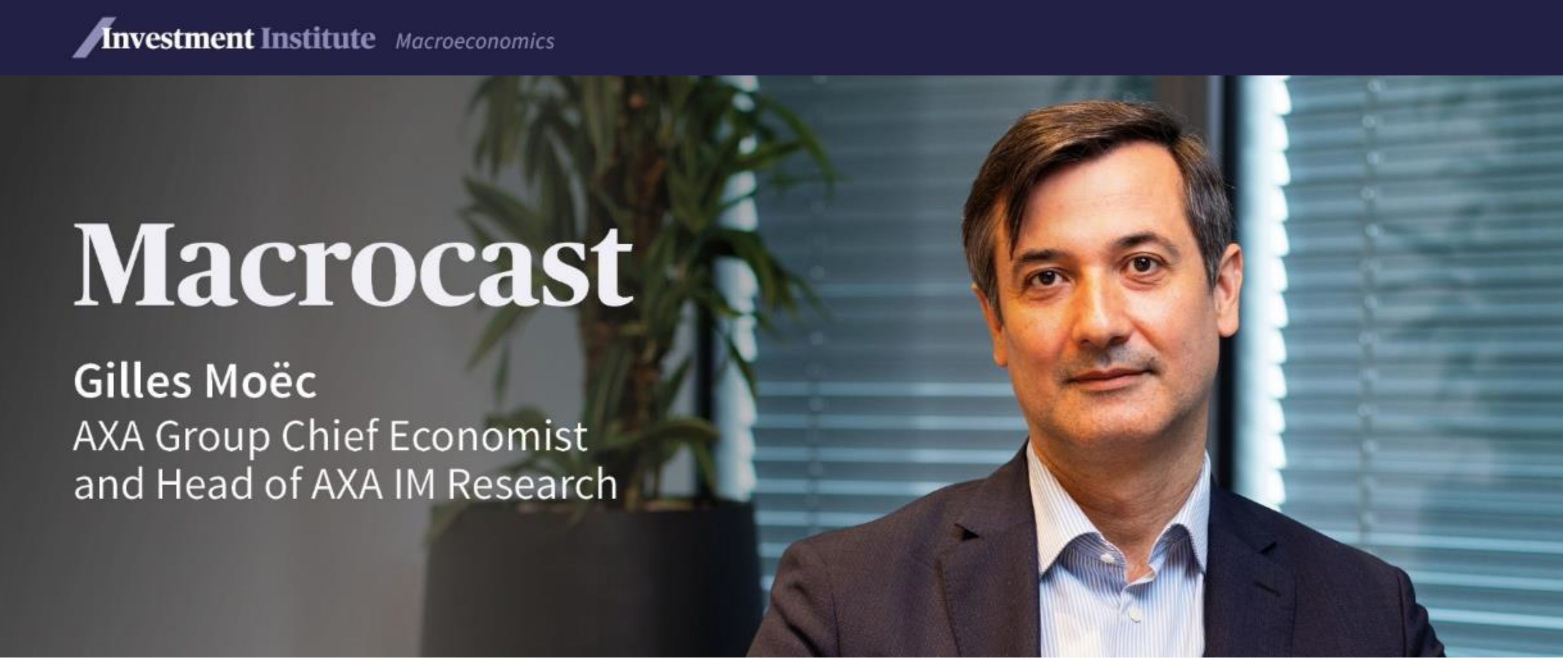
265 – 7 April 2025



Keep Calm and Carry On

- If US tariffs stay at their new level, both the US and the Euro area could experience a "brush with recession" in the second half of this year.
- It's not necessarily "1930 redux". A protectionist spiral can still be avoided.

