Post-21 - 2025-4-13 – The impact of the trade tariffs

After months of warnings that one of the top priorities of Trump administration is to reduce the US trade deficit vis-à-vis the rest of the world, the policy action was finally announced on the 2nd of April of 2025.

As expected, any disturbance to the status quo always leads to huge noise, frustration and anger, led by mainstream media outlets. The policy changes by the Trump administration where a large disturbance to global trade and the way of doing business that prevailed in the last 20 years or so. Therefore, it is worth analysing the policy actions taken, their stated purpose and possible implications. To do so, we need to have a dispassionate view so that we do not get lost in the noise and rhetoric. Firstly, it is worth reading the official White House executive order, where the reasoning for the actions are explained. The following paragraph from the executive order describes the motivation for the change in US policy on trade:

"Large and persistent annual U.S. goods trade deficits have led to the hollowing out of our manufacturing base; inhibited our ability to scale advanced domestic manufacturing capacity; undermined critical supply chains; and rendered our defense-industrial base dependent on foreign adversaries. ***Large and persistent*** *annual U.S. goods trade deficits are caused in substantial part by a lack of reciprocity in our bilateral trade relationships. This situation is evidenced by disparate tariff rates and* ***non-tariff barriers*** *that make it harder for U.S. manufacturers to sell their products in foreign markets. It is also evidenced by the economic policies of key U.S. trading partners insofar as they suppress domestic wages and consumption, and thereby demand for U.S. exports, while artificially increasing the competitiveness of their goods in global markets. These conditions have given rise to the national emergency that this order is intended to abate and resolve."*

The bolded sections were highlighted as we believe they are key for both the methods applied, by setting trade tariffs based on a simple formula that targets the desired outcome and not the individual trade items. The tariff formula approximately applies a tariff to each country which is the trade deficit (as a percent of US exports to that country): Tariff ~ (Exports - Imports)/Trade Volume.

Figure 1 shows the evolution of monthly US trade volumes since 1987. This chart provides a clear illustration of the main issue of the persistent large (and growing) trade deficits. We can observe that the trade deficits in effect accelerated from 1999 onwards. Interestingly, the trade deficit surged in January 2025, perhaps from companies anticipating the change in policy.

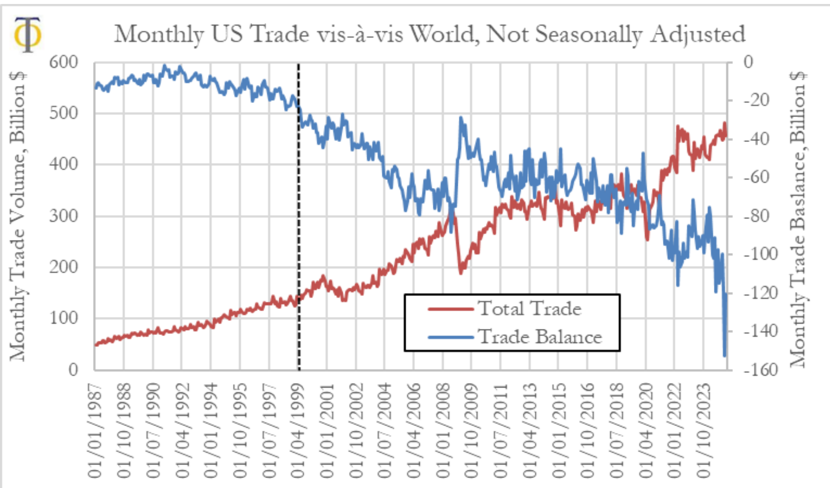


Figure 1 - Historical total trade volume and trade balance for the US (1/1987 to 2/2025). Source: www.census.gov/foreign-trade

1. Let the negotiations begin.

The strategy of targeting the desired outcome (zero trade deficit) should work, over time, to address the persistent trade deficits and by avoiding getting into the minefield of political discussions to measure, negotiate and verify the "subjective" **non-tariff barriers**. Additionally, the best outcome would be the reduction of the trade deficit (and consequently the trade tariffs) by higher US exports instead of trade wars, which would be a race to the bottom, to the detriment of all players.

The 2nd of April (a Wednesday), the day the executive order was announced, and the day after, was followed by the predictable flurry outcry of insults and outrage channelled through mainstream media outlets. By the 4th of April, cooler heads started to voice their opinions as the first countries' officials opened the door for negotiations in order to find a path to rectify the structural deficits and also to reduce their own tariffs imposed on US products. On the 6th of April a news article by Reuters stated that: "*Treasury Secretary Scott Bessent said more than 50 nations had started negotiations with the U.S. since last Wednesday's announcement. "He's created maximum leverage for himself," Bessent said on NBC*".

