Market Strategy
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Key Research Takeaways: Tariffs

February 3, 2025

This piece, which brings together key takeaways from three of our research areas (Investment Strategy, Washington Policy, and Economics), was compiled on Sunday, Feb. 2 in response to the tariffs imposed by the U.S. on Mexico, Canada, and China. The story is still developing but this is our initial reaction to the activity.

INVESTMENT STRATEGY: JASON TRENNERT, CHAIRMAN, CHIEF INVESTMENT STRATEGIST

FACTS on the tariffs that the U.S. has imposed on Canada, Mexico, and China:

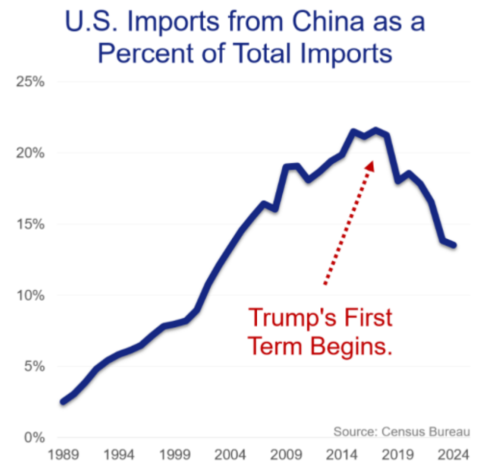
1. President Trump imposed 25% additional tariffs on all imports coming from Mexico and Canada and 10% additional tariffs on all imports coming from China. Energy resources from Canada will see reduced tariff rates of 10%.
2. The administration suspended the "de minimis" exemption for packages valued at less than $800 addressed to individual buyers in the U.S. This exemption has been seen as a boon for Chinese ecommerce retailers.
3. The primary rationale given for the new tariffs is the leverage the administration believes it will give the U.S. to stop illegal immigration and the import of fentanyl and other dangerous narcotics.
4. Secondary justifications given were the impact of illegal immigration on wages, social services, crime, terrorist entry, and human trafficking.
5. Gross trade (imports plus exports) makes up 67% of Canada's GDP, 73% of Mexico's GDP, and 37% of China's GDP. Trade makes up 24% of U.S. GDP.
6. The United States' total trade deficit is roughly -3% of GDP.
7. Spending on services makes up over 80% of the American economy. Despite being a much smaller portion of the economy, spending on goods and manufacturing makes up a greater share of the *volatility* of the economy.
8. **The value of total imports of goods into the U.S. is about $3.3 trillion. Total personal income in the U.S. is roughly $25 trillion. A 25% increase on all goods imported into the U.S. would be roughly equivalent to a 3% tax increase on all income.**
9. Any attempts to retaliate against these tariffs will result in additional tariffs, according to the Trump administration.

Our OPINIONS on the above facts:

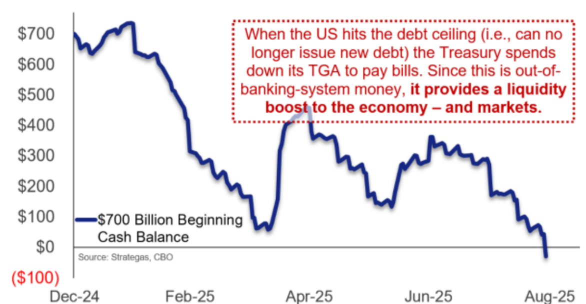
1. The Trump administration prefers bilateral trade agreements to large multilateral agreements and is willing to use economic tools to achieve non-economic goals.
2. In the short-term, tariffs are likely to increase financial market volatility, raise long-term interest rates, and lower earnings multiples.
3. Gold's recent ascent has been sniffing out these moves, serving as a safe-haven asset in times of volatility and as a hedge against currency devaluation.
4. Broader, long-term implications of these tariffs for inflation are difficult to assess due to the potential of U.S. consumers to switch to lower cost domestically produced goods if available as well as currency market fluctuations, and the duration of the tariffs put in place.
5. At the margin, these tariffs should encourage more domestic production of goods in the United States.
6. Small-cap companies with access to relatively cheap funding may outperform large-cap stocks with international operations.
7. **On comparisons to the tariffs that preceded the Great Depression, we note that the Smoot-Hawley Tariff Act (1930) came in the context of a steep decline in money supply, greatly increased regulations on business, and higher taxes. Today, there is an attempt to keep taxes low and reduce the regulatory burden; how the Fed will react to the increase in tariffs is yet unknown.**
8. Tighter trade policy increases the need for the stated policy cushions of an extension of the 2017 Tax Cuts and Jobs Act (TCJA), lower oil prices, and easier regulatory policy.
9. It also increases urgency for artificial intelligence to show real-world productivity gains in the United States.

WASHINGTON POLICY: DAN CLIFTON, HEAD OF POLICY RESEARCH

President Trump enacted tariffs of 25% on Mexican and Canadian goods, effective Tuesday. Canadian energy is one of the few exceptions, with a lower 10% rate. Additionally, a new 10% tariff was enacted on goods from China. With this action, Trump has sent a message to Greenland and Panama that he is not afraid to move aggressively.



