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Trump's tariff rage and its unforeseen dimensions on the global financial markets

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Theme

The Trump Administration's aggressive tariff policy has had a boomerang effect: stock indexes in US dollars in the EU, China and Latin America have risen since Donald J. Trump took office while those in the US have plummeted. We explain why.

Summary

The Trump Administration's tariff rage proved to be a double-edged sword. Since Trump's inauguration, US stock indexes have fallen sharply and the US dollar has depreciated, while markets in Europe, China and Latin America have risen, in some cases significantly.

Logic would suggest that these actions by the Trump Administration should be to the benefit of the US and to the detriment of the 'freeriders' whose playtime is now over. But logic failed to show up.

How is it possible that the aggressive tariff war unleashed by the Trump Administration to end the 'free lunch' at the expense of the US can improve the prospects of European, Chinese and Latin American companies and increase their value relative to those of the US?

Having cornered both friends and foes has improved their prospects relative to the status quo. Like a heart attack patient who, out of sheer shock, begins to live an orderly life, eat a healthy diet, practice sports, quit smoking and improve his quality of life, economic and geopolitical dynamics that until recently seemed impossible, were set in motion.

Economics is sometimes stubborn. What we expect does not always happen, nor does the obvious always occur. That is why voluntarism often crashes against reality. There will be new actions, reactions and counter-reactions and everything can change again in the blink of an eye. The unilateral policy of aggressive trade confrontation of the Trump Administration will surely end up hurting us all. But so far, the judgment of the markets has been conclusive: the star loser is the US.

Analysis

Economics is sometimes stubborn. What we expect does not always happen, nor does the obvious always occur. That is why voluntarism often crashes against reality.

That is happening to the Trump Administration. The tariff rage that started since the beginning of the Administration and reached its peak last 3 April, 'Liberation Day', will undoubtedly be very negative for the global economy, but, according to the reaction of the markets since Trump's inauguration, it has a star victim: the US.

The tariff wrath was initially unloaded against China to which a 20% tariff was applied to counter what in the Trump Administration's view are its long-standing unfair trade practices, which have led to a huge US trade deficit with China and hurt manufacturing industry and industrial employment.

The tariff wrath was also unloaded against its allies, the regional ones (Canada and Mexico) to whom it threatened with a 25% tariff to pressure them to take action to control migration flows and fentanyl trafficking across borders, and the transatlantic ones (the EU) against which the grievance is much broader: 'The European Union was formed to screw (*sic*) the United States'. That situation will no longer be tolerated: neither unfair trade, nor regulatory zeal against US tech, nor spending substantial resources for the defence of Europe that it is not willing to spend to defend itself.

Those initial spasms gave way to the application of generalised reciprocal 'Liberalisation Day' tariffs. On that day every country on the planet was 'punished' with tariffs to sell its products in the US, starting with a generalised base tariff of 10% and from thereon upwards depending on whether the country in question has a trade balance surplus with the US, the higher the trade surplus, the higher the tariff. China was subject to a reciprocal tariff of 34% (on top of the 20% already applied), the EU 20%, Brazil, Chile and Colombia 10%. Mexico and Canada remain under the Damocles sword of the 25% tariff because they are subject to the National Emergency related to fentanyl and migration. In addition to all this there is a 25% across-the-board tariff already applied to steel and aluminium and imported cars.

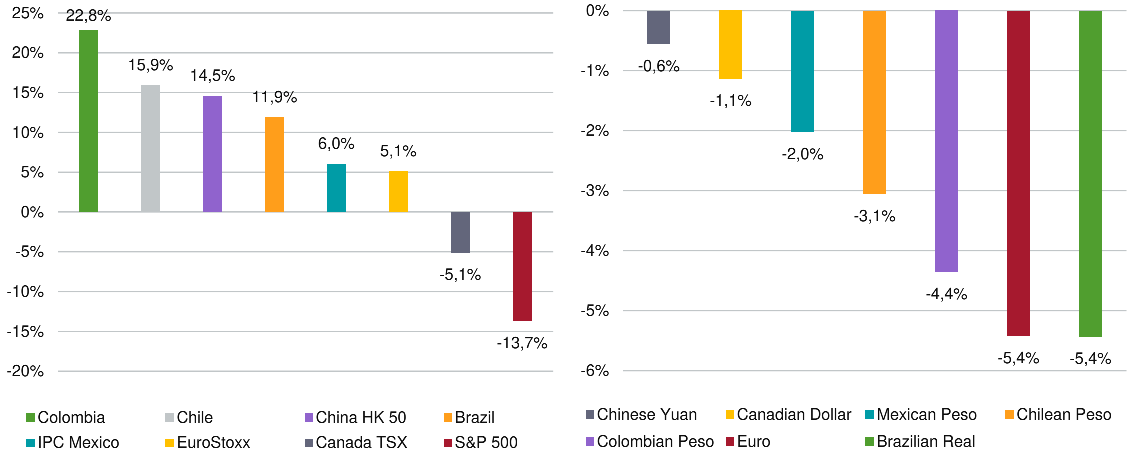
Logic indicates that these actions by the Trump Administration should be to the benefit of the US and to the detriment of the 'free riders' whose playtime is now over.

