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FIRST ANALYSIS

News or events that may affect your investments **April 3, 2025**

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Implications of a growing menu of tariffs

Key takeaways

- President Donald Trump announced new tariffs on April 2 that delivered a 10% baseline levy plus reciprocal tariffs varying widely across countries.
- These measures likely will slow the economy by more than what we previously expected, but we also see several mitigating factors that should allow the economy to escape a recession.

What it may mean for investors

- Our investment guidance accounts for rising tariffs but foresees opportunities for select cyclical equity performance, commodities, and a more selective approach to fixed income.

On April 2, President Trump approved new tariffs to take effect at midnight on April 3, covering imports from roughly 50 trading partner countries and including some of the largest sources of U.S. imports. The new levies establish a 10% minimum tariff and add additional amounts on a country-by-country basis.

In principle, a reciprocal tariff mirrors policies other countries use to limit the attractiveness of U.S. goods. Such measures may include tariffs, government subsidies to local industries, or policies to cheapen the local currency against the U.S. dollar. In this case, the president has set the U.S. reciprocal tariff at half the value that the administration estimates such trade barriers equate to in tariff terms.

Our perspective

The announcement is likely to bring further selling in equity markets, lower fixed income yields, and a modest pullback in the U.S. dollar's exchange value. Our guidance is patience, as markets digest the new tariffs and the responses of governments, companies, and households. Our fundamental conviction remains that equity prices, bond yields, and the dollar's value will rebound this year. While tariff uncertainties persist, our guidance continues to focus on three key themes as a way to see through the fog:

1. Not all tariffs have equal impact. In general, tariffs across all the imports of a particular industry, or all the imports from another country, are more meaningful than tariffs on specific goods from specific countries.
2. Tariffs may raise some prices and slow the economy, but we believe there are mitigating factors.
3. We expect the economy to gain some traction beginning in the coming months and believe a recession remains unlikely.

Not all tariffs are created equal

We view tariffs as having mainly negative economic impacts over the coming 6 to 12 months, with uncertain implications beyond. For U.S. businesses and households, a tariff is a tax that makes a one-time price increase. Historically, the resulting inflation from tariffs has cut private spending and pressured profit margins. We would expect any retaliation by other countries to reduce U.S. exports, another economic drag. Over the longer term, we believe tariffs may raise uncertainty about future business and lead firms to restrain their growth.

But there are mitigating factors, and to sort through the noise for a clearer view of impacts, we like to keep the goals and the breadth of tariffs front-of-mind. The China tariffs and the steel, aluminum, and vehicle tariffs seem intended to reshore industry to the U.S. and likely will persist while firms decide to reshore production to the U.S.

By contrast, the tariffs on Mexico and Canada appear to be inducements to help control activity along their U.S. borders. Mexico and Canada did not appear on the president's April 2 list of reciprocal tariffs. Bloomberg News reports interest in Congress to reduce those tariffs. Importantly, the president is keeping the exemption for products covered under the United States-Mexico-Canada Agreement (USMCA).

