US

# Promises: Tariffs Hit Markets

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Liz Ann Sonders
Kevin Gordon

The Trump Administration's plans to put tariffs on imports from Canada, Mexico, and China have the potential to dent economic growth, boost inflation, and raise uncertainty.

Talk about a moving target. On February 1, President Donald Trump announced the imposition of new tariffs on imports from Canada, Mexico and China, citing national security concerns under the International Emergency Economic Powers Act (IEEPA). These tariffs were set to take effect tomorrow, February 4, before Claudia Sheinbaum, the president of Mexico, announced this morning that the tariffs on imports from Mexico had been delayed by a month (as of the time we're putting this report together), with no word yet from Canada, other than some retaliation announcements.

Tariffs delayed doesn't necessarily mean tariffs canceled. So, while we wait for further details, we thought it prudent to go through the impacts of what has been proposed by the Trump Administration; while keeping in mind that per the developments this morning, timing, scope and scale can change quickly. Per President Trump's initial announcement, a 25% tariff will be applied to all imports from Canada and Mexico, with the exception of Canadian energy resources (including oil, natural gas, and electricity), which will face a 10% tariff.

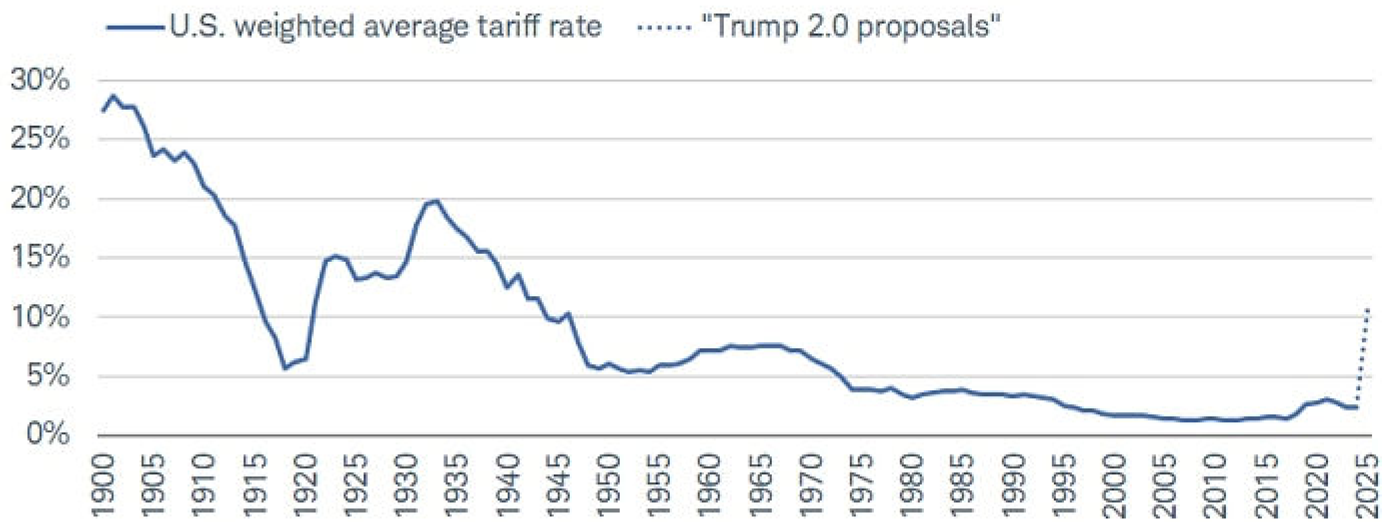
An increase of 10 percentage points will be imposed on all imports from China. As a reminder, the existing four tranches of tariffs on imports from China came into effect in 2018 and 2019. The new tariffs will increase the weighted-average tariff rate by 10 percentage points to 24.5%. The actual impact will be more significant given the removal of the *de minimis* exemptions for imports of less than $800. The Trump Administration is apparently also considering tariffs on the European Union.

