Citi Wealth

Investment Strategy *Bulletin*

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US Trade Deficit, Market Cap Surplus

Key Takeaways

- As expected, global financial markets were significantly driven by President Trump's executive orders and pronouncements in his first week in office. Apprehension over trade conflicts weakened both equities and bonds prior to his inauguration. This left both asset classes to rally in relief when initial tariff steps did not appear as disruptive as feared.
- We continue to believe that US tariff threats are "leverage" to extract a wide variety of economic and political gains. Actual tariff levels could vary dramatically depending on the degree to which foreign governments concede on a range of matters.
- From an economic perspective, highlights from initial Trump executive orders included declarations of "emergency" at the Mexico border, stemming refugee migration and an "energy emergency" lifting electric vehicle mandates and export restrictions. Trump repeated previous calls for 25% tariffs on Mexico and Canada, 10% on China "likely" to be imposed on February 1. We continue to believe imposition depends on negotiations over border issues and steps to stem illicit drug trade. New tariff threats may be a routine feature of the outlook in coming years.

Potential Portfolio Implications

- The US has run a trade deficit every year since 1975. We believe the rise of the US dollar as the world's dominant reserve and trading currency has played some role in this chronic imbalance. It reflects the attractiveness of US assets to foreign holders, allowing US consumers to finance stronger imports than otherwise.
- The absence of a trade deficit would not necessarily be indicative of a stronger US economy. The trade deficit has generally fallen during US recessions.
- The US's larger trade deficit with most key trading partners – meaning greater export dependence on the US – suggests Trump has "greater leverage" to achieve concessions. This view, however, depends on the notion that the trade imbalance is the key variable.
- The US's traded equity market cap has twice the value of all non-US equities combined. The value of US equities and other assets has, to some degree, been driven by access to foreign supplies and market opportunities. It is to be seen if the trade deficit can be forced lower with tariffs without threatening these positive US attributes.

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New Deals Come with New Risks

Donald Trump's inauguration as the 47th US President followed the script of his campaign. As promised, his swearing in was immediately followed by many consequential executive orders and pronouncements of policy changes to come (see **FIGURE 1**). We believe it marks a change towards higher risk, higher reward US policies aimed at changing the nature of the US economy.

With promises of large tariffs on "Day 1," the announcement of new tariffs on Canada, Mexico and China "likely" on February 1[1] fell short of market fears. It left the legitimate chance that the new tariffs can be bargained away for concessions on border controls and illicit drug trade. The relief from greater trade fear, coupled with fundamental strong news on the corporate earnings front, sent equities sharply higher over the past week and bond yields mixed. At the same time, the news is likely just the very beginning of a long period of trade uncertainty (see **FIGURE 2**).

US business confidence is surging on deregulation hopes and greater tax clarity (see **FIGURE 3**). At the same time, the predictability of US policy has been reduced. The potential reward for the US comes with risk of unintended consequences. The chance that tariffs generate retaliation and supply shocks in not insignificant. We have reduced confidence in the US inflation outlook this year as a result.

FIGURE 1: Highlights of Trump 2.0 executive orders, pronouncements in first week

Tariffs	• Will "likely" raise Mexico and Canada tariffs 25%, China 10% on February 1[1]
Immigration	• Declares national emergency at Mexico border to position for expulsions • Shuts down refugee application portal • Signs order to end birthright citizenship for undocumented
Withdrawals	• Pulls out of World Health Organization, Paris Climate Accord
Energy	• Declares "national energy emergency" • Revokes Biden EV mandates, restarts LNG export applications
Miscellaneous	• Pardons January 6 capital rioters • Stays TikTok ban 75 days to find US buyer • Demands full-time return to office for federal workers

Source: Bloomberg as of January 22, 2025.

