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Investment Institute Macroeconomics

Monthly Op-ed

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Beyond Tariffs

Key points

- Despite concessions, the trade war still entails a very large shock for the US economy. Meanwhile, the budget proposals currently going through Congress would significantly lift fiscal deficits and add to the "risk premium" now embedded in US assets
- Less risk free
- Yields on credit attractive
- Equity valuations a concern

It's – a bit – calmer on one front, but another one is heating up

The US equity market rejoiced in the de-escalation of the trade war with China. Yet, a 30% tariff hike on China would still be a hard pill to swallow for the US economy, especially as the agreement with the UK the previous week suggested that it would be difficult to expect a rate below 10% on any country hit by reciprocal tariffs. The weighted average tariff – assuming the 30% rate on Chinese products becomes permanent and the specific add-ons for other countries are suspended beyond the end of the 90 days negotiation phase, due to expire in July, but still taking on board the 25% specific hit on steel, aluminium and cars – would still rise by some 15 percentage points, reaching its highest level since the Hawley-Smoot days of 1934, and still enough to lift US inflation by roughly 1.5%.

This is of course better than the 30% hit after Liberation Day and the further escalation with China, but still a very large shock. We suspect the equity market is also responding to a potential shift of the White House's focus away from trade to more business-friendly matters, such as de-regulation and tax cuts. This may however be a double-edged sword.

The House of Representatives Budget Committee approved on 18 May a tax legislation titled "The One, Big, Beautiful Bill" (OBBB). The bulk of the bill is about prolonging the Tax Cuts and Jobs Acts (TCJA) provisions due to expire, but there are "enhancements" which would lift business profitability in the US. The cut in the headline corporate tax rate from 21% to 15% – a campaign proposition – has gone out, but accelerated amortisation schemes, for instance for R&D efforts conducted in the US, and tax breaks for opening new factories, would still reduce the overall corporate tax bill. There would also be gains for households. While the OBBB does not go as far as to exempt social security pensions from income tax – another campaign pledge – senior citizens would still benefit from a specific exemption of USD4,000 a year. Interests on car loans would also become deductible (for cars made in the US). In line with the campaign promises, tips and overtime would become tax exempt.

While equity investors may understandably focus on what the bill would mean for the “bottom line”, bond investors are more concerned about the further deterioration in the US budgetary trajectory. The Yale Budget Lab has estimated the impact of the OBBB (see link here). Their conclusion is that the Bill in its current form would cost USD3.4trillion over 2025-2034 and USD5tn over the same period should the temporary measures of the OBBB made permanent. It is probably easier to read this in terms of deficit to GDP ratio: according to the Yale Budget Lab estimates, the OBBB would bring the US deficit to 8% of GDP by 2034 (if made permanent) and 7.2% (if only temporary), bringing public debt in a 120/130% of GDP range. This is despite the abolition of most Inflation Reduction Act (IRA) tax incentives, which goes beyond electric vehicles but will also affect projects in renewable energy.

Getting a House vote would not be the end of story. Since the Republicans are using the reconciliation process to avoid filibustering, the same legislation needs to be agreed by the Senate and the House. Some Republican Senators have already voiced their intention to modify the House’s draft. If a modified version is voted by the Senate, a conference would need to be set jointly with the House, and any compromise legislation resulting from such conference would still need to be voted in the same terms by both the House and the Senate.

Moody’s decision to downgrade the US sovereign may have come at the right time to push Republican Senators into a less spendthrift fiscal stance. If a compromise is found at the House’s Budget Committee to overcome the hawks’ opposition, a full House floor vote is targeted for 26 May. If successful, this would then go to the Senate. The aspirational deadline for the finalisation of the process is 4 July, but there could be numerous obstacles on that timeline. We note that the Treasury has been warning about the exhaustion of the “extraordinary measures” by August. Irrespective of the agreement on the full bill, in any case the debt ceiling will have to be pushed again by then.

