GLOBAL PERSPECTIVES

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HIGHLIGHTS

INVESTMENT IMPLICATIONS OF PRESIDENT TRUMP'S TRADE POLICY

- The Trump administration may raise tariffs up to 20% broadly and 60% on Chinese goods, aiming to counter what it sees as damage to US manufacturing from the dollar's reserve currency status.
- The President's newly appointed chief economist recently wrote extensively about the rationale for higher tariffs and potential investment implications.
- Based on his insights, investors should prepare for volatility by reducing Chinese exposure, initially favoring dollar assets, and watching companies with complex global supply chains.

A MAJOR SHIFT IN US TRADE STRATEGY

As President Trump begins his second term, investors are focusing on his plans to reshape global trade — potentially the most significant overhaul of the international trading system since President Nixon closed the gold window in 1971. President Trump did not hike tariffs on his first day in office as some had feared. But he did warn that tariffs of 25% could be applied as early as February 1 to Mexico and Canada and that China could also face higher tariffs soon.

The jury is still out on whether these warnings are simply bluffs to obtain negotiating leverage, or whether they signal a major policy shift. That said, President Trump's campaign proposals included broad tariffs of 10% to 20% on most trading partners and potentially 60% or higher on Chinese goods. A recent paper by Dr. Stephen Miran, Trump's newly appointed chair of the Council of Economic Advisors (CEA), provides insights into the rationale and likely investment implications of such decisive trade measures.[1]

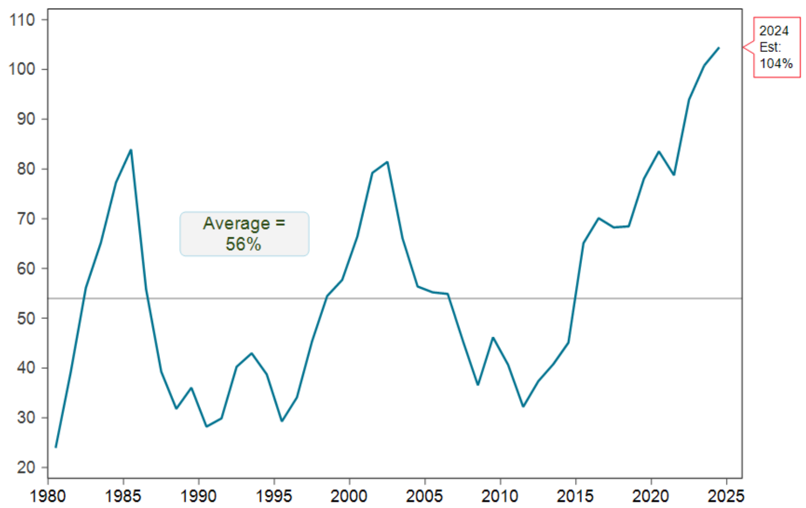
Understanding the Core Problem

The fundamental issue, according to Miran, lies in the dollar's role as the world's reserve currency. This status creates what economists call the "Triffin dilemma": as the global economy grows, the US must run increasingly large trade deficits to supply the world with dollars. This situation has led to three major consequences:

1. An overvalued dollar that makes US exports expensive and imports cheap (**Figure 1**)
2. Growing trade and current account deficits (**Figure 2**)
3. A decline in American manufacturing, exemplified by the "China shock" since 2000 that has resulted in over 2 million lost jobs (**Figure 3**)

FIGURE 1

US Dollar Overvaluation vs. Foreign Currencies Based on Purchasing Power Parity (%)



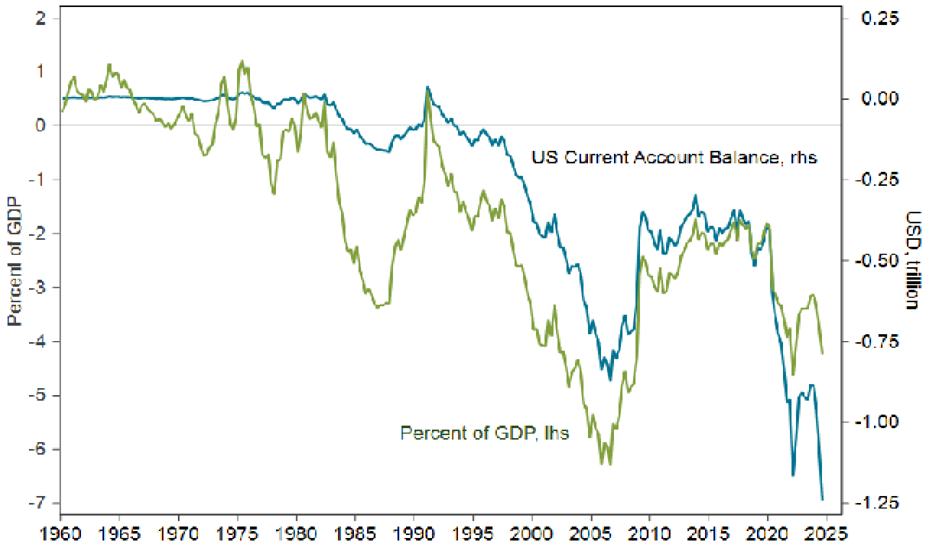
Sources: GW&K Investment Management, IMF, and Macrobond

The US dollar in 2024 was more than 100% overvalued against trading-partner currencies according to IMF estimates of its purchasing power parity.

