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There's a New Tariff in Town (First of Two Parts)

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This week we look at questions from clients and friends surrounding the issue of tariffs. Not surprisingly, as we've discovered in our recent travels, interest in the topic has accelerated (see our *Chart of the Week*).

The origin of the word is obscure. By one account, it derives from the Arabic *"ta'rif,"* meaning "notification" or "inventory." Another reference identifies the port of Tarifa where ships in 10th century Moorish Spain were inspected and taxed as they passed the Strait of Gibraltar.

Whatever the derivation, the term, ironically, was an import to English usage, probably from the Italian (*"tariffa")*. In the early days of the United States, tariffs represented most of the government's revenues. That changed after the federal income tax was instituted in 1913, and then again after the Great Depression. Today it's a small fraction of prior levels.

Part of the confusion around tariffs involves who actually pays for them. Theoretically, American importers pay them to US Customs agents at one of 328 points of entry into the country. Proceeds then go to the Treasury. Companies try to recoup their money by passing costs on as higher prices to the consumer.

While the goal of this tariff policy is unclear, the effect on market confidence is inarguable. The year began with solid tailwinds in US economic growth, muted inflation, and capital markets wide open. That all changed with Liberation Day. To many it felt like rushing a perfectly healthy patient to the hospital for open-heart surgery.

While the 90-day pause restored some order to markets, "uncertainty" has become the operative term. Portfolio managers are carefully combing through their investments and positions, looking for sectors or businesses vulnerable to trade pressures. One rating agency analyst spoke to the challenge. "Overnight we went from a scenario of tariff impacts for Canada and Mexico, to one hitting every country except Canada and Mexico."

This dynamic also left public credit markets in disarray. Asset prices there are based on the velocity and direction of capital flows and rate expectations, particularly for CLOs and retail loan funds. Outflows shut down primary issuance for weeks, with signs of life only in the last few days.

Meanwhile private markets, the certain engine for global growth in markets and the economy, roll on. Because private credit often serves as a countercyclical asset class, economic headwinds can act as tailwinds for private markets activity. It's too early to tell, but if our current pipeline is any indication, second quarter deal volume for middle market PE sponsored financings is picking up. YTD activity across the platform is 25% ahead of last year's pace.

With 1Q GDP having slipped into negative growth, could we be headed for a recession? If so, the best path for private equity buyout financings remains direct lending. That's also good news for investors. Next week we'll explore why.