BEHIND THE HEADLINES

with **Ronald Temple**, Chief Market Strategist

April 11, 2025

The Week Behind

1. **US trade policy took more abrupt turns.**

   <u>The outlook:</u> Exiting the week, the weighted average US tariff on goods imports exceeds 27% versus the ~2.7% level before 20 January. The market rallied sharply on Wednesday 9 April when the pause on tariffs was announced, only to sell off again the following day as the severity of the trade conflict between the United States and China sunk in.

   Looking forward, the ~24 percentage point increase in the weighted average tariff bodes ill for the future inflation. A rule of thumb is that each percentage point increase in the weighted average tariff equates to about 10 basis points (bps) of core inflation. However, it is important to recognize three things:

   a) The inflation pressure is non-linear. The higher the tariff, the less incremental inflationary pressure, as customers substitute where possible to avoid the higher prices.

   b) Tariff-induced pressure is a one-time event (in theory) as the tariff leads to a step change in prices that is not repeated. However, the reason I wrote "in theory" is that retaliation can lead to additional rounds of price increases. It is also notable that increased prices for imported goods typically leads to higher prices for domestically produced alternatives. To the extent that such price increases become widespread, they can lead to systemically higher inflation.

   c) To the extent economic growth decelerates due to a trade conflict, demand destruction (reduced consumption) should partially offset the tariff-induced price increases.

   Putting it all together, I do not believe China will continue to face a 145% tariff on all exports to the United States through year end. If we assume the tariff on Chinese imports falls to 60% which is the level candidate Trump discussed on the campaign trail, the weighted average tariff will decline to approximately 17% to 18% from the current 27% to 28% (holding all other tariffs constant). If that were to occur, US core Consumer Price Index (CPI) inflation could exit 2025 at a rate of 4.0% to 4.5%.

   In my view, this level of core inflation, even if it is deemed "transitory," would likely preclude Fed rate cuts. This contrasts with the current market expectation for three to four Fed rate cuts in 2025.

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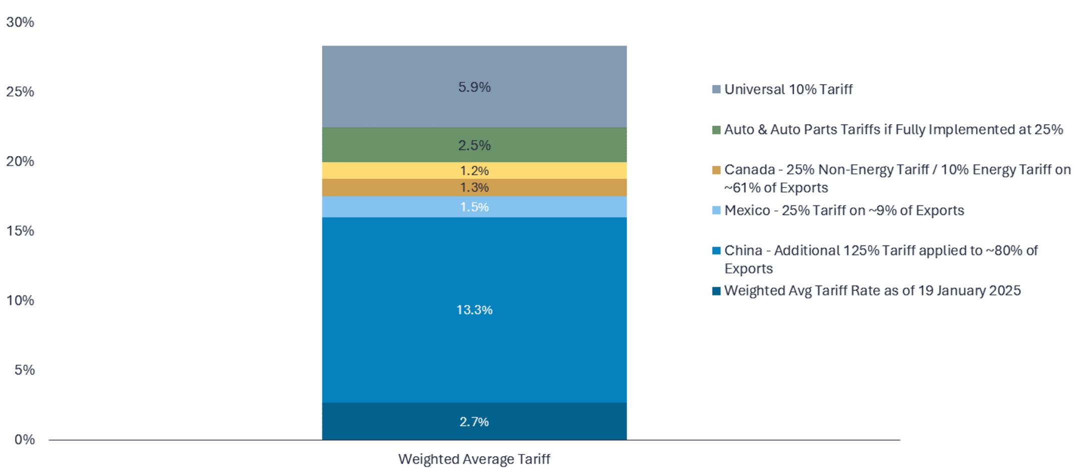
<u>The details:</u> Only a week after announcing a wave or “reciprocal” tariffs, the United States announced a 90-day pause to allow negotiations. During the pause, a universal tariff of 10% will apply to all countries that did not retaliate against the US reciprocal tariffs. This rule apparently singles out China as the only country that retaliated against reciprocal tariffs. At week’s end, the tariff on imports from China stood at 145%. This figure includes the 20% tariff that was in place before 20 January plus 20% related to fentanyl trafficking plus a 34% reciprocal tariff plus a 50% penalty for retaliation plus 21% as additional retaliation. At this point, no other country appears to be subject to an additional tariff beyond the 10% universal tax. China has retaliated against the US retaliation by raising the tariff on imports from the United States to 125% as of Friday.