Well, logic has failed to show up. Since Trump's inauguration and up until the writing of this article, US stock indexes have fallen sharply –the S&P 500 has fallen 14%– and the US dollar has weakened against the euro, the yuan, the Canadian dollar and the Mexican peso. The combined effect of the depreciation of the US dollar and the performance of stock indexes in the EU, China, Mexico and Canada has been an increase in stock indexes measured in US dollars of 5% in Europe, 15% in China and 6% in Mexico. Only Canada's stock indexes fell by 5%, but to a much lesser extent than those of the US (Figure 1a and 1b).

Figure 1. Stock markets in the US, China, the EU and Latin America

a. Stock market indexes in US$ (% change since 31/XII/2024)

b. Currency markets (foreign currency per US$, % change since 31/XII/2024)



Source: the authors.

Again counter-intuitively, the stock indexes of the main Latin American stock exchanges by market capitalisation also rose significantly after Trump's inauguration and their currencies appreciated against the US dollar. In the South American countries –and this according to logic– to a greater extent than in Mexico, which is much more directly linked on trade and investment to the US. The stock indexes measured in US dollars of Brazil, Chile and Colombia rose 12%, 16% and 23%, respectively, in all cases a much higher increase than Mexico's stock index (see Figures 1a and 1b).

In plain English, the Trump Administration seems to be accentuating with its tariff announcements –both the more focused ones at the beginning of the Administration and the generalised reciprocal tariffs of 'Liberation Day'– what motivated the intimidating actions from the beginning: harming itself for the benefit of others.

1. The other side is in the game too

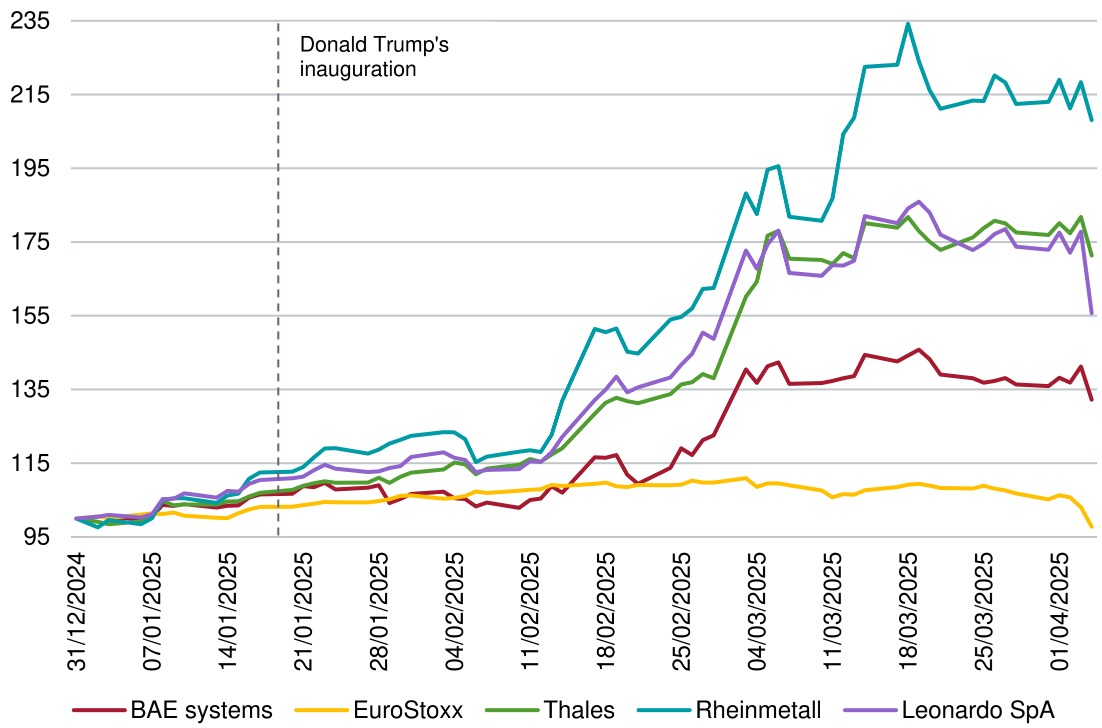
How to explain this apparent contradiction? How is it possible that the 'trade war' against its allies unleashed unilaterally by the Trump Administration to end the 'free lunch' at the expense of the US can improve the prospects of European, Chinese and Latin American companies and increase their valuation relative to those of the US?

