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What Is the End Game for Tariffs?

KATHY JONES: I'm Kathy Jones.

KEVIN GORDON: And I'm Kevin Gordon, sitting in for Liz Ann Sonders.

KATHY: And this is *On Investing*, an original podcast from Charles Schwab. Each week we analyze what's happening in the markets and discuss how it might affect your investments.

Well, Kevin, thanks a lot for joining the show and filling in for Liz Ann while she's out gallivanting on a wonderful vacation.

KEVIN: Yeah, thanks, Kathy. Thanks for letting me crash the party. Looking forward to, you know, talking about everything that needs to be talked about. We're in the midst of a pretty epic week when it comes to the economy and the markets and, you know, what this means for the back half of the year and everything Fed related and trade. It's a pretty epic week.

KATHY: Well, I like to think of it ... it's not quite the World Series of finance, but you know, it's a playoff week.

KEVIN: Oh absolutely.

KATHY: We've got some big stuff going on. Let's dive in. I mean, we have ... let's see, the August 1st tariff deadline is looming.

KEVIN: Oh yes.

KATHY: And in fact, we're recording this on Wednesday. It'll publish on Friday when the tariffs are, apparently, going to be truly set, barring any additional delays. So anything in particular on the tariffs that you want to highlight?

KEVIN: Yeah, so not every country, if you're comparing it to what was announced on April 2nd, not every country has a new tariff rate as of now. And I should be specific, and we always hammer this point, but I should say not all imports because, of course, tariffs are paid by the U.S. importer. But I think that what's interesting, and we're even getting updates ... by the time you and I are having this conversation, there was an update this morning for India with that tariff rate for Friday being proposed at 25%. And we'll see if that sticks.

KATHY: I was going to say, they seem to start high and go down, right? Isn't that the strategy?

KEVIN: Yeah, but some of them have gone up, which I don't quite understand. There's a lot of this that I'm still trying to figure out. But I think even for Brazil, the expected rate now is supposed to be 50%. And for that alone, we have a trade surplus with Brazil. And I know that there was a lot of context around that announcement when it came out as to why the president was imposing that particular rate, but for Brazil and the U.K., it's interesting that we still have relatively high tariffs for those imports, yet we've got trade surpluses with both of those countries. So we'll see what happens by, you know, the first.

But I think that the general sense of things is that tariff rates are going higher from here. We'll see how long they stick for. We still have a lot of sectoral tariffs to get through when all of the Section 232^[1] investigations are wrapped up, which that will happen in phases.

And something I think is getting, you know, and I'm curious your thoughts on this, something I think is getting shockingly little attention is the oral arguments that are going to start this week around the legality of the tariffs, the IEEPA tariffs. And IEEPA is the act, the Emergency Powers Act^[2], that the president's been using to impose all of these tariffs. So what I find interesting is that you could find yourself with some of these, you know, we put, say, "deals" in sort of air quotes, but frameworks of deals with these countries. And if we get to those agreements, but then the tariffs are sort of ruled or deemed illegal, then that kind of sets the administration back. Not that they can't impose tariffs in other ways. I mean there are many other ways that they can impose them, but I would find that pretty interesting if that were to be the case. I'm curious to hear your thoughts on that.

KATHY: Yeah, I've been thinking about that because it's one of those potential surprises out there. And the market seems now just to have adjusted to the idea that we're going to have tariffs ongoing. I'm not sure that ... you would know better than I do in the equity market, like under the surface, it affects various industries and companies differently. But in the fixed income world, I think it's sort of shrugged off and saying, "OK, we're going to have these tariffs. You know, it's going to be a

component of inflation, but it's also going to slow growth. So we're worried about that balance." But no one seems to be talking about this potential legal issue that has arisen. And it could throw the whole thing up in the air again. Sort of start from scratch, I guess? Or at least try to find different ways to maneuver, postpone it. And then how do we assess the economic impact of something that was expected to happen, started to happen, but then doesn't happen? Yeah, I don't think enough attention has been paid to it. And, you know, we'll see if and when we get a ruling that affects it. So the whole thing, I guess, in my mind about the whole tariff strategy is it's not really clear to me what the end goal is.

