February 4, 2025

THE TARIFF MACRO HANDBOOK

Key macro themes

From threats to reality – President Trump came forward with his threat to levy **very high duties on its three main trading partners**. Like in 2018, the tariffs seek to support US manufacturing (F1), but have a variety of other objectives. For example, the President looks to use trade policy as a foreign policy pressure tool, and as a major source of tax revenue.

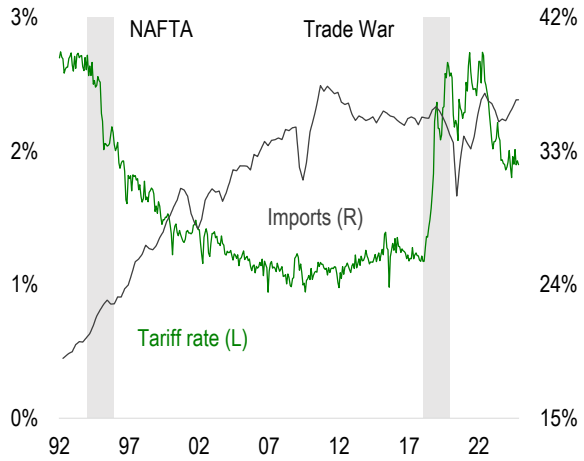
Incoming uncertainty – The possibility of tariffs had already fueled policy uncertainty in recent months (F2), but Wall Street's adverse reaction at Monday's open suggests that **markets had discounted the likelihood of a Trade War**. This month, we explore how these import duties could affect the US economy, drawing on the experience of the 2018/19 China / US conflict.

Investment strategy

A complex shock – In the near-term, we find that duties increase inflation risks, calling for some inflation protection. However, upward pressure on the dollar and the hit to global activity would quickly mitigate these pricing pressures, **eventually resulting in lower inflation**. In contrast to widely held views, this would then improve the risk-reward profile of Treasuries.

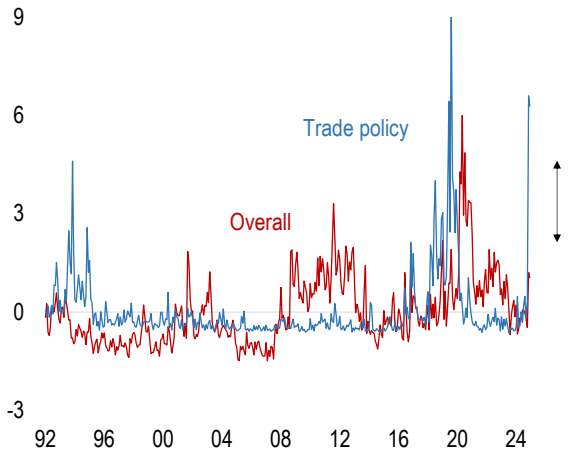
Charts of the month

F1: US government looking to turn inward
Effective tariffs vs. import share of demand



Note: Chart compares the average effective duty on imports versus the import share of US goods demand (consumption + investment). Source: Numera Analytics on BEA, Department of Treasury data.

F2: Prospect of higher tariffs fuels anxiety
US economic and trade policy uncertainty



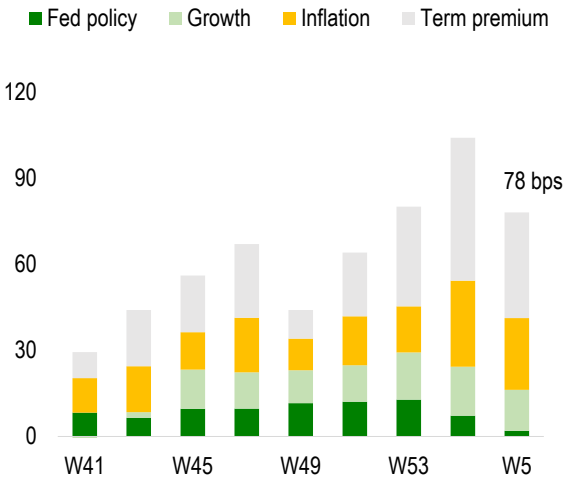
Note: The economic policy uncertainty indices track the share of newspaper articles across major publications focused on macro (e.g. fiscal, monetary, trade) policy. Both series shown as Z-scores. Source: Baker, Bloom, Davis.

