IMPACT OF TARIFFS ON SMALL CAPS

KEY POINTS

- Sentiment has reset much lower, increasing the ability of Small Caps to surprise to the upside.
- Tariffs are bad policy, but the fear of the tariffs outweighs the scale of the problem.
- Changes in portfolios reflect a growing preference for value over growth companies with some opportunistic trades positioning for a recovery.

RISKS TO SMALL CAPS

Uncertainty and pessimism around trade policy and tariffs gradually built throughout the first quarter of 2025, sending small caps initially into a correction. However, shortly into the second quarter, small caps fell into a bear market following President Trump's 2 April "Liberation Day" announcements. Fears of an escalating trade war intensified the perceived risk of the US economy tipping into recession. While this weighed on economically sensitive small cap equities broadly, the offensive positioning in FI portfolios hampered relative returns as defensives led.

Small cap companies are generally more sensitive to the economic and credit cycle, relying heavily on the business cycle to support growth and often using debt funding to increase capacity. Tariffs' longer-lasting impact on small caps comes in two forms: the extent to which they cause inflation or an economic recession, neither of which we believe is likely today.

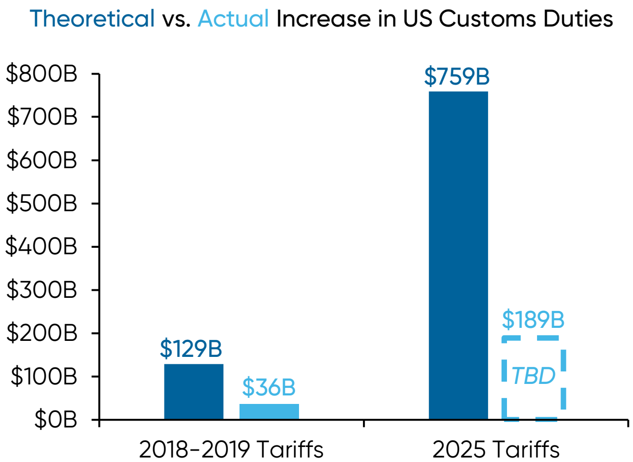
While conventional wisdom says tariffs are inflationary, in the absence of excessive money supply growth, tariffs' impact on costs can be offset through myriad means—including substitution, currency offsets, negotiated trade arrangements, transshipping, and supply chain relocations. Further, US consumers spend more on services than goods, and only a subset of goods are tariffed. By some estimates, roughly 25% of goods and services in the US Consumer Price Index (CPI) are affected by tariffs. [i] With that said, we don't envision a scenario today where tariffs lead to high and rising inflation and don't view this as a long-term headwind.

Economic recessions typically involve some combination of excesses from the prior cycle reaching critical mass and contracting credit supply. Entering 2025 we did not see system-wide excesses that suggested a prolonged period of contraction was needed to clear the bloat. Nor did we see evidence of shrinking credit supply. In fact, we saw quite the opposite. Profitable businesses were increasing CapEx plans, banks were indicating increasing willingness to lend, and central banks around the world were on a largely coordinated easing path. Not much has changed. Banks are still well-capitalised and have incentive to grow credit, and, as trade deals get negotiated, we anticipate corporate confidence will be restored and economic activity should accelerate. Whilst far from perfect, economies broadly speaking are in fine shape, and better than most market participants expect.