Let the negotiations begin!

The analysis of the impact of the new trade policy direction on the complex interlinks of global supply chains is beyond the scope of this short post. Whole economics departments dedicated to "Trade Economics" and operational research of supply chain management are dedicated to the field. The spillover effects will undoubtably be felt for years or decades to come.

Additionally, the trade tariffs, as they are designed are a moving target themselves as they are proportional to the desired outcome, which is to achieve balanced trade, or perhaps targeting a narrower outcome of simply reducing the overall US trade deficit vis-à-vis the rest of the world.

2. Major trade partners and imbalances.

As this process is so dynamic, surely the time this post is published a lot of drama and market flip flops will have occurred, and so any short-term projections are utter nonsense. However, some things can be speculated upon, such as the longer-term implications and the main countries that will be impacted.

While Figure 1 shows the magnitude of the "problem", to understand where it originated from let's analyze the US trade volumes in 2024, vis-a-vis its largest trading partners, as shown in Figure 2.

Europe is the largest trade partner for the US with about $770bn in imports and $503bn in exports with a net trade of close to -$267bn in 2024. The trade imbalance with Europe, however, is only 21% of total net trade. For Germany, the largest European economy, the trade imbalance is 36% of total trade.

Mexico is the 2nd largest trade partner. Net trade with Mexico was about -$171bn in 2024, amounting to about 20% of total trade.

Canada is the 3rd largest trade partner. Net trade with Canada was about -$63bn in 2024, which represents a deficit of only about 8% of total trade.

China is only the 4th largest trade partner by total trade, but the country with the largest net trade imbalance of -$295bn, which represents a trade imbalance of about -50%.

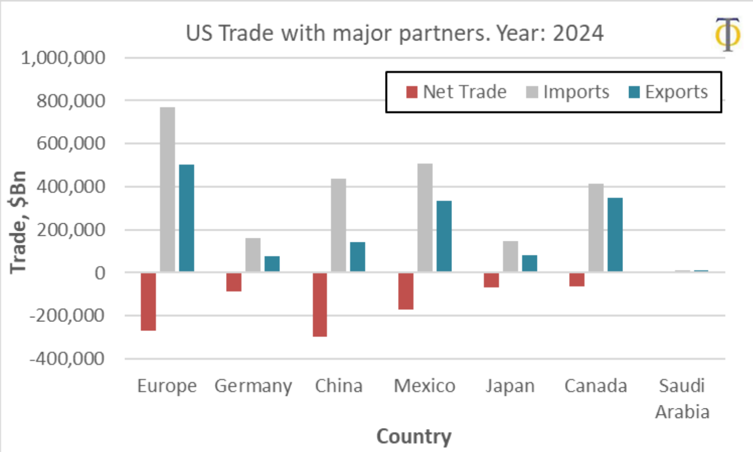


Figure 2 – US – 2024 (full year) trade volumes and net trade with its major trading partners.

The current situation, shown in Figure 2 suggests that Europe and China are the ultimate "targets" for the executive order. The US administration is dealing with the trade deficits of the direct neighbours to the North and South (Canada and Mexico) independently.

In particular, the trade deficit with China is the largest, which is however highly misleading. For instance, Chinese made products are being sold cheaply to Europe (and other countries), which are then sold as premium products to the US. Additionally, China is building factories in many countries across the world (such as Mexico) and selling their products to the US as "Mexican" products. For a clear explanation of the tariffs and their implications [Scott Bessent's interview with Tucker Carlson] is highly recommended viewing.

Consequently, it is no surprise that many smaller nations are already lining up to negotiate with the US, while the political responses by Europe and China have been in the direction of imposing retaliatory sanctions. This will likely backfire, as we'll explain next.

3. Impact on Asia could trigger repeat of 1997/98 style Asian crisis.

China has been growing at extraordinary rates in the last two decades, similar to Japan in the 1980s and Korea in the 1990s. The sheer size and speed of the transformation of a rural country to an industrial powerhouse was always bound to generate a certain degree of poorly allocated investments. Stories abound of completely built (but empty) cities, and underutilised roads and trains. Until 2020, these investments (in extra capacity) were not a big problem as the population growth would eventually use the installed infrastructure. Now, however this is not the case anymore.