While the 90-day reprieve initially excited investors, the reality is that the tariff story is far from over. President Trump indicated within the last week that pharmaceutical tariffs are coming soon. He has also promised tariffs on semiconductors, and we know that investigations related to copper and lumber are underway. My expectation is that further tariff increases are likely which could take the weighted average US tariff on goods imports back above 30% in the weeks ahead.

The Weighted Average US Tariff Rate Has Increased from 2.7% to >27% in Less than Three Months



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. These figures assume the 10% universal tariff does not apply to Mexico, China, or Canada which account for 43% of US imported goods. Current US tariff policies have not been spelled out in sufficient detail to precisely calculate exclusions and inclusions.
As of 10 April 2025

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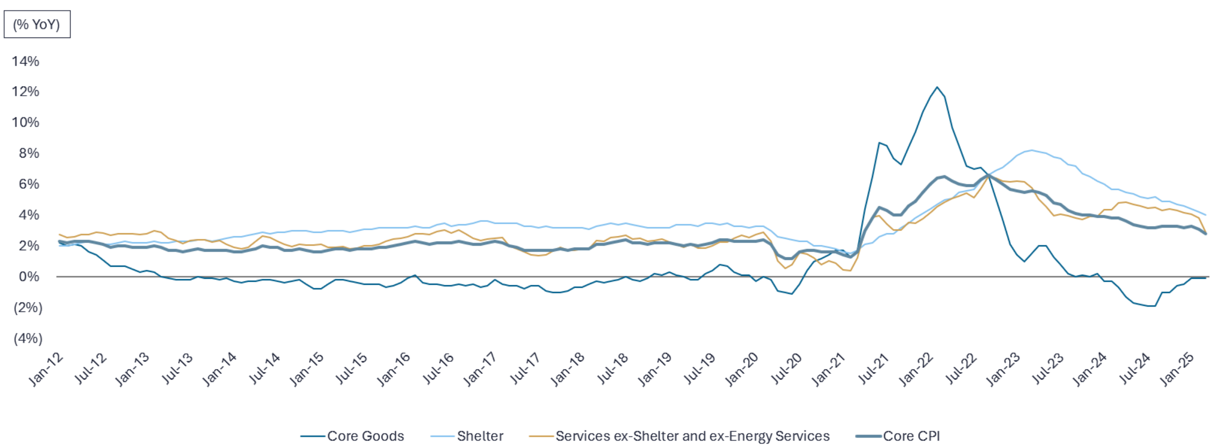
2. US CPI inflation rose less than expected.

The outlook: Entering this week, I had expected core inflation to bottom in March or April. I now think we have likely seen that bottom. April may well match March's y-o-y figure, but it is unlikely we will see another month of such weak inflation on a sequential month basis. Looking forward, I expect tariff-induced inflation to become more apparent starting in the April or May inflation reports (delivered in May and June) as importers run down pre-tariff inventories and are forced to raise prices. As noted above, I expect core CPI to end 2025 between 4.0% and 4.5%.

The details: The US CPI rose less than expected with headline prices falling 0.1% month-on-month (m-o-m) and rising 2.4% year-on-year (y-o-y) while core CPI rose 0.1% m-o-m and 2.8% y-o-y. All figures were better than expected with lower airline fares, hotel rates, and auto insurance premiums helping put a lid on inflation. I focus on the three key categories of prices in the core CPI when assessing inflation trends: shelter (44% of the core CPI by weight), shelter ex-services (32%), and core goods (24%). The three key categories are displayed on the chart below, which makes it apparent that shelter inflation has subsided materially while services ex-shelter ticked down meaningfully this month. Core goods prices, however, have stabilized after months of deflation and are likely to rise materially on the back of higher tariffs.