FIGURE 2: US Trade Policy Uncertainty index

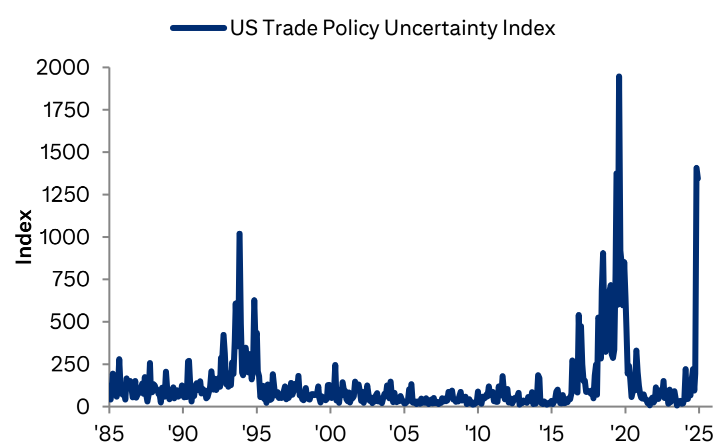
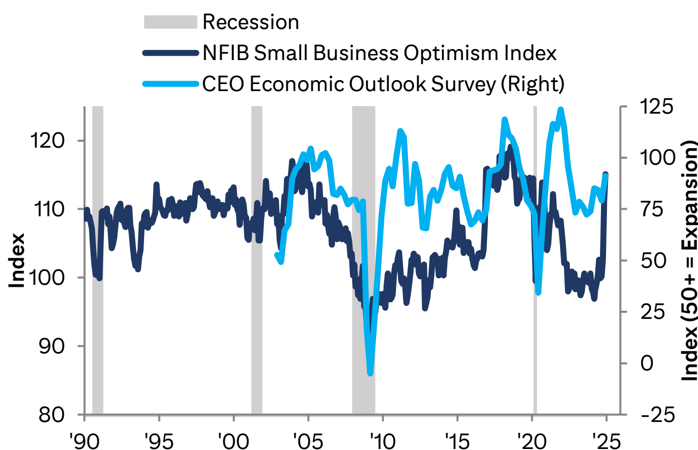


FIGURE 3: US small and large business confidence measures



Source: Bloomberg as of January 16, 2025. Indices are unmanaged. An investor cannot invest directly in an index. They are shown for illustrative purposes only and do not represent the performance of any specific investment. Index returns do not include any expenses, fees or sales charges, which would lower performance. Past performance is no guarantee of future results. Real results may vary.

[1] The order for February 1st directs incoming Cabinet officials to initiate reviews and prepare policy recommendations.

How literal are the trade threats?

As we discussed in a late November CIO Bulletin, full and broad imposition of the new tariffs on Mexico, Canada and China would raise nearly 10X the tariff revenue than more targeted tariffs on China in 2018 if one assumes a static impact on trade flows (see **FIGURE 4**). This is a potentially large share of US economic activity and much larger one for Canada and Mexico. But these are estimates at the extreme end of what is likely if Mexico and Canada instead absorb costs associated with US border control.

We imagine similar dynamics may play out in US trade disputes to come with Europe. The Trump administration is keen for Europe to step up the financing of its security and potential reconstruction costs for Ukraine. Tariffs are unrelated to these issues but may still be used by the US as negotiating leverage.

FIGURE 4: Impact of new US tariffs on Canada, Mexico, and China

2024 estimate, nominal US dollars ($Billions)			
	US Imports	**US Exports**	**US Exports as % of GDP**
Canada	$415	$350	16%
Mexico	$515	$340	19%
China	$430	$145	1%
All US Trade Partners	$4,161	$3,211	

US Consumer Spending	**US GDP**	**Proposed Tariffs as % of US GDP**
$19,935	$29,350	0.94%

Source: Haver Analytics and CGWI as of January 22, 2025. All forecasts are expressions of opinion and are subject to change without notice and are not intended to be a guarantee of future events.

Will a smaller US trade deficit allow manufacturing to be the job of the future?

As **FIGURE 5** shows, the US has run an annual goods and services trade deficit in every year since 1975. There are many forces that have driven this 50-year running imbalance. The US dollar's position as the post-World War II reserve currency and particularly the role it has played since currencies were allowed to float more freely in 1973 is related to the size of the US deficit in our view. The global desire to accumulate US assets and income has made it easy for the US to finance a larger rise in imports than US income growth would suggest.

