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SHOCK AND AWE TARIFFS CHANGE INVESTMENT DYNAMICS

Executive Summary

- On April 2, President Trump unveiled a range of reciprocal trade tariffs on almost all imports entering the U.S. While it is unclear how "reciprocity" was calculated by the Department of Commerce, the magnitude of the tariff rates that were announced implies that "non-monetary" factors like currency manipulation and value-add taxes played a role in addition to "monetary" trade barriers.
- Comments by Treasury Secretary Scott Bessent following President Trump's press conference shed some light on the administration's strategy: as long as countries don't retaliate, these tariff rates should be viewed as the "high-water mark."
- Investors' hopes for a careful implementation of reciprocal tariffs were dashed yesterday, and markets are reacting accordingly today. The S&P 500 fell by more than 3% at the opening, and other major international stock indexes posted declines greater than 3%, as well. Market fluctuations could remain significant over the next few days, as negotiations are kicked off, retaliatory measures are rolled out, and investors continue to digest the far-reaching ramifications of what has been announced.
- Investors, businesses and consumers alike are presented with a much-changed economic environment underlined by an average tariff rate that, if all measures announced yesterday are implemented as is, we estimate to rise to more than 22%—the highest since the early 1900s, and up from just above 2% at the end of 2024. This is likely to have material ramifications on the U.S. economy, with the ultimate impact determined by how higher import prices are absorbed.
- The frontloaded implementation of large and broad tariffs (ahead of more pro-growth policy priorities) has skewed the range of potential economic and market outcomes to the downside in the near term. As a result, we expect market volatility to persist.
- Against this backdrop, diversification within and across asset classes is paramount, and we recommend remaining anchored to up-to-date financial plans, and ensuring that investments are appropriately diversified across equities, bonds and cash holdings, aligned with individual risk profiles.

Niladri 'Neel' Mukherjee
TIAA Wealth Management
Chief Investment Officer

Alberto Favalli-Ragusini
TIAA Wealth Management
Director, Investment Strategy

What was announced?

On April 2, President Trump unveiled a range of reciprocal trade tariffs on almost all imports entering the U.S. While it is unclear how "reciprocity" was calculated by the Department of Commerce, the magnitude of the tariff rates that were announced implies that "non-monetary" factors like currency manipulation and value-add taxes played a role, in addition to "monetary" trade barriers. Consequently, **a 10% baseline reciprocal tariff was levied on all imports**, and this measure is set to take effect on Saturday, April 5. Additionally, **higher country-specific rates were levied on several trade partners**, including China (34%), Japan (24%) and the European Union (20%), and these measures are set to be effective starting at midnight on April 9 (potentially leaving room for negotiations over the next few days). Canada and Mexico were spared, but they are still facing the 25% tariff originally implemented on grounds of national security. And existing product-specific tariffs on automobiles, steel, aluminum, as well as likely future levies on pharmaceuticals and semiconductors are being complemented, rather than supplemented by these new reciprocal duties.

The focus now shifts to how targeted countries might respond. We expect many countries, such as India, to swiftly come to the negotiating table to quickly resolve tariffs, while some others like China and the European Union might first choose to retaliate. Comments by Treasury Secretary Scott Bessent following President Trump's press conference shed some light on the administration's strategy: as long as countries don't retaliate, these tariff rates should be viewed as the "high-water mark." This is an indication that tariffs announcements could be significantly altered or rolled back in the weeks ahead, especially if financial markets come under pressure.

Finally, it is important to note that all these tariffs are being levied under the presidential authority granted by the International Emergency Economics Power Act. As such, there is a possibility that the applicability of national emergency to justify such a sweeping range of trade tariffs could be challenged in court over the next few weeks.

How are financial markets reacting?

Investors' hopes for a careful implementation of reciprocal tariffs were dashed yesterday, and markets are reacting accordingly today. The S&P 500 fell by more than 3% at the opening, and other major international stock indexes posted declines greater than 3% as well. Bond prices moved higher (and bond yields lower by more than 10 basis points [bps]), therefore providing ballast to balanced portfolios.

