Equities, Volatility and the Path Ahead with Don Townswick, Director of Equity Strategies

Conning ConnText is a quarterly podcast that features our firm's view of capital markets, trends and investment strategies for the insurance industry, hosted by Rich Sega, Conning's Global Chief Investment Strategist.

SEGMENT 1 – OPENING

Rich Sega [RS]

Chaos, mayhem, confusion, disruption. A year's worth of all of them and it's only April.

I'm Rich Sega. Welcome to the Conning Context Podcast for the second quarter of 2025.

Trade war fears are running rampant through markets. We're threatened with inflation, recession - hence the dreaded stagflation – retaliation. The dollar's reserve status is in jeopardy. Markets are reeling in the wake of President Donald Trump's self-described "liberating day" of tariff announcements on 2 April. Nowhere is this more evident than in the behavior of equity markets. From all-time highs two months ago to correction territory now, it's been a wild ride since Inauguration Day.

I'll try to sort this all out with my colleague, stock-market guru Don Townswick, a managing director on Conning's Portfolio Management team.

SEGMENT 2 – ECONOMIC OVERVIEW

[RS] (Time stamp 1:06)

Now of course, as a learned friend told me recently, economists like tariffs about as much as vampires like sunlight and holy water. So of course we're hearing some dire predictions from economists about tariffs. U.S. consumers will face higher prices at the grocer and the hardware store. We've already seen rising import prices for consumer goods and industrial supplies and should expect more. Month-over-month manufacturing and services surveys fell in March.

Ten-year U.S. Treasury rates gyrating up and down. Corporate credit spreads: wider.

U.S. dollar demand - both for transaction volume, which would fall during a trade war slowdown, and as a store of value - has been dropping, threatening dollar dominance on the world stage.

All these are valid concerns, but we need some perspective.

The tariff is just a tax, a very narrowly aimed and specific kind of tax, not necessarily inflationary, just like other types of taxes aren't in themselves inflationary without monetary support, which would be inflationary even without the tariffs.

In the past, trade wars have been associated with deflation, not inflation, because they tend to push up some prices at first, but then they create a demand and induce product substitution. If we look back to the 2017 Trump tariffs, we had no pop to inflation, no hit to GDP so recession is not assured, but also interestingly, no change in the trade deficit, a main target of the tariffs in the first place.

(2:42)

There are a lot of creditor countries in the global economy, countries that have more financial claims on foreigners than foreigners have claims on them, and some of it's structural, beyond their control. In balance-of-payment terms, they have more external assets than liabilities. Since those assets are typically not under their jurisdiction, that poses a risk. Would we really want to trade surplus with China, for example, so they got our grain and we got a bunch of yuan in reserves? Trade deficits are just capital surpluses. We get their stuff and they get our inflation-prone promissory notes. Doesn't sound like a bad deal to me.

And while much of the reasoning behind tariffs is to bring manufacturing back to America, the truth is that the U.S. is second in the world after China in manufacturing output and bigger than the next four on the list combined. And we've been increasing in absolute terms.

From that I must conclude that many of these tariffs are fodder for negotiation, providing the U.S. leverage in discussions that range beyond trade imbalances alone, issues like border security, fentanyl interdiction, IP theft, forced technology transfers, to name a few.

But there's no denying their painful impacts on markets and psyches.

SEGMENT 3 – EQUITY MARKET DISCUSSION

[RS] (4:01)

So let me bring in Don Townswick to talk about how this is affecting his equity market outlook.

Hi, Don! So with all this going on, I'm in Hartford. But are you in a bunker at some undisclosed location this week?

[Don Townswick (DT)]

Yes, Rich, I'm actually on an uncharted island in the South Pacific. I'm going to stay here essentially until we get a little bit more clarity.

It seems like a pretty straightforward forecast that short-term market performance is going to be driven by a lot of uncertainty and equity markets hate uncertainty. Our opinion about the market is that we're going to see a correction happening in the short run.

