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TRUMP TARIFFS: INITIAL REACTIONS AND POTENTIAL IMPACTS

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What Happened

As announced February 1, the Trump administration intends to impose a 25% tariff on goods imported from Mexico and Canada, with a lower 10% rate on Canadian oil, which is a critical import for many U.S. households and businesses. In addition, a 10% tariff has been levied on goods imported from China. These tariffs are officially motivated by the lack of sufficient cooperation by these countries to stop the flow of fentanyl and illegal immigrants across the U.S. border. The announcement late Monday morning that tariffs on Mexico would be delayed by one month in return for 10,000 soldiers being deployed to the Mexican side of the border offers a clear indication that President Trump's position is flexible, provided that improvements are made to address his concerns.

Canada has already rolled out a 25% retaliatory tariff on $155 billion of U.S. goods, while Mexico and China are still weighing possible countermeasures.

The spike in market volatility (from low and well below-average levels) in response to these developments reflects the heightened uncertainty brought about by rising trade tensions. U.S. and global equity markets opened the week in negative territory, short-term bond yields climbed while they fell significantly in Europe and Asia, the U.S. dollar (USD) appreciated sharply against most foreign currencies, and energy commodities appreciated.

Why it Happened

Following Trump's inauguration on January 20, market participants misinterpreted the lack of a swift follow-through on his campaign promises to quickly impose tariffs on China and other trade partners as a broad strategy change around trade policy. The imposition of heavy duties on three key trade partners, with the promise for more to come, has therefore caught many investors unprepared and is causing the "tariff risk premium" to rapidly build up again across asset classes. The volatility that we are observing on Monday morning is not only consistent with market prices reflecting the immediate impact of this round of tariffs, but also beginning to discount a range of ramifications from a significant and widespread intensification of trade tensions over the next few months.

- Equities are exposed on two fronts. On one hand, and as we also saw early last week, elevated valuations remain sensitive to rising volatility and downside surprises to market consensus. Falling valuations are driving the stock sell-off today. But on the other hand, a prolonged and worsening trade war would represent a serious risk for equity fundamentals as well, since it could threaten household consumption, business sentiment, and profit margins.

- The reality is more nuanced in the fixed income market. Short-term yields in the U.S. are rising as tariffs could cause a resurgence of inflationary pressures, thereby forcing the Fed to delay, pause or (in a worst-case scenario) even reverse recent rate cuts. But long-term yields are starting the week roughly unchanged, a sign that concerns about a tariff-induced economic slowdown might be already affecting market sentiment. And bond yields globally are falling sharply, as economic growth in targeted countries (especially those most reliant on exports) could be dealt a significant blow, motivating their central banks to ease monetary policy more decisively.

- The U.S. dollar is appreciating against most global peers. This is in line with widening interest rate differentials (the primary driver of relative currency performance) between the U.S. and the rest of the world. But there is another mechanism at play. Currency depreciation over time can work to offset the loss of competitiveness stemming from higher tariffs and is therefore a textbook reaction to these developments. We expect the greenback to remain strong in a scenario of continued tit-for-tat between the U.S. and its trade partners, in turn supporting our view that U.S. stocks should continue to outperform non-U.S. stocks in dollar terms.

What to Expect

We highlighted tariffs as one of the key risks to our baseline outlook for 2025. The probability and impact of these risks depends on how the several competing items within President Trump's economic agenda (which we have simplified as composed of fiscal policy, trade policy, immigration policy and deregulation) are prioritized and executed.

This round of tariffs is not specifically aimed at correcting trade malpractices, but rather at punishing Canada, Mexico and China for what the administration views as negligence in preventing the flow of illicit drugs and illegal immigration into the U.S. This is why the door remains open for a diplomatic solution that addresses the Trump administration's concerns and therefore leads to a reduction or lifting of these duties. This could keep a lid on volatility in the near-term, and we will keep a close eye on how the targeted countries respond and how the rhetoric evolves.

This being said, the rapid escalation in trade tensions over the weekend is a stark reminder that tariffs are a cornerstone of this administration's economic agenda, not just as a negotiating ploy, but more concretely as a key source of revenue as a pay-for within President Trump's ambitious and expensive fiscal policy plans. We therefore caution that trade tensions are likely to remain elevated throughout the year, with more trade partners in sight, including the Eurozone. To this extent, April 1 is a key date to watch as a sweeping review of all trade relationships is due by then. This deadline could usher in yet another phase for how trade policy is executed and how large and broad tariffs will be.

The renewed perception that the sequencing of President Trump's policy priorities is leading to a frontloading of potentially disruptive trade and immigration policies, rather than pro-growth measures, could keep volatility elevated for the time being. This, coupled with the recent uncertainty that DeepSeek has injected into the artificial intelligence (AI) ecosystem and with the ramification that a less accommodative Federal Reserve (Fed) is having on financial conditions, is likely in our view to challenge demanding equity valuations. This should put more pressure on fundamentals to remain resilient and on corporate earnings growth to meet current expectations (~14% year-over-year in 2025 for the S&P 500).

While we expect this round of tariffs to engender market volatility in the near-term, our focus lies more squarely on the impact on economic fundamentals that these and future tariffs will have. We will be monitoring how higher import duties and the ensuing uncertainty affect consumer prices, consumer and business sentiment, and employment decisions, and ultimately profit margins and earnings growth. Bond yields could be a helpful harbinger, as a rise in long-term yields could indicate that investors are becoming more concerned about structural inflation rather than economic growth, and vice versa. The larger and more durable trade tariffs are, the bigger the risks to the economy and therefore financial markets.

As we digest this important development, we maintain our view that the best approach for long-term investors is to be diversified and to resist the temptation to overreact to short-term market swings. That said, we are mindful that uncertainty about the path forward has increased for several of the drivers that have supported strong market performance over the past few years (including expectations for continued disinflation, further rate cuts by the Fed, U.S. dominance in the field of AI, and a further rise in corporate profit margins). Therefore, as we discussed in our 2025 Outlook, we expect volatility to be more frequent and disruptive. As we assess how the risks around our baseline assumptions are evolving, it might be appropriate over the next few weeks to make tactical adjustments to better position portfolios to navigate increased uncertainty.

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