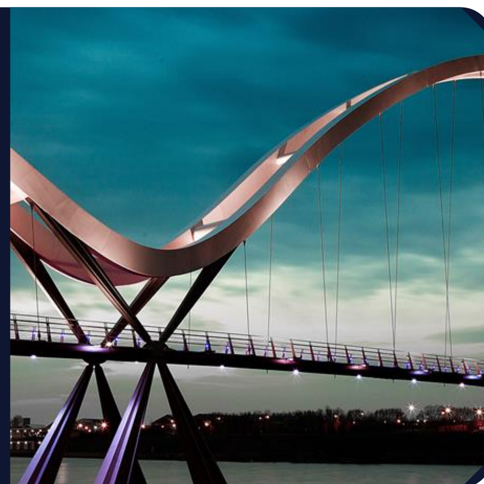
Citi Wealth

Investment Strategy *Bulletin*



March 29, 2025

How Well Can the US Absorb Tariff Shock?

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Key Takeaways

- The imposition of 25% tariffs on auto and parts imports moves the US closer to a "supply shock" scenario given the deep integration of North American vehicle production. Prices will rise and sales will fall, impacting auto dealer and services employment.
- The Trump administration keeps alluding to an April 2 announcement of reciprocal tariffs to match those imposed by other nations on US exports. The threat of additional tariffs to achieve other goals (such as isolating Venezuela) may remain a lasting uncertainty.
- There is no modern precedent for the US raising tariffs broadly. We can look to 2018's targeted tariffs on China along with corporate tax actions of recent decades for some indication. While not likely to be sustained, a 12% effective tariff rate on US goods imports could increase tax collections by about $300 billion from present levels. For perspective, the sharp drop in US corporate taxes in 2017 cut the US corporate tax liability by about $85 billion. In inflation-adjusted dollars, corporate tax rate increases of 1968 and 1993 raised about $30 billion. Tariffs in 2018 were even smaller in scale than any of these measures.
- The scope for tariffs and related business uncertainty is quite material for the economic outlook and will result in significant downward growth estimate revisions (please see the March 8th Investment Strategy Bulletin). At the same time, we see "policy shocks" as quite different from business cycle developments and lasting inflation. **The US and world economies have not expanded recklessly in recent years. Risks are rising, but the tariff shock may be absorbed without setting off a spiral of contraction.**

Potential Portfolio Implications

- A hypothetical $300 billion US tax increase is equal to about 1% of GDP and nearly 10% of US corporate profits. US importers will attempt to pass on the costs to consumers and others in the supply chain, likely causing a price spike in the second quarter of 2025. A pass through of these costs to inflation measures should not change longer-lasting inflation expectations.
- Cyclical industries in the US and trading partners such as Canada will take a large hit from tariffs, but the critical issue is if the change in import taxation catalyzes a self-reinforcing economic contraction. We do not believe US and world equity markets expect this to occur. If correct, the tariffs and US policy uncertainty will largely be a "one-off loss." At the same time, a sustained rise in trade uncertainty along with the tariff shock risks ending the expansion.
- With this as a background, we don't recommend adding to risk assets at this time, but will evaluate if there is an overshooting of negative expectations or relief from the policy-driven economic pressures in the period ahead.

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Autos, Steel, Aluminum. What's Next?

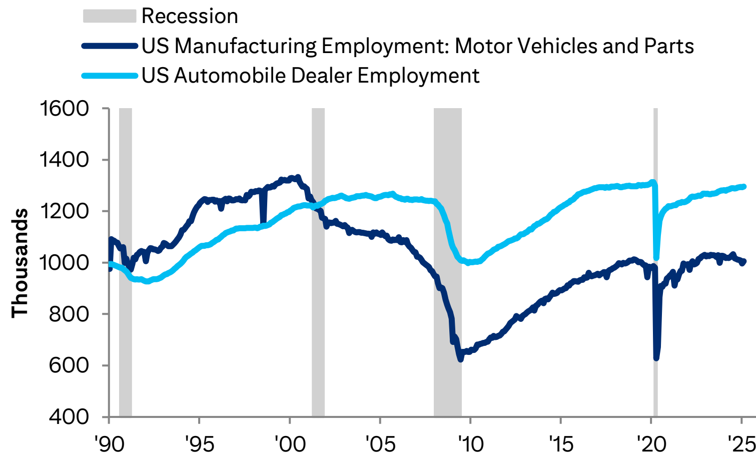
Citing national security, President Trump signed a proclamation adding 25% tariffs on US vehicle and parts imports to be phased in within coming days and weeks. As car and truck production has become highly integrated across North America since a free trade agreement was reached in 1994, most "US vehicles" will rise in price for American consumers in addition to the brands from Asia and Europe.