In this section:

A roadmap to tariffs – No element of President Trump's policy agenda has created **greater uncertainty than the threat of widespread tariffs**. Even if markets discounted this possibility until Friday, tariff risk was still a key factor behind higher inflation expectations since November, lifting Treasury yields (F3). Threats became a reality late last week, as the White House announced a near immediate rise in import duties on the US' three largest trading partners.

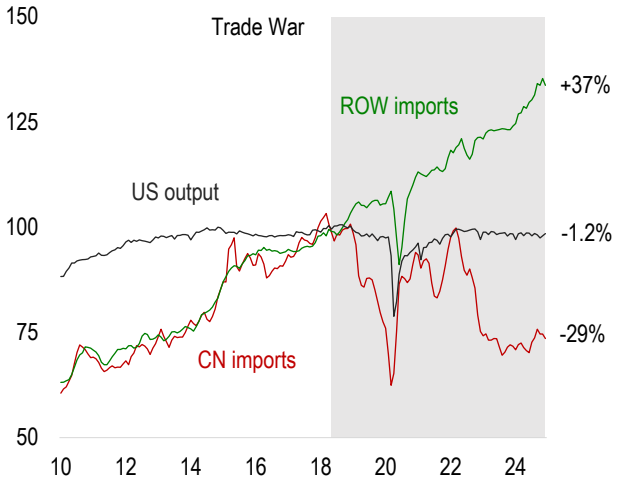
Assessing the impact of tariffs on the economy is complex, as this **depends on multiple second round effects** like USD gains, or substitution to non-tariffed goods. One further challenge is that in a globalized world, tariffs are not an active policy tool in the same way as e.g. fiscal spending. This makes it harder to quantify their impact precisely.

F3: Renewed inflation worries lifting yields
Change in 10Y yields by source (10/24+)



Note: Contribution of Fed policy, growth and inflation expectations to the observed change in 10Y yields since October. Source: Numera Analytics.

F4: Trade war did little for US producers
US manufacturing and import volumes



Note: Chart compares US manufacturing production against real imports of manufactured goods from China and elsewhere. Series indexed to 2018= 100
Source: Federal Reserve, US Census; Numera calculations.

Luckily, the 2018 Trade War offers a useful blueprint for analysis. The US initially levied duties on a narrow set of goods, but when China retaliated, it imposed 'section 301' tariffs on $300B of CN imports. The share of dutiable imports went up 20 points to 60%, and the **effective tariff rate on CN goods rose fourfold to 10%**.

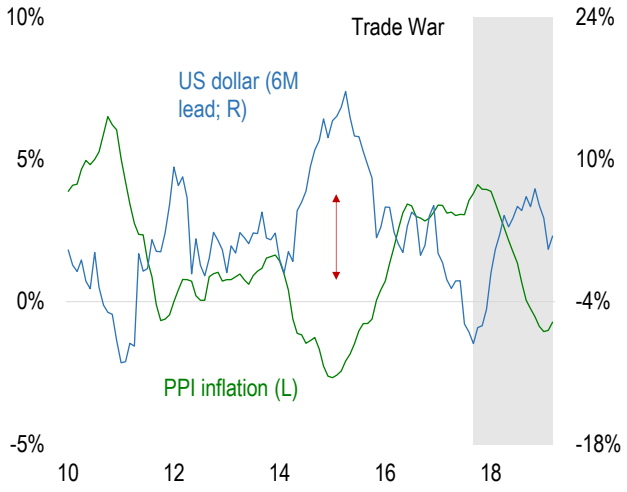
This had a major impact on trade flows. Import volumes from China plummeted, falling 20% below trend in a year. Yet the policy move did not succeed at reigniting US manufacturing. In fact, production took a hit since the tariffs created policy uncertainty, curbed external competitiveness, and discouraged investment as higher costs hurt margins. In this context, consumers substituted towards goods from the rest of the world, up nearly 40% since 2018 (F4).

