GLOBAL
Insight

February 2025

Wealth Management

Perspectives from the Global Portfolio Advisory Committee

Tariffs' leverage extends far beyond trade

Tariffs can have many economic impacts, but we think investors should focus on the economic and political goals that are driving decision-making.

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Produced: Feb. 4, 2025, 14:48 ET; Disseminated: Feb. 4, 2025, 15:30 ET

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All values in U.S. dollars and priced as of market close, Jan. 31, 2025, unless otherwise stated.

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RBC'S INVESTMENT

Stance

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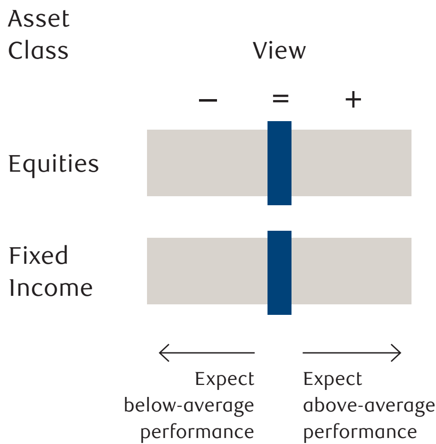

(+/=/–) represents the Global Portfolio Advisory Committee's (GPAC) view over a 12-month investment time horizon.

+ Overweight implies the potential for better-than-average performance for the asset class or for the region relative to other asset classes or regions.

= Market Weight implies the potential for average performance for the asset class or for the region relative to other asset classes or regions.

– Underweight implies the potential for below-average performance for the asset class or for the region relative to other asset classes or regions.

Source - RBC Wealth Management

Equities

- Rising bond yields, stretched U.S. equity valuations, and Washington policy uncertainty conspired to weigh on equity markets globally in the first half of January. Most regional equity indexes resumed their uptrends in the second half of the month as bond yields declined on softer U.S. inflation numbers.
- Though we believe investors will have to navigate higher volatility in 2025, new highs for the U.S. and some other equity markets are possible so long as the well above-average consensus U.S. earnings growth estimates can be reached. This is a tall order, in our view, but the resiliency of the U.S. economy may well facilitate this. However, recent tariff announcements related to Canada, Mexico, and China, along with tariff risks for other major U.S. trading partners, make the economic outlook more complex and uncertain.
- In our view, portfolios should stay committed to equities up to but not beyond their long-term targeted exposure. Investors should be ready to take advantage of opportunities that may arise from higher volatility.

Fixed income

- Global bond yields remained largely steady in Q4 2024 and into early 2025, with the average yield on the Bloomberg Global Aggregate ex-USD Index hovering around 2.7%. The same can't be said for U.S. yields, where the average yield on the Bloomberg U.S. Aggregate Bond Index jumped to nearly 5.0% from a low of 4.2% at the start of October. January saw a bit of a relief rally after cooler inflation data, and we think the bulk of the rise in yields has already occurred. A hawkish Fed meeting in December, with policymakers seeing far fewer rate cuts in 2025 on renewed inflation risks, drove the move, while global central banks appear largely on track to proceed with policy rate easing this year.
- In the U.S., we maintain our Underweight position in U.S. Treasuries. We maintain a Neutral outlook for global developed bonds as other central banks continue to lower policy rates.
- We reiterate our Market Weight stance on U.S. fixed income with yields remaining above multi-decade averages. Credit valuations remain historically rich, which leads us to modestly favor sovereign bonds over corporate bonds, though economic optimism in the U.S. should continue to support rich valuations and, therefore, we remain comfortable with credit exposure and the excess income it provides over comparable Treasuries.

MONTHLY
Focus

Tariffs' leverage extends far beyond trade

"Form," as Louis Sullivan famously remarked, "follows function." He was speaking of architectural design principles, but we think it's a salutary reminder for policy analysis as well. When it comes to investing, we need to look beyond the labels politicians slap on ideas and focus on the economic realities that are driving decision-making.

