MARKET COMMENTARY

US tariff surge sparks recession fears

Macro and Market Research

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- **The tariffs announced yesterday by the Trump administration were steeper than most analysts expected, raising average US tariffs to just under 30%, the highest level since 1920. They will target countries with large bilateral trade surpluses, particularly in Asia.**
- **Mexico and Canada have been exempted, and previously announced auto tariffs are included in the new rates. The ambiguity in the wording of the executive order gives the administration ample room for manoeuvre in up-coming negotiations with trading partners, but in the short term we do not expect any de-escalation.**
- **The EU will likely retaliate in a smart way, using the new Anti-Coercion Instrument which foresees an ample range of measures aimed also at critical US services export.**
- **US will be hit much harder than its major trading partners. Tariffs are likely to cost the US around 1.5pp of GDP by year-end against 0.5 for China and the EU. We now expect the Fed to cut rates three times this year, to 3.5-3.75%. We also add a third cut for the ECB, to 1.75%.**
- **We are probably past peak uncertainty, but uncertainty will remain strong. We see euro area yields bottoming by the summer, while UST may have further scope to decrease. Growth worries and uncertainty will likely continue to weigh on the dollar,. Equities may experience a prolonged sell-off, but we remain constructive medium term.**

Tariff hikes are a game changer: The US will impose a universal 10% tariff on all trading partners. The 60 countries with which the US has the largest trade deficit will also be subject to an "individualised reciprocal higher tariff", which is also intended to take account of non-trade barriers. This has apparently been calculated simply as half the ratio of the bilateral trade deficit with a country to the import flows from that country, which is a rather heterodox way of calculating tariffs.

$$Tariff\ to\ country\ i = 0.5x\frac{Import\ from\ counry\ i - Export\ to\ country\ i}{Import\ from\ counry\ i}x100$$

Tariffs will not apply to gold bullion, energy products and minerals not found in the US, semiconductors and pharmaceuticals. Cars and car parts, which are already subject to the 25% tariffs coming into force today, will be spared. Tariffs will begin to be collected next week. Mexico and Canada have been exempted from this round of tariffs for the time being, with only those in place since yesterday applying.

Tariffs are much higher than expected, but there is still room for negotiation: The actual tariffs are at the upper end of analysts' forecasts and show a very high degree of differentiation, with poorer, more export-oriented countries being hit the hard-est. The hit on the EU is not entirely surprising, given the hostility of the administration, but the hit on Korea and Japan is striking, given their close political and military partnership with the US. It is also important to note that the very high level of tariffs imposed on Asian producers would make it unprofitable to divert Chinese exports, which will amplify the inflationary shock to US good import.

Country	New Tariff	Total Rate
China	34.0%	54.0%
EU	20.0%	22.0%
UK	1.3%	11.3%
Japan	1.5%	25.5%
Korea	25.0%	25.0%
Vietnam	46.0%	50.0%
India	26.0%	28.6%
Taiwan	32.0%	33.3%
Thailand	36.0%	38.0%

The executive order announcing the new measures states that the president could 'reduce or limit the scope' if a targeted country 'takes significant steps to remedy non-reciprocal trade arrangements and sufficiently align with the United States on economic and national security matters'. This is extremely vague and will give the US administration plenty of room for manoeuvre. Additional restrictions will be imposed on countries that retaliate.

