Cetera® Investment Management

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Commentary

Possible Impact of Tariffs on the Economy and Financial Markets

- Over the weekend, President Trump imposed tariffs on imports from Canada, Mexico, and China.
- Using 2018 tariffs as a guide, similar policies can be expected to impact global economies and financial markets.
- With high uncertainty, diversification is even more prudent.

Over the weekend, President Trump signed an order imposing 25% tariffs on imports from Canada and Mexico, as well as 10% tariffs on China. There are partial exemptions such as Canadian energy imports that will be subject to a lower 10% rate. These tariffs on China, Mexico, and Canada may have broad-reaching effects on the economies of all these nations, global trade, inflation, and financial markets. Using 2018 tariff policies as a baseline, similar measures today may influence supply chains, corporate earnings, and consumer prices while contributing to market volatility.

U.S. Economy: The tariffs on China, particularly on technology-related imports, could lead to greater input costs for U.S. manufacturers. With China serving as a major exporter of electronics, machinery, and consumer goods, higher tariffs may also result in higher costs passed onto American businesses and consumers. Tariffs on Mexican and Canadian goods could disrupt the automotive, agriculture, and manufacturing sectors. U.S. businesses reliant on North American supply chains may face production slowdowns and reduced competitiveness in global markets.

Global Economy: The impact on the global economy may be substantial, as tariffs may contribute to slower global growth. However, the impact will not be equal across countries. Per U.K. based economic research firm Capital Economics, Chinese exports to the U.S. make up less than 3% of its GDP. Contrast this to Canada and Mexico, which exports to the U.S. represent close to 20% of their respective national GDP. Both countries will likely look to cut their interest rates and depreciate their currencies. The estimated decline in Canada's GDP is around 2.5% to 3.0%, while Mexico's GDP could decline around 2%. Retaliation should be tempered given the U.S. importance to the economies of both countries.

Inflationary Pressures: A tariff-induced rise in import costs will likely fuel inflation, as businesses pass some of these higher expenses onto consumers. The 2018 tariffs led to price increases in key consumer goods and these new tariffs could have a similar effect, particularly in technology, autos, and food products. With inflation likely rising, these price pressures could impact Fed interest rate policy, potentially delaying rate cuts.

Financial Markets: Similar to 2018, U.S. equities could see a selloff and increased volatility, especially in those sectors with significant global exposure such as technology, industrials, and consumer discretionary. With companies facing tariff-induced higher input costs and reduced demand, they could face margin pressures. Unfortunately, market valuations today are much higher than they were in 2018.

In 2018, the price-earnings ratio of the S&P 500 prior to tariffs were around 18.9x on future earnings (on January 26th of 2018). Tariffs and market volatility caused stocks to fall about 16%, when the P/E ratio of the S&P 500 bottomed out at 14.2x to future earnings on December 21st of 2018. Today's market valuation is much higher than 2018 with a P/E ratio of 22x to future earnings. Higher valuations have priced in market perfection and any uncertainty, such as tariffs, adds to worries and impacts market sentiment.

Overall, with this weekend's tariff news, we do expect U.S. equities to decline on less optimistic market sentiment, potential weaker economic growth, and corporate profit concerns. With that said, domestic sectors and asset classes less reliant on imports, such as small cap companies, may see relative outperformance and, if we use 2018 as a base case, any market sell-off could be short-lived. After the 2018 tariffs, equity markets returned to pre-tariff levels by mid-2019.

Looking at the bond market, inflationary concerns may lead to rising U.S. Treasury yields, putting downward pressure on long-term Treasury prices. Corporate bonds, particularly in trade-sensitive industries, could see widening spreads as investors price in economic uncertainty and potential earnings downgrades.

Capital Economics notes that the revenue from the tariffs could reach close to $250 billion a year for the U.S. That would equate to around 0.8% of GDP. If this revenue doesn't get infused back into the economy through tax cuts or increased federal spending, it could also drag down U.S. GDP, although it would reduce the federal deficit.

Tariff news over the weekend, along with elevated market valuations, adds risks to our current equity market outlook. A correction, or a 10% pull back from the peak, is possible. Corrections typically occur about once a year and the S&P 500 hasn't seen a correction since October 2023. We think it is prudent to be well diversified to mitigate risk. It is important to stay focused on your own long-term financial goals and avoid getting caught up in the market enthusiasm or trying to call the next bear market. As always, please consult your financial professional for guidance during these times.

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A diversified portfolio does not assure a profit or protect against loss in a declining market.

Glossary

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