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US Policy Pulse

Trump's Tariff Games

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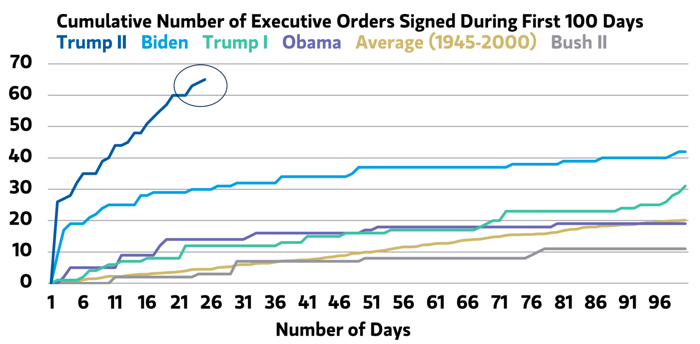
In this report, we discuss recent trade and tariff activity and their impact on markets and the economy.

Key Insights:

- Trump has signed 65 executive orders, the most of any president in their first 100 days, accelerating the rate of policymaking.
- Future tariff negotiations may aim to achieve one or more of the following policy goals: promote US industry protectionism, strengthen national security, increase trade "fairness" and reduce trade deficits, and raise revenues for federal government operations.
- Countries with high trade surpluses with the US and elevated tariffs may be most at risk for future tariffs, including China, the EU, Germany, India and Ireland, among others.
- Country-specific tariffs may place a drag on US growth. A 25% tariff on Canada and Mexico could cause GDP to decline by 1.4 percentage points.
- Tariffs, tariff proposals and broader trade policy uncertainty could drive the US dollar higher and slow growth expectations, while stocks exposed to tariffs on China and Mexico have already experienced pressure.
- Technology, materials, energy and industrials in the US may be the most exposed sectors to tariffs, compared to utilities and health care.
- Following the 2018 tariffs on solar and steel imports, solar and steel industries declined by more than 11% in the first six months following enactment and underperformed the S&P 500 Index in 2018 and 2019.
- Headline risk could contribute to interim market volatility; recent announcement of steel and aluminum tariffs caused related stocks to fall 2% on the news.
- Consumer discretionary stocks could see dispersion in performance as investors reward companies with stronger pricing power.
- Tariff risks reinforce our preference for services over consumer goods. Some services, such as software, cybersecurity, defense tech and large-cap financials may also benefit from other policy tailwinds.

President Trump's second term has started with a wave of executive orders. Unlike his first term, when executive branch activity slowly increased as the president navigated Washington, his return has come with swift action. Since inauguration day, Trump has signed 65 executive orders, the most in the first 100 days of a presidential term in nearly 80 years (see Exhibit 1). The executive orders have sweeping implications across a variety of policy areas and the sheer volume of has left many investors wondering which policies could have the greatest market and economic impacts.

Exhibit 1: Trump Has Signed the Most Executive Orders In The First 100 Days



Source: Oxford Economics, Morgan Stanley Wealth Management Global Investment Office as of Feb. 18, 2025

As we decipher actions coming from the White House, our policy team has created a framework comprised of four policy pillars to guide our consideration of rapid-fire policymaking, paying particular attention to changes that could have notable consequences for market and economic performance. Furthermore, the policy pillars serve as broad umbrella categories allowing for flexibility to interpret investor concerns relating to macroeconomic outcomes, as well as sector and industry market risks and opportunities. Our policy pillars in alphabetical order:

- Budget, Debt and Deficit
- Defense and Foreign Policy
- Deregulation
- Tariffs and Trade

