SALT INSIGHT

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Uncertainty morphs to hard, cold reality

As we entered 2025 and started to pen our thoughts on the outlook for 2025, the most obvious theme at that point was "uncertainty". We knew Donald Trump had won the US presidency, we knew what his key economic policy platforms were – tariffs, tax cuts, immigration and deregulation - but we didn't know exactly what would be implemented, when it would be implemented, nor in what sequence.

A short two months on and the uncertainty is turning to a hard cold reality. Tariffs of 25% on imports from Canada and Mexico became effective on March 4th, along with a doubling of the 10% tariff on Chinese goods that was imposed in January. Trump claimed that none of these countries had done enough the stem the flow of fentanyl into the US, the crisis that enabled him to bring in tariffs under executive order.

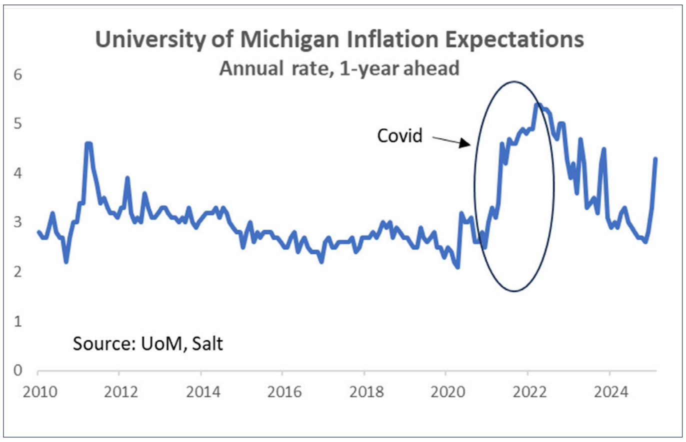
China responded immediately after the deadline, announcing additional tariffs of 10-15 percent on certain US imports from 10th March and a series of new export restrictions for designated US entities. Canada responded with an immediate 25% tariff on US$20.7 billion worth of US imports, and another US$86.2b if Trump's tariffs were still in place in 21 days. Mexico will announce its own retaliatory measures in a matter of days.

President Trump has also signalled a series of new tariffs targeting key industries and other major trade partners. He stated that his administration will soon implement a 25% tariff on imports from the European Union, particularly on automobiles and other goods. This move is in retaliation to what he perceives as an unfair European tariff system, where the EU imposes a 10% tariff on U.S. passenger cars compared to the U.S.'s 2.5% rate on European cars.

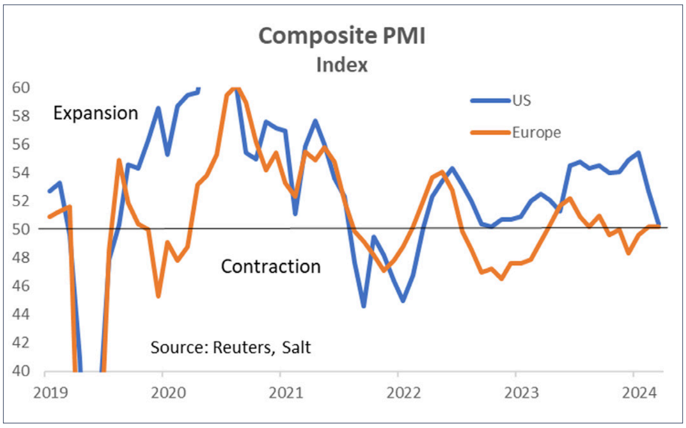
Additionally, Trump unveiled tariffs on pharmaceutical products and microchips, which will start at 25% and could increase further over the next year. He also emphasised incentives for companies with partially U.S.-based manufacturing to relocate production domestically to avoid these tariffs.

Weakness in the "soft" data to become weakness in the "hard" data

Increasing concern amongst consumers and businesses has been reflected in lower sentiment ("soft" data) levels. Consumer confidence has tumbled recently, threatening what has been quite remarkably resilient consumer spending. Both the University of Michigan and Conference Board surveys have seen sharply lower confidence levels, driven predominantly by rising inflation expectations.



Latest US Purchasing Manager Indices (PMI's) from S&P Global showed a second consecutive significant decline in the composite (manufacturing plus services) index. Over the last two months the index has fallen from 55.4 to 50.4 in February. 50 is the dividing line between expansion (over 50) and contraction (under 50). This is the lowest level since September 2023. Policy uncertainty, especially relating to tariffs, and rising costs copped most of the blame.



With higher tariffs now a reality, the weakness in the "soft" data can be expected to flow through to the "hard" data, or actual activity levels, ending the period of so-called US exceptionalism. Consumer spending will be softer as prices rise and firms will likely cancel or, at best, delay hiring and investment decisions until the impact of the tariffs is clearer.

Inflation: transitory or persistent?

The critical question, particularly for interest rate markets, is the extent to which the Federal Reserve can respond to lower growth by cutting interest rates. We think they will have little room to move – if any.

Higher tariffs will manifest as either tighter margins and lower profits for firms or higher prices for consumers. We think US firms still have sufficient pricing power to pass the tariff impost on to end consumers. And if you can, why wouldn't you?

The direct impact of any given tariff impost will be transitory, but we've seen this play book before. Our concern is that consumers will seek to recoup lost purchasing power via higher wage demands, and that these wage demands will likely be successful in a tightening labour market, as another key plank of the Trump administration's policy program – immigration – manifests.

President Trump's immigration policies, including stricter border controls, reduced visa issuance, and heightened deportation efforts, are likely to result in a tighter labour market by limiting the supply of foreign workers, particularly in sectors that rely heavily on immigrant labour, such as agriculture, construction, and hospitality. With fewer immigrants entering the workforce, businesses may struggle to fill these jobs, potentially driving up wages as employers compete for a smaller pool of available workers. Indeed, it was rising immigration boosting labour supply that was a key factor in bringing wage growth back under control in the aftermath of the pandemic.

Much like the Covid experience, if the Fed focuses on just the first-round transitory direct effects of higher prices, they could end up being wrong on the more persistent bit - again.

Nobody wins

We've said this before, but it is worth repeating: President Trump's tariff policies and the inevitable retaliatory measures from other countries create a lose-lose scenario for all involved.

Higher tariffs raise costs for American businesses relying on imported goods, leading to increased consumer prices and reduced purchasing power. U.S. exporters face retaliatory tariffs, making their products less competitive overseas, harming industries like agriculture and manufacturing. Global supply chains suffer disruption, slowing economic growth and reducing investment. Other countries also experience economic strain, fuelling uncertainty and market volatility.

In the end, no one truly benefits—businesses, consumers, and workers alike bear the costs of trade wars and protectionism.

Market implications

Equity markets will continue to react negatively as the trade war escalates and firms face increased costs, disrupted supply chains and lower growth. We are wary of lower bond yields as we think the assumption that the lower growth automatically means lower inflation and lower interest rates will be challenged by the reality of former wage growth and a reacceleration of inflation. In this environment of lower growth and higher inflation, we continue to maintain our allocations to listed real assets (global infrastructure and global property). These asset classes have performed well so far this year, accruing positive returns in both January and February, against a backdrop of deteriorating sentiment for more economically-cyclical shares.