Global Strategy

Trump Tariffs Change the Investment Landscape

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Larger, not priced, and coming at a bad time

The tariffs are:

1) Larger than expected: Trump's proposals are likely to raise the weighted average tariffs on US imports from 2.5% as of end 2024 to 24%, levels not seen since the 1920s. Both the magnitude of 'reciprocal' tariffs imposed per country and the set of countries they were imposed on were larger than many had reasonably anticipated. That they come on top of a 10pc universal tariff is an added shock. This has the potential to considerably worsen the growth inflation mix in the US and the global economy in the coming year. Our US econ team believes it's plausible US' 2025 real GDP could be compromised by 1.5-2pp and inflation could rise to close to 5% if these tariffs are not reversed soon. The magnitude of damage they could cause to the US economy makes one's rational mind regard the possibility of them sticking as low. This brings us to the next point.

2) Not priced: Our Tariff Fear Gauge (Figure 1), which is measured on a scale of 0-100, sat at 11 for US equities and 46 for European equities as of market's close on April 2nd. This fear gauge calculates returns of US and European tariff affected companies that are not explained by changes in macro variables such as growth, real rates, credit spreads or inflation expectations. Essentially, till yesterday the markets were thinking of tariffs purely as a negotiating tool, not an ideological one. Indeed, there is a chance that rates of reciprocal tariffs do come lower as trading partners negotiate with the US, but the 10pc universal tariff suggests this administration firmly believes tariffs are the policy needed to fundamentally alter trade and economic relationships with the global economy. Hope for tariffs being negotiated lower immediately are also challenged by a) the strong possibility of retaliation from US' trading partners, and b) the difficulty of countries negotiating lowering of non tariff barriers which, according to the US administration, includes domestic taxes, currency levels and other regulations.

3) Come on the back of an economy already slowing: The US consumer was already showing clear signs of fatigue. The soft data has been worsening considerably as the fiscal impulse and immigration, two big supports to growth in the last 3-4 years, have both faded. In our opinion, even without tariffs, the US economy was due to go from exceptional to trend this year, a notion that wasn't at all priced in earnings. Negative earnings revisions for 2025 have unsurprisingly been coming thick and fast. From an expectation of 13% at the beginning of the year (Figure 4), 2025 earnings now risk declining much lower than 6-7% earnings growth we thought they would stabilise at.

Equities: Sentiment is poor, but valuations, expectations and flows are elevated

Some sentiment indicators like the AAII are sitting at extreme negative positions. However, we don't think this delivers the same tactical buy signal as it has done in the past because the price is nowhere close to distress associated with this level of sentiment. Equity valuations and credit spreads don't show any sympathy for the negativity in the AAII survey (Figure 2). Importantly, data from the four largest US ETFs shows that, sentiment notwithstanding, investors have continued to buy the dip (Figure 3), seemingly just extending a strategy that was successful in the sell-offs of Q3 2022 and Q3 2023. We think the risk for both earnings and valuations is to the downside. Productivity enhancements from AI can be long term positive but here and now tariffs are growth destructive and the associated uncertainty for corporate investment and cash flows should also cause a widening in credit spreads. Every 100 bps widening in US credit spreads has brought down the equity multiple by 1.5x. Our econ forecasts for US growth could be brought down by 1.5-2pc. Every 1pp change in US real GDP has historically brought down S&P500 earnings growth by 6.9pp. A revision of up 1.5-2 pc on GDP opens up the risk of zero, or even negative, earnings growth in the US this year. We see 5300 as the near term target for the S&P500, but if tariff uncertainty persists or negotiations with trading partners don't go well, risks of downside through 5000 become real. The probability of US stocks entering bear market is going higher.