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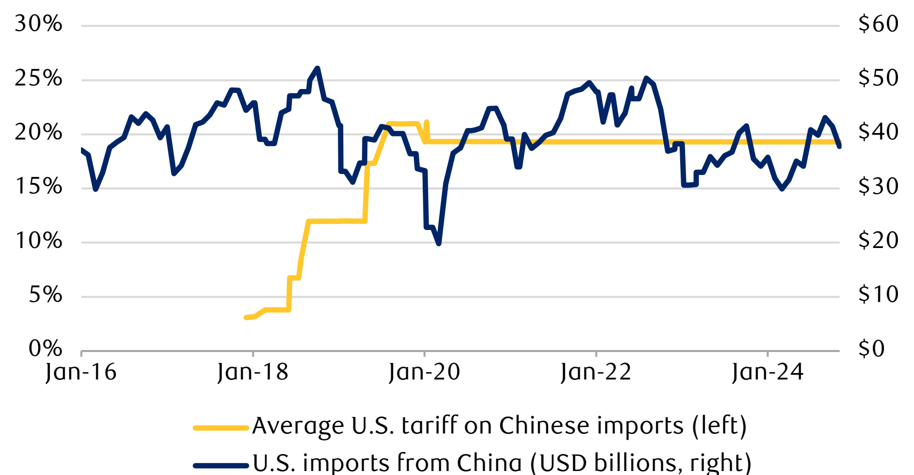
Key points

- **Tariffs are undeniably related to trade, but don't necessarily have to be motivated by trade concerns.**
- **The use of tariffs as a negotiating tactic rather than as an element of trade policy may lead to better outcomes for some investors, but it's not without negative implications or risk.**

Tariffs, in their modern form, are a trade measure. Higher U.S. import duties help domestic producers compensate for lack of cost competitiveness. An import tax helps reduce the U.S. trade deficit in the near term, although the longer-term picture becomes muddied by foreign exchange markets and other countries' retaliatory moves. Thinking of tariffs as a trade measure is likely a pretty good way of understanding President Donald Trump's proposed tariff increases on Chinese goods.

Another way of thinking about a tariff is that it's a pay-to-play measure for countries that want access to the U.S. market. Because if there's one area where the U.S. leads, it's as the source of excess aggregate demand for the global economy. Fancy words aside, if you want to sell goods, you start with your domestic market and your next focus is likely going to be the United States.

Chinese exports to the U.S. have held steady despite higher tariffs



Source - RBC Wealth Management, Bloomberg

TARIFFS' LEVERAGE EXTENDS FAR BEYOND TRADE

Historically, the U.S. hasn't asked for much in return for access to its consumers. The typical approach was to say that relatively free access from global producers was good for American households: more stuff at better prices. That view, however, isn't an immutable law of physics.

Another approach—equally valid—is to seek concessions from other countries to guarantee ongoing access to the American markets. This is essentially what the United States did in the so-called Plaza Accord—a multilateral deal to reduce the U.S. trade deficit by weakening the dollar—and a series of bilateral agreements with Japan in the 1980s and 1990s to get "voluntary" limitations on U.S.-bound exports. Retaining even limited access to U.S. car shoppers required concessions in other areas of trade and finance.

We expect the Trump Administration to use and extend the Plaza Accord mentality. Rather than look for national trade advantages, we think his administration will look to extract concessions across the whole range of economic and political issues. With direct neighbors, border issues are likely to dominate. With the EU, defense spending could take center stage. But no matter what ultimate deal is cut, we think tariffs are just a very powerful means of applying bilateral pressure to allies and competitors alike.

Let's make a deal

If the administration does use tariffs primarily to generate concessions, we think there are two key investment conclusions for U.S. assets.

First, if tariffs are just a negotiating lever, they don't need to be applied for long periods—if at all—to work. A quick demonstration of power—or even just a threat—gets the concession, benefits accrue, and upfront costs are minimal. Much of the conversation in the press and among economists about the multi-year economic costs of tariffs and potential retaliation could significantly over-emphasize the impact of the brief application of a punitive tariff rate on a given country.

We can see this dynamic in action already. In the initial days of the administration, Colombia refused to accept U.S. government flights carrying deportees in conditions the South American nation found unacceptable. In response, President Trump threatened a 25% initial tariff with a rapid step-up to 50% on all Colombian goods. Faced with a potential economic disaster, Colombia had no realistic alternative but to concede, and it quickly did so.

