The Toll of Tariffs

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The last thirty years of global trade has resembled a runaway train, roaring across borders at breakneck speed, picking up almost all passengers along the way. They have in turn shared in the spoils globalisation can offer. However, we forget this is a fairly recent phenomenon with many of America's historical policies actually favouring protectionism. Donald Trump claims that it was in fact tariffs that 'made America rich' and campaigned as a harbinger for their return. That return is now here. On Saturday, President Trump slapped tariffs on Canada (25% on all exports except 10% on oil), Mexico (25%) and China (10% on top of existing) – their three largest trading partners. As the world order reshuffles and financial markets reevaluate, what is likely to play out from here?

Reprieve: Trump may well be using tariffs as a negotiation tactic, adding immediacy to international discussions. Mexico has already been granted 30-day delays for the proposed tariffs after a conversation between Mexico's President Claudia Sheinbaum and Donald Trump. Sheinbaum stationed 10,000 members of the national guard at the border, temporarily appeasing Trump. A very similar agreement was formed at the eleventh hour with Canada who too promised to implement their $1.3bn border plan.

Retaliation: Despite the President's insertion of a 'retaliation clause', a quid pro quo back and forth is likely and it isn't good for anyone. Within minutes of the initial announcement, China imposed additional levies on US produced goods, renewing a trade war between the two countries and effectively reducing export income for both sides. With the EU next up on Trump's list of tariffs, the European Commission is already threatening to 'hit' Big Tech in response. Resultingly, Trump may actually be forcing China and European markets closer together by closing off the US market, in direct contradiction to previous policies from Washington.

Rates: Tariffs are innately inflationary in the short term as the levies get passed on to the US consumer in higher prices on foreign goods. Domestic manufacturers have less competition and can take advantage with higher prices. Trump may be taking solace from the lack of inflationary pressure from his previous trade war with China, however we are starting at a higher base just as central banks were bringing inflation back to target. Therefore, it would likely bring increased US inflation volatility with the Federal Reserve likely holding off on further cuts to see how things play out. On the contrary, exporting countries may have to do the opposite. We saw markets begin to price in rate cuts in Canada and pre-emptively in the UK as the market believes a boost would be needed to make up for the reduced revenue from their exports to the US.

Rising Dollar: Despite Trump lamenting the dollar's strength in the run up to taking office, these policies are poised to strengthen the greenback further. If interest rates stay high in the US relative to trading partners, we will see greater international demand for this higher relative return, and with it demand for dollars. As demand for non-US currencies fall with US consumers shying away from exports, the dollar is also likely to benefit on a relative basis.

Recession? The reduced growth expectations in exporting countries are clear cut. Mexico and Canada are heavily reliant on export revenues, the majority of which from the US. In the US, growth depends on the ability to onshore industry and take market share if consumers shun more expensive foreign produce. Trump will hope this will ignite an American industrial renaissance, but it is unlikely to be so straight forward.

Readjusted returns: When assessing what all this means for markets, we will be keeping a keen eye on the level and duration of tariffs. This will serve as a guide to our inflation and rate expectations alongside changes to central banks' forward guidance on interest rates. Retaliatory policies will damage the outlook for globally focused, US listed companies and with the S&P 500 trading near all-time highs, pressure on the index may begin to mount. Lastly, we watch closely to see how countries, who share in their exposure to US tariffs, join the negotiating table in a bid to circumnavigate US markets.

Despite tariffs being a large part of U.S. history, economies have evolved and are firmly geared towards a multilateral world, with America playing a huge role. Therefore, Donald Trump is playing a high stakes game of poker, and it is likely to be a bumpy ride. Political leaders will be reluctant to concede to this American offensive, so retaliation is likely. Rates, recession risk and return expectations will therefore be recalculated.

If you would like to speak with us about anything in this note, or to discuss our discretionary investment management services in general, please get in touch with our UK business development manager David Terry today.

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