AAM
Insurance Investment Management

President Trump's New Tariffs and Their Global Impact

On February 1, 2025, President Trump issued three executive orders directing the United States to impose new tariffs on imports from Canada[1], Mexico[2], and China[3]. The tariffs are an additional 25% ad valorem rate of duty on imports from Canada and Mexico and 10% on imports from China. The tariffs will apply to all imports except Canadian energy resources exports, which will face a 10% tariff instead.

In response, Canadian Prime Minister Justin Trudeau announced an identical 25% tariff on more than $100 billion of American goods. After speaking with Mexico's President Claudia Sheinbaum, who had promised retaliation, President Trump agreed to delay tariffs for one month in exchange for National Guard officers at the border. China criticized[4] The White House's decision, noting that the tariffs violate World Trade Organization (WTO) rules and vowing to take additional countermeasures without providing details.

The new U.S. tariffs are slated to take effect on Tuesday, February 4, 2025. If they hold, they are expected to have wide-ranging impacts on the global trade system and the economies of the four countries involved. While our base case is for negotiations to prove successful with Mexico and Canada, allowing tariffs to be avoided, we acknowledge the upside risk to domestic inflation and downside risk to U.S. real GDP growth.

1 Executive Order of February 1, 2025: "Imposing Duties to Address the Flow of Illicit Drugs Across Our Northern Border."
2 Executive Order of February 1, 2025: "Imposing Duties to Address the Situation at Our Southern Border."
3 Executive Order of February 1, 2025: "Imposing Duties to Address the Synthetic Opioid Supply Chain in the People's Republic of China."
4 https://www.fmprc.gov.cn/eng/xw/fyrbt/lxjzh/202502/t20250202_11548196.html

Market Reaction

As of mid-day (noon central), Treasury yields were mixed, equity markets were lower, and the U.S. dollar was stronger relative to Friday's close. The Treasury curve is flatter as Fed Funds futures markets have modestly reduced expectations for rate cuts this year. The yield on the 2-year Treasury is up 4.1bps to 4.24% while the 10-year yield is down 2.8bps to 4.51%. The S&P500 and NASDAQ stock indexes are down -0.9% and -1.3%, respectively. The Bloomberg US dollar index is up 0.6 points, with the dollar stronger against the Euro and Canadian dollar.

Moving on to the Investment-Grade fixed-income market, the Municipal bond market is little changed, with spreads following the move in Treasury yields. Structured Product markets are also virtually unchanged, with lower coupons underperforming in mortgages. The Corporate market has reacted a bit more, with spreads 1-10 bps wider, depending on the sector, with those most vulnerable to tariffs (i.e., Autos) underperforming. Companies that had planned to issue new bonds today decided to wait given the uncertainty.

Implications for IG Corporate Sectors Likely Affected by Tariffs

Autos - Given that much of the North American auto manufacturing base is in Mexico and Canada, tariffs would substantially increase the cost of manufacturing vehicles sold in the US. For example, Mexico accounts for roughly 30% of GM's North American production, while Ford is relatively less exposed at 16%. Volkswagen has the majority (75%) of its North American production in Mexico. Furthermore, while the US does not import vehicles directly from China, the international supply chain is vulnerable to tariffs on Chinese exports, and retaliation would worsen the situation. While higher tariffs would be disruptive for the entire industry, it is particularly ill-timed for the supplier base, which is already dealing with challenging market conditions in Europe and China.

Basic Materials - We view the direct impact of higher tariffs as only having a modest impact on the Basic Materials sector. The secondary effects of retaliation and the potential impact on the health of the overall global economy would be a more significant concern. Large international companies populate this sector, and at first glance, the global footprint of these companies may appear vulnerable to tariffs. In most cases, these international companies produce local for local consumption. Tariffs could alter trade flows, but these large companies generally have enough flexibility to withstand the disruption.

Energy - The 10% tariffs on Canadian energy imports are less than and better than earlier advertised. However, they will still have modest impacts on Canadian producers and U.S. refiners, particularly those refiners with a significant presence in the Midwest. Canadian suppliers do not have alternative markets to the Midwest. Theoretically, they should absorb the tariff cost to maintain access to the import market via lower realized prices for their crude oil. Western Canadian Select oil has weakened modestly recently to reflect this dynamic.

