Tariffs in Context

Three Charts That Matter

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Introduction

In times of rapid market change, the temptation is often to react quickly by making sense of new information through the lens of daily price moves and hourly headlines. But when structural shifts are underway, a more productive approach can be to zoom out and evaluate what's happening in the context of long-term trends and historical precedents. That's especially true now that global trade policy takes centre stage once again.

Rather than focusing on political positioning or short-term tactics, we believe it's worth considering the underlying logic driving recent actions. In other words, asking ourselves: what do policymakers believe they are doing and why are they doing it?

According to statements from the current US administration, the goal isn't just about "reciprocity" but rather about fundamentally rebalancing the US economy and thereby global trade. That means reducing the US trade deficit through reviving domestic manufacturing and increasing exports, which will in turn reduce reliance on foreign supply chains, particularly from geopolitical rivals.

For investors looking to invest in Europe, understanding how the structure of global trade may be shifting is crucial. As with any inflection point, this transition brings both risk and opportunities.

Despite the wide range of perspectives on trade among economists, policymakers, market participants and even Trump administration officials themselves, there is some degree of consensus. Thinkers as diverse as John Maynard Keynes, Warren Buffett and Michael Pettis all agree that persistent large global trade imbalances are unsustainable. The question therefore no longer appears to be *if* existing imbalances will persist, but rather on what basis will they be rebalanced. This is a potential profound secular shift on par with the changes that occurred with the original Bretton Woods system implemented post-World War Two as well as the "Nixon shock" of 1971.

Whether or not one agrees with the administration's approach, the reality is that for at least the next four years, we're likely to see continued efforts to reduce the current account deficit of the US. Given the deep and complex interconnections of global trade, any major shift in US policy will inevitably ripple across every major economy. These include the first order impacts from higher input costs but also various second and third order implications that affect currencies, rates and supply chain availability.

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To therefore better understand what's unfolding, we believe the following three charts provide helpful long-term context.

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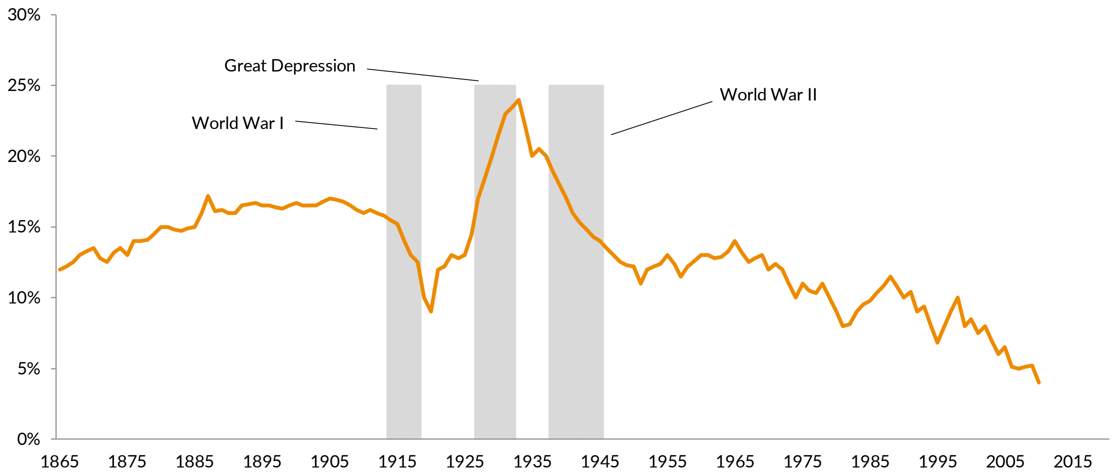
Tariffs Have Not Been on a One-Way Journey Down

Much of the modern investment landscape was shaped in a world of falling trade barriers and increasing globalisation. But this was not always the norm and may not be the future.

From the 1980s to the present, global tariff rates trended downwards significantly. However, history shows that tariff levels have fluctuated and the recent low-tariff era is more anomaly than status quo (global tariffs have been on average 2x higher than current levels since the 1860s). Investors should therefore be prepared for the possibility that a structurally higher-tariff world is returning, regardless of their opinion on the matter. The potential impact of materially higher tariffs today is magnified by the share of trade as a percentage of world GDP being at historical highs (59% as of 2023 versus 26% in 1970).

