Trade Wars: A geopolitical stalemate? What’s next for institutional investors?

2025

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Introduction

The first ten days of April 2025 will go down as one of the most tumultuous in economic history. President Trump's trade offensive started in earnest at the beginning of the year, affecting a handful of countries such as Mexico and Canada. Markets and the rest of the world broadly adapted to this first charge, seemingly unaware of the unprecedented onslaught coming their way on April 2nd. The 'reciprocal' tariffs kickstarted a global whirlwind in the financial markets, potentially shifting us permanently towards a new world order. Following an intense period of market volatility not seen in many decades, President Trump then announced a 90-day pause on reciprocal tariffs for most countries, excepting China, where tariffs were raised further as of writing to 145%.

This decision came after vocal concerns from business leaders including many allies in the current U.S. administration about the potential negative impact of the tariffs on longer-term investor confidence in the U.S. economy. Despite the market surging in reaction to the pause announcement and yields on U.S. treasury notes stabilizing, some jitters continue, and China is fighting back. Analysts and investors remain cautious about the length of this respite and the effects on global supply chains. Nevertheless, several countries including Japan, India, the European Union and Taiwan are using this window to secure more favorable trade deals with the U.S.

The intensity and unpredictability of these policy shifts have heighted uncertainty to unprecedented levels in the financial markets for both the short and long term, leaving investors facing incredibly difficult decisions. In this paper, we consider the likely impact of trade tariffs on global financial market behavior in the short and long-term, and the likely implications for institutional investors.

How did we get here?

A sweeping mandate for change

President Trump rolled out his new global tariffs plan on April 2, 2025, so called Liberation Day. This marked the implementation of the most significant tariff hikes since the Smoot-Hawley Tariff Act of 1930. It included a universal 10% tariff on all imported goods, effective April 5, 2025, targeted tariffs on dozens of countries, starting April 9, 2025, as well as sector specific tariffs on key industries including steel, aluminum, auto-manufacturing, semiconductors, pharmaceuticals, copper, and lumber.

In focus: How do tariffs work?

Tariffs are a type of protectionist barrier that comes in several forms. Typically, these tariffs are to be paid by domestic consumers (so effectively, the tariff becomes a tax paid by domestic consumers) and not the importer country. This has the effect of raising the relative prices of imported goods. If domestic manufacturers rely on imported components for inputs to their production processes, these increased costs may also be passed to consumers.

Implementing tariffs broadly lead to three potential outcomes:

- The importer might pass this tariff to consumers – which could lower demand for these goods.
- The importer might choose to absorb these tariff costs themselves – which would negatively affect their profit margins.
- Exporters to the country might need to lower their prices to retain importers/clients – this may lead to a diversification of suppliers if these importers are able to source similar goods from other countries (notwithstanding the costs of changing suppliers).

The pace of these effects can vary. Businesses, where possible, will often try to stockpile prior to any tariff being implemented. Importers may also adjust supply chains, potentially diversifying suppliers to manage the impact.

Therefore, in the short-term with sufficient inventory, the impact may be less pronounced. But once stock is depleted, the higher costs of new imports will start to affect pricing and profitability.

The apparent rationale behind these tariffs, well-trailed during the 2024 U.S. election campaign, was to correct perceived unfair trading practices, reduce U.S. trade deficits and to reindustrialize the U.S. economy. The U.S. administration is also concerned about alleged WTO violations including IP infringement, as well as ongoing cybersecurity concerns regarding China. Broader national security concerns are at play with the ambition to bring back manufacturing for key industries such as steel and pharmaceuticals. Whilst several countries have seemingly sought bilateral trade agreements to counteract these measures, China have raised the stakes further, and currently Chinese tariffs sit at 125% on U.S. goods. The potential consequences for the global economy of the U.S. and China undergoing an economic decoupling should not be underestimated.

The immediate and dramatic fluctuations in global stock indices, many of which descended into bear territory, were seemingly exacerbated by the nature of the policy implementation as well as the somewhat disjointed messaging from the White House. The ‘retreat and repeat’ approach to the tariffs applied to some countries has made it hard for investors to capture how markets will behave in both the short and long-term. Was it the goal to remove trade deficits or reshape the nature of the economy? Are these goals consistent? Which of these goals should investors think the U.S. will prioritize in terms of impacts on strategic investment decisions, or should they wait to consider the success or otherwise of the country-by-country trade deals? Accepting that there has been a negative impact on the economy, one other open question is what is the acceptable economic price (paid by U.S. citizens) of such a policy when many financial institutions have now raised concerns about the impact on growth and the increased likelihood of recession?