There is a component of the OBBB which is of particular relevance for non-US investors: section 899 of the bill would levy an incremental tax of 5% every year (up to a maximum of 20%) on financial income generated in the US accruing to residents of foreign countries imposing “unfair” taxation on US companies. The definition of such “unfair” practices is wide: on top of the OECD sponsored Under-Taxed Profits Rule – basically the minimum global 15% corporate tax – this would also cover Digital Services Taxes, implemented in several EU countries and in the UK, which the US considers as weighing disproportionately on US Tech companies. This could be one of the issues at stake in the Congressional negotiations, given its potentially counter-productive aspects. Indeed, what it could ultimately amount to is a reduction in the real rate of return on US assets held by non-residents. This would be close to the ideas put forward by Stephen Miran intended to trigger a depreciation of the US dollar with the risk – explicitly recognized by Miran himself – that US funding costs rise further. A bit like with tariffs, the US would ultimately penalise its own economy when trying to punish overseas stakeholders. Such tax on overseas holdings of US assets would also run counter one of the stated objectives of the tariffs, i.e. attracting investment in the US territory.

What is different about “fiscal noise”, compared to “trade noise”, is that Europe is better insulated against contagion risks. So far, the European bond market has remained largely immune to the “bad winds” blowing from America. The European Central Bank (ECB)’s readiness to provide enough accommodation at a difficult juncture for the European economy is increasingly clear. Even prominent hawks – such as the Governor of the National Bank of Belgium – are now openly accepting the need to bring the monetary stance into accommodative territory. This will help protect the European bond market, especially if the US is about to “shoot itself in the foot” with a withholding tax.

Say what you see

Moody’s decision to reduce the US’s credit rating cemented the loss of America’s AAA status, following similar adjustments by the other two main rating agencies in recent years. The decision was unsurprising, especially in the context of recent developments, but it did crystallise the concerns that investors have. The Moody’s press release cited the US’s deterioration in fiscal performance and a belief that current budgetary proposals will fail to reverse the multi-year increases in government debt and interest ratios.

Investors have faced an increase in economic policy uncertainty this year while the cyclical growth and inflation outlook has also deteriorated. Trust in the US has crumbled and there has been talk of disinvestment from US financial assets – or at least a decline in net inflows. In 2024, according to the Bureau of Economic Analysis, net foreign acquisition of US assets totalled more than $2tn. Federal Reserve (Fed) data suggests foreign investors bought around $580bn of US Treasury securities, roughly a third of total issuance. Foreign buying of equities and corporate bonds remains equally important.

Rising borrowing premium

The US dollar's reserve asset status is a necessity given the huge current account deficit and the constant acquisition of dollar assets by the rest of the world. But for it to be a "privilege" depends on foreigners having trust in the insititions, the economy, and the political process. Donald Trump's administration's actions have weakened this trust. The compensation for that means investors need to be paid more for holding US assets. Hence the rise in US Treasury bond yields relative to those of other countries. The spread between 10-year US and German government bonds has increased in recent weeks and looks set to top 200 basis points (bps) again soon, even with the market expecting more German government bond issuance in the years ahead. In fact, on most dimensions, risk premiums are increasing. The yield curve is steepening (risk premium rising with the maturity of debt) and the gap between Treasury yields and swap rates continues to trend higher. None of these moves have been particularly dramatic but those who invest in US Treasury securities may be impacted by ongoing relative underperformance. At the very least, unless cuts to federal spending can be meaningful, investors will be faced with significant new and refinancing issuance from Washington in the next few years.

But corporates do better

Much of the concern about the dollar's role in global finance reflects policy concerns. Corporate risk premiums have remained stable, reflecting the US economy's underlying strength. In that respect corporate credit appears to be relatively sound. Corporate credit spreads did spike higher on the initial concerns about tariffs, but have since narrowed. The current spread on investment grade and high yield indices sits at around the 10th percentile of the range of the last 20 years. Spreads are tight, reflecting what remain solid underlying fundamentals for corporate bond issuers. However, on a yield basis, the market is attractive with yields sitting in the 60th to 70th percentile of the range. For now, any perceived deterioration in the creditworthiness of the US government has had little impact on corporate borrowing. Issuance remains healthy and demand strong. The balance of underlying interest rate levels and corporate spreads in the total yield of corporate bonds is better than for some time.