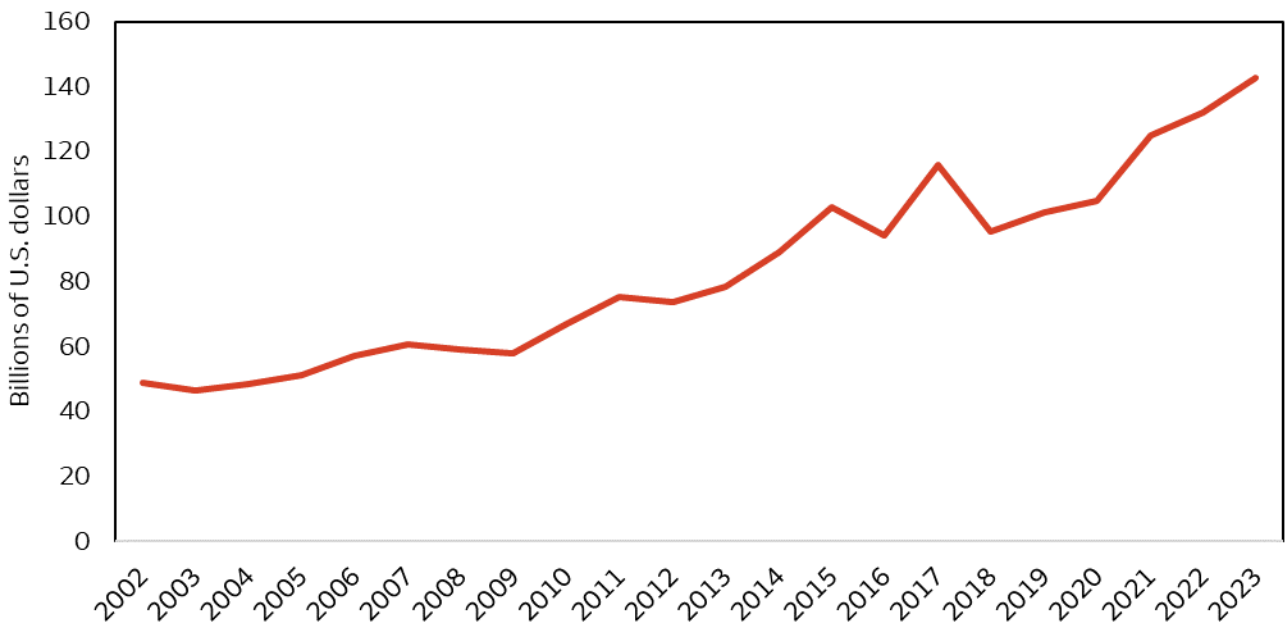
We view the main economic damage coming from the 10% baseline tariff and especially the reciprocal tariffs of 34% and 20% on China and Europe, respectively. Broad-based tariffs on all the goods from another country fall equally on those goods, whether or not U.S. consumers can easily find cheaper replacements. A 32% tariff on Taiwan will raise the price of semiconductors used in a wide array of U.S. industries. Large reciprocal tariffs on Southeast Asian countries could further raise the prices of electronic goods.

However, we further view the prospect for negotiating lower U.S. tariffs as a realistic mitigating factor, and Asia seems a good illustration. For background, Chart 1 on the following page shows that U.S. investment in Asia ex-China manufacturing accelerated quickly after the global pandemic revealed the benefit of supply-chain diversification.

More specifically, as early as 2021, Southeast Asia enjoyed bilateral trade in machinery and equipment with the U.S. amounting to roughly 40% of the region's exports and imports.[1] Yet, two years later, U.S. agricultural products still accounted for only about 3% of Southeast Asia's imports.[2] The disparity may be due to the region's wide range of complex bureaucratic requirements — from import licensing to health and safety rules — that likely hinder U.S. sales of agricultural products.[3]

1. Ayman Falak Medina, "An Overview of U.S. Trade and Investment in ASEAN" ASEAN Briefing, July 7, 2023
2. Ibid.
3. Hossen, Md Deluair. "Tariff and Non-Tariff Barriers Affect U.S. Agricultural Exports to the ASEAN Market." *Southern Ag Today* 3(48.5). December 1, 2023.

Chart 1. U.S. corporate investment in Asia ex-China manufacturing



Sources: U.S. Bureau of Economic Analysis and Wells Fargo Investment Institute. Annual data, 2002-2023 Asia ex-China includes India, Indonesia, Japan, Malaysia, the Philippines, Singapore, South Korea, and Thailand.

It is likely that these non-tariff measures also help explain why the new reciprocal tariffs for Southeast Asia are among the highest on the president's April 2 reciprocal tariff list.[4] We might expect regional leaders to find ways to reduce the non-tariff measures on their imports. such as U.S. agricultural products, in order to help avoid the new U.S. tariffs on the region's much higher value machinery sector.

