Q&A with Investment Strategy
US and China Reach A Trade Truce

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90-DAY AGREEMENT MARKS DE-ESCALATION, BUT SOME QUESTIONS REMAIN

The US and China have announced a trade deal that significantly reduces tariffs on both sides, at least temporarily. This amounts to a meaningful de-escalation of the trade war that originally dates back to the first Trump administration and escalated sharply earlier this year. While tariffs will remain elevated, at least for the next 90 days they will no longer be at embargo-type levels. In the meantime, negotiations continue. There are still some question marks, but the big picture is that today's news is positive for the US and global economy, as well as equity markets.

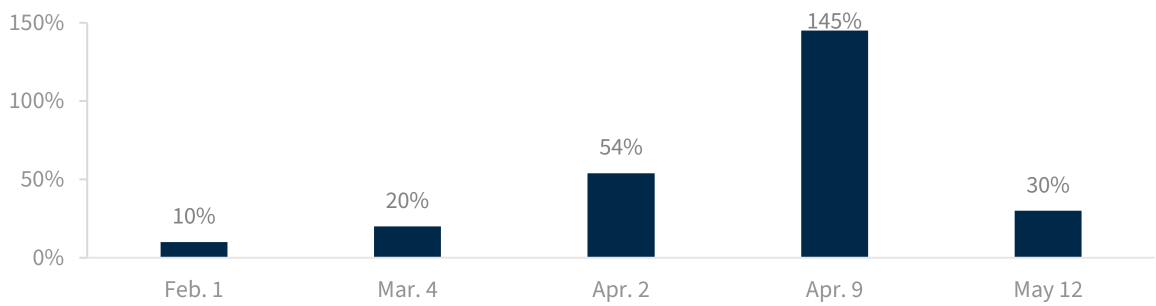
WHAT DID THE US AND CHINA ANNOUNCE TODAY?

Following talks over the weekend between their economic policy teams, the US and China have agreed to significantly reduce tariffs on each other's products. The US tariff on most imports from China comes down from 145% to 30% (includes a 20% tariff related to fentanyl, plus a 10% base-line tariff on all imports), and likewise, the Chinese tariff on most imports from the US decreases from 125% to 10%. This is a 90-day deal, aimed at providing sufficient time for a longer-term, more comprehensive agreement. The most important point is that the new tariffs—30% and 10%—will enable the resumption of relatively normal trade between the world's two largest economies. For the past five weeks, US-China trade plummeted due to tariffs that were so high that they amounted to embargoes (in other words, outright trade bans) in all but name.

WHAT IS THE BACK STORY BEHIND TODAY'S DEAL?

Let's take a step back and recall the history of the US-China trade war. The trade war originated in 2018, during President Trump's first term, though it became mostly a moot point during the COVID pandemic. Tensions continued to simmer at a low level during the Biden administration. After Trump returned to the White House, he almost immediately (February 1) announced a 10% tariff on China, ostensibly aimed at punishing China for allowing fentanyl trafficking. On March 4, this fentanyl tariff was doubled to 20%. On April 2, as part of the broad-based rollout of what the White House called 'reciprocal tariffs', the reciprocal tariff on China was unveiled at 34%. Stacked on top of the fentanyl tariff, the total became 54%. After markets around the world plummeted in the following week, on April 9 the White House issued a 90-day pause on tariffs on everyone except China to 10% but raised China's to a total of 145%. Throughout this time, China's retaliation generally mirrored US actions, so that by April 9 the retaliatory tariff reached 125%.

As a technical point: the tariff rates shown below are separate from sectoral tariffs—steel/aluminum, autos, and (expected to come soon) pharma and semiconductors—which apply to imports from all countries. Sectoral tariffs are stacked on top of country-level tariffs.



US Tariff Rates on China

Source: White House

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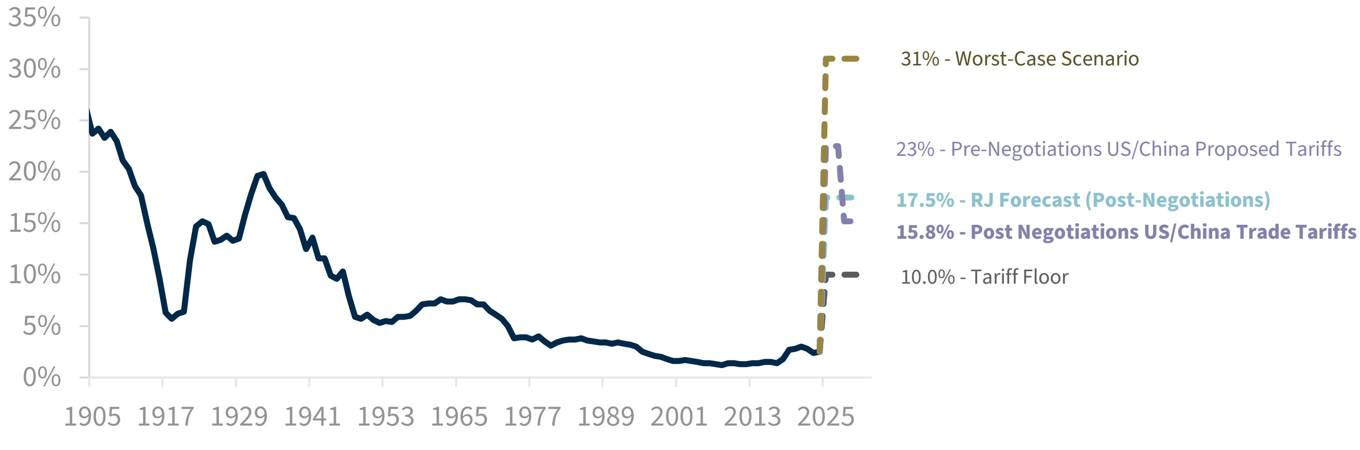
HOW DOES THIS CHANGE OUR VIEW ON THE US ECONOMY?