Before getting to the meat of the implications associated with these new tariffs, let's get what should be mundane—but surprisingly isn't—out of the way. There is short-hand often used to describe tariffs; nearly always by the Trump Administration, but often by the media as well: "tariffs on Canada" or "tariffs on Mexico" or "tariffs on China." A tariff is essentially a "tax" imposed on foreign-made products, and paid by the importing business to its home country's government. Who ultimately bears the cost is dependent on a host of factors; including retaliations, exchange rate moves, companies' (on both sides of the tariffs) pricing power and/or ability to pass higher costs on to consumers, and price elasticities.

# Devil in the details

Using Bloomberg Economics data, the announced tariffs will impact $1.3 trillion in trade, representing 43% of U.S. imports based on 2023 data, and close to 5% of U.S. gross domestic product (GDP). As shown below, the action will raise the average U.S. tariff rate from its current level of about 3% to 10.7%, based on current import patterns. Assuming they go through, it is likely to deal a meaningful blow to the U.S. economy, while putting upward pressure on inflation. The hit to Canada and Mexico is expected to be significantly higher.

## Tariff rates go parabolic




Source: Charles Schwab, Census Bureau, U.S. International Trade Commission, Bloomberg Economics, as 2/2/2025.

"Trump 2.0 proposals" assumes 25% tariff on imported goods from Mexico and Canada (with Canadian energy imports facing a 10% tariff), as well as a 10% tariff on imported goods from China. Weighted average applied tariff is the average of effectively applied rates weighted by the product import shares corresponding to each partner country. Forecasts contained herein are for illustrative purposes only, may be based upon proprietary research and are developed through analysis of historical public data.

# Hit to GDP

The Federal Reserve estimates that tariff impacts could knock 1.2% off U.S. GDP and add about 0.7% to the core Personal Consumption Expenditures (PCE) measure of inflation. Those estimates assume retaliation from the targeted countries. For Canada and Mexico, it could mean a quick move into recession territory, with 14% and 16%, respectively, of their GDP directly dependent on exports of goods to the United States; although the energy adjustment may ease some of Canada's pain. In the case of China, it's estimated that only 2.3% of its GDP is at risk.

As noted, all three trading partners have retaliation plans. According to Bloomberg, Canada announced 25% tariffs on $106 billion worth of goods, representing about 20% of its good imports from the United States. Mexico and China have yet to release detailed plans of their retaliation efforts.

## What about U.S. exporters?

Most of the focus of tariffs' impact tends to be about U.S. importers (again, they pay the tariffs). But U.S. exporters are at risk, too, courtesy of the aforementioned retaliation plans. In 2023, U.S. exports of goods to Canada, Mexico, and China amounted to 1.3%, 1.2%, and 0.5% of U.S. GDP, respectively. According to Bloomberg, stripping out the foreign components embedded in those products, it's estimated that about 2.5% of U.S. GDP is directly exposed to its goods exports to the three countries. The export-related impact on the U.S. economy may be somewhat muted, but certain sectors may feel the pain more acutely, with agriculture likely prime among them.

## Markets not taking it well

In the pre-market session on Sunday, U.S. stocks began taking it on the chin, with the U.S. dollar and oil prices surging. Shown below, while S&P 500 futures sold off pre-market open, stocks recovered some losses in the aftermath of the announced delay of tariffs on Mexican imports.

**Stock futures disliked tariff news**


Source: Charles Schwab, Bloomberg, as of 2/3/2025.

Futures, and Futures options trading involves substantial risk and is not suitable for all investors. Please read the **Risk Disclosure Statement for Futures and Options**: https://www.schwab.com/Futures_RiskDisclosure prior to trading futures products.] Indexes are unmanaged, do not incur management fees, costs and expenses and cannot be invested in directly. **Past performance does not guarantee future results.**

Conversely, the U.S. dollar initially jumped on the prospect of tariffs being both inflationary and delivering a larger hit to other countries' growth, but retreated a little throughout the day. All else equal, hotter inflation would likely keep the Fed from cutting rates sooner, which would in turn result in a stronger dollar. We think the door has likely been shut in terms of additional rate cuts by the Fed at any of the upcoming few meetings.

