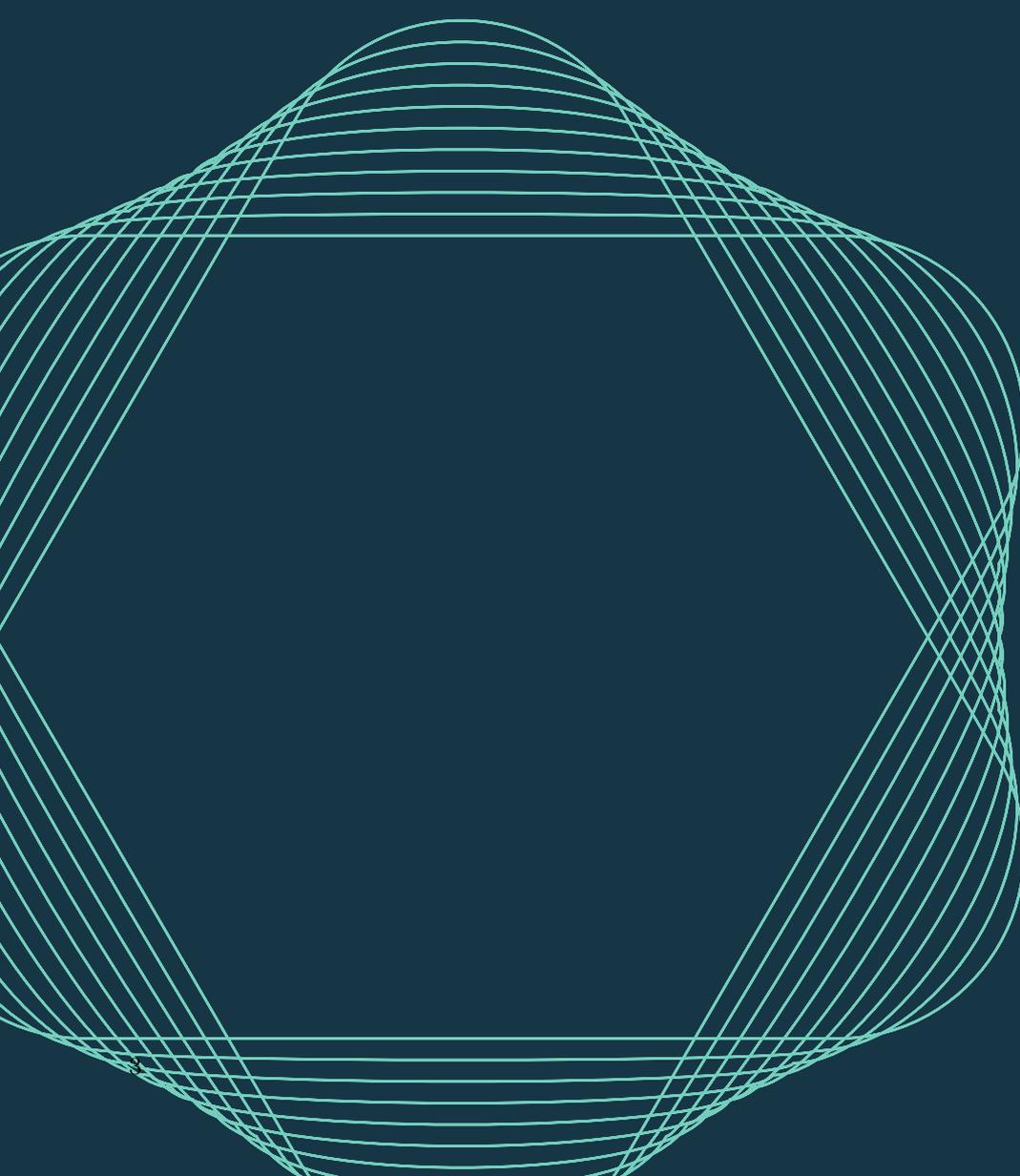


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Trump's Tariffs A Challenge to the Global Economic Order and to Orthodox Economics

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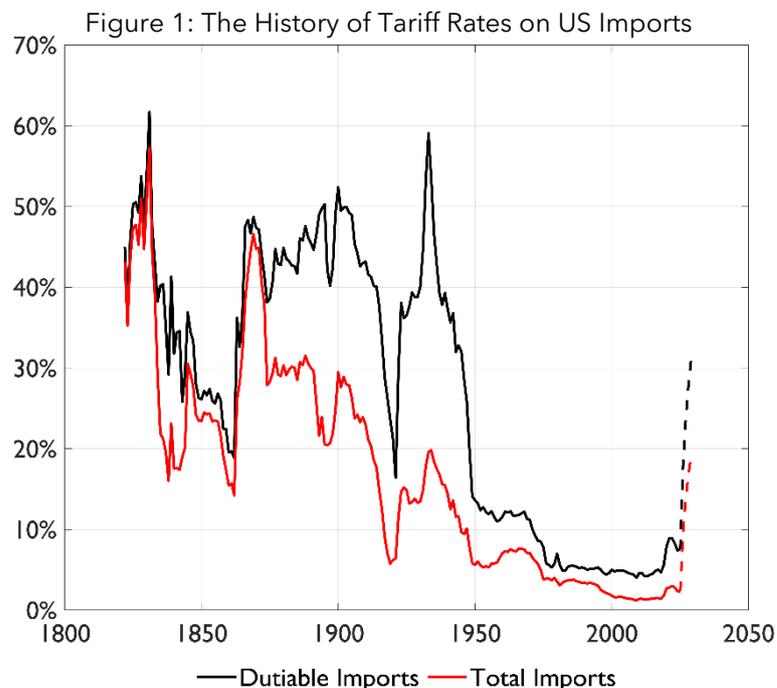
January 14th, 2025