I know we want to bring home manufacturing, want to bring home certain industries, but the way they've been applied is sort of a mystery to me in terms of the means meeting the goal. But be that as it may, the news keeps changing and that keeps us, I think, waiting in this sort of holding pattern, waiting for something to happen.

KEVIN: Yeah, I think that's a really important point because when you think about the end game with this, especially with this new ... you know, it seems like 15% is the new 10%. You know, 10% was that kind of universal baseline that not only was existent on April 2nd but was actually what the thinking was pre-April 2nd—you know, when we still knew tariffs were coming, but it was sort of that 10% being floated as a universal baseline. That seems to be up to 15%.

And this will apply differently for many sectors and industries and companies, but I think in general, to your point about bringing manufacturing back to the U.S., I'm not so sure that 15% is going to be that epic number that's a needle-mover to inspire a bunch of companies to start bringing all their sourcing domestically, because that seemed to be a stated goal of the administration beforehand. So it does ... you know, we opine on this a lot, and nobody really knows the answer yet, but I think it does matter as to what is the end game and what is the goal.

Because from a business perspective, if you're facing these higher tariffs over the next several years, are you planning around that, you know, sort of in perpetuity after you get a new administration, or are you just planning around that to have, you know, in place for the next three and a half years, and then you're assuming that there's going to be some, you know, pretty dramatic change, which I think would probably be favorable for businesses, where tariffs then ultimately come down. So it's really this, this sort of disruptive game, I think, in terms of trying to plan for capital spending or trying to plan for hiring.

And I think it also, to some extent ... and I'm curious your thoughts too on the inflation dynamics because we're having this conversation right before we get the

Fed decision for July. But I wonder what it means for inflation dynamics and ultimately for growth, because that's probably what matters most at the end of the day. I mean, if we get blips in inflation—I mean, you and I think are in the same boat where we don't necessarily expect this massive wave of inflation at the headline level to result from what has been imposed so far, even though you're starting to see some of the goods parts of CPI or PCE, you know, the Consumer Price Index and the Personal Consumption Expenditures Index, pick up and gain some steam. But I wonder what this would mean for growth in the longer term if that's more of the risk as you're seeing it in the bond market and what the bond market's telling us and ultimately what that means for yields.

KATHY: Yeah, I think, you know, we've talked ... Liz Ann and I have talked endlessly and you as well about what comes first, the inflation, the price increases, or the growth slowdown? Because these are the outcomes of tariffs, generally. And then you throw in some of the DOGE cuts and some of the other things going on. And we do expect growth to slow down, but the price increases are happening. And so for the market, this is the tug of war that we've been in.

And I don't pretend to have the precise answer to that. Like, you know, as of October 14th, such-and-such is going to show up. But one reason we do expect the Fed to cut rates in September is that we think between the DOGE cuts, not just to the federal government, but the spending in grants and things like that, the research grants, really starting to trickle through. And then, the slowdown in global growth that is a result of tariffs. So we're expecting all of that to really hit, sort of build in the next three to six months between now and the end of the year. At the same time, the price increases from tariffs will probably show up between now and the end of the year.

But I think if you're sitting at the Fed, and you're trying to weigh which is more important, I think that they can look at the tariffs and say, "Well, typically they're one-time price increases," the market adjusts, and that slows down demand because people's income for a large portion of the population income is not rising fast enough to keep up with the price increases, so demand will slow down, global growth will slow because of the trade war, and that will produce slower growth, and that will weigh more heavily for the Fed.

But it takes time. You know, we all look at these policy changes, and we want an instant reaction. Markets try to instantly react, but in the economics, the numbers take time to play out. So still my thought that by September we see enough slowing in employment growth, we see enough slowing in overall economic growth, sort of the base-level growth, and global growth is slow enough that it warrants a modest rate cut from here.