With US auto-related imports about $475 billion in 2024, the administration's estimate that the tariffs could raise $100 billion seems plausible. This is because cross-border supply chains planned over many years can't quickly be replaced with output sourced solely within US borders. Used vehicles and parts will rise in price as demand shifts from new vehicles to avoid the full price spike. Other tariffs on inputs such as steel and aluminum will also impact industry costs.

One might think that the autos tariffs are part of an opening negotiation on the US-Mexico-Canada free trade agreement, but this is unclear. Over the course of the year ahead, if the autos tariffs are kept, the fixed-weight Consumer Price Index may be pushed up about 0.7% above its trend, even if the autos industry absorbs a significant share of the tariff costs.

As **FIGURE 1** shows, US auto dealer employment is significantly larger than US auto manufacturing employment as automation advancements in manufacturing outpace services. But the services component of the US autos industry is actually much larger than vehicle dealers. It impacts a large but less clear number of advertising, marketing and finance positions. While there will likely be a surge in retail auto sales in the coming couple of months to quickly run down inventories ahead of tariffs, we believe the US auto import tariffs will cause the US new vehicles industry to contract in the coming few quarters.

FIGURE 1: US auto manufacturing employment vs US auto dealer employment



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Not Deeply Vulnerable. Far From Immune

Pandemic-era instability in supply/demand exposed most of the world's consumers to much higher, sustained inflation than at any time in the past four decades. A phobia towards a "cost of living" shock has remained. We believe the weak level of consumer sentiment since economic recovery began in 2020 stems not from labor markets or recent inflation data, but from the sustained loss of purchasing power during 2021-2022.

With this experience, US public concern over tariff impact on consumer prices has vaulted short-term inflation expectations. It's largely behind the 22% drop in the University of Michigan's consumer sentiment index, led by a 26% dive in expectations this year.

With news reports of US tariff actions at an unprecedented level, a jump in short-term consumer inflation expectations has exceeded actual consumer price increases to date (see **FIGURE 2**). What the actual tariffs will be – and the extent of any pass through to consumer prices – is uncertain. But the "fear quotient" seems to be rising well ahead of the actual tariff shock. As an example, US car and truck sales – both imports and domestics – have held up far better than consumer sentiment readings and consumer buying intentions in the year-to-date (see **FIGURE 3**). This data all precedes President Trump's new auto tariff announcement.

FIGURE 2: US consumer inflation expectations jump above actual inflation

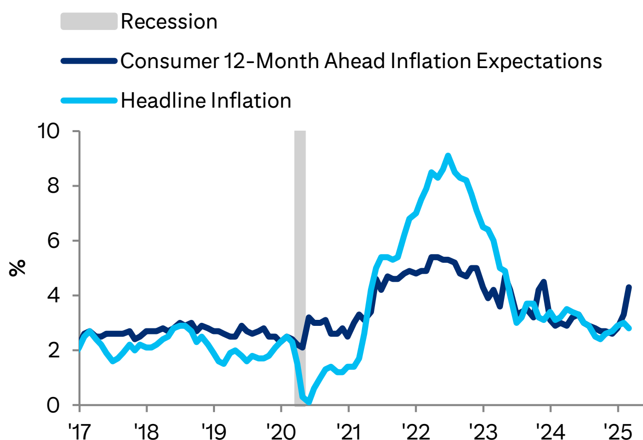
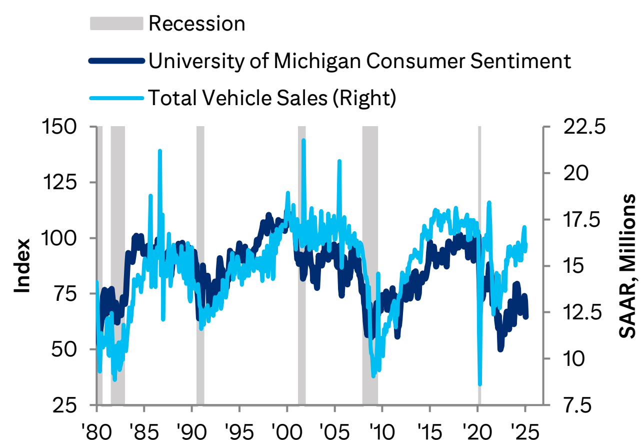


