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POST-LIBERATION POSITIONING: FIXED INCOME CREDIT AT FOCUS

Executive Summary

- Tariffs are likely to introduce heightened volatility in fixed income credit markets, with varying degrees of impact across sectors due to varying exposure to global trade.
- The automotive sector is among the most exposed, with Canada and Mexico accounting for half of vehicle imports and additional reliance on Japan, Germany, and South Korea.
- Retailers face pressure on big ticket discretionary goods, while luxury brands with more pricing power will be less impacted.
- Hardware original equipment manufacturers (OEMs) would see a large negative impact from tariffs, which we expect would be proportionally passed through to consumers, tempering demand and creating margin pressure as well.
- Municipal issuers with significant trade exposure, including state and local governments and U.S. ports may face fiscal pressure from declining trade volumes and weaker economic activity. This could lead to lower tax revenues and reduced port throughput.
- A diversified portfolio focusing on high quality corporates, Treasuries, agencies, and municipal bonds is essential to navigating volatility and sector level dispersion.

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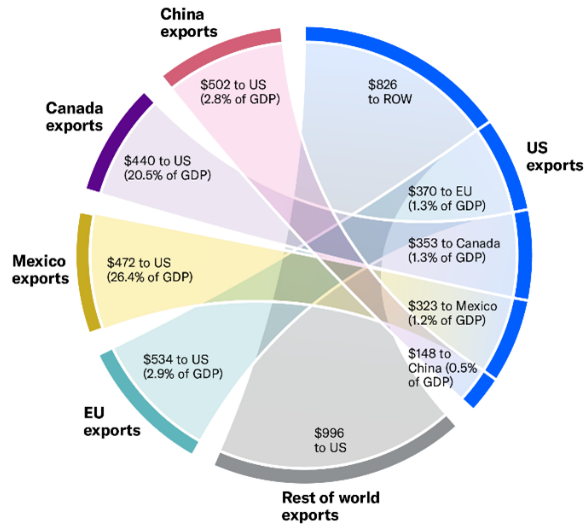
The recent announcement of reciprocal tariffs on almost all imports entering the United States has roiled financial markets and clouded the U.S. economic outlook. The worse-than-expected tariff announcement has broad implications for both the corporate and municipal fixed income markets.

Nearly every sector will feel the impact. Importers and exporters of affected goods face higher input costs and margin pressure, while consumers are likely to see reduced purchasing power. Several factors determine how much of the increase in costs will be passed onto consumers and how much will be absorbed in lower profit margins. However, given the current economic environment where consumers are already more price-sensitive than during the 2018-19 tariff hikes, we generally expect companies to have less ability to pass on these added costs to consumers. On the municipal side, issuers with significant trade exposure, such as state and local government bonds as well as ports may confront fiscal pressure as a result of declining trade volumes and weaker economic activity.

While the policy outlook remains fluid, current information suggests sector-level dispersion in credit impact across both corporate and municipal markets.

FIGURE 1

U.S. and partners' trade flows (USD billion and as a share of each country's GDP %)



Source: U.S. International Trade Commission and Moody's Ratings

Corporates

Autos

The automotive sector looks to be one of the hardest hit sectors as a result of the announced tariffs. Mexico and Canada account for half of total vehicle imports and about a quarter of all vehicles sold in the U.S.. Another 10% or so are imported from countries such as Japan, Germany, and South Korea. The tariff on vehicles imported into the U.S. adds a significant cost to an industry that typically generates a single-digit operating profit margin. Given car affordability concerns related to new car prices, which are 28% higher than pre-pandemic levels and elevated interest rates, it will be difficult for automakers to pass along the cost of tariffs to the consumer. Furthermore, near-term tariff risk mitigation measures are limited considering vehicle models are typically manufactured at only one or two plants, limiting their ability to shift production from one country to another. **Longer term, if the tariffs remain permanent, automakers will need to undertake a plant relocation process, which would cost billions and take several years to implement.**

Retail

Retail operators in the apparel/footwear/consumer electronics space are extremely dependent on imported goods. While most have taken action to rapidly migrate away from China in the past decade, they have shifted production to other lower cost countries in Asia, namely Vietnam and Cambodia—countries that are now clearly in the crosshairs of the reciprocal tariffs. Given the sweeping nature of the tariffs, retailers and manufacturers will have to pass at least some of the costs on to consumers. The increased prices on the consumer will pressure spending, confidence, and therefore earnings and cash flow across the space. **The largest impact is likely on big-ticket discretionary items, which have already been under pressure with less impact on those with more pricing power i.e. luxury goods.** Domestic-heavy food, supermarkets and quick service restaurants are relatively more insulated compared to the broader retail space.

Technology

China remains the single largest exporter of technology to the U.S., although this has declined from over half in 2017 to one-quarter of the total in 2024. China is a massive exporter of smartphones and a large exporter of PCs, servers, TVs and monitors. On the other hand, Mexico has seen a modest increase in tech exports given near-shoring trends and Taiwan's exports to the U.S. have grown considerably, with both countries individually now accounting for nearly one-fifth of tech exports to the U.S. Mexico is the leading exporter of TVs, monitors, PCs and servers while Taiwan exports nearly half of the hardware parts and accessories. Given this mix, **Hardware original equipment manufacturers (OEMs) would see the largest negative impact from tariffs, which we expect would largely be passed through to consumers, tempering demand and creating margin pressure as well.** Software companies on the other hand, would see minimal direct impacts outside of the macro implications.

