

Possible Equity Market Implications of Trump Tariffs

On February 1, 2025, President Donald Trump announced significant tariffs on imports from Canada, Mexico, and China, marking a substantial shift in U.S. trade policy. The tariffs include a 25% levy on Canadian and Mexican goods and a 10% tariff on Chinese imports. This move is expected to have far-reaching implications for global equity markets, particularly in Europe and the Nordic region, as well as notable effects on currencies such as the euro (EUR), British pound (GBP), Norwegian krone (NOK), and Swedish krona (SEK).

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Impact on European and Nordic Equity Markets

The Nordics

Nordic countries, known for their open economies and significant trade with both North America and China, could experience similar challenges. Export-oriented companies in Sweden, Norway, and Finland might see reduced demand due to higher prices and potential trade barriers, leading to a reevaluation of earnings forecasts and possible declines in stock valuations.

The Nordic markets, particularly Sweden and Norway, could face unique challenges due to their small, open economies and reliance on exports.

Swedish Equity Market: Sweden's economy is highly dependent on exports, particularly in the industrial and technology sectors. Companies like Volvo, Ericsson, and SKF could experience reduced demand if global trade slows. Additionally, a weaker Swedish krona (SEK) could lead to increased import costs, adding inflationary pressure.

Norwegian Equity Market: Norway's economy is driven by energy exports, particularly oil and gas. While tariffs may not directly impact energy markets, broader trade tensions could slow global growth, reducing demand for Norwegian exports. A weaker Norwegian krone (NOK) could cushion some of the impact, making exports more competitive but also increasing inflation risks.

Currency Volatility: Both the SEK and NOK are considered small, less liquid currencies, making them more vulnerable to risk-off sentiment in global markets. If trade tensions escalate, investors may shift capital away from these currencies, causing depreciation and increasing the cost of imported goods.

Interest Rate Implications: The central banks of Sweden (Riksbank) and Norway (Norges Bank) may need to adjust their monetary policies in response to currency weakness and inflationary pressures, potentially delaying rate cuts or even hiking rates to stabilize their currencies.

Effects on European Equity Markets

European equity markets are also likely to experience turbulence due to the impact of Trump's tariffs.

Key areas of concern include:

Export-Driven Industries: Many European companies, particularly in Germany and France, rely on exports to both the U.S. and China. If global trade slows due to tariffs, sectors such as automobiles, industrial machinery, and luxury goods could face declining revenues.

Supply Chain Disruptions: European firms with supply chains that involve China may experience increased costs for imported components, similar to their U.S. counterparts.

Inflationary Impact: If tariffs lead to broader inflationary pressures, the European Central Bank (ECB) may have to reconsider its monetary policy trajectory, potentially delaying interest rate cuts or adjusting financial conditions.

Market Volatility: Uncertainty regarding global trade could increase volatility in European stock markets, particularly in sectors sensitive to global demand, such as technology, industrials, and consumer discretionary stocks.

Currency Effects: A stronger U.S. dollar due to higher U.S. interest rates could impact European firms by making their exports more expensive in global markets, further pressuring margins.

Currency Implications

Euro (EUR): The euro may experience increased volatility as investors assess the impact of tariffs on the Eurozone economy. A potential slowdown in economic activity could lead to a depreciation of the euro against other major currencies.

British Pound (GBP): The UK's significant trade relationships with both the EU and the U.S. place the pound in a sensitive position. Uncertainty stemming from the tariffs could lead to fluctuations in the GBP, especially if the UK becomes involved in trade disputes or negotiations.

Norwegian Krone (NOK): Norway's economy, heavily reliant on oil exports, might be indirectly affected by global trade tensions impacting oil demand and prices. The NOK could face depreciation pressures if global economic activity slows.

Swedish Krona (SEK): Sweden's export-driven economy makes the SEK vulnerable to trade disruptions. A decrease in exports due to tariffs could lead to a weakening of the SEK as investors seek safer assets.

Impact on U.S. Equity Markets

The announcement of these tariffs may introduce volatility into U.S. equity markets. Major indices, including the Dow Jones Industrial Average and the S&P 500, might experience declines as investors reacted to potential disruptions in supply chains and increased costs for businesses reliant on imported goods. Sectors such as automotive, technology, and consumer goods, which are heavily dependent on international trade, are particularly vulnerable. Companies within these industries may face compressed profit margins due to higher import costs and potential retaliatory tariffs from affected countries.

Impact on the 10-Year Treasury Yield

The tariffs may also influence the bond market, notably affecting the yield on the 10-year U.S. Treasury note. Investors, seeking safer assets amid equity market volatility, could increase their demand for government bonds, leading to a decrease in yields. However, the potential for higher inflation resulting from increased import prices could counteract this trend, as investors may demand higher yields to compensate for anticipated inflationary pressures. The net effect on the 10-year yield will depend on the balance between risk aversion driving demand for Treasuries and inflation expectations pushing yields upward.