But stocks are exceptional

What may be more concerning is the equity market. Consensus forecasts for S&P 500 earnings suggest a price-earnings multiple of between 22 and 23 times for 2025 and just shy of 20 times for 2026. On the basis of the 2025 earnings forecast, the earnings yield is almost exactly the same as the 10-year Treasury bond yield and some 75bp lower than the average yield on the corporate bond investment grade index. The cyclically-adjusted price-earnings ratio is almost back to record highs and the stock market capitalisation/GDP ratio – a measure liked by retiring Berkshire Hathaway boss Warren Buffett – is as high as it has ever been. If bond yields move higher on concerns about fiscal policy and Fed independence, equity valuations will look even more extreme.

The mitigating argument to these valuation concerns is that the US has higher structural earnings growth, deeper capital markets which allow more of corporate America to become listed, and has a leadership role in information technology which, given the rapid growth in artificial intelligence applications, will not only be a source of potentially exceptional growth but also boost overall US productivity. These are valid US equity performance supports. However, are they valid enough to justify an ongoing excess valuation of US equities – in aggregate – to markets in the rest of the world? Foreign investors have to balance having exposure to strong earnings and new technologies against the risks of higher funding costs and the potential for a prolonged decline in the US dollar's value.

High value, low returns?

There are arguments that valuation alone is not a great predictor of future returns. However, it can be useful in the context of changing fundamentals. Taking a *Buffett Indicator* measure of market capitalisation vs. GDP, comparing that to its own trend and then to subsequent five-year equity returns in the US does point to a relationship. Currently, market cap is around 30% to 40% above its long-term trend for the US market. Historically, that has been associated with five-year annualised total returns of -5% to +5%. Annual total returns of close to 25% from the S&P 500 for the last two years are unlikely to be continued.

Equity returns might not be directly impacted by the US credit rating. However, if it means higher borrowing costs through an increased risk premium in long-term yields and if it impacts on net marginal foreign inflows, it could. The narrative this year has revolved around tariffs and the President's view of the job being done by the Fed Chair Jerome Powell. It will soon turn to the budget and markets will need to assess the importance of higher deficit numbers and rising interest costs on debt sustainability.

These are issues hinted at by Moody's and being discussed in investment committees around the world. A scenario of valuation adjustments in both US equity and Treasury markets (lower returns from both) should be under consideration. Under a slightly more bearish scenario, the concerns about public debt will transfer to private debt given the potential for crowding out and the risk that higher real rates disrupt cashflows from weaker borrowers in both public and private credit markets.

The current geopolitical and economic outlook is fraught with uncertainty. Investors have enjoyed very good returns from equities, and credit markets have begun to generate decent income again. However, rising debt and protectionism do not augur well for investors over the remainder of this decade with concerns likely to remain focussed on the US. Risk-adjusted returns look more attractive in other regions and the realignment of global trade and political alliances could herald an improved relative performance in Europe, Asia – as a result of China – and other emerging markets in the years ahead.

Download the full slide deck of our May Investment Strategy

Macro forecast summary

Real GDP growth (%)	2024	2025*		2026*	
	AXA IM	AXA IM	*Consensus*	AXA IM	*Consensus*
World	3.3	2.6		2.4	
Advanced economies	1.6	1.1		0.6	
US	2.8	1.2	1.4	0.5	1.7
Euro area	0.9	0.7	0.9	0.5	1.2
Germany	-0.2	-0.2	0.1	0.2	1.3
France	1.1	0.4	0.6	0.6	1.0
Italy	0.5	0.3	0.5	0.2	0.8
Spain	3.2	2.4	2.5	2.0	1.9
Japan	0.1	0.8	1.0	0.9	0.7
UK	0.9	0.9	0.7	1.1	1.1
Switzerland	1.3	0.7	1.1	1.0	1.5
Canada	1.3	1.6	1.0	0.6	0.8
Emerging economies	4.2	3.4		3.4	
China	5.0	4.3	4.5	4.0	4.2
Asia (excluding China)	5.4	4.4		4.6	
India	6.7	6.3	6.3	6.1	6.5
South Korea	2.1	0.4	1.3	2.0	1.9
Indonesia	5.0	4.5	4.9	4.9	5.0
LatAm	2.4	1.8		2.0	
Brazil	3.4	1.9	1.9	1.8	1.7
Mexico	1.5	0.0	0.2	0.8	1.4
EM Europe	3.3	2.1		2.0	
Russia	4.1	1.5	1.7	0.9	1.2
Poland	2.9	2.8	3.3	2.9	3.2
Turkey	3.2	3.0	2.9	3.4	3.4
Other EMs	2.8	3.2		3.7	