KEVIN: Yeah, you know, just as a follow on to that, I'm curious to your thought, because I get a lot of questions about the Fed's next phase of the cutting cycle, when they start to cut again, and what that will eventually look like in the context of ... you know, clearly we're in a different inflationary environment today and in this cycle than we were post-financial crisis and what was the norm in that, you know, "Great Moderation" era as we often call it, up until the pandemic. So your best ... I mean, this is all guesstimates, but your sense of where you see the term premium now and where you see yields having gone, especially at the long-end, and how we've kind of been trendless in the 10 year and been in this really wide range. What is your sense of, and of course this assumes that the economy hangs in there and can sort of muddle through throughout all of the trade pressure, but what's your sense of where this Fed ultimately settles on neutral and how they're thinking about it and what you've taken away from what a lot of the members, particularly of the FOMC, have said about that?

KATHY: Yeah, I'm not sure that there's a great consensus at the Fed yet on that. When you look at the distribution of the dot plot for the two years out, it's pretty wide in terms of where the various members have put the estimate. My thought is that in this sort of an environment, if it persists, it will be difficult to get much below 3% on the fed funds rate, and maybe only 3.5%.

And the reason is that you have enough price pressure from the tariffs and from immigration policy, which we haven't touched on yet, reducing the size of the labor force, possibly pushing up wages, causing another form of inflation there. And I think we're in a new era. We don't have a lot of the disinflation from abroad that we had previously.

If we have a shrinking labor force or a smaller labor force, we don't have that dynamic either holding down inflation. So I think getting much below 3% or 3.5% is going to be difficult. You know, that being said, we went through this long era where rates went to 1% or 2%. The fed funds rate was 0 to 2%, and we think ... I think there's a belief that it's normal. I mean, a 3%, 3.5% fed funds rate historically is a pretty low rate. And so getting down there would indicate we're just kind of returning to the low end of a normal range, not historically high end. I think that we've sort of distorted memories for those who maybe haven't been in the markets as long to think that somehow you need to get back to 1% or 2%. That is an emergency level. That is not a normal level for a healthy growing economy.

KEVIN: Yeah, it's similar to how I think about housing. You know, you hear about all this consternation around how much mortgage rates have risen, and you know, I'm younger in this business. And so yes, to me, still, they do look high, but if you just ... I'm also a chart geek, so I'll pull up any long-term chart of mortgage rates and see

that they're ... I don't know, they've kind of come back to normal a little bit. They're not as bad as, you know, certainly not as bad as they used to be. And, you know, I think over time people adjust. That's, I think, the important aspect of when it comes to rates, when it comes to housing, or the broader economy. Yes, you go through a shock period, but ultimately you can sort of adjust to a new normal.

But I'm glad you brought up labor. And I think this is another thing that to me gets kind of just very little attention, shocking, almost at a shocking level, where you look at the potential and the growth of our labor force and how, just looking at the math and the data and the statistics over the past several years and how much we've relied, not just in the U.S., by the way, most of the developed world, how much we've relied on foreign-born labor and the growth of that workforce, and now a lot of that is reversing.

And it reminds me, I was at a dinner about a week and a half ago with John Williams, who's the president of the New York Fed, and I asked him about his sort of best guess about what is the run rate of payroll growth, non-farm payroll growth month to month, if we assume that this contraction in the labor force continues to occur? And I asked it because he had pointed out in his opening remarks that it was something that he was really focused on, the significant reversal in immigrant labor. And he didn't, you know, he didn't give—I wasn't surprised—he didn't give a specific estimate, but he did say that we could find ourselves in a situation where, assuming this policy continues, a year from now, you could be at a very low payroll-growth level, but see the unemployment rate not tick up meaningfully.

