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# 3/31/25 Outlook Theme #1: Stop and Go Tariffs

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Markets are not Republicans or Democrats. They look at future profits and weigh probabilistic outcomes, discounted back to the present. In the short term they can be noisy, but it's usually due to over or underestimating these possible outcomes. Following the election in November, the prospect of lower taxes and deregulation generated a positive market response in Q4'24. But as we frequently mention, tariffs are a tax (a fee levied on importers by the government) AND a regulation (they create artificial incentives or constraints on how businesses can operate). Both taxes and regulations reduce the efficiency of companies and economies. While tariffs and trade have been frequent topics for political rhetoric, they have been primarily viewed as a threat to generate negotiating leverage on trade or other topics, as was the case in the first Trump administration (and most other administrations/countries, all of which enact some form of trade policy).

During Q1, the risk and rhetoric over trade was an overhang, and modest headwind. Tariff headlines started on Feb. 1 with China, an expected target, and then, unexpectedly, focused on Canada and Mexico, our two closest trade partners due to geography and the long-running NAFTA/USMCA deal that created the largest free trade region in the world. The primary issues cited, security and fentanyl, are not even an area of concern with Canada. Yet just as these tariffs were about to start on Feb. 4, they were paused for a month, and markets recovered. When they did go into effect, they included exemptions for USMCA compliant items, which mitigated the impact. This on-and-off pattern persisted for the rest of the quarter and felt like being caught in "Stop and Go Tariffs."

If Q1 was about "Stop and Go Tariffs," the light turned red right after the quarter closed, with April 2's "Liberation Day" event. Tariffs were a well telegraphed policy heading into the event with some degree of new policy announcement expected, with an eye on leveling the playing field: offering a tool to punish those who did not follow the rules of fair trade, as well as provide an incentive for countries to get better. Markets, in fact, rallied that day into the deal as the press discussed a few different rumored programs. However, the announced tariffs were far larger than expected. The market's reaction was immediate, and negative, with the S&P falling 5% on Thursday, then another 6% on Friday as China opted to pursue counter tariffs.

The primary driver of the market's negative response was the formula used to determine the tariff rate. The specific calculation was (goods exports – goods imports) / goods exports divided by two. This translates to the U.S. goods trade deficit with a country divided by the U.S. exports to that country, divided in two. This formula has several weaknesses that directly translated to the markets decline.

The first, and most important weakness, is the size of the tariffs in this calculation. Since the math is not grounded in any specific tariff formula, it created exceptionally high rates in the 20-40% range, especially for smaller countries, with Vietnam at 46%, for example. Meanwhile, the EU ended up with a 20% rate, versus its trade weighted 3% rate on its imports from the U.S. The result is a U.S. tariff rate of about 20% with the world, compared to about 2.5% prior, and the highest since the 1930s. Because of these exceptionally high rates, profit margins of most goods-importing businesses stood to be significantly pressured.

Second, it only looks at goods, not services. The U.S. is now a service-driven economy. While it runs a $1 trillion goods trade deficit with the world, it has a $250b services trade surplus. In effect, the U.S. buys products from the world, while providing it with things like technology, financial services, media and other sought after economic activities: The U.S. sells ideas, while buying things. As an example, the combined goods and services trade deficit with the EU is about half the goods deficit ($235b goods deficit, $125b services surplus, $110b overall deficit). The point being, the formula exaggerates the deficit, making the applied rate much higher than it should be (even when it's divided by two to reach the reciprocal rate).

Here's the third issue: Based on the formula focusing its tariff calculation solely on a country's balance of trade with the U.S., it specifically targets countries with which U.S. companies have built strong supply chain relationships. The overall trade deficit of the U.S. is $750 billion on a $27 trillion economy, or about 3%, a function of $3 trillion exports and $3.8 trillion imports. The U.S. exports a lot and imports a lot. The proposed formula means charging an average tariff of about 20% on about $2 trillion of those imports, for $400b which, again, winds up being focused on the partners with which we trade the most.

A more reasonable formula would entail analyzing what tariffs countries actually charge and/or quotas they apply and then putting them in one or two tiers of tariffs – such as 10% or 20%. Tell countries to fix X or Y to get to the lower tier. This is what the market was looking for.

While the formula itself is problematic, the follow-on concern is the underlying motivation. The concern is that, at its base, the policy sees any goods-based trade deficit as the sign of a problem, which must be fixed. Removing all country-specific goods deficits would be incredibly challenging: It would take time and cause considerable dislocations of lower growth and higher inflation, as well as simply encourage other countries to trade less with the U.S.

The positive is that these tariffs are so high, countries will have to negotiate quickly. While the formula makes it hard to figure out how a country can get out of the tariff penalty box, there are strong incentives to do so. We saw this initially with countries like Vietnam.

Additionally, the market fallout was so severe that within a week it forced the U.S. to walk back its proposal with a 90-day delay. For the rest of the quarter, "Stop and Go Tariffs" will be the market's driver. The good news is that the tariff threat can exit the market as quickly as it arrived, as we saw with the April 9 10% S&P jump. The risk is that the talks drag out and the uncertainty lingers, causing businesses and consumers to start to pull back on activity and consequently start to weigh on the actual economy, even before the impact of tariffs sets in.

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