Morgan Stanley

INVESTMENT MANAGEMENT

Global Equity Observer

The new tariff landscape

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There has been no shortage of headlines in President Donald Trump's first month back in the Oval Office. In his first 30 days, the returning U.S. President has signed more than 70 executive orders, with immigration and tariffs seemingly at the top of his priority list.

At the time of writing, signed executive orders include those imposing a (so far suspended) 25% tariff on all goods imported from Mexico and Canada (excluding Canadian energy resource exports which will face a 10% tariff), a 10% tariff on all imports from China, and expanded tariffs on steel and aluminum. In addition, President Trump has announced plans to implement reciprocal tariffs for U.S. trading partners considered to be adopting "unfair practices",[1] and has recently told reporters that a further 25% tariff on autos, chips and pharmaceuticals is under consideration. With talk of a 25% tariff on the European Union (EU) and another 10% on China, and tariffs being used for broader policy aims, such as the war on drugs rather than just trade goals, we anticipate that the tariff landscape will continue to evolve in the coming months.

As fundamental bottom-up investors, we seek to assess the potentially material impact of such government actions on our portfolio companies. Below, we reflect on the historical backdrop that has contributed to the implementation of tariffs and evaluate their potential impact on our portfolio companies—both direct and nuanced.

A shift away from the "free trade" world

The General Agreement on Tariffs and Trade (GATT) was established in 1947 as a way to encourage world peace following World War II and to shift away from the protectionist policies, including tariffs and quotas, that halted international trade prior to the war. The U.S. joined the agreement at the start of 1948, at a time when the U.S. trade balance was in surplus, making its

[1] https://www.dlapiper.com/en/insights/publications/2025/02/president-trump-announces-plan-for-reciprocal-tariffs

[2] Source: World Trade Organisation

large and growing market more accessible.[2] In the post-war era, many countries within the GATT, such as Japan, were able to achieve fast economic expansion, in part thanks to desirable exports for which the U.S. was willing to run a trade deficit. In subsequent years, the strengthening of the U.S. dollar against foreign currencies (a trend that began in the 1980s and has continued to the present day) has made importing more attractive, at least from the perspective of the American consumer, contributing to the hyper-competitive environment for U.S. manufacturers who have struggled in the face of cheaper international production.

Over the last 40 years, the U.S. trade deficit has averaged close to 3% of gross domestic product (GDP),[3] and the U.S. share of global manufacturing has fallen from 28% in 2002 to 16% today.[4] President Trump's campaign pledge to significantly increase tariffs may well have helped him garner the support, and more importantly the votes, of blue-collar workers feeling disenchanted by the current system. President Trump has stated that he believes his proposed tariffs will help protect American businesses, move manufacturing back to the U.S. and create jobs for American workers, while narrowing the country's long-standing trade deficit. The overall impact, however, remains uncertain, given that tariffs are likely to be inflationary for consumers and unsettling to corporates relative to the free trade environment that has been in place for the last several decades, which could hit consumer confidence and slow growth. The Peterson Institute for International Economics suggested that a 10% universal tariff imposed by the U.S. and the subsequent retaliation from trade partners would result in 1% being knocked off U.S. growth for the two years after its introduction, and continue to impose a drag on growth indefinitely.[5]

While the effectiveness of tariffs as a method of improving the economy is debatable, those already announced will mark a distinct shift away from the previous free trade landscape. Looking at the potential impact of tariffs across our portfolios, we would broadly classify these as direct and uncertain/nuanced.

Direct impacts

As things currently stand, given that our quality portfolios are skewed towards services rather than goods, we believe most of our companies should face limited direct impact from tariffs, while local manufacturing, high gross margins and pricing power may dampen the extent of the impact for the goods producers in the portfolios.

Looking across our quality portfolios, our consumer-facing names and non-U.S. semi-conductor names (where held) are more likely to face some direct impact from the announced protectionist measures.

We view our high quality consumer names as relatively well-positioned versus their sector peers thanks to their high gross margins and pricing power. The high gross margins limit the price rises needed to mitigate the tariffs, while the pricing power makes the required price rises more feasible. For example, our luxury and beauty names may be impacted to the extent they manufacture in Europe and ship to the U.S., but they benefit from high gross margins, and also have strong pricing power given their loyal and relatively affluent consumer base. An American automotive retail company we hold is unlikely to see a meaningful impact given its strong pricing power. While it does source some parts from overseas, these tend to be in the non-discretionary categories, where the company's pricing power is stronger. Nonetheless, we acknowledge that certain industries may be more affected. Industries such as international beverages, spirits and brewers, are facing rising costs on importing to the U.S., while in some markets, U.S. brands are also battling with consumer boycotts and retaliatory actions.