And if you were just looking at non-farm payrolls, and if it was a really low number, that might shock you, but you have to, of course, look at it in the context of the broader labor force. But I think what gets missed in that a lot is that when you lower the growth rate of the labor force, you lower potential GDP growth. So over time that does tend to slow things, and it kind of gets you into a ... you know, I don't want to call it stagnation, but it does weigh on economic growth, and it just puts the onus more on productivity, which is not impossible. I mean I think there are definitely ways that we can see productivity grow, but I do worry a little bit more about how much that labor policy is going to potentially restrict foreign-born labor growth, because you are already starting to see it. I mean, we'll see what the July numbers look like, but even through June, the three-month decline in foreign-born labor was one of the biggest that we've ever seen in history. So it is starting to show up pretty meaningfully.

KATHY: Yeah, and we all know we have an aging population, so people are aging out of the workforce, the Baby Boomers. I guess it's the tail end now of the Baby Boomers. They've already started. I guess Gen X will start, you know, before you

know it. But as older folks age out of the workforce, if there's not enough younger people to replace us, we could theoretically have no growth in non-farm payrolls. I've seen some projections. None or even negative.

And it's not quite the Japan scenario, but it is indicative of what's happening in the broader developed markets, where you don't have young populations to drive growth. And that's a big thing for the markets to deal with. So then what happens to the economy? What happens to inflation? What happens to interest rates? And yeah, productivity, I'm pretty optimistic about, but productivity is one of those things that's notoriously hard to measure.

We always overestimate it when we get some new technological development, and we think, "Oh my gosh, you know, this is going to change the world," and then it takes 15 or 20 years for it to incrementally have its impact. So I do worry that we are getting to an imbalance in the labor force that could really change our outlook on how the economy is developing and what that means for inflation, what that means for interest rates, what that means for various sectors of the market.

And that's where I wanted to segue, though, to sectors. I know we've kind of gone neutral because there's so much going on policy-wise, it's very difficult to kind of sort it all out, and there's so much up in the air, but anything you want to highlight there in terms of our sector views right now?

KEVIN: Yeah, it's been really interesting. I mean, we're still, to your point, we're still neutral on sector ratings because there are just so many cross-currents and so many just massive leadership shifts in sectors. And actually, you know, I use the example, if you look year to date, some of the best performing, it depends on the day, broadly, we're starting to see this convergence towards the best-performing sectors year to date being industrials, tech, and utilities.

And it's interesting because all three of those live in different pockets of what is traditionally thought of as deep cyclical and pure growth and defensives, respectively. Utilities being the defensives, tech being pure growth, and then industrials being the cyclical. So those three leading doesn't really tell you much of a market message. And you kind of have to go below the surface and see what's working well in those sectors. And that's why we've really emphasized, and I know Liz Ann has talked a lot about this on the podcast, and I've talked a lot about it in different forums, but just this emphasis we've been putting on factors and characteristics of markets and industries and sectors and making sure that you're just as open to that as you are sector-based investing, because really where you found the most consistent outperformance in this post-pandemic world, especially

since the Fed started raising rates aggressively several years ago, has been in the higher quality parts of the market.

And you know, companies or industries that have high-interest coverage ratios, you know, where they're earning a lot relative to what they owe on debt, or if they've got strong, you know, profit margins, or if they've got really strong guidance, they don't just exist in a handful of sectors. You can find that in any sector. And I think, in particular now, that's come under the microscope even more because when I look at the industry level—not the 11 sector level, but the 25 industry level—which we don't tend to, you know, publish a lot about because there are, you know, it's pretty granular. However, if you look at what's performing best year to date or since April 8th, you know, the lows in the market, it has been the industries with the strongest profit margins. So it's things like semiconductors and banks and parts of communication services. And to me, that actually perfectly explains what's going on in the economy, because the industries that handle that have the strongest profit margins probably absorb the tariff shock the best. And that's to say if they're even getting hit by tariffs.