In the view of some, this has meant that the US manufacturing sector has been "hollowed out." However, the overall US economy has been fully employed in the past half century apart from cyclical bouts of weakness. The US has had faster than average income growth among developed market economies by shifting to higher-valued service industries such as software. The same trends may have driven greater income inequality. The advent of AI negatively impacting services employment might reverse a bit if this.

As **FIGURE 5** shows, trade deficits have shrunk from time to time, usually when US employment contracted in recession. Importantly, automation and advancements in industrial organization have routinely eliminated manufacturing jobs. It would be hard to introduce productive inefficiencies to sharply drive up headcount, even if US manufacturing output became much stronger.

FIGURE 5: US trade deficit as % of GDP

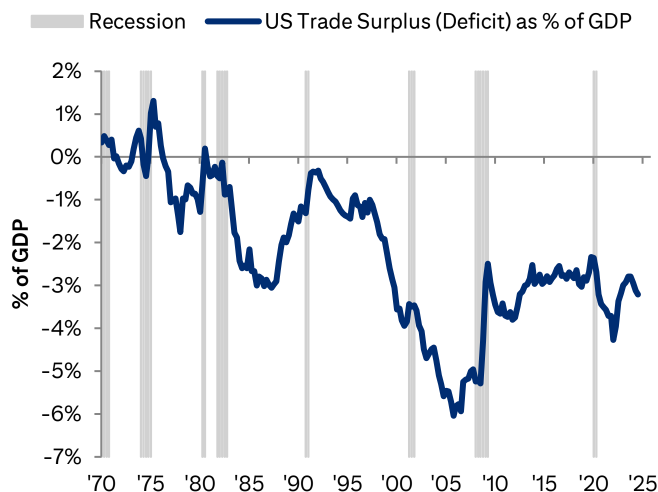
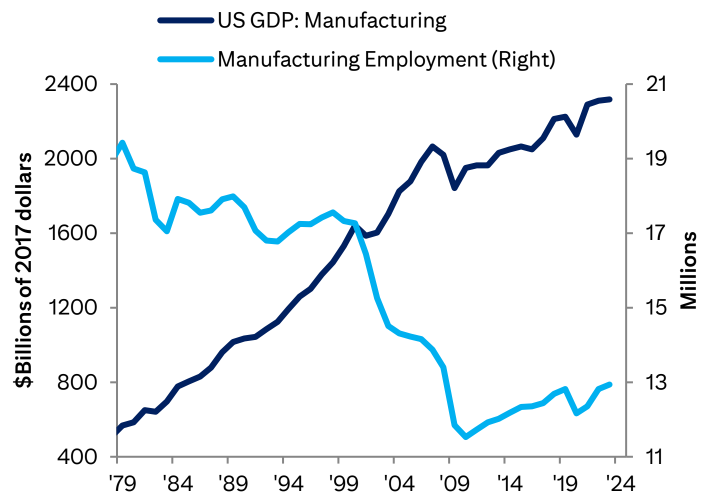


FIGURE 6: US manufacturing output vs manufacturing employment



Source: Haver Analytics as of January 21, 2025.

US trade deficit, market cap surplus

The fact that the US exports less than it imports suggests Trump will have much greater leverage than trading partners when picking a tariff fight. For many individual trading partners, the significance of exports to the US is much larger than the significance to the US of these imports. Mexico and Canada are the clearest examples of this.

But this is not to suggest there will be no pain from a trade conflict. As an example, **FIGURE 7** shows that US firms that rely significantly on China's economy for both inputs and consumer demand have been sharp outperformers to local Chinese shares.

In general, the equities of US firms have been great beneficiaries of global supply and demand sources, making the best of the wider world (see **FIGURE 8**). While it is possible to produce more goods in the US and reduce imports, the net of this may not be consistent with continued outperformance of US equities. For many large cap firms in the US and elsewhere, their business is not a close reflection of local macroeconomic measures.