US Core CPI Inflation Has Fallen by Half, but Remains near 3%

US Consumer Price Index Inflation for Key Categories



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Source: Bureau of Labor Statistics, Haver Analytics
Note: As of March 2025
Core goods represent ~24% of core CPI, shelter represents ~44%, and other services ex-shelter and ex-energy services represent ~32%.

The key movers within the report are broken down in the table below.

March 2025 Core CPI Details	Weight in Core CPI	Contribution/ Detraction (bps)
Key Categories:		
Shelter (OER, rent of primary residence, other accommodation)	44.2%	9.7
Services ex-Shelter	31.5%	(1.6)
Core goods	24.2%	(2.2)
Total Core CPI (from sum of key categories)		5.9
All Items Ex-Food and Energy (reported)		5.6
Contributors:		
Owners' equivalent rent of a primary residence	32.7%	13.1
Rent of Primary Residence	9.3%	3.1
Hospital and related services	2.8%	3.7
Financial services	0.3%	2.0
Detractors:		
Other lodging away from home including hotels and motels	1.4%	(6.4)
Airline fares	1.1%	(6.1)
Motor vehicle insurance	3.6%	(2.6)
Prescription drugs	1.2%	(2.4)
Used cars and trucks	3.0%	(2.1)

Source: Lazard, Bureau of Labor Statistics
As of March 2025

3. **The University of Michigan Sentiment Index fell to the second-lowest level ever.**

The outlook: If the economy weakens to the extent I expect, the drivers of sentiment are likely to shift from fears of future inflation to the reality of rising unemployment and economic weakness.

The details: For the last few years, inflation expectations have largely driven consumer sentiment. This month was no exception. The 1-year inflation expectation jumped by the second-largest amount ever to 6.7% versus the 5.2% consensus expectation. In large part higher inflation expectations likely drove the overall University of Michigan Sentiment Index to the second-lowest reading in history.

University of Michigan Sentiment

	Consensus	Actual	Prior Reading
University of Michigan Sentiment	53.8	50.8	57.0
Current Conditions	60.8	56.5	63.8
Expectations	50.7	47.2	52.6
1 Year Inflation Expectations	5.2%	6.7%	5.0%
5-10 Year Inflation Expectations	4.3%	4.4%	4.1%

Source: Bloomberg, University of Michigan

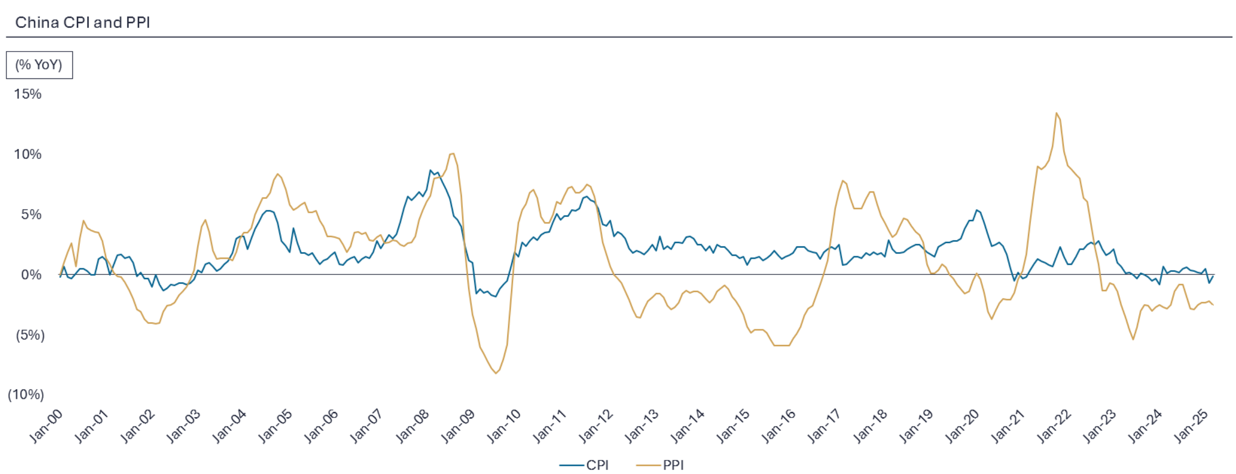
4. **Chinese CPI and Producer Price Index (PPI) inflation were weaker than expected.**

