Research

Currency Research

7 April 2025

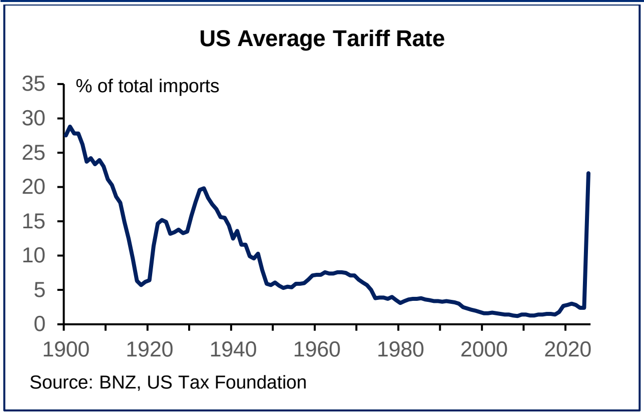
Tariff Turmoil

- **Our prevailing FX projections assumed a moderate Trump II scenario playing out. If Trump's reciprocal tariff regime remains in place, then the average US tariff rate will end up close to double our baseline assumption. The market has been equally shocked by where policy has landed, resulting in market turmoil.**
- **A period of market turbulence isn't a good time to be making forecast revisions. Heightened uncertainty remains and there are wide ranging scenarios ahead.**
- **The NZD is sensitive to the global growth outlook – global economic recessions or major downturns are ostensibly NZD-negative. For our current FX projections to be achieved, we'd need to see a serious de-escalation of the trade war. High on our watchlist over coming weeks will be whether China and US can begin talks to avoid further trade war escalation.**
- **All we can highlight at this point is that 0.55 for NZD/USD remains a key support level but a downward break is entirely plausible if a deep global downturn ensues. Of some comfort, we believe that NZD/USD already looks very "cheap" and a case might be building that we are close to peak pessimism on tariffs.**

Since President Trump was elected in November, our central FX projections have been predicated on a moderate Trump II scenario playing out. This assumed a phasing in of higher tariffs but not to the full extent threatened pre-election. We had assumed increased tariffs on China but well short of the mooted 60%, and mostly 10% tariffs on imports from other countries (likely with various carve outs), which culminated in about a 10% increase in the average tariff rate applied to all US imports (from the prevailing average of 2.4%).

Adding to the recent 25% tariff rate imposed on autos and added 20% tariffs for China, President Trump's Liberation Day reciprocal tariff announcement proposed a much more punitive tariff regime than imagined – much worse than market expectations, and an average tariff rate of about double what we had assumed. China will face an average tariff rate close to 70%, developing countries and South-East Asia in particular will be hit hard. Some two-thirds of countries face a baseline additional tariff rate of 10%, and the rest face additional tariffs ranging from 11-50%. That will lift average US tariff rates to around 22% or back to pre-World War I levels. That figure would rise on promised tariffs for pharmaceuticals, semiconductors, copper and lumber, which are forthcoming.

Avg US tariff rate heading back to pre World War I level



Markets, rightly, have spat the dummy, with a mooted tariff regime that looks even worse than the worst-case scenario envisaged.

Trump's signed executive order allowed for even higher tariffs if countries dared to retaliate while also considered reduced tariffs, subject to negotiations.

Some countries like NZ, Australia and Singapore have already indicated they won't retaliate. The EU is in discussions about countermeasures to be imposed if negotiations fail. Canada, which got off lightly as did Mexico on the reciprocal tariff policy, said it will match US tariffs on autos, but this won't apply to auto parts.

China's retaliation to the additional 20% tariffs applied February-March was meek but on Friday it decided to fight back on the added 34% reciprocal tariff with its own matching policy, adding an additional 34% tariff rate to imports from the US, alongside some other measures. These include immediately restricting exports of seven types of rare earths and imposing export controls on 16 US firms and other company-specific restrictions. A nasty global trade war has now officially begun.

As if forecasting the outlook with Trump at the helm wasn't already difficult, it has now become nigh-impossible. Where we ultimately land on tariffs, following constructive bilateral negotiations with Trump on one hand and layers of retaliatory measures on the other, is anyone's guess.

