CIO expects solid economic growth despite aggressive tariffs, bolstered by continued Federal Reserve rate cuts and a positive US backdrop. (UBS)

Are tariffs the next risk catalyst?

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Monday's DeepSeek tech and AI retreat has made President Trump's initial flurry of executive orders feel like a distant memory.

Prior to the emergence of the low-cost DeepSeek R1 model, markets were focused on the positive aspects of Trump's initial policy, with the S&P 500 reaching all-time highs. Part of this optimism stemmed from a lack of "Day One" punitive tariffs, with the president instead indicating a 1 February timeframe for measures on Mexico, Canada, and China. Trump's subsequent commentary on European and Chinese tariffs also left space for a dovish market interpretation.

With a measure of calm returning to the tech sector on Tuesday, we think tariff concerns may yet come back to the fore. The Financial Times this week reported US Treasury Secretary Scott Bessent is pushing for universal tariffs starting at 2.5%, with a stepped monthly increment by this same amount until they reach as high as 20%. President Trump on Monday suggested he'd like to see a sharper approach, and said he plans to impose tariffs on computer chips, medicine, and metal imports in an effort "to bring production back to our country." These headlines followed Sunday's near trade war between the US and Colombia over migrant deportation flights, with Trump's threats of punitive tariffs and sanctions pushing Bogotá to reverse course.

While the specifics of Trump's tariff policy remain uncertain, we draw several insights from these latest developments:

Tariff risks to Europe, China may be underappreciated. Trump has taken a more diplomatic tone with China in recent weeks, focusing on his personal relationship with President Xi. We note this comes as Trump seeks China's near-term support in pushing for a rapid Russia-Ukraine settlement. Still, there is a hawkish wing within the Trump administration (Rubio, Navarro, Ratcliffe, Waltz) and a bipartisan anti-China consensus within Congress. The EU, meanwhile, imposes a higher average tariff rate on US cars, chemicals, food, and agriculture products. It also has a long-standing trade surplus with the US. Several countries have imposed Digital Services Taxes on US companies, and other countries offer preferential corporate tax rates to large-cap tech companies, which drain US revenues. Europe will likely face non-trade related pressure on defense spending and NATO commitments. Adding to its problems, the EU has no direct negotiator, and has little obvious to offer to entice a compromise.

Other countries can expect a strong-arm strategy after Colombia's fast capitulation. In 12 hours, Colombia's government went from vowing to block the US repatriation flights to threatening 50% retaliatory tariffs on US goods, to ultimately relenting to the original terms. Colombia was a relatively easy target as the United States' third-largest trade partner in Latin America. The signaling intent is clear, in our view; a White House source told Reuters that Trump was "using Colombia as an example" and an official press statement later indicated that Trump "expects all other nations of the world to fully cooperate." Success with Colombia is likely to strengthen the administration's conviction in taking a strong hand when dealing with other partners.

Free trade agreements with the US are no shield against tariff threats. Though a relatively minor US trade partner, Colombia has long allied with Washington to combat drug trafficking and gangs. A Colombia-US Free Trade Agreement (FTA) was ratified in 2012, and Colombia is a major oil exporter to the US. Court challenges and trade dispute processes may yet test tariffs where free trade agreements are in place. Likewise, Canada and Mexico are in a binding free trade agreement negotiated by Trump's team in his first term. However, we believe Trump can still find success in enacting tariffs under the International Emergency Economic Powers Act (IEEPA) if the threat is based on immigration or national security, as in the case with the threatened 25% blanket tariffs on Mexico. The case against Canada on these grounds looks thinner, in our view. Regardless of legal outcomes, the economic damage incurred by Trump's tariffs will accumulate through any challenge, providing Trump with a potent negotiating lever to force changes.

So, we anticipate more tariff threats and asset volatility ahead. Our base case on the severity of tariffs is for an aggressive stance, in which the effective tariff rate on China rises to 30% (up from 11% now), and the US focuses on Rules of Origin to limit transshipments of goods through third-party economies like Mexico, Vietnam, and others. Still, we expect solid economic growth despite these aggressive tariffs, bolstered by continued Federal Reserve rate cuts and a positive US backdrop. While market volatility may increase, we believe the risk-reward for equities remains attractive, with around 9% upside for US stocks over the balance of 2025, thanks to robust economic growth, AI tailwinds, and gradually falling yields.

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