We anticipate that our non-U.S. semi-conductor names (where held) may be impacted, either by tariffs or if they are pushed to increase their production and investment in the U.S. to avoid the penalties. In the event of tariffs, the semi-conductors we own have very strong market positions and at least initially, their customers would have little choice but to pay the increase in cost. Structurally however, tariffs may lower chip demand across the industry, which could drive lower industry capital expenditure at the margin—though the relatively unpredictable road to GenAI (generative artificial intelligence) adoption is arguably a larger source of uncertainty.

Uncertain/nuanced impacts

The secondary and longer-term impacts of tariffs are likely to be more uncertain and nuanced. Other countries could retaliate, for example, with the EU targeting U.S. mega-cap technology companies, while China could ban exports of tech components needed for U.S. technology companies. There are also the macroeconomic impacts. Higher inflation could drive higher rates, indirectly affecting credit bureaus through a delayed cyclical recovery in credit, particularly mortgage issuance. Inflation may also pressure corporate margins, though pricing power should help the companies in the portfolio.

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[3] Source: Federal Reserve Bank of St Louis

[4] Source: World Bank

[5] Source: The Peterson Institute for International Economics, via The Economist

The great unknown

How does this play out? To the extent they cause inflation, tariffs will pressure U.S. consumers and potentially corporate margins. If tariffs or other measures spur a more vigorous Chinese response or rupture with historic allies, such geopolitics may be an unpopular surprise for markets, which are currently characterised by high expectations, despite the elevated policy uncertainty from the U.S. president's policy of "strategic ambiguity". More broadly, if tariff activity results in a broader economic slowdown, perhaps because it triggers a trade war, history suggests that our quality portfolios' pricing power and recurring revenues should mean their earnings once again prove distinctly more resilient than those of the market as a whole.

Risk Considerations

There is no assurance that a portfolio will achieve its investment objective. Portfolios are subject to market risk, which is the possibility that the market value of securities owned by the portfolio will decline. Market values can change daily due to economic and other events (e.g. natural disasters, health crises, terrorism, conflicts and social unrest) that affect markets, countries, companies or governments. It is difficult to predict the timing, duration, and potential adverse effects (e.g. portfolio liquidity) of events. Accordingly, you can lose money investing in this strategy. Please be aware that this strategy may be subject to certain additional risks. Changes in the worldwide economy, consumer spending, competition, demographics and consumer preferences, government regulation and economic conditions may adversely affect global franchise companies and may negatively impact the strategy to a greater extent than if the strategy's assets were invested in a wider variety of companies. In general, **equity securities'** values also fluctuate in response to activities specific to a company. Investments in **foreign markets** entail special risks such as currency, political, economic, and market risks. **Stocks of small- and mid-capitalisation companies** carry special risks, such as limited product lines, markets and financial resources, and greater market volatility than securities of larger, more established companies. The risks of investing in **emerging market countries** are greater than risks associated with investments in foreign developed markets. **Derivative instruments** may disproportionately increase losses and have a significant impact on performance. They also may be subject to counterparty, liquidity, valuation, correlation and market risks. **Illiquid securities** may be more difficult to sell and value than publicly traded securities (liquidity risk). Non-diversified portfolios often invest in a more limited number of issuers. As such, changes in the financial condition or market value of a single issuer may cause greater volatility. **ESG strategies** that incorporate impact investing and/or Environmental, Social and Governance (ESG) factors could result in relative investment performance deviating from other strategies or broad market benchmarks, depending on whether such sectors or investments are in or out of favor in the market. As a result, there is no assurance ESG strategies could result in more favorable investment performance.

DEFINITIONS

The **MSCI World Index (USD)** is a free float adjusted market capitalization weighted index that is designed to measure the global equity market performance of developed markets.

The **S&P 500® Index (USD)** measures the performance of the large cap segment of the U.S. equities market, covering approximately 75% of the U.S. equities market.

The **MSCI EAFE Index (Europe, Australasia, Far East)** is a free float-adjusted market capitalization index that is designed to measure the international equity market performance of developed markets, excluding the US & Canada.

The **Chicago Board Options Exchange (CBOE) Market Volatility (VIX) Index** shows the market's expectation of 30-day volatility.

Earnings per share (EPS) is the portion of a company's profit allocated to each outstanding share of common stock.

Gross Domestic Product (GDP) is the monetary value of all the finished goods and services produced within a country's borders in a specific time period. It includes all private and public consumption, government outlays, investments and net exports.

The **Purchasing Managers Index (PMI)** is an indicator of the economic health of the manufacturing sector. The PMI index is based on five major indicators: new orders, inventory levels, production, supplier deliveries and the employment environment.

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