The additional 10% baseline tariffs measures look likely to stick, while the reciprocal tariffs look less likely so in their current form. These punitive tariffs are based on a simple formula related to the size of the country's trade surplus with the US, not based on actual tariff rates so it is not obvious what countries will need to "give up" to negotiate their reciprocal tariff lower.

The reciprocal tariffs policy is being implemented under the guise of a national emergency, which makes its legal underpinnings dubious. A successful legal challenge – and some are already in the works – could delay or curb the tariffs.

Many in Trump's Republican party currently support the policy, at least publicly, but this could easily reverse course as the economic shock reverberates. Indeed, how deep a hole the US economy falls into over coming months and how much further US equities plunge could be factors in any potential rollback of reciprocal tariffs.

Outside of where we land on US reciprocal tariffs, we must also acknowledge other global trade war factors. With China and South-East Asian exports looking for a new home, how do other regions respond? The EU, in particular, will be sensitive to being used as a dumping ground for discounted Asian goods and might consider imposing their own tariffs against Asia as a countermeasure. The FT reported a senior EU diplomat saying "we will have to take safeguard measures for more of our industries" and reminded that the EU had already put tariffs of up to 35% on Chinese EVs.

Forecast implications

In terms of currency forecasting, we not only need to consider where we might land on tariffs as a baseline assumption but the economic ramifications of the policy.

US-based economic forecasters are already downgrading US growth prospects and JP Morgan got plenty of coverage on Friday with its central forecast of the US economy entering an economic recession. The bank slashed its 2025 GDP forecast by 1.6 percentage points to minus 0.3% y/y for the December quarter.

The US fiscal policy response will be important. New tariffs, as they currently stand are equivalent to a massive tax hike and unless that money is quickly recycled back into the economy – and that might not happen until next year – near-term economic growth stands to be significantly impacted.

The Federal Reserve could soften the blow of a pending economic recession, but with inflation already above target and set to head higher – with many now looking for US core inflation to rise above 4% – the central bank will likely act cautiously.

The US March employment report was consistent with a resilient labour market, ahead of the forthcoming inflation shock. Chair Powell, speaking on Friday, repeated the line of not needing to be in hurry to offer support to the economy with lower rates, and emphasised the central bank had an obligation to make sure a temporary price boost from tariffs doesn't turn into something more persistent. The longer the Fed waits before cutting rates, the greater the chance of recession and the greater the likely depth of any recession.

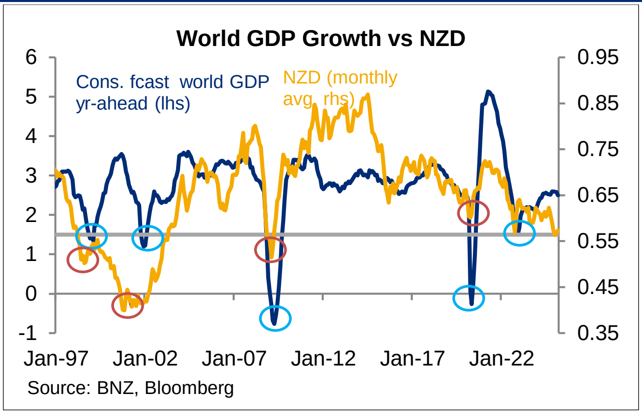
Other major central banks won't face the same constraint as the Fed, with the inflation shock largely confined to the US and other countries likely to face lower tradeable goods inflation in a world of surplus stock looking for a home. The initial reaction of oil prices – plunging to a four-year low – will add to disinflationary global forces if it is sustained.

However, a weaker US economy will reverberate around the world and global growth can be expected to be lower than previously thought.

Forces on currency markets are multi-faceted. Here we will focus on the NZD and broader USD implications.

The NZD is sensitive to the global growth outlook. Global economic recessions or major downturns are bad. It would be unusual for the NZD to appreciate when global growth forecasts are being revised downward. On that basis, our prevailing projection for NZD/USD to be stronger through the second half of the year looks optimistic.

Global recessions are bad for the NZD



That said, the US economy is at the epicentre of any global economic slowdown and the NZ economy has emerged out of economic recession. Prospects still look good for the NZ economy to recover this year. That is a unique feature in the current situation and could mitigate negative implications for the NZD.

