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Tariffs: What they mean for investors' portfolios

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Key points from this article

- Mexico, Canada & China, representing c.40% of US imports, have been the focus of the US's initial tariff announcements. This has led to investor concerns, most notably in sectors felt most at risk e.g. Oil and Gas and Auto Manufacturing.
- To date, despite the considerable tariff uncertainty, markets have been resilient. For example, equities have performed well, (with value stocks outperforming their growth counterparties) and bond yields have fallen (i.e. prices up).
- Looking forward, a range of potential scenarios could play out, each with different implications for investment portfolios. This is why it's very important for portfolios to be scenario tested and be well diversified between and within asset classes.

"Tariff" is already the front runner for 2025's word of the year, with the subject dominating financial and political headlines ever since President Trump was inaugurated in January. In this article, we provide our thoughts on key questions from advisers and investors.

Background

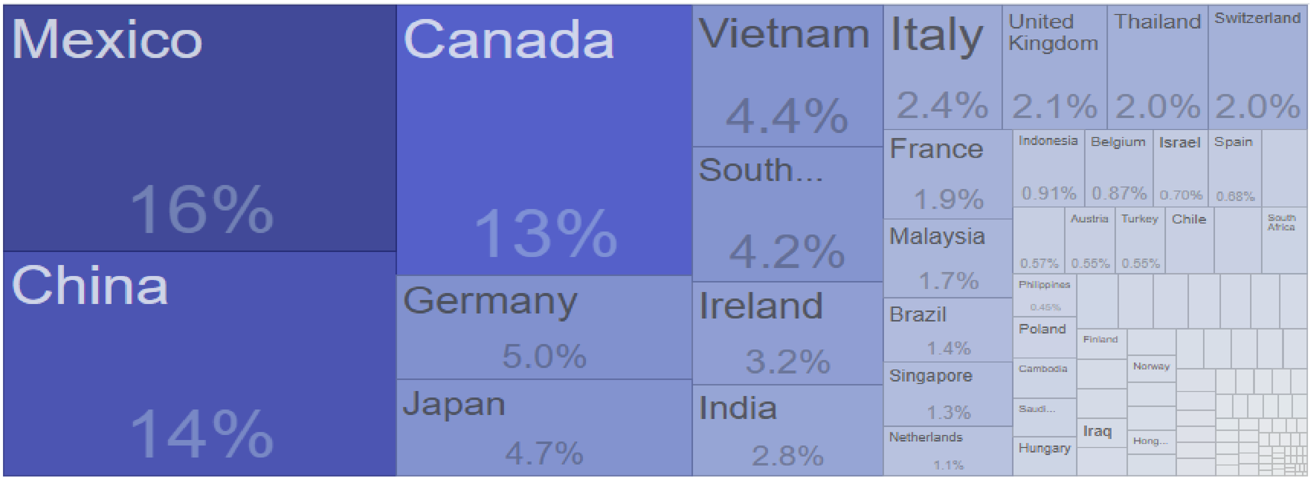
Tariffs are taxes paid by firms importing international goods and were a big part of President Trump's election campaign. On the campaign trail, President Trump spoke of a 60% tariff on all Chinese imports and a 10-20% universal tariff on all other imports. Many thought it might be rhetoric, but it seems he wants to follow through on plans. Among the tariffs announced initially were 25% tariffs on Mexico and Canada (excluding Canadian oil, which would be at 10%) and an additional 10% on Chinese goods. Combined, these policies would quadruple the US effective tariff rate from 2.4% to 10%. The Canadian and Mexican tariffs were subsequently delayed, a day before implementation, however the tariffs on China went through. In February, Trump also subsequently announced a 25% tariff on all steel and aluminium imports which is expected to take effect on 12th March. There's also the prospect of "reciprocal" tariffs being put in place for those that impose tariffs on US goods, setting the stage for a tit-for-tat trade war.

What does this mean for the global economy?

President Trump has made it clear that trade deficits are a key focus for him i.e. where the US imports more than they export (chart 1 below shows United States Imports by country). Given this, Mexico, Canada and China, who in aggregate represent around 40% of US imports, have been in his sights.

Europe is also holding its breath. The EU bloc accounts for approximately 15-20% of US imports, with machinery, pharmaceuticals and chemicals among its top exports to America. Europe's automotive sector is also exposed to tariffs, with European car manufacturers exporting roughly $40bn of cars and components to the US.

