Historic Tariff Conflict Ignites Economic and Market Disruption

Quick take:

- The Trump administration was widely expected to pursue protectionist policies, ending decades marked by expanding free trade. The breadth and magnitude of the tariffs announced by the new administration has been much more aggressive than anticipated.

- U.S. equity markets have weakened over the past several weeks. Interest rates have been volatile while spreads on riskier credit-sensitive bonds have increased, reflecting renewed fears of an economic slowdown or even recession.

- Economic uncertainty and the impact of tariffs on corporate profit margins will likely slow economic growth and upend global trading patterns.

- Fundamental investment concepts such as diversification, rebalancing across portfolio components, and tax loss harvesting to reduce the tax drag on taxable assets remain the best ways to benefit from market volatility.

- The Trump administration was widely expected to pursue protectionist policies, ending decades marked by expanding free trade. Many observers believed the tariff threat was a negotiating tactic and that implementation would only target specific countries.
- The breadth and magnitude of the tariffs announced by the new administration has been much more aggressive than anticipated, culminating in a broad baseline 10% tariff on imports to the U.S. that was enacted this week. Some countries are facing even higher levies.
- The average tariff for goods imported into the U.S., once expected to increase to the 10% range, is now projected to rise to 20%-25%, a level of protectionism not seen since before the Great Depression.
- Canada and Mexico were the first countries slapped with a 25% tariff tied to drug and immigration negotiations but were spared from the new tariffs. Previously a 25% tariff on autos was enacted in addition to other trade measures.
- China was the hardest hit country. Total tariffs on some Chinese goods are as high as 65%, including the new tariffs and those that were already in place. Other Asian countries that are major trading partners with China will likely be negatively impacted.

Impact on the capital markets

- U.S. equity markets, particularly large cap tech companies, have weakened over the past several weeks, while international equities have outperformed. Interest rates have been volatile while spreads on riskier credit-sensitive bonds have increased, reflecting renewed fears of an economic slowdown or even recession. The valuation gap between large cap tech companies and the broader equity markets has narrowed.

- Capital flows have been shifting out of U.S. investments putting downward pressure on the U.S. dollar. The U.S. dollar which had been expected to strengthen in response to new tariffs, instead declined significantly versus the currencies of the major U.S. trading partners, and investors shifted to safe haven currencies such as the yen and Swiss franc.
- Institutional investors and traders had been pulling back on risk and deleveraging portfolios in anticipation of market volatility triggered by Trump administration policies. This may have muted market turbulence.
- Investments with high relative valuations, excessive leverage and exposure to cyclical sectors have been particularly challenged, while defensive investments have outperformed.

What may happen going forward?

- The average tariff for U.S. trading partners will increase and remain elevated versus history. Some of the tariff impact will be passed through to consumers and businesses, thwarting Fed efforts to bring inflation in line with its 2% target.
- Economic uncertainty and the impact of tariffs on corporate profit margins will likely slow economic growth and upend global trading patterns.
- Investors will be closely watching the response from U.S. trading partners and negotiations with the Trump administration. The government policy response to slowing growth and inflation trends which would be upended by the new tariffs will impact capital markets and relative asset valuations. Market volatility in the equity, credit and currency markets will likely remain elevated.
- The Federal Reserve may stay on the sidelines for a while, monitoring the impact of tariffs and expected fiscal and tax policy changes being pushed through by the Trump administration.
- While there may be additional tariffs and changes to trade policy going forward, the likelihood is that the worst is behind us. Once the dust has settled, the average tariff on U.S. imports is likely to be higher than in recent years but below the 20%-25% level as countries negotiate with the U.S. and there is potentially political pushback. Over time, countries, companies and the capital markets will adapt to the new reality.

Which indicators and trends will we be watching?

- Capital markets have remained liquid with orderly trading. Additional political and policy shocks could trigger a more severe sell-off and instigate liquidity issues.
- Consumer and business confidence have been trending downward. These measures are key indicators for consumer and capital spending, major components of economic growth.
- Labor market strength has buoyed the U.S. economy for years. The recent modest uptick in unemployment is not a cause for concern, but a larger move would increase recession risk at a time when the Federal Reserve may be faced with a tariff-driven inflation shock.
- The response from U.S. trading partners and their ability to successfully negotiate better terms will unfold over the coming weeks. Several countries have threatened retaliation and some regions including Europe are concerned about product dumping as exporters shift away from the U.S. and may enact further trade barriers to protect their own markets.
- The Trump administration has been working on spending, tax and regulatory policies that are expected to be favorably received by investors. While these policy changes will take a while to impact economic growth, they may improve business and consumer sentiment and counteract the drag from trade policy changes.

Potential impact on investment portfolios

- Fundamental investment concepts such as diversification, rebalancing across portfolio components and tax loss harvesting to reduce the tax drag on taxable assets remain the best ways to benefit from market volatility.
- It’s nearly impossible to predict how recent events will unfold. What’s perhaps more likely is that volatility will remain elevated in the coming months.
- Individual investors today have a wide range of tools and strategies to protect portfolios from market volatility and inflation.
- Recent price declines allow investors to opportunistically add into weakness with cash waiting on the sidelines or from portfolio repositioning at more appealing valuations.
- Diversified portfolios should have a material allocation to assets that do well in a slow growth, higher interest rate environment or that have returns tied to inflation. Higher interest rates and credit spreads bode well for future fixed income returns for both public and private credit.