## Dollar pops higher


Source: Charles Schwab, Bloomberg, as of 2/3/2025.

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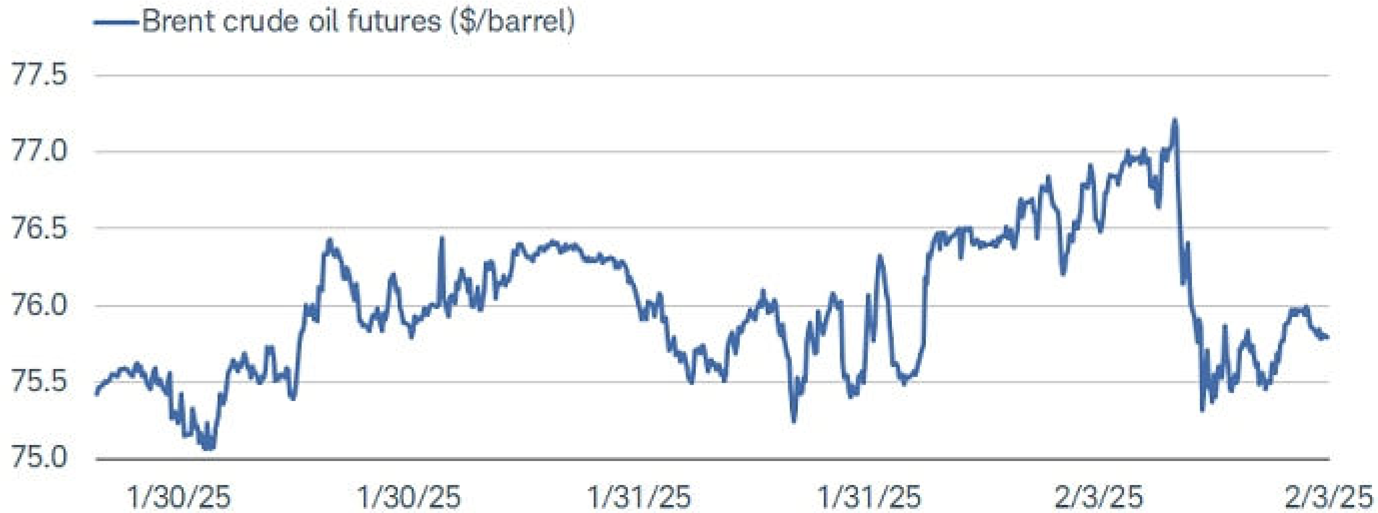
Brent crude oil futures initially moved higher but then dropped sharply, as shown below. The move up was likely driven by the additional 10% tax that is now being proposed for imported energy from Canada. The move down came after reporting that Trump spoke to Canada's Justin Trudeau about the tariffs. If anything, that underscores how markets will continue to be whipsawed by the news.

## Oil futures gyrated on tariff news




Source: Charles Schwab, Bloomberg, as of 2/3/2025.

