

Investment Views

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“Escalate to de-escalate” is a risky policy

Over the first weekend in February, Donald Trump did what he said he would do during his election campaign and imposed the first set of tariffs on several countries, at least for a few hours.

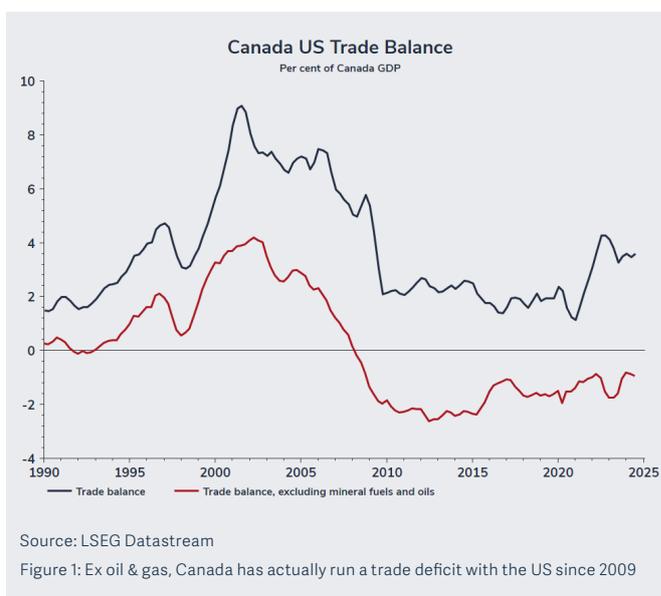
Whether this turns out to be the start of a real or phony trade war remains to be seen but Trump has so far imposed tariffs of 25% on imports from Canada and Mexico and a 10% levy on those from China. Bloomberg called it “the most extensive act of protectionism taken by a US president in almost a century,” whilst the Financial Times wrote about “the absurdity of Donald Trump’s trade war”. Strong words indeed, but we also know the President seldom admits a mistake and he often changes his mind. He is nothing if not unpredictable, and that can be a strength.

Canada quickly responded by imposing 25% tariffs on CAD \$155 billion worth of American-made products, but it took less than a day for an about-turn by both parties. Tariffs were paused for at least a month after minor concessions were agreed. Mexican President Claudia Sheinbaum undertook to station 10,000 members of Mexico’s National Guard on the border to combat fentanyl drug trafficking. A call with Canada’s Justin Trudeau resulted in a similar agreement to deploy Canadian forces to the border along with the appointment of a “Fentanyl Czar”. Although with only 43 pounds of the drug being seized crossing the Canadian border last year (compared to more than 20,000 pounds from Mexico), this calls into question the real reason for invoking these potentially damaging levies.

The Treasury Secretary, Scott Bessent, previously indicated three ways Trump may utilise tariffs. The first is to remedy unfair trade practices and provide a boost to American manufacturing, encouraging companies to build facilities in the US. Second, tariffs raise revenue, which may help pay for the corporate tax cuts that have been promised. Third, they can serve as a diplomatic lever instead of sanctions, which result in countries turning away from the US dollar. The spat with Colombia in January, over the repatriation of undocumented migrants, is an example of the latter.

Bill Dudley, the former President of the powerful Federal Reserve Bank of New York, also noted that tariffs can make sense in a narrow set of circumstances – to protect domestic suppliers of critical inputs; to help nascent industries gain scale to compete internationally; to pressure countries to end subsidies and currency manipulation. None of those circumstances applies to Canada or Mexico. In fact, as the

chart below shows, if you strip out Canadian oil and gas (which only received a 10% levy) Canada has run a trade deficit with the US since 2009, bringing into question the merit of Trump’s protectionist measures.



A swift resolution with China has not yet materialised. Indeed, Chinese policymakers have hit back by imposing tariffs on a swathe of US imports, whilst simultaneously launching an antitrust probe into Google, tightening export controls on critical minerals and adding two US companies to its blacklist of unreliable entities.

Turning to the wider economic impact, the tariffs will likely lead to higher prices for US consumers as businesses will strive to pass on the additional costs. Supply chain disruptions may also resurface, causing shortages and perhaps further price increases. US inflation is thus likely to rise as the tariff impact filters through, suggesting interest rates will stay higher-for-longer.

The bond markets expected two-year level of US inflation surged well beyond 3% (for the first time in two years) as soon as the tariff news broke; a timely reminder that both inflation and interest rate risks remain elevated.

In a world of complex cross-border supply chains, tariffs act “like a bucketful of sand in the delicate wheels of the global economic machinery, leading to major supply chain disruption and imposing significant additional costs for US businesses” (source: Gavekal). Trump’s initial salvo, if implemented after the pause, could thus lead to weaker economic growth over the next 12-18 months, raising the possibility of a recession in the US and beyond. A slower global economy would also see China struggle to work its way out of the deflationary mire it has found itself in for several years.

Ironically, given Trump’s wish to preside over a roaring stock market, his trade policies risk unsettling markets given the prospect for higher inflation, rising rates and slower growth. Even the indomitable S&P 500 would likely struggle if tensions linger with its elevated valuation multiples exposed to any decline in earnings growth. Any sustained increase in volatility would also impair the ability of businesses to make long term plans to invest.

Stronger inflation would reduce the likelihood of interest rate reductions for some countries but increase them for others. Traders immediately pushed back their expectations for the next quarter point cut in US interest rates from July to September but, interestingly, firmed up their expectations of rate cuts from the Bank of England due to fears about the impact of a global trade war on UK growth.

Currency traders had a hard time keeping up with the various announcements, with dramatic swings being witnessed by both the Mexican peso and Canadian dollar. Overall, the US dollar strengthened based on rates remaining higher for longer, but there is a good chance the greenback is forming a near-term peak, much like it did during Trump’s first few weeks in office in 2017.

Gold found another reason to hit a fresh high as investors sought refuge from the uncertainty in a safe haven asset that has doubled since June 2019.

Perhaps the biggest impact of the tariffs so far is to remind investors that Trump is unpredictable and is not guaranteed to be a “market friendly” force. Let’s not forget that he personally negotiated and signed the US-Mexico-Canada trade agreement during his first term in office, calling it “the largest, fairest, most balanced, and modern trade agreement ever achieved”. For better or worse, he has torn that up, which helps to explain why gold is regularly hitting fresh all-time highs as investors seek refuge in an asset that has now doubled over the past 5 ½ years.

It is no coincidence that bullion is thriving just as another perceived safe haven faces an existential threat. As TwentyFour Asset Management notes, US exceptionalism and its enduring status as a safe haven and recipient of foreign flows, is partly derived from the predictability of policy. Trump’s hawkish rhetoric and regular flip-flopping are clearly at odds with this.

There is a risk that an “escalate to de-escalate” negotiation strategy goes wrong, culminating in mutually assured stagnation for all involved. That said, this more bearish take is countered by President Trump’s overwhelming desire to goose up the US economy and its stock markets. That suggests trade tensions may ultimately prove short-lived, but we are braced for plenty of volatility and the odd market setback along the way.

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