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MARKET COMMENTARY

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DeepSeek & Tariff Disruption

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Markets are not short on information flow these days. The steady cadence of corporate earnings, economic reports, and Federal Reserve meetings has been disrupted by news around AI innovations and new tariffs.

As we've commented previously, markets were rather sanguine during 2024 as the economy and business conditions moved steadily higher. This resulted in U.S. stocks beginning 2025 in a Goldilocks state. Following some unexpected news over the last two weeks, investors are adjusting their expectations due to unforeseen data that may lead to economic and business conditions no longer advancing without interruption.

In our discussion below, we summarize the perspective of Miracle Mile Advisors' Investment Strategy Group on Artificial Intelligence (AI) and tariffs.

DeepSeek

Last week, Chinese technology company DeepSeek released its R1 AI model, claiming the cost to develop and train the model was a small fraction of what is being spent by large U.S. technology firms. This announcement marked a shot across the bow, leaving many questioning whether there is more to DeepSeek's story or if, indeed, the cost to develop and train an AI model is coming down meaningfully.

We interpret DeepSeek's announcement as a wake-up call for both the industry and investors that a great deal of uncertainty remains regarding how AI model development and use cases will ultimately play out. DeepSeek demonstrated that innovations will lead to improvements in technical architecture and that competition will ultimately reduce AI-related costs. Lower costs should lead to more use cases, and more use cases will result in faster adoption. However, faster adoption does not benefit all AI-related companies linearly. Former AI winners may cede economic market share to other participants, including new competitors with more efficient products or services, advantageous software applications, and companies with useful and unique data.

Given that stock returns during 2023 and 2024 were driven by a narrow group of seven large technology companies leveraged to AI, we believe the lessons stemming from DeepSeek will serve as a catalyst to broaden participation in the number of stocks influencing returns. In such a circumstance, diversifying more broadly than just among a basket of technology companies will prove beneficial.

Tariffs

Over the weekend, President Trump announced plans to impose a 25% tariff on imports from Mexico and Canada (although Canadian oil will only have a 10% tariff). In a separate move, an across-the-board tariff of 10% was proposed on goods from China. President Trump has subsequently delayed the implementation of the tariffs on Mexico and Canada to afford more time to negotiate policies with both countries.

The incorporation of these tariffs raises two risks to the broader economy:

1. Higher inflation, given that tariffs will lead to an increase in input costs, which will ultimately be passed on to consumers.
2. A potential drag on economic growth as consumers allocate more to higher prices and consume less.

While the uncertainty around the imposition of tariffs is unsettling, we believe the magnitude of the current tariff actions is digestible. First, it's important to note that roughly 80% of the U.S. economy is services, which aren't impacted by tariffs.[1] When looking at the impact on the cost of imported goods, we've seen estimates for the inflationary impact to be between 0.5% and 1.0% due to the Mexico and Canada tariffs. If we take a broader look and assume tariffs end up being applied more widely at a 25% rate, that would equate to roughly a 3% inflationary impact.

From the standpoint of U.S. economic growth, if these tariffs remain in place for a prolonged period, we surmise that they could have a 1-2% impact on U.S. GDP growth. Given that the U.S. economy is currently projected to grow between 2-3%, that impact would be noticeable. Clearly, tariffs are important considerations, but they would not, in and of themselves, be devastating to the economy. What we worry about more is the business and consumer reaction to the tariffs and whether they pull back on spending out of fear, which could have a more material impact.

While equity and bond prices are adjusting to the tariff news, we aren't overly concerned at this point. The actions are consistent with what President Trump suggested he would do. Given the challenges in deciphering whether the tariff rhetoric was posturing versus actionable policy, markets had not yet incorporated the risks associated with tariffs into stock and bond prices. Recent softness in stock prices has now begun to reflect expectations around tariffs.

Moving Forward

As investors continue to evaluate the intermediate- and long-term ramifications of both AI developments and tariffs, we expect an uptick in volatility in the short term. A lesson to take away from the month of January is that having diversification in your portfolio can help smooth the ride. In fact, there was only one sector within the S&P 500 that had a negative return during January—technology, which had a dominant impact on returns during 2023 and 2024. Those segments of the market that were overlooked over the past two years, such as the healthcare sector and non-U.S. stocks, outpaced the broader S&P 500 in January and proved to be worthwhile allocations in an environment with less clarity.

We will continue to monitor and assess policy coming out of the White House. If we begin to conclude that tariffs will be broader, deeper, and last longer than expected, we will consider making enhancements to portfolios to account for the potential inflationary impact and effect on consumer and business sentiment. At this point, it seems more likely that this weekend's actions were more about posturing to extract some policy gains rather than signaling a new economic stance with long-term economic implications.

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(1) Strategas Research. As of 2/2/25.