Introduction

The Trump administration's prospective tariff policies, though not without historical precedent, signify a pivotal inflection point in US trade and economic strategy, reflecting a combination of economic protectionism and evolving geopolitical ambitions. The incoming US administration aims to use tariffs as both a lever for domestic economic growth and as a bargaining chip to achieve a realignment of global trade. In this note, we outline our view of the differing motivations, historical context, and potential economic ramifications, based on simulated scenarios, of this ambitious yet contentious agenda.

I. Historical Context and Policy Framework

There is much precedent for tariffs at or above Trump's intended scale in US history. For most of the 19th century and up until 1933, tariffs in the United States, and elsewhere, were significantly higher than current levels. The disastrous Smoot-Hawley Tariff Act of 1930, which has been accused of deepening the Great Depression, marked the peak of this tariff era. Prior to Smoot Hawley, the average tariff rate on all goods subject to duty (represented by the dark line) and the average tariff rate on all merchandise products (shown by the red line) were always much higher than seen in recent



Sources and Notes: Fulcrum Asset Management LLP, Haver Analytics and Irwin (2017). Dashed lines indicate maximum Trump proposals, an increase in tariffs across the board by 10 percentage points and by 60 percentage points for China.

decades. In comparison, the current tariff levels are among the lowest the US has ever experienced (see Figure 1).

The history of US tariff policy can be understood through what Douglas Irwin (2017) calls the "three Rs" which stand for "revenue raising, trade restriction, and reciprocity". These principles have shaped America's trade protection strategies and are particularly relevant in the current environment.

There have been three main phases in US tariff policy. Pre-Civil War tariffs, from 1820-60, primarily served as revenue-generating measures, generally ranging in the 20% to 30% range. Between the Civil War and the Great Depression, tariffs were used mainly to restrict imports, protecting American manufacturing from foreign competition, helping to nurture a broad industrial base. After 1934, the focus shifted to reciprocity, with the US reducing tariffs in exchange for lower tariffs from other countries. This process has been supported by international coordination, first through the General Agreement on Tariffs and Trade (GATT) and, since its establishment in 1995, through the World Trade Organization (WTO). This system effectively reduced barriers to trade in many sectors and was the key component of "globalisation" in the world economy.

While the Trump administration's tariffs in 2018 and 2019 marked a shift back toward protectionism, Figure 1 demonstrates, in the dashed lines, that the potential impact of the administration's "Maximum Trump" tariff agenda over the next few years would significantly exceed his previous actions.¹ If fully implemented, the new plan would push tariffs back to levels not seen since the late 19th century, when the US sought to protect its nascent manufacturing sector. This was a time when the American economy was still growing relative to European economies, and tariffs were intended to nurture domestic industries.

It remains far from certain that the administration will fully implement this agenda. However, President Trump and incoming members of the new Republican Administration have used each of the "three Rs" to justify their plans to raise tariffs substantially.

The role of tariffs as a source of revenue is now re-emerging as a key factor in trade policy, especially in the context of the President's plans to reduce domestic taxation while curtailing the budget deficit. The second principle, trade restriction, has regained prominence, especially in relation to China, which is seen as engaging in unfair trade practices with the United States. The Trump administration has also made clear its focus on restricting imports from other countries that are seen as exploiting their trade relations with the US, causing a permanent American trade deficit in manufactured goods. The European Union is an important target, along with "feeder" economies like Vietnam and Mexico. Recently, even countries like Canada have been threatened with large tariffs in the absence of co-operation with Trump's wider political agenda.

Reciprocity, the third principle, is also evident in the Trump team's approach to trade negotiations. The new US strategy could involve imposing high initial tariffs with the expectation that foreign economies will be forced eventually to agree to reciprocal trade deals with tariff reductions on both sides. After the failure of the Smoot Hawley tariff in the early 1930s, reciprocity in tariff-reducing trade deals became the main motivation from 1934 until 2018 when tariffs fell to all-time lows. For Trump, this reciprocal approach seems part of a longer-term strategy aimed at reaching trade deals, based on the principle of mutual concessions.

Donald Trump has therefore espoused all three motives for his tariff program. Under the Trump administration, these three principles – revenue raising, import restriction, and reciprocity – are being blended into a strategy that seeks to escalate tariffs to incentivize countries like China and the EU to de-escalate through negotiation. Scott Bessent, the nominee for Treasury Secretary, has

¹ The illustrative maximum Trump scenario increases tariffs by 10 percentage points across the board with an increase for Chinese goods by 60 percentage points.

referred to this as the "escalate to de-escalate" strategy, which underscores the need for a credible threat of increased tariffs at the outset to encourage negotiation and trade resolution.

