Q&A with Investment Strategy

Tariff Drama Reaches A Crescendo

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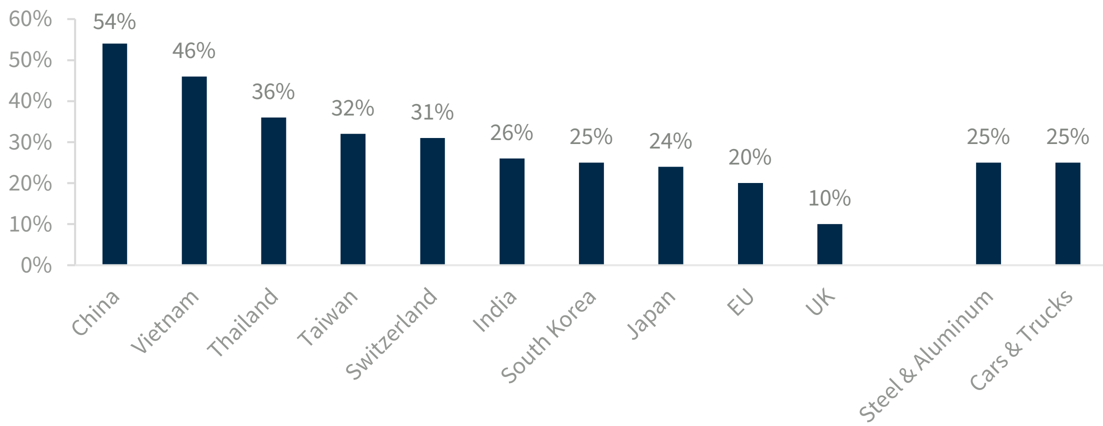
HIGHER THAN EXPECTED TARIFFS RAISE RECESSION RISK – BUT THERE'S HOPE

Yesterday was the long-anticipated announcement day for the Trump administration's tariff policy, and in this Q&A we address the key questions from investors. Combined with what's been previously unveiled, there is a complex landscape of tariff rates levied on individual countries, plus some sectoral tariffs. The US weighted average tariff rate increases to a level that is even higher than in the 1930s, which means there is no modern-day precedent to predict the economic hit. The news is worse than investors had expected, and the only silver lining is that this probably marks the crescendo of the trade war drama. It's clear that the odds of a recession have increased. Whether this outcome occurs depends largely on how long tariffs stay at these levels, in other words what happens with trade negotiations.

WHAT ARE THE MAJOR TARIFFS THAT HAVE BEEN ANNOUNCED?

Prior to yesterday, three significant tariffs had been unveiled: 1) a 20% across-the-board tariff on imports from China; 2) a 25% tariff on steel and aluminum imports, regardless of origin; and 3) a 25% tariff on car and light truck imports, regardless of origin.

Yesterday's new tariffs—what the White House calls reciprocal tariffs—are country-specific. With the exception of Canada and Mexico, every trading partner has its own reciprocal tariff, ranging from a 10% baseline all the way to 49%. For China, the reciprocal tariff of 34% stacks on top of the previous 20%, thus totaling 54%. Imports from Canada and Mexico that are USMCA-compliant will retain preferential treatment, with other products at 25% (energy at 10%). Big picture: this news is bearish for China and many mid-size economies, somewhat positive (vs. expectations) for Canada and Mexico, and mostly neutral for the EU.



US Tariff Rates, Taking Effect On Or Before April 9

Source: White House

WHAT DO WE KNOW ABOUT RETALIATION BY FOREIGN GOVERNMENTS?

Given all of the whiplash-inducing tariff headlines between January 20 and now, we have a sense of how retaliation is shaping up. The caveat is that the brand-new tariff decisions will need to be absorbed by foreign governments, and the planned (but not yet in effect) retaliatory measures will surely change in some ways. Here is what we know as of today.

- China has imposed tariffs of 10% to 15% on US crude oil, LNG, coal, certain agricultural products (most notably soybeans), and heavy machinery. Data over the past two months show that China has essentially stopped buying LNG from the US. In addition, China has placed restrictions on exports of several strategic metals, such as molybdenum.

