Tariffs and Liberation Day: Are There Reasons to be Optimistic?

FOR FINANCIAL ADVISERS AND THEIR RETAIL CLIENTS

THE EXPERTS

Rob Gleeson
Chief Investment Officer

Ed Margot
Head of Client Investment Strategy

Greg Colley
Investment Strategist

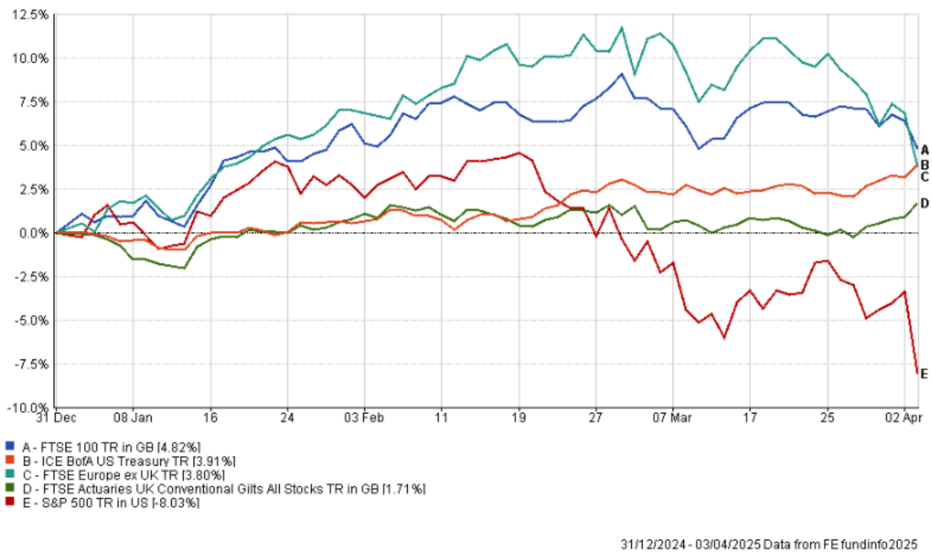
Toyosi Lewis
Retirement Investment Strategist

The threat of tariffs has been hanging over markets since Donald Trump was elected. It has been a mix of tariffs introduced, walk backs and renegotiation, retaliatory tariffs and escalation. Whilst the US president has been predictably unpredictable, tit-for-tat tariffs is likely the running order until there is some form of de-escalation.

Markets have reacted with conviction and in the last week we have seen some sharp falls in equity markets as investors priced in a recession in the US and corresponding falls in rates, while a weak economy burdened by tariffs seemingly puts paid to inflation concerns.

Higher risk investors and lower risk investors will be expecting different performance from their investments in the short term. In local currency (domestic currency terms) we can see that defensive investments have risen in a flight to safety. Riskier investments have fallen. Europe and the UK built gains earlier in the year while the US endured a little more uncertainty.

Chart 1 - Market Performance Since 1 January 2025



Source: FE Analytics, 4/4/2025. Total return, bid to bid in local currency

For a long while higher risk investors with more equity content in their portfolios enjoyed exceptionally strong gains while lower risk investors have endured lower returns from their lower risk investments.

