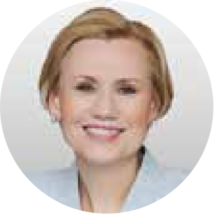
Tariffs rattle stock markets, but what's the long-term impact?

Weekly Market Compass | February 4, 2025



Kristina Hooper
Chief Global Market Strategist

Key takeaways

Tariff talk

The threat of new US tariffs on goods from Canada, Mexico, and China immediately weighed on stocks at the start of this week.

Cautious optimism

I'm cautiously optimistic that while we may see lots of drama, we may not see a meaningful long-term market impact.

Recent history

Why the optimism? Because the market impact of the 2018-2019 US-China trade war subsided quickly once a resolution was reached.

News about new US tariffs on goods from Canada, Mexico, and China (and the announcement of retaliatory tariffs) prompted markets to sell off in an immediate response on Monday. Before the day came to a close, however, we learned that the tariffs on Canada and Mexico would be delayed by a month. While these events continue to unfold, I think it's important to take a look back at the market response to the tariff wars in the first Trump administration. History doesn't repeat itself but it can rhyme — and the first Trump administration trade wars are arguably the best guide we have.

What did the 2018-2019 trade war mean for the US economy?

The 2018-2019 trade war between the US and China had a significant impact on the US economy. It caused disruptions, price increases (which squeezed some businesses' profit margins) and elevated uncertainty, which led to stalled US business investment and hiring.

Here are just some of the observations from Federal Reserve Beige Books during this period:

- "Manufacturers in all Districts expressed concern about tariffs and in many Districts reported higher prices and supply disruptions that they attributed to the new trade policies."[1]
- "The firms continued to note greater uncertainty owing to tariffs and the threat of tariffs."[2]
- "Reports of tariff-induced cost increases have spread more broadly from manufacturers and contractors to retailers and restaurants."[3]
- "Manufacturers reported that tariffs led to higher costs of raw materials and lower profit margins. Trade-related uncertainty remained significant, causing some companies to decrease production levels and staff headcounts."[4]
- "...trade policy uncertainty led to reduced capital expenditures."[5]
- "Trade-related uncertainty remained significant, with some companies decreasing production levels and staff headcounts due to lower profitability."[6]

What did that trade war mean for markets?

The 2018-2019 tariff war also had a significant impact on markets, taking them on a roller coaster ride. It led to higher volatility as ups and downs were dictated by news flow on trade talks and the removal of tariffs/application of more tariffs. In general, there was a flight to perceived 'safe haven' assets globally.

- When talks broke down and/or additional tariffs were applied, US stocks sold off. When talks resumed, US stocks rose. Once the Phase I trade deal was announced in October 2019, US stocks rose significantly. The S&P 500 fell 4.38% in 2018 but gained 31.49% in 2019.[7]
- Chinese stocks also experienced volatility and sell-offs during the trade war but experienced a recovery as the tariff war subsided. For 2018, the MSCI China A Index fell 30.16%. But for 2019, it rose 36.40%.[8]

In other words, tariffs caused short-term headwinds. Once markets grew accustomed to them and then a resolution was reached as the Phase I trade deal between the US and China was announced, volatility eased and financial markets reaccelerated.

What does this mean for today's tariff war?

We have to remember that protectionist measures have tended to result in less optimal economic growth globally in the near term but have not necessarily served as a long-term hurdle for the stock market. Nonetheless, a period of trade policy uncertainty could potentially weigh on markets, as it did in 2018-2019, until greater clarity emerges. We could see a similar scenario unfold this time as we did in the first Trump administration — lots of drama but no real longer-term impact. I am cautiously optimistic that will be the case.

So why have markets reacted so negatively knowing recent history? I think because many assumed the Trump administration would be focused on keeping stocks buoyant and would use tariffs as a threat rather than actually implement them. Maybe that was just wishful thinking. However, I think markets will adjust, then experience a hiccup if more tariffs are levied, and so on and so on, similar to what we saw in the first Trump administration.

What does it mean for inflation and growth?

We also keep getting asked whether the US should be worried about higher inflation or lower growth with tariffs.

In the near term, tariffs cause price increases, but they tend to quickly subside as tariffs are removed (which is why I have argued vehemently that when it comes to inflation, we should be far more worried about immigration policy) so they don't typically result in sustainable inflation.

However, tariffs can suppress demand. So I believe growth is a far bigger issue — and it's the risk we need to worry about if tariffs stay on for a long period of time. Also, retaliation magnifies and globalizes the effects of tariffs, meaning the global economy could end up with less growth and higher inflation. Keep in mind that the US may have less to lose than any one trading partner, but if the war is being fought against a range of partners, the cumulative damage on the US economy could be greater than on any one partner.

We're already seeing signs that policy uncertainty is having a negative impact on US consumer sentiment, as evidenced by a significant decline in consumer confidence in the Conference Board's survey released last week. Also, US gross domestic product data released last week showed that fixed investment spending was down in the fourth quarter, which could very well be due to business uncertainty about tariffs and other policies.