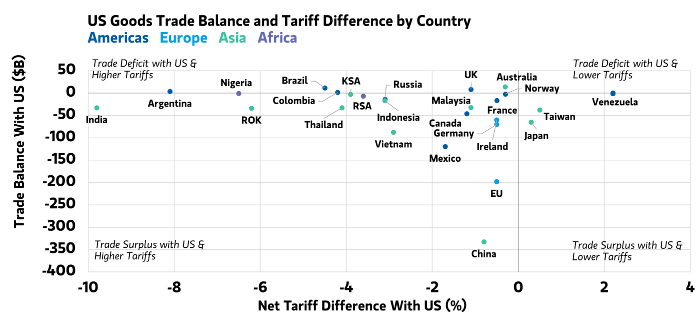
For this report, we discuss recent tariff-related activity, highlighting some of the potential motives and frameworks for policy action as well as the financial market implications for the US dollar and equities. Importantly, this report builds from our September 2024 US Policy Pulse report titled "Tariffs for All?," which provides a discussion of the potential impact tariffs may have on growth, inflation and the consumer.

Tariff Drivers

After many stops and starts on tariff policy, investors and markets have struggled to parse through the various headlines and differentiate noise from concrete action. We view Trump's use of tariffs as a negotiating tool that could result in real tariff risk along the way. We expect future tariff negotiations to stem from one or more of the following policy goals: promoting US industry protectionism, the strengthening of national security, increasing trade "fairness" and reducing trade deficits, as well as raising revenues for federal government operations.

For example, the recent 25% tariff on all US imports of aluminum and steel was intended to both increase the cost of foreign steel and aluminum and incentivize foreign investment in the US to avoid the tariffs. Trump has also issued executive orders to review existing trade relationships and consider reciprocal tariffs, which are examples of a "trade fairness" agenda and addressing trade deficits. We have identified some of the countries most at risk of reciprocal tariffs, based on both the magnitude of the US trade deficit and the net tariff difference with each (see Exhibit 2). These include China, the EU, Germany, India, Ireland, South Korea, Thailand and Vietnam.

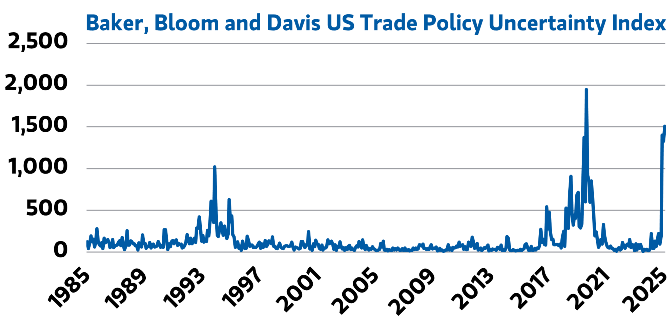
Exhibit 2: Countries with High Trade Surplus With the US and Elevated Tariffs May Be Most At Risk



Note: ROK refers to Republic of Korea; KSA refers to Kingdom of Saudi Arabia; and RSA refers to Republic of South Africa.
Source: Haver Analytics, Oxford Economics, Morgan Stanley Wealth Management GIO as of December 31, 2024.

Lastly, some tariff negotiations may serve to extract certain policy concessions from trade partners and allies. For example, the 25% tariffs on all imports from Canada and Mexico Trump announced Feb. 1 were delayed by 30 days after both countries agreed to take steps relating to migration and drug trafficking. We view potential tariffs levied on Mexico and Canada as an attempt to pull forward the renegotiation of the US Canada Mexico Agreement (USMCA), which is scheduled for reconsideration in 2026. That said, the catalysts for tariffs are likely to be numerous, with unknown outcomes. Unpredictable messaging from the White House could contribute to greater market volatility as investors seek to interpret potential policy shifts. Furthermore, the changeable nature of recent tariff policy proposals has caused the Baker, Bloom and Davis US Trade Policy Uncertainty Index to reach the second-highest level since the index began tracking US trade policy in 1985 (see Exhibit 3).

