FOR PROFESSIONAL INVESTORS - 07/04/2025

FLASH NOTE

By Andrew Craig, Co-head Investment Insights Centre, and Chi Lo, Senior Market Strategist Asia

TRUMP'S TARIFFS – A PARADIGM CHANGE

- **In the absence of major revisions, the tariffs are a stagflationary shock for the US economy, potentially derailing US growth and raising recession risks**
- **A major risk-off move is now underway as financial markets move to a completely new interpretation of 'US exceptionalism'**
- **The best-case scenario would see a significant part of the new tariffs revised down after negotiation over the next three months**
- **Otherwise, the tariffs have the potential to fundamentally change the terms of global trade with those countries dependent on exports to the US the hardest hit**
- **The questions now are whether the US tariffs are a negotiating tool and the extent to which they can be moderated by economic, market, political and perhaps legal pressure.**

A MAJOR RISK-OFF MOVE IN FINANCIAL MARKETS

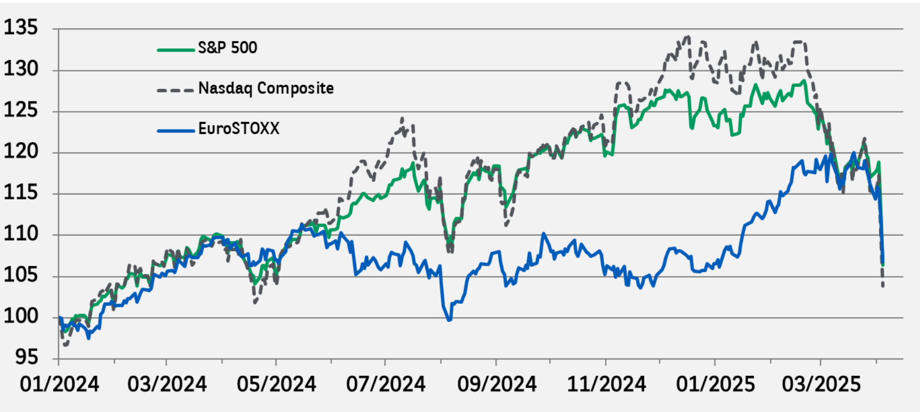
The global risk-off move in financial markets has extended at midday on 7 April in the wake of President Trump's tariff announcements. Stock markets have fallen heavily, and bond yields declined further.

Contracts tracking the US S&P 500 are down 2.8% after falling 11% last week. Asian markets, some of which were closed on Friday, have fallen sharply, with Hong Kong's Hang Seng index down more than 13%. European stock markets continue to fall, with the STOXX Europe 600 sinking 5.3%.

Exhibit 1

Major equity indices nosedive after US tariff barrage

(changes in price indices in local currencies; 100 = 01/01/2024



Data as at 04/04/2025. Sources: Bloomberg, BNP Paribas Asset Management.

In the bond market, US Treasury yields are down across the curve, with the 10-year and 2-year yields at around 3.96% and 3.65%, respectively. The US dollar index (DXY) reflecting the valuation of the dollar against a basket of currencies has continued to fall. West Texas Intermediate crude oil is down and now trading below USD 60/barrel.

These developments in financial markets reflect the risk of stagflation in the US and a greater probability of a global recession, which implies a continued move lower in bond yields and downside to US equities unless it becomes clear that negotiations over the level of the tariffs are envisaged.

