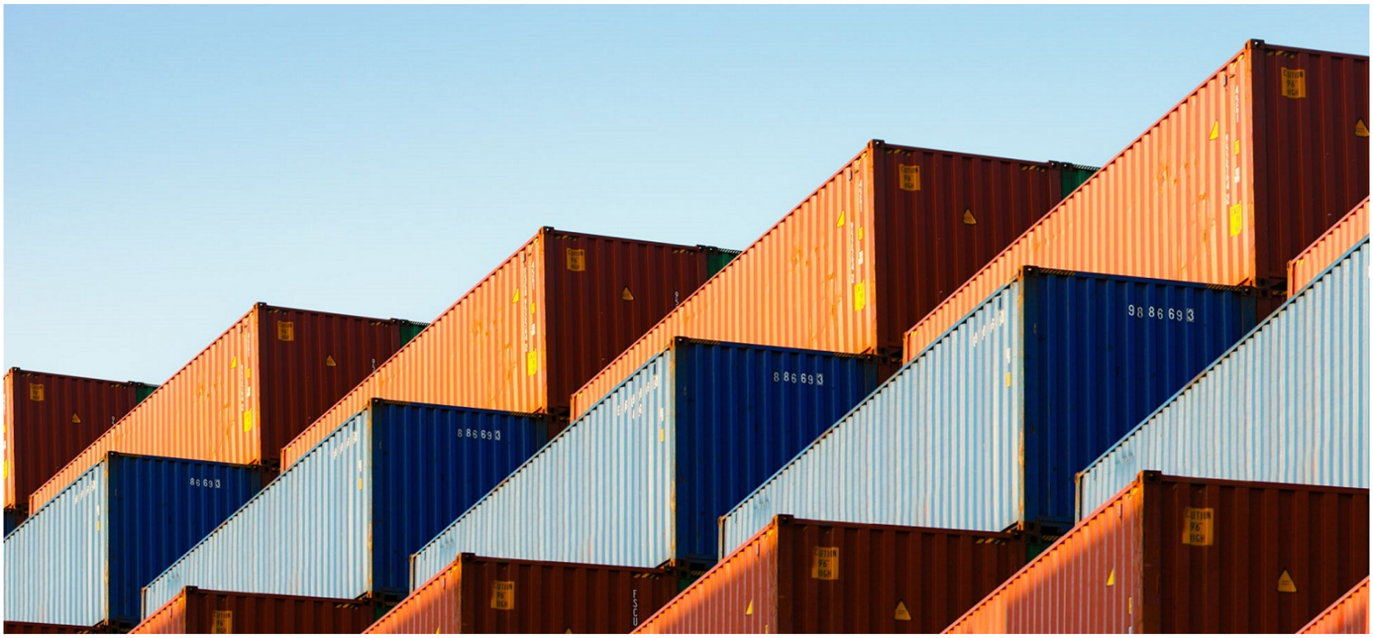

Investors should prepare for market volatility and potential policy surprises by considering portfolio diversification and hedging approaches. (UBS)

Answering some key questions on tariffs

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Equities had a volatile start to the week after the Trump administration pushed forward with plans to impose higher tariffs on Canada, Mexico, and China over the weekend. Sentiment partially recovered after news that the threatened tariff hikes on Mexico would be delayed by at least a month following concessions on border security and enforcement.

Later, Canada announced a similar pause after it revealed its own incremental border control measures and funding pledges. These delays revived hopes that President Trump's tariff threats may be more negotiable than previously thought. While no such deal has emerged to forestall the 10% incremental tariff on Chinese imports, which are now technically in effect, China's response was viewed as relatively muted—including 10-15% levies on US energy and agricultural tools. The measured nature of China's retaliation appeared intended to avoid further escalation.

But uncertainty remains high. Here are some answers to frequently asked questions we have been receiving from investors:

Why is President Trump targeting these countries?

The US president has long stated his enthusiasm for tariffs. But some of his initial targets have come as a surprise—with an additional 25% tariff for neighbors Canada and Mexico. China, a more long-standing trade rival, has also been included, though at a lower additional rate of 10%. The White House has said this reflects a desire to hold these nations “accountable to their promises of halting illegal immigration and stopping poisonous fentanyl and other drugs from flowing into our country.” It is notable that concessions on border control from Mexico and Canada have been sufficient to delay the implementation of tariffs.

