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WESTERN ASSET
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Macro Market Trends:
Global Economic Perspectives from the Desk

In his latest Market Commentary, Western Asset CIO Michael Buchanan discusses the potential impact of US President-elect Trump's proposed tariffs and other protectionist policies on global growth and inflation. While the ultimate timing, breadth and scale of the tariffs remain unclear, the direction is evident. Market pricing largely reflects the policies President-elect Trump touted in his election campaign, but the possibility remains the policies won't be fully enacted. Michael discusses with Western Asset's key macro decision-makers on the implications for interest rates and currencies in their regions.

KEY TAKEAWAYS

- US President-elect Trump has been quick to talk up a wide variety of tariff measures on US imports. Additional tariffs on at least some goods seem inevitable, though the timing and extent are hard to predict.
- Market expectations are that the administration will move forward with select tariff regimes, focusing on key industries, rather than across-the-board tariffs. The rhetorical journey will be volatile, involving threats of less-targeted policies.
- Should the 60% China/10% rest-of-world tariff plan which President-elect Trump campaigned on come into fruition then the broad macro impact would be higher relative growth and inflation in the US vis-à-vis the rest of the world. In essence, this appears to be the US desiring a larger slice of a smaller pie. Counter tariffs would magnify the growth downside whereas increased US investment and production would lessen the impact.
- Tariffs, which are more transactional in nature, less broad-based—perhaps with a border policy goal taking priority over a trade goal—would have a smaller macro-economic footprint. Currently, markets are adjusting the probabilities between the broad and more narrow tariff regimes.
- Many of Trump's desired policy goals such as low inflation, low interest rates, strong growth, buoyant equity markets and a weak dollar sit uneasily with a more draconian tariff regime. Again, this lends support to a more nuanced regime. The journey toward whichever outcome prevails will see heightened market volatility and uncertainty.

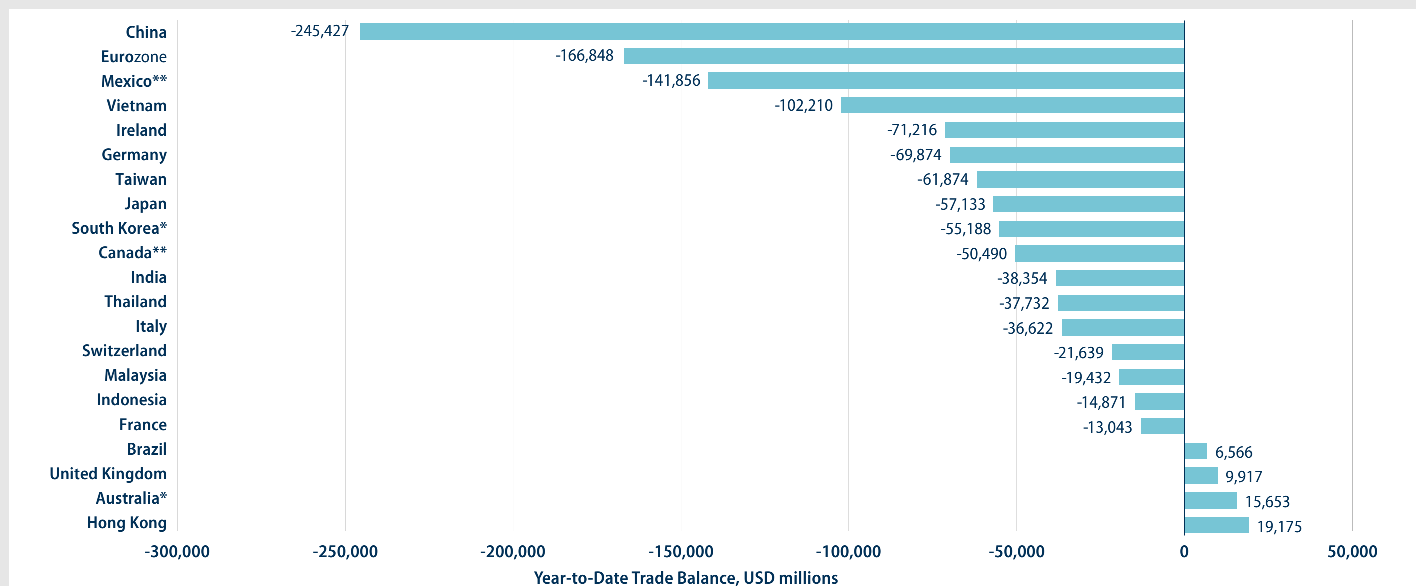
Proposed US Tariffs—Bluster or Actual Policy?