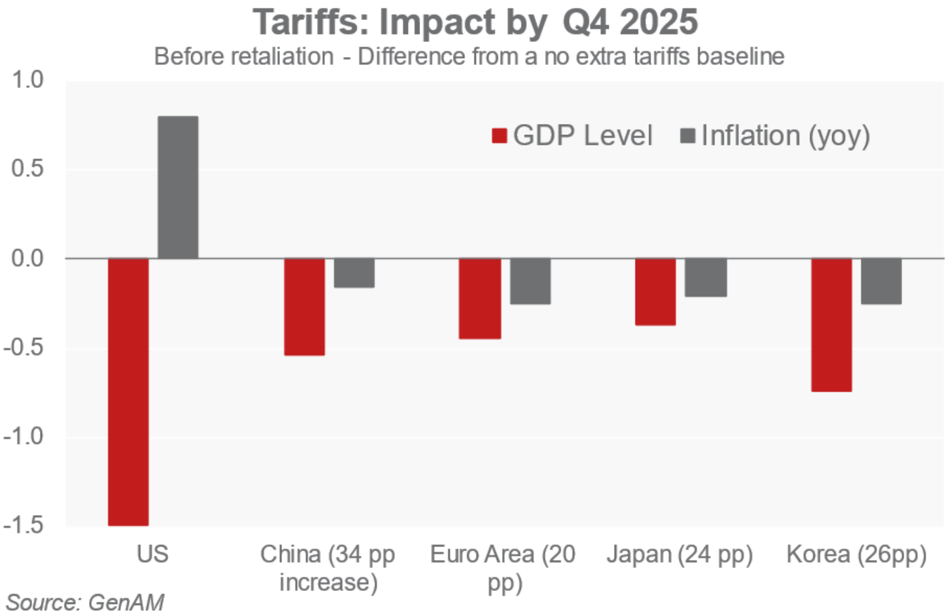
The close relationship between the tariff rate and bilateral imbalances would seem to suggest that deficit reduction/reshoring in manufacturing and income generation is the main objective of the measures, which would leave relatively little room for debate. However, as we show below, the short-term pain to the US economy would be significant and greater than that of most trading partners. Under the (increasingly questionable) assumption of some cost-benefit assessment, and given the vague wording of the statement, we think there is room for de-escalation.

EU still prefers negotiations but is ready for retaliation: The statement of President von der Leyen in response to the US tariffs maintained a constructive tone showing willingness to remove remaining barriers to trade with the US. While stating that it was not too late to negotiate, she also made very clear that countermeasures were in the offing. Moreover, she also stated that the EU was not willing to absorb global excess capacity or accept dumping on its market suggesting that tariffs against third countries (especially China and other large Asian manufacturers) are also on the table.

We deem it most likely that the EU will in the coming weeks try to get the just announced tariffs off the table by offering negotiations and maybe making some concessions. However, if that fails it will retaliate proportionally in our view. There are further possibilities apart from reciprocal tariffs to retaliate. The broadest and in our view appropriate tool is the Anti-Coercion Instrument (ACI) which covers areas such as trade in goods, services, foreign direct investment, financial markets, public procurement, trade-related aspects of intellectual property rights, export controls, and more. An advantage of this instrument is that it doesn't automatically put-up countermeasures but first starts with “cooperative engagement” between the two parties. This would be consistent with the tone adopted by Mrs von der Leyen. A more focused instruments would be imposing technical barriers to trade. Other possibilities like the International Procurement Instrument and anti-dumping measures are designed for the case of local content requirements and subsidies for the exporting country, both is not the case here.

Tailored and selective retaliation is in the EU's best interest as, for example, 23.1% of imports from the US in 2024 were energy. Making relatively price-inelastic energy more expensive would have a very immediate impact on prices. Another issue is the continued need for imports of military equipment to support Ukraine and rearm Europe, especially Germany. In this context, targeting digital services could be an alternative. More generally, comments from EU officials suggest that, while trying to minimise the negative domestic impact, goods produced in pro-Trump states will be in focus.

US hit much harder than partners: Assessing the economic impact is not straightforward, as the list of exemptions could grow. We have plugged the announced tariffs at face value into a large macroeconomic model (The Oxford Economics Global Economic Model) and calculated the difference from a baseline containing only the measures announced before yesterday, with no assumption of retaliation by trading partners. The chart below shows the results of this rough simulation. The US is hit much harder than other trading partners, with low activity and higher inflation by the end of 2025. For the other countries, inflation would fall, mainly due to the impact on oil prices, by 6% relative to the baseline. The full impact on the euro area will depend on the extent to which Asian producers will try to reroute export to Europe. This may trigger further deflation.