[1] Stephen Miran, "A User's Guide to Restructuring the Global Trading System," Hudson Bay Capital, November 2024. This paper was written prior to Miran's appointment as Chief of the CEA and did not purport to speak on behalf of President Trump or his team.

FIGURE 2

US Current Account Balance: Dollar Value and Percent of GDP (SAAR)

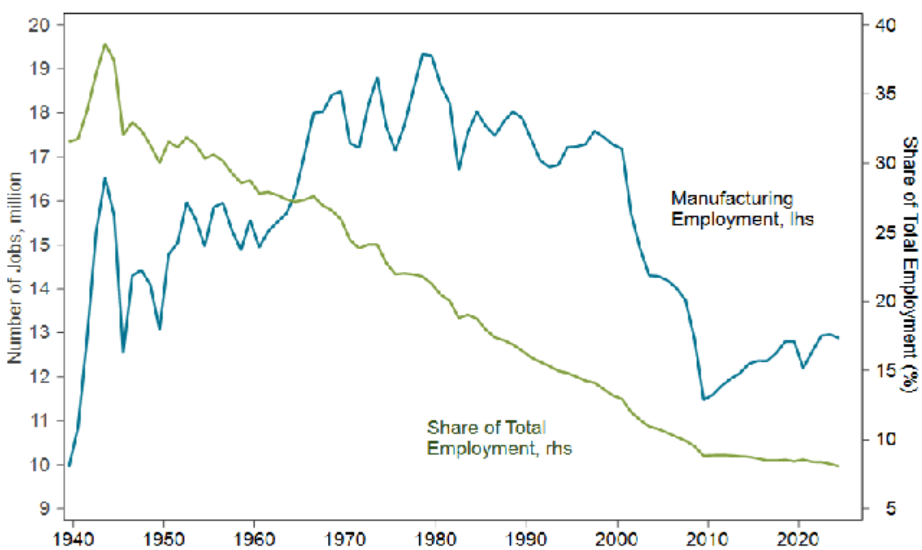


Sources: GW&K Investment Management, Bureau of Economic Analysis, and Macrobond

The overvalued US dollar has helped price US goods out of global markets, contributing to persistent and growing US trade and current account deficits.

FIGURE 3

The Hollowing Out of American Manufacturing: Manufacturing Employment in America



Sources: GW&K Investment Management, Bureau of Labor Statistics, and Macrobond

As US exports goods were priced out of global markets, the manufacturing sector was "hollowed out" as seen in a sharp decline in manufacturing jobs since the 1970s.

THE PROPOSED SOLUTION: TARIFFS AND CURRENCY POLICY

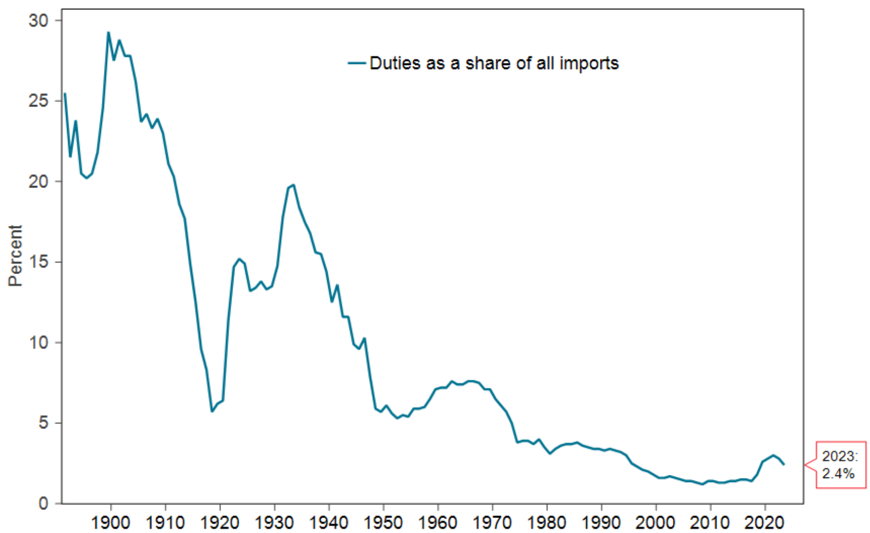
Tariffs as Tools and Revenue Sources

Miran advocates for a significant shift from current policy, suggesting:

- Average tariffs could rise from 2% to approximately 20%, with some reaching 50% (**Figure 4**)
- Implementation should be gradual to minimize market disruption
- Rates would vary by country based on trade practices and security relationships
- Tariffs would serve both as a revenue source and a tool for trade negotiation

FIGURE 4

Could America's Average Tariff Rate be Headed from 2% to 20%?



