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Understanding the Implications of Trump's Tariffs

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Insight from sub-adviser Wellington Management

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I'd like to begin with the caveat that the situation relating to US tariffs on Canadian and Mexican imports, first announced on February 2, is evolving. As of the time of this writing, February 3, the Trump administration announced there would be a delay on tariffs imposed on Mexico, which speaks to the fact that the situation is fluid and subject to change. This said, I'd like to outline the original tariff plan and analyze the implications and potential economic outcomes.

In my view, in the 12 months prior to President Donald Trump's inauguration, the economy had been experiencing a soft landing as a function of sharp improvement in the supply side of the economy—the labor force and productivity. But the new administration's policy proposals increase the likelihood of a reversal in this supply/demand balance, and the onset of material tariffs toward the US's largest trading partners, Canada and Mexico, heightens this probability. Assuming these tariffs hold for the next month, market-based inflation expectations for the coming year look too low.

Key Points

- The Trump administration's tariffs—25% tariffs on Mexican and Canadian imports, 10% on Canadian oil, and 10% on Chinese imports—increase the probability of more inflation volatility.
- These tariffs decrease the probability of improvement in the supply side of the economy.
- The important link between tariff revenue and tax cuts through reconciliation implies, with lots of short-term shifts, more sustained tariff increases.

Unpacking Trump's Tariffs

On February 2, Trump invoked the International Emergency Economic Powers Act (IEEPA), which grants him wide authority on tariffs and trade policy, to announce tariffs on imports from Canada and Mexico for the stated reasons of inhibiting movement of fentanyl and illegal border crossings. These measures include an across-the-board 25% tariff on Mexican and Canadian imports, with a 10% tariff on Canadian energy, and a 10% tariff toward China. It's worth nothing that further carveouts and exemptions are certainly possible before implementation.

Over the last 12 months, the US imported $410 billion in goods from Canada (1.3% of US GDP), $503 billion in goods from Mexico (1.7% of US GDP), and $440 billion from China (1.5% of US GDP). At face value, this implies an increase in core personal consumption expenditure (PCE)[1] of 0.7 percentage points and a 0.5% hit to growth. However, I think appreciation in the US dollar, combined with more conservative assumptions about passthrough, implies about a 0.5 percentage points increase in core PCE—still an extremely large shock to the short-term inflation outlook.

Trump's social-media post suggests these tariffs will take effect on February 4. His rhetoric on January 31 suggested there was little the three countries can do in the near term to stop the tariffs from taking place. However, IEEPA allows for immediate implementation and reversal of tariffs.

Therefore, there's room for all countries to negotiate and potentially reverse tariffs in short order, which may require some creativity on the part of the countries subjected to these tariffs to appease Trump. So far, he's shown no signs of backing down, but previous experience suggests this is probable, and, again, the IEEPA itself allows for a reversal if necessary.

While most are waiting for the reversal, there's also another important risk. The stated tariff rate increases even further should zero progress be made on border security, movement of fentanyl, and/or bilateral trade balances. In separate but related news, Canada is highly unlikely to engage in 51st-state negotiations with the US, as Trump has pushed.

Implications for Other Countries

While countries such as Japan and regions such as Europe have escaped the first round of tariffs, this doesn't mean they're in the clear. Trump signaled last week that the US is formulating a plan for European tariffs. I suspect these will wait until after US Trade Representative (USTR) nominee Jamieson Greer is confirmed. But one might assume at least a 10% across-the-board tariff toward Europe, and possibly Japan, over the next few months.

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Implications for Current Market Growth and Inflation Expectations

At the margin, the biggest gap within 12-month forward-market and US Federal Reserve (Fed) expectations is inflation. The Fed has assumed a glide path toward 2.5% core PCE this year, and 2.2% in 2026. This now looks stale, assuming the tariffs go through. Fed assumptions already include a slowdown in real GDP this year from 2.5% in 2024 to 2.1% this year. The starting point on real and nominal growth already shows robust domestic demand in the context of elevated animal spirits, so the ability to absorb an exogenous growth shock is higher than in the past. Furthermore, there are growth offsets from deregulation.

This said, financial conditions are likely to tighten on the back of this via more hawkish short-term Fed expectations, a stronger US dollar, and lower equities. This presents a new headwind for the cycle overall.

Looking at the bigger picture, this tariff announcement—and, importantly, the ability and willingness to use IEEPA for trade policy—implies much higher inflation volatility over the medium term. Our structural inflation work continues to suggest a higher average inflation rate over time, but notably with much higher volatility around this trend. Rolling changes in tariff policies not only further increase the probability of an acceleration in de-globalization, but also imply much higher inflation volatility.

Implications for the Fed and Fiscal Policy

Basic economics would suggest that tariffs are inflationary in the short term, but disinflationary over the medium term due to the negative growth implications. However, this doesn't account for the starting point on inflation (now going on four years above the 2% target) or potential flowthrough into inflation expectations. Inflation expectations are now as important as spot inflation readings. I think this translates into higher front-end breakeven inflation rates.

Market pricing still shows more than 40 basis points[2] of cuts for the Fed priced-in by year end. Even without making conclusions around the medium-term impacts of such significant tariffs, my bias is the Fed will be more focused on guarding against higher short-term inflation, and the first move from the market will be about pricing out more cuts. A prudent Fed policy would be to hold rates steady, but should inflation expectations rise significantly over the coming months, an interest-rate hike can't be ruled out.

There's also an important interplay with fiscal policy. The cost of simply extending the Tax Cuts and Jobs Act is about $5 trillion over the next 10 years. Without touching Social Security, Medicare, and defense spending, the math is almost impossible to square, and this doesn't even account for some of Trump's proposed additional tax cuts. Tariff revenue is the single largest offset to Trump's tax and spending proposals and is therefore necessary to provide an offset.

Ultimately, combined with a higher probability of increased inflation volatility, I think this will map to a higher term premium over time, but in the short term, I think it's more of a front-end trade.

What's to Come?

After the post-election boost, equity markets have been flat for two months and bond yields have risen. Tariffs increase the probability of a more significant market correction, which would be important in tightening financial conditions.

Trump has already laid the groundwork to blame the Fed—rather than his tariff policy—for any adverse market reactions.

This said, everything can reverse quickly. My forecasts for inflation and trade policy assume significant short-term swings, but overall Trump will deliver much (about half) of what he proposed on tariffs. I doubt Canada will engage in discussions with the US around becoming a 51st state. But there's room for action on border security and drug trafficking. At a minimum, China can start the process around abiding by the previous trade agreements with the US.

The Bottom Line

In my view, the most important, big-picture takeaways from this situation are:

1. Increased probability of more inflation volatility.
2. Decreased probability of improvement in the supply side of the economy.
3. The important link between tariff revenue and tax cuts through reconciliation implies, with lots of short-term shifts, more sustained tariff increases.

These tariffs represent Trump making good on his campaign promises. In this case, he's doing what he said he would do—another takeaway to keep in mind.

Talk to your financial professional to better understand the impact of shifting policies on your portfolio.

[1] Personal Consumption Expenditures (PCE) is a measure of the value of goods and services purchased by U.S. residents.

[2] A basis point is a unit that is equal to 1/100th of 1%, and is used to denote the change in a financial instrument. The basis point is commonly used for calculating changes in interest rates, equity indexes and the yield of a fixed-income security.