Q&A: US TARIFF RISKS

Assessing potential implications from US trade policy measures

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Rhetoric meets reality

Tariff headlines are escalating by the day, unnerving markets with worries that trade tensions could have a greater impact than the damage seen in 2018-2019, when, by some estimates, US gross domestic product (GDP) grew by a full percentage point (pp) less than it otherwise would have.

As the fog of trade uncertainty is rising, investors seek guidance. How might policies that have been announced so far impact GDP and inflation? What are alternative scenarios and their impact on GDP and inflation? What are the risks? How might the Fed react? What is the underlying motive for tariffs?

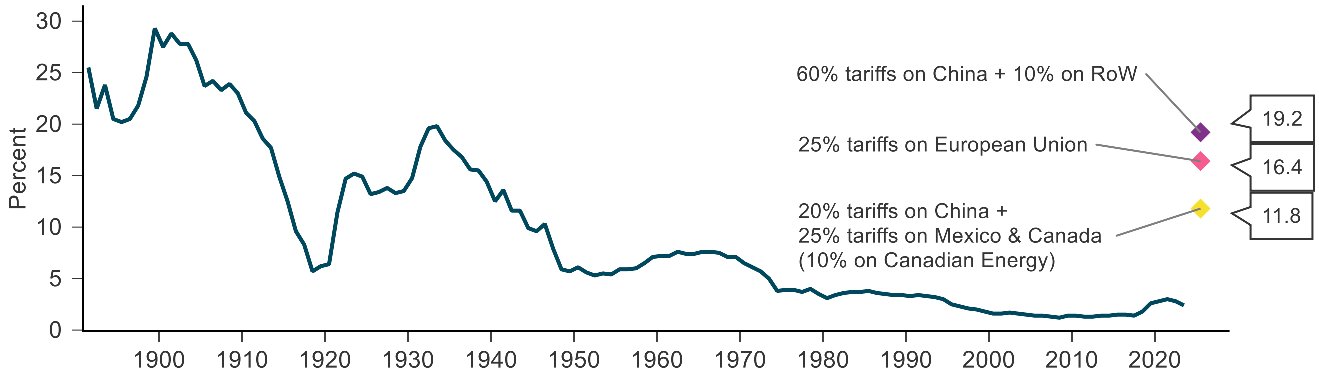
How do current tariffs compare to those seen in 2018?

The new tariffs implemented so far – a 20pp rise in tariffs on imports from China, a 25% tariffs on Mexico and Canada (with a 10% on Canadian energy imports) – are already significantly greater than the total tariff increases seen during the current administrations first term. At the time, the effective tariff rate on US imports rose by 1.5pp. Since early February, that rate increased by ~9pp to ~12%.

Several other measures have been discussed but not yet implemented. These include 25% tariffs on the European Union, 25% tariffs on steel and aluminum, reciprocal tariffs, and 60% tariffs on China plus 10% tariffs on the rest of the world (RoW). Most of these measures would raise the effective tariff rate even more (exhibit 1).

Exhibit 1: The new tariffs implemented so far are already significantly greater than the total tariff increases seen during the current administrations first term

Effective tariff rate; US trade policy implications; mutually exclusive scenarios



Data as of March 4, 2025.
Source: Investment Institute, Macrobond.

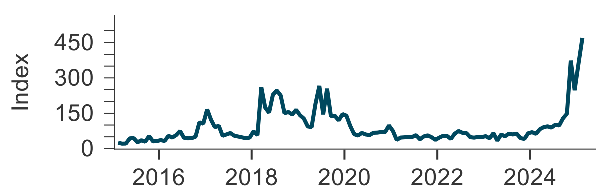
How could tariffs impact growth and inflation?

Estimates are uncertain, but the effects could be large. Based on the 2018-19 experience, a 1pp increase in the effective tariff rate might increase core inflation by as much as 0.1% and decrease US GDP growth by as much as 0.2-0.3% for some time.

Importantly, tariffs' impact on GDP occurs to a significant extent due to the uncertainty created for businesses and households, which dampens business investment and consumption growth. This means that trade policy uncertainty - already much higher than it was in 2018-19 - can have a negative impact on GDP growth even if tariffs implementation is suspended or rolled back, once announced.

The direct impact on GDP – e.g., via higher prices of imports squeezing consumer spending – is also critical.

Exhibit 2: Trade policy uncertainty is already much higher than it was in 2018-19
Trade Policy Uncertainty Index



Data as of March 4, 2025
Source: Investment Institute, Macrobond.

There are caveats. If tariffs are paired with fiscal stimulus, inflation would rise more significantly, while the negative impact on GDP would be less severe. If countries retaliate, the inflationary effect would be less noticeable, but the negative impact on GDP would be more pronounced.