II. The Escalate to De-escalate Strategy

According to Bessent, the administration's proposed tariff strategy should involve a phased approach, although the President's personal views and specifics of the starting rate and the duration of the phases are very unclear. According to Stephen Miran, nominee for Chair of the Council of Economic Advisers, the initial period of high tariffs could be designed to incentivize reciprocal reductions from trading partners, eventually culminating in a Plaza 2-style agreement to address currency misalignments and trade imbalances.

Miran has recently argued that the initial plan should avoid upsetting markets, with the idea that the full extent of tariff increases, such as our illustrative "Maximum Trump" scenario, would only be implemented if negotiations over several years with key trading partners, such as China and the EU, fail. The intention is for the market not to face immediate and significant disruptions, as a succession of deals with individual countries may remove the need for further tariff increases. Miran is specific that, in this phase, the dollar would be likely to rise.

A key aspect of his strategy is the potential for a long-term agreement akin to the 1985 Plaza Accord (see Box 1). In this scenario, the US would initially impose tariff barriers, but these would be followed by negotiations leading to a new framework where the dollar's value is encouraged to depreciate in exchange for a reduction in tariffs. The idea is that such an agreement could help correct global trade imbalances, with specific focus on the Chinese yuan, the Japanese yen, and the euro.

However, a deal like this seems impossible at present, not least because getting China to agree would be a major hurdle. The Chinese government is unlikely to want to encourage a currency appreciation for the yuan before today's deflationary pressures are solved. In addition, central banks in the US and the EU may not be willing to co-operate with a strategy that purposefully devalues the dollar. A further problem is that a strategy to weaken the dollar deliberately may undermine confidence in the US bond market, though Miran believes that this could be offset by lengthening the duration of Treasury debt in agreement with creditor countries.

The obvious challenge is that the market may first react to the escalation phase, where the prospect of much higher tariffs over several years starts to create negative economic consequences (see

Box 1. What Was the Plaza Accord?

The Plaza Accord was a landmark agreement between the G5 finance ministers announced on September 22, 1985. The key provisions included:

- Joint intervention in the foreign exchange markets to reverse the overvaluation of the US dollar.
- The US committed to reducing its federal budget deficit.
- European governments pledged to adopt fiscal policies aimed at stimulating domestic demand.
- Japan agreed to deregulate its economy and stimulate domestic demand.

Following the agreement, the dollar fell by 4% on the day of the accord and by 40% over the next 18 months. The US trade deficit with Europe was eliminated within four years, and the deficit with Japan was halved. However, the deal also led to an overvaluation of the yen, prompting significant easing in fiscal and monetary policies. This contributed to the financial crash of 1989 and decades of low growth in Japan.

section V). This includes concerns over trade uncertainty, supply chain disruptions, and inflationary pressures, which the incoming administration is keen to avoid.

Another immediate concern is potential retaliation from China. Once the US announces tariff increases, China is expected to respond aggressively, potentially limiting access to rare earth minerals, which could escalate tensions beyond the control of the new administration.

The administration's nominated economic officials appear more organized and unified compared to those in earlier governments (see section IV), yet there remains uncertainty about whether the President will adopt a consistent, hawkish stance in the face of market disturbances and retaliation from trading counterparties. His approach could fluctuate, as seen in the past.

III. A Return to Mercantilism?

The term "mercantilism" is contentious, especially when applied to an American President, since the US was of course founded in opposition to British mercantilist policies. However, elements of traditional European mercantilism from the 17th and 18th centuries appear to echo in aspects of President Trump's rhetoric, according to some observers. Similarities include the tendency of the President and members of his new team to describe the US trade deficit as a "loss" of money to other countries; their failure to give any significant weight to the benefits to the US from cheaper imports (including the operation of Ricardian² comparative advantage); their desire to measure US "wealth" as equivalent to its foreign exchange reserves or even its gold reserves; their use of tariffs to further their geopolitical aims or the strengthening of national defence and security; and their willingness to work on national policy with powerful companies in the private sector.

Scott Bessent, in *The Economist* on October 23, 2024, argued that the US should reshape the global economic order. Although he expressed support for free trade "principles", this was no longer on a global scale. Instead, he wanted to create a new bloc (or blocs) centred on the US, with the key intention of redressing issues such as weakening US industrial power and national security, which globalization has exacerbated. He criticized the "Ricardian comparative advantage paradigm" for contributing to trade imbalances and to inequality in the US. Bessent proposed US global tariffs to counteract these economic and security disadvantages, along with reductions in the US budget deficit through spending cuts.

Bessent's strategy, described by some as mercantilist, includes a focus on segmentation of the international economy but does not suggest a deliberate weakening of the dollar, at least initially. The administration's policies, particularly regarding China, instead reflect concerns about national security and trade balances, with a major shift away from traditional economic theories that can be traced back to Adam Smith's free trade principles in "The Wealth of Nations", published (ironically) only four months before the American Declaration of Independence in 1776.

As noted, these policies also emphasize national security, especially in domestic manufacturing and intellectual property. All members of the new trade team in the Trump administration view a strong economic base as vital for national defence, particularly in relation to China. As a result, economic and security considerations have become increasingly intertwined - a marked departure from the approach of most previous US administrations in the post-war era.