However, demand from U.S. refiners in the Midwest is also inelastic. These refiners are not able to easily switch to substitutes, which suggests they are likely to bear the cost of the tariffs. Therefore, we

believe the burden will be split between Canadian producers and U.S. refiners. We do not expect the risk profiles of the affected energy companies to be at risk, given the tariffs currently in place.

Retail and Consumer Products - Most large consumer product/retail IG issuers have at least some manufacturing exposure in China, Mexico, and/or Canada. In general, these companies have largely diversified away from China. At this point, we expect a balance between what companies can bear in terms of margins and what the consumer is willing to accept with higher prices ultimately. We expect the middle-to-low-income segments to be the most at risk. We expect higher food prices will help grocery stores while limiting growth in the restaurant sector, especially the “sit-down” variety.

Manufacturing - A typical international Industrial company accrues 60% of sales and 50% of its cost base in the U.S. Many manufacturers have sourced away from China over the past several years. We expect manufacturers with stronger pricing power to protect margins by raising prices.

Technology - The global IT supply chain for hardware and infrastructure is likely to face challenges in the near term. Following the supply chain disruptions and chip shortages experienced in ‘21/’22, there has been a shift in manufacturing and assembly from China to Mexico and Southeast Asia. Despite supply chain diversification, both China and Mexico still account for a significant portion of the components and assembled hardware in the market. In the medium to long term, if tariffs remain in place, we may see more companies increasing their final assembly capacity in the United States.

In both scenarios, we expect unit costs to rise, which will affect different end markets in various ways. With these higher supply chain costs, we anticipate that most expenses will be passed on to consumers. End markets that primarily serve enterprises or sovereigns (servers and networking equipment) are likely to be more inelastic, but we may see a delay in purchases to assess the impact of higher prices. In contrast, end markets driven by consumer demand (smartphones and computers) tend to be more elastic and sensitive to price changes.

The proposed 25% tariffs on imports from Mexico and an additional 10% tariff on imports from China—along with potential rising tariffs and retaliatory tariffs on U.S. tech products from the EU—will likely hinder growth. We expect software companies to be less affected, as they can deliver services within the country but will face higher input costs as larger purchasers of computing equipment.

Disclaimer: Asset Allocation & Management Company, LLC (AAM) is an investment adviser registered with the Securities and Exchange Commission, specializing in fixed-income asset management services for insurance companies. Registration does not imply a certain level of skill or training. This information was developed using publicly available information, internally developed data and outside sources believed to be reliable. While all reasonable care has been taken to ensure that the facts stated and the opinions given are accurate, complete and reasonable, liability is expressly disclaimed by AAM and any affiliates (collectively known as "AAM"), and their representative officers and employees. Any views or opinions expressed are subject to change without notice, should not be construed as investment advice and should be considered only as part of a diversified portfolio. Any opinions and/or recommendations expressed are subject to change without notice and should be considered only as part of a diversified portfolio. Any opinions and statements contained herein of financial market trends based on market conditions constitute our judgment. This material may contain projections or other forward-looking statements regarding future events, targets or expectations, and is only current as of the date indicated. There is no assurance that such events or targets will be achieved, and may be significantly different than that discussed here. The information presented, including any statements concerning financial market trends, is based on current market conditions, which will fluctuate and may be superseded by subsequent market events or for other reasons. Although the assumptions underlying the forward-looking statements that may be contained herein are believed to be reasonable they can be affected by inaccurate assumptions or by known or unknown risks and uncertainties. AAM assumes no duty to provide updates to any analysis contained herein. A complete list of investment recommendations made during the past year is available upon request. Past performance is not an indication of future returns. This information is distributed to recipients including AAM, any of which may have acted on the basis of the information, or may have an ownership interest in securities to which the information relates. It may also be distributed to clients of AAM, as well as to other recipients with whom no such client relationship exists. Providing this information does not, in and of itself, constitute a recommendation by AAM, nor does it imply that the purchase or sale of any security is suitable for the recipient. Investing in the bond market is subject to certain risks including market, interest-rate, issuer, credit, inflation, liquidity, valuation, volatility, prepayment and extension. No part of this material may be reproduced in any form, or referred to in any other publication, without express written permission. Opinions and statements of financial market trends that are based on market conditions constitute our judgment and are subject to change without notice. Historic market trends are not reliable indicators of actual future market behavior. This material may contain projections or other forward-looking statements regarding future events, targets or expectations, and is only current as of the date indicated. There is no assurance that such events or targets will be achieved, and may be significantly different than that shown here. Diversification does not assure a profit or protect against loss.