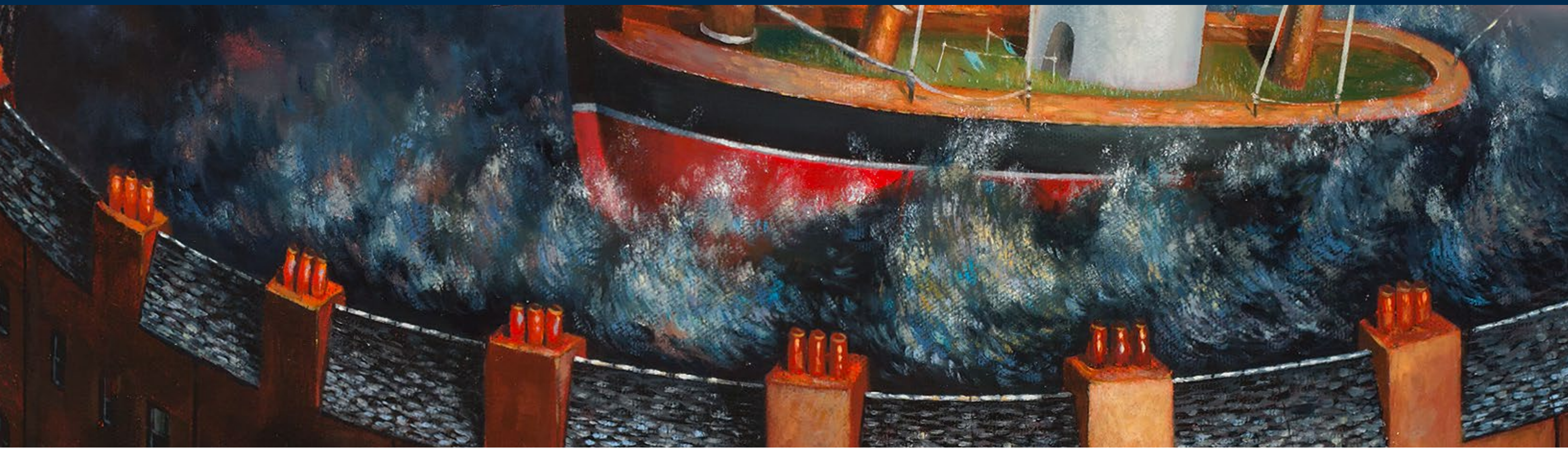
WALTER SCOTT



QUARTERLY THINKING

# TARIFF TEMPESTS

APRIL 2025

FOR USE BY INSTITUTIONAL INVESTORS ONLY. NOT FOR USE WITH THE GENERAL PUBLIC.

## KEY TAKEAWAYS

- Tariff uncertainty is creating significant challenges for companies and investors alike
- The scene is set for volatility in share prices and earnings
- Leading businesses will adapt and thrive – the current turmoil is providing opportunities for the long-term investor

*"By means of glasses, hotbeds, and hotwalls, very good grapes can be raised in Scotland, and very good wine too can be made of them at about thirty times the expense for which at least equally good can be brought from foreign countries. Would it be a reasonable law to prohibit the importation of all foreign wines, merely to encourage the making of claret and burgundy in Scotland?"*

**ADAM SMITH, THE WEALTH OF NATIONS, 1776**

It seems appropriate to begin this quarter's outlook with the expression "caveat lector". The moving feast that is the current tariff turmoil continues to confound all those trying to get to a definitive handle on its consequences. Equity markets have been on a wild and mostly downward ride as they digest the rapidly evolving events. The situation remains fluid, but it is clear that the imposition of tariffs and the on-off approach to their deployment, are depriving businesses and investors of much sought-after commodities – policy stability and certainty.

The initial Liberation Day announcement of draconian US reciprocal tariffs has given way to a relatively more tempered approach, with the President pressing the pause button for a 90-day period. The more flexible US stance towards their application is arguably indicative of their use as a bargaining cudgel to bring trading partners and frenemies alike to the negotiating table. However, even with this pause, US import tariffs still sit at a meaningfully higher level than those of the Trump v.1 and Biden era. There are hopes that through bargaining, the threat of reciprocal tariffs can be defused entirely, but does the Oval Office have the ability and indeed inclination to strike negotiated, complex trade deals with an array of countries in such a short space of time? It would appear that China is not quite ready for a fireside chat, although it has welcomed the postponement of tariffs on consumer electronics imports.

