Mizuho Brief: Trump 2.0 Trade Wars

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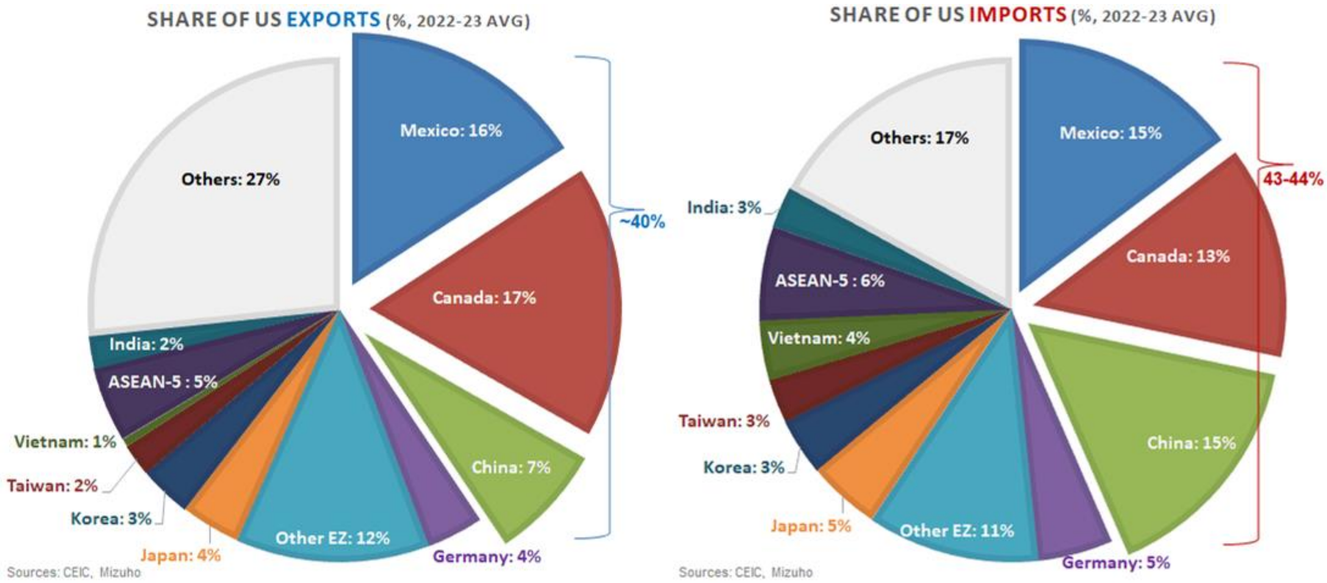
Trump 2.0 Trade Wars

In a Nutshell:

- **Sweeping Trump 2.0 tariffs** imposed on Canada (10% on energy, 25% on all other goods), Mexico (25%) and China (10%-pt increase to existing tariffs) alongside ***warnings of significant EZ tariffs*** in the offing formally **kick off a worrying trade war**.
- The **breadth and scope of tariffs imposed** raise the threat (and intensity) of **adverse global demand impact**
- Specifically, with **tariffs *set to impact upwards of two thirds of all US trade***, the **ramifications for the US its trading partners** may be **profound(ly painful) for all parties involved**. ***US not excepted.***.
- **Especially if the adversarial climate of Trump 2.0 tariffs** inadvertently **results in a spiral of retaliatory escalation**, ***to the detriment of all***.
- **Worryingly, tariff uncertainty exacerbated by tariffs being exploited for multiple objectives**, *which are not necessarily mutually exclusive, obscures a clear path to de-escalation.*
- The silver-lining is that **diplomatic restraint** from US trade partners **buys time for negotiations to avert imminent escalation in trade antagonism**.
- ***But*** this is lamentably **undermined by the multiple objectives** (leverage, exports/industrial/geo-economic advantage, fiscal revenues) of tariffs pursued by Washington, which inadvertently gets in the way of a quick and durable resolution.
- FX Markets Dominated by USD: Against the backdrop of sweeping tariff threats set to expand even more, **USD has gained at the expense of currencies of US trade partners.**_
    - MXN, CAD and CNH have taken the first hit, but EUR bears also lurk ominously on tariff threats.
    - JPY also vulnerable as it swaps haven play for trade pain (exacerbated by BoJ tightening pushed back).
    - Amongst AXJ, KRW, TWD, AUD, MYR and THB are potentially high-beta to the downside.
- Bond Markets More Tentative **Bond markets are taking a more tentative view** for now with **UST yield moves more subdued**. Not due to apathy, but rather ***conflicting economic forces*** amid an obfuscated view ***alongside "risk off"***.
- Equity Bulls Re-evaluating "Trump Boost": Equity bulls seduced by **"Trump is good for equities" narrative** are **subject to rude wake-up call** from potentially jarring impact on growth/earning amid retaliatory tariff spirals.
- Fed - From Pause to Paralysis: While the Fed's pause in January, in anticipation of tariff risks is validated, the approaching policy dilemma (posed by opposing growth and inflation risks) is not alleviated. Sub-optimal policy paralysis rather than an ideal pause becomes the growing risk.
- EM Asia Central Banks More Dovish: **Greater impact of, and sensitivity to, adverse demand shocks** (via exports/industrial channels) **than inflationary risks** means that **Asian central banks will be inclined to ease more**, not less.
- Subject to FX/Macro-stability Risks: Although **headline rate cuts may be impaired** by the tyranny of ***strong USD threatening destabilizing depreciation-capital outflow spirals***.