China's policy response is crucial. While the opening salvo has been one of retaliation to the reciprocal tariffs, one might hope that cool heads eventually prevail and some negotiation to lower tariffs is the result. If negotiations drag on, then China has two key policy responses – deliver a weaker yuan and/or deliver a big bang domestic policy response to counteract the weaker growth implications of tariffs. To date, all year in fact, against market forces China has been actively preventing USD/CNY from rising, whilst making a half-hearted attempt to stimulate domestic demand.

If China loosens its grip on the yuan and allows a significant depreciation, then that would likely have negative spillover effects for the NZD. On the other hand, an overtly positive Chinese domestic policy response would be at worst NZD-neutral and more likely NZD-positive.

High on our watchlist over coming weeks will be whether China and the US can begin talks to avoid further trade war escalation. The NZD looks vulnerable in a world where Trump ramps up China's tariffs even further. But facing an effective average tariff rate close to 70%, which all but annihilates China trade with the US, China is in a position where it probably thinks it doesn't have much more to lose by standing strong against Trump, or fearing retribution by allowing USD/CNY to push higher.

Since tariffs were ratcheted up under Trump II there have been signs of the USD not responding in its usual way in terms of attracting safe-haven flows during risk off events. This has reflected US economic concerns being at the heart of such risk off events this year. In a world where US international trade activity might be structurally lower over years to come, questions about its reserve currency status are increasingly being asked.

The Smoot-Hawley Tariff Act of 1930, which introduced large-scale tariffs to protect the US companies at the onset of the Great Depression, is widely cited as deepening the economic downturn. There is a good argument for potential US economic growth to be structurally lower in a world where large permanent tariffs are in place. These would stifle entrepreneurship, make the US economy less competitive on the global stage and fuel corruption as companies seek to negotiate carve-outs.

Trump's social media post "CUT INTEREST RATES, JEROME, AND STOP PLAYING POLITICS!" is out of order and we can only hope that the Fed remains independent in its policy decisions. Any belief that the Fed is acting anything other than independently would have wide repercussions for the status of the USD, ostensibly negative.

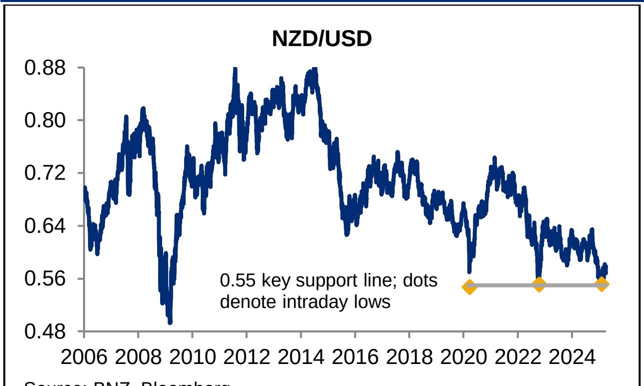
In sum, there are good reasons to believe that an air of vulnerability overhangs the USD, particularly so given the strength of the USD on long term valuation metrics.

A period of market turbulence isn't a good time to be making forecast revisions. Heightened uncertainty remains and there are wide ranging scenarios ahead. Our prevailing NZD forecasts sit at the more optimistic end of the scale and for them to be achieved, we'd need to see a considerable de-escalation of the trade war, such as a ripping up the reciprocal tariff regime. We wouldn't be overly fussed about our current forecasts if policy reverted to the pre-Liberation Day tariff regime even with the 10% baseline tariff policy remaining.

At the other extreme, is a scenario of further escalation of the trade war; equity markets falling another 20+% and a deeper US economic recession and global slowdown. At the extreme, a systemic financial shock must be considered a fat tail risk with unthinkable consequences.

All we can highlight at this point is that 0.55 for NZD/USD remains a key support level but a downward break is entirely plausible if a deep global downturn ensues. The prevailing situation doesn't feel as bad as the global financial crisis where NZD/USD reached an intra-day low of 0.4895. Of some comfort, is that we consider NZD/USD already to be trading as an extremely low level, which should limit the potential for further downside from here and a case might be building that we are close to peak pessimism on tariffs.

Key support for NZD remains at 0.55



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