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FIRST ANALYSIS

News or events that may affect your investments **February 3, 2025**

Global Investment Strategy Team **Global Securities Research Team**

Investing in an era of global policy by tariffs

Key takeaways

- New U.S. tariffs on Canada, Mexico, and China deepen a new era of global policy by tariffs, and they likely portend an ongoing noisy and confusing backdrop for investors.
- Through the noise, we remember that any global policy success through tariffs is likely to come with a domestic economic and inflation cost that should keep the process gradual and transactional.

What it may mean for investors

- As a less predictable policy environment creates volatility across capital markets, we favor looking for buying opportunities based on our 2025 Outlook, which anticipated new rounds of tariffs as policy.

Deeper into the era of global policy by tariff

On February 1, 2025, President Trump announced 25% tariffs on all Canadian imports and a lower 10% tariff on Canadian oil and gas imports. The order included a 25% tariff on all imports from Mexico and added a 10% tariff on all imports from China.[1] We expect U.S. Customs and Border Protection and other officials to implement these within days. Canada hit back immediately with 25% tariffs on $106 billion in U.S. exports, notably fruit and alcohol. Mexico and China also pledged retaliation, but China stopped short of tariffs.[2] By taxing imports from other countries, U.S. tariffs raise U.S. inflation but tend to lower profits and economic growth. Typically, each new tariff introduces a one-time cost increase to importers that bring the taxed goods to market in the U.S. The importer may be a firm from another country, a U.S. firm that buys from overseas, or a U.S. firm that imports from its own factories overseas.

1. "U.S. Tells Canada of New Tariffs as Trump's Threatened Trade War Escalates," The Wall Street Journal, February 1, 2025. Presidential authority to impose tariffs can come from various laws: Section 301 of the Trade Act of 1974 allows the president to investigate and retaliate against countries that unfairly limit commerce with the U.S. Section 232 of the Trade Expansion Act of 1962 gives the president power to adjust imports if they threaten national security. President Trump used both powers in 2018 and 2019. The International Emergency Economic Powers Act is the fastest path to universal tariffs but has not yet been tested in the courts for unilateral enactment because it would require consulting Congress before enacting.
2. Ibid.

The president has made clear several priorities for these tariffs. First, China has the largest trade surplus among U.S. trading partners. He wants China to buy more from the U.S. and to stop using unfair trade practices (for example, government subsidies to exporters) to gain an advantage over competing U.S. firms. He also alleges that China has broken its 2020 Phase One trade deal with the U.S.[3] Ultimately, Trump says he wants to spark a manufacturing renaissance in the U.S. In the meantime, he expects tariff revenue to offset tax cuts he is planning with Congress.[4] In addition, he wants Canada and Mexico to tighten their borders with the U.S., limit immigration, and interdict fentanyl flows to the U.S.[5] Finally, Canada and Mexico send three quarters of their exports to the U.S., and tariffs to leverage this dependency may be Trump's way to prepare these countries to negotiate a new North American trade deal in 2026.[6]

The theme of tariffs for global policy negotiation is becoming more entrenched. President Trump's latest moves start gradually and focus on countries where his strongest leverage and high-priority goals intersect. Some of those goals relate to China, Canada, and Mexico, and tariffs leverage their dependence on U.S. imports. But it is still a negotiation. A 10% tariff on China's goods is significant but far below the previously threatened 60% levy, suggesting additional, incremental tariffs. And the latest tariffs may message Europe and Asia to buy more U.S. natural gas or face possible U.S. tariffs.[7] Trump may be turning up the heat to gradually boil the frog of his various priorities.

Yet, trade policy is unlikely to move in a straight line. We have no complete and final set of country targets, amounts, timing, and breadth of goods to be covered by any future tariffs. We do expect some limited economic and sector-specific effects from the latest tariffs. However, while a gradual tariff approach develops, we are maintaining the conviction behind our 2025 Outlook report.[8] Specifically, the financial-market positives we expect from deregulation and tax-cut extensions, along with the organic strength of the U.S. economy, should outweigh the negatives of (gradual) tariffs and deportations. As we explain in detail below, we favor risk assets (commodities and equities) and would extend maturities in fixed income.

Investor implications of the latest tariffs

We can illustrate the several factors that we will be watching for tariff impacts on the economy and specific equity sectors:

Economic growth and inflation: We expect these latest tariffs to create U.S. macroeconomic impacts that align with the targets we published in our 2025 Outlook report. Our outlook recognizes the negative economic impact of tariffs and deportations but counts deregulation, tax-cut extensions, solid consumer spending, and a healthy labor market collectively as a larger positive. A more aggressive and universal tariff approach is possible and would materially raise our inflation expectation and lower our economic growth forecast. But the latest tariffs suggest a targeted and gradual approach that also avoids derailing the domestic economy.