A tale full of contradictions

As nations, analysts and investors faced the evolving pace of these announcements, many tried to second guess the end goal of the U.S. administration. If the intention was to isolate China, why were reciprocal tariffs also applied to many countries (Vietnam, Malaysia, India, Bangladesh, Mexico) that were being channeled to diversify supply chains away from China? Part of the explanation here is the 'transshipment loophole', where goods from China are shipped to a third country for 'final assembly' or re-export before being sent to the U.S. often with minimal processing or packaging to give the appearance of being manufactured in the third country.

If the goal is to reduce trade deficits, Vietnam is also an example of an export-heavy country that would find it tricky to move the needle on its circa $120bn trade deficit. The Netherlands, Hong Kong and UAE all have trade surpluses with the U.S. but were nevertheless subject to tariffs (with Hong Kong facing the punitive 145% rate, being part of Chinese territory). This contrasts with the services trade surplus the U.S. has with many countries. The calculation of the reciprocal tariffs themselves (seemingly equal to the US trade deficit in goods for that country, divided by the total goods imports from that country divided by two) has caused some speculation as to whether these tariffs are truly 'reciprocal' or in fact designed to eliminate the U.S.'s goods trade deficit with that country.

Certain industries such as natural gas have been excluded from the recent U.S. tariffs. This decision was presumably made to avoid disrupting the energy markets and to maintain stable prices for consumers and businesses. However, there were concerns about potential retaliatory tariffs on U.S. liquefied natural gas (LNG) exports and LNG exporters have been seeking to diversify their markets to mitigate the impact of tariffs and trade tensions.

Amidst all these moves, what strategies are available to non-US investors? Traditionally they would flock to U.S. government bonds and TIPS, gold and defensive sectors and this was certainly observed over the ten days. But at some point, even long-dated treasuries do not provide a sufficient hedge and the old adage of the bond markets being king may have ultimately led to the 90-days pause decision, with 10-year treasury yields (followed very closely given the sensitivity of the cost of U.S. debt refinancing to these rates) spiking over 50 basis points at the height of the volatility. It is alleged that Japanese investors and China were partly responsible, notwithstanding that Japan and China collectively are the largest foreign holders of U.S. debt.

So, all said and done, the Chinese economy faces a massive hit from punitive tariffs in its biggest market. The world is left with a universal 10% tariff, irrespective of whether that country (for example the UK or Australia) sells fewer goods to the US than the US sells to it. There is now no difference between the E.U., which clearly does have a massive trade deficit in goods and was preparing to retaliate, and the UK for example, which had remained neutral.

What may happen over the next 90 days?

History is being rewritten

We ideally learn from the past and some examples do exist but given the sweeping scale of these reciprocal tariffs and the now anxious wait during the 90-day pause, making conclusions about what will happen next is very difficult – we are navigating unchartered territory.

Our own research review concluded that the medium to longer-term impacts on expected growth, risk appetite and economic uncertainty would be negative – all of which chimes with current market sentiment. These are of course key drivers of future expectations of interest rates, exchange rates, and inflation.

Everything points downwards

The short-term negative effects of the trade war have been visible. However, even with the pause, global importers will consider multiple ways to move forwards to manage the effects of these tariffs and future proof against any further changes given that many policies are being cancelled as quickly as they are implemented. It means that over the next few quarters, observers and investors are taking a 'wait and see' approach before landing on the likely magnitude of any downturn in growth and widening volatility and the impact on investment decisions.

As the dust settles, deterioration in economic conditions will be influenced by the pace and scale of any deals constructed and tariff movements at a country and sector level. There are signs that growth may stall, but could be offset by expanding exemptions. We have already seen announcements from car manufacturers on pausing shipments in new regions (Jaguar Land Rover to the U.S.) or pulling out of certain markets altogether (Tesla has stopped taking orders in China). There are now tariff exemptions in place for tech products such as smartphones. How well do these changes offset each other and if/when would it impact aggregate investment? What does that mean for any countries using economic stimulus measures and wanting interest rate cuts? It seems too early to and tell central bank sentiment at this stage seems generally non-committal.

Nonetheless this radical uncertainty does not provide much optimism for global equity markets in the near term despite the intermittent rallies, particularly if we see further slowdowns in specific sectors. Finally, are tariffs inflationary, or is it also too early to know? When tariff costs are passed onto consumers, trade wars are expected to cause upward pressure on inflation, exacerbated by reduced competition. At the same time, rising prices act to reduce investments, consumption and growth, offsetting inflationary pressure.

Capturing this radical uncertainty

As a provider of forward-looking economic scenarios and views we aim to incorporate short-, medium-, and long-term trends. Care must be taken when operating under such extreme shocks to the economic system and especially when the outcomes are still unclear. Nevertheless, general market sentiment on downward trends in GDP, higher levels of volatility of risky assets, interest rates, spreads and currencies are being captured in our models over a 1-to-2-year horizon. However, as we state throughout this paper, whether we are in a new economic regime entirely which might have more structural implications remains to be seen and in the absence of a concrete landing space for the U.S. administration, we must exercise the appropriate degree of caution before counting out all hopes of global economic growth over the next year.

