Chief Economist Commentary

May 2025

Topic:

Tariff negotiations expected to be turbulent

Summary

- Trump announced tariff hikes on Liberation Day and then postponed them, which caused high volatility in the market. The main reason for this drama is that the Trump administration has made three major misjudgments regarding international trades and tariff policies. Firstly, Trump believes that the US trade deficit is equivalent to the money that foreigners took unfairly from Americans. Secondly, he believes that even if tariffs are raised, foreign exporters would absorb the tariff costs or plead for relief, overestimating the U.S.'s leverage in negotiations. Thirdly, he underestimated the dependence of domestic consumers and multinational enterprises on imports. As a result, under the pressure of domestic opposition, market declines, and big companies lobbying to suspend the reciprocal tariffs and seek negotiations temporarily.

- Trump's hopes of completely reversing the US trade deficit through increasing tariffs and trade wars, while revitalizing the US manufacturing and even changing the main source of employment in the US from the service back to manufacturing are unrealistic in our view. A more realistic consideration is to allocate the increased tariff revenues to help finance Trump's tax cut in the 2nd half of this year.

- If the trade negotiations fail to make progress for a longer time, as the US import inventories deplete and production and capex are dampened by tariff uncertainties, the global economy is likely to face greater downward pressure in the later period of Q2. However, there is little chance the Chinese government will yield to Trump or offer significant concessions. Instead, it has responded to export-related economic pressure by introducing further monetary and fiscal stimulus measures.

- China's government bond issuance and financing have significantly accelerated at the beginning of this year. This has alleviated the financial pressure on local governments and promoted the accelerated implementation of government infrastructure investment projects and consumption subsidies. At the same time, Chinese government also attaches greater importance to the role of policies aimed at "stabilizing the stock market and housing prices" in boosting consumer confidence.

- We believe that tariff negotiation will be turbulent and may have setbacks. Therefore, considering that the US stocks have recovered from the Liberation Day plunge, we think there is limited upside room for US stocks. We are more optimistic about the A-shares and Hong Kong stocks, as the Chinese government will prioritize stabilizing the stock market as an essential current policy goal.

Previous Views:

Given Trump's management style and the relatively high level of uncertainty and risk, we remain cautious about the US stock market. At the same time, recent shifts in geopolitics and asset allocation flow are likely to contribute to a decline in the US dollar exchange rate. We maintain a neutral to optimistic view on China's A-shares and Hong Kong stocks, where we believe market pullbacks present buying opportunities. As for commodities, while we are generally cautious, we remain bullish on gold.

Views in May

1. The Ideal Goals and Realistic Considerations of Trump's Tariff Plan

In early April, the Trump administration announced on "Liberation Day" to significantly increase US import tariffs on all countries around the world, which triggered substantial turmoil in the global financial markets. However, as US stocks, US T-bonds, and the US dollar plunged, Trump quickly announced a 90-day suspension period for tariffs in the hope of reaching agreements with countries worldwide. However, the US has not reached effective trade agreements with its major trading partners.

The main reason for this drama is that the Trump administration has three major misjudgments regarding international trades and tariff policies. The first misjudgment: Trump believes that the US trade deficit represents the money foreign countries are ripping off from Americans. Therefore, even if he imposes tariffs of about 50% of the trade surplus on proportion, foreign exporters can still make a profit, though making less.

The second misjudgment: Because he believes that exporters will bear the tariff costs by themselves when tariffs are increased, he believes that the result of increasing tariffs is either that the US government will obtain a large amount of tariff revenue, or that foreign governments will rush to beg the US for tariff reductions, and the Trump administration can use this as a bargaining leverage to advance its various political, economic, and geopolitical requests. This has led the Trump administration to overestimate its advantage in trade negotiations.

But the fact is far from this. The trade balance is caused by the differences in supply and demand between the two countries and does not equalize the profits of the exporting countries. In fact, many Chinese exporters operate on skinny profit margins, so they cannot bear the tariff costs.

Therefore, other countries cannot compromise with the US government because they have nowhere to retreat. Even if they abandon direct trade with the US. in the future, it may still be preferable to compromise the tariff burden themselves. The third misjudgment: It underestimated the dependence of US domestic consumers and multinational enterprises on imports.

The import value of goods in the US accounts for more than 50% of the total annual goods consumption in the country, which means that US consumers have a very high dependence on imports. At the same time, many US multinational enterprises, such as consumer goods companies like Apple, Amazon, Walmart, and Nike, are highly dependent on the business model of overseas production and US sales. Significantly increasing tariffs would severely impact the interests of these large US multinational enterprises. Therefore, achieving its goals is difficult for the Trump tariff war. At the same time, Trump is facing increasing domestic opposition pressure and lobbying influence from various large enterprises.