The administration has also cited the bilateral trade deficits the US runs with these nations, which President Trump has said are evidence of unfair practices. President Trump has also threatened to impose tariffs on the European Union, having criticized the trade bloc for the scale of its trade surplus with the US.

How significant is trade with China, Mexico, and Canada for the US economy?

The US is a relatively self-sufficient economy, with a relatively low reliance on foreign trade by international standards. Imports account for around 14% of US GDP, as of the latest full year of data from 2023. However, China, Canada, and Mexico account for 43% of those imports.

Even this number may understate the importance of trade flows between the US and its neighbors. For example, a component for a US auto may cross the border with Mexico many times during assembly. If each move across the border were to trigger a 25% tariff for the US automaker, the supply chain would need to be adjusted.

Why would energy face a lower tariff rate? Isn’t the US energy independent anyway?

The US is a net exporter of both petroleum and natural gas. However, oil varies in consistency and refineries are configured to process different types of crude. Prior to the US shale revolution—which boosted US production of light oil—many US refineries were set up to process heavy oil, much of which is imported from Canada. As a result, high tariffs on Canadian crude would push up the politically sensitive price of gasoline, especially in the Midwest.

Are these tariffs just a threat or the start of a new normal?

This should become clear over the coming weeks and months. Last-minute reprieves for Colombia, Mexico, and Canada provide some hope that President Trump is using tariffs as a negotiating tool rather than a permanent fixture of economic policy. The administration also came under pressure from business groups to avoid a confrontation with Canada and Mexico. The National Manufacturers’ Association wrote that its members “understand the need to deal with any sort of crisis that involves illicit drugs crossing our border,” but also feels “protecting manufacturing gains that have come from our strong North American partnership is vital.” In our view, the president is unlikely to want to alienate key constituencies in his voter and funding base.

Can we learn anything from factors that led to changes in tariff policies during Trump’s first term?

Various potential lessons can be learned from Trump’s first term. It is notable that the momentum of higher tariffs against Chinese imports was slowed after the nation agreed to step up purchases of US goods.

That said, the start of the second term has been different from the first term, and the mindset of the administration could be different this time. The key will be whether Trump has become convinced that tariffs are worthwhile in and of themselves, and not just a bargaining tool. This might become clearer in the coming weeks.

Are there ways to avoid these tariffs for businesses and consumers?

Global trade patterns can be rerouted over time to avert tariffs. After the first-term tariffs against China, China rerouted about a third of its exports to the US. That is not practical for Mexico and Canada, however, for simple reasons of geography. Also, some of China’s rerouting went via Mexico and Canada and could now be subject to tariffs.

The higher the tariff rates, the more incentive there will be to take actions such as moving factories from China to neighboring low-wage countries. Of course, moving production to the US would be one way to avoid tariffs and the best outcome from the president’s viewpoint, but we are skeptical that there will be significant "onshoring." Wages in the US are high, and retaliatory tariffs could make it difficult to export from any newly built factories in the US.

What would be the effect on US growth and inflation if the tariffs do remain in place?

The effect of a prolonged retaliatory exchange of tariffs is stagflationary—meaning that prices would experience a one-off increase, while we estimate expected growth would slow 80-100 basis points. As it stands, our base case is a scenario of “selective tariffs,” which have the potential to dent, but not derail, US economic growth.

How about the impact on China, Mexico, and Canada?

The prolonged imposition of tariffs may be enough to push the Canadian and Mexican economies into recession while also representing a sizable inflationary shock. The depreciation of their currencies as trade "shock absorbers" could mitigate some tariff-related shock to exports, but also reduces their international purchasing power. Mexico was already grappling with an economic slowdown, with GDP growth of just 1% expected in 2025 prior to the tariff announcement.

What does it mean for global trade and global growth? Is the risk of a recession rising?

Aggressive US tariffs would almost certainly trigger retaliation by US trading partners, and there are risks of a tit-for-tat ratcheting up of tariffs. Policy uncertainty is unusually high, which is damaging to global growth since it is difficult for businesses and consumers to make plans. The US and China are unlikely to suffer recessions even if tariffs prove significant, but other countries that are more reliant on bilateral trade with the US, especially Canada and Mexico, could be more vulnerable. Overall, we still think a global recession remains unlikely.

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