We add these observations this week while overweight US equities across themes by 3% and underweight fixed income and cash by a similar amount. Given this allocation and this year's equity rally, our Global Investment Committee views have stood to benefit relative to their respective benchmarks.

As we've discussed in a previous CIO Bulletin, the range of new US policies is both positive and negative for certain firms and sectors of the economy. We are optimistic that US growth and profits will rise this year and next. With that said, a new approach to trade with US allies and rivals also comes with new risks. The greater diversification we have added to our global equity and bond allocation late last year is a compromise to reflect this uncertainty.

FIGURE 7: MSCI China vs foreign firms with China exposure

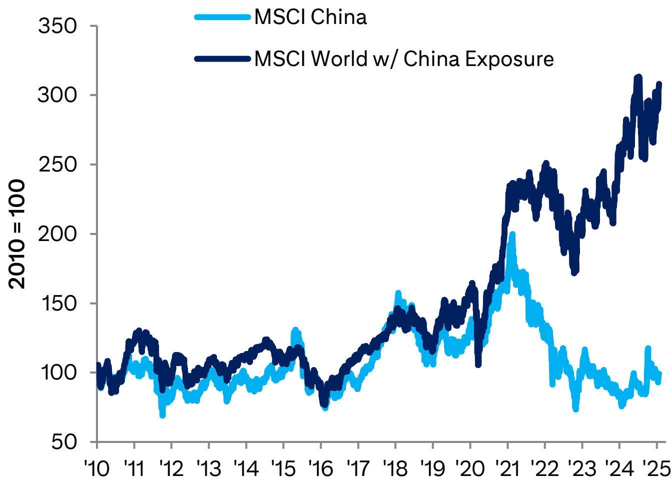
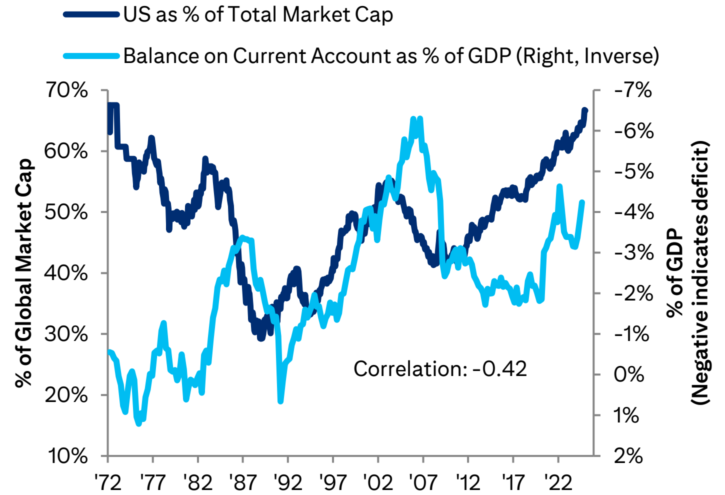


FIGURE 8: US share of world market cap and US current account deficit as % of GDP



Source: Haver Analytics as of January 21, 2025. MSCI indices used as proxy for market cap. Indices are unmanaged. An investor cannot invest directly in an index. They are shown for illustrative purposes only and do not represent the performance of any specific investment. Index returns do not include any expenses, fees or sales charges, which would lower performance. Past performance is no guarantee of future results. Real results may vary.

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High quality (very strong)	Aa	AA	AA
Upper medium grade (Strong)	A	A	A
Medium grade	Baa	BBB	BBB
Not Investment Grade			
Lower medium grade (somewhat speculative)	Ba	BB	BB
Low grade (speculative)	B	B	B
Poor quality (may default)	Caa	CCC	CCC
Most speculative	Ca	CC	CC
No interest being paid or bankruptcy petition filed	C	D	C
In default	C	D	D

1 The ratings from Aa to Ca by Moody's may be modified by the addition of a 1, 2, or 3, to show relative standing within the category.
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