So you think about some services parts of the market that are really not close to the epicenter of tariffs—clearly, they'll be fine, relative to sectors like autos or food and staples and retailers, those are at the bottom of the performance leaderboard. They also, not coincidentally, are at the bottom of the margin, the profit-margin leaderboard. So I think that taking another step down and peeling that onion back one more layer, it really does reveal how tricky it is to invest at the sector level and just making a call saying, "Well, I think so-and-so sector is going to do well because of this." Yes, industrials have been leading, but when you look at what's leading in industrials, it's the services portions of industrials. So it makes a lot of sense as to why that's happening.

KATHY: Yeah, and it's not unlike what happens in the corporate bond market right now. Writ large, the corporate bond market is doing great. Spreads are very, very low. The yield spread relative to Treasury is very tight. Given all the worries about the economy and all the noise going on about policy, you would think that you'd see more of a risk premium there for investors. And yet we're not seeing it.

But if you go to high-yield, and you look a little bit below the surface, and even in investment-grade, you see who's underperforming and who's overperforming. And it is oftentimes those companies that are industries that are more exposed to the tariff pressures than others. So it does pay to look below the surface because it's very much a game of who's winning and who's losing right now.

But I think one of the things that's remarkable to me is the steadiness of markets, the buoyancy of markets, on the surface level continues despite all the noise. There seems to be a sense of optimism among investors out there that keeps going. I have been calling it the calm between the storms. I think we're due for some bouts of volatility coming up.

But so far, we've gone from April, when we saw lots of volatility, to this calm period. And we'll see what happens at the end of the year. But interesting perspective there on the sectors and what's really driving performance, Kevin. I appreciate that.

KEVIN: Yeah, I think it's an interesting period of complacency creeping back in.

KATHY: Well, we know markets like to do that, right? It's like they like to be optimistic.

KEVIN: That's right.

KATHY: I mean, it's a good thing.

I did want to just start to look ahead now. We have data coming up on Friday before we publish this, or it will come out after we publish this podcast, on the employment picture. So that's obviously going to be a really important indicator in terms of Fed policy, and I think the way markets view the economy. But what else is on the horizon that you're keeping an eye on?

KEVIN: Well, you if we look ahead to the coming week, you do get some pretty important data points around business spending and capex, and we'll get factory orders for June, which are always a good indicator of where manufacturing activity is. And then beyond that, to the conversation we were having when it comes to productivity growth, we will get a second quarter productivity growth and unit labor costs, as you mentioned, and always an important disclaimer subject to revision, sometimes heavy revision. So don't necessarily put, you know, too much weight ... we don't put too much weight on the first print, but it gives a good, you know, sense of where things are, especially with inflation. You know, unit labor costs over time tend to have the strongest correlation with core inflation, so it does give you a pretty good sense of where things are going ...

KATHY: Kevin, can I interrupt you? I have to put in the disclaimer that unit labor costs are imputed in the data, meaning it's not an observation—it's an imputed number. So just to get that on record because there will be some economist out there who corrects us if we don't say that.

KEVIN: That's a good point. Thank you for it. No, thank you for that. That's a good point. And on the labor point too, you know, all important in every Thursday morning, but I'm always watching it, is claims. And you're still seeing, and this was evident last week—it's been evident most weeks—you're still seeing this really big divide and pretty firm split between initial jobless claims remaining low and then continuing jobless claims continuing to creep higher. The continuing ones are, you know, people who have to continue to file for unemployment insurance and stay on it because they presumably can't find employment somewhere. So it's that perfect setup of perfect ... not in a good way, but it's ... meaning it's aligned where we've got a low-hiring, low-firing environment, which was even further emphasized by the job openings data that we got yesterday for June, which you saw the layoffs rate unchanged. The hiring rate ticked even lower. And the job openings rate, you know, was also pretty soft. So it was again perfectly aligned with this notion of companies just not being in a very high conviction environment when it comes to wanting to lay off people or wanting to hire people.