TARIFFS: THE SCALE OF THE FEAR OUTWEIGHS THE SCALE OF THE PROBLEM

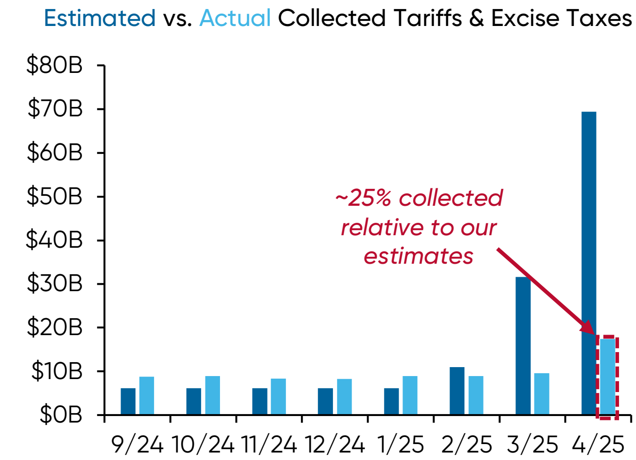
Tariffs, in our view, are always negative economically, and those announced were unprecedented in size and scope and generally, bad policy. Peak fears centred on a retaliatory global trade war, which, if were to occur, would likely be recessionary—yet is unlikely to occur, in our view. The market's steep decline reflected this fear, pricing the 'face-value' of the tariff-able goods without considering the reality of adaptive company behaviours and the scope of workarounds embedded in the global trade system. Actual tariffs collected will likely come in substantially below face value fears, similar to 2018 when the Customs and Border Protection Agency (CBP) only collected around 25% of the theoretical tariff duties (Exhibits 1 & 2). Additionally, we expect growing domestic push back from the courts and congress as well as the majority of countries opting to negotiate rather than retaliate.

Exhibit 1: History Proves Collections Likely Fall Short



Source: Congressional Budget Office, Fisher Investments Research, as of 3/4/2025. Revenues from customs duties, estimated and actual, USD, annual, 2018 – 2019 and 2025.

Exhibit 2: Tariffs Collection In-Line with FI Estimates



Source: CBP, as of 6/5/2025. Monthly Federal deposits from customs & certain excise taxes, through 30/4/25, in USD.

The CBP is ill equipped to enforce and police tariff collection at this scale. Customs entry is based on the honour system, with the importer responsible for inputting all the relevant information from country of origin, value of the good & tariff estimates into the 'ACE' software system. The CBP mostly runs accounting checks on entries, only physically auditing between 3-5% of inbound goods. Prior to tariffs, the CBP was understaffed. We estimate about 2,500 employees across 300 ports of entry are responsible for the physical inspection of goods. This inability to enforce is an incentive for overseas companies to *illegally* skirt tariffs through transshipping and the misclassification of goods. Gaming the system in these ways is not only possible, but likely in the short term, reducing the tariffs collected.

But there are also ample *legal* methods companies can deploy to reduce their tariff value of imported goods. A big one is a method called 'tariff splitting,' where related services costs of the good can be stripped out and contracted separately. Services, unlike goods, are not under tariff, this method strips out SG&A cost to reduce the tariff value of the good. Another method is supply chain rerouting. Companies likely accelerate the trend of diversifying supply chains outside of China. Firms source materials from China then "substantially transform" it into a finished good, avoiding more punishing tariffs. Key benefactors are likely in SE Asia and Mexico, but we do not expect the US to meaningfully benefit from "reshoring." The unit economics simply don't exist.

There is a high likelihood courts will find these tariffs unconstitutional and need congressional legislation—at the very least, it seems likely to be hotly contested and could fall to the Supreme Court quickly. Republican control of Congress is flimsy—only a few defectors, perhaps from battleground states and districts, could sink all this very quickly. Markets likely see relief from any mitigation here, and we are already starting to see these challenges take shape as shown in Exhibit 3.