But interesting enough, when you look into the internals of the market, the biggest pullback has been from the frothiest stocks of 2023 and '24, namely the stocks, colloquially called the "Magnificent Seven."

These companies were selling at a really high price-to-earnings ratio that may or may not have been justified but were certainly based on strong economic growth expectations. Since they were 34% of the market at the year's end in 2024, a correction in these stocks is going to tend to take the entire market down with them.

[RS]

So we heard a lot about uncertainty. How about giving our listeners some examples of the sources of these risks?

[DT]

When I originally made a list of these uncertainties, I put tariffs at number three but I think I'm going to move them up to number one.

Tariffs have, I think, come down in a little bit more of a blanket fashion than I think most investors expected, even though I think that that was certainly telegraphed well in advance. So the uncertainty about the impact of tariffs is really weighing on the market. I think that I agree that this is about negotiations and I think the sooner those start happening, the better for the equity market.

But there are also other questions that were even in place prior to the tariffs.

One important one was whether or not Trump's tax cuts from his first term would be extended or not. If they're not extended, that will act as a significant headwind to the markets and growth.

We really haven't seen much of a deregulatory bent during this Trump administration. But if we do start to see that, that could very well be a positive. Broader fiscal policy could be an issue, too: How much are we spending versus how much are we taking in? Will the tariffs, for example, bring in a significant amount of revenue?

Immigration could also be an issue, I think. Some economists say that “we need more immigration to fill roles in the economy” and others say “no.” But for right now, there’s a significant amount of uncertainty about that.

And then finally, we’re still wondering whether inflation has been brought under control by Fed tightening. We’re looking now at forecast probabilities of several Fed rate cuts this year and there’s always the risk that that might reignite inflation.

[RS] (7:30)

Wow, that’s a lot of uncertainty. How does the market look now to you from a purely fundamental perspective? What are the major indicators that you’re tracking to cut through the noise?

[DT]

Well, really, when you come down to it, the equity market tends to be driven by earnings, which also is driven by economic growth and affected by inflation.

Earnings tend to be the main driver and we really have very little clarity about the positive or negative effects of current Washington policy changes. And if earnings are reduced dramatically in the short run due to these changes, it will not be good but, if they are not, then the opposite would hold true.

Growth and inflation will also likely drive any Fed action. And, as I mentioned before, there are higher expectations for Fed rate cuts in 2025. which again could help economic growth, can add fuel to the inflationary fire. And aggressive Fed action can also sap confidence at times and I think we saw a little bit of that post Great Financial Crisis.

But unfortunately, much like everything else, we don’t know what the net impact of Fed moves will be at this point.

[RS]

Since we’re talking about earnings, what’s your outlook or changes in the outlook for the rest of 2025 and into 2026. and whose earnings are on the hot seat?

[DT]

Well, companies which depend upon their imports for their products or services have earnings on the hot seat. The Big Three auto companies in particular are very exposed to the price of imports because they source, in some cases, almost half of their parts from other countries.

The earnings outlook for 2025 peaked at about 15% year-over-year growth, but unfortunately that’s dropped now to 11% year-over-year, and that was even before the tariffs were announced. But over the same time, the out-year - 2026 - has seen estimates increase over the period from August to today from about 12% year-over-year growth to 14.1%.

If you kind of blend those together, that could actually support equity market returns that would be considered normal of about 7% to 9% per year.

Under the hood, again, the earnings picture is improving for the non-Magnificent Seven stocks versus everything else. So this really should support the rest of the market, which is still about 70%, but FANGAM could be a different story.

[RS] (10:18)

Since you mentioned the auto manufacturers, Don, am I correct in assuming that some of that is going to be shielded because they’re part of USMCA, and if they’re compliant then they won’t be tariffed.? Does that help the auto stocks, if at all?

[DT]

Yes, I think that’s definitely going to, at least at the very beginning, cushion the impact of some of these tariffs. As I mentioned before, U.S. manufacturers get a large percentage of their components from outside the U.S., mostly from Canada and Mexico. GM is the largest importer of parts.

