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Tariff implementation challenges US Exceptionalism

Market update

Ray Farris, Eastspring's Chief Economist believes that US policy change is likely to weaken US growth, making US risk assets vulnerable to further falls in consumer confidence and increases in inflation expectations. Challenges to the US exceptionalism narrative make the case for investors to look beyond the US and diversify their portfolios. In Asia, they can consider economies where policy is turning more stimulative, like China and India. Meanwhile rising wage growth and consumption should support earnings growth in Japan.

The Trump administration's confirmation of an additional 10% tariff on China and 25% tariffs on Canada and Mexico has caused equity markets to fall from their February highs. Better than expected results for the February ISM non-manufacturing PMI overnight and the announcement of a one-month delay in tariffs on autos sparked a relief rally. If February US payrolls data out on Friday are in-line with or better than the consensus expectation of 160k, the rally could extend a bit further.

Yet, what is striking is that despite the bounce, the S&P 500 is increasingly underperforming global markets this year, particularly Europe and MSCI China, and since the opening of China's National People's Congress yesterday, China A-shares have strengthened. One strike against "US Exceptionalism", and multiple scores for portfolio diversification.

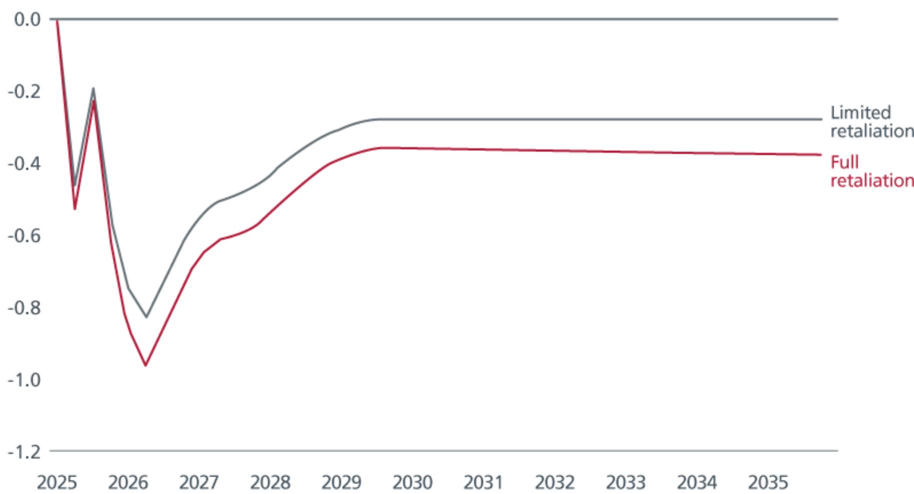
Fig. 1. Tariffs and fiscal tightening drive US underperformance

Source: LSEG Datastream. 4 March 2025.

We expect US underperformance to continue and caution investors against taking too much comfort in upcoming US data for February – e.g. payrolls, retail sales, and CPI – that are likely to suggest that the US economy remained healthy. With aggressive tariffs having been rolled out in March, and the White House recommitting to reciprocal tariffs beginning on April 2, these February data are likely to rapidly become ancient history in favour of data for March, April, and May that should show significant slowing in growth as well as higher inflation.

The Budget Lab at Yale University estimates[1] that the 25% tariffs on imports from Mexico and Canada (ex-energy) and additional 10% tariff on China will cut about 0.6% from US GDP in 2025. Estimates from the prominent Brookings Institute and the Peterson Institute show roughly similar losses to growth. Yale further estimates that if the reciprocal tariffs are implemented in the form they have been proposed, they would cost an additional 0.6% - 1.0% in GDP and add about 2% to inflation[2].

Fig. 2. Real GDP level effects of 20% China + 25% Mexico & Canada tariffs



Source: The Budget Lab. S&P Global, GTAP v7, GTAP-RD, The Budget Lab analysis. Created with Datawrapper.

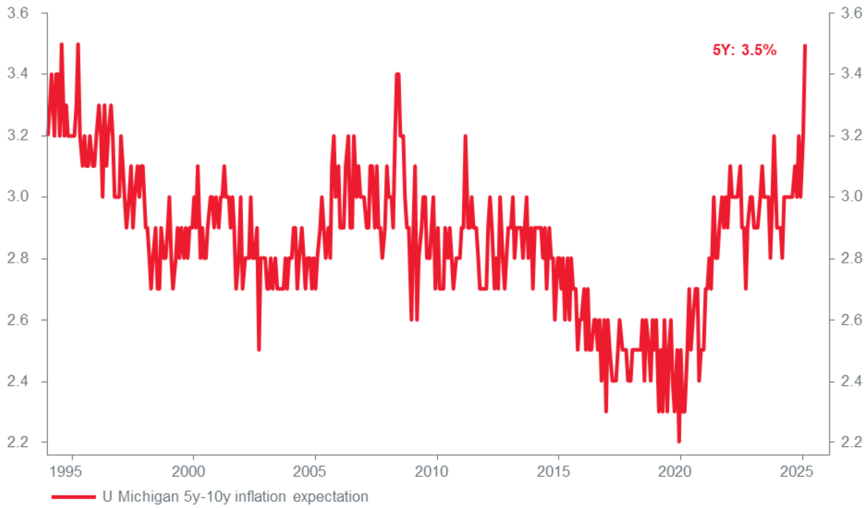
These tariffs will of course hurt growth globally by slowing global trade growth. However, the US stands out for two key reasons. One is that the Trump Administration's restrictions on immigration and its fiscal tightening via the Department of Government Efficiency's cuts to Federal spending programs and employment will also weigh on growth. These two non-tariff factors alone argue for 0.3% - 0.4% slower US GDP growth by year-end.