As I've explained in my book "Economic Cycles, Debt and Demographics", from 2020, China hit a demographic wall, and its demographic dividend became a headwind. China is going through a demographic bust, akin to the one experienced by Japan in from 1994 onwards, which led to 2 decades of "lost growth" and deflation in house prices.

The Evergrande debacle that erupted in early 2021 (the bankruptcy process of one of the largest property developers in China) was the "canary in the coal mine" as it was a sample of the wider real estate market. The construction industry is typically very fragmented and even one of the largest developers such as Evergrande does not represent more than a few percentage points of the overall market. Evergrande was the opening salvo of a housing/debt crisis for which the most acute phase has still not occurred. When the acute phase unfolds, it could lead to a 2008-2009 - type crisis with possible systemic spillovers in the banking system. After this acute phase, the market will still take 5 to 10 years to digest the misallocated resources of capital and buildings." The collapse of Country Garden (in August 2023), the largest construction company in China, with $187Bn in debt[1], confirms that China is close to entering the acute phase of its housing crisis.

To manage its demographic crisis, China, as Japan did from 1994 onwards, is doubling down on infrastructure building as well as trying to export its way out of problems. The Belt and road Initiative targets both these objectives. However, China's impact on the world economy in 2020 dwarfs Japan in 1994 and with most developed countries attempts to export their way out of their own demographic crisis, we believe that trade wars will eventually erupt. However, the trade wars will not be between China and the US but between China and other exporting regions such as Japan, Korea and Europe who will compete for access to the US market.

On the positive side, in 2021 China's urbanisation rate was still at 64.7%, which means that China still has potential from productivity gains from further urbanisation. Furthermore, China is a net creditor nation with ample FX reserves that are greater than its external debt, which should allow it to manage its crisis without external financing. The selloff of Chinese holdings of US treasuries in 2023 was likely due to the Chinese government scrambling to cover liquidity needs due to the recent developments of its internal debt crisis.

The trade war with the US will likely result in lower trade between these nations and likely also with other nations who partner with China. This will result in China drawing down on its FX reserves to finance its investments elsewhere. We believe that the drawing down of US treasuries is more of a necessity than a political manoeuvre to target the treasury market. We anticipate that, as the new US trade policy plays out, the reduction of US treasuries holdings by China will be an ongoing trend.

Spillover to the wider region:

When looking at a broader context, Asia is currently at a dangerous junction as China hit a demographic wall, as Japan starts its **second** demographic bust and South Korea starts being impacted by its own demographic decline. These countries are highly interlinked with China which is their largest trading partner. In terms of demographics, Japan and Korea are set to enter a phase of demographic decline that is unprecedented in modern historical context. The high debt levels mixed with dwindling demographic demand will inevitably lead to periods of painful adjustment to the new reality.

To understand the magnitude of the headwinds that these economies are facing, which will increase in the coming years, we strongly suggest reading our previous post. With geopolitical tensions on the rise, all the elements are present for the emergence of a second Asia crisis, but perhaps bigger than the previous one in 1998.

4. Impact on Europe. Looming European economic crisis.

Germany, Europe industrial workhorse is already in recession, with several other European countries also being on the brink of recession. Overall real GDP growth in Europe in 2024[2] was a paltry 0.9% with sanctions on cheap Russian gas and green energy policies such as shutting the remaining German

[1] https://www.nytimes.com/2023/09/04/business/china-country-garden-debt-crisis.html
[2] https://ec.europa.eu/eurostat/statistics-explained/index.php?title=Quarterly_national_accounts_-_GDP_and_employment

nuclear power plants leading to higher energy costs and downsizing or re-location of manufacturing plants to more competitive countries, such as the US.

Additionally, social and political instability in countries such as Germany, France, Romania and the UK, together with the doubling down of the political establishment towards green and ESG policies point to further volatility ahead.

The US trade tariffs on Europe could be the nail in the coffin for the struggling European economies, in particular if European politicians pursue policies towards trade wars instead of trade cooperation. Additionally, Europe is squeezed between the US and China, and we anticipate will lose to both if it does not change course.

5. Impact on financial markets.

The impact of the announcement of the trade tariffs led to a tantrum by global stock markets. Figure 3 shows the reaction of stock markets across different regions. Europe and Asian markets were the most affected albeit one cannot infer much information on short term market reactions. The S&P500 dropped about 9% from the close of the 31st of March to the close of the 7th of April, as shown in Figure 3. When looking at the year-to-date (YTD) performance of the major stock indexes we observe that the drop is insignificant.

After writing this post, the Trump administration announced a 90 day pause in the tariffs which led to a historical rebound in stock prices on the 9th of April, a **positive** black swan event. The tantrum appears to be over.