After Liberation Day, US tariffs have been multiplied by 10 relative to the "pre-Trump" level. If they were to stay at their new level – i.e. if still elusive negotiations do not start and resolve quickly – the impact on consumers' purchasing power, corporate margins and hence investment could push the US economy into a brush with recession in the second half of this year. Beyond that point, a lot will depend on the Fed's appetite to accommodate the shock. While we have little doubt that, once clear signs of labour market deterioration appear, the Fed will resume cutting, we do not think it will necessarily go very far into accommodative territory. Long-term credibility matters to central bankers, and they will take the risk of over-reacting very seriously. This could trigger a more direct conflict between the White House and the central bank.

Europe will be hard hit as well. Even if the shock is smaller than in the US, the Euro area economy was already soft before Liberation Day and the additional hit on exports and confidence may also trigger a brush with recession later this year – with more space in our view for the ECB to accommodate though, as disinflation should continue. The key questions for Europe now revolve around retaliation. We think there is good argument for "readying" the retaliation measures without implementing them straightaway. If we are right and the US economy slows down quickly, this could change the political balance in the US, and if it is obvious that Europe bears no effective responsibility in this state of affairs, the "European case" could be stronger if/when negotiations start in earnest.

The US move on 2 April naturally draws attention to scary historical precedents, such as the Smoot-Hawley tariff of 1930 which prolonged the great depression and impaired global trade. However, the protectionist spiral of the 1930s was largely explained by the constraints of the Gold Standard. Governments today have more choice. If they keep their composure, there is still a space for the old, rule-based trade framework.

The US will hurt – a lot

The average effective average tariff levied on imports entering the US is now almost 10 times what it used to be before Donald Trump's election. It is also higher than the figure most often mentioned by the Trump team during the campaign last year: they were indicating 10% on everyone except for China (60%). The 60% target on China is almost hit (the 34% tariff announced last week comes on top of the 20% already implemented since D. Trump return to power), but on average the "reciprocal tariff" on other suppliers of the United States excluding Canada and Mexico is higher than 20%. When taking on board the tariff moves announced by the Trump administration before "Liberation Day," including those levied on Canada and Mexico, **the average tariff on all imports reaches 22.5% according to the Yale Budget Lab (see link here). In short, this goes further than anyone had expected, which explains the magnitude of the market reaction last week.**

Of course, in an optimistic reading, last week's announcements could be seen as an "opening gambit" to a negotiation with trade partners, but there is very little in the White House's communication so far pointing in this direction – apart from an offer from Vietnam to bring their own tariffs to zero, in a phone conversation qualified as "productive" by the White House. **The partners' immediate retaliation (China on all US products, Canada on cars) or planned retaliation (EU) makes it difficult to count on a swift "back-pedalling."** For now, we will take the announcements at face value to assess their macroeconomic impact.

Let's start with the US. Mechanically, **the change in tariff will lift consumer prices by more than 2% as roughly 10% of the US consumption basket is directly or indirectly imported**, as per the findings of the Boston Federal Reserve (Fed). Some of the shock on imported goods will be cushioned by margin compression at the exporter, wholesaler, or retailer level…but equally, domestic producers may be tempted to push their own prices thanks to the protection against foreign competition the tariffs will provide. There is a long list of side-effects to take on board. One, on the disinflationary side, is the **decline in oil prices**, in reaction to the expected fall in demand amid lower world growth. Between inauguration day on 20 January and last Friday, West Texas Intermediate (WTI) oil prices fell by 18%, which – using the Fed's old elasticity – would reduce consumer prices by around 0.5% within a year. All in all, in our preliminary new forecasts, we have pushed US inflation up by 1.2% cumulatively over 2025 and 2026 from baseline, to 3.6% and 3.8%, but this takes on board some feedback effect from a slower US economy. The initial price shock will be hard.

