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February 3, 2025

WASHINGTON POLICY STRATEGY

Potomac Perspective

New tariffs on China, Mexico, and Canada have been officially announced. Next comes retaliation, possibly followed by an escalation, and then probably a negotiation. A negotiated settlement is our base case because it fits with President Trump's track record, both in business and government, of using leverage to reach a deal. However, trade hawks may have more sway in this administration, so the odds of escalation and a prolonged trade war cannot be dismissed. They are higher than they were in Trump's first term.

President Trump utilized the International Emergency Economic Powers Act (IEEPA) to issue Executive Orders (EO) invoking tariffs against China, Canada, and Mexico. This act gives the President broad authority to impose the tariffs and does not require a lengthy approval process through which companies can lobby for exemptions. The EOs placed a 10% tariff on China and 25% tariffs on Mexico and Canada. Canadian energy imports, however, were subjected to a lower rate of 10%.

In his confirmation hearing, Treasury Secretary Scott Bessent said there are three reasons for imposing tariffs:

1. To counter unfair trade practices
2. To raise revenue
3. To provide negotiating leverage

This round of tariffs falls under the third reason – negotiating leverage. The pretext of the tariffs was fentanyl, but in interviews, President Trump cited trade deficits. This suggests the administration is looking for a political deal. It could be on trade, it could be on fentanyl, but it seems like the administration wants to be able to claim some tangible benefits. The next step in the process is retaliation. Canada has already moved to implement retaliatory measures. Negotiations will then follow, or at least that seems to be the plan, but as Mike Tyson noted – everybody has a plan until they get punched in the mouth.

Mr. Trump ran for President on a platform that included tariffs, but he also ran on lowering prices for consumers. The fact that the tariffs include a lower levy on energy imports from Canada suggests the administration is aware of the potential conflict between the two goals. This also supports our view that a deal is the ultimate goal. The administration understands the political risk of higher prices.

It is also aware of the impact on financial markets. As of this writing, equity futures are down approximately 1.5% - 2.5%, which is in addition to Friday afternoon's sell-off. Mr. Trump has said that the U.S. might suffer some short-term pain, so he seems to be prepared for investors' reactions. He has, however, touted the stock market as a barometer of his performance. It is therefore possible that additional or prolonged market declines could impact his views and policies.

As we weigh the risk of a deeper trade war and its impact on the economy and markets, we acknowledge the risk that all sides will continue to retaliate. Mr. Trump's actions in his first term, however, suggest that he will ultimately agree to a deal for which he can claim a political victory even if there is no significant change in policy – a cosmetic win. This remains our base case, but we admit the risks of a deeper trade war might be greater than they were in Trump 1.0.

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