As we mentioned earlier, tariff rates above 100% rendered much of US-China trade practically unworkable over the past five weeks, and this was evident in the sharply lower volumes of marine shipping between the two countries. Given that China is the third-largest source of US imports—accounting for 14% of US imports in 2024—the disruption in trade could have led to actual product shortages (i.e., empty shelves) the longer the trade war dragged on. Today's news alleviates fears of such a scenario. Likewise, export-centric US industries, such as aircraft manufacturers, LNG producers, and soybean farmers, are breathing a sigh of relief that they will be able to resume sales to China. It remains to be seen whether, and how quickly, Chinese purchases of these US products may get back to pre-trade war levels.

The not-so-good news is that even 30% is still a very hefty tariff on China, looked at by pre-Trump standards. A key question mark is whether that 30% will continue after the next 90 days. In that same context, let's recall that July 8 is the deadline for trade deals with everyone other than China. Last week's deal with Britain maintained a 10% tariff, and that's despite the fact that the US has a trade surplus with Britain. It stands to reason that long-term tariffs with some countries may be higher than 10%, given that the US has a trade deficit with most other countries.

Given the latest announcement, the estimated proposed tariffs will be reduced from 22.5% to 15.8%. While significant progress has been made, in particular with China, many questions remain about the tariffs delayed until July 8 on several other countries, supporting our view that ultimately the effective tariff rate may settle around 15 to 17% level—nearly as high as during the infamous Smoot-Hawley tariff era of the 1930s. In the meantime, the trade-related question marks will continue to feed into a high level of uncertainty among consumers and businesses alike. For this reason, we maintain our view that US GDP will grow approximately 1% in 2025, with the probability of a recession at 50%.



Source: Tax Foundation

WHAT ARE OUR LATEST THOUGHTS ON EQUITIES?

Markets reacted positively following the trade deal: the S&P 500 gained ~3% today and is now up ~16% from the recent lows set on April 8. The rally today is unsurprising given the reduction in tariffs on China to 30% was much better than the anticipated 60+% heading into the weekend meeting. This has alleviated severe downside risks for the economy and corporate earnings, providing a somewhat better, though not optimal, level of clarity for business planning. The question now is: with the S&P slightly above our year-end target of 5,800, is the market poised to break out to all-time highs? We do *not* think so, for a few reasons.

Valuations Remain Expensive | Despite recent volatility, equity valuations remain expensive vs. historical levels. At ~24x, the S&P 500's trailing 12-month PE is in the 91st percentile over the last 20 years. With weaker economic growth estimates as compared to the start of the year (our forecast of ~1% vs. +2.4%), the prospect of slightly hotter inflation, and broadly the same level of interest rates, we see limited room for multiple expansion from current levels. Therefore, earnings will need to be the driver from here. This is consistent with history, as multiples typically compress during the third year of a bull market.

Headwinds For Earnings Are Still Intact | Since the start of the trade war, we reduced our 2025 earnings estimate for the S&P 500 from $270 to ~$250-255. The reason for this was two-fold: 1) reduced economic activity would weigh on sales growth; and 2) tariff-related costs would pressure margins. When calculating our earnings estimate, we used a weighted average tariff assumption of 15% as we expected the initial severe tariff levels to be negotiated downward. As mentioned earlier, we still look at the mid-teens as a reasonable assumption for ultimate destination of the weighted average tariff rate. Assuming GDP growth of ~1%, we still feel comfortable with S&P 500 earnings at $250-$255. This equates to a ~4% downward revision from the current consensus estimate of $264. These downward revisions will likely weigh on the equity market over the coming months.

The past month's rally in the equity market is justified as the most severe tariff impacts have been taken off the table. However, in the face of still-high uncertainty and building economic headwinds amid a weighted average tariff rate that may be ~5x higher versus the start of the year, we maintain our year-end of 5,800 for the S&P 500. As a result, we expect limited near-term upside in the equity market overall and volatility to remain elevated. However, there is room for individual sectors (most notably our favorite sectors of info tech, industrials and health care) to outperform.

WHAT ARE OUR LATEST THOUGHTS ON BONDS?

Treasury yields have pushed higher as risk assets have recovered as trade tensions de-escalate between the US and China. As noted earlier, concerns about the economic outlook have eased, and market expectations for Fed rate cuts have been pared back considerably. Over the past two weeks, nearly two Fed rate cuts have been priced out in 2025—the market now expects only 2 cuts this year—and market expectations for the Fed's next rate cut is now not expected until September. This hawkish repricing has put upward pressure on Treasury yields since the start of May, with the policy-sensitive 2-year yield back to ~4%, and the 10-year Treasury yield up to 4.45%.

While recent trade developments are a step in the right direction, the ultimate destination for tariffs is still much higher from where it was at the start of the year. This should pose headwinds for the economy, which the Fed will respond to later this year. However, until the hard economic data starts to turn decisively lower, the 10-year Treasury is likely to remain in its recent 4.0%-4.6% range.

THE BOTTOM LINE

The US-China trade deal is the latest case study of the White House walking back its tariff agenda, thereby alleviating worst-case fears for the economy and markets. This explains why the S&P 500 has posted healthy gains since bottoming in early April and is nearly back to where it started the year. That said, there are still plenty of question marks vis-à-vis trade with China and other key trading partners. While encouraging developments, our views have not changed. We still expect the US economy to narrowly avoid a recession, with no change to our 4.25% 10-year Treasury or 5,800 S&P 500 year-end forecasts.

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Source: FactSet

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