It is a pure supply-side shock: it will eat into consumers' purchasing power and trigger a contraction in spending. This will be magnified by the adverse wealth effects triggered by the decline in equity prices. According to the Federal Reserve model (FRB-US) a 10% decline in equity wealth reduces consumption by 0.3-0.5%. Corporate investment is also going to suffer. While in the medium-term, capex could be boosted by firms relocating production in the US, in the short run tariffs will deteriorate business margins, leaving less financial space for investment, while lower consumption and heightened uncertainty would in any case create a difficult environment for investment. Overall, **we have revised down our GDP forecast for the US for 2025 from 2.2% to 1.3%, with two quarters of marginal GDP contraction in the second half of 2025.**

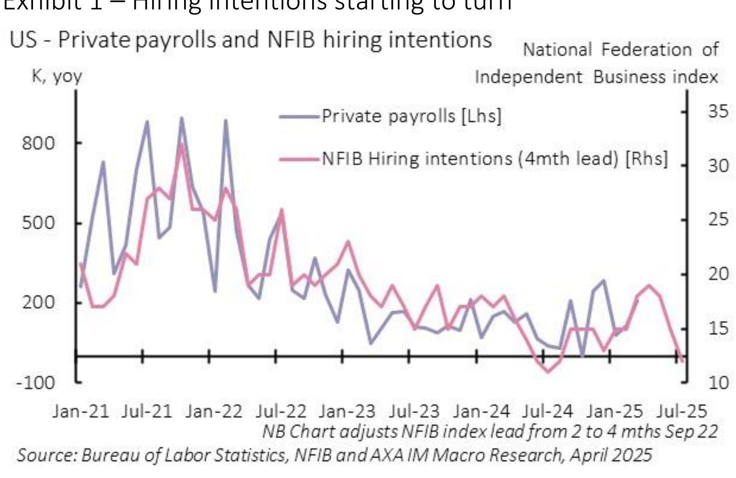
Unsurprisingly, given the high level of uncertainty, our level of confidence in this projection is low – even if this is in line with what we have seen from many sell-side houses after "Liberation Day". The tariff shock is so large – with no precedent in the US modern economy – that non-linearities will likely abound and we don't know at this stage how far the trade partners will retaliate, hence by how much we need to trim US exports, on top of the mechanical effect from lower foreign demand, as the rest of the world reels from the shock.

For 2026, the US economy will continue to feel the second-round effects of the shock but may benefit from a fiscal push which should emerge if the US administration manages to get Congress approval. The latter is however not certain, with first signs of dissent appearing, on the tariff issue, within the Republican caucus in the Senate. But **an even more fundamental issue will be the timing and extent of the support the Fed will be ready to provide.**

Jerome Powell – despite explicit calls from Donald Trump to resume cutting – kept his cards close to his chest in his speech last Friday, and we took some of his points as an attempt to correct the impression he had given the market at the last Q&A following the Federal Open Market Committee (FOMC) meeting. Indeed, at the time he had laid the emphasis on the possible transitory nature of a tariff-induced inflation shock. We had interpreted this as the sign he did not want to antagonize the White House too clearly. This time, he was more focused on the "persistence risk" in the way he phrased his answer: *"while tariffs are highly likely to generate at least a temporary rise in inflation, it is also possible that the effects could be more persistent*." In any case, he reiterated his point on the Fed not having to hurry to make decisions.

It is highly likely that the Fed will be reactive, and not pre-emptive: the FOMC will want to see signs of an actual deterioration of the labour market – which down the line will keep inflation from turning persistent – before resuming its cutting phase. It may not have to wait that long. We have been insisting on the divorce between the deterioration of consumers' perceptions of the labour market reflected in surveys and the reality depicted, for instance, in the Employment Reports. However, the latest NFIB survey – which has been doing a good job at predicting job creation – suggests that hiring intentions in the *business* sector – which were buoyant at the very beginning of this year – are also starting to turn (see Exhibit 1).

