TARIFF TEMPESTS

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INVESTMENT VIEWS
FROM OUR PARTNERS
AT WALTER SCOTT

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KEY TAKEAWAYS

1 Tariff uncertainty is creating significant challenges for companies, which may lead to further volatility in share prices and earnings.

2 A reset of global trade comes at a cost as investors question the practicality and expense of replanting supply chains in the U.S.

3 The current turmoil is providing opportunities for active, bottom-up investors with a long-term focus to identify resilient and leading businesses that can adapt and thrive in challenging times.

While investors have been celebrating the current reciprocal tariff reprieve, equity markets could still be prone to a degree of volatility. Tariff uncertainty continues to confound all those trying to get to a definitive handle on its consequences. Equity markets have been on a wild ride as they digest the rapidly evolving events. The situation remains fluid, but it is clear that the imposition of tariffs, and the on-off approach to their deployment, are depriving businesses and investors of much sought-after commodities — policy stability and certainty.

The initial Liberation Day announcement of draconian U.S. reciprocal tariffs has given way to a relatively more tempered approach, most notably with China. The more flexible U.S. stance is arguably indicative of their use of tariffs as a bargaining tool to bring trading partners and frenemies alike to the negotiating table. Even with the temporary pause and rollback, U.S. import tariffs are still meaningfully higher than those of Trump's first term and the Biden era. There are hopes that through bargaining, the threat of reciprocal tariffs can be defused.

Tariffs "R" Us

The spate of tariffs from the Trump administration is stress-testing deep strands of interconnection in global trade that are difficult and costly to unravel. The world has broadly functioned on the principles of Ricardian comparative advantage, the idea of countries trading what they're relatively best at producing. Proponents of globalization point to its benefits in terms of promoting cost efficiency, lowering prices for consumers, fostering competition, and elevating the economies of developing nations.

But it has led to unfairness, according to successive U.S. governments, with President Trump now seeking to rejig a system that has defined global trade since the 1980s. For the U.S., tariffs are seen as a stimulant to foster a resurgence in domestic manufacturing, protect security interests, address trade deficits, and as a means of filling fiscal holes (theoretically), which would allow proposed cuts in taxes.

However, a reset in terms of trade, especially with China, comes at a cost. Investors are questioning the practicality and expense of replanting supply chains in the U.S. and are fearful of the impact of tariffs on inflation and on price and demand elasticity. It is the consumer and importer that typically pays tariffs, not the exporter.

Not FDIC-Insured. Not Bank-Guaranteed. May Lose Value.

Divorcing China is difficult

Ever since the first Trump administration, China has been in America's sights as a trading "frenemy" and perceived security threat. Tariffs on China may be temporarily reduced, but uncertainty and trade tensions remain. The imposition of the current levels of U.S. tariffs continues to pressure supply chains from China. Although now postponed, hefty reciprocal tariffs on Southeast Asia also undermine efforts by Chinese (and U.S.) companies that have invested in the region as a manufacturing platform. The U.S. has also not been alone in targeting China. Although now negotiating minimum pricing, the European Union (EU) sought to bolster its ailing car industry by imposing extra tariffs of up to 35% on Chinese car makers late last year. This is a testament to our view that in many spheres, China is moving up the value-added ladder.

Aside from the direct impact of tariffs on China, there are second-derivative effects on the Chinese economy in terms of the impact on global economic growth and trade. Mitigating these hits to the Chinese economy to some degree are the ongoing fiscal and monetary stimuli and continued support for the property market by the Chinese government. China enjoys a massive trade surplus with the U.S., but Beijing has long seen the writing on the wall. The Global South[1] now accounts for a higher proportion of Chinese exports than G7[2] countries. However, tariffs represent a challenge to the developed and developing world alike so this diversification is unlikely to insulate China from a downturn in global growth.

Euro-tilt?

Concerns over the U.S. have partly been evident in the outperformance of some international markets since the start of the year. Europe, in particular, initially caught the attention of investors, helped by improving economic news. With the European Central Bank in loosening mode, signs of "bottoming out" in parts of the region, and with defense spending on an upward trajectory, the economic prognosis for Europe seemed to be mildly improving. The current abandonment of Germany's notorious Schuldenbremse, or fiscal debt brake, now permits higher government spending, and has boosted investor sentiment. However, with the uncertainty from the tariffs and global volatility, the near-term prospects for the European economy have become unpredictable.

One silver lining is that the spectra of tariffs should give current efforts to foster EU deregulation extra urgency and importance. The EU wants to reduce the regulatory burden on businesses by 25%, and 35% for small-and-medium-sized companies by, for instance, simplifying sustainability reporting rules. Any step to facilitate enterprise and growth is welcome.

Slow change in Japan

Japan's U.S. reciprocal tariff reprieve comes at a time when the country is trying to "normalize" its economy and monetary policy. Central bank governor Kazuo Ueda remains of the view that the economy should continue to be weaned off monetary support as it moves to a non-deflationary environment. The trouble is that Japan's elevated inflation remains of the cost-push variety. While wages are rising, inflation is dampening real wage growth which is inhibiting sustained consumer spending growth.

However, the gradual tide of reform in Japan continues to manifest itself in the form of shareholder activism. Last year, Japan was the second-most active market for activist investing globally, according to Bloomberg.

For us, the bullish case for Japan or Europe has never been based on hopes of broad economic recovery. Rather, we see them as the domain of many leading companies in fields, such as factory automation, specialized areas of technology, luxury and healthcare, that can compete and thrive globally, despite the travails of their home economies.

Volatility = opportunity for the long-term investor

In this volatile environment, Walter Scott's research team is continuing to evaluate the potential impact of tariffs on each and every portfolio company. We are speaking with management teams and investment theses are being put through the mill of rigorous analysis and debate. It is important to not lose sight of the long term in such an environment. A major, lasting reset in global trade has potentially profound consequences. Yet, in such periods of flux, opportunities arise for the bottom-up stock picker with a long-term investment horizon. In the last five years alone, companies have had to navigate the challenges of the Covid-19 pandemic, rising Sino-Western trade tensions and the war in Ukraine. Few businesses are immune from economic upheaval, but turbulent times separate the fundamentally robust from the weak, with leading businesses often strengthening their positions in times of disruption.

We remain optimistic over the long term. This confidence stems not only from the rigor of our investment approach, where every company undergoes a detailed qualitative and quantitative financial analysis, but also from our belief that many of the world's best companies are continuing to take advantage of trends that will outlast the current turmoil. The combination of market leadership, high profit margins, relative pricing power, a strong balance sheet with robust cash flows and the ability to adapt and innovate are always key attributes in terms of what we look for in a company. We believe that these qualities come to the fore in challenging times.

About Walter Scott

Walter Scott is the global equities–focused investment firm within BNY Investments.

[1] The Global South is a term that broadly comprises countries in the regions of Africa, Latin America and the Caribbean, Asia (without Israel, Japan, and South Korea), and Oceania (without Australia and New Zealand), according to the United Nations Conference on Trade and Development (UNCTAD).

[2] The Group of Seven (G7) is an intergovernmental political and economic forum consisting of Canada, France, Germany, Italy, Japan, the United Kingdom, and the United States.

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