## TARIFFS R'US

The tariff barrage of the Trump administration represents something of a policy howitzer. It stress tests deep strands of interconnection in global trade that are difficult and costly to unravel. Although often diluted by national self-interest and political expediency, the world has broadly functioned on the principles of Ricardian comparative advantage. Proponents of globalisation point to its benefits in terms of promoting cost efficiency, lowering prices for consumers, fostering competition, and elevating the economies of developing nations.

But it has led to unfairness, according to successive US governments, with President Trump now seeking to rejig a system that has defined global trade since the 1980s. For the US, the tariff weapon is seen as a stimulant to foster a resurgence in domestic manufacturing, protect security interests, address trade deficits, and as a means of filling fiscal holes (theoretically), which would allow proposed cuts in taxes.

However, a reset in terms of trade, especially with China, comes at a cost. Investors are questioning the practicality and expense of replanting supply chains in the US, and are fearful of the impact of tariffs on inflation and on price and demand elasticity. It is the consumer and importer that pays tariffs, not the exporter. A shadow has been cast on US and indeed global growth.

## DIVORCING CHINA IS DIFFICULT

Ever since the first Trump administration, China has been in America's sights as a trading 'frenemy' and perceived security threat. The imposition of the current levels of US tariffs significantly ramps up the pressure on supply chains from China. Although now postponed, hefty reciprocal tariffs on South-East Asia also undermine efforts by Chinese (and US!) companies that have alighted on the region as a manufacturing platform. The US has also not been alone in targeting China. Although now negotiating minimum pricing, the EU sought to bolster its ailing car industry by imposing extra tariffs of up to 35% on Chinese car makers late last year. This is testament to the fact that in many spheres, China is moving up the value-added ladder.

Nonetheless, aside from the direct impact on China of tariffs, there are second-derivative effects on the Chinese economy in terms of the impact on global economic growth and trade. Mitigating these hits to the Chinese economy to some degree, are the ongoing fiscal and monetary stimuli. Key to reviving sentiment will be continued support for the property market, the travails of which have sapped consumer spending. China enjoys a massive trade surplus with the US, but Beijing has long seen the writing on the wall. The Global South now

accounts for a higher proportion of Chinese exports than G7 countries. However, tariffs represent a challenge to the developed and developing world alike, so this diversification will not insulate China from a downturn in global growth.

**EURO-TILT?**

Concerns over the US have partly been evident in the outperformance of some international markets since the start of the year, albeit returns in US dollar terms have been enhanced by the weakness of the 'greenback'. This tilt towards EAFE has also been due to some extent by the optical cheapness of international markets.

Europe, in particular, initially caught the attention of investors, helped by a faint glimmer of improving economic news. With the European Central Bank in loosening mode, signs of 'bottoming out' in parts of the region, and with defence spending on an upward trajectory, the economic prognosis for Europe seemed to be mildly improving. The current abandonment of Germany's notorious *Schuldenbremse*, or fiscal debt brake, now permits higher government spending, and initially provided a further fillip to investor sentiment. However, it is now likely that all bets are off in terms of the near-term prospects for the European economy.

One silver lining is that the spectre of tariffs should give current efforts to foster EU deregulation extra urgency and teeth. The EU wants to reduce the regulatory burden on businesses by 25%, and 35% for small-and-medium sized companies by, for instance, simplifying sustainability reporting rules. Any step to facilitate enterprise and growth is welcome.

**SLOW CHANGE IN JAPAN**

Japan's US reciprocal tariff reprieve comes at a time when the country is trying to 'normalise' its economy and monetary policy. In view of macro risks, the Bank of Japan kept interest rates steady at 0.5% in March, although central bank governor Kazuo Ueda remains of the view that the economy should continue to be weaned off monetary support as it transits to a non-deflationary environment. The trouble is that elevated inflation remains of the cost-push variety. While wages are rising, inflation is dampening real wage growth which is inhibiting sustained consumer spending growth.

However, the gradual tide of reform in Japan continues to manifest itself in the form of shareholder activism. Last year, Japan was the second-most active market for activist investing globally, according to Bloomberg. Perhaps a signal that activism is needed, but also a sign that investors think it's 'game on'.