OVERVIEW

The US presidential election in November saw the Republican party take control of the White House and claim victory in both houses of Congress. When Donald Trump is inaugurated in January, he will become the 47th President of the United States of America. President-elect Trump has made tariffs a central plank of his campaign, declaring the word tariff to be "the most beautiful word in the dictionary." Only a month has passed since the election as I write this. Since then, Trump has been quick to talk up a wide variety of tariff measures on US imports—all under his banner of "Make America Great Again." Additional tariffs on at least some goods seem inevitable, though the timing and extent are hard to predict. Tariffs are taxes on imports that can lead to higher prices, inefficient allocation of resources and often result in retaliatory tariffs from trading partners. Despite these downsides, the Trump administration has deemed tariffs a necessary tool for national security to address unfair trade practices, reduce deficits, protect key industries and manufacturing jobs, and compel economic rivals to comply with America's demands.

While the ultimate timing, breadth and scale of these theoretical tariffs remain unclear, the direction is evident. Relatively free trade is giving way to more protectionism. This will have both near-term and longer-term implications for inflation, interest rates, exchange rates and global economic growth. China, the eurozone and Mexico are those most under fire from President-elect Trump due to their large trade balance surpluses with the US (Exhibit 1). If protecting US businesses is successful then it will undoubtedly support the US economy and strengthen the US dollar. Conversely, lower exports to the US by key trading partners will dampen domestic economic activity in those countries. Second-order impacts will be felt in more far-reaching areas of the globe such as Australia, which is heavily dependent on China's growth. Market pricing today currently largely reflects the policies Trump touted in his election campaign. But let's keep in mind there is always the possibility his policies won't be fully enacted, especially those aimed at countries other than China. Perhaps some of Trump's proposals were hollow from the start—this is the man that wrote "The Art of the Deal" after all—and are simply meant to serve as negotiating chips. We certainly witnessed some of these tactics during his last term. Under a scenario of fewer actual tariffs implemented, the risks to growth outside the US will decrease, strengthening global stability, and the US dollar should retrace some of its recent strength.

US Trade Balance by Country/Region



- **Impact on Key Trading Partners:** China, the eurozone and Mexico are most vulnerable to protectionist policies due to significant trade surpluses with the US. If implemented, this could lead to subdued exports and dampened domestic economic activity in these regions.
- **US Economic and Currency Effects:** Protecting US businesses is expected to support the US economy, potentially strengthening the US dollar further. However, if the proposed policies are not fully implemented and used more as negotiation tactics, the US dollar could retrace some of its recent strength.
- **Global Ripple Effects:** Second-order impacts of US protectionist policies could affect other regions beyond the primary targets of China, Mexico and the eurozone, such as Australia, which relies heavily on China's growth. Market pricing currently reflects Trump's campaign policies, but what actually comes to pass may vary starkly, possibly even resulting in increased global economic stability.

Source: Census Bureau. Figures are not seasonally adjusted. As of 30 Nov 24.
** Countries denoted by asterisks represent countries with Free Trade Agreements with the United States.*
*** Countries denoted by double asterisks represent countries included within Free Trade Agreements with the United States.*

GLOBAL PERSPECTIVES

"I spoke with the key macro decision-makers from across our global offices and posed each of them the question: 'What would Trump's tariffs likely mean for your region?"

— **Michael Buchanan, CFA**, *Chief Investment Officer*

UNITED STATES

Nicholas J. Mastroianni, CFA
Portfolio Manager

The initial impacts of tariffs and other trade protections are fairly clear: an initial spike in prices and the possibility of higher policy rates. A buoyant US dollar could offset some of the price increases. On the consumer side, paying higher prices for goods results in lower demand for additional consumption. Businesses whose supply chains are heavily dependent on products sourced from impacted countries face particular problems. To cope with these challenges, affected companies either raise prices, absorb the impact through lower margins or reshuffle their supply chains to countries not impacted by tariffs.

With imports representing roughly 10% of US household consumption, a 10% tariff impact could add a one-time increase of 1% to inflation. However, this estimate is theoretical and there are many factors that could alter the calculus, not the least of which is the impact of a stronger US dollar.

Over time, the resulting weaker global growth has the potential to push down commodity prices and labor demand, acting as a headwind to inflation and offsetting some of the initial impact of higher prices and higher interest rates. At the same time, many of the growth headwinds generated by tariffs are likely to be offset by business and consumer optimism related to other Trump agenda items (i.e., tax cuts, deregulation, a stronger southern US border) that have the potential to be more stimulative.