Chart 1: United States Imports by country



Source: Trading economics/UN Comtrade

Until all the dust settles, and people know the lay of the land, it's going to mean lots of uncertainty- which no one, especially investment markets, likes. A big question that economists and markets are trying to get their head around is, will the cost of tariffs be passed on to consumers i.e. potential inflationary shock? Or will they be absorbed by companies i.e. potential earnings/growth shock? Neither outcome is positive. The preferred route might also vary per company or industry therefore, the implications could vary per country. Ultimately this may result in dispersion of global interest rates with some countries being more willing to cut interest rates than others. This might mean there is a prospect of higher interest rates in the US, which could be a challenge for President Trump, who has made clear he wants borrowing costs to fall “a lot”. Europe looks more susceptible to a growth shock meaning interest rates may be allowed to fall further.

What do Tariffs mean for the UK and its economy?

Only 15% of British exports make their way to the US, so if tariffs were to be enacted, the overall direct effect would be small, albeit the impact may be more acute on certain industries like whisky e.g. the 2019-2021 25% tariffs on whisky was thought to cost an estimated 33% of revenue to whisky companies compared to a counterfactual scenario with no tariffs. Machinery and transport equipment were the UK's largest sectors for exported goods, with £27.2bn of exports, making up almost half of all goods exported to the United States. This included £6.4bn of car exports - the United States were our largest export partner for cars.

It's important to note, it remains unclear as to whether the UK will be dragged directly into the tariff war. Trump so far has spoken more positively about the UK than its other trading partners. This may be due to Trump's Scottish roots, but most likely it's because, according to US figures, the US ran an overall trade surplus with the UK in 2023. Interestingly, the Office for National Statistics reports that the UK also ran a trade surplus with the US. The statistics offices across the Atlantic are aware of the discrepancy, thought in part to be due to the US taking into account Channel Islands and Isle of Man, where the UK figures do not.

Overall, there is a general thought that President Trump's tariffs will be stagflationary (pushing up inflation while hurting growth) for the UK, even if the country avoids being directly hit by US levies; concerns over rising prices and slowing global growth would have knock-on implications for UK growth.

How are global stock markets reacting to all this news?

On the whole, markets have been remarkably resilient. For example, at time of writing, the Vix index, a measure of equity market volatility (known as Wall Street's “fear index”) remains relatively low. Equities have done well, with Value stocks outperforming their Growth counterparts (interestingly Europe, one of the main regions concerned about tariffs, is among one of the stronger regions year to date). Bond yields have fallen (i.e. prices have risen), as concerns over the economic growth impact comes into focus. Commodities have also done well as investors have sought to shore up supply but also to hold for some diversification, in the case of gold.

There are various potential reasons why the markets have been so resilient, including:

- Investors are not taking President Trump seriously and ultimately believing it is a negotiating tactic.
- Companies are better insulated from trade shocks, Covid may have helped build this resilience.
- Much of the bad news is already priced in at the time of the election victory.

It’s hard to know which of these is true, but if it’s the first scenario there is a risk of market complacency which would cause investors the biggest headache if they are proven wrong.

What does this mean for investors’ portfolios?

Ultimately there remains a lot of unknowns, so for us it’s about what different scenarios might play out and what this may mean for our portfolios under each scenario. Three potential scenarios we see are:

- “Deal”;
- “Stick to the election promises”; or
- “No Deal”

“Deal”

In this scenario a combination of negotiations and market volatility would cause a rethink of tariff policy. Whilst there could be significant short-term volatility, equity markets could be supported by deregulation and modest fiscal measures. This seems to the market’s base case this time.

“Stick to the election promises”

The impact on markets would be more disruptive, with the initial economic impact likely to be stagflationary. In this scenario, rising inflation would potentially prevent the US Federal Reserve from cutting rates; equity market volatility could rise as business confidence falls, while alternatives, in particular real assets e.g. infrastructure, could help. Within equities, Income and Value strategies may do best on a relative basis. One positive to take would be that there would be less uncertainty with no negotiations and no tit-for-tat ramp up.

“No deal”

Which is our extreme risk scenario; with a return of average US tariff rates to a level last seen in the 1930s. This scenario would see significant effects on global trade. Bond markets would rally and, despite fiscal stimulus, risk markets might struggle.

Given all the uncertainty at this stage, it’s really important to understand how your portfolio might perform in different scenarios. To assess our portfolios’ robustness we forward test them against a broad range of scenarios. We also look for them to be well diversified between and within asset classes - we believe it is especially important for portfolios to be well diversified by region and investment style at this time to help navigate this uncertainty.

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