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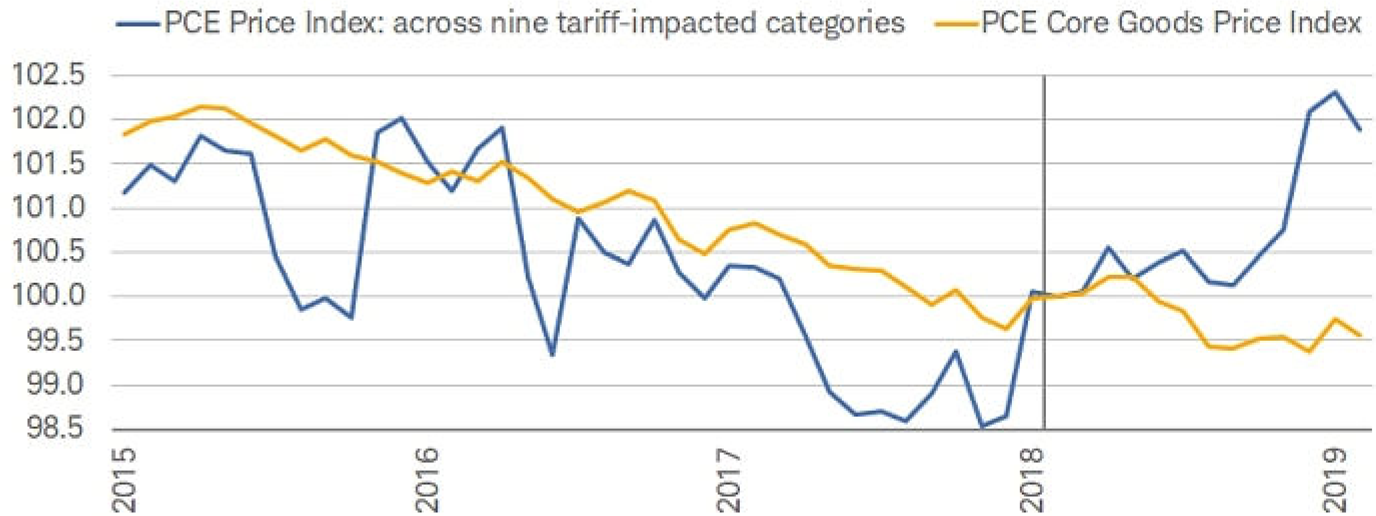
Those in favor of tariffs often cite the lack of inflation that occurred during the 2018 trade war. Indeed, broad measures of inflation remained contained, but the background macro conditions were quite different that year relative to the current environment. In addition, the tariffs in 2018 were significantly lower and more targeted relative to what has been announced most recently. Finally, there actually was an inflation impact on those goods on which tariffs were placed in 2018, as shown below.

### Targeted goods' inflation in 2018




Source: Charles Schwab, Bloomberg, as of 12/31/2019.

Data indexed to 100 (base value = 2/28/2018). An index number is a figure reflecting price or quantity compared with a base value. The base value always has an index number of 100. The index number is then expressed as 100 times the ratio to the base value. Nine tariff-impacted categories include: Sewing, household appliances, furniture and furnishings, carpets and floor coverings, auto parts, household linens, motorcycles, sport and recreation vehicles, and household supplies.

## Negotiating tool?

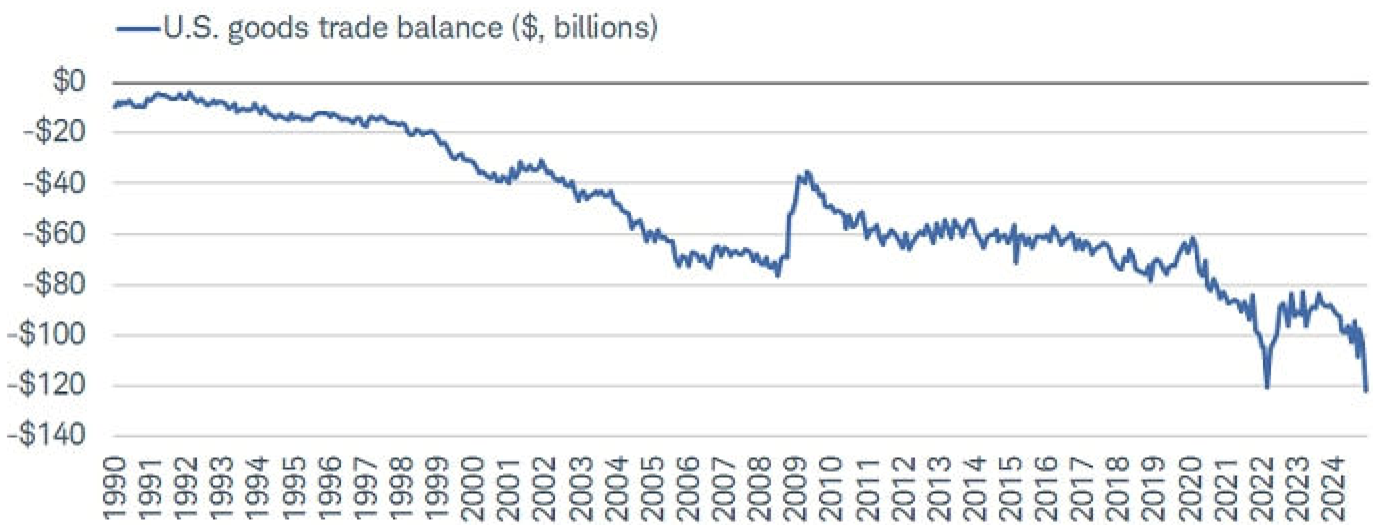
There were many hoping and/or assuming that Trump saw tariffs as a negotiating tool. We're not sure there was obvious justification for that view; and in fact, when asked by reporters (at the White House after signing the executive order) whether Canada, among others, could do anything to forestall the tariffs, he stated simply, "no." He then specifically emphasized that the tariffs are "not a negotiating tool" but are economic measures aimed at addressing trade deficits with the targeted countries.