Exhibit 1 – Hiring intentions starting to turn



Source: Bureau of Labor Statistics, NFIB and AXA IM Macro Research, April 2025

Yet, timing is not the only issue. The magnitude of accommodation is another, and there, we are not certain that the Fed would be willing to go very far. Since the late 1970s, every Fed President has been dreading following the same path as Arthur Burns, who did not stand up to pressure from successive US Presidents and allowed inflation to get out of control. The Fed's dual mandate makes it difficult for the FOMC to ignore a rise in unemployment, but seasoned central bankers usually believe in establishing policy credibility on inflation as key to ensure full employment in the long term. While we think the Fed could cut by 100bps more than what we were expecting before "Liberation Day", we do not think they will take the risk of taking Fed Funds too far into accommodative territory. It is highly speculative at this stage, of course, but 2.50% – 50bps below the median estimate of the FOMC members for the long-term level of the policy rate – could be the right level. Indeed, we should not forget the state of play before Liberation Day: inflation was already on the strong side, no longer clearly converging towards the Fed's target. This will inform the FOMC members on the risks of providing too much support ahead.

If the Fed is only "mildly accommodative," we think the rebound of the US economy in 2026 could be slow, with annual GDP growth barely positive on an annual average basis (the base effects from the slight contraction in 2H 2025 would not help). This would be the price to pay to bring inflation fully back on target in 2027 and close the stagflationary episode as swiftly as possible.

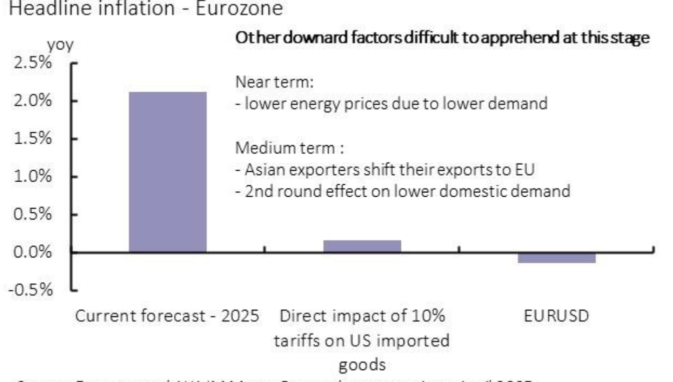
Such approach is likely to draw Donald Trump's ire, and his appointee to replace Jerome Powell as Chair of the Federal Reserve Board in May 2026 could be of a more dovish persuasion. We have however already made the point in Macrocast that this alone would not ensure a swift realignment of the Fed's stance, given its collegial decision-making (Jerome Powell himself would remain a member of the Board of Governors until January 2028). In any case, if the White House manages to strong-arm the Fed into an overly dovish stance, the ramifications for the US economy may not all be positive, with a risk of a rise in long-term interest rates.

Europe would be right to take its time on retaliation

Europe will be significantly hit. The loss of demand from the US – both as a direct consequence of the tariffs on the price of European products and the induced recession – will lower European exports. The effect will be magnified by the ongoing re-appreciation of the euro exchange rate. All this will have second-round effects on investment and employment. However, the slowdown in the real economy, lower energy prices and stronger euro should help speed up disinflation in Europe which would allow the European Central Bank (ECB) to continue cutting rates into properly accommodative territory. Such relief would however be unable to completely offset the demand shock. While the cumulative impact on GDP would be significantly smaller than for the US (-0.8% cumulatively over 2025 and 2026), the starting point for the Euro area economy was significantly lower than for the US: it was already barely growing before "Liberation Day". A mild recession in the second half of 2025 is probably unavoidable. The huge fiscal push in Germany will help, but the impact will not probably show before next year, while public finances in more fragile countries, including France, will suffer even more as the recession will eat into tax receipts.

