MAY 14, 2025

TRADE TARIFFS UPDATE: AN ONGOING BALANCING ACT

Executive Summary

- As a result of ongoing trade developments, we estimate that the U.S. effective tariff rate will fall from ~24% immediately following the April 2 "Liberation Day" announcement to ~13% as of May 14.
- We believe that recent progress proves that more deals should be expected; however, a further decline in the effective tariff rate could be more difficult to achieve as the 10% baseline tariff looks like a non-negotiable, structural shift in trade policy.
- Risks to our base case scenario (characterized by prudent and orderly execution of government policies, slower but not contracting economic growth, inflation stabilization, and modest but positive market performance) have moderated following the positive developments on the tariff front. However, we continue to see a wide range of potential outcomes for markets and the economy going forward.
- Long-term investors should resist the temptation of attempting to time the market and instead remain anchored to their long-term asset allocation strategies. To this effect, we continue to hold a favorable view on equities relative to fixed income over the strategic asset allocation time horizon (10+ years), while acknowledging that this environment also requires tactical[1] flexibility to adapt to fast-evolving economic and market conditions.

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Our view of President Trump's trade policy has been informed by what looks like a three-fold set of (somewhat competing) objectives: drawing trade partners to the negotiating table, raising tax revenue to fund the administration's tax cuts ambitions, and shrinking the U.S. goods trade deficit. Balancing these goals carries significant execution risks for the economy, given that higher tariffs are tantamount to a tax increase that weighs on households' purchasing power and businesses' profit margins. Progress made over the past week, with the announcement of deals reached with the UK and China, has shed some light on the Trump administration's efforts to find an equilibrium after the chaos unleashed following "Liberation Day" on April 2.

What should we expect going forward?

Since April 2, when President Trump rolled out a list of country-specific reciprocal tariff rates (roughly calculated to reflect each countries' trade surplus with the U.S.), extreme equity, bond and currency volatility has accelerated a series of announcements aimed at defusing tensions and reducing perceived risks to the economy. The elevated reciprocal rates were paused for 90 days (through July 9) and replaced with a 10% baseline tariff, several carve-outs have been applied to product-specific duties (auto and steel), and the administration has

1 Tactical asset allocation (TAA) incorporates short-term global market views based upon the current market environment that slightly modify the Strategic Asset Allocation (SAA, the long-term asset allocation) to form final portfolio weights.

recurringly emphasized the swift progress made on negotiations with trading partners. Trade tension pressures have been relieved by two key developments over the past week:

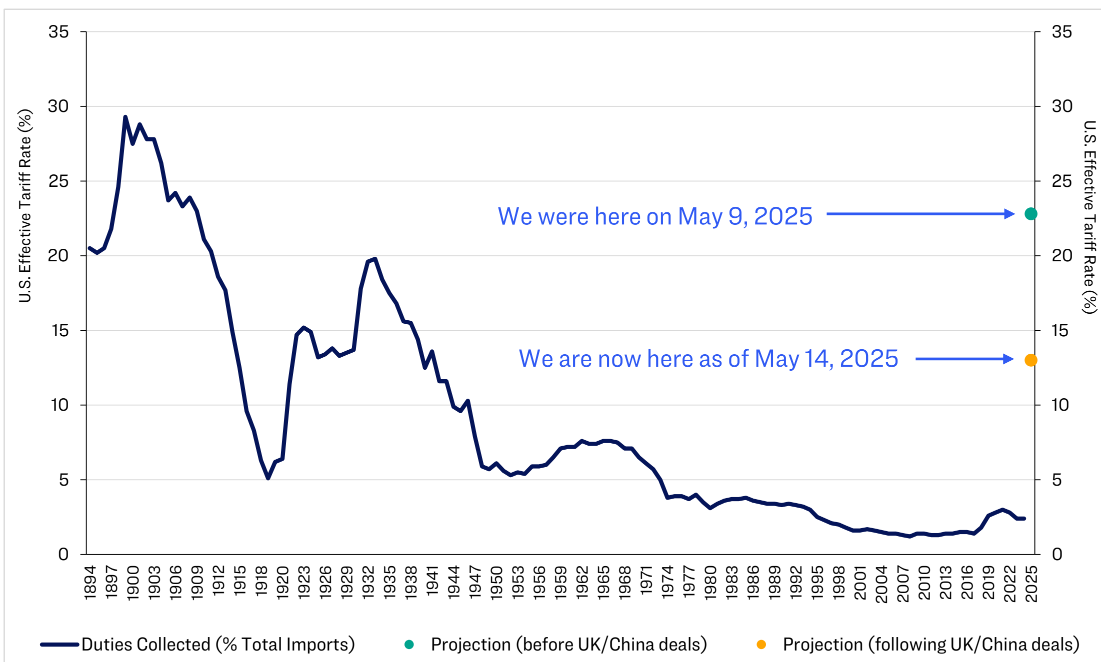
- A trade deal between the U.S. and the UK, in which we focus on two important aspects: the fact that a 10% baseline tariff was maintained; and the decision to lower the tariff rate on up to 100,000 UK-produced cars from 25% to 10%. These are critical details, as they provide a possible framework for other deals and demonstrate that tariff relief through negotiations is being balanced with the more structural objectives of raising tax revenue and reshaping the global trade system.

