

New world order for trade: What Next?



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IN A NUTSHELL

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Picking up the pieces after Liberation Day: Deal making, but tariffs the new norm

April 2, 2025, or “Liberation Day” as called by President Trump, marks the beginning of a new world order for trade. This date will go on our wall poster chart of significant historical events for US markets. The magnitude of change is still uncertain, and the influence of other country responses has yet to play out. But change is likely to be significant, not just for and shaped by the U.S., but also for and shaped by other world regions as new security and trade agreements are explored by the world’s key political and economic blocks. A change in trade norms, requires reexamination of many other economic and capital market norms. The norms for productivity, inflation, interest rates, foreign exchange (FX) rates, commodity prices, geopolitical risks as well as demanded investment risk premiums in the real economy and financial markets, especially if cross border. Little about past 25 years is a good mean to assume reversion and perhaps not the past 75+.

The US and China spheres are more distinct and their alignment propositions to others will intensify with carrots and sticks. We suspect China’s full response to US actions is yet to come.

Cut 2025E S&P EPS from \$270 to \$260: Assumes many reciprocal tariff reprieves

Our expectations for tariffs include many reprieves from what’s been announced so far. Yet we remain braced for more sector tariffs to be announced in coming weeks. Since Liberation Day, we raised our expected aggregate US tariff rate, as incorporated into our S&P earnings per share (EPS) estimate, from 5-10% to 10-15%. Essentially, we expect at least 10% tariffs on all trading partners, except Canada & Mexico (border security and fentanyl related tariffs aren’t likely long-term) and higher tariffs on other countries when sectoral tariffs are included such as on steel/aluminum, cars, chips, pharmaceuticals, etc. Our 10-15% expected total tariff rate range, suggests roughly \$450bn of notional tariffs on U.S. goods imports of \$3trn in 2024. We expect changes in import activity to lower that to about \$300bn in realized tariff revenue. Less and redirected import activity will weigh on gross domestic product (GDP) and profits, but if we assume that S&P 500 companies absorb a third of realized tariff duties that would be a 3.5% after-tax hit to S&P EPS or about \$10 per share.

We note that the weak dollar since Liberation Day, suggests less FX absorption of tariff costs and greater U.S. inflation risk. However, weaker dollar foreign profit translation is a partial positive offset to the \$10 hit to S&P EPS from absorbing a third of tariffs. As a 5% decline in the mature currency dollar FX index raises S&P EPS by about \$3 all else the same. That said, we think the combination of tariff absorption, foreign profit translation, and much slower U.S. and world growth support a \$10 cut. Our biggest cut is at Consumer Discretionary (Retailers, Auto, Home related), retailing at Consumer Staples, multinational Industrials and Materials. We cut Energy on slower global growth and oil price outlooks, but it’s uncertain given dollar volatility and geopolitical risks. Our revised 2025 and 2026 S&P EPS estimates of \$260 and \$285 assume much slower growth, but no U.S. recession, thus remain subject to GDP estimate revisions from DWS economists.

Greater interest rate uncertainty across the curve: Hits to GDP and valuations

Currency and capital flows go hand in hand with trade. Now is the time for the administration to provide more clarity about the purpose and endgame of trade policy changes. In our view, they should speak to the benefits of a stable and strong dollar, which include tame inflation and attracting foreign capital. They should welcome foreign investment and not interfere with the market value of the dollar. Speaking of a desired weaker dollar, as rumored per a Mar-a-Lago plan, would suggest the main goal of trade policy is to close the trade deficit. This is misguided in our view and will cause more inflation and challenge deficit financing. Thus, we will listen for renewed commitments to free trade among allies, a stable and strong dollar and plans for shrinking the deficit to help rebuild confidence among allies and investors. Security and peace are essential considerations and security commitments must be reiterated. The Federal Reserve (Fed) takes a back seat in such strategic policy decisions and communications and should simply reiterate its commitment to 2.0% inflation regardless of how these policies develop. The Fed has its own mounting challenge of maintaining its credibility to control inflation under various conditions in a timely fashion. Accelerating inflation during a recession would pose a problem.

Changed sector preferences: Tech to EW, Consumer Discretionary/ Staples UW

Everything goods retailing and manufacturing related is now less preferred, everything services related more preferred. This is also true within Tech and overall we are now equal-weight (EW) Tech or digital after adding during the sell-off. We're over-weight (OW) Health Care, Financials and Utilities. We added to Financials during the sell-off. We're under-weight both Consumer sectors, Real Estate Investment Trusts (REITS), Industrials and Materials. We're EW Energy with a preference for oil services.

Fair S&P 500 PE?: Right now, hard to be confident in it sustaining above 20

The fair price-to-earnings (P/E) ratio is a function of expectations and uncertainty for normal EPS, normal interest rates, fair risk premiums and ability to generate value added EPS growth (greater than nominal cost of equity less dividend yield). We use our time-tested framework, but struggle to justify a fair PE above 20x (20 times) forward EPS or 21.5x trailing. We note the surge in CBOE Volatility Index (VIX) and our PE/VIX sentiment indicator (S&P 500 trailing PE divided by VIX). It seems that the observed PE relative to numerous volatility measures surging across asset classes suggests equity investor emotion being more of a denial than capitulation.

Glossary

The **CBOE Volatility Index (VIX)** is a trademarked ticker symbol for the Chicago Board Options Exchange Market Volatility Index. It is a popular measure of the volatility of the S&P 500 as implied in the short term option prices on the index.

Cost of equity (CoE) is the return (often expressed as a rate of return) a firm theoretically pays to its equity investors, to compensate for the risk they undertake by investing their capital.

Earnings per share (EPS) is calculated as a company's net income minus dividends of preferred stock, all divided by the total number of shares outstanding.

Equity risk premium is an excess return earned by an investor when they invest in the stock market over a risk-free rate. This return compensates investors for taking on the higher risk of equity investing.

FX is the abbreviation for **foreign exchange**, i.e. currencies.

Geopolitical risk is a risk that an investment's returns could suffer as a result of political changes or instability in a country.

The **gross domestic product (GDP)** is the monetary value of all the finished goods and services produced within a country's borders in a specific time period.

Inflation is the rate at which the general level of prices for goods and services is rising and, subsequently, purchasing power is falling.

Mar-a-Lago plan refers to the idea that US could force countries to accept a weaker dollar and lower interest rates on their US Treasury investments in order to still be protected by the US security umbrella.

The **price-to-earnings (P/E) ratio** compares a company's current share price to its earnings per share.

Productivity measures how much economic output is produced for a given level of inputs (such as capital and labor).

The **risk premium** is the expected return on an investment minus the return that would be earned on a risk-free investment.

The **S&P 500** is an index that includes 500 leading U.S. companies capturing approximately 80% coverage of available U.S. m

A **Real Estate Investment Trust (REIT)** is a company that owns and, in most cases, operates income-producing real estate. REITs sell like a stock on the major exchanges and invest in real estate directly, either through properties or mortgages.

A **tariff** is a tax imposed by one country on the goods and services imported from another country.

The **U.S. Federal Reserve**, often referred to as "**the Fed**," is the central bank of the United States.

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