How will tariffs impact the labor market?

Without offsetting stimulus, tariffs might increase the unemployment rate, depending on their extent and the uncertainty they create. A common rule-of-thumb is that the unemployment rate rises by half the impact on GDP growth. E.g., the rise in the effective tariff rate due to new tariffs on China, Mexico, and Canada might result in a 1pp rise in the unemployment rate, without offsetting stimulus.

That said, risks might be greater as labor market changes tend to be non-linear. For instance, a 0.5pp increase in the unemployment rate from its recent lows typically precedes a larger rise in unemployment (and a recession) in the US.

Is the US at risk of recession?

Before tariff announcements, we estimated US recession risks to be relatively low at 20%. Whether the US is now at greater risk of recession, depends on future growth-friendly policies to be introduced.

Without fiscal support in addition to the extension of the 2017 tax cuts, the large rise in the effective tariff rate seen so far, met with retaliation from trade partners, would increase the probability of a small US GDP contraction within 12-months closer to 40-50%.

How do tariffs impact the Fed?

We think a wait-and-see mode from the Fed is most likely for two reasons: one, today's world of above target and sticky inflation; and two, deep uncertainty around how inflation expectations and firms' price-setting behavior might react to a temporarily large increase in inflation.

Exhibit 3: The macro impact of tariffs could be large
Increase in effective tariff rate

	+2pp	+5pp	+10pp	+15pp
Inflation	+0.2pp	+0.5pp	+1.0pp	+1.5pp
GDP	-0.4pp	-1.0pp	-2.0pp	-3.0pp
Unemployment	+0.2pp	+0.5pp	+1pp	+1.5pp
Monetary policy	1 cut	2-3 cuts	3-4 cuts	5-7 cuts, or more

Source: Investment Institute as of March 4, 2025.

Could the Fed lower rates in response to tariffs?

Yes, if the Fed believed that inflation expectations were fully anchored, and had absolute confidence in this, they would lower interest rates to cushion the impact of tariffs on growth and unemployment, accepting a temporary period of higher inflation. Indeed, this is what happened in 2019 as the US economy was slowing on the back of tariffs. This scenario is unlikely to play out *immediately* in the current high inflation environment.

Hypothetically, assuming no fiscal support, a 10pp rise in the effective tariff rate could *eventually* lead to at least three additional rate cuts from the Fed. Admittedly, core personal consumption expenditure (PCE) inflation could rise by 1%, but GDP growth would likely slow down sharply, and the unemployment rate could rise by 1pp or more. If countries retaliate, the Fed might lower rates even further.

Could the Fed increase rates?

A strong rise in inflation expectations, and evidence of wages reacting to temporarily higher inflation could see the Fed deliver rate hikes. We see this scenario as unlikely, but not impossible, particularly if tariffs are accompanied by fiscal stimulus. A more likely scenario is that the market prices in some rate hikes that are not delivered, as policy stays on hold.

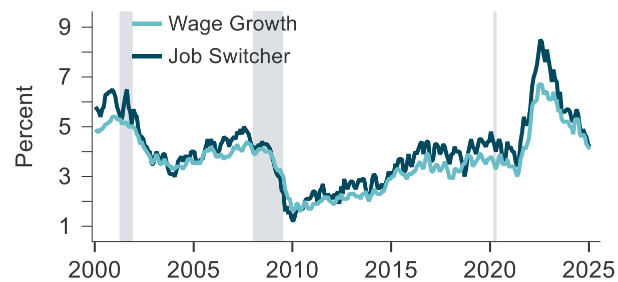
Somewhat worryingly, inflation expectations have risen sharply in the US in recent months. Since inflation expectations are sensitive to realized inflation, they might increase further as headline inflation rises when tariffs take effect. This is a key risk that we expect the Fed to be watching closely.

Exhibit 4: Inflation expectations have risen sharply in recent months
Inflation expectations; 3-month moving average

Data as of March 4, 2025
Source: Investment Institute, Macrobond.

More positively, we don't believe the labor market is tight enough for a wage-price spiral to occur. E.g., the job switching rate (exhibit 5) has been falling significantly over the past year, hampering one of the key ways that employees can secure higher wages in the US.

Exhibit 5: Job switching rate has fallen in recent months
3-month moving average

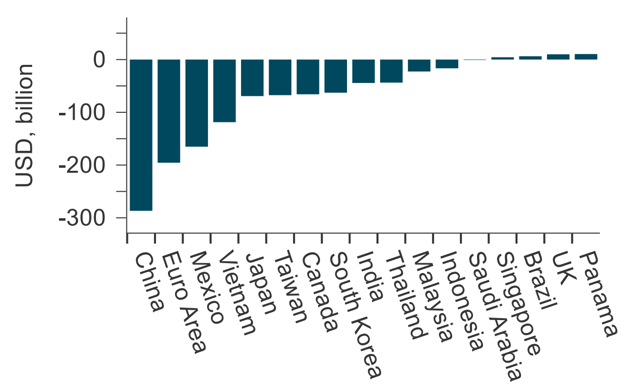


Data as of March 4, 2025
Source: Investment Institute, Macrobond.

