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Global Markets Research

Research Alert

Potential impact from US tariffs – a revisit

US & China will likely be harder hit; third countries can benefit from trade diversion
Impact on growth likely quicker than inflation; leaving room for policy easing still
Implications on FX – broad-based USD strength; increased volatility

Background

On 1-Feb-2025, Trump signed an order imposing 25% tariffs on imports from Mexico and Canada, as well as an additional 10% duty on China. Energy resources from Canada will be hit with a lower 10% tariffs. In response, Canadian Prime Minister Justin Trudeau had announced retaliatory tariffs of 25% on US goods effective 4th Feb, while Mexico and China have vowed to retaliate.

Impact

While the tariffs on Canada and Mexico have been delayed for a month at the point of writing, financial markets were clearly rattled by Trump's announcement and the subsequent retaliatory moves. With this, we thought it is only apt that we revisit our article "No clear winners from trade tensions" dated 31 July 2024 briefly with some added inputs.

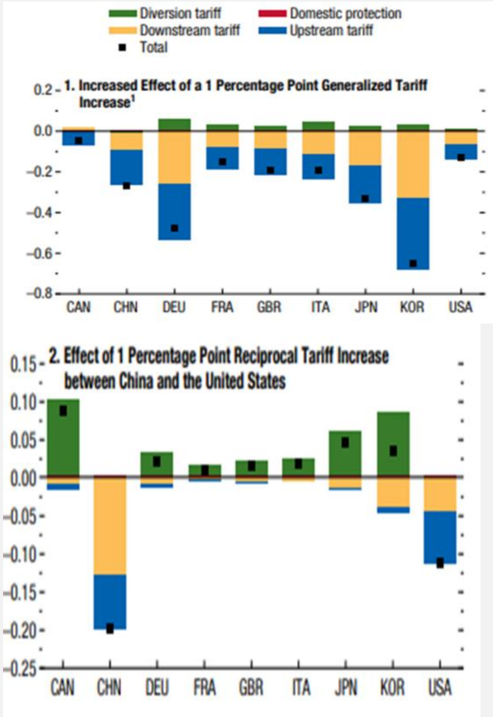
World trade – downside risks

- A free trade policy is positive for economic growth, more than a protectionist policy. We have highlighted that world trade volume slowed from +4.0% y/y in 2018 to 1.3% y/y in 2019 after the Trump administration took over in 2017 and raised tariffs on several products, and this will likely repeat again this time round, but potentially seeing a bigger impact given the more extensive and pervasive nature of the policies. That said, most economies appear better prepared this time compared to Trump 1.0.

China and US will be harder hit than Canada; Japan, Korea and Malaysia could benefit

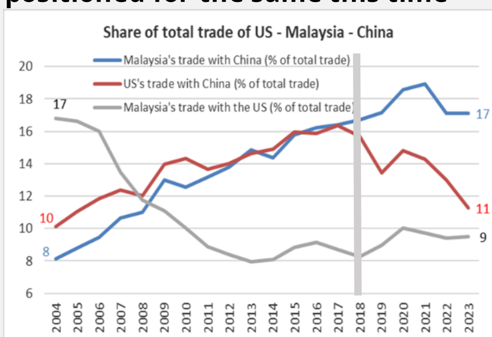
- Integration into global supply chains has increased the elasticity of demand to tariff changes, but to varying degrees dependent on: 1) how big the manufacturing sector; & 2) how integrated the economy is into global supply chain. If history is any reflection, Figure 1 suggests that higher tariffs can be harmful to those imposing them, and China and US will be harder hit than Canada in this latest trade war.

Figure 1: Tariff effects on GDP (ppt)



Source: IMF

Figure 2: Malaysia benefitted from the previous trade war and is well-positioned for the same this time



Source: Bloomberg, HLBB Global Markets Research

- That said, third countries can benefit from trade diversion if the tariff hikes are discriminatory to selected countries. This is apparent when the 1ppt increase in tariffs were limited to trade between China and US.
- Figure 1 showed that GDP growth for both US and China in such scenario, while third countries, like Korea and Japan saw their economies benefitting from the trade diversion, negating the negative spillovers from the disruption in supply chain and slower trade growth.
- For Malaysia, as share of US trade with China decreased, share of Malaysia's trade with the US and China increased since US-China trade war started in 2018 (Refer to Figure 2).

Upside risks to inflation

- With energy and food on the tariff list, and Figure 3 illustrating how tariffs on intermediate good could amplify the impacts on production costs and prices, inflation for both Canada and the US are subjected to upside risks, potentially disrupting their policy easing cycles. A Bank of Canada (BoC) calculation suggests that it will send inflation up for Canada by 0.1ppt in year 1 and 0.5ppts for year 2 (Refer to Figure 4).
- Meanwhile for the US, the White House, under the Biden Administration, had pencilled in a 0.75ppts increase in inflation following Trump's across-the-board 10% tariff rate.