- Canada has imposed tariffs on C$31 (US$20) billion of US products—a combination of commodities and manufactured goods—and plans to expand this list to a total of C$155 (US$108) billion. Some of the individual provinces are also likely to respond, such as by pulling US liquor from store shelves.
- Europe plans to reinstate tariffs from 2018 and 2020 as well as impose new tariffs on €26 (US$28) billion of US goods including such iconic products as motorcycles, jeans, and bourbon.

While most of us think about trade in terms of physical goods, it is also important to keep services in mind. Whereas the US has a persistent trade deficit in goods ($1.2 trillion in 2024), the opposite is true of services, which had a $293 billion trade *surplus* in 2024. As foreign governments plan retaliatory measures, the US service sector may be vulnerable. Examples include banks and insurance companies, professional services firms, movie and music studios, and Big Tech (vis-à-vis intellectual property licensing). Retaliation may include tariffs as well as regulatory measures.

COULD THE TARIFFS COME DOWN IN THE FUTURE?

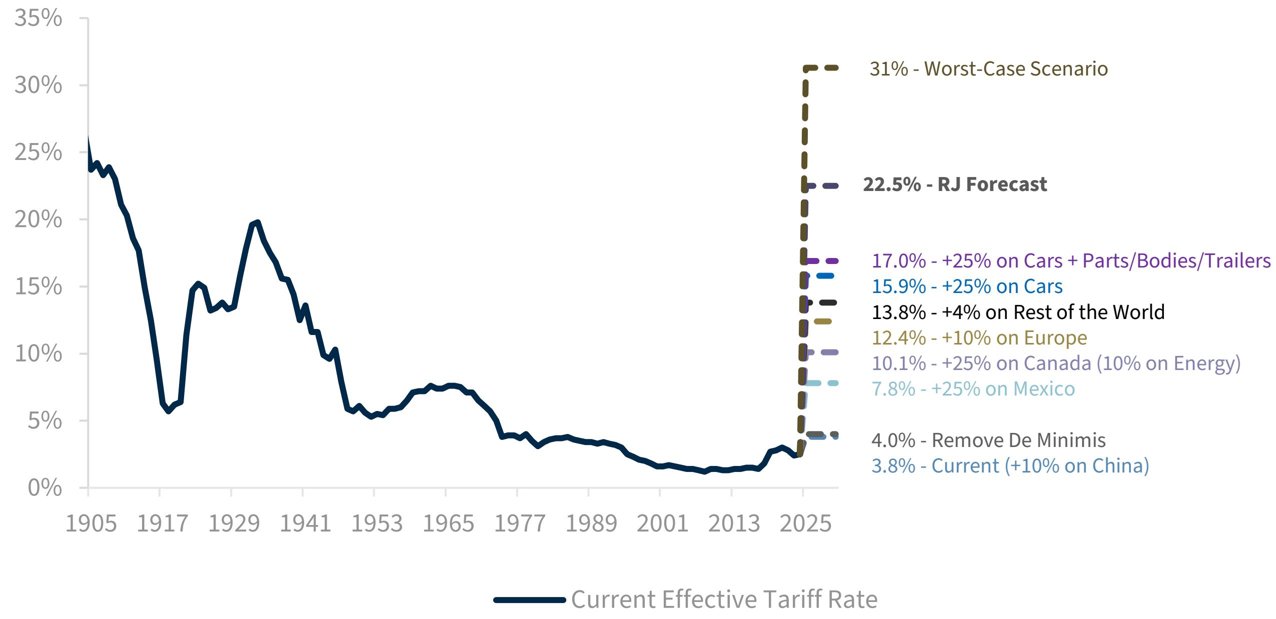
While America's largest trading partners are retaliating, it is worth noting that some mid-size trading partners are taking a more accommodative approach, in other words offering concessions by reducing tariffs and/or non-tariff barriers on US products. India, Vietnam, and Israel are recent examples. In general, the larger an economy, the more willing it is to engage in an outright trade war with the US.

As we wrote in March, it is readily apparent that tariffs are being used by the Trump administration as a means to address a wide range of issues. Some are purely economic: fixing the structural imbalance of the US trade deficit; and reducing foreign tariffs on US products, non-tariff impediments to trade such as domestic content rules, and unfair competitive practices. With that in mind, there is potential for bilateral trade negotiations to lead to mutually beneficial compromises that reduce barriers on both sides. These negotiations will typically be a marathon rather than a sprint—but could lead to long-term benefits to the US if other countries reduce their own trade barriers.

