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Citi Wealth

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Special Edition | Tariff Time: Markets Quickly Repricing Growth, Will Assess Opportunities

Key Takeaways

- **News**: Effective US tariffs of 20%-25% on Mexico, Canada and China have begun on President Trump's orders. Along with other factors, the tax increases for US importers have catalyzed a US equity selloff of about 6.5% since a record high was reached on February 19 (President Trump may address this in his speech to a joint session of the US Congress tonight).
- How long the tariffs last on individual countries is an open question. Having the tariffs in place shows the US administration wasn't bluffing in trade negotiations. The tariffs would apply to $1.36 trillion of US imports at last year's level. If trade and consumption patterns were static, they would raise about $300 billion. As we've discussed previously, that is highly unlikely (see our Investment Strategy Bulletin | When the World Divides). However, the potential hit to profits and price pressures is highly material if the tariffs last (in a key report, 7 of 10 U.S. manufacturing industries mentioned tariff impact yesterday).
- **Since the tariffs on North America and China are far above "reciprocal" levels, we think the largest effective tariff increases have already been announced.** Additional tariffs on specific countries and industries might amount to an additional $50 billion or (for a stretch) $100 billion. Meanwhile, a measure of trade policy uncertainty has reached a record high.
- **Market Comment:** US equity returns benefited from record high profits last year. In 2024, US returns beat foreign equity markets by a massive 19 percentage points. With record long positions in the US dollar, US equities have been vulnerable to domestic tax increases (tariffs are paid for by US importers). With this in mind, we've taken some defensive measures in asset allocation both late last year and again last week (see our Quadrant | Move Fast, Break Things). Constructive for diversified investors, US Treasuries are rallying, helping portfolios in a way that bonds didn't in 2022 during an inflation shock.
- **The speed of the market correction in the past few trading sessions is indicative of a rapid repricing of growth expectations.** S&P 500 option implied volatility (VIX) has jumped 64% in the past two weeks and correlation measures have spiked across industry groups. At 25, the VIX and other measures are not at extreme levels indicative of a market bottom. But just **as we noted in August of last year (see our GIC Asset Allocation) the pace of declines is indicative of a market that could create opportunities over the relatively near term if the repricing continues.**

Repricing Growth for Very Large Tariffs

Some shock is setting in that President Trump is indeed imposing very large tariffs on North American trading partners today. While he campaigned on tariff increases of as much as 60% on Chinese imports, the surprise this year has been the 25% tariffs on the free trade zone of the US's neighbors Canada and Mexico (10% on Canadian petroleum).

Mexico and Canada's currencies have slipped about 4% since Trump's election with greater weakness in anticipation. But as we discussed in the latest Quadrant | Move Fast, Break Things, US assets are now taking the brunt of the impact as domestic consumer confidence slides on inflation concerns.

The US dollar index (vs major currencies) has slipped more than 3% from this year's high. US equities are underperforming global equities, with the S&P 500 down 2.3% year-to-date as of our writing (see **FIGURE 1**). As **FIGURE 2** shows, a measure of trade policy uncertainty has risen above levels hit during the extreme supply chain disruptions of the pandemic.

FIGURE 1: Regional equity market returns YTD

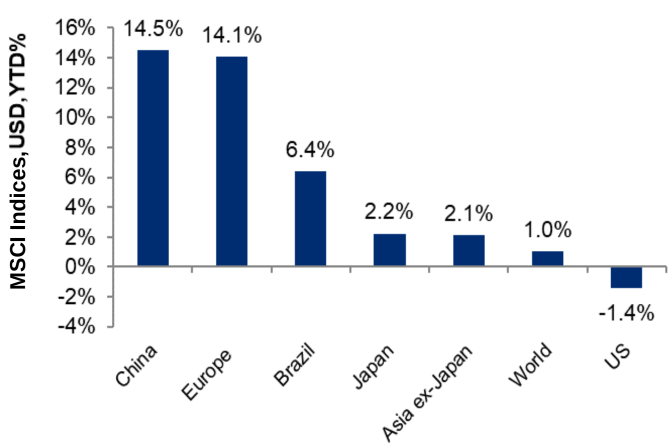
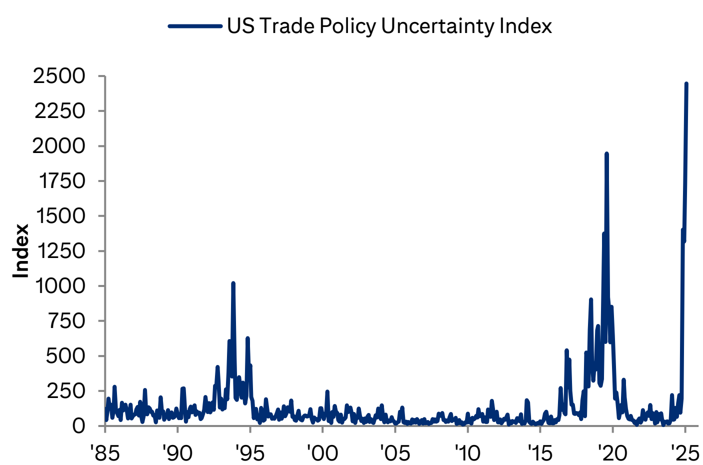