Average Global Tariffs (1865-2015)



Source: Institute for Research in Economic and Fiscal Issues. From 1865-2010 (Solid line): Robert C. Feenstra and Alan M. Taylor (2014). Unweighted average of 35 countries. The average duty rates are calculated from the total revenue from import duties divided by the value of imports in the same year. From 1985 to 2015: William Nordhaus (2018). URL: http://voxeu.org/article/trump-doctrine-international-trade-part-two. Inquired on 09.11.2018. Average of 64 countries that accounted for 91% of world trade in 2010, weighted by the share of imports in 2010. With data from the World Bank.

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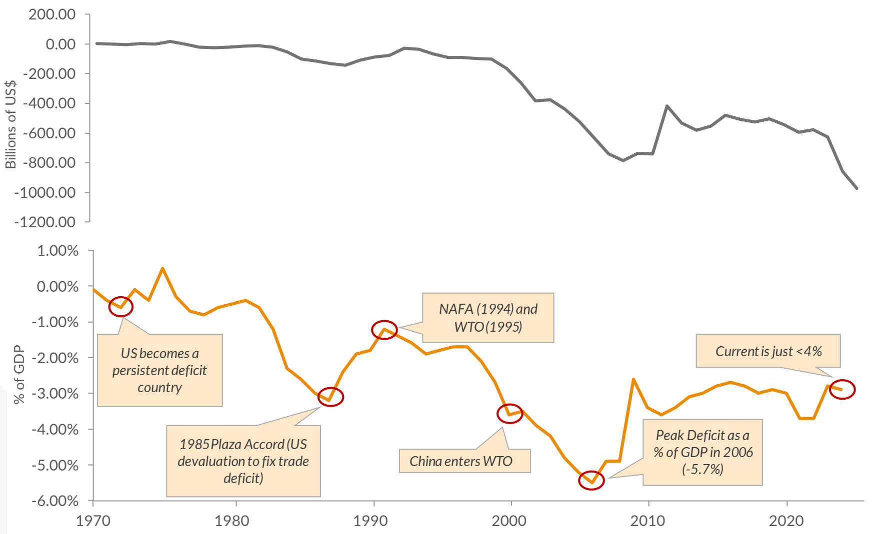
There Have Been Various Attempts to “Fix” the US Trade Deficit Since the 1970s

From the 1880s until the early 1970s, the United States ran a significant trade surplus with the rest of the world. The US therefore only became a persistent deficit country in the modern era. Attempts to reverse this trend (such as the 1985 Plaza Accord which devalued the dollar) have been made before. Despite some fleeting success, the current account deficit increased meaningfully from the mid-1990s on the back of the introduction of NAFTA and the “China Shock” of 2001 (when China permanently entered the WTO).

While the US trade deficit peaked in 2006 at nearly 6% of GDP, it has remained stuck around 3-4% for over a decade. That deficit is now under renewed scrutiny in Washington after a failure to alter the trajectory. For example, the last two presidential administrations have both tried to reduce the trade deficit. This includes the original 2018 China Tariffs introduced under the first Trump administration (which were continued and even furthered under the Biden administration), as well as efforts to revive US manufacturing through direct investment in strategic industries (i.e. the Inflation Reduction Act, the Infrastructure Act and the Chips Act). Form and tactics aside, we believe that addressing the US trade deficit is likely now a bipartisan issue and therefore potential implications surrounding this need to be considered by allocators.