What about the effect on prices? Academic research finds a full pass-through of tariffs to import prices. **Yet the impact on CPI was limited**, with US retailers absorbing most of the cost. Work by the NY Fed does find that higher input costs and reduced competition raised producer prices by around 1%, but this mainly affected retailer margins.

Yet even if tariffs had a causal impact on prices, **actual inflation nearly halved in the year of the Trade War**. This highlights the importance of second round effects, and of the broader macro context. For example, the dollar rose 8% between Q1/18 (when tariffs were first implemented) and mid-2019. This captured both a direct response to the duties, and the fact that the Fed started raising policy rates in late 2017 amid signs of strong economic activity.

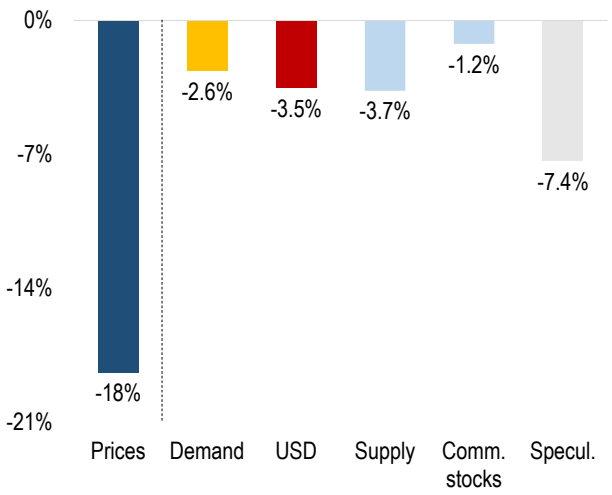
As we can see in F5, USD appreciation more than compensated for higher import costs, eventually lowering inflation. Similarly, PPI inflation in China eased noticeably during this period, partly compensating for the loss of competitiveness. A strong dollar and weaker CN activity also curbed inflation via lower oil prices. We estimate these factors lowered real oil prices by 6%, with Brent falling even further on higher supply and weak speculative demand (F6).

F5: Pricing pressures *eased* in Trade War
Producer prices vs. broad US dollar (YoY)



Note: YoY changes in US producer prices (excl. fuels) against 6M prior changes in the trade-weighted US dollar. Source: BLS, Federal Reserve.

F6: Falling oil prices also lowered inflation
Drivers decomposition - Brent (06/19 YoY)



Note: Bars isolate estimated contribution of selected drivers to the change in real oil prices between June 2018 and 2019. Source: Numera Analytics.

Will tariffs fuel inflation? – The 2018 tariffs had two objectives: To reignite US industry, and to reduce the degree of economic interdependence with China. **Today's trade policy agenda is more ambitious**, also looking to limit exposure to supply chain disruptions, use tariffs as a pressure / bargaining tool, and to raise revenue to compensate for tax cuts and even reduce the fiscal deficit. In this context, the US is considering broad tariffs on all trade partners.

The revenue objective, in particular, **requires a very sizeable jump in duties**. The effective tariff rate on all US imports last year was 2.3%, 1-point higher than pre-2018. As we can see in T1, only China faced significant trade barriers, both in the form of high dutiable rates (17%) and because a large portion of their goods are subject to tariffs.