We all continue to be in wait-and-see mode; not dissimilar to the 2018 trade war experience. We've already read numerous headlines suggesting these tariffs might quickly be reversed (before they've even kicked in). We're not sure where those clear crystal balls are being sold, but if someone knows, let us know.

# Trading places

Not unique to this most recent trade dispute is President Trump's dislike of trade deficits. In both his first and (still very new) second terms, he has often expressed that he would like to see a "closing of the gap" between the United States and other countries. There are several difficulties associated with that, though, not least being the fact that the United States is a net importer. Shown below is the U.S. trade balance of goods. Not only has the United States been in a deficit for decades, the deficit widened to a record at the end of 2024—thanks to a strong consumer (perhaps front-running some purchases in anticipation of tariffs).

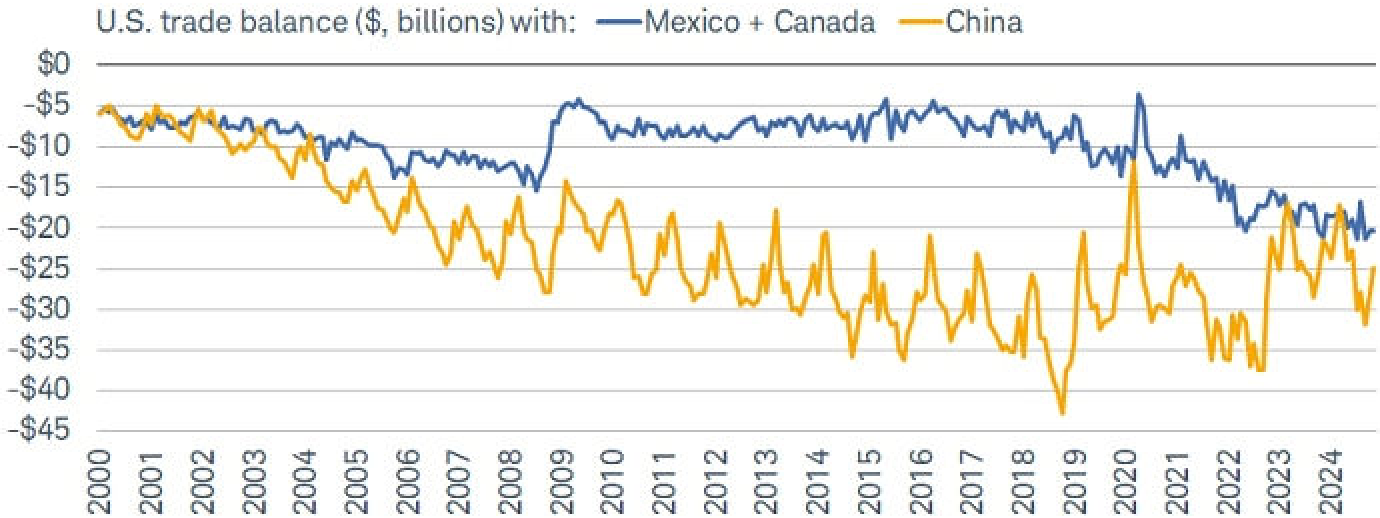
## Goods deficit at a record




Source: Charles Schwab, Bloomberg, as of 12/31/2024.