US Trade Deficit



Source: U.S. Trade Balance 1970-2025 MacroTrends

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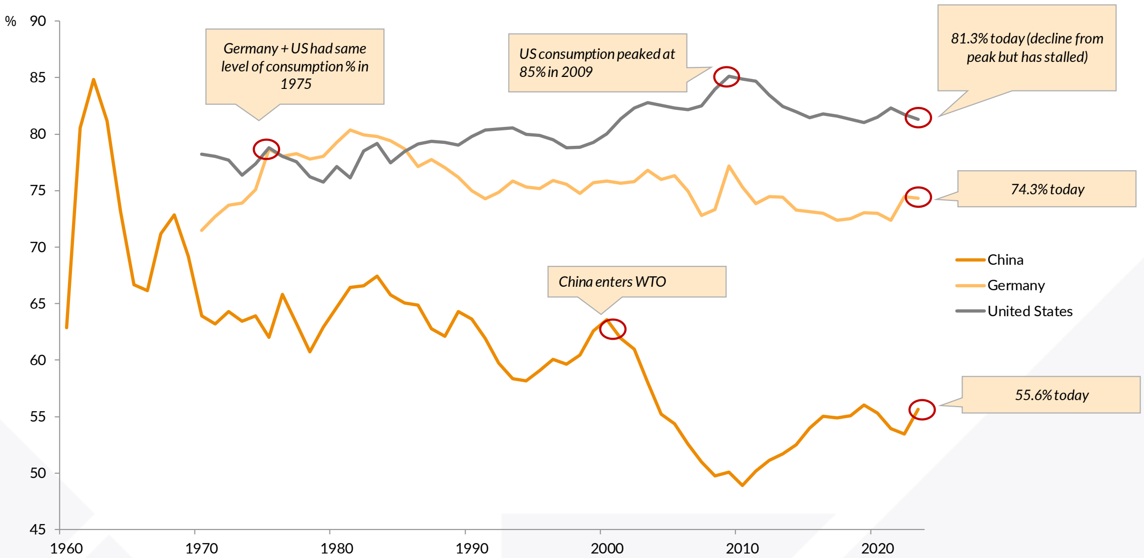
Global Imbalances Stem from Differing Levels of Consumption and Savings, Especially in China and the US

A long-standing concern of many economists has been the higher levels of US consumption relative to other major export-oriented economies, particularly China.

The US's consumption as a percentage of GDP is one of the highest in the world. On the flipside, Chinese workers capture just 50% of the GDP, compared to 60–70% in most countries, which depresses consumption. This imbalance is a key driver of global trade tensions. Similar patterns can also be seen to some extent in certain European countries (like Germany). A fundamental rebalancing of consumption and investment in the three major economic regions (North America, China & Southeast Asia and Europe) will have significant impacts on global supply chains and profit pools.

Final consumption expenditure (% of GDP) - China, United States, Germany



Source: World Bank National Accounts data, and OECD National Accounts data files. License: CC BY-4.0

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What Should Investors Looking at Europe Keep in Mind?

The future path of global trade policy is still uncertain, and multiple scenarios remain in play. But if we accept that reducing the trade deficit is now a central aim of US policy, then investors looking to allocate to Europe should consider a few factors as they assess potential opportunities:

- A potential dollar devaluation, boosting US exports and making EU exports relatively more expensive (think a "Plaza Accord 2.0")
- A decline in oil prices and the dollar being deflationary for Europe (which is an energy importer) and thereby potentially boosting consumption
- Increased European fiscal stimulus (particularly in Germany, which has recently ended its "debt brake"), which could boost domestic consumption and reduce export dependency
- Rising US exports of energy, agriculture and industrial goods to Europe as trade rebalances
- Tariffs on Chinese goods within the EU as a protective measure against Chinese dumping
- Alternatively, the potential for Chinese overcapacity to flood European markets, creating deflation but also pressuring certain local industries
- The importance of carefully scrutinising business models that are heavily reliant on exports or complex global supply chains, especially in countries that have benefited from a weaker currency environment and relatively low wages

Final Thoughts

Trade policy is now investment risk and will be a core part of underwriting any future investments. It will shape borrower performance, sponsor strategy and ultimately credit outcomes. However, as outlined in our *Opportunities in Volatility* paper, this presents a source of opportunity. Whilst near-term M&A activity may slow and major investments may be postponed as businesses reassess the impact of tariffs on supply chains, it will create other opportunities such as increased demand for refinancings, recapitalisations or rescue financings. Secondary credit markets are likely to be impacted, including bouts of indiscriminate selling. Over the longer term, the secular changes resulting from a restructuring of the global trade order would likely usher in both a rebalancing of portfolios and demand for new capital investment.

Previous experience of market shocks, such as those felt during the financial crisis, the Eurozone crisis, the pandemic or the Russia-Ukraine conflict, are key to navigating the volatility. At Hayfin it all begins with supporting borrowers, utilising these relationships to learn more about what is happening and then identifying the high-quality credit opportunities emerging from uncertainty. While we don't know what the near term might look like, if we continue to use long-term trends as our "True North", we can take a thoughtful, risk-aware approach to credit investing and avoid potential secular losers. In a world where change is the only constant, perspective and temperament generally matter more than predicting the next headline.

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