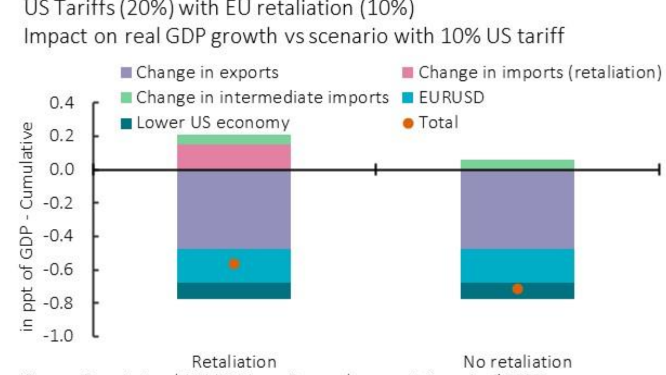
The key questions for Europe right now revolve around retaliations: whether to strike, and how far. We do not think the immediate reaction of the economy can be a good adjudicator here. If the European Union (EU) sticks to retaliate on goods only, a 10% tariff on US imports (we do not think the EU would go to a 1-1 response) would not move the dial much (see Exhibit 2). US goods – except for energy, which we think would remain exempt given the need of a substitute to Russian gas – do not play a critical role in European consumer prices. The effect would likely be swallowed by other factors (decline in oil prices, euro appreciation). Retaliation tariffs would lower Euro area imports, mechanically raising GDP a bit – all else kept equal (see Exhibit 3).

Exhibit 2 – Retaliation would not move the dial on inflation



Source: Eurostat and AXA IM Macro Research computations, April 2025

Exhibit 3 – Breaking down the growth impact



Source: Eurostat and AXA IM Macro Research computations, April 2025

But **retaliation – a negative sum game – should have a purpose**. They could be implemented to deter further action by the US. Everything is possible, of course, but given the magnitude of last week's shock, we do not think that another round of US tariffs is just around the corner. They could be a bargaining chip for a future negotiation. If this is the case, **the best course of action for the EU may be to "talk up" the possibility of retaliation, readying lists, setting up timelines, but abstaining to implement the measures for now**. Why wait, rather than "hit now" to show resolve? Because this would give time for the American political process to turn around. Indeed, if we are right and the US experiences a brush with recession in the second half of this year, the Republican party may start heaping pressure on the White

House to negotiate in earnest. **If the Europeans have not responded in kind by then, no one in the US will be able to accuse the EU of any responsibility in the US economic slowdown. We think it is an important card to play.**

Europe's energy could be put to better use by focusing on domestic policies shoring up growth at home as well as ensuring that the ripple effect of the US decisions on world trade is as contained as possible. Deepening the EU trade with Canada, sealing the deal with Mercosur, luring the UK back into a customs union with the EU and opening talks with other regions should also be part of the response. As much as the decisions from Washington last week remind everyone of the fateful choices in the 1930s which triggered a collapse in global trade, there is no automaticity here. There is still space for a cooperative, rule-based approach to trade.

It need not be 1930 again

Assessing whether the US decisions herald a proper protectionist spiral the world over is now key. **Historical precedents can be scary.** The "delta" in tariff announced last week is close to what was seen at the time of the infamous "Hawley Smoot" tariff of 1930, widely seen as having prolonged the Great Depression of 1929 as every country started retaliating not only against the US but also against each other.

It is however important to recognise the massive differences between the 1930s configuration for world trade and financial relations and today. **It was the interaction between trade and the Gold Standard (GS) which explained a lot of the spirals of the 1930s**. Indeed, under GS, a country with a trade deficit would mechanically face outflows of gold, reducing domestic money supply, thus forcing a tightening in financial conditions which could lead to recession (and increasingly so in the 1920s and 1930s, civil unrest). Protectionism was seen as a politically more "sellable" way to avoid generating current account deficits than restrictive policies… and protectionism in one country – raising the chances of deficits appearing in other countries – led the way to protectionism everywhere. Since the end of the GS, governments have more choice.