1. **Effective tariff rate to increase 6%.** We estimate that Trump's tariffs will raise $150 billion of new tariff revenue on an annual basis and is equivalent to a 10-11% increase in the corporate tax rate. The effective tariff rate will likely increase by 6%. The scale of these new tariffs is much larger than the 2018-19 tariff increases on China, which were ~$30 billion per year. The new tariffs are 4-5 times larger than 2018-19 when fully effected.
2. **Mexico mostly priced in, more to go for Canada.** Expectations for tariff increases this early were low (betting markets had the odds at 35%), but markets priced in some tariff increases via currencies and levered stocks. Treasury Secretary Bessent noted recently that for every 10% jump in tariffs, the country should see a 4% currency depreciation. The Mexican peso's 9.4% depreciation relative to the U.S. dollar since August 1 suggests most of the Mexico tariffs were priced in. In Canada, it was about half of that, and there is more to go. The yuan's recent appreciation suggests more pricing is needed to adjust to its 10% tariff hike. We also expect more supply chain migration.
3. **Increased tariff revenue likely lowers Treasury issuance in 2025.** Higher tariff revenue will work like a tax increase, and the higher tariff revenue will have the effect of lowering projected Treasury issuance. This is on top of our view that the deficit was coming down this year due to higher capital gains tax revenue and more restraints on spending once Trump gets settled.
4. **We anticipate that use of the IEEPA will be challenged in the courts.** To justify imposing these tariffs, Trump invoked the International Economic Emergency Power Act (IEEPA), which has not previously been used in this context. We have argued since the election that Trump's use of IEEPA brings significant legal liability since the provisions have never been used or challenged previously. Our anticipation is that impacted parties will bring a legal challenge to the tariffs. And those challenges could have a similar effect as the recent spending freeze challenge, which put the Trump administration's actions on ice, at least temporarily. If the courts find that IEEPA cannot be used in this fashion, tariff risk goes down meaningfully.
5. **Trump's actions suggest that tariff policy is not just threats.** We've argued that Trump likes the threat of tariffs more than the actual tariffs and that he would only use tariffs if he was not getting the policy he wants from other countries. This view is being proven wrong by Trump's actions over the weekend. Illegal border closings have collapsed in the past week and Mexico has really stepped up its game to get the border under control. None of that mattered. Trump himself said this is no longer about what the countries can do. White House aides argue that the tariffs can come down when fentanyl levels are lower, but once tariffs go up, they are hard to cut. This feels more like a policy change.
6. **A liquidity bazooka gives cushion to financial markets at the start of the tariffs.** Treasury spending down its Treasury General Account (now that the U.S. has hit the debt ceiling) provides a cushion if Trump were to start his trade war early. The scale of the liquidity injection over the next six weeks, $300 billion, is more than double the annualized level of tariffs that were imposed. So, we expect some near-term volatility from the abruptness of the tariffs but starting on February 11, 2025, we begin to see the liquidity pick up and really begin to flood the zone by February 24. The timing of when Congress raises the debt ceiling—potentially as soon as March—will matter for the liquidity outlook, but if Congress does not act, the debt ceiling likely will not have to be raised until August (which is when we estimate the funds in the Treasury General Account will have been spent down).



7. **Killing a chicken to scare the monkeys.** There was a quote in the New York Times this weekend of a national security analyst saying that Trump "will need to kill a chicken to scare the monkeys," in other words to show the world he is serious and his threats are credible. We don't believe the timing of the tariffs is a coincidence with Secretary of State Rubio being in Panama this weekend, as the administration wrestles with its belief that China could technically blockade the canal if there was a national security emergency. Same is true for Greenland as China and Russia make gains in the Arctic.

8. **Trump has replaced soft diplomacy with hard diplomacy.** For decades, the U.S. used soft diplomacy with allies and adversaries. Those days are over. Trump's hard diplomacy on its largest trading partners and neighbors is a sign of things to come.

9. **Personnel is policy, and Peter Navarro seems to be winning the internal debate.** We argued in November that Robert Lighthizer not being in the administration could lead to more tariffs, not less. The best example is when White House advisor Peter Navarro convinced Trump to pull out of NAFTA in 2018-19 and Lighthizer came in to stop that from happening. With no Lighthizer, Navarro seems to have the ear of Trump while the newer staff struggle to get their message across. For the past week, the threat of tariffs on Mexico and Canada was de-escalating. But something changed on Thursday, and Trump pulled the lever despite efforts by other staff to water down the timing and scope of the proposal.

10. **The Fed is probably uncomfortable with the new tariffs.** Our sense is that the Fed will read the tariffs as inflationary, all else being equal, which makes its job more difficult on monetary policy. They made this assessment in 2018 and kept rates too high, in our opinion. The yield curve flattened all year, and the S&P 500 fell 20% in the December 2018, which ultimately forced the Fed to cut rates. Whether these tariffs are inflationary, deflationary, or stagflationary will be the issue.