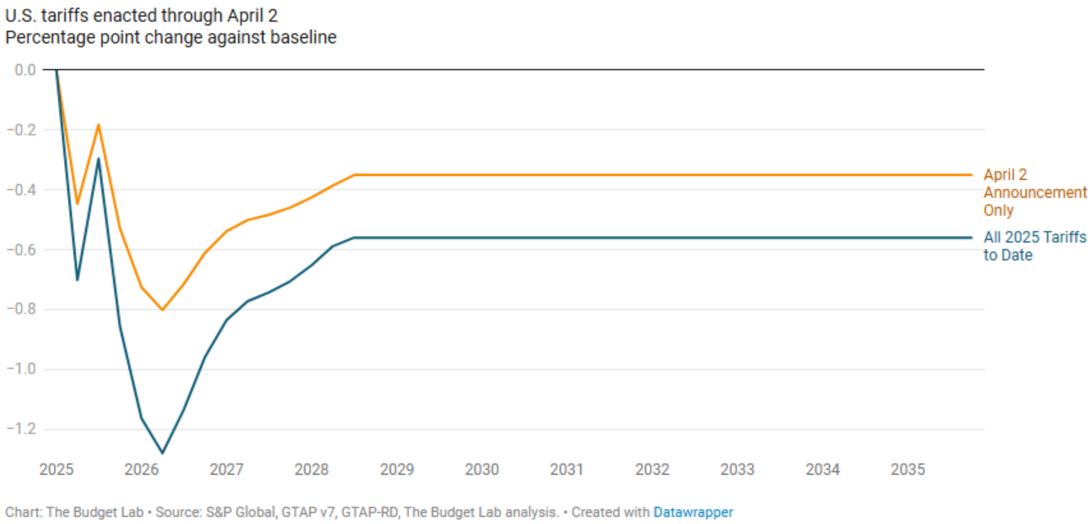
What we are seeing is some sort of reversion in returns. Investments pass through good times – sometimes exceptional – and languish over other times. Is it normal? We think so and with political and geopolitical uncertainty it makes sense that there has been a change in sentiment.

What about tariffs?

The overall effect of tariffs will affect inflation and growth. The tariffs introduced and analysed by independent policy research from The Budget Lab at Yale indicates that approximately 1.2% will be shaved from US GDP assuming all tariffs to date. The annualised rate of US GDP growth from Q4 2024 was 2.4%. This is not recessionary, however, markets have become very gloomy. Our view prior to the 2 April announcement is that a recession will be unlikely and slower growth more likely.

Confirmation bias would let us rest on these data, however, we will continue to assess changes to economic information as it evolves over the coming months.

Chart 2 - US Real FDP Level Effects of 2025 Tariffs



Source: The Budget Lab. Where We Stand: The Fiscal, Economic, and Distributional Effects of US Tariffs, 2/4/2025

What about inflation?

Markets have assumed inflation won't be an issue. Bond prices have risen, and yields fallen (as they are inversely related to each other). Usually if inflation is a problem bond prices fall as yields go up along with interest rates to slow the economy and cool inflation. Maybe markets have assumed a recession would deal with inflationary pressures from prices rising due to tariffs on top of goods or raw materials for goods entering the US. Maybe they have sold riskier investments and moved to bonds to reassess the outlook. Maybe it is a bit of both.

We cannot discount a spike in inflation, especially in goods, and with the recent rises in prices globally to keep inflation elevated above target, firms with pricing power may maintain the levels of price increases and inflation. Moving 12 months ahead, the effect of the spike should abate as long as tariffs settle.

Reasons to be hopeful

Sentiment has changed and markets have reacted sharply but further analysis has shown that the economic effect might not be as strong as sentiment. Growth seems to be trending lower, which is what we expected earlier in the year, but we are not seeing signs that the economy has stalled. Some economic information is trending slower which is what we have expected to see. US tax cuts or US interest rate cuts could also change the outlook and shore up markets so there is more to consider, and some scope to improve sentiment. A rate cut would signal that the Federal Reserve – the US central bank – will look through an inflation spike and support the economy.

Other geographies may be on better footing. Global trade is widely dispersed and Europe and China account for large swathes of trade. Germany for example has announced that it intends to free its fiscal buffers and spend more on defence and infrastructure which is positive, not just for Germany but its trading partners, including the UK.

Tariffs could also see other nations work more closely together. With the US 'sanctioning' itself, businesses and countries will likely aim to derisk in case the US continues its policy of isolationism. There was already a move for 'friend-shoring' or the production of goods by friendly nations – away from China – so the question is how to adapt and evolve in case there is a persistent shift in global trade.

Some nations can adapt to trade friction. China, for example, can devalue its currency versus the US dollar. If it allows the yuan to depreciate against currencies around the world it will reduce some of the inflationary pressures. Trade deals between other countries in a pact(s) outside of the US could also diminish pricing pressure and stimulate growth.

With all of the above considered there are reasons to be hopeful and a stronger case for diversifying portfolios globally. As for an isolationist United States of America, we have four years of the current president and then, change, maybe to a less frantic period in geopolitics.