Finally, tariffs generally raise revenue and so are a goal in themselves. We do not believe the administration expects to raise enough revenue to close the entire federal deficit, but it may see tariff revenue potentially balancing out a new corporate tax cut in the government's budget plans. However, the increasing diversity of supply chains may undercut plans for sustained revenue growth. This is one hint that ambitious budget goals by congressional leaders may again face a difficult fight and potentially generate more financial market volatility.

The overarching point is that our guidance does not treat all tariffs the same. Some tariffs seem more likely for removal as political concessions come, while others may have longer impacts but are likely to encourage more supply-chain diversification.

Tariffs have economic consequences but there are offsetting factors, too

Shorter-term economic implications are negative, in our view, but substitution is one of several factors that can blunt the economic damage. As a starting point, we observe that the U.S. already offers many substitutes. A January 2025 U.S. Commerce Department report found that about 52% of domestic consumer purchases reflected domestic content in 2023.[5]

4. The tariffs for Southeast Asia ranged from 10% for Singapore to 46 % and 49% for Vietnam and Cambodia, respectively. Source: "Regulating Imports with a Reciprocal Tariff to Rectify Trade Practices that Contribute to Large and Persistent Annual United States Goods Trade Deficits," whitehouse.gov, April 2, 2025.
5. Allison Derrick and William Hawk, "Purchased in America, 2023: Are Americans Buying American-Made Goods.", U.S. Department of Commerce, January 2025.

On a related note, some firms may choose not to pass along the full tariff amount when business is slow. Chinese factories faced weakening orders in 2018 and assumed some of the tariff cost. Similar weakness continues among Chinese factories, evidenced by the falling producer prices that Chinese factories have been taking since late 2022. As in 2018, the U.S. manufacturer may this time again elect to pass on some tariff burden to the supplier factory overseas.

The U.S. dollar also has a role to play. To the extent that tariffs reduce U.S. imports, there are fewer dollars in the world and the dollar's value should appreciate. So, for example, a European wine priced at 100 euros would cost $5 less if the dollar appreciates from $1.05 to $1.00 per euro.

We believe a recession is unlikely

We think one of the best investment rules of thumb is to avoid confusing correlation with causation. Tariffs have grabbed the early 2025 headlines, but other factors with only tenuous links to tariffs also have weighed on markets and likely will reverse. For starters, we consider that the weakest S&P 500 Index sectors by far have been Information Technology, Communication Services, and Consumer Discretionary. Among the 13 days in the first quarter when the index lost 1% or more, those three sectors took 27, or 70%, of the bottom three places for worst underperformance (Table 1).

Table 1. Worst-performing S&P 500 sectors on large down days, January 2, 2025-March 31, 2025

(number of times each listed sector ranked in the bottom three on days when the S&P 500 Index lost at least one percent)

Between January 2, 2025 and March 31, 2025	
Information Technology	**11**
Communication Services	**7**
Consumer Discretionary	**9**
Industrials	**3**
all seven other sectors	**9**

Between February 20, 2025 and March 31, 2025	
Information Technology	**8**
Communication Services	**6**
Consumer Discretionary	**8**
Industrials	**2**
all seven other sectors	**6**

Sources: Bloomberg and Wells Fargo Investment Institute, daily data, January 2, 2025-March 31, 2025. An index is unmanaged and not available for direct investment. **Past performance is no guarantee of future results.**