Having cornered both friends and foes has improved their prospects relative to the status quo. Like a patient who suffers a heart attack and, out of sheer shock, begins to lead an orderly life, eat a healthy diet, practice sports, stop smoking and improve his quality of life, economic and geopolitical dynamics that until recently seemed impossible, were set in motion.

First, the EU locomotive, Germany, at the initiative of the winner of the elections last February and future Chancellor, Friedrich Merz, obtained the approval of the outgoing parliament to remove the straitjacket of constitutional restrictions on the country's indebtedness and promote a €1 trillion package aimed at increasing defence spending and modernising the country's infrastructure. This spending package could revive the anaemic growth that the German economy has exhibited in recent years.

In addition, the European Commission has proposed €150 billion from the EU budget for member states to borrow and spend on defence, with the aim of rapidly increasing military capabilities in response to the Trump Administration's actions. The rise in the shares of European defence companies since Trump's inauguration has been meteoric –between 55% and 100%– and far superior to that of their British counterparts, which along with those of other European countries that are not members of the EU and, incidentally, those of the US, were excluded from this initiative.

Figure 2. Defence industry stock prices (31/XII/2024 = 100)



Source: the authors.

Secondly, the further deepening of the EU's internal market –in line with recent proposals put forward by the former Italian Prime Ministers Mario Draghi and Enrico Letta– integrating the energy and telecommunications markets, creating a truly unified capital market, removing barriers that allow companies to scale up to the continental market level, could gain new momentum.

Suddenly, the economic prospects of old Europe take on a new lustre. As Gideon Rachman persuasively argues, 'all the great leaps forward for European unity have been brought about by geopolitical shocks: first, the end of World War II; then, the end of the Cold War'. More recently, the financial and sovereign debt crisis in the Eurozone is another striking example of Europe's formidable ability to react when the survival of its project is at stake. Now, as the transatlantic alliance has collapsed, Europe is hinting that it can rise to the occasion.

In Latin America, the loss of confidence in the US as a stable and predictable partner, and the reluctance to increase dependence on China –with which, moreover, and in particular South America, trade is unattractive for its development prospects insofar as it sells raw materials and buys manufactured products– has also set in motion other dynamics.

These two factors have combined to make feasible what seemed impossible, perpetually delayed agreements such as the EU-Mercosur agreement whose negotiation was finalised in Montevideo in December last year. This agreement, added to others that the EU already has with other Latin American countries and blocs –in January of this year the negotiation of the EU-Mexico modernisation agreement, which had been frozen since 2019, was also finalised– together cover 95% of the region’s GDP and open promising prospects for Latin America as a recipient of capital, technology and know-how from the EU, to integrate into highly sophisticated and high value-added decarbonised value chains within the framework of the EU’s green transition, which will serve as a stimulus to rekindle the region’s growth.

Even in China, in the face of rising tariffs and trade pressure from the US, the government will be forced to implement bold measures. For example, to ease regulatory restrictions, to moderate the crackdown on entrepreneurs that began in 2021 –which according to *The Economist* even ‘China’s Leninist autocrats think went too far’– giving even greater stimulus to technological innovation, and to encourage the long-delayed boost to domestic consumption, all measures that under normal circumstances might have been postponed. These measures could ultimately improve China’s economic prospects.

The transformation of the geopolitical landscape and the end of the Atlantic alliance as we knew it has been decisive for the EU. The initiatives that are being unleashed to renew the commitment to deepen integration, to take charge of its own defence, and to seize opportunities to reconfigure its international alliances with Latin America and Asia, could give the EU an injection of economic dynamism that was hitherto unseen. For its part, Latin America is rediscovering its role on the new geopolitical chessboard. The move to strengthen ties with the EU, the economic bloc that best complements Latin America, sows the seeds of a probably more auspicious future. China will also have the opportunity to reconfigure its international alliances to ‘redraw the geopolitical map of Asia in China's favour’.

Conclusions

We mentioned at the beginning that economics is stubborn. There will be new actions, reactions and counter-reactions and everything can change again in the blink of an eye. The Trump Administration’s unilateral policy of aggressive trade confrontation will surely end up hurting us all. But so far, the judgment of the markets has been conclusive: the star loser is the US.