FX: $ trades differently but strength could re-emerge as EM growth weakens

Periods of market stress have historically been positive for the dollar. Over the last 25y, through weeks where US equity volatility has risen by 1 standard deviation or more, the DXY has gained an average 0.3% (EUR down 0.3%) (Figure 5). By contrast, since Trump's victory in the 2024 election, similar periods of a rise in equity vol have seen the DXY sell off by 0.5pc and the EUR gain by 0.6pc. It's contrary to our expectations but so far in Trump's second Presidency, EM currencies have also fared better than they have done during stress historically. The same behaviour is evident in European and China's equity market showing a low or negative beta to the S&P500's decline. Lack of positioning in ex US assets is partly responsible, but, more simply, it's possible that a larger rotation away from US assets has begun. We have been skeptical of this as we still see lower growth hurting global assets more than US assets over the long term. For now we retain 1.12 as our end 2025 target for EURUSD. Despite the well-advertised tariff announcements today, USDCNH has been stuck in 7.25-7.30 range - albeit gradually losing value on trade-weighted basis (-2% since the inauguration). The currency's relative calm – so far - is partially explained by authorities' intolerance for a weaker currency, as seen from the stable daily fixings. And, partially from a 20+% YTD outperformance of China equities (vs. US), or a 75bps compression between 5y US-CN yields. But with the 54% tariff rate on China risking more than 1.5ppt of growth, this resolve would be seriously tested. Previously, we had estimated that the RMB TWI needs to lose ~2ppt for every 10ppt increase in tariffs to neutralise the ToT shock. As such, the currency now faces a severe depreciation pressure in the coming weeks (UBS 25F: 7.60). With markets having pared back the premium in vols/risk-reversals recently, we'd reiterate that the hedging cost to position for a FX policy re-think (via OTM USDCNH call options) is at ~10y lows.

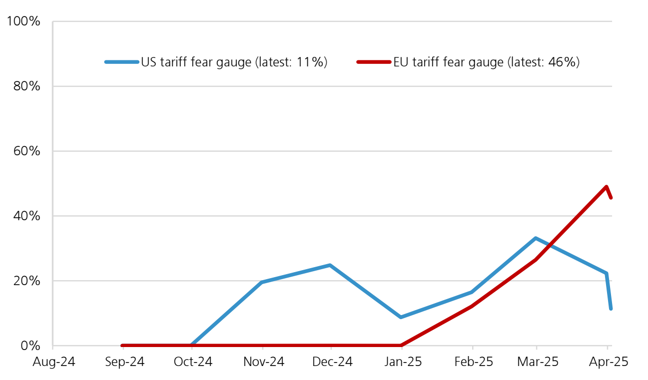
Fixed income: 5s should take the baton from 2s temporarily

The majority of central bank commentary has focussed on the growth damage of potential tariffs rather than the inflation upside risk it brings. Nonetheless, they do admit huge uncertainty in their estimates and are expected to stand pat on policy till data compels them in either direction. With 100bps of Fed cuts and 41 bps of ECB cuts already priced for the next two years, the 2y, our preferred tenor to receive over the last 12m, may stay rangebound for some time. Instead, the 5-7y tenors are likely to lead yields lower as terminal rates begin to get priced below neutral. 10y and 30y are likely to do well in absolute terms, but we struggle to see them break 4.0 and 4.30, respectively. Through the course of 2025, as equities have suffered, bonds have done well. Total returns for MSCI ACWI and Bloomberg global bond aggregate through Q1 have been -1.1% and 2.85% respectively. In line with our thinking, bond equity correlation has turned negative (Figure 6) once again. If anything, it has happened a little sooner than we had anticipated (we'd calculated US core CPI of roughly 2.6% y/y as the threshold below which bond-equity corelation turns negative; it's still at 2.8% y/y). As bonds diversify portfolios again, bids for fixed income should appear from multi-asset investors.

Credit: The last shoe to drop

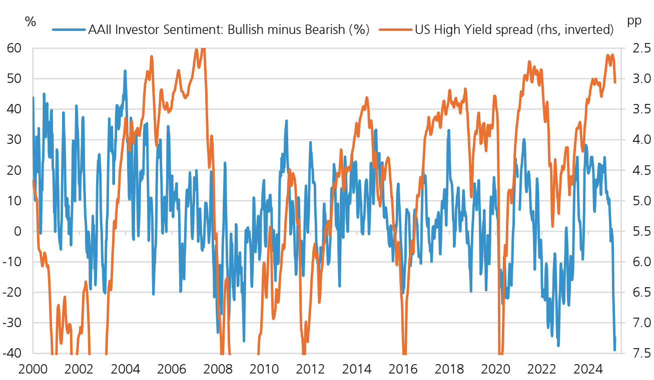
US spreads have held in well versus other macro asset classes, in particular EU spreads; in coming days we expect retaliatory tariffs will do little to settle investors even if medium term negotiations result in lower rates. First, we shift our near-term IG/HY spread ranges from 90-100/ 300-350bp to 100-110/ 350-400bp on moderately lower growth/ earnings and materially higher inflation. Second, we expect sector dispersion to increase: leveraging UBS Evidence Lab's Global Trade Monitor we overlay the sectors most exposed to imports and the approximate weighted-average tariff rate that will be applied across sectors based on country level announcements: sectors with the highest combined exposure include tech, consumer durables and autos. Those with the lowest risk include energy, basic materials, chemicals and consumer durables. We reiterate our underweight in US IG tech and retail, and still like energy as a cyclical underweight. We are overweight IG tobacco and the bulge bracket banks.