Inflationary Implications

The imposition of tariffs is expected to exert upward pressure on inflation. Higher costs for imported goods are likely to be passed on to consumers, leading to increased prices for a range of products. Essential items, including food and automobiles, may see noticeable price hikes. Economists warn that this could push inflation rates above the Federal Reserve's 2% target, potentially eroding consumer purchasing power and impacting overall economic growth.

Conclusion

The newly imposed U.S. tariffs are poised to introduce uncertainties into global markets. European and Nordic equity markets may face headwinds due to disrupted trade flows and increased costs, while regional currencies could experience heightened volatility. Investors are advised to monitor developments closely and consider strategies to mitigate potential risks associated with these trade policy changes.

However, there is also a positive side. While the newly imposed U.S. tariffs in Canada, Mexico, and China introduce inflationary pressures and market uncertainties, there are several potentially positive aspects to consider:

Stronger Domestic Industries: Higher import costs may encourage reshoring of manufacturing, benefiting U.S.-based producers and boosting domestic job creation.

Resilient Equity Markets: Despite initial volatility, markets have historically adapted to trade policy shifts, with companies finding ways to mitigate cost pressures and maintain profitability.

Selective Equity Opportunities: While some sectors may face challenges, others—such as industrials, commodities, and domestic-focused firms—could benefit from tariff-related shifts in demand.

Stronger Negotiation Leverage: The tariff policy may serve as a bargaining tool in future trade negotiations, potentially leading to better long-term trade agreements that benefit global markets.

Although near-term inflationary pressures and rising yields pose challenges, investors with a long-term perspective can find strategic opportunities in domestic industries, fixed-income assets, and resilient equity sectors.

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Why Will the Newly Imposed U.S. Tariffs on Canada, Mexico, and China Affect Inflation and Possibly Increase Treasury Yields?

The tariffs imposed by the U.S. on Canada, Mexico, and China on February 1, 2025, are expected to have inflationary effects and influence Treasury yields in multiple ways. The key mechanisms at play involve higher import costs, supply chain disruptions, and changing market expectations regarding inflation and Federal Reserve policy.

Impact on Inflation: Higher Costs Passed to Consumers

Increased Prices for Imported Goods

The U.S. relies on imports from Canada, Mexico, and China for essential goods, including automobiles, electronics, industrial components, and consumer products.

A 25% tariff on Canadian and Mexican goods and a 10% tariff on Chinese imports will increase costs for U.S. businesses that depend on these imports.

Businesses will pass on these higher costs to consumers, raising prices for goods and services.

Example:

If a car manufactured in Mexico costs \$30,000 and faces a 25% tariff, the new cost could rise to \$37,500.

Consumers will bear these higher costs, leading to consumer price inflation.

Supply Chain Disruptions Leading to Cost-Push Inflation

Tariffs disrupt global supply chains, making it harder for companies to source materials efficiently.

Delays and shortages in supply chains increase production costs, which again are passed on to consumers.

This cost-push inflation occurs when higher production costs lead to higher overall prices in the economy.

Retaliatory Tariffs Could Further Drive Up Inflation

Canada, Mexico, and China are likely to retaliate with tariffs on U.S. exports, making U.S. goods more expensive abroad.

This could hurt U.S. businesses, forcing them to raise domestic prices to offset lost export revenue.

Retaliatory measures may increase commodity prices, particularly in agriculture and manufacturing.

Impact on Treasury Yields

Inflation Expectations Push Bond Yields Higher

Inflation erodes the real return on bonds, meaning that bond investors will demand higher yields to compensate.

The U.S. 10-Year Treasury Yield is particularly sensitive to long-term inflation expectations.

If inflation rises, bond markets anticipate rate hikes by the Federal Reserve, causing Treasury yields to rise.

Example:

If inflation expectations rise from 2% to 3%, investors might demand a higher yield on the 10-year Treasury to maintain a positive real return.

Federal Reserve Response: Potential Rate Hikes

The Federal Reserve targets inflation at 2%, and if tariffs push inflation above this target, the Fed may raise interest rates to cool inflation.

Higher interest rates make newly issued bonds more attractive, driving up yields on existing Treasuries.

The market prices in future rate hikes, leading to an immediate jump in bond yields.

Increased Government Borrowing Costs

Rising bond yields mean the U.S. government will face higher costs when issuing new debt.

Given the U.S. fiscal deficit, any rise in borrowing costs could further complicate budgetary concerns.

Potential Counteracting Factors: Demand for Safe-Haven Assets

While inflation concerns may push yields higher, increased trade uncertainty could drive investors into safe-haven assets like U.S. Treasuries.

If global markets react negative over trade disputes, demand for Treasuries may increase, which could lower yields.

The net effect on yields will depend on whether inflationary pressure outweighs the flight-to-safety effect.