BNP PARIBAS ASSET MANAGEMENT

The sustainable investor for a changing world

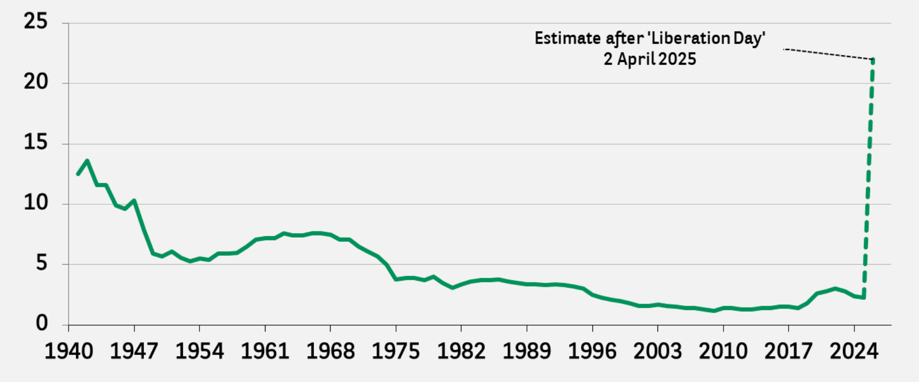
US TARIFFS ARE A MAJOR SHOCK FOR A US, GLOBAL ECONOMY

If maintained, we anticipate these tariffs skew risks to growth meaningfully to the downside and risk to inflation to the upside.

Modern economies have never seen such sizable and broad-based tariffs. The global sell-off in risk assets reflects growing concerns about a significant US economic downturn impacting the global economy.

Exhibit 2

Average effective US tariff rate on imports skyrockets*



*ratio of duties collected/US imports for consumption, US International Trade Commission; source: Bloomberg, BNP Paribas Asset Management

A DEFINITIVE BREAK WITH PREVIOUS US POLICY UNDER THE TRUMP ADMINISTRATION?

Until the announcements on 2 April, financial markets were simply not reckoning with such a radical and abrupt break with long-standing US trade/foreign policy. If confirmed, this new policy is a break with the policies and goals pursued by US governments since World War II. It potentially casts President Trump's administration in a completely different light to his first presidency.

Prior to 2 April, there was a view, that ultimately, this administration would be constrained and balanced to ensure it supported the economic expansion and business sector. This belief was undermined by tariffs on Mexico and Canada.

The declaration of tariffs on 2 April appears to put an end to any idea that this would be a "business friendly" administration. This revelation explains to some extent the severe sell-off since 2 April in financial markets. It potentially paves the way for a significant decline in US business and consumer sentiment.

Other areas of the new administration's policies that could have been offsets are, so far, not materialising.

There are question marks as to whether fiscal policy can go beyond an extension of the existing tax cuts. If future tax cuts are to be paid for by spending cuts, it implies more austerity.

The Department of Government Efficiency (DOGE) initiative is arguably also a negative shock for the US economy due to the resulting layoffs of government employees and the negative repercussions of institutional damage to government services

HOW HAS THE LEVEL OF TARIFFS BEEN SET?

A notable, and disconcerting, feature of the tariffs is that they are based on the deficit in goods trade, as opposed to differentials in tariff rates (the common understanding of 'reciprocal' tariffs).

These tariffs do not appear to have been designed with a tactical approach in mind to deal with unfair trade practices.

This suggests they are aimed at eliminating deficits with trading partners, which would be a more difficult and drawn-out adjustment than simply negotiating down tariff rates charged by other countries – an easier path to pursue.

A BLOW TO ASIA

Regionally, Asia is being hit hard: the import tariffs on many regional economies are comparatively high given that their large trade surpluses with the US have been used to calculate the levies. Vietnam, Thailand, and China face the highest levels under Trump's latest package.

The blow comes as growth has been slowing. Activity as indicated by purchasing managers' indices has declined: the PMI for Asia ex China fell to 50 in March from 50.7 in February. Three quarters of the countries in the survey saw their PMIs fall to below the boom-bust line at 50. A drop to below 50 would signal a contracting economy.

The new tariffs look to set weaken regional growth further as they undermine consumer and business confidence, weaken asset prices, and cause capital spending and trade to falter. Generally, the more open an economy is, the bigger its role in trade and capital flows, and the bigger the drag on growth from the US import tariffs will likely be.

CHINA – ROOM FOR FISCAL STIMULUS

If we add the new 34% tariffs to the 20% announced in February and March and assume they do not replace the pre-2025 tariffs, the total rate on Chinese imports into the US shoots to over 60%, according to estimates by our research team and those of the wider market.