Broad-based tariffs risk causing higher inflation, increased interest rates and slower growth, which we think conflict with broader goals of the Trump 2.0 agenda. Consequently, we believe that economic pragmatism, which prioritizes economic growth, low/stable interest rates and strong equity market performance, will ultimately prevail. China is apt to face trade restrictions in addition to tariffs due to national security concerns. Outside of China, the implemented tariffs will likely be targeted and used as negotiating tools rather than as rigid economic policy.

Given what we believe is already priced into the market, a more obvious move toward targeted tariffs, for example focusing on the automotive and electric vehicle industry specifically, would likely be positive for business and consumer sentiment, supportive of lower near-term policy rates and cause the US dollar to modestly weaken versus a broad basket of currencies.

LATIN AMERICA

Paulo Eduardo Clini
Head of Investments, São Paulo

Trump's tariff program will likely impact Latin America through two primary channels. First, a stronger dollar could pressure Latin American currencies and disrupt the region's projected easing cycle. Second, with US oil production at its peak, Trump's "drill baby drill" agenda might push Saudi Arabia to ramp up production, driving oil prices lower to force out competitors. This scenario would hurt revenue prospects for Latin American oil exporters struggling to cover growing fiscal deficits. The latter will likely lead to weaker domestic economic growth while the former could see government bond yields trade higher as central banks may be forced into a more restrictive stance than they would otherwise prefer.

Mexico is uniquely vulnerable to a Trump 2.0 scenario given its large trade relationship with the US and the complex immigration/migration situation with its northern neighbor. Trump will likely want concrete and expedited actions from the newly elected Sheinbaum administration to address immigration, drug/fentanyl transit and trade friction points. Sheinbaum will need to address these issues in the shadow of the upcoming USMCA sunsetting/renegotiation where there are significant areas of difference the Trump administration will want to address. Although we believe over the long run Mexico will be an important trade partner and closely linked to the US, the path over the next several years will likely not be linear, but rather rocky with plenty of conflicting headlines. We have reduced our Mexico peso positioning throughout 2024 and will continue to be nimble expecting near-term volatility. We remain constructive on local Mexican rates; as inflation continues to fall, we see scope for additional monetary policy easing.

ASIA (EX. JAPAN)

Desmond Soon, CFA
Head of Investment Management, Asia (ex. Japan)/ Portfolio Manager

Trump tariffs and "made in USA" policies are designed to promote US-centric growth, which would weaken global growth, particularly for Asian export-oriented economies that have significant trade surpluses with the US. Countries with large domestic economies like India and Indonesia will be better shielded. China, which is targeted by 60% tariffs, may suffer disproportionately but has developed strategies to mitigate the impacts, including fiscal stimulus, accommodative monetary policy, diversified exports and a plan to reroute exports via other countries. Smaller export-oriented economies like South Korea, Vietnam and Malaysia may suffer second-order effects if China is hard hit. Singapore, which has a Free Trade Agreement with the US, may be partially shielded.

Stronger growth in the US will see the US dollar strengthen to the detriment of Asian currencies. The impact on inflation from the proposed tariff regime across Asia is skewed to the downside. Trump tariffs, immigration curbs and tax cuts are expected to stoke US inflation. However, the delta from US inflation to Asian inflation is expected to be low due to subdued domestic inflationary pressures. Energy prices are expected to be soft due to increased US production. We remain conscious of erratic weather patterns that plague the region and lead to bouts of sharp volatility in food price levels.

Demand for Asian local bonds is expected to remain robust. Asian long-dated bonds do not suffer from the same supply overhang as the US due to Asia's fiscal prudence. Demand for long-dated paper is also anchored by insurance companies and pension funds. The People's Bank of China will focus on currency stability, applying fiscal stimulus and accommodative monetary policy to support the economy. We see the possibility that the Chinese renminbi weakens through 2025, which would be in line with other Asian currencies.

EUROPE

Richard Booth
Portfolio Manager

The proposed 10% blanket tariffs on eurozone exports to the US would likely weaken growth and have a modest disinflationary impact. Demand for eurozone exports would dissipate, both from the US (via tariffs) and from China (elevated tariffs in China will weaken growth and import demand). The sectors with the largest exports to the US (pharmaceuticals, autos and chemicals) are already struggling with competitiveness issues vis-à-vis high energy price inputs and increasing competition from the Chinese auto industry. Countries with a larger manufacturing base, such as Germany, could face the most negative impact.

Weaker growth and increased competitiveness would either result in higher unemployment or reduced wage pressures. It is noticeable that both are already at play in Germany. Trade diversion could lead to a further weakening in core goods inflation, likewise a build-up in eurozone inventories could lead to discounting in local markets. Although not under the remit of tariffs, there is a clear desire within the Trump administration to lower energy prices and increase US energy exports into the eurozone. Adding all these components together could lead to a 0.1%-0.2% negative impact on eurozone headline inflation.