FIGURE 3: US vehicle sales much stronger than implied by consumer sentiment



Source: Haver Analytics as of March 26, 2025. Total vehicle sales includes all imported and domestic light vehicle retail sales. 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.

How well can we handle a shock?

As we've covered in these pages over many weeks, the attention of investors has swerved from deregulation and tax cuts to tariff increases and federal spending cuts (and to a lesser extent, immigration/labor supply). The news flow has created a massive swerve in investor sentiment (see **FIGURES 4-5**).

While clearly brimming with apprehension, the imposition of large scale US tariffs and subsequent retaliation is still a real shock to come. One plausible estimate for a "large scale" rise in US tariffs – even if unevenly applied – is a rise in the effective tariff rate on goods imports from roughly 2% to 12%. This would increase tariff (tax) collections by about $300 billion, or just over 1% of US GDP. This "static" number would push up costs and reduce real economic growth, spread between inflation and unit sales. It excludes retaliation measures on US exporters. While some domestic activity measures – such as steel production – could rise in the short term to take advantage of higher prices, the impact on US growth excludes any impact from business uncertainty over the economic outlook.

FIGURE 4: Trade policy uncertainty surges to record

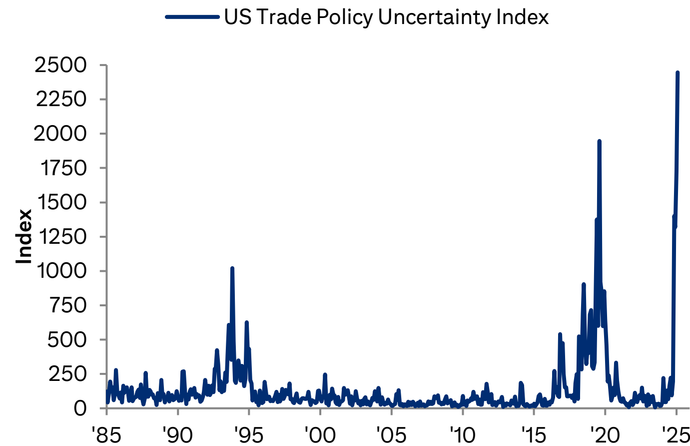
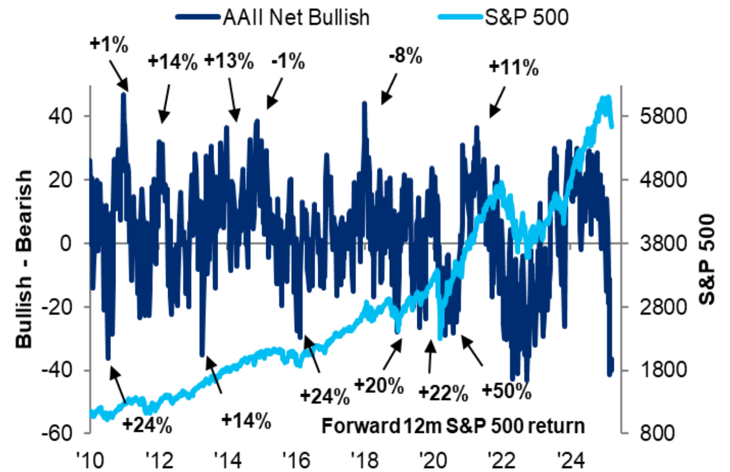


FIGURE 5: US equity investors swing from bulls to bears



Source: Haver Analytics and Bloomberg as of March 26, 2025. Arrows and returns indicate forward 12-month S&P 500 returns from the indicated date. 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.