Therefore, when the Trump administration faces economic and political challenges, other major global economies are likely to be even less willing to compromise on tariff reductions. While it may appear on the surface that the US has the upper hand, Trump's need to secure agreements with major trading partners such as China, the EU, and Japan has become- increasingly urgent. This would require Trump to abandon some of the unrealistic goals he previously envisioned for the tariff trade war in exchange for some more realistic considerations.

What are some of Trump's unrealistic goals regarding the trade war? We believe they include: The Trump administration's objective to eliminate the US trade deficit by raising tariffs and engaging in trade wars, while revitalizing the manufacturing sector and shifting the primary source of employment in the US back from services to manufacturing. Whether in the US, Europe, or China, the decline in the share of manufacturing in the economy and employment is an inevitable trend due to advancements in productivity and rising average household incomes. It is clearly against the laws of natural economics and social development for a highly developed country like the US, with a world-leading per capita income, to make manufacturing the central part of its economy and job market again.

In 2024, the share of manufacturing in US GDP dropped to 10%, marking a new historical low. Since 1953, the continuous decline in the proportion of the US manufacturing industry has lasted for more than 71 years (Figure 1). Therefore, expecting that Trump's tariff policies alone can reverse this long-term trend is unrealistic. A more realistic approach for the US is to use its own technological and market advantages to develop more high-end technology-manufacturing and new service industries. However it is impossible to achieve that only by increasing tariffs.

For China, future development will also require more efforts to develop high-end technology manufacturing and new service industries. Therefore, future economic competition between China and the US is inevitable but tariffs will not change the overall situation of Sino-US industrial competitions. Thus, the tariff trade war cannot achieve the idealistic goals envisioned by the Trump administration.

Source: Bloomberg，CEIC，Wind

On realistic considerations, raising tariffs can help the US government increase its fiscal revenue and contribute to balancing the budget. But this means that US consumers and importers will bear more tax burdens, making it, in reality, a form of fiscal austerity policy. However, from the economic stance of the Trump administration and the GOP, increasing the tax burden on US enterprises and households is not their preferred fiscal policy. At the same time, increasing taxes may also lead to a decline in the US economy and a fall in the US stock market.

Therefore, in essence, it is unwelcome mainly by the Trump administration and Republican Congressmen who are facing midterm election competitions.

So, from a pragmatic perspective, the current trade negotiations between Trump and various countries are aimed to identify tariff range that foreign governments and exporters can bear on their own without passing it on to US importers and consumers. Of course, this range will vary for different countries. Therefore, Trump hopes to negotiate separately with each trading partner to set different tariff rates. Although the extremely high tariff rates he previously mentioned are only used as negotiation chips and are unlikely to be fully implemented, he will not entirely cancel the increased tariffs because he still expects to use them to at least partially reduce the level of the US fiscal deficit.

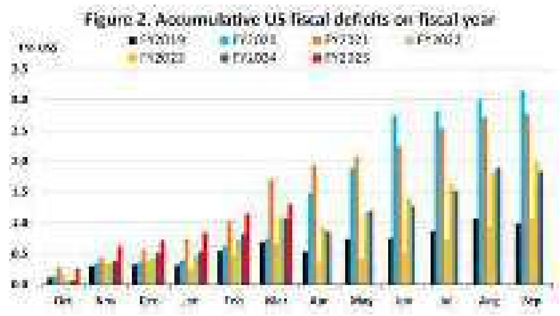
2. The core issue beneath the surface of the tariff war remains the US fiscal problem

Compared with trade issues, the more central concern of the US government lies in the continuous rise of its fiscal deficit. Many policies since the Trump administration came to power, including the intention to quickly withdraw from supporting Ukraine in the war, significantly increasing import tariffs, and the Department of Government Efficiency (DOGE) under Elon Musk to cut government spendings, in fact, all point to the goal of reducing the US fiscal deficits.

However, the Russia-Ukraine war is still ongoing. During a period of high geopolitical conflicts around the world, such as in the Middle East and between India and Pakistan, it is unrealistic for the US to cut military spending and international expenditures significantly. Moreover, although the DOGE led by Musk has claimed to have cut fiscal spending by more than $160 billion, it is still far from his initial plan of cutting $2 trillion.

At the same time, the US Congress has passed Trump's new tax cut bill, which aims to reduce taxes by a cumulative total of $4.5 trillion over 10 years. Therefore, Trump indeed hopes that tariffs can significantly increase the fiscal revenue of the US and, at the very least be able to finance the fiscal shortfall caused by his tax cuts to a certain extent. Otherwise, during his term, he may fail to reduce the government deficit and intensify the pressure on the fiscal deficit and national debt.