Given that tariff implementation would further weaken both growth and inflation in the eurozone versus the US, this would likely see continued weakness in the euro. The feedback link from a weaker euro currency to eurozone inflation is more benign; it would require a sharp depreciation in the trade-weighted euro to cause upside inflationary pressure.

JAPAN

Hiroyuki Kimura
Head of Investment Management, Japan

The possible tariffs on Japan's exports to the US would weigh on the Japanese economy. The direct impact on Japan's GDP growth rate could be marginal in our view, potentially lowering economic growth by approximately -0.2% at most. This would be under the premise of a 5% reduction in real exports to the US from Japan due to higher tariffs. Japan's exports accounts for 20% of GDP, with the share to the US being 20%. A shift in the direction of Japanese exports away from the US could offset the direct impact mentioned earlier. In addition, as Japanese companies have already increased production capacity overseas, the negative impact could be mitigated. Second-order impacts, such as a serious downturn in the Chinese economy and a broader slowdown in global growth would have a much greater impact on Japanese growth.

The direct impact of US tariffs on Japan's inflation would be negligible as there is little possibility that Japan would counter with retaliatory tariffs. However, in the case of slower global growth led by second-order effects, a modest disinflationary impact would be unavoidable. If the global economy weakens, the Bank of Japan would likely pause its hiking cycle, suggesting lower Japanese government bond yields and a weaker Japanese yen.

AUSTRALIA

The direct impact of Trump's policies on Australia are likely to be minimal, given the strong relationship between Australia and the US, and given that the US has a trade surplus with Australia. A larger impact is likely to come indirectly from the large trading partners of Australia, such as China. If Chinese growth is negatively impacted, then that could impact the level of exports from Australia to China.

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AUSTRALIA *continued*

Anthony Kirkham, CFA
Head of Investment Management, Asia and Australia

In the face of higher tariffs, China is expected to increase stimulus to its economy and the ultimate mix of fiscal and monetary support will be important to Australia. China is unlikely to boost its housing and infrastructure significantly due to problems in that sector, especially housing, but if it does that would be beneficial for Australia as the demand for iron ore exports would increase. Given Chinese exports to the US are likely to be reduced, China could look to increase exports into other countries including Australia. We are already seeing exports of electric vehicles to Australia increase, and this could expand to other goods as well.

With heightened uncertainty about the responses of other governments to changes in US tariffs and other policies, the outlook for the world economy will likely be increasingly uncertain in coming years. Our view is that slower global growth and weaker export prices from China could result in softer economic growth and inflation in Australia. That said, Australia is in a relatively strong fiscal position and if inflation and growth are slower, then the Reserve Bank of Australia should be able to ease monetary policy to stimulate domestic economic growth. We expect the Australian dollar to remain on the weaker side relative to the US dollar during these periods of uncertainty; however, on the cross rates it is likely to do better than most due to Australia's more sound underlying fundamentals.

CONCLUSION

"The Trump tariffs may have an outsized impact on global trade dynamics, economic growth and inflation. The path of outcomes remains uncertain. As an active manager we remain vigilant but if the aggressive measures proposed by the incoming administration are not fully implemented, our base case should continue to play out."

The US labor market and growth are slowing gently toward trend whereas growth challenges remain in Europe and Asia. The balance of risks, which is highly dependent on US government policy outcomes, suggests a further widening in the growth gap between the US and the rest of the world. Headline inflation has moderated but the balance between services inflation and goods inflation remains wide. We expect further services disinflation in the first half of 2025 and goods inflation to remain benign. Should this take place, central banks can continue to lower policy rates toward more neutral levels. We remain overweight interest rate duration, but less so as rates have fallen and markets have moved closer to our base case.

The greatest risk to our base case is a severe volatility event in which credit-related spreads widen significantly while interest rates spike higher. Initially, this could be experienced via an aggressive trade war where trading partners of the US retaliate strongly, ultimately leading to higher rates. Deeper trade tensions risk pushing global growth sharply lower and potentially causing a worldwide recession. Under this scenario, equity markets would come under pressure while spread sectors would widen, eventually forcing central banks to ease policy rates. That said, there is a broad expectation that the aggressive measures proposed by the incoming Trump administration may not be fully implemented, with a more targeted approach favored. If this happens, Western Asset's base case should continue to play out. As always, to help reduce overall portfolio volatility, we carefully integrate risk management strategies into how we build our portfolios—a key component for successful investment management.

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