Are tariffs "transitory" or a catalyst for decline?

Policy shocks such as a discrete rise in tax rates have a distinctly different impact than "natural" developments in business activity, such as supply and demand imbalances that arise over long periods of prosperity. US business cycle turning points have occurred when producers *overestimate or underestimate* demand. This causes production and employment to plunge into recession at an economic peak and then recover at recessionary troughs. The vulnerable periods are those when producers are far too optimistic over future demand, when they overproduce. Memorable examples from industry include the telecom equipment boom of the late-1990s, the home production boom of the mid-2000s and the oil production boom of the mid-2010s. In some of these periods of excess optimism, only a modest shock catalyzed a business cycle "purge."

Where would we put these vulnerabilities today? Not very high for the US economy overall, but also not in a place that is immune to large shocks. One clear example of lessened cyclical vulnerability is the US housing market, where construction booms and busts have often accounted for and amplified the business cycle. Today, the US is short of housing supply at a national level. As **FIGURE 6** shows, home sales and construction per household are far below long-term averages. With sales weak for decades, even dramatically higher mortgage rates (measured over a three-year timeframe) haven't pushed home sales to new lows.

Broader US investment spending hasn't been unusually robust but is somewhat more vulnerable than residential investment spending to a bust. It includes a torrid 40% pace of capital investment spending on AI infrastructure by a handful of large companies over the past year. In terms of immediate risk to the economy, we also believe imports and domestic production could decline together to reduce business inventories (see **FIGURE 7**). Both business sales and inventories rose together in early 2025 to race ahead of new US tariffs. Imports could fall in the second quarter of 2025, statistically boosting US GDP. Nonetheless, domestic goods producing employment and related services could weaken. Fortunately, the meager 0.7% annualized growth rate of US industrial production over the past two years suggests any drop won't be deep.

FIGURE 6: US new single family home sales and housing starts per household

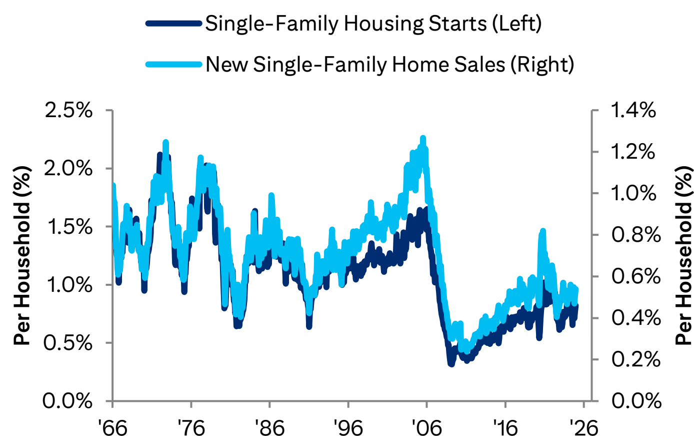


FIGURE 7: Real US business inventory-to-sales ratio (manufacturing, retailing, wholesaling)

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Sorry to invoke “transitory”

A big mystery of tariff impact is the degree to which businesses will attempt to pass on cost increases in the form of higher prices. Absorbing a profit margin hit is never anyone’s intention. But losing sales altogether could harm a businesses’ profits more. While the impact of the 2018 China-focused tariffs on virtually every inflation measure was minimal, the scale of proposed tariffs in 2025 are on the order of 10X larger in scope (see **FIGURE 8**).

Absorbing the higher input costs won’t make US wallets any larger. If prices rise, the Federal Reserve will be further from hitting its long-term inflation targets, but its own monetary policy won’t be the factor behind it. The Fed will not be able to protect consumers from the price increases, but it won’t see them as recurring “monetary inflation” (see **FIGURE 9**).