With Canada and Mexico, the story—in our mind—is quite similar. Large tariffs on both countries were threatened, and then delayed for a month after both Mexico and Canada agreed to boost border security. If tariffs are imposed on Mexico, Canada, or another U.S. ally—as may happen—we think they are likely to be quite brief. Our view is that the Trump administration is more likely to ratchet up tariff levels—as was threatened in the Colombian case—instead of letting time increase the pressure on our counterparties. Again, though, this should keep the overall immediate economic cost to the U.S. relatively low.

TARIFFS' LEVERAGE EXTENDS FAR BEYOND TRADE

The second implication of viewing tariffs through the prism of a negotiation lever is that policy is likely to be incredibly fluid, particularly in the early stages. Part of the leverage of tariffs is that they're not only absolute but also relative. Being charged 10% to access the U.S. market is painful, but it's doubly so if other nations only pay 5%. That reality means that the Trump administration negotiation stance is likely to be fluid, with lower relative tariff rates, targeted exemptions, and long phase-in times all in play at various times with different countries.

Domestic political considerations in the U.S. may also lead to ad hoc policymaking and temporary relief. In general, this fluidity should benefit larger companies—they have the scale to get the ear of policymakers and the resources to adjust their supply chains on the fly.

Varied outcomes and heightened risks

Tariffs as a negotiating tactic versus a trade measure may lead to better outcomes for some investors, but it's not without negative implications nor without risk.

We think the most obvious negative is for major U.S. trading partners. Even the threat of tariffs can lead to supply chain shifts, cutting sales for overseas suppliers to U.S. companies. That pain will be felt even if no tariff is ever applied and can be durable.

For certain combinations of industries and countries, U.S. exports are critical for production economics. Canadian oil tends to find its way to U.S. refineries, for instance, and not all refineries are equally adept at handling Canadian-grade crude. Even a temporary disruption to exports from these national critical sectors can carry meaningful economy-wide impacts to U.S. trading partners, as we recently discussed with reference to the Canadian economy. It's worth noting that some—but admittedly far from all—economists have argued that the Plaza Accord contributed directly to Japan's poor economic performance during the 1990s, the so-called "Lost Decade." Adding to the concern is that many non-U.S. economies are

Not just China: bilateral trade characteristics leave many countries vulnerable to tariff threats

Country	Value of exports to U.S.	Bilateral U.S. trade surplus	2023 GDP	U.S. exports % of GDP	Net U.S. trade % of GDP
Mexico	$529	$162	$1,789	30%	9%
Vietnam	$116	$103	$429	27%	24%
Canada	$482	$41	$2,142	22%	2%
South Korea	$132	$41	$1,712	8%	2%
Germany	$206	$87	$4,525	5%	2%
Japan	$187	$66	$4,204	4%	2%
China	$448	$252	$17,794	3%	1%

Monetary values in billions of U.S. dollars as of 12/31/23.

Source - RBC Wealth Management, U.S. Bureau of Economic Analysis, World Bank, Bloomberg

TARIFFS' LEVERAGE EXTENDS FAR BEYOND TRADE

currently in a relatively fragile growth position. A downturn in a particular export to the U.S. could be an economic nuisance during a boom, but a grave threat when the economy teeters.

This does not mean that tariffs will be painless in the United States. As our RBC Economics colleagues have discussed, the U.S. is not invulnerable to a trade war, although Canada is likely in a weaker position overall given the trade and manufacturing realities both countries face.

This brings up what we see as the primary concern for U.S. assets if tariffs are used as a negotiating lever: the U.S. position is so strong that it could easily lead to a miscalculation that hurts both sides. The U.S. is the global growth leader in dollar terms, and in nearly all bilateral relations, any interruption to trade is more costly for foreign exporters than U.S. consumers.

The risk that we see is that the U.S. overplays its hand, asking for political impossibilities such as territorial concessions or economically catastrophic shifts in terms of trade. If counterparties are pushed too far, the U.S. could end up kicking off a trade war on the assumption that it will all be resolved quickly and favorably but ends up dragging out. This could conceivably lead to a global economic growth slowdown.

This is not our base case, but it should not be dismissed out of hand. We think negotiations are ripe with opportunities for misunderstanding, and domestic political realities are often opaque to outsiders. The risk that a negotiating tactic morphs into a mutually painful trade war is not merely theoretical.

Short-term gains versus (potential) long-term pain?