A look at the sectors that tariffs would affect shows the potential value of investor selectivity. Table 1 shows that U.S. imports from Canada and Mexico concentrate in machinery and energy, and so we consider next the potential impacts for the S&P 500 Industrials, Materials, and Energy sectors.

3. Wendy S Cutler, "Trump Wants a Trade Deal, Not a Trade War. He May Get One." The New York Times, January 31, 2025.
4. Jarrett Renshaw, David Morgan, and David Lawder, "Trump push to use tariffs to pay for tax cuts faces opposition," Reuters, January 22, 2025.
5. Ibid.
6. Ibid.
7. Stephen Stapczynski, "Trump again calls for EU to buy more US energy to avoid tariffs," Bloomberg, January 20, 2025.
8. Wells Fargo Investment Institute, "2025 Outlook: Charting the economy's next chapter," December 10, 2024.

Table 1. U.S. principal imports from Canada and Mexico, January 2024 – November 2024

Top U.S. imports from Canada	In billions of U.S. dollars	Percent of U.S. imports from Canada	Top U.S. imports from Mexico	In billions of U.S. dollars	Percent of U.S. imports from Mexico
Oil, minerals	**$119.9**	**37%**	**Nuclear reactors, boilers, machinery**	**$89.8**	**25.4%**
Vehicles	**$31.7**	**9.8%**	**Electric machinery**	**$74.8**	**21.1%**
Nuclear reactors, boilers, machinery	**$24.7**	**7.6%**	**Vehicles**	**$55.8**	**15.7%**
Plastics	**$12.3**	**3.8%**	**Optical, medical instruments**	**$20.9**	**5.9%**
Electric machinery	**$8.9**	**2.7%**	**Oil, minerals**	**$15.7**	**4.4%**

Sources: Wells Fargo Investment Institute, Bloomberg, U.S. customs international trade data by U.S. census. Data as of January 31, 2025.

Industrials equity sector: We reiterate our favorable guidance on this sector and on the Multi-Industrials[9], Aerospace & Defense, and Commercial & Professional Services sub-sectors. Automotive and machinery both source large amounts of low-end components as well as some final assembly across North America. In the short term, we assess that soft underlying demand and continued inventory reductions create weak pricing power. Any tariff impact probably would fall on gross margins for the companies with the greatest exposure to imports. Eventually, we expect product markets to strengthen and allow most companies to pass tariffs to final buyers dollar for dollar, even after currency fluctuations. Historically, there has been a modest lag (measured in quarters) in capturing this price, and it can take a longer period to recoup this on a margin percentage basis. Meanwhile, the Rail Transportation sub-industry derives a meaningful percentage of revenue from both Mexico and Canada, and impediments to trade could have a modest negative impact on cross-border volumes in the near term.

In sum, we do not believe the latest tariffs will spark a broader inflation cycle in these goods but, if sustained, these tariffs (and any new ones or added countries) pose price inflation, a volatile path for gross earnings margins, and downside return risks in the coming quarters. Further ahead, U.S. companies could defer expansion plans. It is also plausible that some processes ultimately could relocate to the U.S. Our favorable areas all feature some combination of 1) strong industry and margin structure to blunt cost headwinds; 2) end-market diversity, including exposure to areas with secular growth, such as data centers; and 3) a U.S.-heavy orientation in terms of supply chain or revenue mix. We will address potential single-stock impacts as necessary in our Investment Rationale updates.

The Materials equity sector: We retain our neutral sector rating (that is, holding at market-cap weight). Within the sector, we remain favorable on Specialty Chemicals and neutral on Metals & Mining. We retain our favorable rating on the Commodities asset class and look for commodity metals and energy prices to move higher. We also expect tariffs to impact steel immediately. U.S. Census Bureau data show that the U.S. imports roughly 25% of its total steel consumption, with Canada and Mexico combined representing about 40% of total imports (10% of total U.S.

9. Multi-Industrials includes the Industrial Conglomerates, Electrical Components & Equipment, Industrial Machinery & Supplies & Components, and Trading Companies & Distributors sub-industries.

consumption). The latest tariffs should provide producers higher selling prices, but any retaliatory tariffs from Canada or Mexico could offset any benefit to U.S. steel producers from the U.S. tariffs.

Specialty chemicals manufacturers generally have less import-export activity but prefer to manufacture outside the U.S. and sell products into the local markets. However, second-order effects from tariffs and trade conflict may reduce demand for their products both domestically and abroad. We expect basic commodity chemicals to be most at risk from tariffs, while specialty chemicals manufacturers can likely pass along most (if not all) the tariff-related price increase due to the highly specialized nature of their products, which tend to be difficult to substitute.