Sources: GW&K Investment Management, US International Trade Commission, and Macrobond

The current average tariff rate versus all imports is about 2%, but the potential for aggressive tariff hikes suggests that the average rate could rise to about 20% — to a level not seen since the early 1900s.

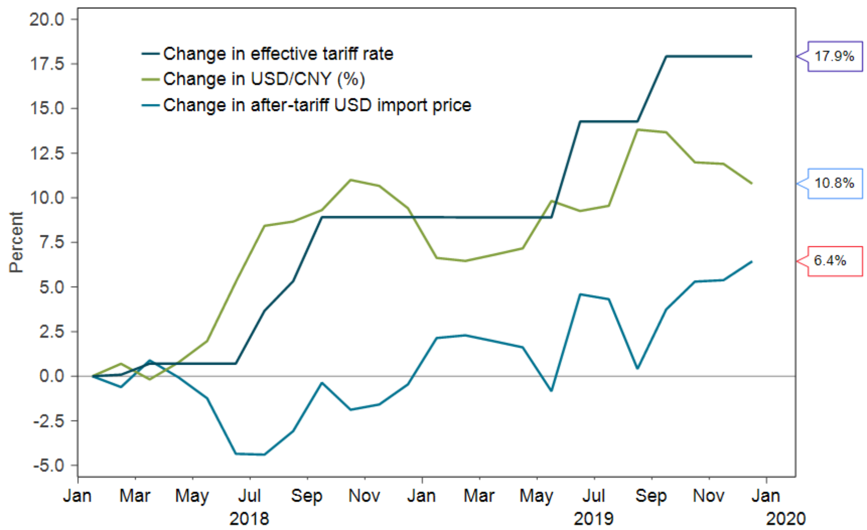
Are Inflation Concerns Manageable?

Miran argues that inflation risks from higher tariffs could be manageable because:

- Foreign currency depreciation often offsets tariff impacts
- Previous tariffs on Chinese goods (2018 – 2019) led to modest price increases (**Figure 5**)
- The Federal Reserve can adjust monetary policy to prevent sustained inflation
- Expected CPI impact would be limited to 0.3% –0.6%, primarily as a one-time adjustment

FIGURE 5

Changes in Effective Tariff Rate vs. Currency Offset (2018 – 2019)



Sources: GW&K Investment Management, Peterson Institute for International Economics, and Macrobond

The effective tariff rate on Chinese imports increased by 17.9 percentage points over the 2018 – 2019 period, but the US dollar rose by almost 11% over that period.

The currency change offset more than half of the impact of the tariff hike on import prices measured in US dollars.

Careful Currency Intervention

While not an immediate priority, a weaker dollar policy could eventually become part of the strategy:

- A proposed "Mar-a-Lago Accord" would encourage trading partners to hold longer-term Treasury bonds
- The US could implement fees on foreign Treasury holders through emergency powers to discourage dollar buying
- Currency intervention would be approached cautiously due to inflation risks

Aligning Trade Policy with National Security

Trade policy would be explicitly linked to national security, with market access tied to defense cooperation. As Miran states, "Countries that want to be inside the defense umbrella must also be inside the fair-trade umbrella."

Investment Implications

Miran's investment conclusions are as follows:

- **Dollar-positive before dollar-negative:** Miran believes that tariffs will likely be the first tool used in any trade overhaul, which would strengthen the dollar before any efforts are made to weaken it. Companies whose supply chains are vulnerable to tariffs should be monitored carefully.
- **Increased volatility:** Miran says to expect a "structural increase" in implied volatility in currency markets. This means investors should anticipate more significant fluctuations in currency values. More

broadly, he notes that: "There is a path by which these policies can be implemented without material adverse consequences, but it is narrow."

- **Global rebalancing to favor the US:** Miran points out that the goal is to reallocate global demand and jobs from other countries to the US. Initially that suggests opportunities in US assets as well as the risk of reduced growth in some other parts of the world.
- **China exposure:** Exercise caution with Chinese assets due to potential increased tariffs and currency devaluation risks.
- **Diversification opportunities:** Efforts by global investors to eventually move away from the dollar could intensify, potentially benefiting alternative reserve assets like gold or cryptocurrencies. This could increase interest in diversifying beyond traditional assets.

