PERSPECTIVES Memo

Tariffs – No big surprise, markets still down

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Key takeaways

- White House announces significant tariffs on Canada, Mexico and China.
- Markets selling off at a controlled pace as tariff moves had been telegraphed for months.
- Most recent news on a potential tariff delay for Mexico already providing some relief for the markets.
- Currency moves since U.S. election day have partly offset the threats of tariffs being imposed. Currencies such as the EUR and the CAD have weakened in recent months, which compensates companies somewhat for the new tariffs.
- Dynamic playbook – paradoxically, a less negative market reaction increases the risk of tariffs being imposed on the EU.
- Overall DB view confirmed – higher for longer for rates, robust nominal earnings growth and heightened volatility in 2025 and beyond.

What happened?

The long-feared tariffs by the Trump administration finally arrived over the weekend as the U.S. announced 25% tariffs each on its neighbours and key trading partners, Canada and Mexico effective February 4 (energy products face a lower 10% tariff). Also, Chinese products now face a 10% tariff in addition to the ones imposed by the past two administrations. The trade weighted USD index surged to its highest in over two years in the aftermath as investors fled to the safety of the greenback. The stock market tumbled with S&P 500 and Nasdaq 100 down by around 1.6% and 1.8% at the time of writing this memo. The shorter 2-year Treasury yield jumped by more than 4 bps whereas the longer 10-year Treasury yield moved marginally lower. The 5Y5Y inflation swap, a measure of longer-term market-based inflation expectations also increased marginally 2 bps to 2.56%. The VIX index jumped to almost 20.

The market reaction has been accentuated by the announcement of retaliatory measures and the rhetoric of the trading partners. Canada has announced 25% tariffs on USD155bn worth of goods – with USD30bn coming into effect on February 4 – while the charge on remaining products will come into effect in 21 days. While Mexico did not provide specifics, statements from its President suggested both tariff and non-tariff measures may be implemented. Similarly, China announced it would be taking necessary countermeasures and will file a lawsuit with the World Trade Organization (WTO). It is pertinent to mention that the tariffs against China are much lower than the 60% threatened by President Trump in his election campaign.

While the EU was not targeted, Trump did state that he will "definitely" impose tariffs on the bloc, while indicating a softer stance on the UK. An EU spokesperson stated that the bloc would respond firmly to any such measures. On the back of this, European markets opened in the red with the STOXX Europe 600 down 1.2%, the DAX down by 1.7% and the FTSE 100 down by 1.3%. While all the underlying sectors were down in the broad European market, autos (-3.3%) were the worst hit as Trump specifically mentioned "cars" in his statement regarding the EU. IT (-2.0%) and industrials (-1.7%) were the other poor performers. The EUR also weakened to its lowest against the USD since November 2022.

What does it mean for investors?

The impact of the announced tariffs depends on how long they remain in effect. Negotiations between the U.S., Canada and Mexico are already underway. Given the severe economic effects that tariffs would cause in the three countries, we believe it is in the best interests of all players to compromise. This occurred during U.S. President Trump's first term with the United States-Mexico-Canada Agreement (USMCA) which will have to be re-negotiated by 2026. However, since tariffs are arguably one of President Trump's preferred negotiating tools, he cannot roll them back completely if he intends to maintain a credible threat of force versus China, the EU and other countries.

The announced measures affect around USD1.3tn in trade, which correspond to 43% of U.S. imports and 5% of GDP. The average U.S. tariff rate would rise from 3% to 10.7%. If these measures remain in place for longer, and are followed by responses from its trading partners, estimates show that U.S. GDP could decline by more than 1% and core PCE inflation could increase by close to 1%. In such an environment the Fed would face the difficult task of responding to falling economic growth and rising inflation. If growth holds up, the Fed will not be able to cut rates further. Instead, rate hikes could be back on the table and the USD could strengthen further.

The consequences for Canada and Mexico would be more significant. For both economies an imminent recession would seem inevitable. The respective shock could be larger than Brexit was for the UK. Meanwhile, the hit to the Chinese economy is less significant. Exports to the U.S. only make up 2.3% of the Chinese GDP.

Treasury yields are likely to see continued upward pressure, especially at the short end as near-term inflation reprices due to higher tariffs. The impact on longer-end Treasuries is likely to be measured as the tariffs generate a one-time effect on prices which arithmetically fades away over the longer term. Nevertheless, the uncertainty created by these moves should prompt investors to demand a higher term premium.

The effects for stock markets are multi-layered. Fundamentally, if sustained, by some estimates the announced tariffs would lower aggregate S&P 500 earnings per share (EPS) only by c.3%. S&P 500 companies generate less than 1% of their revenues in Canada or Mexico. However, any monetary policy tightening by the Fed in response to rising inflation, could weigh on demand and hence translate into lower EPS. Furthermore, additional USD strength would hit EPS as well. A rule of thumb is that a 10% increase in the trade-weighted USD reduces S&P 500 EPS by c.2%. Valuations could also come under pressure as investors demand a higher risk premium for lingering trade policy risk. Additionally, rising bond yields driven by renewed inflation fears could drive valuations lower.

