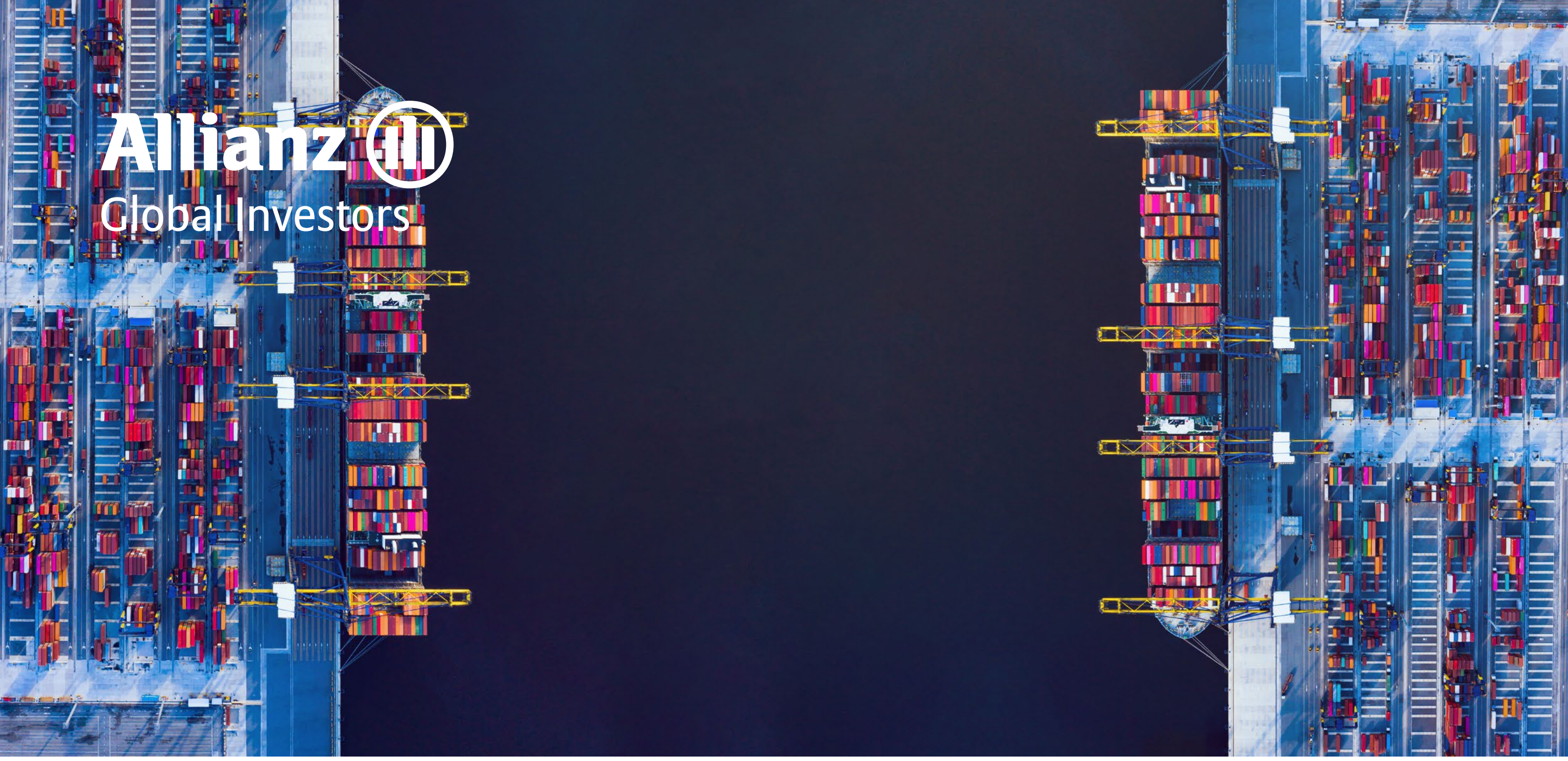

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Tariffs latest: should investors be concerned?

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Donald Trump's threat of 30% tariffs on EU imports endangers the world's largest bilateral trading relationship – and could be damaging to the bloc's economy and markets. We think the rate is likely to be negotiated lower, but investors may need to prepare for a period of market adjustment.

The trade war is back in focus for markets after Donald Trump ratcheted up tariff threats against the European Union and other key US trading partners from 1 August.

Key takeaways

- The US is a significant market for EU goods and simple calculations suggest lower export volumes could result in a GDP hit of 1% for the EU over a couple of years, while raising inflation in the US.
- Market moves suggest that investors believe Mr Trump will back down from any action that seriously harms US growth, but we would guard against the risk of complacency.
- We think the most likely scenario is a negotiation with the EU that leads to a scrapping or watering down of the 30% tariff. But the EU will likely need to make concessions to reach a deal with the US.