What about the main players?

China and the U.S. – who blinks first?

The commencement of the 90-day pause laid the foundations for the next phase of the trade war between the world's two largest economies. On increasing retaliatory tariffs on U.S. imports to 125%, Beijing accused President Trump of violating 'basic economic laws and common sense.' The U.S. administration in turn have highlighted the regular 'violations' of international trade rules and norms as well as IP infringement practices. This comes alongside a mounting wave of shipping disruption. We have also seen some of China's largest companies (such as JD.com and Alibaba) rolling out measures to soften the impact of the U.S. tariffs, such as spending commitments to buy made-for-export goods to resell in China. These new shifts come with their own obvious challenges, given Chinese companies have spent years 'going global'.

The wider impact on Asian markets has been significant, and the pause triggered both positive short-term reactions and ongoing concerns. Taiwan, Thailand and Vietnam stock indices are still deep in the red, and as 'China-plus-one' countries (alternative manufacturers to China) they are still caught in the crossfire. There is a concern of dumping cheap Chinese products into Southeast Asia which places pressures on domestic producers. Slowing foreign investment is also a concern given that has been a crucial driver for growth in the region.

For the U.S., tariffs are not the only factor affecting the current economic outlook. U.S. debt levels and sovereign bond rates, potential spending commitments on 'bringing back manufacturing' or tax cuts means there is uncertainty on the direction of longer-term U.S. interest rates. J.P. Morgan amongst others recently revised down their U.S. GDP growth forecasts and business confidence appears rattled. Observers are watching the volatility of 10-year yields very closely, and investors are now 'pricing in' interest rate cuts by the Federal Reserve (which affects short-dated rates) on May 7th. Investors are also waiting to see how key industries such as pharmaceuticals, sources of important material such as rare earth minerals and the production of microchips will be managed as the U.S. administration embarks on a long quest to establish free-trade deals with dozens of countries.

Ultimately, protectionism can erode competitiveness and supply chains are already disrupted, all of which may impose disproportionate costs on consumers. In this instance the increasing one-upmanship in reciprocal tariffs between the U.S. and China becomes meaningless. Both countries seem very far away from compromise.

Other regions

The European Union decided to suspend its retaliatory tariffs in response to the 90-day pause, which would have affected $21bn of U.S. imports. Even so, these retaliatory measures were legally adopted by the E.U. and that legislation has not been rescinded. The European Commission president stated that 'our countermeasures will kick in' if agreement could not be found. The specter of levies on U.S. tech giants remains. There also appear to be mixed views within the European Union on the appropriate response, with some countries such as Spain keen to maintain their own pivot towards China.

The U.K. on the other hand faced a much lower 10% blanket tariff although there remain concerns for U.K. luxury car brands for example. Their approach, like Japan and others is to secure a deal that would remove almost all existing tariffs. As of writing the U.S. administration appears to be suggesting that agreeing more favorable trade deals will conclude this process for most countries, but the threat of withdrawing certain exemptions remains, which means that the radical uncertainty (and how best to incorporate that within any future decision making) remains.

How does this impact institutional investors?

As we have seen, investors need to navigate an incredibly fast-moving and complex economic environment. The reaction to the pause was a mix of immediate relief and ongoing uncertainty. The equities rally was also accompanied by falls in U.S. government bond yields and oil price given that ongoing China tariffs remain high. In the short term, institutional investors may be reassessing their portfolio mix although there is also a sentiment to 'wait and see' during the next 90 days instead of jumping back into the market. Getting the positions right at the short and long end of the spectrum at the same time is a key challenge when we do not know which moves may become permanent.