Combining this with the negative effects of tariffs implemented so far suggests US GDP growth could slow from 2.5% last year to 1.5% - 1.9% this year, well below the consensus for 2.2%. If they are maintained with no extension to the one-month delay of auto tariffs and reciprocal tariffs are imposed in April, the US economy could plausibly go into recession later this year.

Another key tariff impact for the US is that they are increasing US inflation expectations sharply. The University of Michigan's 5y-10y inflation expectation survey rose in February to its highest level since 1995. Recent surveys by The Conference Board and the Harris Poll show similar increases in inflation expectations while the prices paid component of the ISM manufacturing survey jumped higher in February.

[1] https://budgetlab.yale.edu/research/fiscal-economic-and-distributional-effects-20-tariffs-china-and-25-tariffs-canada-and-mexico
[2] https://budgetlab.yale.edu/research/fiscal-economic-and-distributional-effects-illustrative-reciprocal-us-tariffs

Fig. 3. Highest long term inflation expectations since 1995

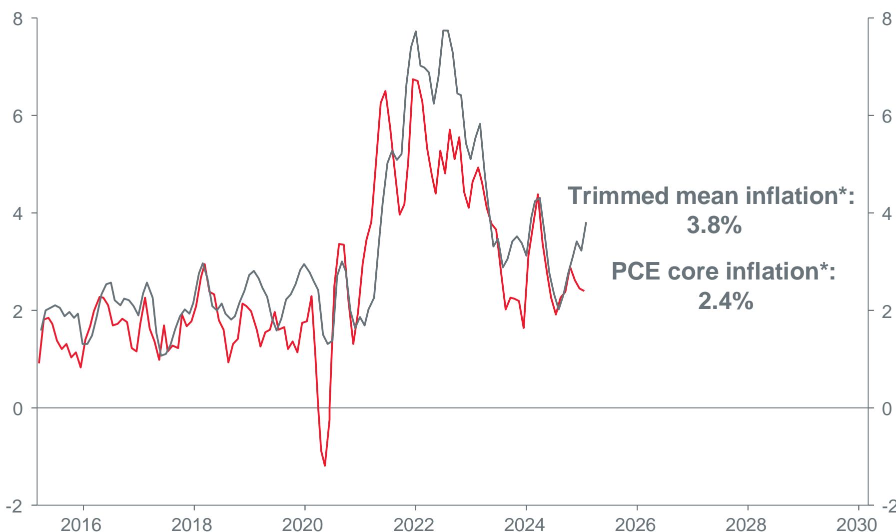


Source: LSEG Datastream. 5 March 2025.

These higher expectations increase the likelihood that companies will pass on much of the tariffs to consumers, pushing inflation higher, weakening real incomes, and cutting into consumption growth.

We think the US Federal Reserve (Fed) will be slow to respond to weaker growth with rate cuts. Inflation remains above the Fed's 2% target and its pace of disinflation has slowed. New tariffs combined with rising inflation expectations threaten to cause inflation to reaccelerate.

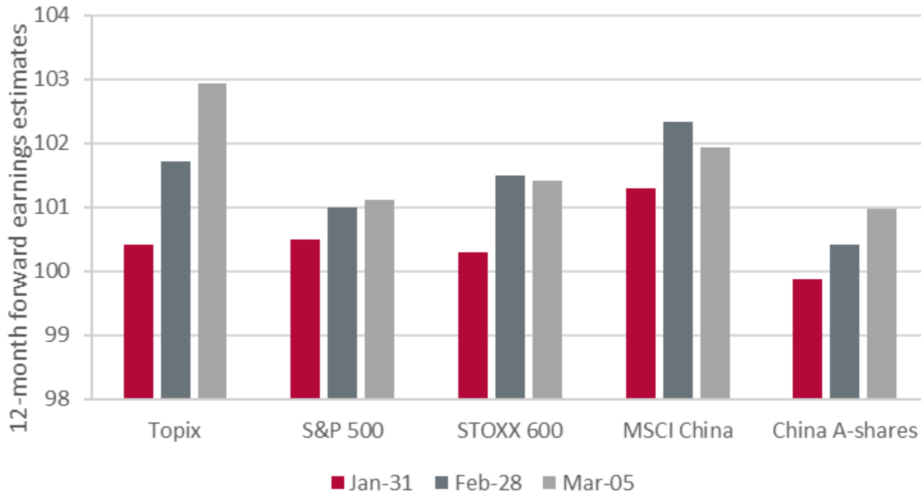
Fig. 4. US disinflation has slowed, tariffs could push US inflation higher



Source: LSEG Datastream. March 2025. *3-month average annualised.