More generally, we think the tariff issue reflects what will likely be a tendency by the Trump administration to focus on short-term results over amorphous long-term benefits. Prior administrations, for instance, largely avoided using tariffs for non-trade negotiations in the hopes of fostering better bilateral relationships to confront other issues. The Trump administration is clearly operating under a different set of priorities.

To be clear, neither approach is obviously superior; it boils down to what concessions can be negotiated versus what impact—if any—diminished goodwill may have in the future. Neither point is known today, and the latter could potentially be unknown for years. But it's clear to us at least that the Trump approach likely entails both risks and benefits to the U.S. with the bulk of the gains upfront as risks accrue over time.

We can see the same trade-off in other areas as well. Bank capital requirements are a good example. We think it's very likely that Trump-appointed bank supervisors will look to slow the implementation of higher capital requirements on U.S. banks. All else equal, tying up more capital in bank vaults tends to slow economic growth while simultaneously allowing banks to absorb future credit losses more easily, potentially lowering the probability and cost of any future financial crisis.

Like most regulations, there's no single correct answer when setting those requirements. Reasonable people can, and do, differ. We think it is fair

TARIFFS' LEVERAGE EXTENDS FAR BEYOND TRADE

to say, however, that on this, as with most regulatory issues, the Trump administration will look to tilt the scale in favor of near-term economic growth, while de-emphasizing other regulatory goals. Over most investors' time horizon, we think the pro-growth policy bias is likely to dominate. As time progresses, however, the risks of miscalculation likely grow.

Same, with a twist

There's nothing new with the idea that investors need to strip away labels and focus on fundamentals. The nuances we see with the administration are a greater willingness to use the widest possible range of policy moves to apply negotiating pressure on other countries, as well as a sharper focus on stimulating near-term economic growth. For investors, we think the message is to position for continued global economic growth led by the United States, but with a watchful eye toward risk and valuations. We see those risks likely accumulating over time, emphasizing the need for pragmatic analysis and nimble positioning.

GLOBAL
Equity

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Phase detection

"A stock market top is a process, while a market bottom is an event" is a frequently cited observation mostly borne out by history. The final bottoming phase of a bear market typically plays out over just a few weeks, during which most stocks are falling every day as fearful investors rush to sell to stem their mounting losses. At some point the selling is exhausted, buyers take control, and the market surges higher, usually regaining what it has lost in the unnerving, final selloff very quickly.

Tops, on the other hand, play out very differently: they are usually drawn out over several months or quarters, during which the broad averages may reach a succession of new highs, each not far above the previous one and each followed by a pullback. This traces out a trading range which bullishly inclined investors often interpret as no more than a "pause that refreshes." However, eventually a sharp drop below the bottom of that trading range seals the deal, signaling that a deeper, more prolonged market retrenchment is underway.

Very often it's not clear-cut which phase, "pause" or "top," the market is in. We watch market breadth closely to monitor whether the majority of stocks are moving in sync with the capitalization-weighted indexes like the S&P 500 and others in the U.S., as well as the closely followed major indexes in Canada, the UK, Europe, and Asia. When the S&P 500, for example, sets a new high, we look to see whether that is confirmed by a new high for the equal-weighted version of the index and by other breadth measures like the advance-decline line (which shows the difference in the number of stocks that are rising versus falling in a stock market). Such "confirmations" occurred consistently over the entire course of the 27-month powerful market advance from the last major low in the fall of 2022.

Equity views

Region	Current
Global	=
United States	=
Canada	=
Continental Europe	–
United Kingdom	–
Asia (ex Japan)	=
Japan	=

+ Overweight; = Market Weight; – Underweight
Source - RBC Wealth Management

At the moment, however, the jury is out. The S&P 500 recently posted a new all-time high in early December and now another in late January, but so far the breadth measures noted above have not followed suit. They may yet do so and look to be trying. But if that breadth confirmation fails to arrive (i.e., if the advance-decline line and the unweighted S&P 500 don't also post new highs), then, in our view, the probabilities will be rising that equity markets are in the process of forming a top rather than simply marking time before the long-term uptrend reasserts itself.

Another picture that should line up with the market's eventual direction is the outlook for earnings. 2024 looks to have been a very good year for S&P 500 Index earnings—up 10% y/y. The Street's earnings estimates at the start of the year usually turn out to be too optimistic, with actual achieved results by the end of the year falling short—on average by about 5%. But not so for 2024; earnings look to have come in at almost exactly where forecasts made a year ago predicted they would—a rare feat.