Source: Datastream, IMF, Bloomberg and AXA IM Macro Research – As of 21 May 2025
**Forecast*

CPI Inflation (%)	2024	2025*		2026*	
	AXA IM	AXA IM	*Consensus*	AXA IM	*Consensus*
Advanced economies	2.6	2.7		2.4	
US	2.9	3.2	3.2	3.2	2.3
Euro area	2.4	2.0	2.0	1.7	2.0
China	0.2	0.4	1.3	0.6	1.6
Japan	2.7	2.9	2.0	1.5	1.7
UK	2.5	3.2	2.3	2.0	2.0
Switzerland	1.1	0.2	1.0	0.5	1.0
Canada	2.4	2.4	2.1	2.6	2.1

Source: Datastream, IMF, Bloomberg and AXA IM Macro Research – As of 21 May 2025
**Forecast*

These projections are not necessarily reliable indicators of future results

Forecast summary

Central bank policy Meeting dates and expected changes (Rates in bp / QE in bn)										
		Current	Q2-25	Q3-25	Q4-25	Q1-26	Q2-26	Q3-26	Q4-26
United States - Fed	Dates	4.50	17-18 Jun	29-30 Jul 16-17 Sep	28-29 Oct 9-10 Dec	27-28 Jan 17-18 Mar	28-29 Apr 16-17 Jun	28-29 Jul 15-16 Sep	27-28 Oct 8-9 Dec
	Rates		unch (4.50)	-0.25 (4.25)	-0.50 (3.75)	-0.50 (3.25)	-0.25 (3.00)	unch (3.00)	unch (3.00)
Euro area - ECB	Dates	2.25	05-juin	24 Jul 11 Sep	30 Oct 18 Dec	5 Feb 19 Mar	30 Apr 11 Jun	23 Jul 10 Sep	29 Oct 17 Dec
	Rates		-0.25 (2.00)	-0.50 (1.50)	-0.50 (1.00)	unch (1.00)	unch (1.00)	+0.25 (1.25)	+0.25 (1.50)
Japan - BoJ	Dates	0.50	16-17 Jun	30-31 Jul 18-19 Sep	29-30 Oct 18-19 Dec	Jan Mar	May June	Jul Sep	Oct Dec
	Rates		unch (0.50)	+0.25 (0.75)	unch (0.75)	unch (0.75)	unch (0.75)	unch (0.75)	unch (0.75)
UK - BoE	Dates	4.25	19-juin	7 Aug 18 Sep	6 Nov 18 Dec	5 Feb 19 Mar	30 Apr 18 Jun	30 Jul 17 Sep	5 Nov 17 Dec
	Rates		unch (4.25)	-0.25 (4.00)	-0.25 (3.75)	-0.25 (3.50)	unch (3.50)	unch (3.50)	unch (3.50)
Canada - BoC	Dates	2.75	04-juin	30 Jul 17 Sep	29 Oct 10 Dec	Jan Mar	May June	Jul Sep	Oct Dec
	Rates		unch (2.75)	-0.25 (2.50)	unch (2.50)	-0.25 (2.25)	unch (2.25)	unch (2.25)	unch (2.25)

Source: AXA IM Macro Research - As of 21 May 2025

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Our Research is available on line: www.axa-im.com/investment-institute

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AXA IM manages approximately €879 billion in assets*, of which €493 billion are categorised ESG-integrated, sustainable or impact. As an established player in responsible investing, we adopt a pragmatic approach with a view to provide long-term value to our clients, our employees and the broader economy.

Part of the AXA Group, a worldwide leader in insurance and asset management, AXA IM employs over 3,000 employees and operates from 24 offices in 19 countries globally.

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

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