T1: US import duties detail Imports by origin, 2024 (%)	World	Canada	China	Mexico	Eurozone
Dutiable tariff rate	7.5%	0.5%	17%	2.5%	3.7%
Dutiable import share	30%	22%	61%	10%	31%
Effective tariff rate	2.3%	0.1%	10%	0.2%	1.2%

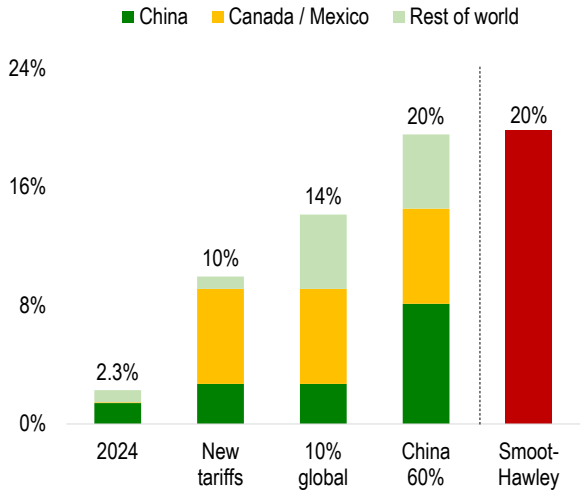
Note: The dutiable tariff rate is the average tariff rate levied on dutiable imports, while the dutiable import share is the % of US imports subject to tariffs. The effective tariff rate is the product of both factors. Source: Numera Analytics on USITC data.

The US announced on Friday 25% duties on Mexico and Canada (but 10% on Alberta oil), and a 10% tariff on China starting today. At current import shares, **this would lift the effective rate to 10%** and raise $300B+ in tax revenues, more than offsetting the loss from a reduction in corporate taxes. Yet the current situation is highly fluid, as illustrated by the one-month postponement on Mexico and Canada after rapid negotiations over border protection.

Duties may get rolled back, but may also rise further after federal agencies report their findings on 'unfair' trade policies on April 1st. For example, if the US also levied a 10% universal tariff, this would raise effective duties to 14%. A 60% tariff on all CN goods – which the President threatened during the campaign – would in turn push this to 20%, **matching the effective rate after the highly disruptive Smoot-Hawley Act** of the early 1930s (F7).

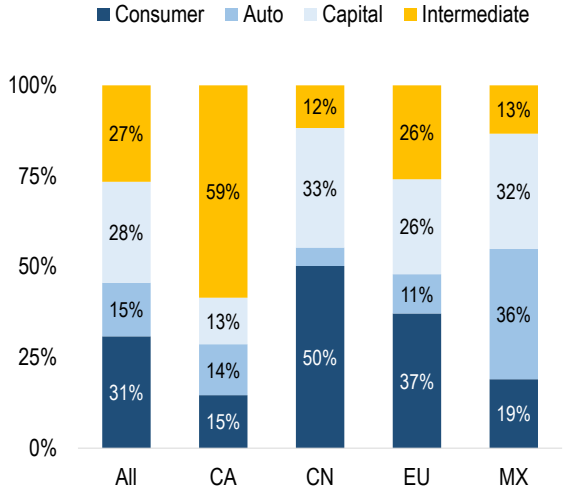
While trade policy will likely mutate over the course of the year, for the purpose of our analysis we assess the impact of announced duties. Given multiple channels of transmission, a proper assessment requires a framework that captures global linkages, and nuances such as substitution between imported and domestic goods.

F7: Effective duties could rise four-fold
US effective tariff rate policy scenarios



Note: Alternative tarfiff scenarios assuming the newly announced duties affect all goods imported from China, Canada and Mexico. Source: Numera Analytics.