The U.S. dollar is weakening sharply against developed market currencies (while its performance is more mixed against emerging market currencies) in a sign that risk-aversion is being led by the fading attractiveness of U.S. assets. Gold, which has been a safe port for investors amid growing uncertainty year-to-date (YTD), has been ensnared in the global sell-off as well, indicating that market volatility is causing a broad deleveraging of investment positions.

Market fluctuations could remain significant over the next few days, as negotiations are kicked off, retaliatory measures are rolled out, and investors continue to digest the far-reaching ramifications of what has been announced.

The road ahead

Trade policy is gradually taking shape, and assuming that "policy uncertainty" has been caused by the lack of clarity over policy details, this big announcement should lift some fog on crucial details surrounding trade tariffs, including how reciprocal duties would be imputed and what countries would be targeted.

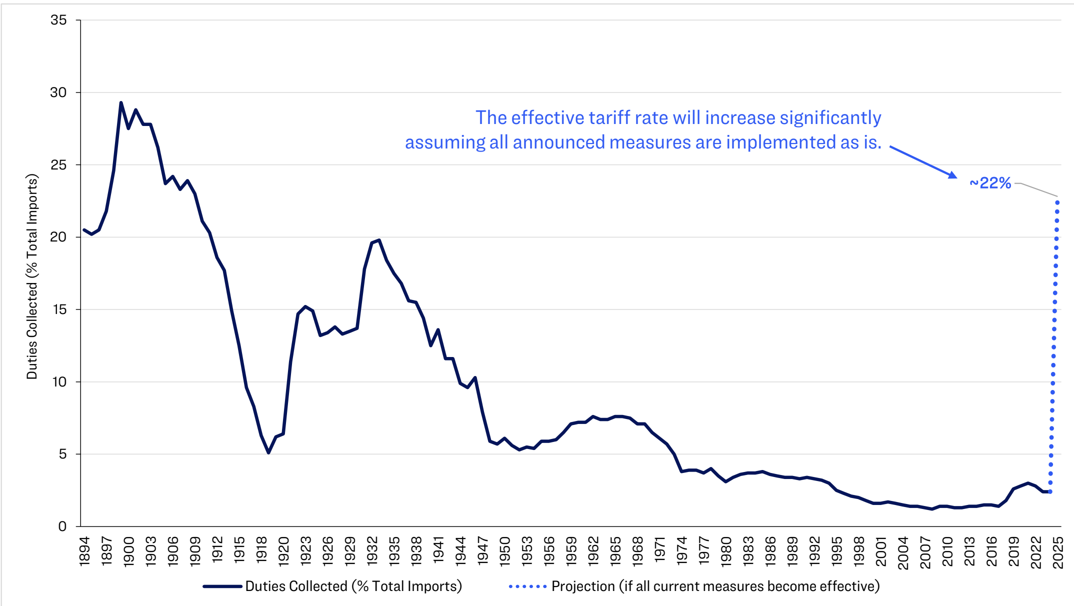
More clarity, therefore, should at least allow businesses to better align their strategies to this new economic reality. However, we caution that **less uncertainty is not the same as clear skies**. As the fog is beginning to dissipate, investors, businesses and consumers alike are presented with a much-changed economic environment underlined by an average tariff rate that, if all measures announced yesterday are implemented as is, we estimate to rise to more than 22%—the highest since the early 1900s, and up from just above 2% at the end of 2024 (Figure 1). This is likely to have material ramifications on the U.S. economy, with the ultimate impact determined by how higher import prices are absorbed. As we illustrated in our Focus*Point* "Trade Tariffs – What is the Deal?," there are three ways in which that could happen:

- Exporters in targeted countries can lower their prices to maintain competitiveness and retain their market share; or
- U.S. importers can absorb most of the price increase, which would lead to higher input costs, lower profit margins, and hence risks to employment; or
- U.S. importers can pass higher input costs to consumers, with a direct impact on price inflation, affordability, and therefore aggregate demand.

Our view is that we could see a combination of these three dynamics, **with further complications added by possible retaliatory measures from targeted trade partners.**

FIGURE 1

The effective tariff rate is bound to climb significantly.