FIGURE 2: Trade Policy Uncertainty Index



Source: Bloomberg and Haver Analytics as of March 4, 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.

The rise in tariff concerns and some unrelated consumer price spikes have pushed US consumer confidence lower this year and business confidence should follow. With "tariff avoidance" impacting business activity, a key measure of US manufacturing orders fell into contraction in February (see **FIGURE 3**). In comments reported by the Institute for Supply Management yesterday, seven of 10 industry comments called out tariff impact, with other comments loosely related.

S&P 500 companies earned nearly $2 trillion in operating profits last year. The same firms will face much of the tariff cost. They will absorb or pass on these costs in coming months if the tariffs are held in place or expanded. With all these issues in mind, we cut our US equity allocation for a second time since November last week. Our investment grade US bond allocation was raised to 6.2 percentage points overweight vs 4.2%. With yields far above pandemic levels, a bond market rally is helping offset the US equity weakness (see **FIGURE 4**).

FIGURE 3: ISM new orders vs S&P 500 12-month return

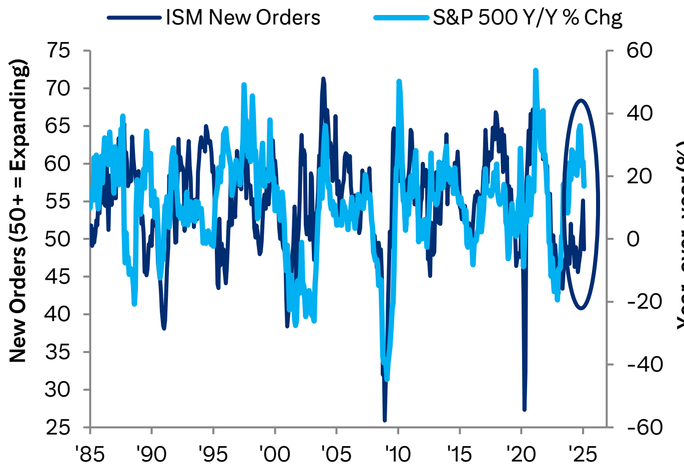
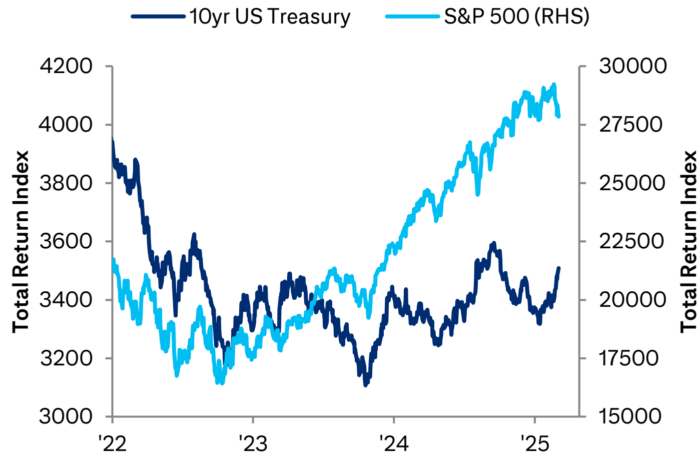


FIGURE 4: S&P 500 vs 10yr UST total return



Source: Haver Analytics as of March 4, 2025. The circle indicates the drop in ISM new orders activity coinciding with equity drops. Indices are unmanaged. An investor cannot invest directly in an index. They are shown for illustrative purposes only and do n ot 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.

How far have markets adjusted?