Exhibit 3: Trade Uncertainty Has Reached Its Second-Highest Level Since 1985

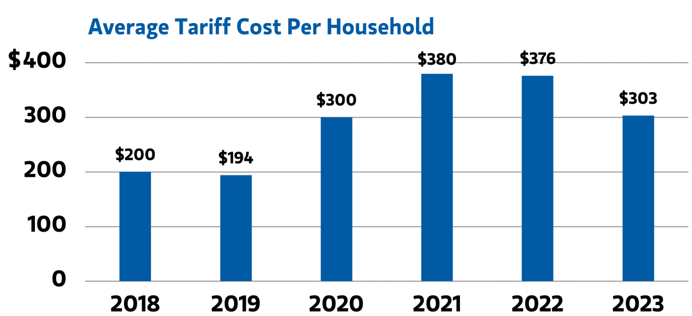


Source: Bloomberg, Morgan Stanley Wealth Management Global Investment Office as of Feb. 18, 2025

Tariffs and the Economy

When considering the economic and market impacts of a heightened tariff regime, we must first acknowledge that many of Trump's first-term tariffs were continued and expanded under the Biden administration. As of May 2024, the Trump-Biden tariffs have together raised over $264 billion in revenue—66% of it during the Biden administration. That said, the Tax Foundation indicates that these actions, along with China's retaliatory responses, have resulted in what may be considered an $80 billion tax on US consumers annually. Specifically, the Trump-Biden tariffs have been found to add between $200-$300 in annual cost per household, on average (see Exhibit 4). Importantly, the impact may be greater as these estimates do not account for lower incomes as tariffs decrease output or a reduction in consumer choice as consumers shift to products not affected by tariffs.

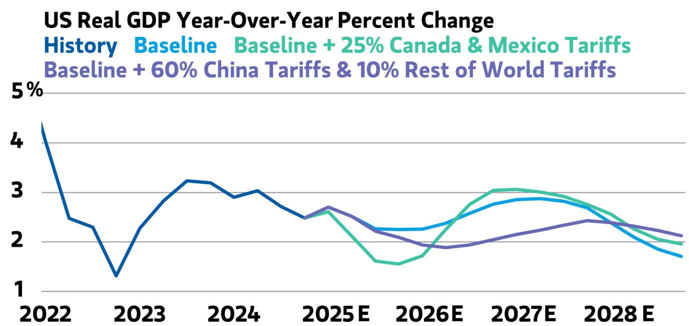
Exhibit 4: Tariffs Tend to Put Pressure on Consumers



Source: Tax Foundation, FRED, Morgan Stanley Wealth Management Global Investment Office as of Feb. 13, 2025

While tariffs are structurally regressive, the increased burden is often viewed as a one-time cost level adjustment and not a cause of sustained inflationary pressures. Rather, the effected industries engage in supply chain reorganization and address labor concerns, costs which could be passed on to the consumer, depending on the product and its consumer demand, before pressures normalize. These pressures could have broader impacts for growth expectations as companies assess their business models and consumers reconsider their budgets, which could alter spending behavior opting for less tariff-exposed goods. For example, a tariff stress scenario conducted by Oxford Economics found that a 25% tariff on Mexico and China could cause GDP to decline by 1.4 percentage points to 1.56% in 2026 but could reaccelerate after the USMCA trade agreement is renegotiated next year. Similarly, when testing for a 60% tariff on China and a 10% universal tariff, it was estimated to cause growth to fall to 1.86% by the end of 2025 but is accompanied by a weaker reacceleration as sweeping tariffs could have a more sustained effect on GDP (see Exhibit 5).

Exhibit 5: Tariffs Could Slow Growth Expectations



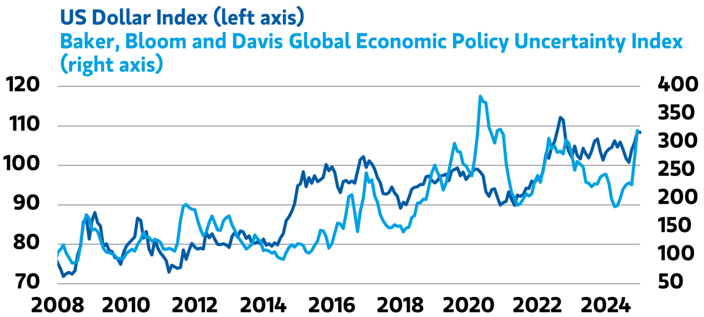
Source: Oxford Economics, Morgan Stanley Wealth Management Global Investment Office as of Feb. 18, 2025

Tariffs levied in the US since 2018 support the directionality of these findings, with long run GDP estimated to have declined by 0.2%, long-run capital stock by 0.1% and 142,000 full-time jobs lost since their onset. Looking forward, we caution investors as the negative rhetoric associated with tariff proposals could weigh on business and consumer sentiment.

