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Executive Summary

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Trade War Wages On - Knowns and Unknowns

Tariffs are a tax hike and, like many other taxes, the goal is not just revenue but also a change in behavior: "Buy American!" We have been talking about this shift toward economic nationalism and de-globalization for years. Tariffs forcibly accelerate this trend and are likely to cause some pain – you cannot change where your manufacturing plants are and what they make overnight. If your whole supply chain is onshore, you may have just gained more business or an ability to increase prices. However, many companies have complex supply chains and source and produce both within and outside of the US. We are in for a supply chain scramble as those businesses search for domestic sources of inputs and, when possible, shift production across plants. However, the US does not currently have the ability and capacity to produce every part and product needed, so a big part of the adjustment ahead of us is going to be in pricing.

Who Pays?

This question is far more complex than whose bank account the tariffs will be paid from. This is a question of pricing power. The burden will likely fall on a combination of 1) the company who produced the good abroad, 2) importers, 3) wholesalers, 4) retailers, and finally 5) consumers. There is no formula that will fit all cases, and the reality is that pricing conversations and trial and error will determine new prices on individual products. Substitutes are a big part of that equation – some goods may just be priced out of the market if it is cheaper for the end user to switch to a substitute good, or the existence of that substitute will at least limit how much the price can be shifted to the end user. Pricing with tariffs is likely to take a few months as this discovery process occurs, but prices will eventually settle down. While the net effect is not yet knowable, there are likely outcomes:

1) Consumers will alter spending patterns – some consumers will continue purchasing the same goods and services at new higher prices. However, faced with higher prices, many consumers may choose to forego discretionary products. Alternatively, they could cut back on their purchases or substitute with less expensive options.

2) Margin squeeze – the above effect means that some burden of the tariff will fall on businesses, potentially cutting into margins. We have been preaching the importance of driving efficiencies to protect margins for years, and this is even more important now

Communicating with your upstream and downstream business partners is critical. While the recent round of tariffs is larger than any modern precedent, keep in mind that businesses have experience adapting to price changes and supply shocks coming out of the pandemic. Many mapped out their supply chains, reduced complexity, and some already began onshoring. The period ahead will require grit and flexibility, but we would encourage you to keep a positive attitude and remember that we have those post-pandemic skills to lean on.

Our pre-tariff forecast already had inflation picking up later this year. Tariffs pose an upside risk to that outlook. The impact on the overall Consumer Price Index (CPI) will likely be blunted by the sizable services and housing components, which account for about 61% of the total. Additionally, energy prices were excluded from recent reciprocal tariffs, although they could still be tariffed under the existing fentanyl/migration IEEPA orders if they are not USMCA compliant. The impacts will likely show up faster and potentially more dramatically in individual commodity prices.

The Fear Factor

Business confidence and especially small-business optimism rose after the election uncertainty had passed, but these monthly data sources are too lagged to show us the tariff impacts. The stock market, while prone to volatility, gives us a clear indication that the market does not appreciate the rules of the game changing. The S&P 500 dropped to around 5000 in early April. Gold, which is typically seen as a hedge against risk, broke record highs into early April before turning down in recent days alongside the stock market selloff. US 10-Year Treasury Yields, another "safe haven," have seen increased demand and the resulting lower Yields. The financial markets are clear – fear is high.

"Don't Panic!" This catchphrase from The Hitchhiker's Guide to the Galaxy is sage advice for today as well. Running with the herd can feel safe, but you do not want to follow the herd off a cliff. The herd will have you buying high and selling low. Zoom out to your longer-term plans and the macroeconomic fundamentals. It is important to stick to your plans when volatility strikes. Do not let fear make your decisions.

The Broader Concern

As humans, we all want to know how all these individual changes add up as they impact both our personal and professional lives. With so many potential outcomes swirling about, it can be hard to wait for more definitive answers. The reality is that what businesses need for planning is stability.

While the probability of recession has increased, that does not mean a recession is certain or likely. We continue to expect mild growth for 2025, though growth could be slightly weaker for volume-based metrics due to tariffs. The economic fundamentals preceding the tariff volatility suggested a relatively healthy economy, and leading indicators were rising. While there was still some lingering discomfort from the post-pandemic price increases and low housing affordability, the consumer was still buying a record volume of goods and services. Corporations were bringing in record profits. There was some relief on interest rates, though they remain higher than many would prefer. The economy has a lot of momentum, as consumers still want to be able to improve their lives with new and higher quality products, businesses are still striving to create value and use resources efficiently, and investors still want to make a return on their money. Tariffs are a stumbling block but are unlikely to bring the economy to a screeching halt. We foresee a few different potential timelines:

Scenario One - Near-Term Volatility Passes, and Policy Stabilizes

Businesses and consumers will adjust to the new reality. Prices will increase over the course of a few months. Buying behavior will shift slightly as consumers potentially opt for substitute goods to manage higher prices. Markets with more exposure to tariffs or that are more discretionary will struggle. Domestic production will increase somewhat as capacity and input-availability allow, helping the overall economy grow gradually. In the near term and even medium term, the US will still need to rely on imports. Higher prices on imports could cause some demand destruction. While US producers will gain in some cases, wholesalers and retailers could struggle with higher import prices. Higher prices will push up on dollar-denominated metrics, but margin squeeze could hurt bottom lines.

