that the efficient market hypothesis does not hold, at least not in its strong form. This can lull one into thinking that there are opportunities to outperform the market despite the heavy odds against it. No one likes to think that they are average in any field; most people would consider themselves 'above average'. Prof Bill Sharpe, Emeritus Professor at Stanford, in his classic 1975 paper, "Likely Gains from Market Timing" concludes that unless you can be right seven times out of ten in predicting market movements, it is best to avoid attempts to time the market.

Luckily for us, pension funds are among the few pools of capital that have the luxury of an indefinite time horizon. We don't need to be skilled at market timing or even be 'above average.' We need to set our asset allocation keeping in mind obligations to our beneficiaries. That is the sole reason we exist. Bear markets will come and go. The next bear market may not be like the previous one. Prolonged pain is possible, but we can withstand volatility. According to research by Harford Funds, 36% of the market's best days occur within the first two months of a bull market, well before we know that we're in one.

Given the long-term trajectory of returns on risk assets, market downturns are extraordinary opportunities to buy assets at lower prices. During panic selling, the baby is often thrown out with the bathwater. Patient, long-term investors can capitalize.