KATHY: Yeah, I think again, this calm between the storms. The economy is meant to be dynamic, things are meant to change, meant to keep moving. And the idea is that they should be going somewhere, right? Not just kind of floating along at this low level, really a very low level of activity. And, you know, the guess I think amongst a lot of people is that that portends a real slowdown, but we've seen this before. We came into this year with the expectation of potential recession. The Fed did cut late last year in anticipation of that. The Sahm Rule [\[3\]](#) was triggered. There was lots of worry about potential recession or a deep slowdown, and we bounced back. So you know, it has happened. So we'll see what happens.

On my radar, I'll have to say, in addition to all the economic data that you've mentioned, we just got the Treasury quarterly refunding announcement for the quarter. The Treasury has to borrow a trillion dollars this quarter. That's a big number. Everett Dirksen, from Illinois—and I know you grew up in Chicagoland—used to say it was "A million here, a million there, pretty soon you're talking real money," and now we're talking trillions. So I think a lot of that, looks like a lot of that will continue to be T-bills because we're under the debt ceiling constraint right now. The Treasury has to do that, but we'll have some pretty big refundings coming up, and that, I think, has potential. I don't usually look at the supply side and auctions as being super significant for long-term trends, but it's growing in terms of the market's focus. So at least in the short run, I think we can see some volatility around some of the auctions that are coming up and the general concern about rising debt levels, the management of the debt, and then with the looming debt-ceiling discussion coming up, which our colleague Mike Townsend says he's just not really sure how that's going to go. It's coming up in October.

KEVIN: Yeah. It's a great point to make. I do sometimes sit and think about the magnitude of the numbers when you talk about a trillion. We often just talk about it and brush it off and seem ... talk past it and talk fast about it. But it is kind of remarkable when you think about how much this has grown. And I do ... it's a great point on the debt ceiling. That's something that just kind of creeps up quickly. And we were just talking to Mike recently about it in a conversation, and he's talked a lot about it, whether it's in different forums or with media, but it is something that creeps up quickly. So it'll be definitely a volatility watcher when it rolls around, not that long from now.

KATHY: Yeah, I think it's one of those things like the IEEPA ruling where the market's just kind of saying, "Oh, it'll get resolved. It always gets resolved. We won't worry about it." But then it comes up on you. And I don't know, I think Mike was not as sanguine in his expectation of how it gets resolved as the market seems to be.

Well, Kevin, thank you so much for sitting in this week. It's been a lot of fun. I'm hoping that when Liz Ann gets back, she will be relaxed and have that well-deserved vacation, and then you'll get a chance to take a break.

KEVIN: Yeah, I don't know when my break is coming, but it'll happen sometime. But yeah, she's on a well-deserved break. And thanks again for letting me crash this party and join. It's always fun to chat with you and riff.

We always remind listeners that they can keep up with us in real time on social media. I'm @KathyJones—that's Kathy with a K—on X and LinkedIn. And I know, Kevin, you're also active on X and LinkedIn too.

KEVIN: Yep, that's right. You can follow me on X @KevRGordon, and I'm on LinkedIn as well. Just those two. I have also had the imposter issue kind of creep up a lot more lately. So make sure that it's @KevRGordon and I've got the blue check, but you can follow me there.

KATHY: Great. And you can always read all of our written reports, including charts and graphs, at schwab.com/learn.

And of course, if you've enjoyed this show, we'd be really grateful if you'd leave us a review on Apple Podcasts, a rating on Spotify, or feedback wherever you listen—or tell a friend about the show. We're going to take next week off, but I'll be back with Liz Ann the following week. So we'll talk to you again soon.

For important disclosures, see the show notes or visit schwab.com/OnInvesting, where you can also find the transcript.

[1] <https://www.cbp.gov/trade/programs-administration/entry-summary/232-tariffs-aluminum-and-steel-faqs>

[2] International Emergency Economic Powers Act

(IEEPA) <https://www.cbp.gov/trade/programs-administration/trade-remedies/IEEPA-FAQ>

[3] <https://fred.stlouisfed.org/series/SAHMTIME>