What countries are more at risk from tariffs?

Vulnerable economies are those with large trade surpluses versus the US (exhibit 6). Amongst these, the most at risk are countries with competing interests with the US, like China and its close economic allies. Next in line are countries seen as benefiting from US security guarantees without contributing enough (e.g. Germany, Italy, Taiwan), and countries seen as acting in a way that is not consistent with crucial US interests (Panama, Mexico, Canada).

Exhibit 6: Vulnerable economies are those with large trade surpluses versus the US
US bilateral trade balance



Data as of March 4, 2025
Source: Investment Institute, Macrobond

What is the tariff end game?

Understanding the strategic motives behind US trade policy is challenging but important. We believe three main hypotheses capture the current administrations' motives. First, tariffs are viewed as a significant source of tax revenue paid by third countries, which will fund tax cuts for US citizens. Second, tariffs are viewed as a negotiation tool to extract concessions from other countries (such as greater investment in border security, increased consumption of US exports, and additional defense spending from NATO partners). Third, a combination of the first two hypotheses, where the aim is to raise more tax revenue while also seeking negotiated concessions.

We view the third hypotheses as the most likely and consistent with the evidence seen so far. Additional tariffs on China, a country seen as an adversary by the US, have been implemented without demands provided. In contrast, tariffs have been used to extract concessions from other countries, such as from Panama or Colombia. The fact that tariffs on Mexico and Canada, two allies of the US, were implemented despite the diplomatic efforts to suspend them and the threat of reciprocal tariffs makes us worried, as it signals a broadening in the trade conflict.

An upper bound estimate for the tariff 'end game' could be provided by assuming that tariffs will increase by the amount required to cover additional fiscal stimulus by the US administration.

We estimate additional fiscal stimulus to be around $430bn/year (vs. what is in the law today). This could be covered by an increase in the effective tariff rate of at least 13pp (under the strong assumption that trade flows would not fall). Aggressive reciprocal tariffs, or a 60% tariffs on China and 10% on the RoW, would raise the effective tariff rate by 16-17pp. Since February, the effective tariff rate rose by ~9pp.

A more benign assumption is that the US intends to use tariffs only to finance the ~$115bn/year of new stimulus excluding the renewal of the Tax Cuts and Jobs Act (TJCA). In this case, the effective tariff rate would need to increase by at least 3.5pp, implying a significant roll back of the measures introduced so far.

What are the implications for markets?

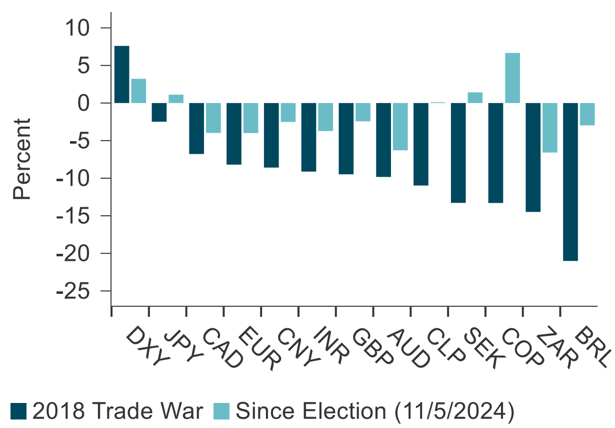
To some extent, the market had already priced a moderate increase in tariffs, but not more severe scenarios.

Given the risk of a more disruptive trade policy, we see tariffs as continuing to benefit the US dollar against the currencies of the countries most at risk (exhibit 7). Gold and international bonds (if hedged for the FX risk of US dollar strength) are also expected to benefit. Gold is likely to gain from greater macro uncertainty, while international bonds may benefit from a negative hit to growth outside the US.

Equities are likely to remain volatile, but their overall direction will also depend on any growth-supporting policies that have yet to be announced by the US and others, as well as longer-term drivers such as Artificial Intelligence. Equity indices of countries most at risk from tariffs are most likely to underperform US equities over the next 12 months.

Exhibit 7: We see tariffs as continuing to benefit the US dollar against the currencies of the countries most at risk

FX performance versus USD



Data as of March 4, 2025
Source: Investment Institute, Macrobond. 2018 trade war date range: 1/22/2018 - 12/1/2018.

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