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Brewin Dolphin

Markets in a Minute

Guy Foster, Chief Strategist, takes a closer look at U.S. trade tariffs against Mexico, Canada and China. He also discusses Europe's new measures to increase military spending.

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On Tuesday last week, the U.S. imposed 25% tariffs on most imports from Mexico and Canada. The exceptions to this were potash (a fertiliser used in farming) from both countries and energy products from Canada, which would be tariffed at a reduced rate of 10%.

Canada, however, has been quick to react with retaliatory tariffs, including an export tariff on the electricity it provides to northern U.S. states, which is designed to impose a real cost on U.S. consumers. Over the weekend, former governor of the Bank of Canada Mark Carney successfully contested the leadership of the Liberal party and will soon become prime minister.

Referring to the trade war, Carney said "We didn't ask for this fight, but Canadians are always ready when someone else drops the gloves."

Earlier today, in response to those retaliatory measures, U.S. President Donald Trump announced that tariffs on Canadian aluminium and steel would be increased to 50% on 12 March.

By last Wednesday, it seemed there would need to be an exemption for the car industry, because many products cross the border several times during the manufacturing process. Car makers argued that subjecting their cross-border supply chain activity to tariffs that European and Asian carmakers don't suffer from puts America at a disadvantage. It's unclear why this took until Wednesday to recognise because it had been widely discussed during the presidential campaign.

An exemption was granted on Thursday for goods traded under the United States-Mexico-Canada Agreement (USMCA) – the agreement negotiated by President Trump's first administration.

Investors are bracing for the impact of President Trump's erratic trade policy. This U-turn on Mexican and Canadian tariffs follows an eleventh-hour decision last month to defer their implementation until 4 March. The president lauded the progress made in the fight against fentanyl imports since the tariffs were first threatened. However, he promised there won't be another deferral in April, when reciprocal tariffs on Mexico and Canada are due to come into effect following a review.

The seemingly endless stream of deferrals and modifications to the Canadian and Mexican tariffs follow February's attempt to end the tariff exemption on small packages (which had to be temporarily halted due to logistical challenges related to enforcement).

It's surprising that these challenges hadn't been foreseen. However, the Trump administration has seemed to be in a state of disillusionment over the effect of tariffs and trade. President Trump believes companies in another country selling goods to Americans are effectively ripping America off, and that producers pay tariffs; overwhelmingly, it's consumers who pay them. This is not a widely held opinion.

The art of ~~the deal~~ war

Perhaps what's most surprising about his approach is his apparent desire to go after all other countries at once (assuming he follows through with promised reciprocal tariffs in April).

Analysts acknowledged ahead of the election that the U.S. would be in a strong position to negotiate with other countries under the threat of tariffs because trade doesn't actually make up a particularly large share of the U.S. economy. However, it seems this position of strength is being squandered.

Other countries may trade more, but if the U.S. imposes tariffs on all trading partners simultaneously, as President Trump seems to be suggesting, and if those trading partners impose counteracting tariffs, this raises the amount of U.S. trade subject to tariffs relative to peers, who'll be trading largely tariff free between each other.

Thousands of years of military strategy, dating back to Sun Tzu's text 'The Art of War', contains variations of the idea that the best path to success is to 'divide and conquer'. Whilst not a warrior, the Trump administration seems more willing to unite its rivals. Perhaps it's telling that in his negotiating guide 'The Art of the Deal', Trump never really addresses the power dynamics that come from collective or individual negotiations (despite this being a tried and trusted path to negotiating success).

The effects seem telling. Business surveys have shown a marked deterioration in confidence. In some cases, this has been reflected in less activity. In others, the shoe seems likely to drop in coming months. Companies struggle to explain how they'll react to tariffs because they don't know what these tariffs will be.

It seems reasonable to believe that a company might be more willing to invest in a new U.S. plant than a non-U.S. plant given the threat of tariffs. However, the decision to invest at all might be in question if you don't know what tariff you'll pay on imported components, or how much of a tariff advantage there is to invest in the U.S., relative to the much higher labour costs.

The only certainty is uncertainty

Some business surveys include anecdotal comments from submitters. Almost all of them are negative at the moment, and most of them cite tariffs as the reason for anxiety. An example that stands out from the Institute for Supply Management (ISM) manufacturing survey says: "Management now has us running scenarios to project tariff impacts to our business. They want numbers in 24 hours on variables that equate to a wild guess. Interesting times we live in." This shows how difficult it is for companies to make decisions when the taxation of imports changes almost by the day.

