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WS Global CIO Office
03 February 2025

Market Watch

Tariff war begins

Summary

US President Donald Trump unveiled plans to impose 25% import tariff on Canada and Mexico and 10% tariff on China from Tuesday, with threats to raise the tariffs if the target countries retaliate. He also pledged to impose tariffs on Europe. Canada has announced 25% counter-tariffs, while Mexico pledged to retaliate.

Asia equity indices and US and European equities futures fell, the USD and oil prices rose, while US long-term bond yields fell. The reaction suggests risk-off behaviour amid concerns tariffs will ultimately hurt global growth, despite raising near-term inflation risk.

The tariffs belie earlier expectations Trump may tone down his trade rhetoric. The tariffs could still be Trump's opening gambit of negotiations with trade partners with the goal to cut the US trade deficit and attract foreign investment. Nevertheless, risk assets are likely to remain under pressure until such deals are reached.

Stay diversified, with a preference for US assets and gold. A well-diversified foundation allocation is critical for navigating trade-related volatility. We continue to add to US and European government bonds to lock-in elevated yields. The USD is likely to be bid near-term, with next EUR/USD support at 1.018. The S&P500 has support at 5,800.

Background and policy implications

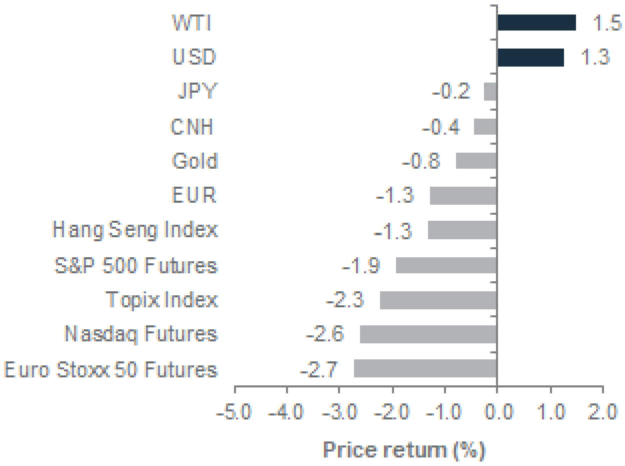
Stiffer-than-expected. The starting 25% blanket tariffs on Canada and Mexico are stiffer-than-expected, although Canada's energy exports face a lower 10% tariff, while the 10% tariff against China is significantly lower than the 60% threatened during Trump's election campaign. Trump's threat to raise the tariff rates if the target countries retaliate and widen the scope to include the European Union are bigger concerns as it could signal further escalation. China's response is another unknown, although we believe it's likely to be measured.

Opening gambit for trade negotiations? Trump's softer tone in the first week after he assumed office suggests the tariffs are the starting point of renegotiating trade deals to get more favorable terms for the US. Trump plans to speak to Canada's PM Trudeau and Mexico's President Sheinbaum, sustaining the possibility of a last-minute deal before the tariffs go into effect on Tuesday, 4 February.

Near-term inflation, medium-term growth risks. History shows Trump's prior tariffs imposed in 2018 lifted short-term inflation, but hit medium-term growth. This explains why bond yields initially rose after tariffs were imposed in 2018, but then fell sharply on growth concerns. Nevertheless, the Fed could delay rate cuts until it has more clarity on inflation. Hence, short-term bond yields are likely to stay elevated, while long-term yields are likely to decline amid growth uncertainty.

Stocks fell, while the USD and oil prices rose, amid concerns Trump's tariffs would hurt global growth

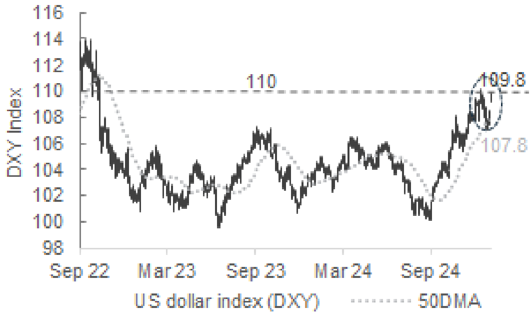
31 January close to 03 February 3PM HKT/SGT



Source: Bloomberg, Standard Chartered

The US dollar index faces resistance just above 110

US dollar index (DXY)



Source: Bloomberg, Standard Chartered

Trump tariffs in 2018 eventually lowered bond yields

US 2-year and 10 year government yields in 2018-19

Source: Bloomberg, Standard Chartered

What does this mean for investors?