² The classical Ricardian model predicts that all countries may benefit if they engage in free trade and produce goods and services according to their comparative advantage. Even if one country is better placed to produce all goods, free trade is potentially welfare enhancing if there are differences in relative productivity.

IV. Who's Who in the New Trump Cabinet?

President Trump has announced several key nominations for his top economic team. Some of these need to be approved by the Senate, but this approval seems very likely to be smooth, given the undoubted high quality of the names involved.

A notable distinction between this team and the one assembled in 2017 is the deliberate alignment of the new appointees with President Trump's views on trade policy, particularly their more hawkish stance on tariffs and relations with China. Unlike the previous administration, which included figures like Stephen Mnuchin, the former Treasury Secretary, and Gary Cohn, a former White House advisor, who advocated a more free-trade-oriented agenda during the early part of Trump's first term, the current team reflects a unified commitment to the Trump trade agenda. This alignment ensures there will be no internal opposition to the administration's tariff-focused approach. Indeed, this has been the clear intention of the President and his transition team as they assembled the new trade leadership.

Table 1: Key Personnel in the New Administration

Name and Role	Background	Political Pedigree	Education
Scott Bessent <i>Treasury Secretary</i>	Hedge fund economist at Soros and founder of Key Square Group.	Republican, Former Democrat	Yale Politics BA
Stephen Miran <i>CEA Chair</i>	Hedge fund strategist at Hudson Bay and fellow at Manhattan Institute. Treasury adviser in Trump 1.0 and macro economist.	Former centrist Republican, now MAGA	Harvard Economics PhD
Peter Navarro <i>Trade Advisor</i>	White House trade adviser in Trump 1.0. Jailed for contempt of Congress after Jan 6 events.	Strong MAGA, former Democrat candidate	Harvard Economics PhD
Howard Lutnick <i>Commerce Secretary</i>	CEO of Cantor Fitzgerald. Remarkable charitable history after Sept 11.	Strong MAGA supporter	Haverford College BA
Jamieson Greer <i>USTR</i>	Trade lawyer. Chief of staff to USTR Lighthizer in Trump 1.0. 4 years of active service in US Air Force.	Republican, now MAGA	University of Virginia JD
Kevin Hassett <i>NEC Director</i>	Chair of CEA in Trump 1.0. Hoover Institute. Potential candidate for Fed Chair as an alternative to Kevin Warsh.	Traditional Republican, Now pro Trump	University of Pennsylvania Economics PhD
Robert Lighthizer <i>No Formal Role</i>	Trade lawyer, USTR in Trump 1.0, Deputy USTR under Reagan. Main intellectual opponent to Ricardo-based free trade. Key force behind tariff agenda.	Traditional Republican, now pro Trump	Georgetown University JD

Source and Notes: Fulcrum Asset Management LLP. USTR stands for United States Trade Representative, NEC stands for National Economic Council, and CEA stands for Council of Economic Advisers.

The resulting team is an impressive group, with deep knowledge of financial markets, macro-economic policy, trade policy and its legal framework, and its relation to national security (see Table 1, which contains some subjective descriptions by Fulcrum). Political opponents have been quick to dismiss the new nominees as lightweight or ignorant. This is not a fair assessment of the economic and trade team, though the members certainly reject the conclusions of the post-war economic consensus among academics and policy makers.

Within this broad alignment there are, however, some nuanced differences that are potentially significant. In the following paragraphs, we comment on how these differences may emerge, based on our subjective assessment of the recent writing and statements of the officials concerned. The terms "hawks" and "doves" are intended in a relative sense, within the context of broad agreement among all team members that much higher tariffs are essential in the initial phase of trade and security policy for the new term.

The China "Hawks"

Peter Navarro - White House Trade Advisor

Peter Navarro stands out as the leading figure at the more hawkish end of the spectrum. Navarro, a longtime ally of President Trump and one of his most trusted aides, has consistently held a firm stance on China. He has been a strong advocate for a significant and lasting shift in US-China trade relations, emphasising a more confrontational approach. Notably, Navarro authored a tariffs chapter of Project 2025, effectively shaping the blueprint for a hawkish trade policy under the Trump agenda.

Jamieson Greer - US Trade Representative

As the new term begins, it appears likely that the administration will pursue high tariffs with little interest in phase two negotiations that could lead to de-escalation. Probably supporting this approach will be Jamieson Greer, the newly appointed US Trade Representative. This is a significant role, and Greer brings substantial experience to the position. As a lawyer and former chief of staff under Robert Lighthizer, Greer has a strong background and a clear track record of advocating for a hawkish stance on tariffs, particularly concerning China. His deep understanding of trade law is expected to make him an asset to the pro-tariff camp.