That may be a tough act to follow in 2025, but consensus forecasts appear undaunted as they look for earnings growth to accelerate to almost 12% to reach $273 per index share. Aggregate sales for the S&P 500 companies are

GLOBAL EQUITY

unlikely to grow that fast, implying yet another year of profit margin improvement.

The GDP handoff into Q1 looks solid enough in the U.S., in our view, with manufacturing new orders strengthening and service sector revenues showing few signs of fading. However, hurdles abound. Policy uncertainty is elevated with the Trump administration's tariff salvo now underway for China, with Canada and Mexico given a 30-day reprieve, while the UK and Europe are likely to learn their fates in the coming weeks or months. So far, currency markets have borne the brunt rather than equity markets. But we think the worst has probably not yet been seen, and a quick settlement seems too much to hope for. Meanwhile, in the U.S. economy itself, inflation remains sticky, probably keeping the U.S. Federal Reserve from following through, for now, on further rate cuts. Consensus forecasts see GDP growth slowing modestly in 2025 and gearing down further in 2026. Growing earnings by 12% in a slowing economy will be a challenge.

The first big test for 2025's chunky $273 S&P 500 consensus earnings estimate is coming right now as companies report full-year 2024 earnings results, a time when many CEOs give shareholders guidance on how the business is likely to fare in the coming year. Guidance that doesn't support the Street's optimistic earnings forecasts, were that to be the case, would not be welcomed by a market trading at today's elevated price-to-earnings (P/E) multiple (25x latest 12-month earnings and 22x the consensus earnings estimate for 2025).

Markets outside the U.S. (including Canada, the UK, Europe, and Japan) are not nearly as expensive in large part because they don't contain any of the "Magnificent 7" (Alphabet, Amazon, Apple, Meta Platforms, Microsoft, NVIDIA, and Tesla), nor as much exposure to technology stocks as a group, nor do they have many of the mega-cap growth stocks, all of which have been major contributors to the S&P's rich valuation. That said, all those non-U.S. markets are trading above their long-term average P/E ratios and all have moved up by one-to-two multiples since last summer; so they too look to have priced in expectations of larger-than-average earnings gains.

That optimism is all the more remarkable because consensus forecasts see all those economies continuing to grow at what are already very subdued rates through 2026, while the impact from trade disputes could easily be somewhat worse than assumed by markets.

It's also worth noting that this latest bump up in P/E multiples for all the major indexes has occurred against a backdrop of rising bond yields—the 10-year U.S. Treasury yield has climbed from 3.60% in September to 4.80% recently. Rising bond yields would normally compress P/E multiples, not elevate them. So, stocks have not only become more expensive relative to their own historical norms but also in relation to bonds. In the latter case, perhaps more expensive than at any time in the past 23 years: the "earnings yield" for the S&P 500 (i.e., earnings per share divided by price) now sits at just 4.00%, below the 10-year Treasury yield (4.54%) for the first time since 2002.

"Priced for perfection" is an overused bit of stock market hyperbole, in our view. But we think it is closer to being the appropriate descriptor of the market valuation than at any time in the recent past. And that's all the more reason to pay close attention to the equity market's internal conditions like breadth that speak to its ability to keep advancing.

Above-average P/E ratios don't necessarily limit the market's upside—they can always go higher still. But when the tide eventually turns, an elevated P/E multiple tells the investor something about the near-term risks they may be facing.

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We expect most major global equity markets can go on climbing the “wall of worry” into new high ground in the coming months but acknowledge that there is an element of “threading the needle” about achieving those gains. From our vantage point, another surge higher in bond yields, say beyond 5% for the 10-year Treasury, or a meaningful deterioration in earnings prospects, perhaps triggered by trade issues, might be enough to break the spell and usher in a more problematic downturn.

In our view, portfolios should stay committed to equities up to but not beyond their long-term targeted exposure.

GLOBAL

Fixed income

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The Fed breaks from the pack

After a series of consecutive rate cuts over the final meetings of 2024, the U.S. Federal Reserve opted to take a pass at its first meeting of the new year in January. The Fed held rates steady at a target range of 4.25%–4.50% while signaling that a solid labor market, signs of waning disinflationary progress, and uncertainty about the potential for an inflation reacceleration this year gave it scope to be both patient and cautious. We also expect the Fed to skip a rate cut at its March and May meetings, with any real chance of another rate cut likely not appearing until June.