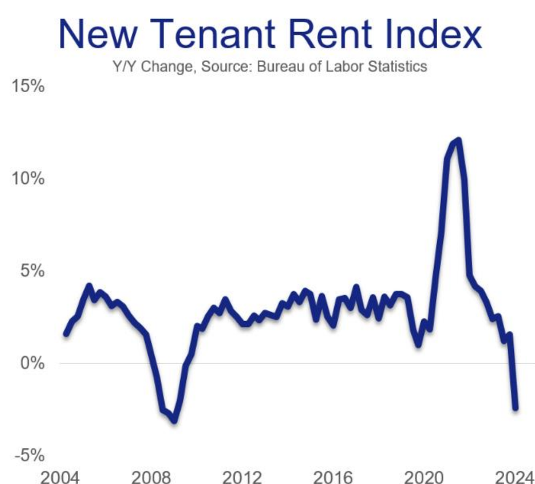
ECONOMICS: DON RISSMILLER, CHIEF ECONOMIST

It seems clear that the new administration won't be constrained by previous global norms of trade treaty obligations, even with friendly neighboring countries, and is intent on changing the patterns of global trade. At this point, backtracking looks impossible – the ships have been burnt. Yet reducing status quo trade flows quickly can present risk for (elevated) U.S. asset valuations. Having inflation firmly anchored would free up other tools (e.g., monetary policy easing) and could reduce this risk.

1. **What happens now?** The auto and farm sectors are at particular risk (there's the potential for retaliation and one-time level price shifts up). However, there are some checks and balances. As noted above, impacted parties will likely bring a legal challenge to use of the IEEPA. In the meantime, tariff (tax) revenue should lower projected Treasury issuance, the debt ceiling-induced liquidity bazooka provides a cushion, and currency markets could offer some built-in offset to tariffs if the U.S. dollar strengthens. Further, local consumers can still substitute non-affected products (for now). Producers may also aim to hold their market share, limiting price pass-through, if they believe the duties to be temporary.

2. **Supply chain challenges could create an inflation issue, but slowing rents are likely a limiting factor for now.** The rent component of key U.S. inflation metrics like the Consumer Price Index (CPI) has a heavy weight but moves very slowly. The Bureau of Labor Statistics (BLS) also produces a New Tenant Rent Index quarterly. This indicator leads the shelter component in the official data, and it plunged in Q4.

3. **The Fed likely wants to gather more data** (especially concerning policies they do not control – fiscal, trade, regulatory). In a unanimous decision, the fed funds rate was held unchanged at 4.25-4.50% last week. The FOMC statement offered little guidance on what comes next. Fed Chair Powell noted that he thought policy rates remained "meaningfully restrictive." He reiterated that the U.S. inflation target is 2%, and that is not going to be up for discussion any time soon. The Fed statement cut a phrase about inflation moving toward the target that had been in previous statements, but Powell noted in his press conference that this was about cleaning up the language of the statement (rather than being intended as a signal).



4. **The economic data are likely good enough for a Fed pause, though central banks abroad may see things differently.** U.S. real GDP rose at an adequate, but not gangbusters, 2.3% q/q annual rate in Q4 (it was held back by the volatile inventories component). U.S. initial jobless claims fell last week to 207,000. No problem there in the timely data. The US inflation picture is neutral currently – not quite to the Fed's target, but not that far off. The PCE deflator (the Fed's preferred inflation gauge) was +0.3% m/m in December (2.6% y/y). Core PCE inflation was +0.2% m/m (2.8% y/y).

5. **The Fed remains in a rate cut cycle, in our opinion, but pausing longer would buy time to gather data.** We continue to believe that the next Fed rate cut will be in June.

6. **To counter disruptive economic policies, other boosts are needed.** Key U.S. government supports available are 1) extended tax cuts (more growth); and 2) lower energy prices (less inflation). Both look necessary. The private sector can also bail out the public sector with productivity gains (more growth and less inflation). Instead of having too much money chasing too few goods, productivity increases the goods. With the unemployment rate low (~4%) there's little slack in the U.S. economy. With a combination of disruptive policies and cushions, real economic growth could stabilize around potential (which we believe is +2% in the US), and the debate will become what longer-term inflation rate and interest rate accompanies that trend in activity. *Growth abroad is at risk more immediately*.

7. **The U.S. economy has underlying momentum with the unemployment rate low.** But domestic "full employment" has been supported by an accumulation of debt. This system may be close to a political inflection point. Absorbing a large disruption to international capital flows – which have supported U.S. assets – could prove disruptive. Valuations would be at risk. There are tools that could help cushion the blow, e.g., monetary policy easing (which is underway), but the Fed's inflation mandate is a key constraint. Viewed in this light, it makes sense to be certain that inflation is anchored, freeing the Fed to act to support the economy if needed, before disrupting the current trade system too aggressively.

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