The outlook: For the last several years (if not much longer), exports have been the critical release valve for excess capacity, but the escalating trade war with the United States is shutting off that release. As a result, I expect deflationary pressure in China to worsen in 2025 and 2026, posing risks to highly leveraged corporate borrowers that have to service large amounts of debt while the prices for the products they sell decline. There is good deflation, e.g., when input costs decline, and China has enjoyed that good deflation relative to commodities in some recent months. Looking forward, the recent sharp declines in oil and some other commodity prices could contribute to sustained "good deflation" in China in the months ahead. However, the bigger issue in China is and will continue to be excess production capacity and weak domestic demand which contributes to "bad deflation."

The details: China's CPI was -0.1% y-o-y in March versus -0.7% in February as the effects of Lunar New Year (LNY) faded. In 2024, the Lunar New Year was in mid-February, while it was in late-January this year. The shifting timing of LNY affects prices of food items as well as services such as transportation each year. In March, food prices fell 1.4% y-o-y versus a decline of 3.3% in February. Non-food prices rose 0.2% y-o-y in March versus a decline of 0.1% in February.

PPI deflation was sustained for the 30th consecutive month coming in at a weaker-than-expected -2.5%. Falling commodity prices contributed to lower PPI in March, but excess capacity remains the driving issue in the Chinese economy.

China Inflation Is Undesirably Low with PPI Deflation for 30 Months and CPI ≤1% for 26 Months



LAZARD Source: Bloomberg, National Bureau of Statistics
Note: As of March 2025

The Week Ahead

1. **The US-initiated trade war is likely to continue leading the headlines in the week ahead.**

   The outlook: While there are no "scheduled" announcements expected next week related to tariffs, I am hopeful that we might start to get news regarding the early outlines of deals with some key trading counterparts. Larger relationships like that between the United States and European Union will almost certainly be more complex to negotiate and will take time. Others, however, where the United States has disproportionate leverage, e.g., countries like Vietnam, could be negotiated much more quickly as the trade counterpart feels compelled to take whatever it can get from the United States to sustain exports to the US market.

   The other areas to watch are guidance or announcements regarding sectoral tariffs. As noted above, President Trump has indicated that pharmaceutical tariffs are likely to be the next sectoral announcement, but we do not know the timing thereof.

   One other area investors will be watching for indications of how tariffs are affecting the economy will be earnings calls. Historically, ~20% of companies offer guidance for the next quarter during their earnings call while ~43% offer guidance for the year ahead. I will be watching to see how many companies pull guidance in light of tariff and trade uncertainty.

2. **US retail sales are expected to rebound in March.**

   The outlook: The retail sales figures for March could deliver a surprise, as consumers scrambled to avoid tariffs by buying cars and other big-ticket items before tariffs were implemented. In the February report, a 1.5% decline in restaurant sales stood out to me as a signal of consumers cutting back on the most discretionary spending. While it might be hard to decipher the core underlying consumption trends this month due to the distortions around front-running tariffs, I will be looking for any clues that might confirm or undermine readings from soft data like consumer sentiment surveys.