The same can't be said for many other global central banks. The European Central Bank and the Bank of Canada both delivered further rate cuts, while the Bank of England is widely expected by investors to follow suit with another rate cut at its Feb. 6 meeting. While central banks are continuing to keep an eye on inflation risks, particularly due to tariff threats, the focus has largely shifted to economic growth concerns with lower rates aimed at shoring up economic outlooks—at odds with the more robust U.S. growth outlook.

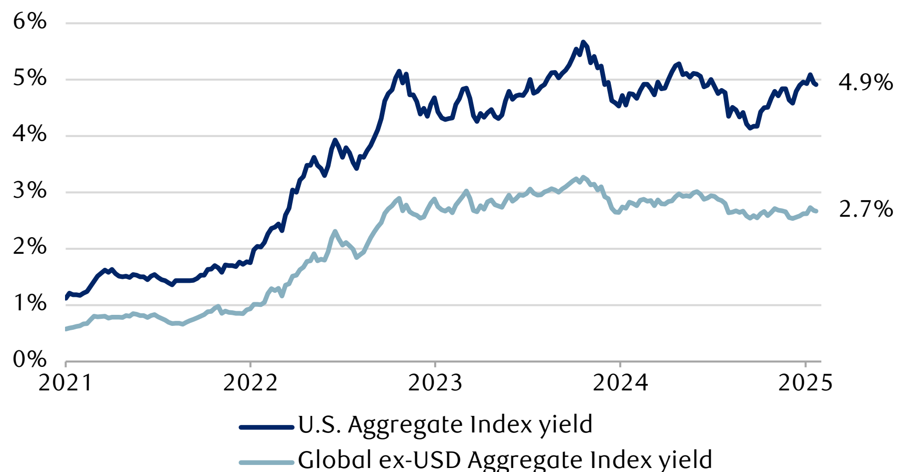
Fixed income views

Region	Gov't bonds	Corp. credit	Duration
United States	–	=	3–7
Canada	+	=	3–7
Continental Europe	+	=	3–7
United Kingdom	=	=	3–7

+ Overweight; = Market Weight; – Underweight
Source - RBC Wealth Management

The diverging paths of monetary policy, and economic growth trajectories, between the Fed and other global central banks are being reflected in growing yield gaps. In the U.S., the benchmark 10-year Treasury yield pulled back in January following a near-relentless rise toward 5.00% over the final quarter of 2024. With the Fed on hold, we see the 10-year yield settling down and into a range of 4.25%–4.75% on a near-term basis. Global yields are likely to remain lower, and trend lower still, as global central banks clearly remain biased toward further policy easing even if the Fed is content to stand pat.

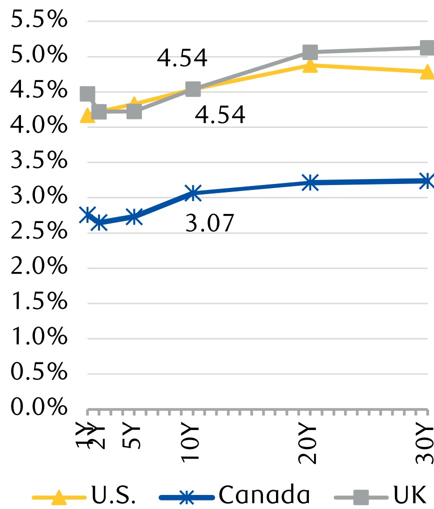
Yield gap between U.S. and global bonds grows



Source - RBC Wealth Management, Bloomberg U.S. Aggregate Bond index, Bloomberg Global ex-USD Aggregate Bond Index; data through 1/21/25

