MACRO STRATEGY | Economic Monthly

Deglobalization. What's Next?

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We believe the Post-World War II, U.S.-dominated world order of globalization is quickly coming to an end. Between the possibilities of diversification, division, and disengagement that we discussed in our piece on globalization several years ago, the Trump Administration appears to be pursuing a disengagement strategy. Everyone—domestic players in the U.S. included—is now working to accommodate a less globally engaged U.S.

The U.S. Scrambles to Adjust

Both firms and consumers are scrambling to accommodate the anticipated price shocks from the new tariffs.

Although withdrawal of the higher reciprocal tariffs was applauded by markets, the remaining 10% tariffs are still extremely significant. Profit margins of S&P 500 companies were estimated to be 12.1% in Q4 2024[1], while smaller businesses tend to have lower profit margins. While a single firm is unlikely to absorb the entire tariff, even absorbing a portion of the 10% tariffs is likely to be significant for valuations and cost management.

Which firms are the most vulnerable? Obviously, firms that depend on imported goods; but also, those firms that lack negotiating power with their suppliers, those firms that sell discretionary goods, those firms that export their goods and need to compete internationally on price, and smaller firms with fewer financial resources to weather uncertainty.

These conditions hold equally for manufacturers and services. Although many services firms may be minimally exposed to imported goods, several sectors—e.g. retail trade, transportation services—are much more vulnerable. By the same token, many U.S.-based manufacturers could become accidental losers if their imported intermediate inputs cost more or if their exports are tariffed.

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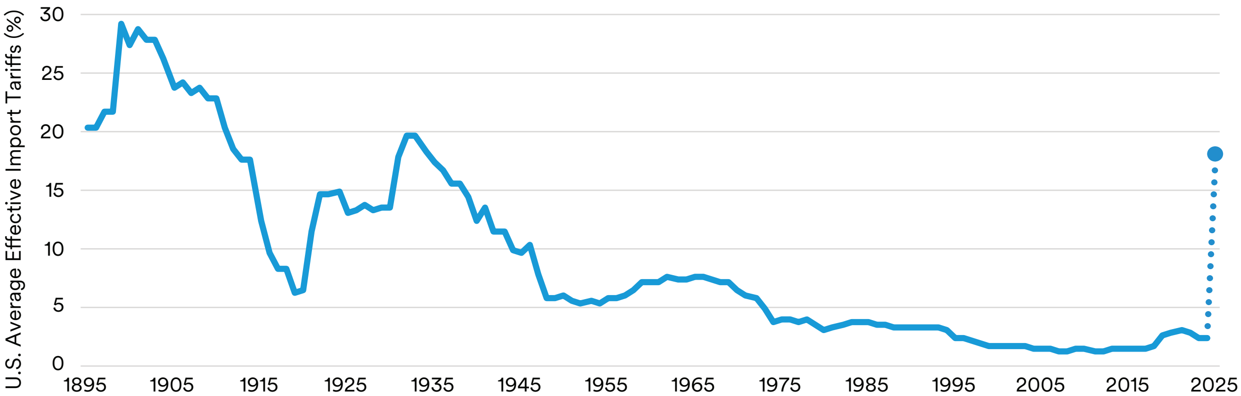
Consumers are doing their own scrambling, which in turn is scrambling near-term data. What appeared to be front-loaded car purchases hit retail figures in March, while other consumer goods items might see a bump up in April. The strength of these figures may, however, be temporary, if the purchases are indeed a front-loading.

As always, lower income consumers are more vulnerable than wealthier ones, although a continued weakening of the stock market may create vulnerabilities among higher income households as well.

