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INVESTMENTS

DECODING TARIFFS: WHAT'S THE ECONOMIC IMPACT?

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A new round of tariffs targeting Canada, Mexico and China has whipsawed financial markets in recent days as investors wrestle with the implications of rising policy uncertainty and the impact on the global economy.

Assessing the potential damage to economic activity is challenging, given the rapidly changing news events. Those include on-again, off-again tariffs, a one-month reprieve for the auto industry, a pause on some tariffs against Mexico, and the likelihood that certain newly erected trade barriers are a negotiating mechanism to achieve other policy goals of the Trump administration. The unfolding narrative could, and probably will, change tomorrow.

The standard models for analysing the global economy are based on 40 years of data that covers a period where the direction of travel was uniformly towards greater cross-border integration, not less. Add in the high level of uncertainty and you are left with an environment where model results must be viewed with caution.

That is why we are using this four-box framework, along with extensive scenario planning, to consider a range of potential outcomes for the economy, markets and companies.

A key question for investors is whether we are at the beginning of a new structural shift in the geopolitical world order, or are we witnessing a continuation of trends that have been brewing over the past decade? The answer is probably both. Trump's election victory represents a structural shift in how the US approaches its leadership role in the world, but it is also an extension of forces that have been in place in the US for many years and are likely to continue, in our view.

That message has been delivered more forcefully in the past few days, which explains much of the market volatility seen in late February and early March.

Against this backdrop, the evolving tariff story can be viewed in four ways:

1. Decoupling
Part of the motivation for the latest tariffs is to reduce dependence on single-source supply chains, particularly in countries such as China, where the trade war has been focused for years. This type of tariff is aimed at bringing some manufacturing activity back to the United States.

2. Rebalancing
So-called reciprocal tariffs are intended to restore balance with other trading partners, such as Europe, Japan, Mexico and Canada. The goal here is to lower the US trade deficit and compel these countries to facilitate more balanced trade.

Decoding tariffs: Motivations and implications

Decoupling: Shift supply chains and reduce reliance on certain countries

High, persistent impact

Potential countries/regions impacted: China

Potential industries impacted: Tech, energy, industrial materials, pharma, biotech, aircraft

Rebalancing: Reduce trade deficits and boost domestic production

Medium, persistent, mixed impact

Potential countries/regions impacted: China, EU, Japan, South Korea, Vietnam, India, Mexico, Canada, Brazil

Potential industries impacted: Autos, steel, aluminum, agriculture, food, chemicals, consumer electronics, pharma, luxury, defense, energy, oil

Negotiating: Create leverage through economic pressure to achieve policy outcomes

Low, temporary impact

Potential countries/regions impacted: China, Mexico, Canada, EU, Japan,
Latin America

Potential industries impacted: Autos, steel, agriculture, consumer electronics, construction machinery, minerals, defense, energy, semiconductor equipment

Funding: Generate revenue to fund domestic budget priorities

High, persistent impact Potential

countries/regions impacted: May be a broadly applied universal tariff

Potential industries impacted: Consumer goods, autos, industrials; price effects and margin pressure across industries

Source: Capital Group, American Compass. As of 5 March 2025

3. Negotiating

The Trump administration has made it clear that some tariffs are specifically meant to pressure other countries to assist with US policy goals, such as cracking down on illegal immigration and curbing the cross-border flow of illicit drugs.

4. Funding

Tariffs are seen as a way to raise revenue for the US government and potentially offset the impact of other policy goals, including tax cuts and regulatory reform.

These four motivations will have an important role in how the story plays out. For instance, tariffs that are used for negotiating purposes are unlikely to persist over long periods of time. Conversely, tariffs that are part of a larger decoupling process could be here to stay.

As those issues are sorted out, the impacts on the US economy and the global economy could be significant. But until we know the details and see at least some of the initial outcomes, it will be tough to reach a conclusion — beyond the obvious fact that we are navigating through a cloud of extreme uncertainty.

Our base case remains that the US economy will continue on a path of healthy growth this year, driven by solid consumer spending and business investment, which in turn are supported by strong income growth and accelerating corporate profits. We think US GDP growth for 2025 will be in the range of 2.5% to 3%. But the size and scale of recent policy moves could complicate that forecast.

We have always believed that focusing on fundamental drivers of the economy, such as income and profits, is the best way to forecast activity. However, we must also acknowledge that the sheer number of geopolitical developments that have occurred in the past two months might be creating enough uncertainty that economic activity could diverge from those drivers in ways that we have not seen before. Which is why, as fundamental, bottom-up investors, it may be time to just judge the impact of these unprecedented events as they unfold.