- More Levers: In which case, expect **EM Asia policymakers to flexibly employ a wider range** of *liquidity, rates* and *fiscal levers* alongside FX **tools to absorb exports shocks** whilst mitigating risks to FX and macro stability.
- Wider Risk Premium: The **price of economic relief** though could come through **wider risk premium demanded** to compensate for diminished earning prospects, macro stability risks and heightened uncertainty.

"Wars not make one great" – **Master Yoda, Star Wars: The Empire Strikes Back**



- Trump Trade War Initiated: The weekend's **executive order by President Trump**, invoking emergency powers* that bypass Congress, **to impose sweeping tariffs on Canada, Mexico and China formally kicks off Trump 2.0 trade wars**.
  - All Mexican imports into the US are now subject to 25% tariffs.
  - Similarly, all Canadian non-energy imports are also subject to 25% tariffs.
  - Canadian energy imports (oil and electricity) are subjected to 10% tariffs as a (self-)compromise to contain inflationary shocks.
  - All Chinese imports are hit with a 10%-pt *increase to existing* tariffs.

- Retaliation: Canada has announced **retaliatory response** while Mexico and China also warn of counter-measures.
  - **Canada** has been quick to respond with corresponding **25% tariffs on C$155bn (US$105bn) of US imports**.
    - This accounts for *~30% of (2023) US exports to Canada* (~5% of all US exports) and could have **scope to expand and evolve as tariff dynamics play out**.
  - **Mexico has also warned of retaliation** although no specifics have been detailed as at the point of writing.
  - **China** too has **flagged "corresponding countermeasures"**, likely to start with a WTO complaint, but has yet to strike.

- Tariffs Don't Surprise: To be sure the **tariff volley should not surprise** given tariffs have been long **positioned as a key plank of President Trump's MAGA** agenda.

- But Scope & Scale are Concerning: But the **brutality of sweeping tariffs** as opposed to a more targeted, nuanced approach ("small yard, high fence") **risks back-firing in a highly charged trade spat environment**.
- Significant "Tariff Net": **Canada, Mexico and China** collectively **account for over 40% of US exports market** and account for **43-44% of all US imports**. Which makes for a **tariff net that is significant**, ***rather than strategically targeted***.
- Compromise Flexibility to Substitute: In other words, these are ***significant trade relations/reliance that may not be so easily substituted***. Not without considerable trouble and cost.
- Threat of More, Trained on EZ: What's more, **Trump's threat of significant tariffs on Euro-Area**, *which accounts for ~16-17% of all US exports and imports,* only **amplify the profusion and proliferation of global trade shocks**.
- Risks Pain All Around: In **aggregate,** with **tariffs *set to impact upwards of two thirds of all US trade*,** the **ramifications for the US its trading partners** may be **profound(ly painful) for all parties involved**. ***US not excepted.***
- Worst-Case risks of Full-Blown Retaliatory Spiral: A **full-scale trade way involving escalatory tit-for-tat tariff response** is the **worst-case outcome** that brings with it **non-negligible risks of global hard-landing**.
- Silver Lining of Restraint: Although the **silver-lining** is that there may, ***for now,*** still be **sufficient diplomatic restraint to avert worst-case** iterations of ***mutually assured economic gloom***.
    - **Mexico and China could respond**, as is the diplomatic obligation to, ***but* without necessarily triggering a retaliatory spiral**.
    - Promisingly, Mexico has suggested non-tariff response with an inclination for dialogue (to walk back).
    - What's more, **Beijing may also be inclined to measure its response** whilst creating enough space for negotiations. Especially given Trump has been far more restrained so far (compared to 60% tariff threats).
- Exceptional Acute Tariff Uncertainty: Nonetheless, time bought by diplomatic restraint is only temporary relief. Whereas **acute tariff uncertainty undermines a path to quick resolution**. Especially as the **tariff tool is being exploited for multiple objectives**.
- One (Tariff) Tool, Many Objectives **Apart from the obvious motivation to force trade re-balancing** and ***attendant supply-chain relocation*** (to the US), **tariffs are also being exploited for geopolitical leverage** (Colombia being the case in point) and to raise **fiscal revenues**.
- Obfuscate Path to Resolution: And the trouble is, with a **multitude of objectives**, which are ***not necessarily mutually exclusive***, the **prospects of reaching a negotiated compromise to walk back tariffs gets harder**.
- Amid Shifting Tariff Goalposts: As a result, compared to Trump 1.0 tariff dynamics, **any durable resolution to US tariff threats may be significantly more elusive** *as Trump shifts goalposts as he cycles through different motivations for tariffs.*
- And Adversarial US Stance: And the risks of miscalculations on tariffs (trade conflict) is further accentuated by retaliatory clauses embedded in executive orders on Trump 2.0 tariffs. This narrows wiggle room.