HISTORY HIGHLIGHTS THE DOWNSIDE RISKS OF SUCH A POLICY

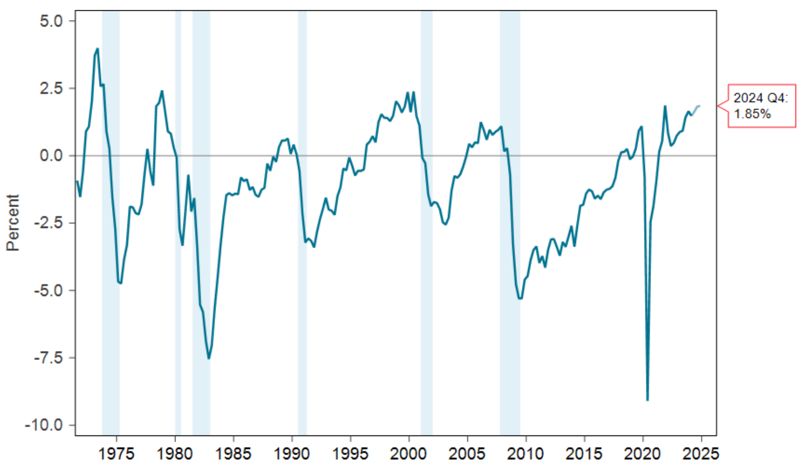
Miran's conclusions notwithstanding, historical evidence suggests investors should carefully weigh the potential downside risks of aggressive trade policy changes. A comprehensive International Monetary Fund (IMF) study analyzing five decades of data across 151 countries found that significant tariff increases typically led to:[2]

- Reduced domestic economic output
- Decreased productivity growth
- Higher unemployment levels
- Increased income inequality
- Limited effectiveness in addressing trade imbalances
- Currency appreciation that further undermines export competitiveness

These effects were particularly pronounced in advanced economies during periods of economic growth, suggesting that protectionist measures could be especially counterproductive in current market conditions (**Figure 6**). Note also that the size of tariff hikes being contemplated are 10x to 20x in economic magnitude compared to the previous hikes on Chinese goods (2018 – 2019) that are offered as evidence for minimal inflation effects (**Figure 7**).

FIGURE 6

Positive Output Gap: US GDP as Percent of Potential GDP



Sources: GW&K Investment Management, CBO, BEA, and Macrobond

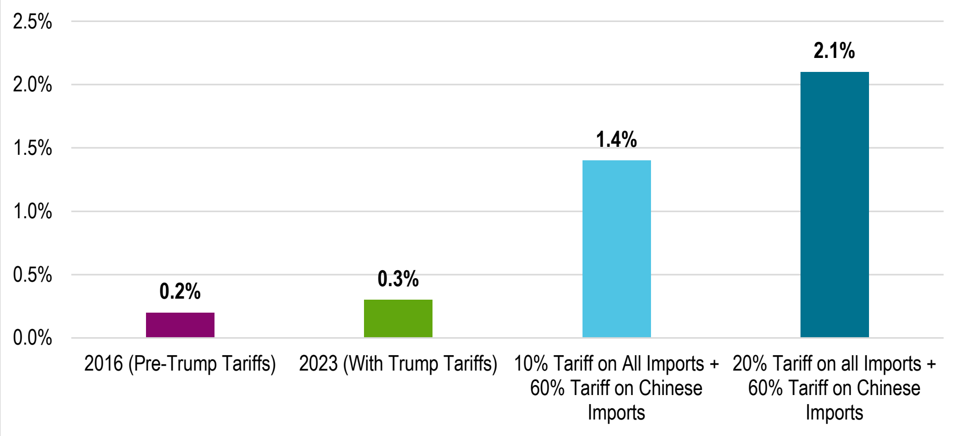
Strong economic growth has left America with little spare capacity, as reflected in a positive gap between actual and potential GDP.

Against this backdrop, tariff hikes have potential inflationary consequences that Fed officials will need to monitor carefully.

[2] Davide Furceri, S. Hannan, J. Ostrey, A. Rose, "The Macroeconomic Consequences of Tariffs," IMF Working Papers No. 2019/009, January 15, 2019.

FIGURE 7

Customs (Tariff) Revenues as a Percent of GDP



Source: Brendan Duke at CAP Action, analysis of CBO data and Clausing Lovely (2024). Revenue numbers do not include income/payroll tax offsets since those do not show up in customs revenue numbers.

President Trump's new proposed import tax hikes are 10x – 20x the size of his import tax hikes during his first term.

CONCLUSION

The proposed changes represent the most dramatic restructuring of global trade since the collapse of the Bretton Woods system in 1971. While the administration may implement changes gradually with careful attention to market stability, investors should prepare for potential volatility and closely monitor developments in trade and currency dynamics. The historical record suggests that managing the transition while avoiding negative economic consequences will require careful execution and coordination between fiscal and monetary authorities.

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