Stock Index	Country/Region	31/March - 7/April	YTD
S&P500	USA	-9.28%	-1.57%
EuroNext 100	Europe	-12.93%	-3.24%
DAX	Germany	-11.90%	-3.21%
Shangai Composite	China Mainland	-7.61%	1.31%
Hang Seng	Hong Kong	-15.36%	0.68%
Nikkei 225	Japan	-16.12%	-3.93%

Figure 3 - Reaction of selected stock indexes to the trade tariffs. Period (31-Mar-2025 to 7-Apr-2025.

As we explain in a recent post we believe that the real risk to equity investors is the historically high CAPE (Cyclically Adjusted Price to Earnings ratio) ratio. The stock market seems to be under the influence of a "new tech paradigm" of crypto and AI, which rings eerily similar to the 2000 tech bubble. In a prior post we analyse the relative value proposition of bonds when compared to expected future returns on the stock market based upon the CAPE ratio.

We conclude that the current enthusiasm with the stock market in detriment of the bond market may be misplaced. The inflation episode from late 2021 to the middle of 2024 has led to risk aversion towards bond investments by asset allocators. We expect that investors will eventually have a new tantrum once this information is highlighted by the mainstream media outlets. However, this tantrum will probably be justified.

US Treasury markets:

It is said that the stock market is akin to a moody child while bond markets are the adults in the room. To understand the market reaction to the trade tariffs and their impact on the real economy, Figure 4 shows the evolution of the US 3-month bill, 1-year bond and 10y bond from December 2024 to the end of the day of the 11th of April of 2025.

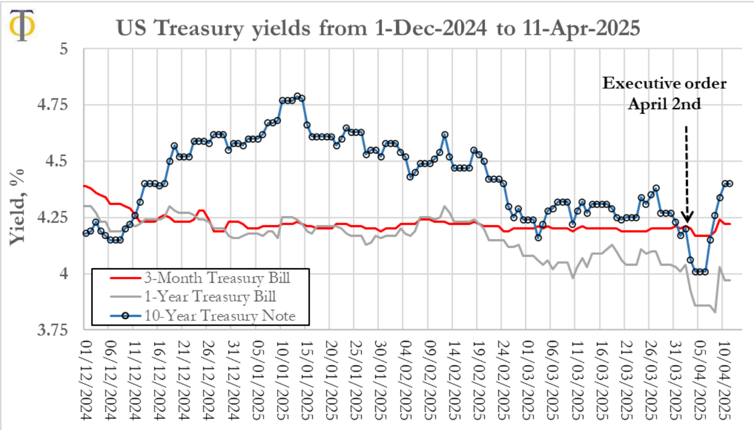


Figure 4 - US Treasury yields from Dec-2024 to 11-Apr-2025. Source: St. Louis Fed FRED.

It can be observed that the reaction 10y treasury yield on the day, and the following day, of the tariff announcement resulted in a 20 basis-point (0.2%) drop in yields. The reaction to the trade tariffs was subdued and not abnormal in the context of the fluctuations over the short period since December 2024 as plotted in Figure 4.

However, in the week following (7 to 11 of April) the executive order, yields rebounded sharply and by the end of the week stood at 4.4%, a level about 20 basis points higher than prior to the announcement. Inflation fears and liquidity dynamics have likely both played a role in this rise.

The 3-month treasury bill remained almost un-altered, which indicates that the Fed will likely not be under pressure to drop interest rates due to the market reaction to the tariff executive order, even though the Fed chairman released a statement towards the readiness of the Fed to intervene in the case liquidity conditions in the bond markets worsen.

6. Impact on prices (inflation).

As explained in a previous post[3], inflation is a monetary phenomenon. We can understand how inflation surfaces by analysing the equation of exchange that states that Nominal GDP is the quantity of Money (M) multiplied by the velocity at which it circulates (V). When writing the equation in terms of changes, we observe that percentage changes in nominal GDP equal percentage changes in the money supply plus percentage changes in the velocity of money, which is written as:

$$\Delta M/M + \Delta V/V = \Delta GDP/GDP$$

As nominal GDP can be decomposed into real GDP and inflation, we can observe how inflation is related to the money supply and velocity of money. Real GDP is related to changes in employment and productivity.

The impact of the trade tariffs is akin to a tax hike and will likely lead to lower velocity of money in the short-term, resulting in a deflationary pressure. As prices for some goods and services will surely

[3] https://phinancetechnologies.com/content/2023-5-30%20-%20LinkedIn%20Post-11-%20Inflation%20Update%20-%20V2.pdf (Direct link)

increase, particularly on the short term, overall prices won't if there are no increases in the money supply.