Downside risks to GDP growth for US and Canada

- BoC's calculation also suggests that the tariff hikes could send Canadian GDP growth down 2.5ppts and 1.5ppts respectively in year 1 and year 2.
- For the US, the Tax Foundation estimates that it will reduce long-term output by 0.4%, worse than the 0.2% estimate during the Trump-Biden tariffs.

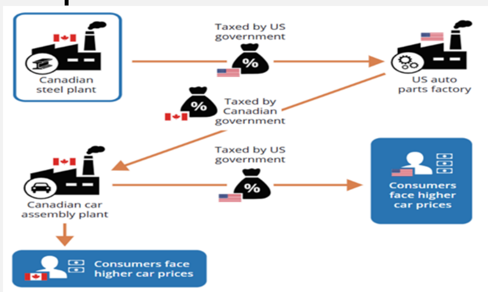
Impact on forex - increased volatility and broad USD strength

- As seen in Figure 5, all G10 and regional currencies have depreciated against the USD since Trump's win. While the widening interest rate differential contributed to a modest share of the overall depreciation, most of the weakening for G10 currencies can be explained by the exchange rate risk premium, namely heightened uncertainty due to US President Donald Trump's threat of import tariffs.

Summary

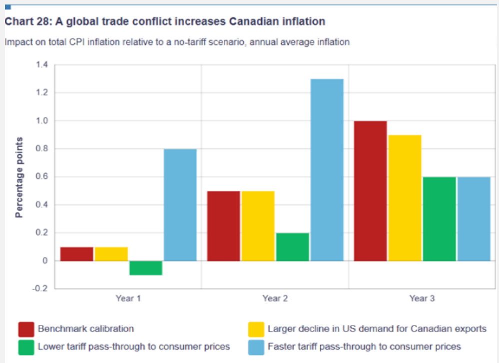
We hold to our view that this trade war is broadly negative for the global economy and the US. While the trade war has raised stagflationary risks, we hold on to our view that 1H is the epitome time for the Fed to cut rates, to support growth and before the delayed inflationary pressures from the tariff hikes trickle in.

Figure 3: How tariffs on intermediate goods could amplify the impacts on production costs and prices



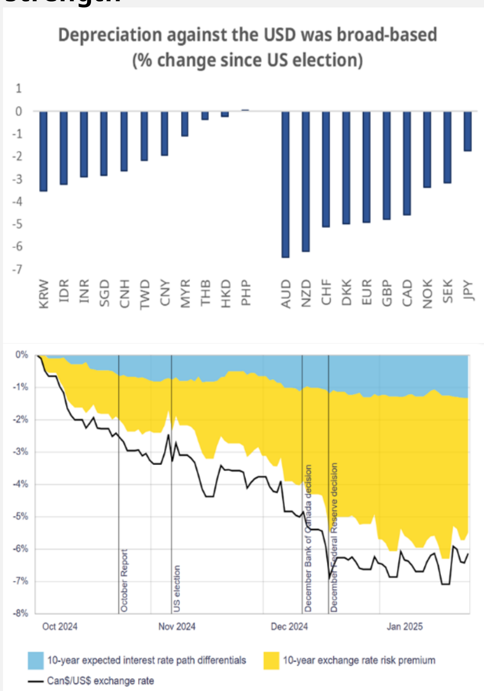
Source: Bank of Canada

Figure 4: Impact of trade protectionists policy on Canada's inflation



Source: Bank of Canada

Figure 5: Impact on forex markets – increased volatility and broad USD strength



Source: Bloomberg, Bank of Canada, HLBB Global Markets Research

House View and Forecasts

FX	Current	1Q-25	2Q-25	3Q-25	4Q-25
DXY	107.96	109.10	108.58	106.93	105.27
EUR/USD	1.0379	1.03	1.03	1.05	1.06
GBP/USD	1.2480	1.24	1.24	1.25	1.27
USD/CHF	0.9052	0.91	0.91	0.90	0.88
USD/JPY	154.34	158	155	150	146
AUD/USD	0.6254	0.62	0.63	0.64	0.66
NZD/USD	0.5651	0.56	0.56	0.57	0.58
USD/CNY	7.2446	7.37	7.30	7.23	7.15
USD/MYR	4.4440	4.55	4.50	4.40	4.35
USD/SGD	1.3530	1.37	1.35	1.32	1.29

Rates, %	Current	1Q-25	2Q-25	3Q-25	4Q25
Fed	4.25-4.50	4.00.-4.25	3.75-4.00	3.75-4.00	3.75-4.00
ECB	2.75	2.50	2.00	2.00	2.00
BOE	4.75	4.50	4.25	4.00	4.00
BOJ	0.50	0.50	0.50	0.75	0.75
RBA	4.35	4.35	4.10	3.85	3.60
BNM	3.00	3.00	3.00	3.00	3.00

Source: HLBB Global Markets Research

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