In recent days, Mr Trump threatened to impose tariffs of 30% on imports from the EU, the US's largest trading partner across goods and services. He also threatened tariffs of 50% on Brazil, 35% on Canada, 30% on Mexico and 25% on Japan.

The impact on individual economies and markets will depend on whether the US president follows through with his rhetoric and the extent of any retaliation from those trading partners in the firing line.

What does this mean for Europe?

EU officials are reportedly pushing for a deal with their US counterparts while considering a package of possible retaliatory tariffs.

European markets initially fell in response to Mr Trump's latest threat against the EU before recovering. Market volatility, as measured by the Vix index, has also dropped to near its lowest level of the year. Market moves suggest that investors believe Mr Trump will back down from any action that seriously harms US growth.

We think the most likely scenario is a negotiation with the EU that leads to a scrapping or watering down of the 30% tariff. We think a return to the previously planned reciprocal 10% levy for the EU is also plausible. Either scenario may require large concessions by the EU.

If the 30% US levy on EU imports becomes a reality and the EU does not meaningfully retaliate, the US-EU dispute will hit EU export revenues. This could mean lower growth across Europe and lower prices through the flooding of the home market with goods that would otherwise be exported, on top of diverted exports from other US trade partners hit by tariffs.

The US is a significant market for the EU, accounting for around 20% of EU exports in 2024. Excluding cars and steel, which Mr Trump already hit with sectoral tariffs of 25% and 50% respectively, the targeted exports accounted for 2.6% of EU GDP in 2023. By country, the exposures vary from 9.8% of GDP in Ireland to 0.4% in Cyprus. Among larger economies, Germany (3.1%) and Italy (2.8%) are more exposed than France (1.5%) or Spain (1.2%).

Simple calculations that assume a hit to fiscal revenue through lower export volumes would result in a GDP loss of 1% for the EU over a couple of years. More comprehensive modelling, which includes indirect effects such as a diversion of trade and an appreciation of the euro, suggests an impact of double that or more.

We would expect EU firms to take most of the hit in their margins initially. Corporate profits would drop. Over time, the cost would be passed on to workers via lower wage growth and eventually cuts in employment, with an overall disinflationary effect.

In the absence of retaliatory action by the EU, the bloc may try to bolster domestic demand via lower interest rates (see below) and fiscal stimulus in the short run. In the longer run, we expect the EU to give more urgency to structural reforms to become less dependent on the US, as well as trade deals with other countries.

What might be the economic impact on the US?

For the US, the tariffs imposed on the EU would decrease the supply of goods in the domestic market. Around 10% of US consumer spending is on imported goods, so 30% tariffs on all imports could raise inflation by up to 3% in the (unlikely) case that the costs are passed onto the consumer in full. Any impact could start to be felt in the autumn when current inventories deplete.

The tariffs are intended to raise revenue for the US government, and leaving aside the negative factors, this fiscal boost would be significant. An average of 30% tariffs on USD 3 trillion of US goods imports could yield USD 900 billion in fiscal revenue, collected largely from foreign firms. The extra fiscal revenue could ease US debt sustainability concerns.

Impact on interest rates and markets

We expect the tariffs to have an impact on monetary policy and markets:

- We think the US Federal Reserve may face a quandary in its response to higher inflation. Policy doves – who favour lower rates – will likely argue that price changes may be temporary and can be ignored, but hawks will be uncomfortable with inflation overshooting for even longer.
- In the EU, the impact of tariffs could push European Central Bank interest rate expectations lower. Expectations about EU fiscal easing may push up longer-term bond yields.
- Even if tariffs don't materialise, the uncertainty about their likelihood could dent European growth and markets. This scenario may test the recent outperformance of European equity markets against their US counterparts. Any market wobble may remove a tailwind for the euro.

Is another "liberation day" market sell-off likely?

Mr Trump's latest stance suggests he has returned to the combative trade posture that he followed in April when he unveiled a raft of reciprocal tariffs against trading partners. The rollout – on what Mr Trump called "liberation day" – triggered a market downturn before Washington delayed implementation.

Similarly to the "liberation day" levies, the latest round of tariffs is also large and potentially damaging. As was the case in April, valuations are high in equity markets and many investors expect a pragmatic approach from Mr Trump.

But as was also the case in April, we think markets could face a period of adjustment before any tariffs are lowered, delayed or scrapped.

While investors may remain cautiously optimistic about the eventual outcome, we would guard against the risk of complacency. With the EU and many other economies in Mr Trump's line of fire, investors might adopt a nimble approach that doesn't depend too heavily on any single asset class or geography.

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