But so far, auto parts sourced outside the U.S. and Mexico and Canada are exempt from tariffs because they're compliant with the USMCA. And if the U.S. consumer begins to substitute into U.S.-made vehicles and out of foreign vehicles, it could also be a partial offset to tariff pain for the Big Three auto stocks.

[RS]

If I could step away from tariffs for just a second or two, do you have any more color on the DeepSeek effect on the AI industry? Has there been a real shift in tech investments or was that just a blip?

[DT]

Well, so far it seems like it was just a blip.

There are a significant number of doubts about the legitimacy of DeepSeek and whether or not it was actually just a derivative of some of the main U.S.-driven AI models out there, such as ChatGPT.

[RS] (11:54)

In your recent experience, talking to folks around the industry, how are our clients viewing the role of equity in their portfolios now in light of all this. How should they (view it)?

[DT]

Most of our clients seem to see this as a buying opportunity, once the dust settles. They have a very long horizon for their equity investments and I've spoken to several clients that are planning to invest more, have already invested more, or are contemplating adding a little bit more beta to their portfolios so that when the market recovers, they can actually make up some of these losses and more.

This is very interesting because most of our clients tend to be pretty risk averse, so their beliefs must be pretty strong that the selloff is overdone, which I think we would agree with too.

So speaking of adding more beta to their portfolio is really a horse of a different color compared to our usual experience.

[RS]

So to sum up, what's your short-, medium- and long-term outlook for the equity markets? If you were completely unrestricted, what are some of the sector-level or strategic recommendations that you'd have for this environment?

[DT]

Well, for a short-term, medium- and long-term outlook for the equity markets, there's no question that there's going to be short-term volatility caused by uncertainty, and over the medium term, we think, which could be six to 12 months out, some greater stability should set in as earnings improve. And then long term, we see this is potentially very bullish as Trump's new "America First" agenda solidifies in the economy.

It would be a very good thing for our economy if trade barriers to other countries in place now were to be removed and that in and of itself, I think, would have a very stimulative effect to our manufacturing sector.

Our strategy recommendations would be to stay fully invested for this roller coaster ride. If you have cash. keep it there until the current emotional selloff eases. Perhaps, for now, invest in utilities and real estate which have little to no import exposure and also tend to pay a solid dividend yield. Select consumer staples that don't import much of their raw materials could be a good spot as well, so not companies that import cocoa, for example, but companies that are more dependent upon just plain, good old

American-grown sugar.

[RS] (14:45)

So Don, in light of all that, how does the high dividend strategy that we pursued for a long time, how does that hold up in this environment?

[DT]

We've always sold the high dividend equity strategy according to what its philosophical tenets are and what we've actually seen in live performance, and that is upside participation but downside protection. And in the current market, we've really seen downside protection and because the high dividend equity strategy is based upon owning companies with a solid and growing dividend stream, low leverage, and significant free-cash-flow generation, and that have been really maintaining these characteristics for years, it's really a quality strategy. And in this kind of environment, quality is what's holding up, and having good free-cash-flow dividends tends to provide a little bit of a buffer on the downside.

So, not to toot our own horn but it is a very good place to be in the current environment.

[RS]

Thanks a lot, Don. Be careful out there.

SEGMENT 4 –CLOSE

[RS] (16:09)

We believe a fundamentals-first approach will serve investors well during this continued period of heightened volatility. While the mood is heavy right now, as Don mentioned, it's still unclear as to how some of the negotiations with trading partners will work out; Treasury Secretary Bessent says there's at least 70 countries that have indicated a willingness to start discussions.

And we should keep in mind that, despite the fact that tariffs have taken center stage, the tone could change quickly should the benefits of cheap energy, lower taxes, less burdensome regulation and some relief from the raging global conflicts take hold.

Thanks for listening in on our session.

I hope our discussion today helps to frame the risks and opportunities that we see in markets and our economy.

We always welcome your feedback and questions. You can get messages to us through your relationship manager, your portfolio manager, or send them directly to us at ConnText@Conning.com (that's ConnText w/ 2 Ns).

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