BEHIND THE HEADLINES

with **Ronald Temple**, Chief Market Strategist

April 4, 2025

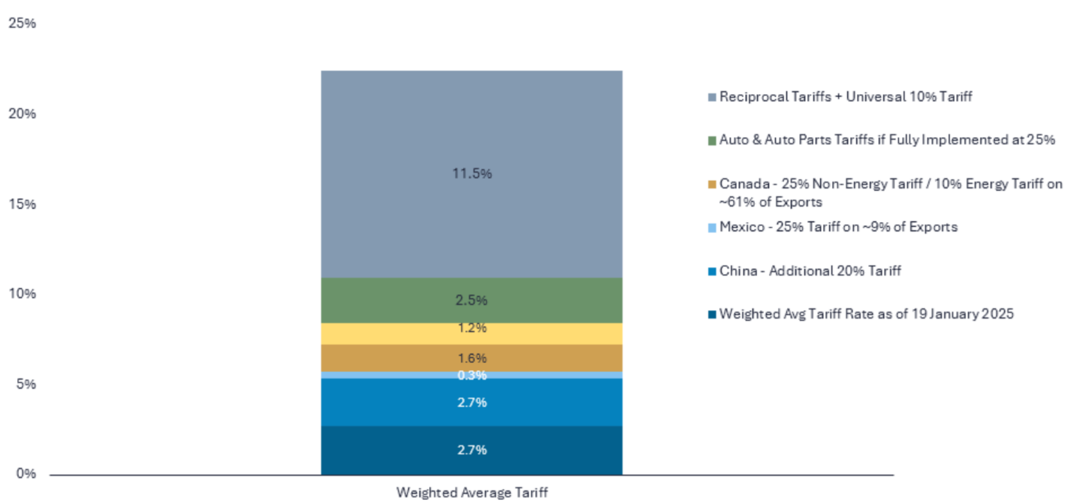
The Week Behind

1. **The United States announced larger-than-expected tariffs, triggering retaliation by China.**

   The outlook: The trade conflict initiated by the United States is not over. China announced retaliation today, and I expect broad-based retaliation from other counterparts in the weeks and months ahead. Even while key trade counterparts like the European Union are imposing countermeasures, I expect that there will also be simultaneous efforts to reduce tensions by offering concessions such as increased imports of US liquefied natural gas, and depending on the country, potentially defense equipment or other American commodities.

   Economically, the weighted average tariff on US goods imports has increased from just under 3% at the end of 2024 to approximately 22.5% according to The Budget Lab at Yale University. As a simple rule of thumb, every 100 basis points (bps) increase in the weighted average tariff translates to about 10 bps of additional US core inflation which implies that the tariff increases to date could lead to a nearly 2 percentage point increase in core inflation later in 2025, holding all other factors constant.

The Weighted Average US Tariff Rate Has Increased from 2.7% to ~22.5% in Less than Three Months



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Source: Lazard, Bureau of Economic Analysis, HSBC, World Bank
Note: Weighted average tariff rate measured across $3.3 trillion of goods imports into the United States in 2024.
As of 3 April 2025

While I have long expected the US administration to raise tariffs more aggressively than markets had anticipated, I had expected a more gradual increase than those in the announcements this week. As a result of these large tariff hikes, I now expect the economic damage to be more severe than would have been the case in a gradual escalation. Initially, it is reasonable to expect that there could be a surge in purchases of some goods as consumers and companies hope to front-run the tariffs and take advantage of lower prices. However, after the tariffs take effect and work their way through the supply chain, I expect demand to fall materially for discretionary items as consumers divert income to paying for necessities that have increased in price.

On net, while recession is not yet my base case scenario for the United States, the probability has risen to the point where it might be a coin toss in terms of whether growth falls below zero in 2026. The severity of retaliation and the speed of negotiations that might lead to lower reciprocal tariffs will likely be key determinants of whether the US economy slows to growth levels below 1% or tips into recession. At this point, I am leaning toward the sub-1%, but still positive, growth with unemployment rising to 5% in 2025 and core Consumer Price Index (CPI) inflation ending the year over 4%.