However, U.S. equities still have a lot of appeal. At the end of the day, they should benefit from Trump's America first-policies, including tax cuts and deregulation. Moreover, they are significantly less exposed to global trade than European or Asian stocks. Close to 60% of S&P 500 revenues are generated domestically.

Depending on respective production and end market profiles effects for individual companies are significantly larger and concern not only North American firms. Over the last couple of decades many European companies for example have established factories in Mexico to produce goods for the U.S. market. Prominent examples include German car manufacturers and suppliers. It is worth noting that in current production setups intermediate goods are often passing the border multiple times. These production chains could be significantly distorted in a new tariff regime.

In the following days analysts will estimate the possible effects for individual companies. This will take time as "the devil is in the details". Market participants may not show patience and "sell now, ask questions later", especially since U.S. tariffs on EU imports are yet to be announced. The sectors healthcare, luxury and automobiles have the largest revenue exposure to the U.S. via exported goods and are hence most affected by possible tariffs. On the other side, European real estate, banks, utilities, insurance, and software are insulated from tariffs on goods trading. However, they would be affected if services were to be restricted as well in the future. We recommend to continue with a barbell investment strategy including financials, industrials, consumer discretionary and IT stocks.

Trade war 2.0 has arguably started. Although, companies have started to reorganize supply chains and localized production over the last couple of years, and countries seem to be better prepared to answer U.S. tariffs, the net-effect of a tighter trade policy is certainly negative. However, given their different economic profiles some countries are more affected than others. In the U.S. growth may just hold up, while the prevailing weakness of the European economy may be aggravated. We expect tariff concerns to remain priced into financial markets for the foreseeable future.

The first Trump term saw markets nosedive several times after trade war escalations. Nevertheless, the direction of travel for U.S. stock markets was up. These sell-offs however seemed to prompt de-escalations. After all, Trump has often pointed to stock market gains as a reflection of his political success. In other words, he does not want the S&P 500 to decline.

Glossary

5Y5Y Inflation swap refers to a fixed to floating swap arrangement. It is a kind of a breakeven rate which measures the expected inflation in 5 years for next 5 years.

CAD is the currency code for the Canadian dollar.

The **DAX** is a blue-chip stock-market index consisting of the 40 major German companies trading on the Frankfurt Stock Exchange; other DAX indices include a wider range of firms.

Earnings per share (EPS) are calculated as a companies' net income minus dividends of preferred stock all divided by the total number of shares outstanding.

EUR is the currency code for the euro, the currency of the Eurozone.

The **U.S. Dollar Index (DXY)** is a weighted index based on the value of the U.S. dollar versus a basket of six other currencies.

The **FTSE 100** Index tracks the performance of the 100 major companies trading on the London Stock Exchange.

Gross domestic product (GDP) is the monetary value of all the finished goods and services produced within a country's borders in a specific time period.

The **Nasdaq 100** Index is a collection of the 100 largest, most actively traded companies listed on the Nasdaq stock exchange.

The **S&P 500** Index includes 500 leading U.S. companies capturing approximately 80% coverage of available U.S. market capitalization.

The **STOXX Europe 600** Index includes 600 companies across 18 European Union countries.

USD is the currency code for the U.S. Dollar.

The **VIX** Index is a measurement of volatility implied by S&P 500 Index options.

The **World Trade Organization (WTO)** is an intergovernmental organization, founded in 1995, that provides a framework for trade agreements.

Appendix

Historical performance

Performance	3.2.2020 – 3.2.2021	3.2.2021 – 3.2.2022	3.2.2022 – 3.2.2023	3.2.2023 – 3.2.2024	3.2.2024 – 3.2.2025
S&P 500	17.9%	16.9%	-7.6%	19.9%	21.8%
DAX	6.8%	10.3%	0.7%	9.3%	28.5%
FTSE 100	-11.2%	15.7%	5.0%	-3.6%	13.9%
STOXX Europe 600	-1.1%	15.1%	-1.7%	5.0%	11.5%
Nasdaq 100	46.9%	8.2%	-13.3%	40.3%	21.7%
STOXX Europe 600 Auto & Parts	19.8%	20.9%	-7.2%	3.3%	-9.7%
STOXX Europe 600 Basic Resources	22.8%	21.5%	5.4%	-18.3%	-1.2%
STOXX Europe 600 Technology	20.7%	7.6%	1.4%	17.0%	5.3%
STOXX Europe 600 Industrial Goods & Services	8.2%	10.5%	-0.6%	9.7%	19.7%
2-Year U.S. Treasury	2.5%	-1.2%	-2.2%	3.5%	4.5%
10-Year U.S. Treasury	6.4%	-3.3%	-11.8%	-0.6%	0.0%
EUR/USD	8.8%	-5.0%	-5.6%	-0.1%	-4.3%

Source: Deutsche Bank AG, Bloomberg Finance L.P., LSEG Datastream; Data as of February 3, 2025.

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