China will be decisive there. With a tariff now totalling close to 67%, between last week's "reciprocal" move of 34%, the 20% additional hike at the beginning of Donald Trump's second mandate and the legacy from his first term, Chinese products are now virtually excluded from the US market, and Washington has closed "back doors," e.g. by slapping a 46% tariff on Vietnam which had become a "hub" for transforming Chinese inputs into exports to the US. Beijing chose to immediately retaliate in kind against the US. The damage to the US is not going to be massive (US exports to China stood last year at only 0.5% of the US GDP) but the Chinese tariffs will still create some political headaches in some Republican strongholds in the mid-west (agricultural products account for a large part of these exports). Ultimately, the trade decoupling between the US and China will be complete. All this still leaves open the question of its attitude towards the rest of the world. Quite simply, it will have to choose between a cooperative and a non-cooperative strategy.

The cooperative strategy would entail upping its fiscal and monetary stimulus to boost consumer spending, at the cost of raising even further its already ballooning public debt. The uncooperative one would consist in devaluing its currency to help "dump" its products on non-US markets, especially Europe. This could in turn trigger some protectionist reactions from Europe (Ursula Van der Leyen was already clear on this last week). This would be a negative sum game and hopefully this risk will be taken on board by Beijing. The fact that, so far, China has not allowed its currency to depreciate after "Liberation Day" is reassuring.

The lure of the "old" cooperative trade system is valid beyond the economic superpowers. Vietnam provides an interesting example. The impact on the Vietnamese economy of the 46% tariff could be devastating. Using the data from the Vietnamese statistical office, exports to the US stood at 22.5% of GDP in 2023. The mechanical impact on exports of the 46% tariff will be to a large extent offset by a decline in imports from China. Still, given the magnitude of the dependence on the US market, the shock on GDP and employment will be tangible. In those cases, with very high

tariffs, non-linear effects are very likely: there are entire sectors of the economy for which exporting to the US which will simply become non-viable. Hanoi has responded by offering the US a complete removal of the tariff on US products (9.5%). So far, Vietnam has maintained a balance between the "Global South" and the West, choosing not to sign the joint declaration of the BRICS summit. In case of rejection of the offer by the White House, Hanoi could be tempted into a closer relationship with China and the "global south in general". This is however not the only possible avenue for Vietnam. The EU has also become a major destination of their exports, which in 2023 accounted for a bit more than 10% of their GDP. Wholeheartedly choosing "the South" against a "West" which is no longer as united as it used to be may not be in the best interest of Hanoi.

A point we developed a few weeks ago in Macrocast is that we should not mechanically focus on all-out "deglobalisation", with trade being reorganised around tight clubs, united more by political bonds than by any joint economic interest. There is still space for a loose, informal alliance of countries which, irrespective of their political choices, would rather stick to the "old", post-World War 2 cooperative framework for international trade, than regressing to a mercantilist, "everyone against everyone" approach. This will however take a lot of sang-froid from major players, China and the EU in particular. We however think this would be in their best interest.