The details: US trade policy dominated the news this week. On 2 April, President Donald Trump announced a universal 10% tariff on all imports into the United States as well as reciprocal tariffs across dozens of trade partners. The tariffs excluded semiconductors, pharmaceuticals, copper, and lumber, which are all likely to be assigned their own tariff rates globally in the future. The reciprocal measures also do not include tariffs already announced on steel, aluminum, autos, and auto parts.

The universal tariff will be effective on 5 April, while the reciprocal tariffs are set to be effective on 9 April. The later date for reciprocal tariff implementation is presumably intended to allow for expedited negotiations or concessions from trading counterparts hoping to reduce the magnitude of their incremental tariff beyond the universal minimum of 10%.

While the tariffs are being called “reciprocal,” which implies that they are set based on leveling the playing field against unfair tariffs from other countries, the reality is that the formula used was based on a goal of eliminating trade deficits. The US Trade Representative’s office has confirmed that each country’s tariff was calculated by dividing the US trade deficit with the country by the total exports to the United States from that country and then dividing that number by two. Hence, in the case of China, which was assigned a tariff of 34%, the math would work out as follows:

($295 billion / $439 billion) = US trade deficit with China divided by total goods imports from China

x 0.5 = 67%/2 = 33.5% which is then rounded up to 34%

While markets were clearly not expecting the magnitude and scope of the tariffs, no one should have been surprised given that Trump campaigned on a platform promising a 10% to 20% universal tariff and a 60% tariff on China. With this week's announcements, the US administration has now raised tariffs on China by a headline amount of 54%, almost matching his campaign pledges. (The 54% headline figure includes the already announced 20% of additional tariffs imposed on China plus the new 34% reciprocal tariff. The actual tariff is approximately 47.5% given that some products are exempted from the tariffs at this point in the sectors listed above.)

The US actions triggered retaliation, most importantly by China which announced a 34% tariff on US goods imports. Other retaliatory measures are likely in the coming days and weeks.

Markets reacted severely to the news as investors marked down expectations for growth and significantly increased their assessments of recession risk. By early Friday morning, the S&P 500 Index had fallen over 16% from the all-time high of mid-February 2025. US 10-Year Treasury yields fell below 4% for the first time in over six months as investors ramped up expectations for rate cuts due to higher recession risk. By Friday morning, markets were anticipating rate cuts of as much as 120 bps by year end versus expectations the prior Friday for cuts of only 73 bps.

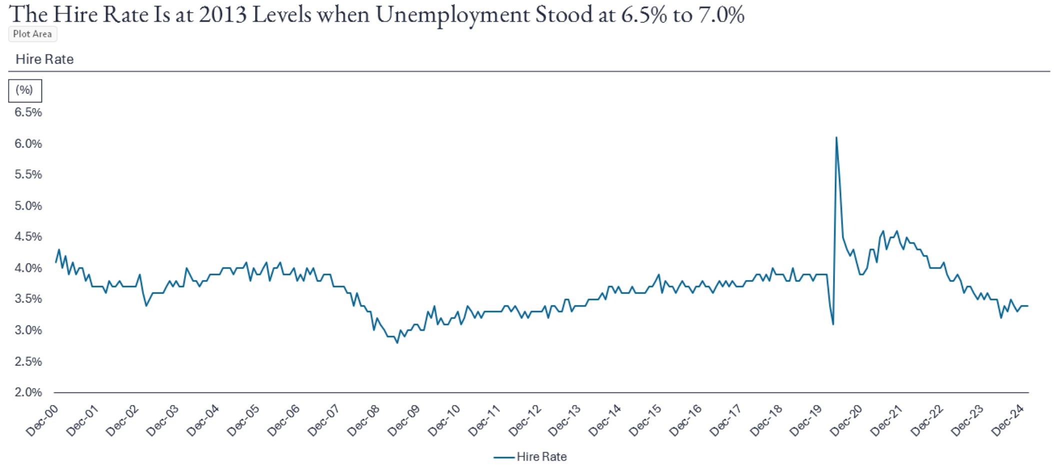
2. **US labor market reports were generally resilient with strong nonfarm payroll growth, but data regarding hiring and quits remain worryingly weak.**