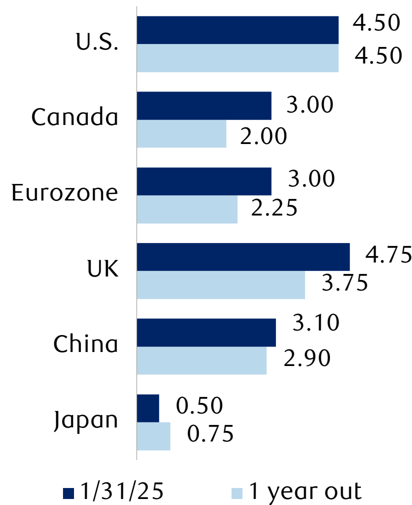
GLOBAL FIXED INCOME

Sovereign yield curves



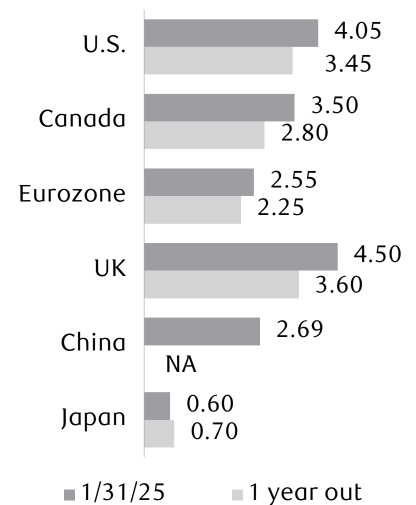
Source - Bloomberg; data through 1/31/25

Central bank rates (%)



Source - RBC Investment Strategy Committee, RBC Capital Markets forecasts, Global Portfolio Advisory Committee, RBC Global Asset Management

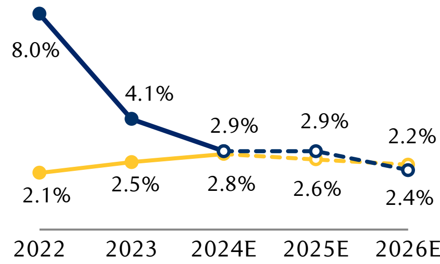
10-year rates (%)



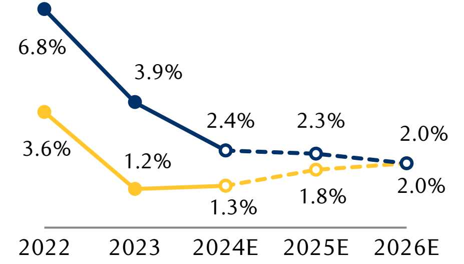
Note: Eurozone utilizes German Bunds.
Source - RBC Investment Strategy Committee, Global Portfolio Advisory Committee, RBC Global Asset Management

KEY
Forecasts

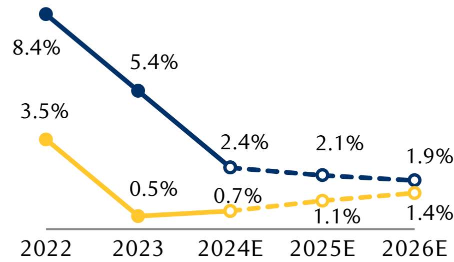
United States



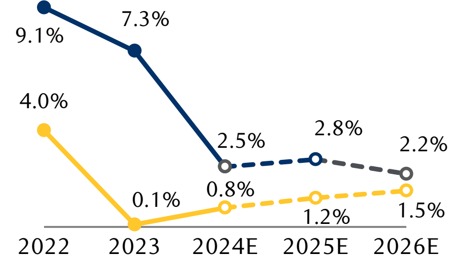
Canada



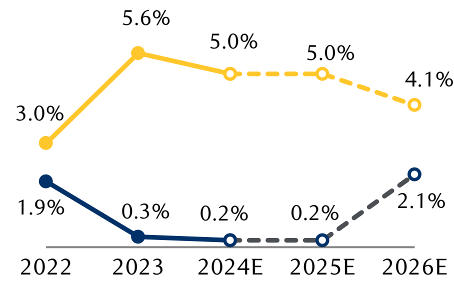
Eurozone



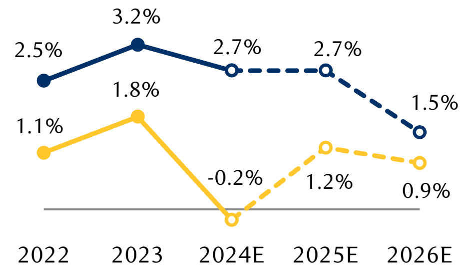
United Kingdom



China



Japan



Real GDP growth

Inflation rate

Source - RBC Investment Strategy Committee, RBC Capital Markets, Global Portfolio Advisory Committee, RBC Global Asset Management, Bloomberg consensus estimates

Research resources

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