Scenario Two - Prolonged Uncertainty

This is the more negative case. Uncertainty will cause some capex to freeze up. Consumer discretionary categories will suffer, especially if the stock market downturn and recovery are prolonged. The economy could stagnate this year, and the risk of a recession either later this year or in 2026 is heightened.

There could be many potential variations on those scenarios. The amount of the final tariffs matters and has yet to be settled, as negotiations are ongoing and retaliation is possible. How the Federal Reserve reacts could have a big impact as well – lower interest rates would provide some relief. Exchange rate fluctuations could also be a mitigating factor. Another major factor is the speed with which US producers are able to ramp up domestic capacity.

The Return of the Golden Screw Problem

The US is a powerhouse, but it is not set up to produce everything. For example, some mined materials are very geographically concentrated, and in other cases, we have opted to outsource the production of environmentally destructive processes to other countries. We run a trade deficit in most categories of manufactured products, but some industries are more exposed than others – take a look at the table below. That analysis and more are available in our recording of our March Summit on the topic of tariffs.

Apparel, leather, computers and electronics, and electrical equipment and appliances have an especially high reliance on imported goods. The US is more insulated on petroleum, paper, food, wood products, and nonmetallic mineral products. Even when we have domestic production capabilities, capacity may be insufficient to absorb a switch from imports to domestic production. Prepare for longer lead times at domestic producers. We cannot transform our manufacturing infrastructure overnight – that process will take time.

Exposure to imports is also highly individual to each company. Some domestic producers, assuming their upstream flow of inputs is not disrupted, could benefit from tariffs. For them, Christmas came early this year. However, many companies do have exposure to imports, and adjusting to tariffs will be a challenge.

Where Do Our Goods Come From?

Source: US Census Bureau

Imports by NAICS

*Total market estimated as shipments plus imports minus exports.

Commodity	Total Domestic Market* (Bil. $)	% Domestically Sourced	% Imported
Transportation Equipment	$1,314.7	62.4%	37.6%
Chemicals	$1,080.2	63.5%	36.5%
Food & Kindred Products	$1,004.7	88.3%	11.7%
Petroleum & Coal Products	$708.1	91.1%	8.9%
Computer & Electronic Products	$649.2	15.0%	85.0%
Machinery, Except Electrical	$538.5	54.0%	46.0%
Fabricated Metal Products, Nesoi	$476.8	79.3%	20.7%
Primary Metal Mfg	$377.8	64.7%	35.3%
Plastics & Rubber Products	$336.9	77.1%	22.9%
Electrical Equipment, Appliances & Components	$293.3	33.3%	66.7%
Beverages & Tobacco Products	$256.8	87.2%	12.8%
Miscellaneous Manufactured Commodities	$244.7	36.5%	63.5%
Paper	$210.8	87.3%	12.7%
Nonmetallic Mineral Products	$176.3	83.4%	16.6%
Wood Products	$175.6	85.8%	14.2%
Furniture & Fixtures	$121.7	63.5%	36.5%
Printed Matter And Related Products, Nesoi	$90.5	93.1%	6.9%
Apparel & Accessories	$86.6	3.9%	96.1%
Textile Mill Products	$45.7	47.9%	52.1%
Leather & Allied Products	$43.1	6.9%	93.1%
Textiles & Fabrics	$24.7	63.0%	37.0%
Total for Above Categories	**$8,256.7**	**65.5%**	**34.5%**

Go Entrepreneurial

Change is vital to economic growth – we need entrepreneurs to see the future first, find new ways to use resources, and take risks. One of the best ways to buck the business cycle is to develop new products or services. Being a leader in your industry will also allow you relatively more pricing power, which will become increasingly important as margins come under pressure in the years ahead. We encourage our clients to diversify into more recession-proof industries and to try to gain exposure, even if indirectly, to the service sector ahead of the 2030s.

If you are one of the businesses that is likely to benefit from tariffs, we urge you not to be complacent. It will take a lot of careful management to maximize the upside from tariffs. If you are unable to take on more capacity, you may lose out. Or, if you price yourself too high, substitute goods could blunt the upside benefit of tariffs.

Takeaways

1) Do not let fear drive your decisions in this volatile environment.
2) Prices will rise, and volumes could soften. Margin squeeze is likely – fight back with efficiency gains where possible.
3) Mild growth is still probable in 2025, though the risk of stagnation or recession has increased. We continue to run analyses on the policy situation as it evolves. Prolonged uncertainty is a major risk.
4) Relative exposure to imports varies by industry. Supply chain pressures will increase, and lead times may lengthen.
5) Approach tariff challenges with an entrepreneurial mindset.