3-13-25

A 'Liquidationist' Plan for the Economy?

The administration's view that damaging the economy now could help it later comes with little upside for investors

During President Trump's first term, stocks rode high on the belief that he would always pull back on policies that led to a selloff. Now, the administration is making a much tougher pitch: Even if tariffs and budget cuts cause a period of havoc, there are unexpected gains to be made on the other side. The problem is there isn't much evidence to make investors believe that. Indeed, such views edge close to the "liquidationist" approach historically espoused by laissez-faire economists, and most infamously associated with former President Herbert Hoover's Treasury secretary who advised him to let the economy fall.

The S& P 500 lost 7.5% over the past month and the technologyheavy Nasdaq is down a larger 10.2%. Both indexes had particularly steep falls this week, after Trump declined to rule out a recession this year. The S& P 500's consumer-discretionary sector, which includes economically sensitive industries such as automakers, retailers and hotel chains, fell 13.1% in a month.

Meanwhile, European stocks— particularly in Germany—are being buoyed by officials ditching austerity policies and seeking to splurge on infrastructure and military outlays.

Trump and his advisers, conversely, are focused on cutting the federal workforce and slashing spending to narrow the government's budget deficit, which in 2024 amounted to more than 6% of gross domestic product. Treasury Secretary Scott Bessent has spoken about the need for the economy to undergo a "detox period" from fiscal stimulus.

The administration imposed large duties on Canadian, Mexican and Chinese imports, and threatened duties on much more.

The moves mark a clear break with Trump's tariffs eight years ago, which were rolled out slowly and only after aggressive tax cuts that spurred growth. During that period, Trump was seen as eager to strike a deal with China to defuse trade tensions that led to market declines. *

So widespread was the conviction that Trump wanted to shield the market from declines that traders began calling it the "Trump put," named after an options contract that can protect a trader from downside losses.

But in a recent interview with CNBC, Bessent said equity investors must stop thinking about a "Trump put" and embrace a "Trump call" instead. That is, a bet that stocks will see a surge once economic misallocation is purged out of the system.

The theory has some backers on Wall Street: In a research note sent to clients on Monday, economists at Morgan Stanley argued that short-term pain for stock markets could be offset by a longer-term gain by the end of this year and into next year, as the shift from public to private spending stokes a rally that is less reliant on a few technology megacorporations.

It is true that U.S. profit margins recently rising to near-historic highs has a lot to do with the government. An analysis of official figures suggests almost 60% of the corporate earnings generated between 2022 and the third quarter of 2024 can be attributed to public- sector spending and investment.

This is because, for the corporate sector on aggregate to earn profits, someone in the economy must be spending more than they earn. This can come from individuals running down their savings, but it rarely happens: Households usually don't spend all of their income and thus are a drain on profit. The net spending can also come from corporate investment, which has been structurally weaker since the turn of the century, and net exports—though the U.S. has a large trade deficit. Recently, then, the major source of this extra demand in the U.S. has been government deficits.

In fact, this recent dependence on government is less than the average level in the post-World War II era. Take the 1980s, when Ronald Reagan implemented his program of tax cuts, deregulation and building up defense: Substantially all of the profits earned by firms back then were explained by a wider budget deficit, national-income data implies.

To be sure, economies can have other drivers. In the 1990s, corporations caused a profit bonanza through their urge to invest in computer equipment. In the 2000s, households did actually spend more than they earned thanks to easy mortgages and consumer credit. But these economies weren't "balanced"—they led to the dot-com bubble and a global financial crisis.

Of course, the tough medicine of cutting government outlays won't in itself spark spending elsewhere, let alone in sectors that don't have the protection of big tech companies' cash buffers.

Could the Trump administration feasibly engineer a more sustained domestic-investment boom through its efforts to reshore production, particularly if the U.S.'s wide trade deficit narrows? Possibly, but its erratic tariff policies so far are a poor instrument for doing so, only blunting incentives for investment by raising uncertainty.

It isn't just the full-on liquidationist policies attempted after the Great Depression that have a poor record. Austerity drives failed in Greece and most European countries following the euro crisis.

At most, bringing a hot economy to a screeching halt can serve to break countries out of inflationary spirals, as Javier Milei has recently tested in Argentina. Currently, however, it is Trump's tariffs that risk stoking inflation, making it harder for the Federal Reserve to cushion any blows by lowering interest rates.

Investors are clearly unimpressed with the liquidationist turn in policy. They can be forgiven for thinking that the Trump administration's call option will expire worthless.

—Jon Sindreu