Country/Region	What we focused on last week	What we will focus on in next weeks
	• Liberation Day. An est. 11.5ppt rise in the US effective tariff rate, varied across countries, raised tariff rate >20% and highest since 1909 • Stock markets fell by 4.4% the next day alone • Labour market (Mar) payrolls up 229k, above consensus in line with our view, unemployment stable at 4.2%, earnings rise soft at 3.8%yoy • ISM indices (Mar) mfg -1.3pt to 49.0 a 4mth low; svcs -2.7 to 50.8 and lowest since June	• Ongoing market reaction to tariffs • Any variation in tariff policy (pharma/chips) or deals • CPI inflation (Mar) to gauge underlying pace before tariff shock • PPI inflation (Mar) to gauge impact on PCE inflation • Continuing claims rose 3yr+ high, initial remain low • FOMC minutes (Mar) to better judge balance of perceived output/price risks from tariffs • U Mich sentiment (Apr, p) esp inflation expect's
	• Trump administration announced 20% tariffs on EU goods (excepted on pharma), to be implemented in coming days. Direct impact is worth an extra -0.5pt on GDP growth but will depend on EU retaliations • EMU inflation (Mar) came at 2.2%yoy, core at 2.4% (-0.2pt), down with early Easter impact • EMU unemployment rate (Feb) at 6.1% (-0.1pt)	• Comments from EU officials and national governments in response to US tariffs, potentially some retaliations already • EMU retail sales (Feb)
	• BoE consumer credit (Feb) dropped back to £1.4bn, from £1.7bn • BoE mortgage approvals (Feb) fell to 65.6K, from 66.0K, as impact of SDLT threshold fades • Nationwide house prices (Mar) unch on the month; yoy growth unch at 3.9% • Final PMIs (Mar) manu 44.9, from 46.9 in Feb. Serv 52.5, from 51.0. Comp. 51.5, from 50.5 • S&P construction PMI (Mar) rose to 46.4, from 44.6, still very weak	• RICS Residential Market Survey (Mar) look for a further drop back • Monthly GDP (Feb) look for a small rebound after the weakness in Jan. We see a 0.1% increase, reversing the previous 0.1% drop
	• Retail sales (Feb) up 0.5%mom. IP (Feb) up 2.5%mom more than reversing 1.1% drop in Jan. • Unemp rate (Feb) down at 2.4%, from 2.5% • Tankan (Q1) large manu. bal. fell to 12, from 14. Large non-manu. bal. up at 35, from 33 • HH spending (Feb) up 3.5%mom • Final PMIs (Mar) manu. fell to 48.4, from 49.0. Serv. fell to 50.0, from 53.7. Comp dropped to 48.9, from 52.0	• Av. cash earnings (Feb) look for slight fall in Feb due to base effects • Eco watchers survey (Mar) look to hit to confidence from trade uncertainty • Consumer confidence (Mar) edged up to 35.0, from 34.3 in Feb. • PPI (Mar) look for small mom increase
	• NBS mfg PMI (Mar) edged up to 50.5 from 50.2; Non-mfg PMI rose to 50.8 from 50.4 • Caixin mfg PMI (Mar) rose to 51.2 from 50.8; services PMI up to 51.9 to 51.4	• CPI (Mar) to rebound marginally from Feb's low • PPI (Mar) to narrow the decline further • Credit numbers for (Mar), key to watch HH and small business credit demand
	• CB: Colombia (unch 9.5%), Poland (unch 5.75%) • CPI (Mar, yoy): Thailand (0.8%), Peru (1.3%), Philippines (1.8%), South Korea (2.1%), Poland (4.9%), Turkey (38.1%) • Industrial production (Feb, yoy): South Korea (7.0%), Thailand (3.9%), Brazil (1.5%), Chile (-3.6%), Hungary (-8.0%)	• CB: India (25bp cut to 6.0%), Philippines (25bp cut to 5.5%), Romania (unch 6.5%), Peru (unch 4.75%) • CPI (Mar): Brazil, Chile, Colombia, Czech Republic, Hungary, Indonesia, Mexico, Romania, Taiwan • Industrial production (Feb): India, Malaysia, Mexico, Turkey

Upcoming events		
	US:	Tue: NFIB small business optimism (Mar); Thu: CPI (Mar), Initial jobless claims (w/e 5 Apr); Fri: PPI (Mar), Michigan consumer sentiment (Apr, p), Michigan inflation expectations (Apr, p)
	Euro Area:	Mon: Ge IP, Ez Retail sales (Feb); Thu: It IP; Fri: Sp HICP (Mar), Fr Moodys credit rating review, It S&P credit rating review, Sp Fitch credit rating review
	UK:	Mon: Halifax house price index (Mar); Thu: RICS Housing Survey (Mar); Fri: S&P credit rating review
	Japan:	Tue: Current account (Feb); Wed: Consumer confidence (Mar); Thu: PPI (Mar)
	China:	Mon: Foreign exchange reserves (Mar); Thu : CPI (Mar), PPI (Mar)

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**All figures, as at end of December 2024*

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