F8: Tariffs would affect entire value chain
US imports by product type (% of total)

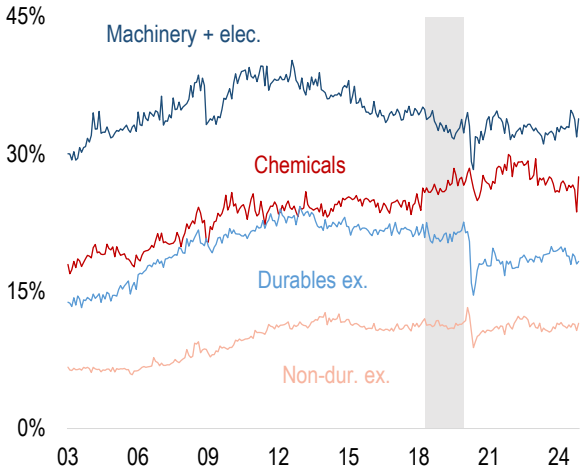


Note: Chart breaks down US import shares by product type and country of origin. Source: Numera Analytics on BEA data.

We constructed such a 'general equilibrium' framework, expanding a global structural model we built in 2018 during the Trade War. The model allows for detailed scenario analysis, accomodating for multiple second round effects. As such, it is not a forecast, but a tool to assess the net impact of tariffs absent any other shocks. Note also that the results vary from our October *US Macro Strategist*, when we discussed only the direct impact on CPI.

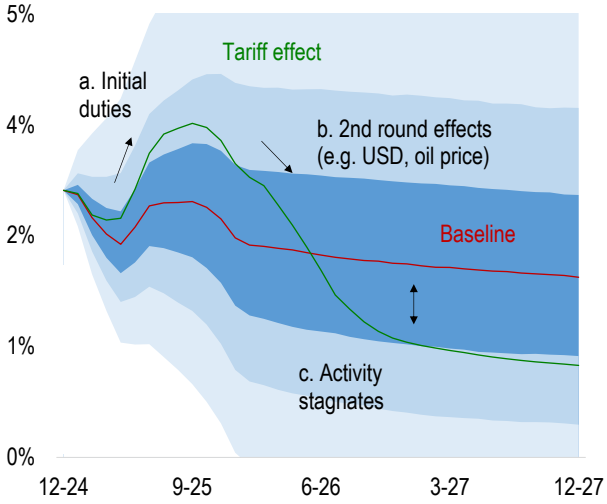
One crucial element is the pass-through from producer to consumer prices, which explicitly depends on the strength of the economy. This matters more than in 2018, since **a lot of the trade in N. America is in intermediate goods** (F8). Another important component are global linkages. Duties will hit growth in affected countries, and have already triggered retaliation. This is problematic for US industry, mainly for durables producers and chemicals (F9).

F9: Manufacturing vulnerable to tit-for-tat
Export revenue share for US manufacturing



Note: Export revenues as a share of total shipments by manufacturing sector. Durables ex. and non-durables ex. exclude machinery and electronics and chemicals respectively. Source: Numera Analytics on Census Bureau data.

F10: Full impact on inflation is complex
Simulated effect on tariffs on US inflation



Note: Chart compares the simulated impact of global tariffs on US inflation relative to Numera's inflation forecast model. Source: Numera Analytics.

Assuming a full pass-through to imports, the duties would cause consumer prices to rise directly by 0.6% - a relatively low impact reflecting the low import share of the consumer basket. Yet notice in T2 below that the impact on producer prices is much higher, both due a higher reliance on imports and Canada's role as a major raw materials supplier.

F10 shows the simulated impact on CPI inflation, accounting for second round effects. At their peak, we find consumer prices would rise 0.9%, owing to cost pass-through and less competition (allowing US businesses to raise their mark-ups). Absent any other shocks, this would cause US inflation this year to average 3.1%. Yet notice that the effect quickly dissipates, eventually **resulting in much lower inflation than we expect in our base scenario**.

The reason for this are the types of indirect effects that lowered inflation in 2018/19. There are four key channels. The most important one, which is already evident today, is **a sharp increase in the value of the dollar**, reducing import costs and eroding US competitiveness. Tariffs in our simulation cause the USD to rise close to 20% in 2025/26.