Source: U.S. International Trade Commission, IMF, White House, TIAA Wealth Chief Investment Office.

The implications

While trade policy uncertainty might have peaked on April 2, downside risks to the U.S. and global economies have increased. A commonly shared rule of thumb suggests that every 1% increase in the effective tariff rate could raise core PCE inflation by 0.1%. This means that, even if successful negotiations result in a lower spike in the average import duty (say, 15%), upside risks to core inflation might range from 1% to almost 2%, which would push core PCE to at least 3.5% year-over-year (YoY) at its peak in the second half of 2025. At the same time, Gross Domestic Product (GDP) growth may come under pressure via three primary channels: lower consumption in response to higher prices; falling equity market prices further impacting consumer confidence, especially for high-income households; and subdued business sentiment, limiting employment growth and capital expenditures.

This announcement should reinforce the notion that tariffs are more than just a negotiating ploy—they are a cornerstone of President Trump's economic agenda. Yes, we expect this announcement to lead to several rounds of negotiations with trading partners, which could lead to lower tariff rates over time. But, during yesterday's press conference, President Trump also explicitly linked tariffs to overall fiscal policy, suggesting that the administration views tariffs as a source of revenue to partially pay for tax cuts. This confers a more durable and structural connotation to import duties and could lead to an adjustment period in the U.S. where upside risks to inflation and downside risks to economic activity coexist.

Against this backdrop, we see some mitigating factors that could eventually buffer the negative impact of tariffs.

- Given the Federal Reserve's (Fed) tendency to view tariff-induced inflationary pressure as "transitory," monetary policy could be eased more than currently expected in response to a significant worsening of economic and labor market conditions. However, our view is that it could take some time for the Fed to gain the necessary confidence that inflation is indeed temporary, especially if consumers' inflation expectations continue to rise.
- The flipside of trade tariffs being framed by the Trump administration as a source of funding for additional tax cuts is that, at some point later this year, it is reasonable to expect the government to make a decisive push to cut taxes. While our view is that the stimulative effect of these cuts could be relatively small, it could provide some much-needed support to consumers.
- Deregulation, another important element of President Trump's agenda, could accelerate as well later this year.

Investment considerations

The frontloaded implementation of large and broad tariffs (ahead of more pro-growth policy priorities) has skewed the range of potential economic and market outcomes to the downside in the near term. Corporate earnings are likely to come under further pressure, with the S&P 500 profit forecasts for 2025 already moving from ~14% YoY at the beginning of the year to ~10% currently. Multinational companies, arguably the biggest beneficiaries of globalization, face a challenging landscape of shifting supply chains, margin pressures, and a higher risk of diminished access to important global markets. In addition, the unfavorable mix of higher inflation and weaker growth could keep pressure on valuation multiples for global equities. As a result, we expect market volatility to persist, defensive stocks to outperform cyclical ones, and high-quality bonds to outperform high-yield and emerging market bonds, and we have positioned our tactical asset allocation accordingly.

Against this backdrop, diversification within and across asset classes is paramount, and we expect rising risks to economic growth to allow bond yields to decline (and bond prices to rise) during bouts of volatility, thereby partly offsetting equity drawdowns. We highlight the following considerations for investors:

- Remain anchored to up-to-date financial plans. Ensure investments are appropriately diversified across equities, bonds and cash holdings as per risk profile, as well as diversified income solutions that can help to support spending.
- Global diversification is becoming important again, given diverging fundamentals and economic and fiscal engines.
- Risk-averse investors, in consultation with their advisors, can discuss raising some cash if needed for immediate purposes. However, consider balancing the need to remain invested in equities for growth of capital during retirement years.
- Maintain a long-term perspective. Equities are a volatile asset class and have a history of bouncing back quickly from drawdowns.
- Market timing is an impossible exercise and attempting to do so can significantly lower long-term average returns.
- Investors with time horizons longer than 3 years should begin to consider making plans to deploy excess cash into high quality equities, using dollar cost averaging.
- If currently not in place, consider having an emergency fund for unforeseen costs like medical emergencies, home repairs, etc. This lowers the possibility of dipping into retirement assets during a market downturn.

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