Figure 1: US and EU Tariff Fear Gauge



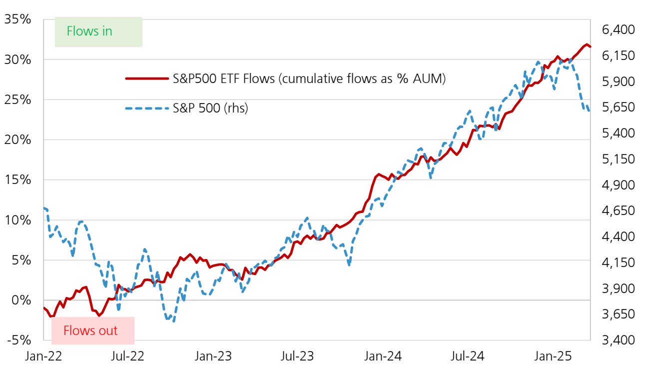
Source: Bloomberg, UBS

Figure 2: AAII survey bull-bear sentiment spread vs US HY spreads



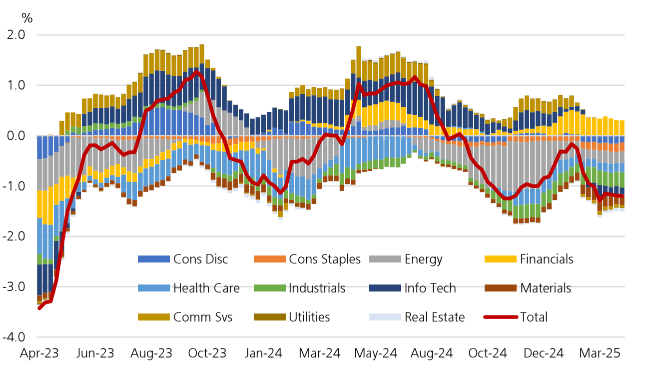
Source: Haver, Bloomberg, UBS

Figure 3: S&P 500 price index and cumulative flows into S&P500 ETFs



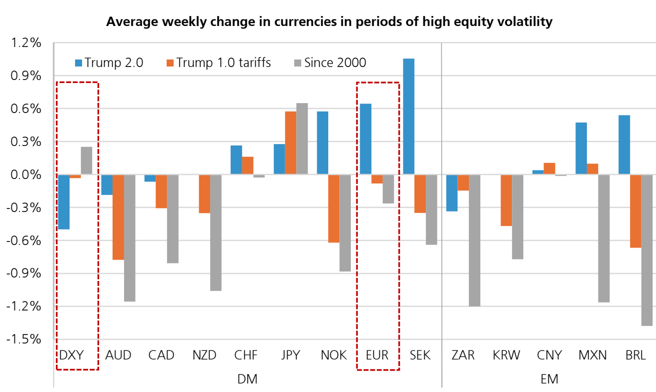
Source: Bloomberg, UBS

Figure 4: MSCI US sector contribution to 3m change in 12m fwd earnings



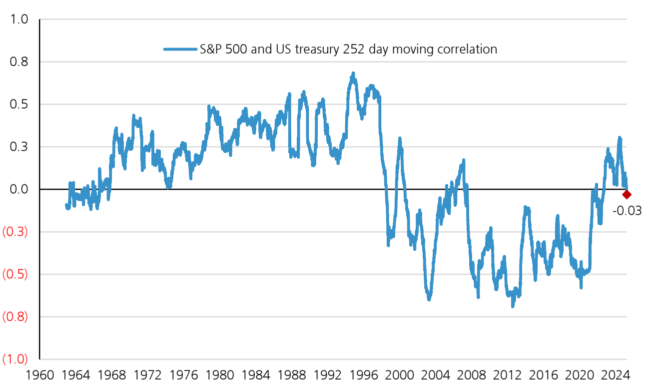
Source: IBES, MSCI, Datastream, UBS

Figure 5: Response of currencies to higher equity volatility



Source: Bloomberg, UBS

Figure 6: S&P 500 and US 10 treasury correlation



Source: Bloomberg, UBS

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