T2: Direct impact of duties Shares and change in prices	Import share by type of good			Imports / spending	Impact
	Canada	China	Mexico		
Consumer prices	9%	17%	19%	7.5%	0.6%
Producer prices	18%	11%	13%	26%	1.9%

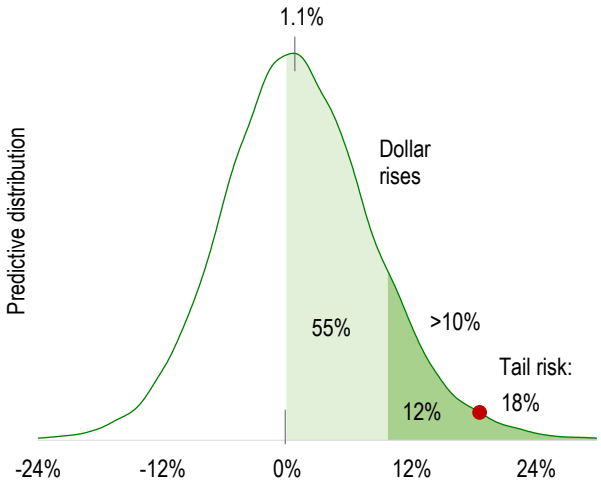
Note: Table illustrates the direct impact of duties on US CPI and PPI. The direct effect depends on the share of CA, CN and MX goods in imports of consumer, and intermediate and capital goods, and on the import share of spending. Source: Numera Analytics.

While this may sound excessive, in 2018 the USD went up 8% with a much smaller shock. In addition, notice from F11 that a double digit jump this year, while unlikely, is still a realistic outcome. Besides a strong dollar, another factor that mitigates the impact on prices is **a decline in producer prices in China, as its economy slows**. Weaker global growth and a strong dollar hits US GDP via exports, while also lowering oil prices – exerting a further drag on prices.

F12 breaks down the contribution of these effects in 2026/27. Persistent USD appreciation lowers inflation by 0.5% over this period. **Lower oil prices are also an important drag**, lowering price growth by an additional 0.3%. Finally, lower PPI inflation in China and a slowdown in global growth amplify the deflationary impulse by 0.2%.

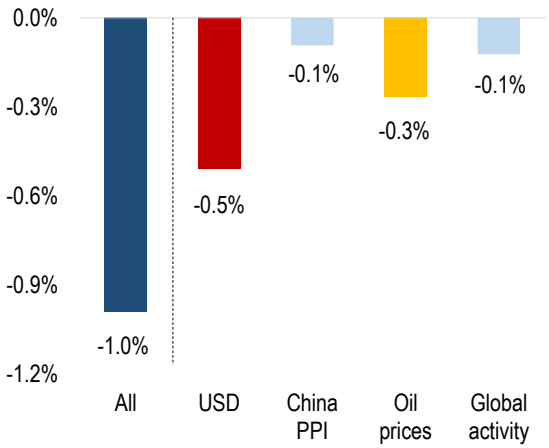
Our findings have important investment implications. If the US leaves these duties in place, this will initially fuel inflation. **This calls for greater inflation protection**, the topic of our latest *Percentage Play* report. Yet tariffs also trigger a number of deflationary responses. These would eventually lead to a downgrade of inflation and growth expectations, which actually improving the longer-term risk-reward profile of high quality debt.

F11: Extent of dollar response is critical
USD appreciation probability - 2025 (%)



Note: There is a 52% probability that the dollar appreciates in 2025, and a 9% chance of a double-digit rally. The highest potential appreciation rate, based on what we know today, is 18%. Source: Numera Analytics.

F12: Global spillover is just as important
Tariffs' indirect impact on inflation - 2026/27



Note: Bars show the reduction in CPI inflation by source in 2026/27 after a jump in the US effective tariff rate to 10%. Estimates from global structural model that captures second round effects. Source: Numera Analytics.