A number of retailers reported earnings last week, and so the topic of tariffs came up with management. Very few companies have anything significant to say in terms of their mitigation strategies. Commentary tends to make trite references to leveraging global buying power and focusing on value for customers. Very few know exactly what the impact will be or can do much about it in the short term.

There has been some evidence of a slowing U.S. economy. The Citigroup Economic Surprise Index edged below zero, suggesting the economy was performing worse than expected.

Perhaps most extraordinarily, the Federal Reserve of Atlanta's current estimate of gross domestic product ('nowcast'), known as GDPnow, fell sharply at the beginning of last week. The biggest detractor came from the sharp increase in imports. Imports reduce GDP while exports increase it, but as businesses anticipate an increase in tariffs, they try and buy ahead of the tax increases. That effect should reverse in coming months, notwithstanding the constantly moving tariff environment.

U.S. consumer confidence drops

However, beyond this, there also appears to have been a more pronounced drop in consumption. This seems likely to reflect an increase in economic caution.

Reduced retail sales and weaker confidence surveys have been the clearest indications that the economy is turning. The U.S. labour market broadly held firm. The non-farm payroll report showed employment creation was weaker than expected and the unemployment rate rose unexpectedly. However, some of that impact is due to a higher-than-average number of workers being unable to work due to bad weather.

Government employment will receive lots of scrutiny as the impact of the Department of Government Efficiency builds. So far, federal government employment was only down by 10,000 jobs in February, but next month will be a better test.

There was some reassuring news on inflation, with lower-than-expected wage growth. Given the weak economic data momentum recently, this firmed up bond markets' expectations of three rate cuts from June this year.

Forget MAGA and get MEGA

Whilst President Trump's activities may be dampening economic activity in the U.S., they seem to be accelerating it in Europe.

An acrimonious meeting between President Trump and Ukrainian President Volodymyr Zelenskyy saw the U.S. halting aid and ending intelligence sharing

with Ukraine. The move was a devastating blow to Ukrainians and a boost to Russia. It had a galvanising effect on Europeans.

On Tuesday evening, German leaders announced their intention to reform the constitutional debt brake to essentially allow for open-ended borrowing for defence. It would also allow for the creation of a €500bn special purpose vehicle for infrastructure investment.

The announcement came on the same day that European Commission President Ursula von der Leyen proposed her 'ReArm Europe' plan. The plan includes providing loans to member states to buy military equipment and, more importantly, a commitment to trigger the European Union (EU)'s national escape clause. This would prevent military expenditure from being counted in the bloc's punishment mechanism for countries breaching EU spending limits.

So, while Trump is trying to Make America Great Again, it's also time to Make Europe's Guns Again. Hardly a reassuring thought but one that has boosted the equity market and pushed down European bond prices.

There are immense challenges around increasing defence spending at a time when European countries have very stretched public finances. France's government fell last year after struggling to pass tax increases to try and restore its fiscal poise.

Aerospace and defence companies can be challenging investments as they are inherently unpredictable, have complicated accounting, and rely on government orders. Following the recent rally, European defence stock valuations appear generous and are vulnerable to headline risk, so we're not inclined to chase this rally.

However, stepping back, increased European defence and infrastructure spending may have longer-term benefits for European indices beyond the defence sector, so we've raised our allocation to European equities.

We also cut our gold weighting slightly, remaining overweight. The conditions supporting gold remain broadly in place. It could be sensitive to a further rise in bond yields, but recently, gold has been relatively resilient in the face of yield movements. Instead, it seems to be driven more by being bought by central banks seeking to reduce their dependence on U.S. dollars.

There's little indication of that trend changing, but in recognition of the extremely strong performance from gold, we thought it was prudent to take some profits.

What's coming in the week ahead

This week, the economic landscape will be filled with key events that will likely shape market expectations and investor sentiment.

We'll see the release of several significant economic indicators, including China's inflation rate, Germany's balance of trade, and the U.S. Job Openings and Labor Turnover Survey, inflation rate, and producer price index. These data points will provide valuable insights into the current state of the global economy and will likely influence monetary policy decisions and market trends.

The Bank of Canada's interest rate decision and the UK's GDP growth rate will also be closely watched.

In terms of corporate earnings, this week will see reports from several major companies, including Oracle, Ferguson, Adobe and Inditex. Investors will be watching these reports closely for signs of growth and guidance – although for some companies, the tariff confusion will complicate this.

If recent weeks are anything to go by, scheduled releases from companies and statisticians will be overshadowed by the latest erratic action from President Trump.

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