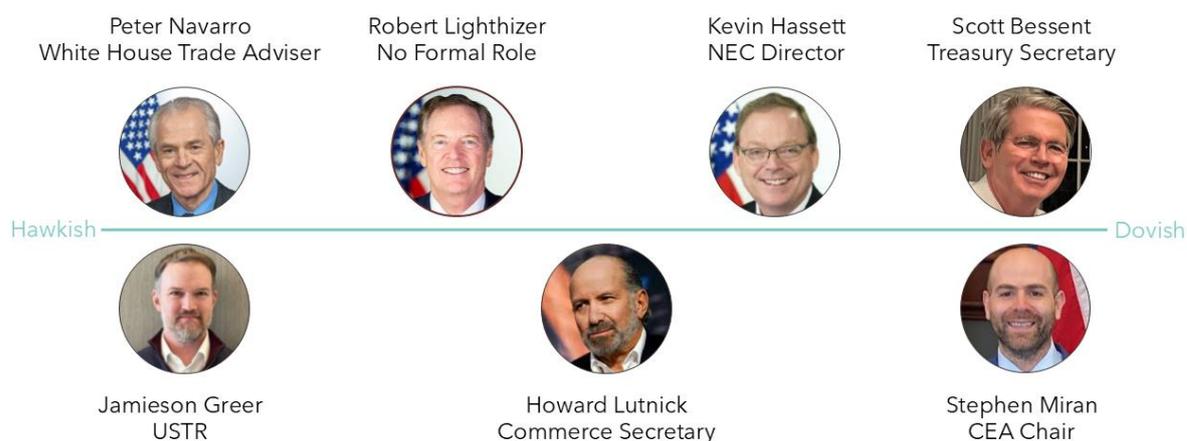
Robert Lighthizer - No Formal Role

Then there's Robert Lighthizer. While Lighthizer does not hold a formal role in this administration – reportedly due to disagreements with President Trump over the implementation of the first administration's tariffs against China or perhaps due to his apparent play to become Treasury or Commerce secretary recently – his influence remains significant. He is widely regarded as the intellectual architect of the hawkish trade agenda in America, with a legacy that dates to his work in the 1980s. Lighthizer has not only shaped the strategy but also documented its history, making him a key figure in this movement. Even without an official position, he is part of a formidable group of seasoned and knowledgeable advocates who have long championed a fundamental and generational shift in trade relations with China, driven by deep-seated and existential concerns.

The "Doves"

When describing this group, it is important to note that any differences are nuanced. The "doves" may place greater emphasis on the "escalate to de-escalate" strategy. These members could advocate for a more measured approach, aiming to explore pathways for negotiation and resolution after the initial tough stance. Understanding who they are and why they hold this slightly more moderate view requires looking at their backgrounds, priorities, and perspectives on long-term trade relations and diplomacy.

Figure 2: Fulcrum Assessment of Relative Trade Hawkishness of Nominated Economic Officials



Source and Notes: Fulcrum Asset Management LLP, illustrative positions. USTR stands for United States Trade Representative, NEC stands for National Economic Council, and CEA stands for Council of Economic Advisers.

Scott Bessent - Treasury Secretary

Scott Bessent, the Treasury Secretary nominee, is a market favourite, though his relationship with President Trump remains somewhat uncertain. As noted above, one of Bessent's key strategies is the "escalate to de-escalate" approach. He advocates a significant increase in tariffs on China and, to a lesser extent, the European Union, but prefers a phased implementation. While he is steadfast in his stance on tariffs, Bessent is also conscious of the potential market impact and is likely to seek reciprocal trade deals as a means of managing these effects. Looking toward the future, Bessent envisions a transformative shift in the structure of global trade and finance, possibly including a second "Plaza Accord" to fundamentally reshape international economic relations.

Stephen Miran - Council of Economic Advisers, Chair

Stephen Miran, the incoming chair of the Council of Economic Advisers, shares a closely aligned economic vision with Scott Bessent. Their strategic thinking is grounded in a two-phase approach. Phase 1 focuses on the gradual implementation of increased tariffs, mirroring Bessent's approach, and would also require a stronger US dollar to mitigate inflationary pressures. Phase 2, however, holds the potential for a new Plaza or Mar-a-Lago Accord, which could involve a weaker dollar, aligning with Miran's long-term vision. A key priority for Miran is maintaining market confidence, particularly within the dollar and bond markets. His strong relationship with President Trump positions him well to influence policy direction and ensure these objectives are pursued.

In Miran's "Mar-a-Lago" type of agreement, the dollar would be intentionally devalued. This presents a challenge, since although President Trump has expressed a desire for a weaker dollar, he also wants to preserve its role as the cornerstone of the global financial system and as the premier global reserve currency. Balancing these objectives will be a delicate task, but Miran and (probably) Bessent believe it could be achievable in a future phase of their strategy.

The Inbetweeners

There are also a couple of figures who are clearly pro-tariffs, but who do not fit neatly into either the hawkish or dovish categories, occupying a more ambiguous position.

Howard Lutnick - Commerce Secretary

Howard Lutnick is the presumptive Commerce Secretary. While he does not have a background in trade, he secured this position for a variety of political reasons, and it remains unclear how influential he will be. Lutnick apparently has a strong personal relationship with President Trump, though this dynamic may have shifted recently. He is known for his hawkish stance on China but has not expressed distinctive views on broader economic policy. Given that his beliefs seem largely undefined and fluid, he may take a more ad-hoc approach in his role. Despite holding a significant position, and considerable experience in other areas, Lutnick is considered by some observers to be an intellectual lightweight on trade issues, and it is possible that he will soon be sidelined from the key decision-making process. Lutnick has advocated for the aggressive use of the Reciprocal Trade Act as a tool to address what he sees as unfair practices by China and other nations.