US earnings estimates have already lagged increases in Europe, Japan, and parts of China's markets and a mix of weaker consumption and higher costs could increase this US earnings underperformance. In contrast, Japan should benefit from rising wage growth support for consumption while likely fiscal stimulus of about 2% of GDP in China should support domestic economy growth and A-share earnings.

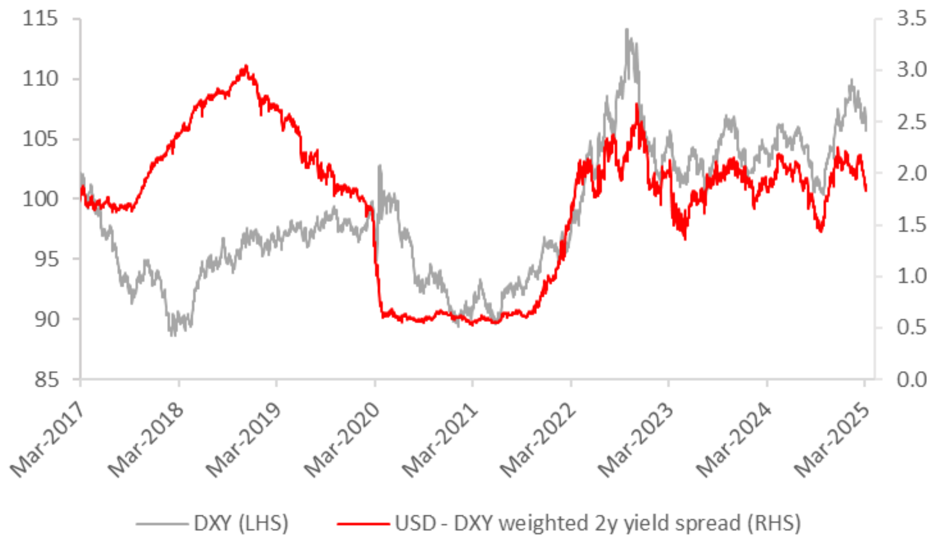
Fig. 5. US earnings estimates are beginning to lag



Source: Bloomberg. As of 5 March 2025. Rebased to 100 as of 31 December 2024.

Contrary to consensus expectations, fears of slower US growth and higher US inflation are pushing the US dollar weaker in response to tariffs, not stronger. This mix has pushed both nominal and particularly real interest rates lower relative to other major currencies. If US hard data begin deteriorating in the coming months, US interest rates would likely move further against the USD.

Fig. 6. Interest rate spreads are moving against the USD



Source: Bloomberg. March 2025.

What to watch for:

The key question is whether President Trump will stick with these new tariffs or even implement more in the form of "reciprocal tariffs" or whether he will delay or reverse them in response to new negotiations or deals with trading partners. For example, a reasonable chance of at least some lessening of the tariffs on Mexico exists, in our view.

However, even if the bulk of the tariffs remain in place or intensify, their impact on inflation and consumption is likely to take at least a couple of months to be felt in inflation data, i.e. in April, May, and June. We suggest avoiding trying to draw firm conclusions from March data for these variables.

In the interim we will be focused on the weekly initial jobless claims data for hints of damage to the US labour market. A rise in the four-week average from 224k recently to over 300k would be worrying. Although markets have historically rewarded focusing on what consumers do – retail sales data – over what they say – confidence surveys – we think the nature of the current shocks suggests that US risk assets would respond negatively to further falls in confidence and increases in inflation expectations. Similarly, sharp falls in the ISM indexes in March and April would likely drive equities, bond yields, and the US dollar lower.

For relative performance we remain focused on countries where policy can ease to offset some of the tariff shock and support growth. China stands out thanks to the large fiscal stimulus being announced at the NPC. Europe appears to also be in the process of introducing fiscal stimulus, albeit to a much smaller degree than in China. We expect the ongoing rise in wage growth in Japan to cushion its economy somewhat. We also expect India's central bank to cut interest rates significantly as the year progresses.

Investment implications

Markets are likely to remain choppy under the tariff barrage and policy uncertainty. Relying on pure beta plays for portfolio performance would be challenging and active investing would be needed to extract alpha. Diversifying and staying disciplined on valuations would increase portfolio resilience, as would having some quality income within portfolios. Our equity teams are seeing idiosyncratic opportunities across the region – including niche Chinese consumer companies, Indian financials and domestic-focused plays in Japan. Active investing is not limited to the equity markets. Our fixed income teams are also staying agile. With a bias towards quality, they are taking advantage of opportunities that arise from the market's rapid repricing of Fed rate cuts as well as the dislocations in the local bond markets to enhance returns.

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