Exhibit 3: Pushback from Courts & Congress

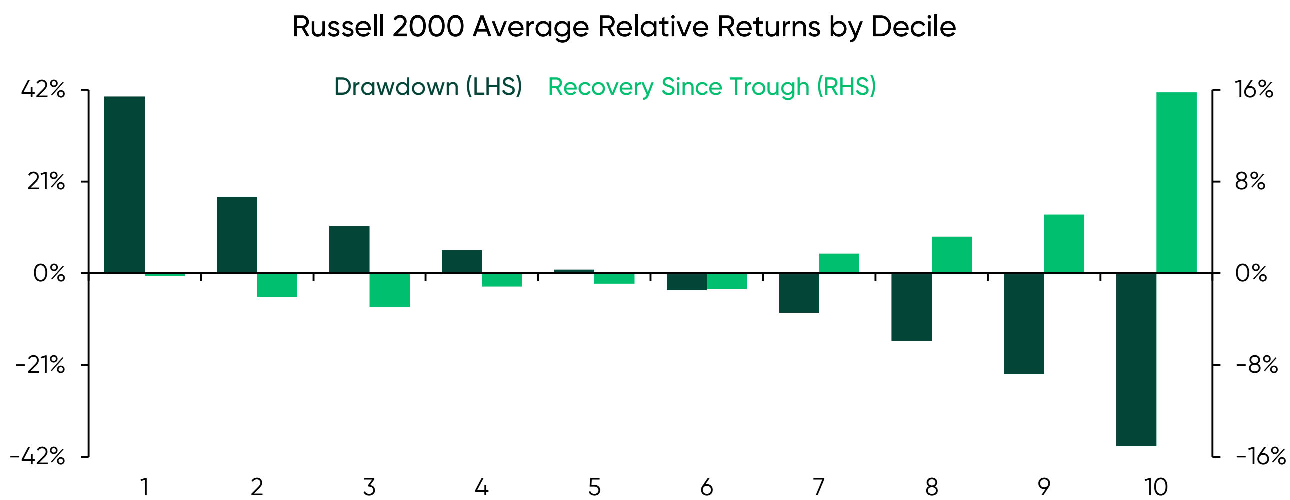
Legal		Congressional	
28 April	MT lawsuit moved to Court of International Trade	30 April	Senate challenge fails 49-49
23 April	12 states files lawsuit challenging IEEPA tariffs	28 April	Trump admin states he will veto congress challenge if passed
22 April	NY-based Court of International Trade upholds IEEPA tariffs	9 April	The House passed a rule to delay any vote challenging the 2 April national emergency
16 April	CA Gov. Newsom files lawsuit arguing IEEPA doesn't allow for tariffs and requires congress	3 April	White House says it would veto Trade Review Act bill
3 April	First court challenge to IEEPA tariffs filed in FL	2 April	Senate passed S.J.Res.37, terminating the 1 Feb. national emergency to impose Canada tariffs

Source: Fisher Investments Research as of 5/5/2025.

POSITIONING AND PORTFOLIO CHANGES

Changes in most small cap portfolios reflect our longer-term shift from growth to value with some opportunistic trades to capture the bounce following recent volatility. Recent purchases have targeted firms impacted the most during the tariff selloff (lowest 8-10 performing deciles) but also positions that we'd expect to outperform during a value-led environment such as in non-residential constructions and Aerospace & Defence (Exhibit 4). Conversely, sells during this period have primarily been from holdings that have held up better than small cap indices as a whole (deciles 1-3): fully selling cash takeover/deal firms, paring idiosyncratic winners to limit concentration risk, and paring holdings in non-defensive categories that held up well. We have also continued reducing our tech weight, by selling commoditised Tech holdings. These trades are consistent with our belief that the tariff impact fears will prove to be overblown as we likely avoid the much-feared recession and that our forecast for a positive year led by value will resume post-volatility.

Exhibit 4: Russell 2000 Average Relative Return by Size Percentile



Source: FactSet , Russell 2000 Index, Russell 2000 Index Constituents Prices. Deciles based on relative performance from 25/11/2024-8/4/2025. Since trough performance from 8/4/2025-2/5/2025.

We continue to employ a quality bias in portfolios. The smallest and junkiest equities may rally strongly from their lows, but historically, such periods are unsustainable and fade quickly. To clarify, recent trading activity reflects the ongoing shift from growth to value which has been our preference for some time. We are also opportunistically adding to categories that align with our long-term view *and* are likely to benefit from a swift equity market recovery. This, in our view, positions us well for the remainder of 2025 in an environment that should favour small caps.

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FIE outsources portfolio management to FI. FI's Investment Policy Committee (IPC) is responsible for all strategic investment decisions. The Joint Investment Oversight Committee (IOC) is responsible for overseeing FI's management of portfolios that have been outsourced to FI.

This document has been approved and is being communicated by Fisher Investments Ireland Limited.

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[i] *Source: Federal Reserve Bank of Atlanta as of 5/5/2025. "Tariffs and Consumer Prices" Published 28/2/2025.*