Tariffs and the Markets

Economic uncertainty stemming from tariff risk could help extend the strength of the US dollar. The Baker, Bloom, and Davis Global Economic Policy Uncertainty Index, which quantifies worldwide economic instability, has tripled since 2016, driven by the trade war in 2018 and exacerbated by the Covid-19 pandemic, the Russia-Ukraine war as well as Trump's recent tariff action. The dollar, which is often viewed as a "safe haven" asset, has rallied alongside global uncertainty (see Exhibit 6). We anticipate dollar strength to continue while the potential for global economic instability remains high. Any negative impacts to US growth or inflation trends relative to rest of world could lead to less accommodative monetary policy, potentially resulting in higher interest rates for longer alongside an elevated dollar.

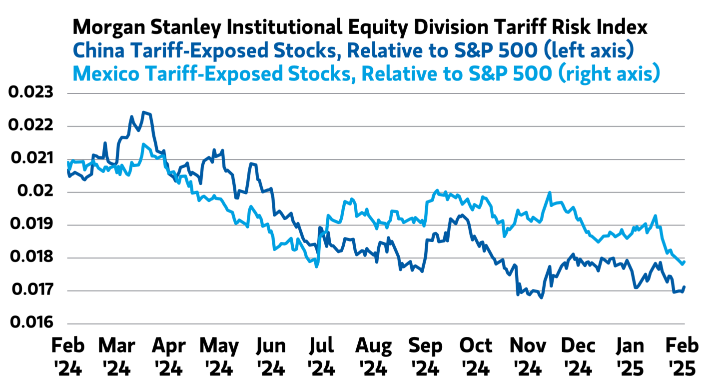
Exhibit 6: Trade Tensions and Global Economic Uncertainty Could Drive the Dollar Higher



Source: Bloomberg, Morgan Stanley Wealth Management Global Investment Office as of Jan. 31, 2025

Equity market risk can be viewed using both geographic and sector-specific lenses as the White House is simultaneously proposing and enacting sweeping, country-specific and industry-level tariffs. Most notably, these include the potential for a 60% tariff on China as well as a 25% tariff on Mexican and Canadian goods. We can see the market impact of country specific tariffs when reviewing the Morgan Stanley Institutional Equity Division Tariff Risk Index, a basket of stocks with high sensitivity to increased tariffs on China and Mexico. Relative to the S&P 500, China and Mexico tariff-exposed stocks have sold off about 15% since March 2024. On the campaign trail, Trump began to discuss his plans to aggressively use tariffs as a key component of his international policies. Since taking office, the China-exposed stocks have declined by 2% and Mexico-exposed stocks fell by 6% (see Exhibit 7).

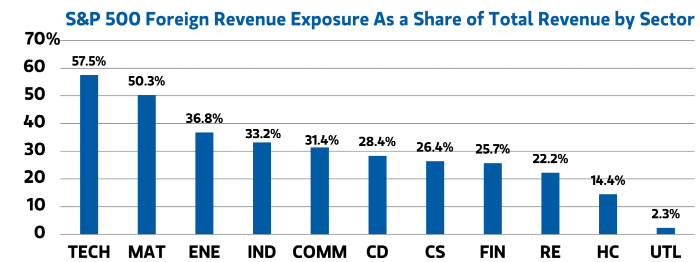
Exhibit 7: Stocks With Exposure to Countries Likely to Experience Heightened Tariffs Have Sold Off



Source: Morgan Stanley & Co. Research, Morgan Stanley Wealth Management Global Investment Office as of Feb. 13, 2025

We underscore that the potential for heightened idiosyncratic risk goes presents at the sector and industry levels. When reviewing sector-level impacts, technology, materials, energy and industrials are particularly exposed to tariffs as they have foreign revenue exposure as high as 57% (see Exhibit 8). For example, recent tariffs targeting aluminum and steel could place a drag on materials and China-specific tariffs could have secondary impacts for tech. Should the tariff regime escalate, we expect the defensive nature and low-tariff exposure of utilities to support the sector's performance.