Kevin Hassett - National Economic Council, Director

The final key figure is Kevin Hassett, who has usually been more aligned with traditional Republican views and is not expected to be as hawkish as some of his counterparts. While he may resonate more with Bessent, he still advocates for strong action against China. As the Director of the National Economic Council, Hassett is an independent thinker who commands President Trump's respect, though his views are unlikely to be the deciding factor in policy decisions. Hassett believes that China "deserves any harsh trade policy a country chooses to impose" and even suggests that China should be expelled from the World Trade Organization. He draws a parallel between China's steel overcapacity and the US's industrial strength during World War II, arguing that this overcapacity signals a more aggressive stance from China. He has proposed the use of a "Reciprocal Trade Act" alongside a universal tariff, but his approach seems less extreme than the "maximum universal" tariffs discussed by Trump, and he believes that any significant trade measures should involve Congressional input.

The common thread among all the new economic team is their support for rapid and aggressive action against China, with the expectation that while this strategy may persist for an extended period, it holds the potential to lead eventually to negotiated trade deals.

V. Economic Impact and Risks

While it is a considerable exaggeration to suggest there is a fixed benchmark proposal, the incoming President has indicated plans to increase tariffs on all Chinese goods to 60%, up from the current 17% average tariff rate. Additionally, he says that he aims to implement a global tariff of 10% on all imports into the United States. He has also proposed imposing various additional tariffs on goods from Canada and Mexico, and other countries, depending on their policy actions. While the 10% global tariff and 60% tariff on China could be considered a benchmark, the actual implementation and timing will depend how the situation evolves. If these tariffs are enacted over the course of a four-year presidency, it would result in a significant trade shock for the global economy.

The macroeconomic implications of the proposed tariff hikes are profound. Various sources have outlined different scenarios (shown in Table 2) to assess the potential impact of President Trump's tariff policies on the US economy. Note that these are not Fulcrum's own estimates. They are based on different policy assumptions run on different macro-economic models of the US and global economies, so they cannot really be compared with each other directly. Our intention is to offer a gauge of the likely range that central banks and markets might consider realistic estimates of possible economic effects as the narrative on tariff increases begins to emerge.

To standardise the analysis, we translate these scenarios into a common shock where the average tariff rate on China and all other countries rises to 10% - a more moderate form of the Trump

proposals than shown in Figure 1. This assumption would allow some countries to avoid increased tariffs even if others, notably China, are subject to much higher rates.

The resulting tariff increase on all countries would average 7.7 percentage points, about half of the impact described earlier as “Maximum Trump” tariffs. Although there is great uncertainty about what could happen over coming years, markets will need to form a view in advance, and this seems like a reasonable opening guesstimate.

Broadly speaking, these scenarios agree that significant tariffs would result in a negative supply shock, which would lead to a reduction in output and an increase in the price level. We examined the models’ estimates of the maximum impact this would have on both GDP and consumer price levels. Our findings show that the impact on GDP could range from a decrease of 0.6% to a fall of as much as 2.7%. For the consumer price level, the estimated increase ranges from 0.8% to 1.8%. These are substantial effects, indicating that meaningful tariff increases would likely have significant adverse consequences for the US economy. However, it is important to note that the impact on *GDP growth and inflation rates* could be spread over more than one year, which might reduce the shock effect on markets. Furthermore, monetary policy might be adjusted to smooth the effects even further.

Table 2: Impact of Trump Tariffs

Source	Tariff Increase (percentage points)	GDP Impact (percent)	Price Level Impact (percent)
IMF	7.7	-1.0	-1.0
<i>of which: tariffs</i>		-0.6	-0.3
<i>of which: uncertainty</i>		-0.5	-0.7
Peterson Institute	7.7	-2.7	1.8
<i>of which: autonomous</i>		-1.0	0.8
<i>of which: retaliation</i>		-1.6	1.0
Goldman Sachs	7.7	-1.1	0.8
<i>of which: autonomous</i>		-1.0	
<i>of which: retaliation</i>		-0.1	
Oxford Economics [†]	7.7	-0.6	1.9
FOMC (Tealbook A, 2018) [†]	7.7	-1.4	1.7

Source and Notes: Data derived from IMF (2024), Peterson Institute (2024), Goldman Sachs (2024), Oxford Economics (2024), FOMC (2018) and Fulcrum Asset Management calculations. The table presents various estimates of the economic impact of Trump tariffs on GDP and price levels, reported as the percentage change from baseline. For consistency, each shock has been converted into an equivalent move to a universal 10 percent effective tariff on all goods imports. The cumulative effects on GDP levels and price levels are shown relative to an alternative baseline projection. [†]Indicates estimate rescaled from published source.

One notable outlier in these analyses is the International Monetary Fund (IMF). Projections from the IMF’s global model showed a different effect on prices, forecasting a decline rather than an increase. This difference appears to be because the IMF incorporates significant confidence and trade uncertainty effects into their framework, which translate into negative demand shocks, building considerably over time. As a result, the IMF’s forecast for the price level diverges from the broader consensus. Nevertheless, most other sources agree that the primary consequence of a substantial tariff increase would be negative for GDP, accompanied by rising prices.

This negative impact on US GDP growth would be increased in size if there are significant retaliatory tariffs imposed by foreign countries on US exports. There are threats that this may happen, though many countries might try to avoid exacerbating the trade war in the initial period, preferring to attempt “constructive” negotiations with the new US administration.

