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ASSET MANAGEMENT

RESEARCH INSIGHTS

THE PRICE OF PROTECTIONISM – HOW TARIFFS COULD IMPACT GROWTH

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Summary: The U.S. has added significant and broad-based tariffs that exceeded market expectations, while quickly evolving retaliation measures could worsen the macroeconomic consequences. Absent a significant pivot in trade policy, we expect global growth to meaningfully slow and inflation to move higher this year. This raises the likelihood of more forceful central bank easing, with the timing dependent on the speed at which growth slows.

Detail: Announced tariff policies represent a significant shock to what has otherwise been a decent U.S. growth backdrop. We view tariffs as a supply-side shock that reduces output while raising prices. Beyond direct transmission mechanisms, elevated policy uncertainty is likely to continue to be a drag on growth. A key focus of our analysis will be the *speed* at which growth slows. We would expect an economic downturn that occurs sooner and in a non-linear fashion to lead to earlier and more forceful Federal Reserve (Fed) policy easing. If inflation rises before economic activity materially worsens, we believe the Fed would be more patient in its response.

Given elevated uncertainty, we find it helpful to assess the economic outlook in terms of four major economic areas: corporates, consumers, fiscal policy and financial conditions:

- The U.S. corporate sector is entering the slowdown from a supportive starting point. Cash flow generation has been strong, robust profit growth has been supported by higher margins, and balance sheets are healthy. Policy risk could manifest in weakness via a few avenues. Margins could move lower as companies are forced to re-route supply chains and absorb some of the higher costs from tariffs. Also, continued tariff policy uncertainty risks corporations "pausing" investment decisions. Fed researchers have asserted that

trade policy uncertainty from the 2018-2019 trade war had adverse effects on Gross Domestic Product (GDP) and business investment. When trade policy uncertainty spiked in 2018, business fixed investment moved lower over the next several months, with the most weakness seen in equipment. Investment is one of the more volatile components of GDP and is typically the component that sees the most weakness in recession. So, while consumption represents the bulk of GDP at around 68%, swings in private business fixed investment, which represents 14% of GDP, should not be overlooked. Key indicators we will be watching include the new orders component of Purchasing Managers Index (PMI) figures, which have already shown signs of weakness. We will also look toward the change in capex intentions from regional Fed and small business surveys, and CEO confidence measures. Finally, the first quarter earnings season kicks off next Friday and will be key for insight into how companies are assessing the impact of tariffs.

- The U.S. consumer is also starting from a decent position, but we see high risk from the policy shock. Higher inflation risks eating into real income gains and weighing on consumer spending. This is particularly the case for lower income consumers who spend more of their income on non-discretionary items and have less flexibility to substitute. Regarding broader income growth, the April jobs report showed that the labor market remains on firm footing overall, consistent with jobless claims. With an average gain of around 150,000 jobs in the past three months, nonfarm payrolls are well above negative levels typically associated with recession. However, we do not believe recent labor market data reflects much of the impact from tariffs yet, and survey-based leading indicators of labor demand have pulled back. There is also risk to consumer spending from wealth effect drag. From 2019 through 2024, household net worth increased over $52 trillion, most of which accrued to higher income consumers who account for the lion's share of personal consumption. This coincided with consumers tapping into their savings to support spending. While previously a support, a meaningful decline in asset prices could present incremental consumption drag. In terms of seeing a consumer slowdown, some signs we will be looking for include a rise in initial jobless claims, slower income growth, cracks in high-frequency spending metrics and continued weakness in high income consumer confidence.

- Regarding fiscal policy, our top risk case heading into the year included disruption from trade policy. For now, we assume that trade policy remains a significant headwind on economic activity. It is possible that we will see some trade deals struck over the coming weeks, however, some of the more complex trade negotiations could take over a year. Moreover, while reciprocal tariffs are being

negotiated, it is probable that the 10% universal tariff is here to stay for the time being. Tariff revenues could equate to around 2% of GDP, which creates room for more meaningful tax cuts. As part of the broader fiscal package, Congress may attempt to raise the debt limit, which currently has an estimated X-date of sometime in the second half of this year. These fiscal negotiations will be important to keep an eye on.

- A key component of financial conditions is the Fed's reaction function to what we expect will be a lower growth, higher inflation environment. Without some signs of growth weakness materializing, the Fed policy decision is much trickier given inflation could be above-target and rising; even if tariff inflation impacts may only be temporary. However, if a growth slowdown does materialize, we would expect the Fed to ease earlier and more forcefully. Inflation expectations will be very important to keep an eye on, as a rise in market-based long-term inflation expectations (e.g., 5y5y forward) could limit the Fed's ability to respond to growth concerns. Outside of expectations for Fed policy, we will continue to monitor bank lending conditions, small business credit conditions, corporate spreads and financial condition indexes.

Potential upside surprises in the global financial landscape could stem from opportunistic trade agreements between the U.S. and individual nations, boosting international commerce. Lower-than-expected inflation shocks, driven by corporations effectively absorbing higher input costs, may stabilize economies, while increased hiring and growth among domestic firms signal a rejuvenated business environment. The prospect of an EU-U.S. trade deal could further enhance cross-continental collaboration, and substantial monetary and fiscal support across Europe and Asia could inject additional resilience and growth into these regions, fostering a more robust global economy.

Adverse shocks in the global economy could arise from escalating tensions between the U.S. and China, which might provoke foreign leaders to resist U.S. trade rhetoric. Higher tariffs could place unsustainable pressure on consumers, leading to retrenchment and weakening economic activity. This strain may exacerbate challenges in the retail sector, driving an increase in bankruptcies. Additionally, the Federal Reserve might find itself in a precarious position, reluctant to take aggressive actions amidst a trade war, potentially leaving the economy vulnerable to further shocks.

Given the uncertainties, please do not hesitate to reach out with any questions or concerns. We are happy to assist in any way we can.

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