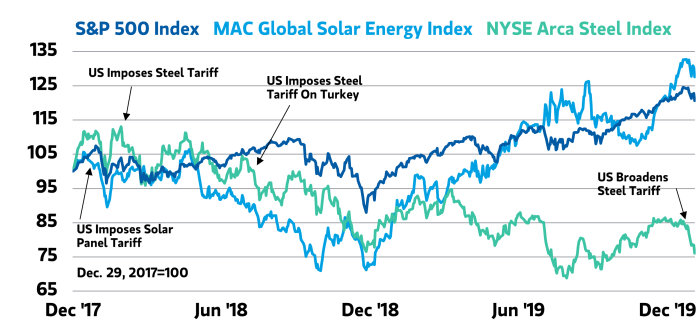
Exhibit 8: Many of the S&P 500 Sectors May Be Exposed to Tariff Risk



Source: Strategas, FactSet, Morgan Stanley Wealth Management Global Investment Office as of Dec. 31, 2024.

Markets are likely to quickly price idiosyncratic risks. This dynamic can be seen clearly when isolating for steel and solar products. In January 2018, Trump imposed tariffs on solar panels and washing machines of 30% to 50%. In March 2018, he imposed tariffs of 25% on steel and 10% on aluminum from most countries, which, according to Morgan Stanley & Co. Research, covered an estimated 4.1% percent of US imports. Following these measures, industries impacted by the tariffs underperformed. For example, both the MAC Global Solar Energy Index and the NYSE Arca Steel Index declined by more than 11% in the first six months following enactment (see Exhibit 9). In February of 2025 Trump announced additional tariffs of 25% on steel and aluminum. While the tariffs are expected to go into effect in March 2025, the news caused steel and aluminum stocks to correct 2% before rallying on global supply/demand dynamics.

Exhibit 9: Tariffs Tend to Weigh on Industry Market Performance



Source: Bloomberg, Morgan Stanley Wealth Management Global Investment Office as of Feb. 18, 2025

Investment Conclusion

We expect further idiosyncratic sector risks to emerge throughout Trump's second term. Promoting US industry protectionism and prioritizing national security are likely to remain two of the most steadfast drivers for the use of tariffs in foreign policy. This means that select tariffs on global goods, and specific countries, like China, are likely to increase before they decline, and perhaps last longer, while broad tariffs on allies and US trade partners with deeply integrated supply chains, like Mexico and Canada, may be avoided through concessions. If a robust and long-lasting universal tariff regime comes to fruition, defensive stocks may outperform cyclicals, and stock-picking becomes more prudent. Consumer discretionary stocks, for example, may experience dispersion within the sector between those with stronger pricing power and the ability to absorb tariffs, and those without. Importantly, bifurcation may occur according to individual income cohorts as well, as companies with greater reliance on revenues generated from lower-income consumers experience the most pressure. If some tariff risks are avoided and prove mostly benign, cyclicals may outperform defensives and the dollar could weaken.

Overall, tariff risks reinforce our preference for services-oriented industries over consumer goods. Areas such as software, cybersecurity, defense tech and large-cap financials, some of which have lower foreign revenue exposure and could be beneficiaries of AI adoption momentum. Furthermore, utilities have low tariff exposure and may serve as a defensive leader should broad-based tariffs increase market pressure.

Disclosure Section

Index Definitions

For index, indicator and survey definitions referenced in this report please visit the following:

https://www.morganstanley.com/wealth-investmentsolutions/wmir-definitions

Glossary

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