Half of the 2025 US fiscal year has passed, and the cumulative fiscal deficit in the first six months of this fiscal year has already reached a staggering $1.31 trillion, significantly higher than the $1.06 trillion in the previous fiscal year. And the total fiscal deficit in the last fiscal year was $1.83 trillion. Therefore, without a significant tariff revenue increase, the total deficit in the 2025 US fiscal year is likely to exceed $2 trillion again.



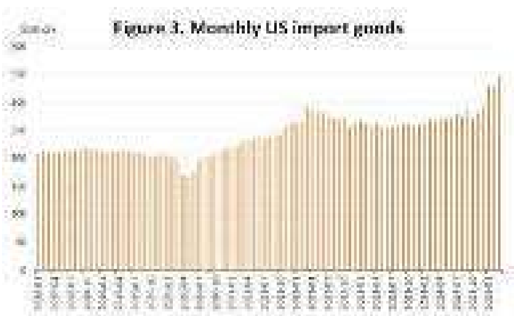
Source: Bloomberg，CEIC，Wind

Based on the tariffs announced by Trump so far, his goal is to achieve an effective tariff rate of at least 10%. Based on this calculation the US tariff revenue can increase by $300 billion per year. From April to the end of this fiscal year in September, the expected increase in fiscal revenue in FY2025 is around $150 billion. Therefore, we believe that Trump is unlikely to abandon tariffs because he still hopes to use the increased tariff revenue to offset the negative impact of corporate tax cuts.

However, whether the Trump administration can obtain incremental tariff revenue of $300 billion per year and make foreign producers bear the tax burden entirely still poses significant difficulties. A 10% tariff rate will likely exceed the limit many overseas producers can afford within their profit margins. . Therefore, the Trump administration may find it difficult to reach an agreement with major trading partners such as the EU, China, and Japan within the 90days.

At the same time, before Trump increased tariffs, US importers were already aware of the potential tariff hikes. As a result, in Q1 this year, US importers significantly increased their import volumes in advance. According to the statistics of the US Customs, from January to March this year, the import value of goods to the US was $329.4 billion, $328.9 billion, and $346.8 billion, respectively. The cumulative import of goods in Q1 was $1 trillion, a year-on-year increase of 26% compared to $795.8 billion in Q1 2024 (Figure 3).

Through time conversion, it means that the US has accumulated an import inventory equivalent to about 25 days of domestic consumption in Q1. This will leave time for the Trump administration's trade negotiations with countries worldwide. However, as time goes by, if Trump's trade negotiations with various parties still cannot reach an agreement by the end of May or even in June, then as the inventory depletes, the impact of tariffs on US consumption and prices will begin to emerge.



Source: Bloomberg，CEIC，Wind

And if the trade tariff issue remains unresolved, the uncertainty will continue to affect the confidence of entrepreneurs and investors. In today's world, which is highly dependent on global industrial collaboration and international trade, the uncertainty of tariff policies has a greater impact on entrepreneurs' confidence in production and Capital Expenditure (Capex) than the tariff itself. However, enterprises cannot predict what and how these changes will occur under highly uncertain tariff policies. Therefore, the uncertainty will lead to a reluctance in corporate production and Capex, negatively affecting both the US and global economies. The longer the trade talks remain unresolved, the higher the risk that this uncertainty will further suppress production and investment.

Although the global economy still performed well in the first quarter, China and the EU, have achieved faster GDP growth, helped by the quick development of exports driven by the significant increase in US imports. Although the US experienced sequential negative GDP growth in the first quarter due to the substantial import increase,, its domestic employment, consumption, and investment indicators still performed normally.

However, if the Trump administration fails to quickly reach an agreement on trade issues with countries such as China, the EU, and Japan in the second quarter, the combination of reduced trade volumes and weakening corporate sentiment couldcause global economic growth to slow markedly in the second quarter.

However, considering the tax cut plan that the Trump administration is about to introduce in the second half of the year, and Trump's hope of using increased tariff revenue to finance the fiscal shortfall caused by his tax cuts is difficult to shake in the short term. Therefore, there is still significant uncertainty and the possibility of worsening regarding whether the US can reach trade agreements with its major trading partners . And this is also likely to continuously impact and cause fluctuations in the global capital market trends in the second quarter.

3. China continues to use policy easing to offset the impact of the "trade war"

There is little chance that the Chinese government will compromise with Trump or make significant concessions This is primarily because it recognizes that China and the US are engaged in long-term strategic competition. Therefore, making substantial concessions, even if it can ease the short-term export pressure, cannot truly resolve these problems, and may lead to a more vulnerable situation in international economic and geopolitical games in the future. In addition, Chinese government firmly believes that the resilience of the Chinese economy is much stronger than that of the US and the trade war initiated aimed at all countries, not just China.

