On The Mark

February 2025 Special Edition

Tariffs 2.0

Key Takeaways

- President Trump's widely telegraphed tariff policies **caught global markets by surprise**.
- Tariffs have the potential to lower economic growth and increase inflation, but **distinguishing between noise and actual implementation details is crucial** as discussions continue.
- If tariffs are used as a negotiation tool, we believe the **impact wouldn't be material enough** to push the U.S. economy into a recession or cause a lasting increase in inflation.

Tariff Warning Flare

With a new president and a mandate for change, we entered the year with unusually high policy uncertainty. President Trump vowed changes to trade, immigration, and fiscal spending, among other things. Over the weekend (2/1/25), he made good on his campaign promise to impose tariffs on imports from the United States' three largest supplier countries. The tariffs, 25 percent on Canada and Mexico and 10 percent on China collectively represent about $1.3 trillion or 43% of U.S. imports. The goal of the tariffs is to curb the inflow of fentanyl and illegal immigration into the United States in addition to protecting U.S. business from foreign competition.

U.S. stock markets opened sharply lower (-1.2%) on Monday (2/3/25) morning. Later in the day, it was announced that the tariffs on Mexico and Canada would be delayed by one month after both leaders agreed to border protection plans. Markets pared their losses to -0.8% to close the day.

Lessons from Trump 1.0

During the first Trump administration, tariffs were imposed on approximately $380 billion worth of Chinese imports. Despite this, the U.S. economy maintained an average annual growth rate of about 2.8%. While both the unemployment and inflation rates experienced fluctuations, they remained relatively stable overall.

We draw two key observations from this period. First, many businesses adapted to the policy shift by modifying their manufacturing processes, which contributed to Canada and Mexico becoming the United States' largest trading partners. Second, the Federal Reserve regarded tariff-induced inflation as a "one-time" increase that did not factor into its broader monetary policy decisions.

Potential Economy Impact

Of course, there are many differences between today's economy and the one during President Trump's first administration. Companies may be able to pass price increases on to consumers this time around (resulting in higher inflation). Consumer inflation expectations, which stayed well-anchored previously, may be more susceptible to shifting after the inflationary episode in 2022.

If implemented in their current state, tariffs will hit Canada and Mexico much harder, as trade makes up about 70% of both economies. Exports to the U.S. alone account for roughly 20% of their economic growth.

Given the significant ramifications for all parties, we believe this weekend's tariff actions are likely a negotiating tactic to draw Mexico and Canada into helping secure U.S. borders and negotiate better trading terms. The one-month reprieve gives us hope that this is the case. However, it is always possible that things will devolve into a full-blown trade war. If this happens, estimates are that it could reduce U.S. GDP by 1.2% over the next few quarters and add 0.7% to inflation—an outcome that serves no one's best interest.

What Investors Should Do

As noted in our 2025 outlook, we believe the U.S. economy is strong enough to weather most policy scenarios. Tariffs have the potential to lower economic growth and increase inflation. However, if tariffs are used as a negotiation tool, we don't believe the impact would be material enough to push the U.S. economy into a recession or cause a lasting increase in inflation.

Because the road to policy change is windy and unpredictable, we expect elevated volatility in financial markets. Shocks to growth, inflation, or financial conditions could warrant reducing portfolio risk, while price dislocations could present buying opportunities. This is a good time to ensure you are diversified from a geographical and strategy perspective and stay invested as we parse through the noise and focus on the signal of actual implementation.

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