- FX Markets Dominated by USD: Against the backdrop of sweeping tariff threats set to expand even more, **USD has gained at the expense of currencies of US trade partners.**

  - Direct Hit to MXN, CAD & CNH: For now, as markets digest the announced tariffs on Mexico, Canada and China, **MXN**, **CAD** are **hardest hit**, *tumbling around 2%,* with **CNH also wobbling** (some 1%).
  - EUR Bears Lurk: But **EUR will not be spared either** as markets brace for tariffs on Euro-Area, which Trump has warned of.
  - JPY Not a Haven: Notably, JPY will not function as a haven currency even with generalized "risk off". Instead, bearish JPY dynamics from adverse trade impact are set to overwhelm, likely *exacerbated by justifiably downgraded if not suspended BoJ tightening.*
  - Asia FX Double-Whammy: **Nor will Asian FX** that may be **significantly compromised by** a doubly whammy of; i) ***adverse, and in some cases higher-beta, CNH ripples*** (via entrenched supply-chain linkages); ii) **potentially compounded by risks of direct US trade antagonism**.
    - ***KRW, TWD, THB, MYR and AUD could be particularly vulnerable*** based on trade linkages and recent CNY-beta relations.
- Hollow USD Strength: As a corollary, the **USD is set to be the most distinct beneficiary**. But this is a **reflection of threats elsewhere**, ***not absolute strength of the US****.*
- Perverse & Potentially Counterproductive: Point being, with the Greenback already elevated **further (excessive) USD undesirable, if not outright counter-productive**. Especially as it ***perversely hampers US' manufacturing/exports advantage****,* which is a key motivation of tariffs in the first place.

- Bond Markets More Tentative **Bond markets are taking a more tentative view** for now with **UST yield moves more subdued**. Not due to apathy, but rather ***conflicting economic forces*** amid an obfuscated view ***alongside "risk off"****.*
  - Opposing Growth & Inflation Risks: Mainly, *given* that first blush estimates **pit adverse growth impact** (that knocks 1.2%-points off GDP) **against bump up in core inflation** (PCE) of 0.7%-pts, resulting in tensions that ***hamper yield gyrations for now****.*
  - "Risk Off" Further Dampening UST Yield Upside: Moreover, **"risk off" may also be dampening upside pressures on yields** from worries of cost-shocks given the breadth and magnitude of tariffs.

- Equity Bulls Re-evaluating "Trump Boost": Equity bulls seduced by **"Trump is good for equities" narrative** are **subject to rude wake-up call**. Especially with regards to an **evolving re-evaluation of potentially jarring impact on growth/earning amid retaliatory tariff spirals***.*
  - Imports-Dependence: Imports-dependent US forms are likely to be at the sharp end of broad and brutal US tariffs. And so a shake-down in US equities is a real and present danger.
  - Exports-Driven Weakness in Asian Bourses: That said, export-dependent Asia equities may be a higher-beta downside for the time being as uncertainty casts a further pall on an already dire situation.
- Fed - From Pause to Paralysis: While the Fed's pause in January, in anticipation of tariff risks is validated, the approaching policy dilemma (posed by opposing growth and inflation risks) is not alleviated. Sub-optimal policy paralysis rather than an ideal pause becomes the growing risk.

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* Invoking the International Economic Emergency Powers ACT (IEEPA), which endows the President with powers to bypass Congress and trade consultations to impose unilateral tariffs.

** MAGA: Make America great again

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