- A much-needed de-escalation with China, which until Sunday (May 11) was facing a 145% tariff rate, a level that amounted to a de-facto embargo of Chinese imports with growing risks to supply chains. As of today, China's rate will be lowered to 30% for 90 days.

As a result of these developments, we estimate that the U.S. effective tariff rate will fall from ~24% before the UK deal was announced, to ~13% as of May 14 (Figure 1). We believe that recent progress proves that more deals should be expected; however, a further decline in the effective tariff rate could be more difficult to achieve as the 10% baseline tariff looks like a non-negotiable, structural shift in trade policy.

FIGURE 1

Historical duties collected (%) and projections post "Liberation Day."



Source: U.S. International Trade Commission, White House, TIAA Wealth Chief Investment Office.

Besides bilateral negotiations, two dynamics will be crucial as well:

- Will China be able to reroute some of its exports to the U.S. via third-party countries, and will the Trump administration tacitly condone that? Given the limited scope of trade tariffs implemented in 2018, China was successful in redirecting large trade flows through other countries like Vietnam, Thailand and Mexico. Export data from April shows that the same dynamic might be at play once again. China's exports to the U.S. collapsed by 21% in April, but exports to Vietnam, Thailand and Malaysia spiked by 24%, 29% and 16%, respectively. The U.S. administration is of course aware of this, and official statements have focused on the need to crack down on "transshipping" by forcing other countries to place secondary tariffs on China. How aggressively President Trump pursues the need to close these loopholes will be a crucial development to watch, as a more lenient approach would further reduce the effectiveness of the official 30% tariff rate.

- It would be imprudent to assume that trade policy is going to quietly disappear from President Trump's economic agenda. More product-specific tariffs on pharmaceutical goods and semiconductors are under discussion, and there is a chance that a failure to reach bilateral agreements by the July 9 deadline could lead to the re-imposition of reciprocal rates on select countries.

As a result, while we thought that the 23% effective tariff rate was likely to be the ceiling—with prospects for a sharp step lower—we view the current rate as more in line with President Trump's complex balancing act between the three objectives described above.

What matters for markets now?

