Markets faced with rising tariffs

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Having recovered from Covid-19 and weathered the repercussions of the Russo-Ukrainian conflict, American and European equity markets, which recorded respective performances of 97% and 52%[1] after these periods, can they now withstand Donald Trump's new trade war?

The tariff increases on imports from over 180 countries announced by Donald Trump on 2 April were far above expectations. His tariff plan, described as "reciprocal," will roll out in two phases. Firstly, a 10% tariff will apply to all imports from 5 April, excluding, at this stage, Canada and Mexico. Secondly, additional country-specific taxes calculated on the basis on the U.S. trade deficit relative to import volumes will take effect from 9 April.

Asia has been hit hard, with tariffs of 54% for China, 46% for Vietnam, 32% for Taiwan, and 24% for Japan[2]. Europe's treatment is broadly in line with expectations, set at a rate of 20%[2]. At the sector level, there are a few exceptions. Steel and aluminium, previously targeted are currently exempted, alongside energy products, pharmaceuticals, semiconductors, wood, and copper. However, they may face a second wave of announcements.

These measures, combined with the 25% tariffs already announced last week, will raise the effective tariff rate from 2.5% before Donald Trump took office[3] to 9% on 1 April 2025, and around 24% after these announcements[4]. This level brings us back to those of the late 1920s or even the 19th century, at least partially challenging the beneficial effects of global trade on prices.

Although anticipated, as they featured in the Republican candidate's programme, the scale of these measures came as a surprise. They are justified by the dilemma Donald Trump is facing. The American president pledged to extend the tax cuts implemented during his first term while promising additional ones, despite the projected U.S. budget deficit for 2025 standing at 2 trillion dollars, or 7.4% of GDP[5]. Estimates of revenue potentially generated by these tariffs range between nearly 300[6] and 700 billion[7] dollars annually, compared to an electoral promise of 400 billion[7], depending on substitution effects or reduced imports caused by higher prices.

Will this revenue be sufficient to offset tax cuts, given the significant impact these measures have on growth and inflation? These elevated tariff levels will likely serve as a ceiling, subject to reduction through negotiations. Regarding inflation, higher taxes will mechanically raise the cost of imported goods. Several research offices estimate the rise could range between 1 and 1.5 percentage points pushing the core PCE[8], the Fed monitored indicator, above 4%[7].

Moreover, some signs of slowing growth were already observed. An economy that relies 70% on consumer spending[9] in a country where consumers have already exhausted all their "Covid savings" will likely suffer from any price increase. The impact on purchasing power could reach 2% of income[7], especially affecting lower-income households with high consumption of goods. Another risk for the U.S. economy lies in the wealth effect which, through the rise in stocks valuation and property valuations, has enabled households to consume by reducing their savings rate. A market downturn would probably reverse this effect. Beyond the impact on purchasing power in the United States and elsewhere, uncertainty arising from this new environment could lead companies to postpone their investment and hiring decisions.

For Europe, although goods exports represent only 3.2% of GDP (3.7% for Germany)[10], risks stem mainly from a potential escalation of the conflict and retaliatory measures. As announced, European countries will probably target services sectors, in which the U.S. enjoys a surplus of 146 billion euros relative to Europe[11]. Germany and Italy should be more affected than France or the United Kingdom. The risk for the Old Continent is that the negative impact on growth occurs before the beneficial effects of the infrastructure and defence plans approved by Germany and presented by the European Commission. This situation also complicates central banks' tasks, making their forecasts even more complex and preventing them from supporting growth while inflation remains above their targets.

Market reactions differ on either side of the Atlantic on fixed income markets. There has been a sharp fall in U.S. yields, primarily driven by the real interest rate component, whereas in Europe, long-term rates reacted more moderately downwards, and the German yield curve continues to steepen following the announced fiscal spending plan. In the face of stagflation fears, the downward adjustment in long-term rates may be slower than during previous periods of economic concern.

For equity markets, uncertainty around growth forecasts has sharply increased. In the U.S., downward revisions in earnings forecasts for 2025 have already begun and are likely to accelerate with estimates of the impact of higher tariffs on corporate margins. These margins, however, remain relatively high, around 10%[12]. The effects of the "Trump Rally" on U.S. markets have been entirely erased but valuation levels combined with uncertainties justify some caution.

European corporate profits should be affected to a lesser extent. However, the zone's performance over the last three months puts it 8 percentage points ahead of the US over 3 years and almost match it over five years[13], thanks to the exceptional performance of the banking sector, which significantly outperform that of the "Magnificent 7" over the same period. Despite political awareness and initiatives favouring growth and less regulation, after this catch-up, it seems challenging for Europe to withstand the uncertainties generated by U.S. policy. A rebound might come from central bank support, which remains premature to anticipate, or a policy shift from Donald Trump. Nevertheless, the current President of the United States is convinced that a "transition period," despite its negative impacts, is necessary to implement his programme, and this well ahead of the mid-term elections of 2026.

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[1] Source: Bloomberg, from 31/12/2019 to 02/04/2025. Performance calculated in euros, dividends reinvested.
[2] Source: Donald Trump, 2 April 2025.
[3] Source: UBS, April 2025.
[4] Sources: Consensus, April 2025.
[5] Source: U.S. Department of Treasury, Rothschild & Co Asset Management, 03/04/2025.
[6] Tax Policy Center, April 2025.
[7] Source: JP Morgan, April 2025.
[8] Inflation calculated excluding food and energy.
[9] Source: Federal Reserve Bank of St. Louis.
[10] Source: Eurostats, April 2025.
[11] Source: Macrobond, April 2025.
[12] Source: Bloomberg, 02/04/2025.
[13] Sources: Bloomberg, JP Morgan, 02/04/2025. Performance calculated in euros, dividends reinvested.

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