Other Trump priorities are essentially non-economic, such as attempting to achieve progress on illegal immigration and drug trafficking across US borders. Trade negotiations are intersecting with broader political disputes that cannot be analyzed via a narrow lens of 'dollars and cents', which explains why the administration is willing to absorb a certain amount of near-term economic dislocation.

HOW DO THE TARIFFS CHANGE OUR VIEW ON THE US ECONOMY?

With yesterday's changes, the US weighted average tariff rate, encompassing the full spectrum of trading partners, jumps from less than 3% to more than 20% (depending on assumptions, it could be as much as 31%). As shown on the next page, this is the highest level in more than 100 years—even higher than the 19% imposed by the infamous Smoot-Hawley tariff law of the 1930s. In response, imports will decline—such is the basic reality of Economics 101—so it is purely a question of how much of a decline there will be for each country and product category. Consumers and businesses will substitute 1) imported goods for domestically made goods, as well as 2) move from goods that are made in the most high-tariff countries, such as China, to goods that are made in relatively lower-tariff countries, such as Mexico.



Source: Tax Foundation, RJ Economics

As a rule of thumb, for every 1% increase in the weighted average tariff rate, we expect US economic growth to *slow* by 0.1%, and consumer inflation to *increase* by 0.1%, all else being equal. However, given that there has never been such a steep, abrupt tariff increase in US history this is truly unprecedented. Even Smoot-Hawley does not provide a directly comparable case study, given the vast changes in the nature of the US economy and global trade patterns over the past century.

With that in mind, we can only guesstimate the impact of the new tariffs on GDP, but directionally the picture is certainly worse than we (and probably anyone) had previously expected. The result of the administration's more aggressive tariff action significantly raises the risk of a sharper than expected slowdown, possibly even a recession. It should also lead to significantly higher inflation than we were expecting. While tariffs will cause substantial near-term economic headwinds, there are still some factors that could support the economy.

- The labor market remains tight, with jobs that are generally plentiful, even taking into account the high-profile headcount reductions in the federal government.
- The consumer remains on solid footing, evidenced by historically low debt servicing ratios and supported by the still-healthy labor market.
- The AI/data center buildout remains a potent driver of infrastructure development, industrial activity, and electricity demand.
- Increased tax revenues from tariffs could help to support additional tax cuts.

Depending on how long the higher tariffs remain in place, the Federal Reserve (Fed) is going to be in a challenging position—weakening growth and higher unemployment suggest more rate cuts while accelerating inflation suggests more policy restraint. We think growth concerns are likely to dominate. While the Fed cannot prevent a recession from happening, prompt rate-cutting action would be able to keep it a mild recession rather than a severe one if growth slows more than expected. Again, there are massive question marks vis-à-vis what happens with trade negotiations.

HOW DO WE EXPECT THE TARIFFS TO IMPACT CORPORATE EARNINGS?

Based on what we know as of today—in other words, without trying to predict future US tariff announcements and retaliatory measures that have not yet been signaled—we estimate that there is downside to our current 2025 EPS estimate of ~$265/share. Coming into the year, we estimated that 2025 S&P 500 earnings would be $270/share. There are two things that we are laser focused on right now that could negatively impact earnings going forward: margin compression via tariffs and a potential economic slowdown. In isolation, our new 22.5% effective tariff rate, if long-lasting, could pressure earnings lower by ~4%. That would take earnings down to ~$260/share. A slower economy, with growth remaining below 1%, likely takes earnings down another 1-2%. As a result, as of now, S&P 500 earnings are likely to be in the $250-$255 range. A recession, though not our base case, would lower earnings even further. The bottom line: our current year-end target is likely to be revised lower by 8-9% to around 5,800 if the tariff rates remain elevated—modestly above our bear case scenario of 5,400 at the beginning of the year.

At this early stage, it is difficult to quantify the specific sector-level earnings impacts, but directionally it is likely that the Consumer Discretionary, Materials, and Energy sectors will experience above-average pressure from tariffs, whereas Financials, Health Care, and Utilities are on the opposite end of the spectrum. Please refer to the appendix on the next page for commentary on each sector.