1. Strategic Asset Allocation

Overweight	Neutral	Underweight
🟢	🟡	🔴

Strategic allocation Positioning by asset	Asset allocation[1]	Sector rotation[2]	Key macro factors / comments
Stocks	🟡	-	Earnings vulnerable to negative growth surprises in H2/25
Large-cap (S&P 500)	🟡	-	Remain OW in H1/25, reduce exposure as growth slows
IT	-	🟡	IT has a much better entry point after DeepSeek sell-off
Health Care	-	🔴	Staples, utilities have higher upside with similar protection
Financials	-	🟡	Neutral as banks gain from wider term spread, deregulation
Consumer Discret.	-	🟡	Upgrade due to improved risk-reard profile for e-commerce
Industrials	-	🟡	Downside risk contained by likely pick-up in US manufact.
Comm. Services	-	🟢	Greater resiliency to IT overall to growth fluctuations
Cons. Staples	-	🟢	Improving volume growth, recovering expenditure share
Energy	-	🟢	Effective near-term hedge to tariff-induced inflation risks
Materials	-	🔴	Worse inflation hedge than energy, as O&G affect chemicals
Utilities	-	🟢	Fed easing, AI investments improve risk-reward profile
Real estate	-	🟢	CRE prices are rebounding + high sensitivity to rate cuts
Mid-cap	🔴	-	Heightened volatility from trade policy favours quality
Small-cap	🔴	-	Heightened volatility from trade policy favours quality
Bonds	🟢	-	Mild OW, as markets understating extent of future Fed cuts
Sovereign bonds	🟢	-	Trading below 'fair' value, upside once growth decelerates
Corporate bonds	🔴	-	High coupon payments, but very tight spreads dent appeal
Investment-grade	🟡	-	High coupon payments, better risk-reward profile than HY
High yield	🔴	-	High coupon payments, but very tight spreads dent appeal
Money market	🟡	-	Fed easing cycle reduces appeal of short-term debt

1. Positioning relative to 60/40 benchmark. See our *US Asset Allocation* report for suggested portfolio weights and analysis.

2. OW/N/UW relative to market weights in the S&P 500. Positioning depends on projected risk-reward balance for each sector. See our *US Equity Sector Strategy* report for optimal sector weights and analysis.

2. Top Conviction Calls & Scorecard

US Investment Ideas Top Conviction Calls	Action	Open date	Recently closed	Trailing stop-loss[1]	P&L	Report
US small-cap stocks	Long	16-Sep-24	18-Dec-24	6.2%	6.2%	
Materials stocks	Long	3-Oct-24	18-Dec-24	-8.0%	-8.0%	
Real estate stocks	Long	21-Oct-24	-	-9.0%	-6.3%	
S&P equal weighted	Long	30-Oct-24	-	-5.0%	1.9%	
Regional banks	Long	6-Nov-24	11-Dec-24	7.1%	7.1%	
US aerospace & defense	Long	6-Nov-24	-	-4.0%	3.2%	
US refiners / E&P	OW	6-Nov-24	-	-8.0%	-0.2%	
US diesel	Call option	20-Nov-24	15-Jan-25	66%	66%	
US gasoline	Call option	20-Nov-24	15-Jan-25	47%	47%	
US semiconductors	OW	11-Dec-24	27-Jan-25	5.0%	5.0%	
OW defensives	OW	8-Jan-25	-	-5.2%	0.8%	
Long duration	Long	8-Jan-25	-	-8.0%	2.1%	
UW high yield	UW	8-Jan-25	-	-7.7%	0.1%	
US semiconductors	Sector	3-Feb-25	-	-5.0%	-1.7%	

1. Stop-loss threshold matches the expected loss over the remaining holding period, relative to the current P&L.

3. Benchmarks

- **Stocks**: Large-cap: S&P 500 by GICS sector; Mid-cap: S&P midCap 400; Small-cap: Russell 2000
- **Bonds**: ICE BofAML US Treasury, US Corporate and US High Yield, US TIPS; Money market: 3-month T-bill