In short, tariffs tend to lead to less optimal outcomes but are unlikely to derail the current business cycle — but the risk grows as more tariffs are applied and the longer they're in place. And so while both US manufacturing Purchasing Managers' Index surveys released Monday show a more optimistic outlook for the sector than we've seen in a while, that can easily change as the application of tariffs have entered the picture. We will want to keep an eye on signs of any kind of deterioration in sentiment or spending plans resulting from tariffs.

Earnings season and central banks in the headlines

On a more positive note, I think it's important to point out that while there have certainly been some disappointments, earnings season has been going well thus far for S&P 500 stocks overall. Of the companies that have reported thus far, 77% have had fourth quarter earnings come in above estimates.[9] What's more, the blended earnings growth rate for the S&P 500 is 13.2% which, if it comes to fruition, will be the best year-over-year earnings growth rate since the fourth quarter of 2021.[9] I'm also encouraged to see more upgrades to earnings forecasts for Europe ex-UK and Japan stocks.

Finally, we heard from some major central banks last week. The Bank of Canada and the European Central Bank cut rates and indicated a lot of uncertainty about the future, largely fueled by the potential for US tariffs. They're clearly leaning dovish — the Bank of Canada also announced the end of quantitative tightening — but recognize they are constrained to some degree by the inflation data.

The Federal Reserve decided to sit on its hands, as expected. It also has to contend with the impact of tariffs and other possible policies on the US economy but made clear that it's data dependent and willing to be very patient, which suggests to me the earliest possible rate cut for 2025 may not occur until the second quarter — likely late in the second quarter.

Looking ahead

This week will no doubt be a busy one as we follow the telenovela that's the evolving tariff wars. We're also getting a lot of services Purchasing Managers' Index data this week from around the world as well as the Bank of England decision and the US and Canada jobs reports.

There's likely to be a heightened sensitivity to any inflation-related data given tariffs already have markets nervous. I would reiterate the importance of knowing your time horizon and acting accordingly. For the vast majority, that means to stay calm, diversified, and carry on. And for those looking to be more tactical within their portfolio, short-term sell-offs are likely to present buying opportunities for those with a long enough time horizon if we see a similar scenario to the 2018-2019 tariff wars unfold again.

With contributions from Paul Jackson

Notes

[1]Source: Federal Reserve Beige Book, July 2018

[2]Source: Federal Reserve Beige Book, October 2018

[3]Source: Federal Reserve Beige Book, December 2018

[4]Source: Federal Reserve Beige Book, March 2019

[5]Source: Federal Reserve Beige Book, July 2019

[6]Source: Federal Reserve Beige Book, November 2019

[7]Source: Standard & Poor's, as of December 31, 2019

[8]Source: MSCI, as of December 31, 2019

[9]Source: FactSet Earnings Insight, January 31, 2025

Important information

All investing involves risk, including the risk of loss.

Past performance does not guarantee future results.

Investments cannot be made directly in an index.

Diversification does not guarantee a profit or eliminate the risk of loss.

This does not constitute a recommendation of any investment strategy or product for a particular investor. Investors should consult a financial professional before making any investment decisions.

The Summary of Commentary on Current Economic Conditions by Federal Reserve District (the Beige Book) is published eight times per year. Each Federal Reserve Bank gathers anecdotal information on current economic conditions in its district, and the Beige Book summarizes this information by district and sector.

Investments in companies located or operating in Greater China are subject to the following risks: nationalization, expropriation, or confiscation of property, difficulty in obtaining and/or enforcing judgments, alteration or discontinuation of economic reforms, military conflicts, and China's dependency on the economies of other Asian countries, many of which are developing countries.

Dovish refers to an economic outlook that generally supports low interest rates as a means of encouraging growth within the economy.

Monetary easing refers to the lowering of interest rates and deposit ratios by central banks.

The Federal Reserve Beige Book is a summary of anecdotal information on current economic conditions in each of the Fed's 12 districts.

Gross domestic product (GDP) is a broad indicator of a region's economic activity, measuring the monetary value of all the finished goods and services produced in that region over a specified period of time.

Inflation is the rate at which the general price level for goods and services is increasing.

Profit margin measures the profitability of a company by dividing net income by revenues.

Purchasing Managers' Indexes (PMI) are based on monthly surveys of companies worldwide and gauge business conditions within the manufacturing and services sectors.

Quantitative tightening (QT) is a monetary policy used by central banks to normalize balance sheets.

Safe havens are investments that are expected to hold or increase their value in volatile markets.

In general, stock values fluctuate, sometimes widely, in response to activities specific to the company as well as general market, economic and political conditions.

Tightening monetary policy includes actions by a central bank to curb inflation.

The Consumer Confidence Survey® is a monthly report that details consumer attitudes, buying intentions, vacation plans, and consumer expectations for inflation, stock prices, and interest rates.

The opinions referenced above are those of the author as of **Feb. 3, 2025**. These comments should not be construed as recommendations, but as an illustration of broader themes. Forward-looking statements are not guarantees of future results. They involve risks, uncertainties and assumptions; there can be no assurance that actual results will not differ materially from expectations.