Equities

Prior to the Lunar New Year holidays, Hong Kong and China equities had seen some sentiment improvement from DeepSeek and the "rise of Chinese AI". These gains are fading with the tariff news. We see 20,300 as the near-term resistance for the Hang Seng Index, with 19,640 as near-term support. If news on the trade war worsens, we may see Hang Seng Index test 18,670. We maintain a neutral allocation to China equities and prefer a barbell approach, with exposure to the Hang Seng Technology Index, as well as China's high-dividend yielding, non-financial state owned companies.

While we continue to favour US equities as we anticipate the upcoming tech earnings updates to allay DeepSeek-triggered fear and exhibit strong earnings growth, investors may be concerned near-term about how Trump can generate "non-inflationary growth" given tariffs are inflationary by nature, and volatility may rise. We see resistance for the S&P500 at 6,120 and support at 5,800.

Bonds

US government bond yields fell as investors sought safety amid an equity sell-off following Trump's tariff announcement. The yield curve continued to bull flatten, with long-term yields declining faster than short-term yields. This shows economic growth concerns have outweighed inflation fears. That said, we need to watch oil prices closely – the 10% tariffs on Canada's oil exports to the US risks boosting US gasoline prices, a key driver of US inflation expectations.

Nevertheless, we maintain our view that the Fed will cut rates by 75bps in 2025, compared with the 50bps currently priced by the money market, as growth concerns return. After the recent yield rally, we see an opportunity to lock in attractive yields at current levels.

The benchmark US 10-year government bond yield briefly touched a high of 4.58% last Friday before retreating to 4.52% in Asia Monday morning. Technical indicators suggest that 4.52% remains a key resistance level, with a break lower potentially opening the way to the next support at 4.47-4.48%, followed by 4.25%.

FX

The US tariffs are likely to provide a short-term boost for the USD index (DXY). A firm break above 110.2 could pave the way for a test of the next resistance at 111.3. However, with most tariff concerns already priced in, further tariff escalation could become a headwind for the dollar as US economic growth suffers. The focus now shifts to how target countries respond. In particular, China's response will be closely watched, especially its fixing of USD/CNY when markets reopen after the holiday on Wednesday. We see USD/CNH key resistance at 7.40. We also anticipate increased chances of fiscal stimulus at China's National People's Congress in March.

Tariff-related uncertainty is likely to support safe-haven currencies, particularly the Japanese Yen, in Q1. The JPY stands out as the only G10 currency to strengthen against the dollar this year, rising 1% YTD. This partly reflects the BoJ's rate hike expectations, while other major central banks cut rates. However, most USD/JPY technical signals are in neutral territory, with the pair facing resistance at 160 and support at 152.8. We expect the JPY's strength to be more pronounced against non-USD currencies. With Europe potentially being the next target of US tariffs, any tariff announcement could drive EUR/USD towards parity. We have a bearish EUR/JPY view to capture potential EUR downside and JPY upside.

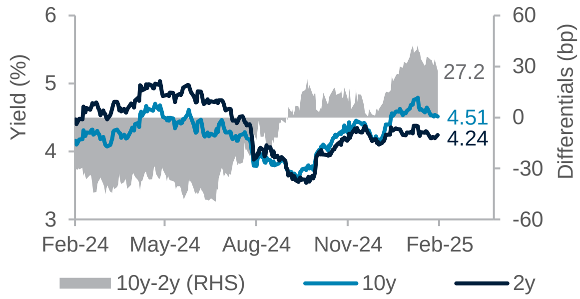
The sentiment lift for Hong Kong stocks from China's AI boost is fading; the Hang Seng index faces next support at 19,640, followed by 18,670

Hang Seng index, with key technical levels

Source: Bloomberg, Standard Chartered

The US government bond yield curve continues to flatten after peaking in early January, with long-term yields falling faster than short-term yields

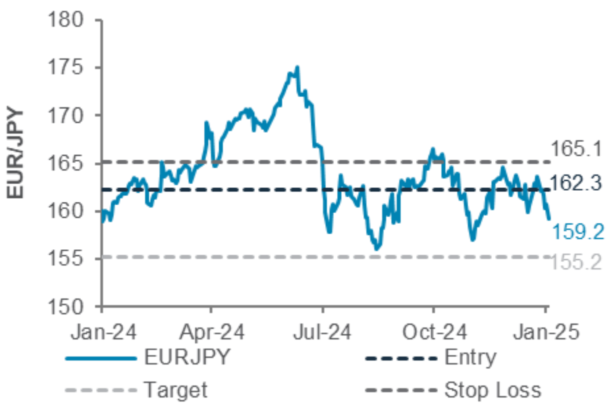
US 10-year and 2-year government bond yields and their difference



Source: Bloomberg, Standard Chartered

We're bearish on EUR/JPY amid US-related trade risks facing Europe and ECB rate cuts, while the JPY is supported by expectations of BoJ rate hikes

EUR/JPY, with key technical levels



Source: Bloomberg, Standard Chartered

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