March US Retail Sales	Consensus	Prior Month
Retail Sales m-o-m	1.4%	0.2%
Retail Sales ex-Auto m-o-m	0.4%	0.3%
Retail Sales ex-Auto and Gas m-o-m	0.4%	0.5%
Retail Sales Control Group	0.5%	1.0%

Source: Bloomberg, U.S. Census Bureau

3. **China will release its array of monthly economic data as well as Q1-24 GDP.**

The outlook: China will release trade data first providing a glimpse into how demand for exports has begun to adapt to US tariffs. Since the US election in November, China has benefited from front-loading of orders from the United States as customers attempted to accumulate inventories before tariffs were imposed. I would expect the beginning of an export slowdown in March that should accelerate in April given the sharp increase in tariffs this month. Imports will also signal how Chinese producers are managing their risk relative to buying commodities and components that are often incorporated into products that are subsequently exported.

Industrial production will likely be driven in part by trade, but retail sales results will be important for observing the trajectory of domestic demand as consumers digest the economic uncertainty created by the US trade actions and Chinese retaliation.

Looking beyond the data reports, I anticipate that in the weeks ahead, the Chinese central government will announce concrete measures to mitigate the blow to growth from US tariffs. I am hopeful these measures will come sooner rather than later.

March China Economic Data		Consensus	Prior
Q1-24 GDP	y-o-y	5.2%	5.4%
	YTD y-o-y	5.2%	5.0%
Exports	y-o-y	4.4%	-3.0%
Imports	y-o-y	-2.1%	1.5%
Industrial Production	y-o-y	5.6%	**
Retail Sales	y-o-y	4.2%	**
Fixed Asset Investment	y-o-y	4.1%	4.1%
Property Investment	y-o-y	-9.7%	-9.8%
Residential Property Sales	y-o-y	*	-0.4%
New Home Prices	m-o-m	*	-0.14%
Used Home Prices	m-o-m	*	-0.34%

Source: Bloomberg, National Bureau of Statistics
* No consensus estimate available on Bloomberg.
** Due to Lunar New Year distortions, China does not report individual month data for January and February.

4. **The European Central Bank (ECB) is likely to cut interest rates by 25 bps.**

   The outlook: Markets suggest a 96% probability of a 25-bps rate cut this week with an 80% chance of another rate cut at the 5 June ECB meeting. I expect the ECB to ease rates to 1.5% in 2025 due to the effects of the universal tariff and other sectoral tariffs on growth and inflation in the Eurozone.

   To the extent additional reciprocal tariffs end up being imposed by the United States, the ECB could cut rates even further. The uncomfortable part of the ECB decision-making relates to the likely acceleration of growth in 2026 when the large increase in German defense and infrastructure spending and other national defense spending increases begin to lift growth. I expect the ECB to remain as dovish as possible to help finance these spending plans, but rates much below 1.5% likely will become more and more difficult to justify in 2026.

5. **Japan's headline CPI inflation is expected to be steady, while core inflation is likely to accelerate.**

   The outlook: In recent months, prices for rice have added to inflation pressures while energy prices have subtracted due to government subsidies. I will be watching for signals regarding the sustainability of inflation as the Japanese yen approaches the strongest levels of the last year against the US dollar which reduces JPY costs for imported goods, especially energy.

Japan March CPI

	Consensus	Prior Reading
Headline y-o-y	3.7%	3.7%
CPI y-o-y ex-fresh food (core)	3.2%	3.0%
CPI y-o-y ex-fresh food and energy (core-core)	2.9%	2.6%

Source: Bloomberg, Japan Ministry of Internal Affairs and Communications

6. **UK CPI**

   The outlook: UK inflation is expected to ease modestly in March from still-elevated levels. As usual, I will focus on services inflation given how important the service sector is to the UK economy and the fact that price pressures have remained so strong despite a relatively weak economic backdrop.

UK March CPI

	Consensus	Prior Reading
Headline m-o-m	0.4%	0.4%
Headline y-o-y	2.7%	2.8%
Core y-o-y	3.4%	3.5%
Services y-o-y	4.8%	5.0%

Source: Bloomberg, UK Office for National Statistics

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