   The outlook: The US labor market is likely to weaken as we move through 2025 for two reasons. First, while the high-level statistics look solid, there are cracks beneath the surface that suggest that labor hoarding after the pandemic could have led to employers retaining more workers than they need. Because of this excess "inventory" of workers, employers have been reluctant to add to headcount and could be poised to shed workers if the economy weakens. Second, with sharp increases in tariffs, companies will likely need to find offsetting cost cuts. To the extent they do have excess workers, that would be a way to save money and protect margins. Given the risk of a significant slowdown in growth, or perhaps even a recession, unemployment is likely to rise to 5.0% or higher.

   The details: The US unemployment rate rose 10 bps to 4.2% in March despite stronger-than-expected job growth of 228k. The two prior months' job growth numbers were revised downward by 48k, but the March outperformance of 88k left the year-to-date (YTD) job creation at 152k per month. Average hourly earnings rose 0.3% month-on-month (m-o-m) as expected while year-on-year (y-o-y) earnings rose 3.8% versus the 4.0% expectation.

   The Job Openings and Labor Turnover Survey (JOLTS) data, which are lagged one month, were slightly weaker than expected with the openings rate slipping to 4.5% in February from 4.7% in January. The hiring rate was stable at 3.4%, roughly equal to levels last seen in 2013 when unemployment was between 6.5% and 7.0%, while the quit rate of 2.0% was in line with 2016 levels when unemployment was 5.0%.

The Hire Rate Is at 2013 Levels when Unemployment Stood at 6.5% to 7.0%



LAZARD Source: Bureau of Labor Statistics, Haver Analytics
Note: As of February 2025

3. **China's National Bureau of Statistics (NBS) and Caixin Purchasing Managers' Index (PMI) figures were slightly better than expected.**

   The outlook: China's economic outlook is likely to dim due to the additional 54% tariff imposed on Chinese exports to the United States in the last three months. Fortunately for China, only about 13% of its goods exports in 2024 were destined for the United States. To the extent China attempts to redirect these exports to other countries, likely at even lower prices to address excess supplies, it will potentially face tariffs or other restrictions from other countries.

   While the assumptions underlying economic forecasts vary, most economists have estimated that a 10% tariff on Chinese goods imposed by the United States would reduce GDP growth by about 30 to 40 bps, absent offsetting fiscal stimulus. With the US-China trade dispute escalating, I would expect negative shifts in PMI indices moving forward.

   The details: For the NBS Manufacturing PMI, the new orders sub-index helped lift results. The NBS indicated that readings for the output and new orders sub-indexes were above 55 for railways, ship, aerospace equipment, and computer, communication, and electronic equipment sectors. Both the construction and services sub-indexes were up within the NBS's non-manufacturing PMI.

   The Caixin PMI which focuses more on smaller, privately owned companies also improved for both manufacturing and services. For the Caixin PMI, the new business sub-index improved but the new export orders sub-index deteriorated.

BEHIND THE HEADLINES

March China PMI Data

Release Date			Consensus	Actual	Prior Month
3/30/2025	NBS	Manufacturing	50.4	50.5	50.2
		Non-Manufacturing	50.6	50.8	50.4
		Composite	*	51.4	51.1
3/31/2025	Caixin	Manufacturing	50.6	51.2	50.8
4/2/2025		Services	51.5	51.9	51.4
4/2/2025		Composite	*	51.8	51.5

Source: Bloomberg, China Federation of Logistics & Purchasing, S&P Global
* No consensus estimate available on Bloomberg.