Risks to our base case scenario (which is characterized by prudent and orderly execution of government policies, slower but not contracting economic growth, inflation stabilization, and modest but positive market performance) have moderated following the positive developments on the tariff front. This has allowed U.S. equity prices to erase the losses incurred in the first half of April. Market sentiment has been buoyed by four drivers:

1. Growing enthusiasm about receding trade tensions and, as a result, reduced risks to the economy.
2. Solid corporate earnings. S&P 500 earnings-per-share (EPS) grew ~13% year-over-year in Q1 '25 (~8% above expectations), boosted by continued strength in the artificial intelligence (AI) theme.
3. Expectations that policymaking will pivot from trade tariffs to tax cuts and deregulation. As we mentioned in our latest CIO Perspectives, federal agencies have been directed to identify for elimination or modification regulations that are unconstitutional or unlawful. In addition, new leadership at key regulatory bodies like the SEC is likely to adopt a more business-friendly approach. This narrative should support markets over the medium-term.
4. Resilient hard data (household consumption, employment growth, income growth) despite dismal consumer and business confidence, raising the probability that fading trade uncertainty could prevent weak sentiment from durably denting economic fundamentals.

However, we continue to see a wide range of potential outcomes for markets and the economy, for the following reasons:

- The effective tariff rate, while lower than last week, remains at levels last seen in 1941, and much higher than at the end of 2024 (2.4%). The impact on inflation, consumer spending, corporate profits and eventually labor market conditions is difficult to quantify, with many direct and indirect dynamics at play. We are watching indicators across six categories: jobs data (unemployment rate, initial jobless claims), consumer spending data (weekly Redbook retail sales, weekly credit card spending data, airport traffic, restaurant bookings), business health (corporate earnings expectations, hiring intentions, cash reserves), consumer confidence (with a focus on inflation and employment expectations), trade data (U.S. and China port activity, imports data, daily custom tax revenue data), and market pricing (credit spreads, bond yields, relative performance between defensive and cyclical stocks).

- We think economic data could remain volatile over the next few months. Business and consumer uncertainty may remain elevated due to lack of clarity around the ultimate impact of the ongoing policy shifts. This could lead to softening employment growth, capital expenditures (outside of the AI ecosystem), and household spending. Inflation data may be murky and subject to tariff-related distortions, raising the possibility that it remains sticky and higher than the Fed's target.

- The combination of softening economic growth and above-target (and possibly rising) price inflation will further complicate the Fed's efforts to balance its dual mandate of achieving stable prices and full employment, reducing its incentive to shift monetary policy preemptively. Instead, the Fed remains likely to be data-dependent, raising the risk that monetary policy support may respond too slowly to rapidly changing economic conditions. That said, the Fed may retain a bias toward cutting interest rates if the unemployment rate ticks higher over time, especially if inflation expectations remain anchored.

- The Committee for a Responsible Federal Budget estimates that the current Senate budget proposal (the basis for the budget reconciliation process) would cause the ratio of U.S. debt held by the public to GDP to spike from around 100% today to 211% over the next 30 years, compared to the 156% current baseline projection by the Congressional Budget Office (CBO). Based on how negotiations within Congress evolve over the next few months, markets could begin to express increased fiscal sustainability concerns, which in turn could cause equity and bond volatility.

- On the other hand, there remains a strong contingent both within Congress and the White House that is likely to push for more sizeable spending cuts to pay for tax cuts. These could reduce fiscal concerns, but with risks to the economy, given that many of the targeted spending categories (including federal jobs, food stamps, Medicaid, federal contracts and grants, and transfers to state and local government administrations) play a key role in directly or indirectly supporting the U.S. private sector.

Investment considerations

Against this still uncertain backdrop, long-term investors should resist the temptation of attempting to time the market and instead remain anchored to their long-term asset allocation strategies. To this effect, we continue to hold a favorable view on equities relative to fixed income over the strategic asset allocation time horizon (10+ years), especially in those areas of the global equity market that are trading at more attractive valuations.

That said, this environment also requires tactical flexibility to adapt to fast-evolving economic and market conditions. For now, we reaffirm our neutral tactical view (relative to our Strategic Asset Allocation target, or SAA) within equities as we wait for more data to assess the balance of risks faced by the U.S. and global economies. Within fixed income, we remain overweight higher-quality investment-grade bonds and underweight riskier U.S. high-yield and emerging market bonds (relative to SAA), in line with our view that credit spreads are not yet reflecting the probability of continued market and economic volatility.

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