THE BOTTOM LINE

After months of whiplash-inducing headlines about US tariffs and retaliatory measures, yesterday marked the crescendo of the trade war saga. The reciprocal tariffs were, on the whole, steeper than expected, especially for China. This will lead to slower economic growth in the US as well as internationally and will raise the odds of a US recession. Furthermore, inflation will be pressured to the upside. Can a recession be avoided? Yes, provided policymakers in the White House and their counterparts abroad end up reaching compromises that lead to tariffs coming down from their currently elevated levels. The number-one question mark—the outcome of trade negotiations—is inherently political, which makes it so difficult to make predictions. The worst-case scenario—maintaining the new tariff rates for all of 2025—seems unlikely. Hopefully, there will be a lessening of the trade war drama as the process shifts from confrontation toward compromise.

As uncertainty surrounding the trade war will likely continue over the coming weeks, we expect that volatility will remain elevated. While never comfortable, pullbacks are a part of the fabric of the market. Dating back to 1980, we have experienced one 10% decline per year, on average, with an average maximum intra-year decline of ~13-14%. Despite this, the S&P 500 has had an average annual gain of ~10%. Staying with your long-term asset allocation framework, keeping a long-term horizon and not making abrupt changes is what is most important throughout periods of volatility.

APPENDIX: THOUGHTS ON TARIFF IMPACTS FOR EACH S&P SECTOR

Consumer Discretionary: As we wrote in March, the US auto industry, which fits into the third-largest slice of the US import mix, has a uniquely high degree of cross-border integration, especially with its North American neighbors. Of the 16 million light-duty vehicles sold in the US in 2024, 8 million were assembled abroad, more than 80% coming from four countries: Mexico, South Korea, Japan, and Canada. Practically all of the US-assembled autos contain Canadian and/or Mexican components. As it relates to electric vehicles, the vast majority of lithium-ion battery supply comes from Asia.

Materials: Plastics comprise the ninth-largest slice of the US import mix, and organic chemicals are #11. There are also various industrial metals that are mined and/or processed almost entirely outside the US, such as cobalt from the DR Congo, tungsten from China, and lithium from Australia and Chile.

Energy: Half of US crude oil imports come from Canada, plus one-tenth from Mexico. Drivers will notice higher prices at the pump, and refiners will likely absorb some of it via lower margins. Also, higher steel prices will raise the cost of building infrastructure such as pipelines and LNG terminals.

Industrials: Similar to automakers, US heavy machinery suppliers—which fit into the largest slice of the US import mix—have significant linkages with Canada and Mexico. Furthermore, many industrial companies use steel in large quantities, hence their exposure to the across-the-board steel tariff.

Consumer Staples: While the US agricultural sector is capable of exporting vast amounts of corn, soybeans, and beef, there is no avoiding dependence on a wide range of imported food products, such as fresh fruit from Mexico, coffee from Brazil, and chocolate from West Africa. This is a highly competitive sector, so price pass-through may be limited.

Communication Services: The media companies in this sector face minimal tariff risk. There is more exposure for the telecom companies because their infrastructure buildout requires large amounts of electronics, steel, and other industrial metals.

Information Technology: Electronic products, most notably from China, comprise the second-largest slice of the US import mix. At the same time, the Tech sector is generally well-placed to pass on higher input costs to consumers. It is also worth noting that a sizable portion of profitability comes from software, which faces minimal tariff risk.

Real Estate: As it relates to the economics of existing buildings, tariffs are irrelevant. Tariffs come into the picture vis-à-vis raising the cost of new construction projects, which require steel, cement, and other materials.

Utilities: These are fundamentally regulated businesses, with returns on equity that are set by state-level utility commissions. That said, tariffs on steel and other metals will raise the cost of building power plants, water pipelines, and other infrastructure.

Health Care: This sector can be divided into two categories. Healthcare services (e.g., hospitals) do not have much linkage to imports. There is more dependence on pharma imports—the fifth-largest slice of the US import mix—including prescription drugs from Ireland and generic drugs from India and China, but these are products where pass-through to the consumer tends to be very high.

Financials: This sector is even more service-centric than Health Care, and thus imports play a minimal role; however, the sector is more sensitive to market-related index price movements.

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