Shown below are the trade balances the United States has with Mexico and Canada (combined), as well as China. Both series are in negative territory because U.S. imports from these countries are greater than U.S. exports to them. While the U.S. deficit with China has shrunk over the past five years, the U.S. deficit with Canada and Mexico has widened considerably over the same timeframe (and is near a record). In fact, for all the cheering about how the 2018-2019 trade war "successfully" reduced the United States' reliance on China in terms of imported goods, all it did was shift import demand to other countries. The United States' status as a net importer did not change.

## Deficits with major partners still wide




Source: Charles Schwab, Bloomberg, as of 11/30/2024.

Another aspect of the above chart that often gets less attention than it deserves, is the fact that the trade deficit with China actually *widened* in the immediate aftermath of President Trump's first trade war in the 2018-2019 period. That was driven by the effects of the massive stimulus from the 2017 Tax Cuts and Jobs Act (TCJA), which highlights an important point: given the United States is a net importer, any boost to demand (via fiscal and/or monetary stimulus) will—all else equal—have an import bias to it, and that means trade deficits widen out.

## Goal conflicts

That also means the goals of more fiscal stimulus and narrower trade deficits—both of which President Trump wants—are in conflict with each other. It's difficult to envision a scenario in which trade deficits are narrowed dramatically, more tax cuts occur (beyond what was included in the TCJA), and business sentiment/capex remain stable. At least one of those may have to give.

## Agriculture, oil, autos, tech

It's early days, but we think investors should be aware of the risks associated with massive tariffs on imported goods from two key trading partners/allies in Canada and Mexico. Two-thirds of our agricultural imports come from Mexico; 60% of our crude oil imports come from Canada; and nearly half of our auto part imports come from both countries.

There is an impact on the technology sector as well. According to CreditSights, the most significant impact on the sector from this round of tariffs could be PCs and servers made in Mexico; while China is a massive exporter of smartphones to the United States, and a large exporter of PCs and servers. Hardware original equipment manufacturers (OEMs) would likely see the largest negative impact from tariffs, with most of the cost increase likely passed along to customers. This would likely result in lower demand and/or profit margin pressure.

Should these tariffs stay on for a considerable period of time, they will act as a supply shock—one that is tougher to digest, not least because the world is more supply-shock-prone today than it was in 2018-2019. Using a computable general equilibrium (CGE) model developed by the Word Trade Organization (WTO), Bloomberg estimates that U.S. imports of goods, in the medium term, from Mexico could be down close to 70%, from Canada by 62%, and from China by nearly 40%.

"Those are big numbers. The way to think about them is as the final impact after businesses have had time to shift supply chains and consumers to change spending patterns. Like the GDP and inflation estimates, they also have a wide band of uncertainty around them. In the short-term, the impact will depend on how fast economies adjust to the shock. It would likely take some time for U.S. importers to switch to new sources of supply. Big moves in the exchange rate could also help smooth some of the adjustment. On balance, this points to a more gradual decline in U.S. imports from targeted partners in the short term, helping cushion some of the initial shock to their economies."

# In sum

Yesterday, President Trump said that Americans could "feel some pain" from the emerging trade war, alongside threats of imposing steeper tariffs on imports from elsewhere in the world, saying they will "definitely happen" with the European Union and possibly with the United Kingdom as well. For now, markets are teetering in risk-off mode; but the stock market's recovery of some of the early-day losses courtesy of the announcement about the delay in tariffs on Mexican imports supports our view that this will continue to be a moving target in terms of actions and reactions. As mentioned, we have no clarity in our crystal ball on how that will all play out; but it's a no-brainer to expect that bouts of volatility, weakness (and perhaps relief rallies) are likely to persist. This is a very difficult market backdrop to navigate, so stay disciplined around long-term goals and strategies.