With tariffs leading to higher prices, we expect that consumers will react by buying less products and consequently impacting negatively the velocity of money. On the positive side, local producers will gain a competitive advantage providing a boost for the velocity of money. Additionally, over time on a longer-term basis, international companies are likely to invest in manufacturing capacity in the US, which will provide a tailwind. The challenge will be to manage the transition period.

One of the possible spillover effects of the trade tariffs is to add to the disinflation pressures caused by falling new tenant rents as we analyse in our short follow up report to the outlook for the US Economy in 2025. New tenant rents lead housing CPI by several months, with housing costs representing a large portion of the consumer price index.

To add to these considerations, in our US Economy outlook for 2025 we explain the underlying forces that could lead to a risk of a deep worldwide recession in 2025. Trade wars only add an acute element to the risks we outline in our report. Namely, the unravelling of the US housing market due to DOGE and immigration policies. The bursting of the AI bubble, which is rhymes eerily with the dotcom bubble in 2000, will only add additional deflationary pressures.

Ultimately, inflation will result from the policy response by the Fed. As currently inflation is still above the target policy range and unemployment rates are close to record lows, the Fed will likely only act once substantial pain in the financial markets and economy unfolds.

Summary

The trade tariffs, announced on the 2nd of April 2025 are a tool to achieve the desired outcome of a new trade policy, as described in the executive order signed by President Trump. The event is likely a landmark event in the history of the current century. The executive order is like the first piece of a domino that is going to lead to a multi-year process (or multi-decade), a new path, a new way of doing business, with a lot of uncertainty surrounding the final destination.

At the core of the current way of doing business is the mercantilist model adopted by most export oriented developed countries who after reaching higher income status failed to restructure their economies and societies towards a consumer based economy, with balanced trade vis-à-vis the rest of the world. This model had the US as the "consumer of last resort" and with the new trade policies implemented in the executive order, is now set to change.

The largest imbalance is with China that is undergoing a real estate crisis due to is demographic bust, akin to Japan in the 1990s. China is trying to export its way out of the crisis and opting to double down on a model that is ultimately not sustainable due to the sheer size of its population. China, the US and other countries in the world need to work together to help China manage its restructuring.

On the short term, the trade tariffs will be akin to a tax on consumers or companies, depending on who bares the cost for the price increases. This will likely lead to deflationary conditions due to the impact on the velocity of money, adding to the structural economic challenges that the US is facing due to the necessary measures to correct the illegal migration flows from 2020 to 2024, financed through government subsidies, government deficits and NGOs. This is the task that DOGE is undertaking. We explain these pressures and how they will likely lead to a recession during 2025 in our US Economy outlook report.

Additionally, the stock market is likely to be under pressure mostly due to is bubble-like conditions, akin to the 2000 tech bubble. The unwinding of this bubble will add to the structural economic problems. We believe that the rebalancing of investment portfolios from stocks to bonds will turn into a flood throughout 2025 as inflation decelerates due to weak economic output, driven by the forces we explain in our US Economy outlook for 2025 report.

These processes are slow to unravel, typically manifested through a multi-month saga of stock market routs followed by enthusiastic rebounds. The underlying structural forces are a permanent pull, which are usually obvious with hindsight, but seldom before the events unfold. The new trade policy and drama associated with it is just another piece of wood that was thrown into the fire.

2025 will be an interesting year.

➔ If you wish to receive these type of updates, Subscribe here for free updates.

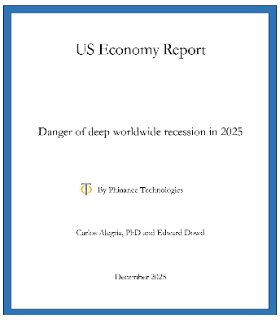
➔ Free resources on our website.

➔ **Our US Economy outlook for 2025 report.**

The full report is an extensive analysis that provides insights into the most consequential forces that will be acting on the US economy in 2025.

The report is aimed for decision makers for investments and risk management, providing a roadmap to understand and successfully navigate the economic conundrum that the US and global economies will be facing in 2025.

The report package includes:
- Full report on the US Economy outlook for 2025
- Executive presentation aimed at executive level decision makers.
- 1h Video with Ed Dowd and Carlos Alegria go through the executive presentation.


US Economy Report

Danger of deep worldwide recession in 2025

By Phinance Technologies

Carlos Alegria, PhD and Edward Dowd

December 2025