For us, the bullish case for Japan or Europe has never been based on hopes of broad economic resuscitation. Rather, we see them as the domain of many leading companies in fields such as factory automation, specialised areas of technology, luxury and healthcare, that can compete and thrive globally, despite the travails of their home economies.

**ARE BAZOOKAS PRIMED?**

In the months ahead, markets are likely to experience further equity market volatility as the tariff saga unfolds. Can we expect the fiscal monetary cavalry to ride to some sort of rescue, or at least mollify the direst outcomes? The Federal Reserve currently appears reticent to reduce interest rates, mindful of inflationary pressures, although the European Central Bank has more scope to loosen monetary policy. Burgeoning budget deficits in the US and much of Europe, mean that bond market vigilantism could stalk debt markets in the wake of excess fiscal abandon. Indeed, the UK and France are seeking to reduce swollen budgets, although given the US dollar's status as the world's reserve currency, America has possibly more latitude. Tax cuts remain part of President Trump's agenda. However, concerns over debt and vulnerable business models are evident in the increase in junk bond spreads. Corporate financial strength is always vital, but never more so than in times of economic stress.

**TURBULENCE AHEAD**

In this volatile environment, Walter Scott's Research team is continuing to evaluate the potential impact of tariffs on each and every portfolio company. We are speaking with management teams and investment theses are being put through the mill of rigorous analysis and debate.

Ever since the protectionist bent of the first Trump administration, companies have been implementing strategies to help mitigate the impact of tariffs, through diversifying supply chains or relocating manufacturing facilities. However, the scale of potential economic and supply chain disruption remains uncertain in view of the unfolding tariff saga, with companies still evaluating its impact. It is likely that share prices and earnings will experience volatility in the near term.

**VOLATILITY = OPPORTUNITY FOR THE LONG-TERM INVESTOR**

It is important to not lose sight of the long-term in such an environment. A major, lasting reset in global trade has potentially profound consequences. Yet, in such periods of flux, opportunities arise for the bottom-up stock picker with a long-term investment horizon. In the last five years alone, companies have had to navigate the challenges of the Covid-19 pandemic, rising Sino-western trade tensions

and the war in Ukraine. Few businesses are immune from economic upheaval, but turbulent times separate the fundamentally robust from the weak, with leading businesses often strengthening their positions in times of disruption.

We remain optimistic over the long-term. This confidence stems not only from the rigour of our investment approach, but also from our belief that many of the world's best companies will continue to take advantage of trends that will outlast the current turmoil. The combination of market leadership, high profit margins, relative pricing power, a strong balance sheet with robust cash flows and the ability to adapt and innovate are always key attributes in terms of what we look for in a company. They are qualities that should come to the fore in these challenging times.

**ROY LECKIE**

Roy is Executive Director, Investment & Client Service at Walter Scott. Since joining the firm in 1995, he has held a range of investment, management, client service and governance responsibilities. Roy was integral to the development of the firm's emerging market capabilities, and he has played a central role in the stewardship of Walter Scott's global and international strategies since 2007. Roy joined the firm's Board in 2008 and is Co-Chair of the Investment Management Committee. He holds a BSc (Hons) in Statistics from the University of Glasgow.

## IMPORTANT INFORMATION

This article is provided for general information only and should not be construed as investment advice or a recommendation. This information does not represent and must not be construed as an offer or a solicitation of an offer to buy or sell securities, commodities and/or any other financial instruments or products. This document may not be used for the purpose of an offer or solicitation in any jurisdiction or in any circumstances in which such an offer or solicitation is unlawful or not authorised.

## STOCK EXAMPLES

The information provided in this article relating to stock examples should not be considered a recommendation to buy or sell any particular security. Any examples discussed are given in the context of the theme being explored.

WALTER SCOTT & PARTNERS LIMITED, ONE CHARLOTTE SQUARE, EDINBURGH EH2 4DR
TEL: +44 (0)131 225 1357 · FAX: +44 (0)131 225 7997
WWW.WALTERSCOTT.COM

Registered in Scotland 93685. Registered Office as above. Authorised and regulated by the Financial Conduct Authority.
FCA Head Office: 12 Endeavour Square, London E20 1JN · www.fca.org.uk

BNY | INVESTMENTS

*1.0_COM002319_21/04/2025*