The Energy equity sector: We remain favorable on the Energy sector and on Integrated Oil but unfavorable on Refining. A symbiotic relationship exists between Canadian oil producers and U.S. refiners. In October 2024, Canada exported 87% of its production to the U.S., primarily by pipeline and rail, according to Statistics Canada. October 2024 U.S. Energy Information Administration data show Canadian crude oil exports to the U.S. at roughly 4 million barrels per day, accounting for 60% of total U.S. crude oil imports. (Mexican heavy crude accounts for a further 11%.) Logistically and geographically, Canadian producers cannot practically route their crude oil to other countries.

Not all crude oil is created equal, however, and most U.S. refiners blend imported Canadian heavy crude oil with lighter domestic oil, for the molecular properties needed across a range of refined products. We do not see an opportunity for the U.S. refining complex to replace Canadian supplies with lighter domestic crude oil at scale without major operational disruption. Heavy crude sources from the Middle East offer neither economically nor politically good options.

Neither side seems to have much alternative. We would expect the Canadian producers and U.S. refiners to split the 10% tariff cost and that this would narrow U.S. refining margins and raise gasoline prices. Integrated oil companies may feel a negative impact from their exposure to both U.S. refining operations and Canadian oil production, although we would expect much less of a hit to earnings due to their broadly diversified nature. Lastly, if a U.S.-Canada trade conflict escalates, Canada might decrease its oil production as a retaliatory measure. This would magnify the negative impact on U.S. refining margins and likely raise gasoline prices further.

Investment implications

News stories with tariff policy twists and turns are common, but we prefer to look through the details to the destination, which we believe is more tariff threats, and across more countries, but not so many enacted. This is not undiluted optimism but the thread running through all our analysis above — namely, that any global policy success through tariffs is likely to come with a domestic cost that we expect will keep the process gradual and transactional.

Still, after two years of tightening credit spreads and rising equity valuations, tariffs could push market volatility higher across interest rates, equities, and currencies. As tariff-related volatility arises, we favor adding to our favored positions, as follows:

Fixed income: Tariff-related inflation should raise bond yields but give the Federal Reserve further reason to pause its interest-rate cuts as fixed-income investors demand greater compensation for the inflation risk. The initial knee-jerk reaction to tariffs may be volatility, but we expect the 10-year U.S. Treasury yield to remain within our year-end target range of 4.50% – 5.00%. We reiterate our preference to extend maturities, especially away from money-market funds and other short-term instruments.

The U.S. dollar: Tariffs tend to strengthen the dollar against competitor currencies, which benefits U.S. companies that import but harms multinational companies and those that export.

Equities: We believe that solid economic growth will drive earnings and an S&P 500 Index target of 6500 – 6700. As we saw above, other countries count more on trade than the U.S. does. Tariffs leverage that dependence and so reiterate our preference for U.S. equities over international markets. Meanwhile, generally stronger margins and greater flexibility to policy changes also favor U.S. Large Cap Equities over smaller companies. At the sector level, we continue to favor those sectors that should benefit from economic growth, including Financials, Energy, Industrials, and Communication Services. What's more, our analysis above shows that selectivity within sectors may avoid those industries that are more vulnerable to the international or domestic consequences of tariffs. Among the top 20 companies in the S&P 500 Index Industrials sector by market capitalization, for example, only a minority have significant exposure to supply chains from Mexico.

Commodities: We remain favorable. Oil and gasoline prices are likely to rise somewhat after the tariff on Canadian oil. Metals imports from Canada, Mexico, and China also should rise in price, increasing export costs and possibly inhibiting supply. Additionally, uncertainty over international retaliatory tariffs appears to be reinforcing the bid in gold prices.

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Each asset class has its own risk and return characteristics. The level of risk associated with a particular investment or asset class generally correlates with the level of return the investment or asset class might achieve. **Stock markets**, especially foreign markets, are volatile. Stock values may fluctuate in response to general economic and market conditions, the prospects of individual companies, and industry sectors. **Foreign investing** has additional risks including those associated with currency fluctuation, political and economic instability, and different accounting standards. These risks are heightened in emerging markets. Investments that are concentrated in a specific **sector** or industry may be subject to a higher degree of market risk than investments that are more diversified. **Bonds** are subject to market, interest rate, price, credit/default, liquidity, inflation and other risks. Prices tend to be inversely affected by changes in interest rates. The **commodities** markets are considered speculative, carry substantial risks, and have experienced periods of extreme volatility. Investing in a volatile and uncertain commodities market may cause a portfolio to rapidly increase or decrease in value which may result in greater share price volatility.

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