The steel and aluminum tariffs fall under Section 232, a provision for addressing national security concerns, while the broader reciprocal tariffs would be issued under Section 301 to address unfair trade practices. (UBS)

Why trade imbalances cannot easily be negotiated

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US President Donald Trump on Monday raised import tariffs on steel and aluminum to 25% "without exceptions or exemptions." This marks a substantial step up from the 10% level he imposed in 2018. The administration looks set to end carve-outs, quota deals, and exemptions for partner nations that expanded under both him and his successor, Joe Biden.

The new tariffs, which the White House says will take effect on 4 March, will expand to cover a wide range of downstream metal products.

When asked about potential retaliation from the US' trade partners, Reuters reports Trump said "I don't mind." Canada's industry minister said he is consulting with "international partners," and the response will be "clear and calibrated."

Other tariffs may also be coming, with Trump reiterating plans in the coming days for "reciprocal tariffs" on all countries that impose duties on US goods. This round follows the on-then-off plan earlier this month to levy a 25% tariff on most Canadian imports—except for energy, which had a lower 10% rate—and all Mexican imports over disputes around narcotics and immigration control. While Trump ultimately hit pause on those tariffs, he did move forward with a 10% blanket tariff increase on Chinese imports, prompting retaliatory tariffs from Beijing.

Unlike last week's whipsaw response to tariffs, in which risk assets sold off and then recovered, the market reaction thus far has been fairly muted. The CBOE VIX Index of implied US equity volatility remains subdued at 16 points, within range of its 2025 lows. Gold hit a fresh all-time high of USD 2,942 an ounce, before giving up some gains to USD 2,905/oz—still about 12% up since late December.

With investors taking more of a tempered approach, we make several observations:

Trade imbalances cannot easily be negotiated. While the US imports close to 25% of its steel and nearly 70% of aluminum, its reliance varies. Steel production has room to expand if prices justify it, given existing overcapacity and new plants coming online. Aluminum, however, is far more import-dependent, with high costs and regulatory hurdles making domestic expansion unlikely. We are skeptical of this outcome given high US wages and other barriers such as environmental factors, permitting backlogs, long lead times for new facilities, and capital discipline by smelters, which are reluctant to invest in long-term projects unless prices remain elevated for an extended period. Other exporters of metals to the US, such as South Korea and Brazil, also have sizable trade surpluses with the US. Making matters more difficult, the strong US dollar side effect of higher US tariffs may also exacerbate the US trade deficit as it limits foreign buying power for US goods.

It's also important to distinguish between the different tariff categories under consideration. The steel and aluminum tariffs fall under Section 232, a provision for addressing national security concerns, while the broader reciprocal tariffs would be issued under Section 301 to address unfair trade practices. The steel and aluminum tariffs have been in force since 2018. While Trump initially made clear there would be no exceptions, he later left the door open to a possible exception for Australia, citing its trade surplus with the US and its large purchases of US aircraft. With the executive order not yet published, markets will await more clarity beyond the headlines on both the legal basis and final details on exemptions, quotas, and effective rates.

The metal tariffs may serve as negotiating leverage. The US is heavily dependent on its North American partners for the two metals: Canada is its number one export partner for both aluminum and steel, while Mexico ranks third for steel and is a major provider of scrap aluminum and alloys. Trump's team may be seeking to accelerate a renegotiation of the United States-Mexico-Canada Agreement (USMCA) free trade pact. Ultimately, we believe if these specific tariffs are imposed, the relative growth hit to the US economy will be more manageable than the ones Mexico or Canada would face.

Other partners with higher barriers to US goods are on notice. Under our base-case tariff scenario, we've been arguing that nations with higher average/effective tariffs may face the risk of higher US tariffs. The trade-weighted versus average tariffs can vary significantly, but the distinction may not be important to the White House. Outside of North America, South Korea, Vietnam, India, and Brazil stand out for higher average tariffs. The European Union is lower on the list, but several categories like autos and food have high barriers, and the underlying value of trade at risk is significant.

So, despite the relative calm in markets this week, we believe investors need to remain vigilant to changes in trade and tariff policies. We still expect that a solid US economy, AI tailwinds, and gradual Federal Reserve rate cuts will offer a favorable backdrop for equities. Our base case remains for the S&P 500 to rise to 6,600 by year-end. Volatile markets do require an increased focus on portfolio diversification and hedging approaches. In equities, capital preservation strategies can potentially help limit portfolio losses. Changes to trade policy tend to have a notable impact on currency markets, providing investors an opportunity to use volatility spikes to boost portfolio income. We continue to see gold as an effective portfolio hedge and diversifier, and believe an allocation of around 5% within a USD balanced portfolio is optimal.

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