Once the price increases occur, the US central bank will have to judge whether US demand is outstripping supply in a lasting way. Looking forward, we expect tariffs to be largely a “one-off” shift down in available supply to the US economy. In time, higher relative prices of imports will bias US consumers to favor domestic products that may have fallen in price relative to imports. With this in mind, a weaker real economic growth outlook will help keep US interest rates constrained despite a jump in imported goods costs.

In conclusion, we believe US tariffs and some other policies are raising recession risk for the US. If the US keeps adding to the list of industries it attempts to protect with large tariff increases, that risk will rise materially. But it is still not the most likely scenario given the discrete nature of the tax increases and the relatively healthy state of economy.

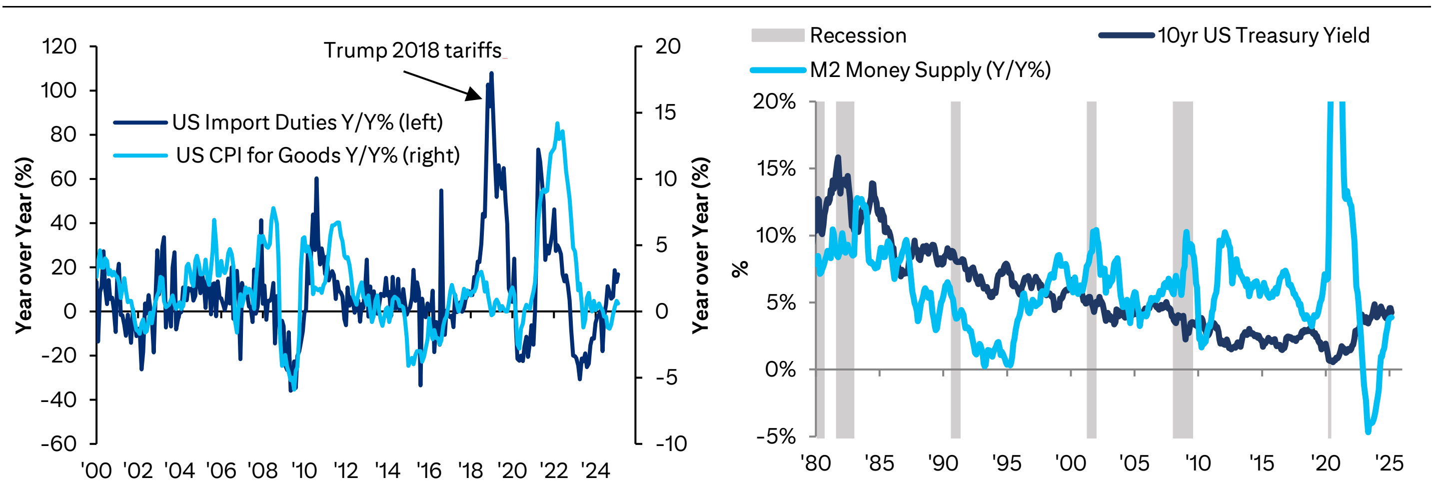
As we have described elsewhere, the US yield curve has sent troubling signs about the economic outlook since late 2022. We believe the unusual impact of the pandemic has muddied that message (please see our Wealth Outlook 2025). In short, without a negative shock, the US economy would not be facing a particularly high risk of recession at this juncture. The US economy has expanded in 87% of all the months since the end of World War II, therefore the probability of the US economy contracting is ordinarily close to 15% or less. We believe a trade and cost of living shock, with other negative elements, more than doubles that probability to close to 40%. However, the underlying growth of the US economy with healthy supply/demand fundamentals does not suggest the shock at this stage is overwhelming.

Questions remain and the unpredictable shifts in US policy announcements in 2025 have forced us to take a more cautious asset allocation posture than our late-2024 Outlook views (please see our February Quadrant). We will update forecasts in an attempt to embed tariff announcements of early April soon. While increasingly cautious, for

now, we would not assume that US policy will drive the US and world economy into a self-reinforcing contraction that would drive risk assets much lower in price.

FIGURE 8: US tariff collections and CPI for goods Y/Y%

FIGURE 9: US M2 money growth and nominal US Treasury yield (%)



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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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