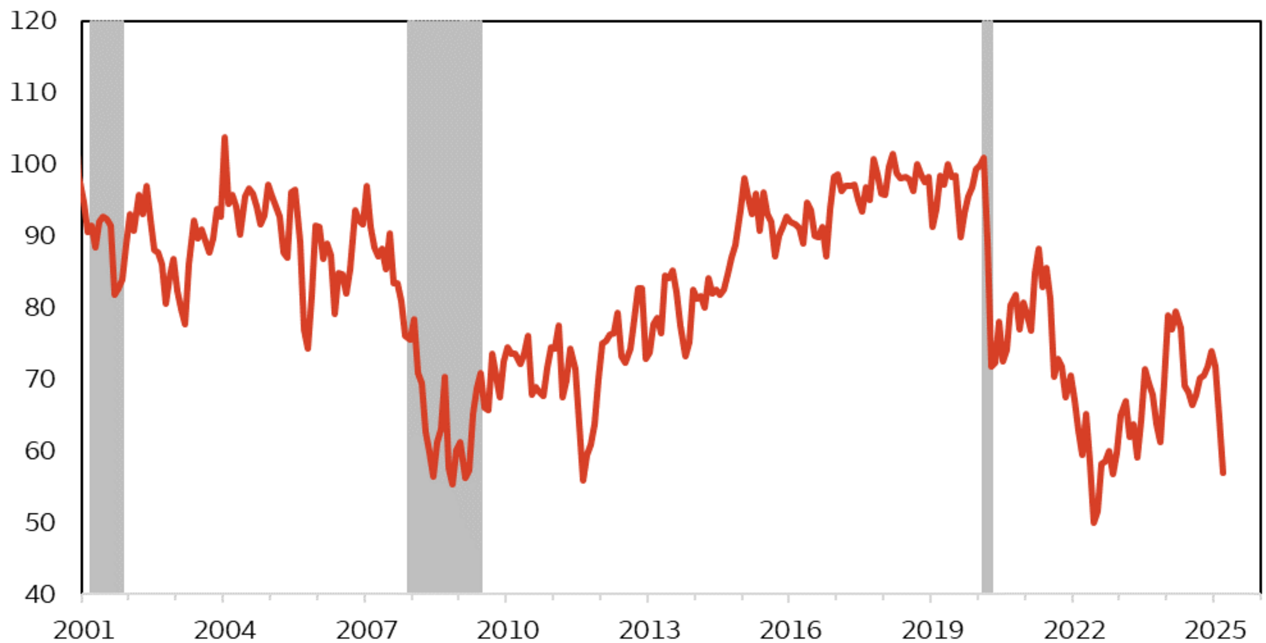
Even after the initial tariffs were implemented in February, Information Technology, Communication Services, and Consumer Discretionary again accounted for roughly 70% of bottom-three performances during the 10 largest down days. These technology- and consumer-oriented sectors were a consistent and overwhelming drag on the S&P 500 Index on its worst days during the quarter, irrespective of tariff increases. The two strong drivers beyond tariffs have been a repricing of technology companies and worries about weakening consumer spending.

Repricing of the technology sector: Shares of companies linked to artificial intelligence infrastructure came under pressure in late January, following a Chinese firm's breakthrough in training computers at a surprisingly low cost. The Chinese innovation may be exaggerated, but we believe it helped coalesce previous investor concerns about high technology valuations.[6] The Information Technology sector was the most notable underperformer during the quarter (see Table 1), but we see positive long-term technology trends and treat the weakness as a healthy correction.[7] Bottom line: We remain neutral on the Information Technology sector but are encouraged by the significant pullback in valuations.

Tariffs matter, but we believe the economy can still grow: Persistent tariffs can undercut long-term growth through a combination of factors, including higher prices and slower job creation. But when weak consumer sentiment postpones spending decisions in a growing economy — as airlines and consumer retail have done — the apprehension doesn't reliably predict a recession.

Chart 2 shows a couple of salient features of consumer sentiment. First, historically there is no apparent tendency for sentiment to increase or decrease over decades. Instead, monthly sentiment readings have moved in small increments, depending on the news of the day. Second, persistent fear sometimes accelerated the incremental moves into spikes higher or lower over a span of months. The spikes sometimes accompanied economic recessions, as they did in 2001 – 2002, 2008 – 2009, and 2020. If tariff uncertainty persists, sentiment could weaken; disrupt spending, triggering unemployment and contraction in housing and manufacturing activity; and from there cascade into recession.