Chart 1 | Average U.S. Effective Tariffs Are Expected To Reach Pre-WWII Levels



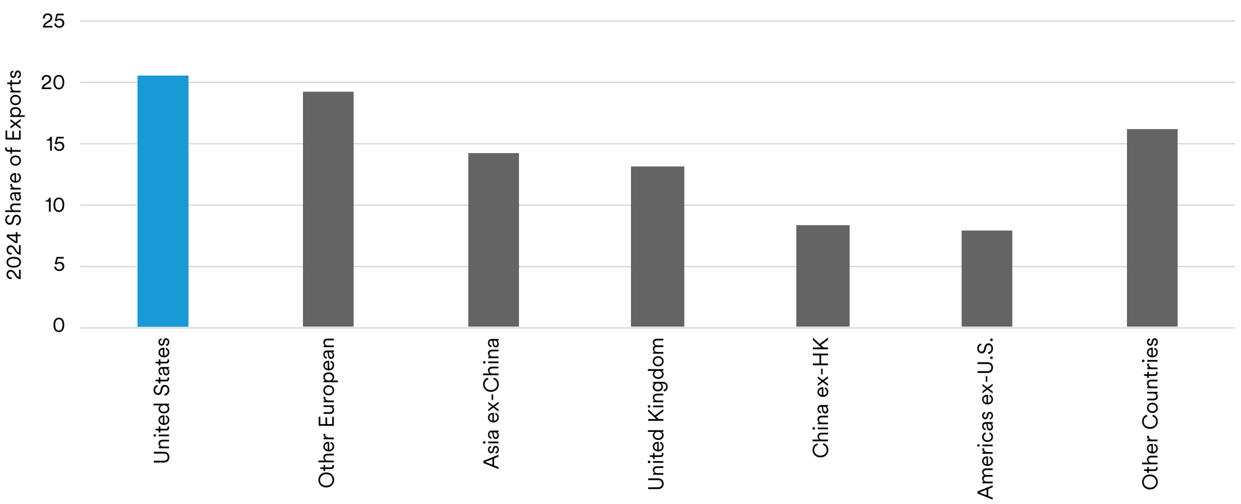
Note: The dotted line is the expected tariffs for 2025 based on the 10% universal tariff plus 25% tariffs on steel, aluminum and non-USMCA covered goods, and the 145% tariffs on China adjusted for substitution toward lower tariffed-countries.
Source: USITC, Bloomberg, MIM calculations based on Yale Budget Lab, MIM. Data as of 4/16/2025

Europe Hopes for the Best and Prepares for the Worst

Europe seeks to negotiate with the U.S. administration even as it readies countermeasures and pursues non-U.S. trade deals. Early indications are that those negotiations are not going well.

The U.S. is reportedly insisting on concessions on behind-the-border measures such as Europe's VAT sales taxes, food safety standards, and a roll-back of the region's legal protections for minorities. None of those are acceptable points of concession for the EU, which would rather focus the discussion on at-the-border tariff issues.

Chart 2 | European Union Exports



Source: Eurostat. Data as of 4/17/2025.

If trade talks with the U.S. fail, Europe's response is likely to be multifaceted. It may include the gradual introduction of counter-tariffs on a large part of its goods imports from the U.S. and higher taxation of digital services companies. It could ultimately extend to restricting the inflow of FDI and ability of U.S. services' firms to do business in the region.

At the same time, member states are likely to increase fiscal support to sectors affected by higher U.S. tariffs, accelerate efforts to remove lingering frictions to trading between countries in the EU (particularly services) and try to deepen its trade ties with non-US countries. The EU has reportedly already reached out to the likes of Canada, India and other countries and is likely to take this opportunity to try to strike new trade deals across the world.

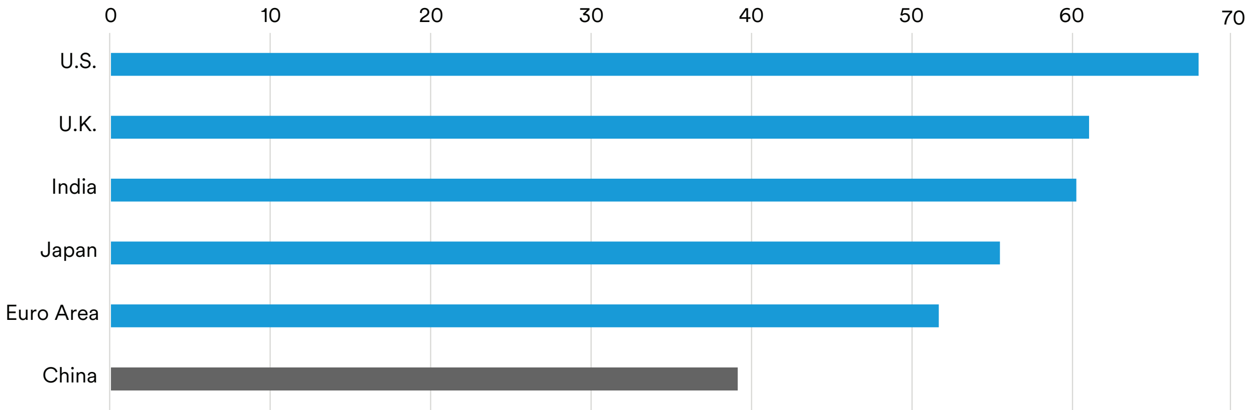
Outreach is unlikely to fully extend to China, where the EU shares many of the U.S.'s concerns around its trade practices and will continue to protect the automotive sector and other strategic domestic industries from Chinese competition.

