

The impact of new tariff measures

The new tariff measures

Our previous scenario incorporated higher US tariffs on Canada, Mexico and the EU (+12.5pp declining over time) as well as a permanent 30pp increase in the effective tariff rate on China (comprised of the 20pp already in place, and 10pp to come later this year). In addition, we expected a 4.5pp increase in the weighted average effective tariff rate on the rest of the world. This rather optimistic scenario was also reflected in asset prices as there was little risk premium observed.

Donald Trump's announcement yesterday brought major changes. It represents one of the biggest tariff increases in the history of the US. It will probably take the effective tariff rate from around 2.5% prior to the Trump presidency to 22% currently. This is highest level since around 1910. The announced tariffs are significantly larger than either we or the market had anticipated.

The economic impact of tariffs, retaliation and tariffs uncertainty

Higher tariffs impact economic growth and inflation via multiple channels:

1. Higher prices of imported goods sold in the US leading to higher producer price and consumer price inflation.
2. Falling purchasing power reducing consumer spending.
3. In the event of retaliation, higher tariffs on US exports would hurt US economic activity.
4. Sustained uncertainty regarding tariffs (time frame and possible new changes) weigh on both consumer and business sentiment.

We now see a greater risk of a stagflation scenario (low growth and high inflation) for the US economy. The upcoming Q1 earnings season as well as business and consumer surveys will be important to monitor in view of the risks for employment and investments. There is even room for tariffs to move higher in an environment in which other countries decide to retaliate. This suggests that uncertainty related to tariff policies should remain very high for the foreseeable future.

Changes to our investment strategy

The many uncertainties and yesterday's announcements suggest a more cautious approach to asset allocation in the coming months. Our key assumption that tariffs would be used mainly as a negotiation tool is now much less likely to hold. The Trump administration seems determined to keep tariffs high for a long period and to see them as a recurrent source of government income and a means to force the repatriation of supply chains. We believe this will have a negative impact on global growth for at least the next few months. The tariff announcements are also having a negative impact on US inflation. We had initially expected a peak later this year, but that now looks much less likely.

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We expect economic growth in the euro area to follow a J-shaped pattern. Indeed, the negative effects of higher tariffs and remaining uncertainties will not be offset by the positive effects of the large infrastructure and defence spending programmes recently announced.

Things are therefore likely to get worse before they get better, both in terms of sentiment and economic growth. The net effect of higher tariffs on euro area inflation expectations is likely to be negative, at least in the coming months. We have already considered a moderate acceleration in inflation over the next few years as a result of the economic stimulus. The negative impact of higher tariffs would more than offset this effect, at least in the coming months (we do not expect any major retaliation from Europe).

Rates, bonds and the US dollar: We do not change our outlook for the Fed and still expect two rate cuts, with a terminal rate at 4%. Inflation pressures will rise but should be temporary. The risks related to a stronger-than-expected fall in economic growth should convince the US central bank to continue cutting rates despite inflation remaining above 2%. The ECB is still expected to cut rates twice, bringing the deposit rate down to 2%. In the short term, uncertainty remains elevated, and the trend towards lower yields in the US is likely to persist. Investors will seek refuge in safe-haven assets. Against this backdrop, we are tactically turning Positive on US Treasuries and have revised our 3-month target for the US 10-year yield to 4%.

We see no reason to change our outlook for 10-year government bond yields. Our 12-month forecast remains 4.25% in the US and 2.50% in Germany. We keep our Positive stance on euro core government bonds and eurozone high-grade corporate bonds.

We see two reasons to expect the USD dollar to rebound after the recent weakness: i) Higher US inflation due to increased tariffs will probably lead to fewer rate cut expectations in the US while expectations of a J-curve pattern for the eurozone could lead to expectations of more rate cuts and ii) sustained uncertainty and risk aversion has historically been supportive for the USD. We expect the EUR/USD to fall back to 1.05 and hover around this level on a 12-month horizon.

Equities: As already mentioned, the result of yesterday's tariff announcement is clearly negative for growth in a global basis and even carry the risk of stagflation for the US economy. As a result, we revise our long held Positive stance on equities and downgrade our overall view from Overweight to Neutral. Furthermore, we downgrade our view on the US equity market from Neutral to Underweight. The effects from the tariff announcements should have negative impacts on consumption while driving up companies' input costs. Thus, profits may face pressure from two sides that does not appear to be reflected in analysts' estimates. The still high level on concentration in US mega-cap names is another reason for concern. Valuations are still well above historic turning points and companies could face regulatory pressures in the US while being an obvious target for European retaliatory measures. We stick to our preference for the equal-weighted S&P in the US. Outside the US, we keep our regional preferences but would advise reviewing high exposure to global trade and US tariff sensitivity. The longer trade uncertainties persist, and these high levels of tariff are kept in place, the more negative the overall consequences will be. We need to monitor closely the recession probabilities, and our favourite indicators are initial jobless claims on the macro side and US high yield spreads (via credit default swaps) on the market side. In case of major changes, another review of the overall equity allocation could seem appropriate.

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