Source: GenAM

Steeper Fed and ECB rate cuts: The Fed will find it hard to react. According to the model run, it should cut again in Q4, when the unemployment rate would be almost 0.5pp higher than in the baseline. However, core PCE inflation would be 1.1 pp higher, which could prevent rapid easing. Despite higher inflation, we expect the Fed to cut three times (June, September, December), instead of two as we had in the previous baseline forecast, bringing forward one of the two cuts we expected for 2026; the Fed funds rate will then stand in the 3.5%-3.75% range by year end. The ECB is torn between the demand- and price-boosting effects of the German bazooka and the opposite effects of tariffs. As it stands, the tariffs have just been introduced and will remain in place for the time being, while the fiscal tailwind will only kick in later, mainly supporting growth from 2026 onwards. Governing Council members expect a reduction in euro area growth of 0.3 to 0.4 pp within a year. Retaliation will increase these losses. Our simulations suggest that higher inflation would only come from EU retaliation, but as the EU will choose its countermeasures carefully, the negative output effect is likely to dominate. We now expect the ECB to cut back to 1.75% from the current 2.5% (not clear what our previous scenario was) and look for 25bp cuts in April, June and July.

Risks are two-sided. De-escalation is slightly more likely but not immediately. It is unlikely that the Commission will not respond, and a very forceful retaliation would trigger higher US tariffs and the risk of a full-blown trade war, which could encompass non-economic issues like NATO. As we approach to the November 2026 mid-term election (and probably already by the summer), some relief is likely as the Republican Party will have to tackle more seriously the damage done to the economy.

Market impact:

Rates: Yields on international government bond markets had already fallen sharply in recent weeks in anticipation of the US tariff announcement. However, the higher-than-expected tariff rates caused yields to drop sharply again today. Short-dated bond yields have declined in anticipation of further key rate cuts. With little prospect of de-escalation in the short term and looming retaliation from other countries, we believe there is still downside potential, especially at the long end of the curve. We do not forecast a lasting rally, given the current levels. Euro area core yields are likely to bottom out in the second half of the year as the effects of the fiscal paradigm shift in the euro area slowly take hold. Our long UST view has proven right and US yields still have the potential to fall further as the year progresses, but there is a risk the Trump administration will compensate the growth hit with even more tax cuts / fiscal easing, which would quickly put a floor on long rates. We maintain our preference for EM external debt over local debt with a defensive bias that favours IG over HY. Risks are skewed for wider EM spreads, but the move will be limited by the initial strong economic fundamentals. The weakening of the USD and the resilience of EM FXs eventually make local debt more attractive. EM rates should continue to decline as central banks have room to cut further. LatAm will be less affected while Asia is the most vulnerable. In EMEA, we are neutral on CEE countries that could benefit from a stronger EUR and the German fiscal package. Middle East countries look more immune.

Credit: The negative impact on global growth is of course not positive but we believe that our case for a long recommendation on credit versus government bonds remain intact. Recession is not our central scenario, so we expect defaults to remain under control over the coming months. We believe that amid lower rates the demand for credit is likely to remain strong particularly in IG. HY being more volatile of course more vulnerable, but we believe that it will remain much more resilient than equities

FX: The USD further weakened against the EUR, but Asian Currencies weakened and are poised to suffer further, while The Canadian Dollar and Mexican pesos will benefit from the lack of additional tariffs. The theoretical upside push from tariffs to the USD has been so far more than offset by the heightened risks of a hard lending and a sharp drop in interest rates. Moreover, unpredictable policymaking, and the apparent lack of any economic rationale could harm the safe-haven status of the USD.

Equity: The pressures on EU stocks add to those on China, Moreover, Chinese goods diverted from the US market might flood the European market, increasing competition for local businesses and representing a double whammy for EU firms. While future negotiations are not excluded, in the short term, news of retaliation against US goods could prevail. In such circumstances, analysts will continue to slash macro and earnings forecasts, before any central banks reaction. For these reasons, the market could experience a prolonged sell-off, which we estimate could bring the S&P 500 down to around 5,200 (-5.5% and 13% from the recent peak), with a similar percentage for EU stocks. Our estimate does not contemplate a recession scenario, which would bring us further down (nearly -25% from the peak). For the time being, our mid-term view remains constructive, albeit with lower total returns than previously estimated.