Beijing Still Constrained From Boosting Consumption

Beijing is adamant about reaching this year's "around 5%" GDP growth forecast. China's monetary and fiscal policy constraints provide an incentive for the leadership to de-escalate tensions and negotiate with the U.S. on trade.

Current tariffs are expected to all but cease bilateral trade in the months ahead. To offset this massive external headwind, Beijing is expected to announce monetary and fiscal policy support and allow the CNY to weaken more. Many are hoping that Beijing will follow through on its pledge at the March National People's Congress to "vigorously boost consumption."

Chart 3 | Consumption as a Share of GDP, 2023



Source: World Bank Development Indicators, MIM. Data for Japan is 2022. Data as of 4/17/2025.

We are skeptical that Beijing will undertake major structural reforms to rebalance the economy toward more consumption anytime soon, despite some recent pro-consumption policies such as the expansion of the trade-in subsidy program for consumer durables.

Beijing could try to fix "under-consumption" by reversing transfers to targeted strategic sectors, as argued by Michael Pettis, a senior fellow at Carnegie China. This would raise interest rates and wages, and appreciate CNY, giving households a bigger share of GDP. However, this cannot be done without reducing investment in the economy, which would dent China's manufacturing prowess and technological edge in an increasingly hostile world, undermining its national security in the process. At the same time, Beijing is reluctant to roll out excessive infrastructure stimulus given local government fiscal constraints and longer-term de-leveraging goals.

Property sector support could be a good compromise to boost aggregate demand and household consumption via the wealth and confidence channel, however even here there are constraints given moral hazard risk.

Outlook

We now expect a recession in the U.S., although the probability (60%) remains close to a coin flip. This call depends on tariffs remaining at or above April 9, 2025 levels.

Our biggest concern is with investment. Volatile polices and valuations are causing some firms to slow investment and hiring decisions, as well as deal-making. We expect the 10% near-universal tariff rate to cut significantly into profit margins of firms that are heavily exposed to imports and have less pricing power.

Consumers are increasingly worried, although their inflation concerns (6.7% for year-ahead according to the latest U Michigan survey) are likely misplaced. In the near term, we expect households and firms to front-load the purchase of imported goods, with a tapering off into midyear. We are also concerned about whether the households who are invested in the stock market will pull back spending in light of weaker investment returns. Households in the top 10% make up 50% of all consumption, so the behavior of this group of consumers is critical to continued economic growth.

Q2 is likely to be a critical one for the labor market, as the cumulative effects of tariffs, DOGE actions, and policy uncertainty are brought to bear.

We expect the Fed to focus in the near term on inflation, and to resist cutting until there is greater clarity on the ultimate effect of tariffs on prices. In the second half of the year—assuming that tariff policy settles down by then—we would expect the Fed to turn its attention more toward the labor market and make substantial cuts by year-end.

MIM Forecast

	2024	2025
Policy Rate (Upper Bound, YE %)	4.25-4.50*	2.35-3.75
GDP (Ann. Avg. % Chg.)	2.8*	0.0
CPI (Dec. Y/Y %)	2.7*	3.0
10-year Treasury (YE %)	4.57*	3.75
Unemployment (YE %)	4.1*	5.1

*Actuals. *Source: BEA, BLS, Treasury, Federal Reserve, MIM. As of April 2025.*

Looking forward, we expect continued tariff uncertainty as well as a broadening of attention by the Trump Administration to include more growth-oriented policies such as tax cuts and deregulation.

Risks to The Outlook

We believe the risks to our view are tilted toward stronger than expected growth. Some sort of tariffs are likely to remain in place, but if there is a moderation in the universal tariffs, a détente with China, and few or no other bilateral tariffs are imposed, this could help tilt the economy toward growth. We also expect the Trump Administration to focus on more growth-positive policies in the second half of the year, including deregulation and an extension of the Tax Cuts and Jobs Act.

Labor markets may remain stronger than we expect, especially given the diverse actions that are broadly discouraging of inbound labor flows.

If an off-base case growth scenario does begin to prevail, however, we would expect it to go hand in hand with greater inflation as consumers remain relatively strong and willing to accept higher prices.

Endnote

1 FactSet Insight, January 27, 2025.

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