Chart 2. Consumer sentiment drops have been poor predictors of recessions*



Sources: Bloomberg and Wells Fargo Investment Institute, monthly data based on the University of Michigan's consumer sentiment index, January 2001 - March 2025. Index: March 2000 = 100. *Gray bars denote recession periods.

We foresee no such falling dominoes, however. Spending shifted significantly lower in the first quarter, but under conditions we don't expect to continue. U.S. imports not only hit record-high levels but marked record monthly increases, likely anticipating tariffs. Imports don't count as part of U.S. economic growth until they flow from the

6. For a full report, please see "Perspectives on sell-off in AI-capex stocks", Wells Fargo Investment Institute January 28, 2025.
7. Ibid.

ports into shopping carts and delivery trucks as domestic purchases. The coldest January since 1988 and California wildfires also limited spending.

Meanwhile, income growth has quickened and household saving as a percentage of after-tax income increased through February. Households hesitated to spend to start 2025, but there is cash in the drawer. We expect a weak first-quarter economy and then a gradual recovery in growth from spring into year-end. This year's U.S. economic growth should be slower than last year's, in our view, but without a recession.

Broader strength in economic activity reinforces this outlook. Even beyond growing savings, ample bank credit makes funds available throughout the financial system; stock-market windfall gains have retreated but remain sizable; and the economy's credit-sensitive sectors (including housing) are seeing relief from recent lower longer-term borrowing rates. Encouraging gains in February factory orders reinforce our outlook.

What we favor doing now

We maintain our focus on the three themes of this report, which we may summarize as — a moderating economy, a valuation-related correction in technology stocks, and tariffs all impact financial markets negatively. However, we believe that the economy will recover from a weak first-quarter performance and that positive fundamentals in technology-related stocks will eventually reassert themselves. Finally, we would not be too quick to extrapolate tariff impacts based on the current size of the levies. Not all tariffs are created equal, and, ultimately, we believe people will again adjust to a higher tax by finding substitutes.

Tariff uncertainty is likely to continue, and actual tariffs will have costs, although we doubt that they will derail either the economy's moderate pace or the investment returns we continue to expect. Our guidance focuses on quality. We are skeptical of the rallies in Europe and China, and favor U.S. over international markets. In the U.S., we favor Large Cap and Mid Cap Equities. In fixed income, we favor reducing exposure to intermediate and long-term maturities (in other words, from three years and longer in maturity) while uncertainties remain high.

To that last point, tariffs focus on the Industrials Sector. While tariffs are a negative factor, we expect continued economic growth and some dilution of tariff impact. On balance, we hold a favorable view of the Industrials sector, but we also see areas of opportunity in sub-sectors Aerospace & Defense and Commercial and Professional Services, which should be somewhat insulated from tariffs. We also favor the Multi-Industrials, although here some due diligence is necessary, due to the diverse potential tariff impact.

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Each asset class has its own risk and return characteristics. The level of risk associated with a particular investment or asset class generally correlates with the level of return the investment or asset class might achieve. **Stock markets**, especially foreign markets, are volatile. Stock values may fluctuate in response to general economic and market conditions, the prospects of individual companies, and industry sectors. **Foreign investing** has additional risks including those associated with currency fluctuation, political and economic instability, and different accounting standards. These risks are heightened in emerging markets. **Mid-cap stocks** are generally more volatile, subject to greater risks and are less liquid than large company stocks. **Bonds** are subject to market, interest rate, price, credit/default, liquidity, inflation and other risks. Prices tend to be inversely affected by changes in interest rates. The **commodities markets** are considered speculative, carry substantial risks, and have experienced periods of extreme volatility. Investing in a volatile and uncertain commodities market may cause a portfolio to rapidly increase or decrease in value which may result in greater share price volatility. **Sector investing** can be more volatile than investments that are broadly diversified over numerous sectors of the economy and will increase a portfolio's vulnerability to any single economic, political, or regulatory development affecting the sector. This can result in greater price volatility.

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