Municipals

The recent announcement of tariffs has produced substantial market volatility within fixed income, including municipals, as they embrace the role of safe haven while also weighing the potential detrimental impacts to growth and inflation. While tariffs are expected to exert some pressure on certain municipal sectors, **the overall impact will be more nuanced due to the lag effects of tariffs on the economy and tax revenues.**

State and Local Government

State and local governments with high exposure to international trade will be the most affected. Key trade-dependent economies such as **Texas, Kentucky, Louisiana, Michigan, and Ohio face elevated risks due to their significant import and export activities relative to state GDP**. Areas that depend heavily on imports, particularly in the Rust Belt, will likely see increased costs for intermediate goods. Manufacturing intensive states such as Ohio and Pennsylvania, for instance, may see slower growth and elevated job losses as costs rise for imported steel and aluminum. Additionally, California, with its high volume of imported consumer goods, could face rising costs that translate into increased retail prices for residents. **Local governments in these regions may experience fiscal strain if economic slowdowns reduce sales and business tax revenues. However, higher prices from import tariffs may also generate increased sales tax revenues in the short term, partially offsetting declines in economic activity.**

Areas with high export exposure, including Texas and Michigan, face potential retaliatory tariffs, which could reduce demand for locally produced goods and disrupt supply chains. In Texas, the energy sector is particularly vulnerable, as crude oil exports may be subject to countermeasures from trading partners. Similarly, Michigan's automotive industry, which heavily exports vehicles and auto parts to Canada and Mexico, could see declining sales as trading partners impose reciprocal tariffs on American-made cars. Detroit, as a major automotive hub, is particularly exposed due to its reliance on international trade for both manufacturing inputs and vehicle exports. Localities that rely on these industries for employment and tax revenue could see budgetary pressures. However, the fiscal impact on tax revenues may take time to materialize, as retaliatory actions by other countries often lag initial tariff implementations.

Despite these challenges, state and local governments generally maintain healthy reserve levels and benefit from diverse economic and tax structures, which should mitigate the impact of trade disruptions. For instance, while Louisiana is significantly dependent on port activity and energy exports, its economy is also bolstered by tourism and domestic manufacturing, helping to cushion some of the adverse effects of tariffs. While tax revenues may slow in the short term, negatively impacting budgets, the overall credit fundamentals for most municipalities should remain sound in the long run.

U.S. Ports

Ports are among the most directly affected municipal sectors due to tariff-related shifts in trade volumes. The average tariff rate has already increased substantially with projections indicating further rises in 2025.

Major trade hubs, including the Ports of Los Angeles, San Francisco, and Seattle, have struggled to return to pre-2018 trade volumes following tariff implementations from the first term of President Trump. Tariff increases could further suppress trade activity, affecting both imports and exports. Additionally, ports along the Gulf Coast, such as those in Louisiana and Texas, which are heavily involved in energy exports, may see fluctuations in cargo volumes depending on how tariffs affect global demand.

Operator ports, which generate revenue based on cargo volumes, are most directly exposed to increased tariffs. For example, the Port of Savannah (Georgia Ports Authority) could be particularly impacted, as 50% of its cargo imports come from the five largest U.S. trading partners, including 24% from China. Other significantly exposed operator ports include the Port of Houston, Port of Virginia, and Port of Charleston, all of which generate over 35% of cargo imports from the five leading trade partners (China, Japan, South Korea, Vietnam, and Germany). However, these ports generally maintain strong liquidity and benefit from relationships with state governments, providing financial stability.

Landlord ports, such as the Port of Los Angeles, Port of Long Beach, Port of Oakland, and the Port of Seattle, derive revenue from renting facilities to shipping companies under long-term contracts. While they are less vulnerable to short-term tariff fluctuations, prolonged trade disruptions could impact shipping tenants and, in turn, port revenues. On the East Coast, the Port of New York and New Jersey also face exposure but benefit from diversified revenue streams, which mitigate risks.

Although spreads for weaker port credits may widen, most port issuers maintain strong credit quality, limiting the likelihood of widespread credit deterioration. Many major ports have invested in infrastructure and diversified revenue sources, such as logistics services and real estate, to help stabilize their financial positions amid trade volatility.

Credit Positioning & Strategy

While “Liberation Day” has passed, the initial shock from the unexpectedly broad tariff package continues to ripple through markets. Looking ahead, heightened uncertainty is likely to persist as negotiations evolve and retaliatory measures take shape.

For corporates, barring a quick and meaningful reduction of tariffs—which seems unlikely given the latest political rhetoric—we believe that further credit

spread widening is the most plausible scenario over the near to intermediate term. Spread decompression, or the disproportionate widening (underperformance) of lower rated credits, is expected to persist until there is greater clarity and/or reduced fears of a material economic downturn.

As such, we maintain a preference for higher-quality corporate issuers—those with strong free cash flow generation and conservative balance sheets. From a sector standpoint, while no industry will be spared from the far-reaching effects of universal tariffs, we favor underweights to the most highly exposed sectors and an ongoing modest overweight to financials, which stand to benefit from deregulation. It is also important to note that, despite moderate spread widening, investment grade credit total return has been positive in the days immediately following the tariff announcements, attributable to the rally in U.S. Treasuries.

For municipals, although certain regions and sectors—such as port authorities and trade-reliant states—may see incremental fiscal strain, the broader credit outlook remains stable. Most municipalities benefit from strong reserves, diverse revenue sources, and prudent fiscal management, which should help absorb trade-related shocks. We continue to emphasize essential service sectors and general obligation credits tied to diversified regional economies while remaining cautious on issuers with direct exposure to international trade.

A high quality, well-diversified fixed income portfolio with exposure to Treasuries, government agencies, the securitized sector, investment grade credit and municipals remains essential for investors to navigate volatility and preserve capital.

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IMPORTANT DISCLOSURES

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