4. **Eurozone inflation.**

The outlook: Eurozone inflation is likely to continue decelerating a) as the lagged effects of the European Central Bank's (ECB) tightening in prior years continue to reduce inflation and b) as US tariffs weaken economic growth relative to what it would have otherwise been. I expect falling inflation to open the door to more aggressive rate cuts by the ECB than the market currently expects despite the additional fiscal stimulus likely to lift activity in 2026.

The details: The better-than-expected inflation data for the core Harmonized Index of Consumer Prices (HICP) was driven by lower services inflation which fell to 3.4% y-o-y, the lowest level since June 2022. Inflation for nonenergy industrial goods remained at 0.6% y-o-y which marks the eleventh month at or below 0.7%.

EU HICP for March

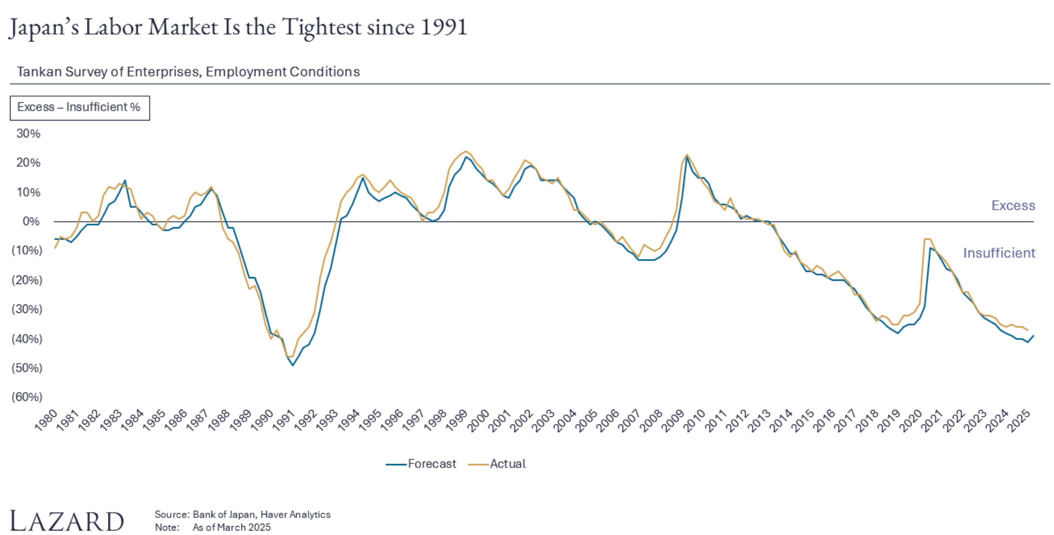
Release Date	Country		Consensus	Actual	Prior Reading
3/28/2025	Spain	Headline m-o-m	0.9%	0.7%	0.4%
		Headline y-o-y	2.5%	2.2%	2.9%
3/28/2025	France	Headline m-o-m	0.4%	0.2%	0.1%
		Headline y-o-y	1.1%	0.9%	0.9%
3/31/2025	Germany	Headline m-o-m	0.4%	0.4%	0.5%
		Headline y-o-y	2.4%	2.3%	2.6%
3/31/2025	Italy	Headline m-o-m	1.3%	1.6%	0.1%
		Headline y-o-y	1.8%	2.1%	1.7%
4/1/2025	Eurozone	Headline m-o-m	0.6%	0.6%	0.4%
		Headline y-o-y	2.2%	2.2%	2.3%
		Core y-o-y	2.5%	2.4%	2.6%

Source: Bloomberg
Note: Consensus estimates changed in some cases from what was previewed previously.

5. **Japan's Tankan survey was modestly stronger than expected.**

   The outlook: I expect the inflation normalization story to continue in Japan as the economy remains resilient and the labor market remains near the tightest levels since the early 1990s. One risk to the Japanese story could be the 24% reciprocal tariff announced this week by the United States. Fortunately for Japan, it is less dependent on exports than many believe with total goods exports representing about 15.4% of GDP in 2024 with about 20% of those exports going to the United States.

   The details: The outlook for large and small manufacturers was stronger than expected while labor markets eased slightly but remained near the tightest levels in over 30 years.