Last August, we added quickly to US equities after an 8.5% drop. At the time, we believed the modest correction did not represent material economic risk. Today, the tariff increases are a more fundamental challenge, even if they are discrete. If the US administration reaches new trade agreements quickly, it could limit damage to business confidence, but it is difficult to argue the uncertainty will pass quickly.

With this said, it is important to point out that the tariffs on Mexico and Canada are far larger in scope than most “reciprocal” tariffs likely to be announced in a month’s time. Such measures could add another $50 billion to tariff collections beyond North America and China. A focus on a range of particular industries such as pharmaceuticals, autos, and metals could possibly double that figure, but still represent a much smaller additional tariff imposition than $300 billion (see **FIGURES 5-6**).

FIGURE 5: North America and China trade, tariff estimates

2024 nominal US dollars ($Billions)			
US Trade Partner	**US Imports from...**	**US Exports to...**	**Country's Exports to the US as % of GDP**
Canada	$413	$349	18%
Mexico	$506	$334	27%
China	$439	$144	2%
All US Trade Partners	$4,110	$3,192	
US Consumer Spending	**US GDP**	**Proposed Tariffs as % of US GDP**	
$20,263	$29,720	1.01%	
Revenue to US from Proposed Tariffs ($Billions)			
Reciprocal Tariffs	Country/Industry Specific Tariffs	Total Tariffs as % of US GDP	
$94	$307	1.35%	

Source: Haver Analytics and Citi Wealth Investments as of March 3, 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.

FIGURE 6: Potential reciprocal tariffs

Top 10 US Trade Partners (%)				
Trade Partner	Effective Tariff Rate	Trade Partner's Effective Tariff Rate on US	Trade Partner's Exports to the US as % of GDP	Potential Revenue to US from Reciprocal Tariffs ($BB)
China	2.86	7.13	3.20	24.58
Euro Area	2.22	1.50	3.57	--
Mexico	0.01	5.17	32.47	23.69
Canada	0.12	1.08	20.87	4.28
Japan	1.58	3.90	3.65	3.59
Vietnam	4.63	2.85	33.24	--
South Korea	0.01	14.39	7.26	17.38
India	2.99	9.45	2.69	5.88
United Kingdom	1.32	0.69	2.11	--
Thailand	0.85	6.19	12.72	3.36
			TOP 10 TOTAL	**82.75**
Rest of World	2.15	3.57	1.47	10.77

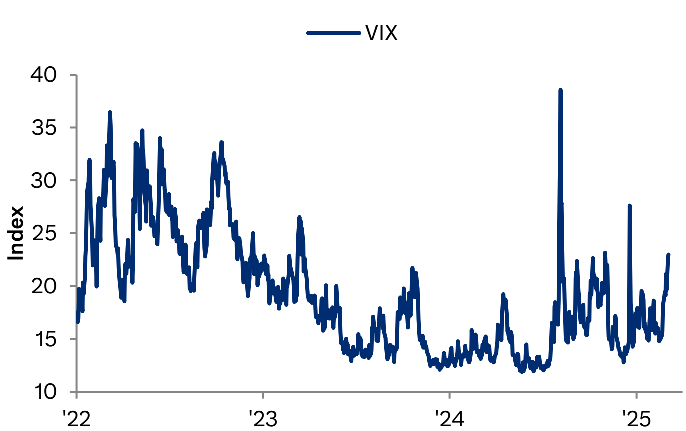
Source: World Integrated Trade Solution and Citi Wealth Investments as of February 12, 2025. All forecasts are expressions of opinion and are subject to change without notice and are not intended to be a guarantee of future events.

Fast markets, but for a reason

US equities are weakening rapidly but from a high level. Measures such as the VIX and industry correlation suggest a correction is ongoing (see **FIGURE 7**) but could extend further depending on how the administration proceeds. If the pace of share price declines continues, we would look for opportunities much as we did in August of last year. As we noted in Quadrant, first quarter EPS estimates are very weak and likely to be exceeded. However, we would tend to look for industries and firms that have been indiscriminately hit by risk aversion. Thus far, the selloff in equities has not taken that shape.

We believe investors diversified across regions and asset classes are better able to face idiosyncratic risks, even as large as the US's new tariffs. The gains in non-US equities and US bonds are helping such portfolios generate a positive return in the year-to-date even with the 6.5% drop in the S&P 500.

FIGURE 7: S&P 500 VIX index



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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

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