For the Federal Open Market Committee (FOMC), the simulations conducted in the Tealbook in September 2018 during the first Trump presidency suggest that their view aligns roughly with the middle of the estimated ranges for GDP impacts. Their model agrees that a tariff shock, would constitute a negative supply-side shock, with adverse effects on GDP and price levels.

Importantly, Chair Powell said in his December FOMC Press Conference that the 2018 results represent a "good place to start" for the FOMC's consideration of a further round of Trump tariffs, but he has emphasised that many aspects of the policy shock, and the baseline path for the economy, could be very different this time.

There has been a tendency in the past for the FOMC to argue for "looking through" the adverse impact of supply shocks (i.e. leaving interest rate policy unchanged), provided they believed that the effects on inflation would be temporary and that the impact on long term inflation expectations would be contained. However, Chair Powell specifically said that the significant inflation shock of 2021-24 might make the impact on inflation - and therefore on monetary policy - different from last time. He also suggested that the diversion of US imports away from China since 2018 might alter the effects of the new tariffs. His main point was that the Fed was not yet ready to make any decisions on these important questions.

The results of these models reinforce the expectation that a significant tariff shock would dampen economic growth, driving down output while pushing up consumer prices. However, given the complex nature of these simulations, and their differing assumptions, there is a wide range of uncertainty around these estimates.

We should also note that the economic policymakers in the Trump team (e.g. Bessent and Miran) generally do not accept that any adverse economic effects are inevitable following the increase in tariffs, since they believe that the initial rise in the dollar, and other new policies designed to reduce oil prices, the budget deficit and the burden of regulation, will mitigate the adverse effects of tariffs on inflation and growth.

The more hawkish members of the new trade team seem to have a different view, arguing that higher tariffs are needed to restructure the US and global economies for the long term, partly for national security reasons, and some of them believe that short term economic pain should be accepted to achieve these objectives. This outcome, or an outcome in which large scale retaliatory tariffs are imposed on the US, might be very adverse for markets.

VI. What Might (Or Might Not) Happen Next

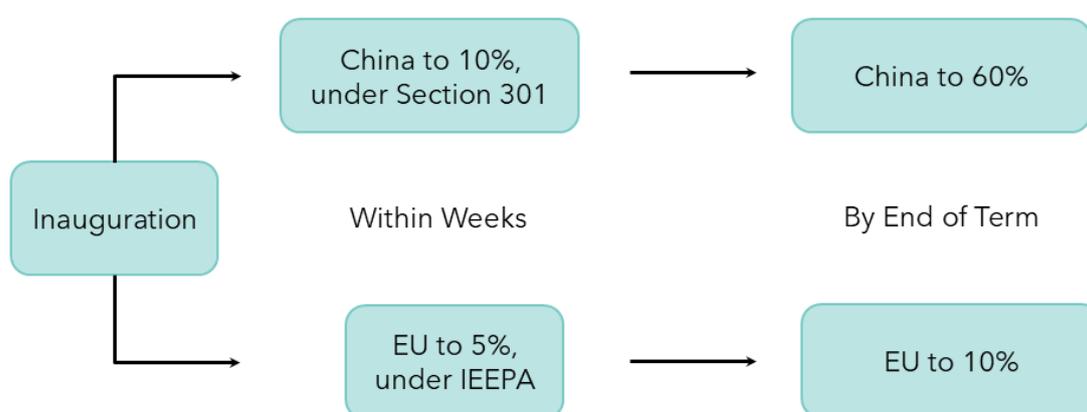
It remains unclear where President Trump stands on these tariff issues, and it is possible that he may not have a firm stance yet. Given his past behaviour, his policy views are likely to remain opportunistic and not founded on a consistent strategy, making it difficult to predict his actions with certainty. The "Maximum Trump" scenario is unlikely to be adopted as the base case by market forecasters, but it is still worth considering. If a dramatic announcement were made immediately regarding China, followed by retaliatory measures, it could seriously undermine financial confidence and lead to rapid instability in global equity markets. While this is not our central case, it is impossible to predict with certainty how President Trump will approach this issue.

The simulations of institutions shown in Table 2 appear consistent with a meaningful economic impact, even in a moderate case for the scale of new tariffs in the first year. Clearly, the precise phasing of new tariff barriers will be crucial, both in assessing the initial adverse effects from the supply shock, and the possible reversal of these shocks if any "Plaza 2" arrangement becomes possible later.

To make this discussion more tractable for investors, we suggest that one plausible scenario could be as follows:

- The US could immediately raise tariffs on Chinese goods by (say) 10% under Section 301 of the 1974 Trade Act, with the stated intention to progressively increase them to 60%. The incoming administration is expected to take an aggressive stance toward China, using these powers to implement significant tariff increases swiftly, bypassing Congress, the courts and the WTO dispute process. These tariffs could begin as early as May or June and rise gradually, potentially monthly, putting pressure on China to make rapid concessions. In response, China is likely to retaliate moderately, with the intention of trying to reach a deal. Given the economic stakes, particularly in manufacturing, negotiations with China are expected to be complex and prolonged. Meanwhile, the US would continue to raise tariff rates progressively to raise pressure for a deal.