The Week Ahead

1. **Retaliation and negotiations are likely to be prominent market drivers.**

   The outlook: The universal 10% tariff imposed by the United States will take effect over the weekend and is likely to lead to some retaliation. The incremental reciprocal tariffs are scheduled to be implemented on 9 April. In some cases, countries will try to avoid the reciprocal tariffs by offering concessions to the United States, but the universal tariff is likely to remain in place across all trader partners. Some countries will take longer than others to respond, but next week is likely to be eventful on the trade front regardless.

2. **US CPI inflation is likely to subside modestly in March before reaccelerating after April when tariffs begin to materially increase price pressures.**

   The outlook: Tariff pressures are unlikely to be evident in the March CPI figures as many companies pre-ordered goods to avoid tariffs late in 2024 and early in 2025. I expect inflation to bottom in the next couple of months before we see materially higher goods inflation start to lift the broader CPI. The consensus expectation for March is for headline CPI to rise 0.1% m-o-m and 2.6% y-o-y versus 0.2% and 2.8%, respectively, in February. Core inflation is expected to rise 0.2% m-o-m and 3.1% y-o-y versus 0.2% and 3.1%, respectively, in February.

3. **The preliminary University of Michigan Sentiment Index for April is expected to weaken further.**

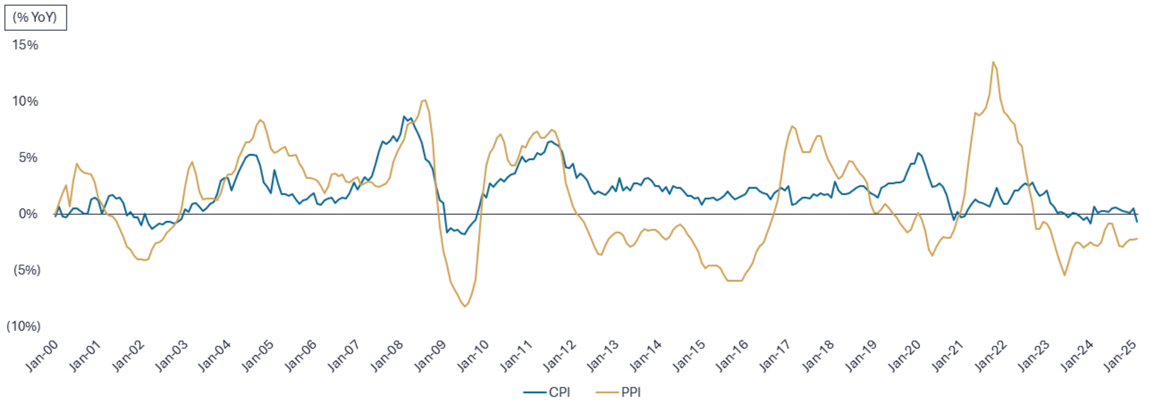
   The outlook: The University of Michigan Sentiment Index has declined to 57.0 from 74.0 in only three months. This is the sharpest decline since the pandemic. The key driver of the slide has been in consumer expectations which have declined by 20.7 points to 52.6 since year end. Expectations in this index have been highly correlated with inflation expectations since the pandemic. Given the negative outlook for inflation and the constant news regarding tariff increases, I expect a further decline in the April readings.

4. **China CPI and Producer Price Index (PPI) inflation data are expected to show softness in prices.**

   The outlook: China's PPI has been in deflation for 29 consecutive months, while CPI has been at or below 1% for 25 months. The consensus expectation for March is that PPI will be -2.3% y-o-y versus -2.2% in February while CPI will rise by only 0.1% y-o-y versus -0.7% in February. Deflationary pressure is likely to increase in China through the year as the negative impact of tariffs on exports leads to even more excess supply of goods domestically.

China Inflation Is Undesirably Low with PPI Deflation for 29 Months and CPI ≤1% for 25 Months

China CPI and PPI



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Source: Bloomberg, National Bureau of Statistics
Note: As of February 2025

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