Therefore, China has greater flexibility in diplomatic and trade negotiations and can strive to reach more agreements with other trade partners such as the EU, the Association of Southeast Asian Nations (ASEAN), and the “one Belt and one Road Countries”, to reduce the impact of the decline in direct exports to the US. China will still seek to negotiate with the US under fair and equal conditions. However, it is tough for China to take the initiative to make significant compromises and concessions to seek any deals.

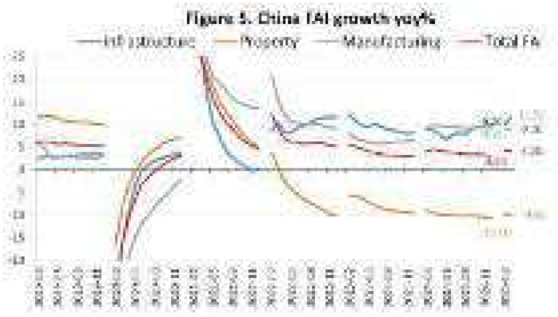
Therefore, the Chinese government realizes that the competition in the China-US trade war is a contest of the economic endurance on each side. As a result, the Politburo meeting in April clearly stated that domestic policies will be further relaxed to hedge the risk of declining in exports to the US. This week, PBoC also announced that the reserve requirement ratio will be reduced by 0.5% again, and a 25bps will lower the interest rate on housing provident fund loans. In addition to monetary easing, the significantly accelerated financing and issuance of government bonds, better reflect the relatively loose macro policies of the government this year.

From January to April, the net increase in Chinese government bonds (including treasury bonds, local government bonds, and government financial institution bonds) is close to 5.5 trillion RMB, while the same number from January to April last year was only 2 trillion RMB.

Overall, the government bond issuance this year is significantly frontloaded, which helps to solve the pressure on local government funding, accelerates the speed of government infrastructure investment, and promotes the implementation of more funds for stimulus programs.

Source: Bloomberg，CEIC，Wind

Therefore, judging from the investment data in Q1 this year, although the performance of property investment is still slow, the growth rate of government-led infrastructure investment has significantly picked up, with a YoY growth of 11.5% in Q1 (Figure 5), which is closely related to the heavy government bond issuance and the early implementation of project funds.



Source: Bloomberg，CEIC，Wind

However, against the backdrop of the intensive introduction of government stimulus policies, there are still significant "bottlenecks". In other words, these government stimulus policies primarily drive government financing and bank loans, so their direct impact on increasing household income and consumption remains weak. Currently, the government's stimulus of consumer demand mainly focuses on policies such as "purchase subsidies" and consumption vouchers for durable consumer goods. Although this can boost the consumption of related products in the short term, it has limited effect on improving the income growth expectations and consumption confidence and lacks a long-term impact.

At the same time, data show that households remain reluctant to take out loans from banks. To solve this "bottleneck" problem, Chinese government now hopes to use "wealth effect" by promoting the stock market and housing prices, thereby boost the consumer confidences. Therefore, relevant government departments have recently introduced a series of policies aimed at stabilizing housing prices and the stock market. Nevertheless, we believe that the government needs to introduce more powerful policies to effectively improve consumer confidence in the face of pressure on the domestic economy and exports.

4. Market strategy

The US stocks plunged after Trump hiked tariffs on “Liberation Day”. Then the market rebounded remarkably after Trump postponed reciprocal tariff hikes. Currently, the stock prices of US stocks reflect the expectation that all parties can reach a trade agreement. We agree with the market judgment that a trade agreement can eventually be reached, but we believe that the process will be turbulent and even have setbacks. Therefore, considering that the US stocks have basically recovered from the Liberation Day plunge, we think that there is limited upside room for them. However, it is also unlikely that the market will make new lows, and most likely, the stocks will fluctuate within the price range formed during the past month.

Regarding the A-shares and Hong Kong stocks, we are more optimistic. Although the trade war will still disrupt the economy and the market, we believe that the Chinese government will prioritize stabilizing the stock market as an essential current policy goal. Therefore, it means that it is difficult for the stock market to experience a significant decline soon. The room for the stock market to rise will depend on further domestic economic stimulus and the progress of Sino-US trade negotiations in the future.

Our view on commodities is similar to that of US stocks. After the price recovered from the plunge in early April, there is limited upside room for commodity prices. Overall, the trend of metals is likely stronger than energy commodities.

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Straits Financial

Singapore (Global HQ)

Straits Financial Group
Straits Financial Services Pte Ltd

9 Temasek Boulevard #28-02 Suntec Tower Two
Singapore 038989

straitsfinancial.com
+65 6672 9668