While high, China could manage the impact: Beijing has already announced fiscal stimulus plans which according to our research team's estimate amount to 1.6% of gross domestic product for the coming year.

If we also consider the effects on local consumer and business confidence as well as asset prices (and by extension on domestic demand), and consider possible measures by China's trading partners to protect their industries from Chinese competition, China's growth could be hit harder. With lofty tariffs also imposed on China's regional supply-chain partners, its ability to divert trade to other countries to offset the tariff impact might suffer.

COMPETITIVE CURRENCY DEVALUATIONS?

Many countries will likely seek to negotiate individual deals with the US. If that fails, they could impose retaliatory measures and depreciate their currencies. However, such measures would disrupt their supply chains, slow global trade and economic growth, and risk triggering a spiral of currency deprecation.

With the US dollar weakening, the option to depreciate one's way out from under the tariff pressures looks closed off. Indeed, expectations of US growth faltering faster than that of other economies has been weighing on the USD since January. Exhibit 3 shows the fall in the DXY index, a global benchmark for the value of the US dollar against a basket of foreign currencies, since then.

Exhibit 3

US dollar has been weakening since early January

Data as at 07/04/2025. Sources: Bloomberg, BNP Paribas Asset Management.

We expect China not to pursue currency devaluation since a stable exchange rate is still Beijing's policy. However, the central bank will likely tolerate a gradual and orderly depreciation to lessen the impact of the tariffs and stabilise the economy. In the 2018-19 tariff war, the renminbi fell by a total of 14% against the USD in two years.

Boosting domestic demand could be another way to counter the US tariffs. Generally, a country that runs a fiscal surplus is well positioned to take action to stimulate growth. Such moves could help retain investor confidence. Most Asian economies are running fiscal surpluses, giving them some defensive power to manage the shock.

Given China's still feeble economic recovery amid deflationary pressures, we believe Beijing will have to intensify policy support if it wants to achieve this year's target of 5% growth. Expect it to speed up planned measures and even introduce new stimulus.

RISKS GOING FORWARD

- A significant risk now is that the tariff shock will be magnified by retaliation. The US tariffs go into force on 9 April, so that is an important date in determining the scope for negotiation. China announced on Friday that it will impose reciprocal 34% tariffs on all imports from the US, effective 10 April. Similar responses from other trading partners would raise the risk of escalation and exacerbate uncertainty.
- Given the intricacy of supply chains in a globalised economy there is considerable scope for disruption beyond the direct impact of higher tariffs on import prices.
- Under a worst-case scenario, the selloff in equity markets could become disorderly that would add further to economic uncertainty and weigh even more on investment and spending decisions.

PORTFOLIO POSITIONING

Our equity portfolio management teams have been seeking to reduce risk since the policy announcements by trimming those positions vulnerable to a growth and/or tariff shock.

This has created some opportunity to rotate capital towards companies with strong balance sheets, minimum exposure to tariffs, domestic content manufacturing and supply chains and solid revenue backlogs given both revenue and earnings visibility.

Where appropriate we have shifted positioning to favour large cap companies with so-called long-cycle exposure

In multi-asset portfolios our equity exposures are broadly neutral relative to benchmarks. We continue to overweight gold and await more clarify on US policy before increasing fixed income risk positions.

Our fixed income team expect the US Federal Reserve to remain on hold initially, looking to manage the competing risks of higher inflation relative to weaker growth.

If the tariffs are sustained, we would expect the negative consequences for growth and employment to become apparent by September at the latest. This would lead the US Federal Reserve to continue cutting policy rates. We are positioning sovereign bond portfolios such they are overweight 5–7-year maturities in anticipation of a cycle of rate cuts by the Federal Reserve from September onwards and through into 2026.

On the basis that for the eurozone, tariffs are arguably a demand shock and disinflationary we are overweight eurozone duration and expect the European Central Bank to lower policy rates to 2% in 2025.

Given the considerable near-term uncertainty, we will update you on our analysis and positioning when there are significant developments.