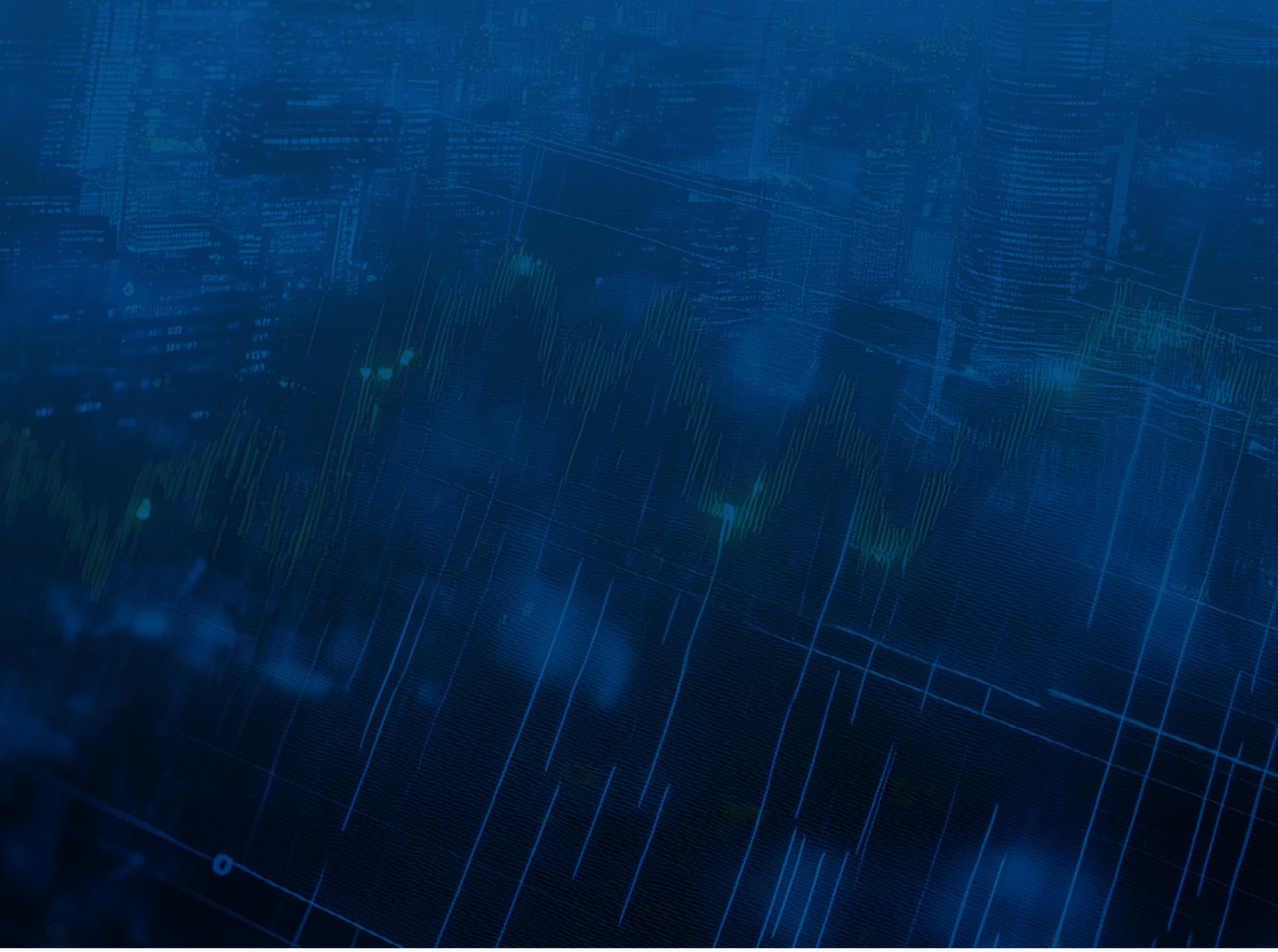
This unpredictability may also force institutional investors to reassess their risk management strategies, particularly where there are underlying liabilities. For example, a decrease in expectations of long-term yields will have the impact of increasing liabilities for pension funds and insurance balance sheets which can be sensitive to government yields under different valuation measures. Similarly, there may be impacts on regulatory measures, such as funding and capital management. The liability exposure of course depends on the level of hedging inherent in any investment strategy and the immediate costs of unwinding these positions, should that be necessary.

Another implication for institutional investors is the impact on liquidity, and the potential to reduce exposure to illiquid assets. Illiquid asset exposure has increased across insurers and pension funds in recent years due to yield and hedging requirements at the long end. There are indications that large institutional investors are studying options to shed allocations to illiquid private equity funds. There may be long-lasting impacts on the private equity industry and more embedded trends regarding public versus private markets, given the wider spreads available.

Insurers may also be concerned with managing policyholder behavior in case of sudden large-scale allocations to less volatile asset classes. Impacts on pension funds will be influenced by the maturity of the fund, its plans for run-off, pension risk transfer or other endgame solutions, and the extent to which the need for short-term liquidity arises.

Can we plan for this?

When living under such enormous economic fluctuations in a short period of time it is no wonder many institutional investors are adopting a 'wait and see' strategy. Stochastic scenario analysis, which forms the core of many robust risk management frameworks, can help us understand the impact of these types of extreme events. By aggregating thousands of scenarios together, we can view a cloud of possible outcomes, including tail risk scenarios. In recent days we have seen long rates spike up and then down, sharp currency movements, and market noises about a global recession. Deterministic stresses which incorporate these narratives, when applied alongside the scenario analysis can be a powerful way to understand the robustness of any investment strategy. Liquidity, capital measures and funding ratios can all be tested under this approach. Hedging positions are also most vulnerable when investors need them most, so the ability to test diversification strategies that capture the complex correlations/relationships between asset classes is vital.



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