Figure 3: A Scenario for the Trump Plan



Source and Notes: Fulcrum Asset Management LLP. Illustrative example of next stages. Section 301 refers to the 1974 Trade Act. IEEPA stands for International Economic Emergency Powers Act.

- The US may announce plans to impose tariffs on other countries, including the European Union, starting at 5% in (say) six months and rising to 10% over the Presidency, likely under the International Economic Emergency Powers Act (IEEPA), passed in 1977. These tariffs would vary by country and sector. In contrast to China, the US approach to the EU is expected to be less confrontational and more gradual, with lower tariff increases implemented over the term. A key focus of these negotiations will be defence spending, as President Trump urges European NATO members to boost their defence budgets to 5% of GDP, more than twice the present level. If European countries meet these demands, it could prevent more severe trade disruptions, but if the EU resists, tariffs may escalate further
- President Trump may make random tariff threats against individual countries based on his broader geopolitical aims, potentially targeting nations such as Mexico, Canada, Panama, or Denmark. These threats would likely be used to achieve specific political goals, further adding uncertainty to international trade dynamics.

If this scenario unfolds, the overall tariff rate could rise by roughly the 7.7 percentage points assumed in Figure 1, towards the end of President Trump's term. This assumes that Congress and the courts will not significantly challenge decisions made by the President and his White House team, with the Executive Office of the President (EOP) maintaining control, at least until the midterm elections.

VII. Market Implications

The Trump administration's tariff agenda presents a high-stakes reform programme with significant potential implications for US and global economic stability. While aiming to recalibrate trade relationships and address strategic vulnerabilities, the risk of economic and market disruptions remains elevated. Since the most likely strategy involves the "escalate to de-escalate" principle, and since the President himself seems eager to send a hawkish message initially, the first few weeks or months of the new term could prove to be a volatile period for financial markets.

The Federal Reserve's view will be crucial in navigating the economic uncertainty arising from potential tariff increases. As noted above, the Fed's stance appears to be firmly adopting a "wait and see" stance. While the December FOMC minutes touched on tariff-related issues, there were no definitive conclusions. At this stage, the Fed seems inclined to postpone major policy shifts, meaning that a clear new message about delaying rate cuts - still less warning about rate hikes - is not currently on the table. Policy will remain "data determined", a very familiar form of guidance that usually means very little in practice. (We assume that the Fed will remain unencumbered by direct political interference during 2025 at least.)

Critically, the Fed under Chair Powell appears less predisposed to mechanically "look through" the impact of tariff increases relative to 2018, given the current state of the economy. Furthermore, the baseline behaviour of the economy involves the persistence of high economic growth and sticky inflation, which has already radically altered the expected path for short rates, and the term premium in the bond market, since the very dovish Fed guidance at the September FOMC meeting.

As the situation unfolds, the market's response to the tariff shock will be the most salient element of the new administration's economic strategy and there is likely to be a period of learning about the timing and magnitude of any policy actions. There is already a firm expectation that a flurry of executive orders and tariff increases will occur shortly after the inauguration and this has now been reflected to some extent in bond and currency markets, and in Chinese equities. There could well be periods in which these "tariff trades" extend further as the Trump strategy clarifies.

So far, however, the market has been disposed to remain somewhat "forgiving" in its pricing of many risk assets, including US equities and credit, where there has been minimal downside at the time of writing this note.

The real turning point could come when the market looks for more concrete guidance from the Fed. If, by mid-year, the Fed signals greater concerns over inflationary pressures or suggests that an indefinite delay in rate cuts may be necessary, this could trigger more significant economic consequences for global risk assets, including US equities and credit. Furthermore, if there is any suggestion that rates may eventually need to rise to contain inflation, a significant market shock to risk assets would be hard to avoid.

In any event, the comfortable talk of a soft landing, which dominated market sentiment in 2023 and 2024, could be much harder to sustain in 2025.

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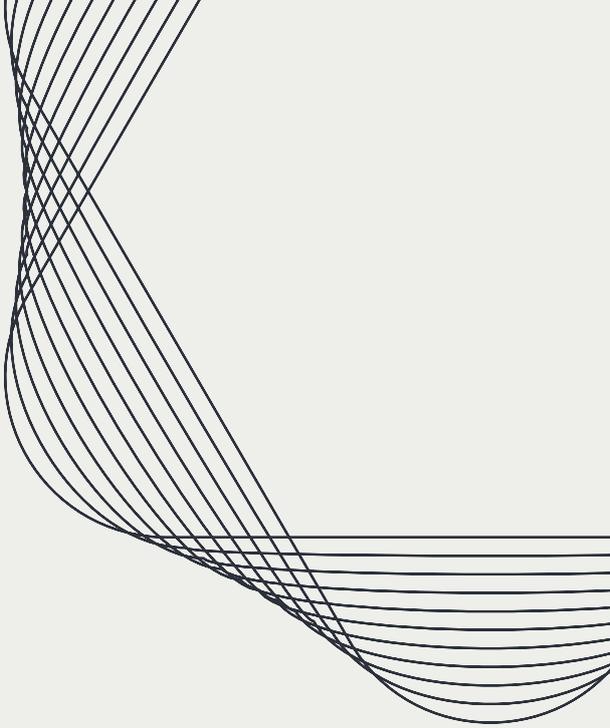
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