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Rapid Response

The US Announces Reciprocal Tariffs

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On 2 April, the Trump administration announced a very broad set of reciprocal tariffs to become effective over the next week.

The announcement appears to be near the upper range — *i.e.*, the worst-case scenario — of market expectations in terms of the set level of tariffs imposed on trading partners. In particular, a number of countries, especially in Asia, will now be subject to elevated custom duties, such as China (54%), Vietnam (46%), Taiwan (32%), India (26%), South Korea (25%) and Japan (24%). European countries are also severely impacted, with tariff rates set at 20% for Germany, France and Italy, among others. On a relative basis, Mexico and Canada received better treatment and were exempted from the latest wave of tariffs. In the aftermath of the US announcement, a number of countries have signaled that they will retaliate, thereby raising the risk of trade war escalation. At the same time, it is also likely that negotiations will begin, especially with those countries that may have some room to negotiate, with the goal of lowering the final tariff burden.

In terms of products, the reciprocal tariffs do not cover the goods that have already been subjected to sectoral tariffs, such as autos, steel and aluminum. It is also worth noting that the administration has signaled that sectoral tariffs may be announced, including on minerals, semi-conductors and pharmaceuticals. Overall, latest estimates point to the effective tariff rate on US imports rising to about 23%, the highest level in well over a century.

What are President Trump's goals?

In the runup to the tariff announcement, the Trump administration laid out several goals for the US policy shift on trade. Chief among these is the reindustrialization of the US economy, which President Trump believes has a national security dimension. Such action, he believes, will boost investment and employment in the US over time and make the US less vulnerable to global supply chain disruptions. In addition, President Trump aims to counter what he sees as unfair trade practices by countries that impose higher tariffs on US goods than the US imposes on imports from those countries. The administration also targeted non-tariff barriers and value-added taxes, which it feels disadvantage US exporters. Countries with unusually favorable corporate tax structures, such as Ireland, will likely face additional scrutiny if the White House adds sectoral tariffs on items such as pharmaceuticals down the road. Finally, the administration envisions tariff receipts as a significant source of additional government revenue.

The macro impact of tariffs can be severe.

If implemented for long enough, tariffs are likely to act as a stagflationary shock to the US economy, negatively impacting growth and having an adverse impact on inflation. Current estimates point to a drag of about 1% to economic growth, together with an inflation boost of about 0.5%. Because tariffs are a tax on consumers, domestic demand is expected to be directly impacted. Beyond the US, the growth impact is anticipated to be a lot more severe on both Canada and Mexico as a substantial portion of Canadian and Mexican total exports are to the US, at 77% and 83%, respectively. Ultimately, we believe that there are substantial risks to the global growth outlook if the tariff developments escalate into a full-fledged trade war.

The impact of the tariffs could potentially be damaging to the US economy.

Given that higher tariffs act as a tax on consumption, the US consumer will likely suffer the brunt of the macro shock, with major repercussions for the growth outlook. The US economy is already slowing moderately, but the additional shock substantially raises the probability of a recession over the next year. A major deterioration in survey and confidence data has already been observed over the past few weeks. We anticipate that the effect will only start being felt in the hard macro data in a couple of months, mainly impacting growth in the second quarter and beyond. In addition to the consumer, it will be important to watch corporate profitability. Beyond the US, global growth expectations will also have to be revised substantially lower. It is likely that the targeted countries will look into implementing countervailing measures. For instance, the Chinese government already had measures in place to support the local economy. The latest developments raise the probability of further policy easing through both monetary and fiscal action. Where there is policy room, global central banks will likely err on the dovish side in order to alleviate the growth shock. Overall, it is worth noting that macro volatility and policy uncertainty are set to remain highly elevated in the period ahead.

In the near term, the market reaction is likely to trigger further risk aversion.

On the fixed income side, we expect a traditional risk-off response that combines lower rates and wider spreads, though it is worth noting that ahead of the tariff announcements investment grade spreads had displayed relatively strong resilience, so it will be interesting to watch whether the spread widening accelerates there. The market reaction has recently been more pronounced for high yield spreads, but some additional widening appears likely to us. Regarding duration, it is perhaps too early to raise the conviction level on being long duration in the US, given that US Treasury yields have already moved down aggressively to about 4%. The case for being long duration appears to be stronger in non-US markets, including Europe. On the equity side, the latest tariff announcement may hurt the appetite for the US equity market disproportionately relative to the rest of the world. This may therefore reinforce the case for a continued global rotation. In terms of sector allocations, we believe the cyclicals and high-beta sectors are likely to be most impacted, given the pricing of higher recession risks. Finally on the currency front, we no longer believe that the US dollar will benefit from the higher tariffs because of the potential severity of the macro shock to the US economy. With that in mind, our investment team continues to be constructive on the euro.

Is there an exit ramp in the future?

It is possible that President Trump may backpedal on tariffs if the shock to US growth turns out to be too costly, especially for the consumer. As part of the so-called "Trump put," the administration may try to accelerate the implementation of more growth-friendly policies such as tax cuts and deregulation. The US Federal Reserve may also respond with further rate cuts, but only once there is tangible evidence of sufficient macro damage. In other words, we view the "Trump put" as more likely to be exercised first rather than the Fed put. Any signs of sweetening policy action, especially if the support package is sufficiently large, may ultimately have the potential to rekindle investor sentiment.

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