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Tariffs: Bigger impact on growth than inflation

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Executive Summary

The US Administration's reimagining of global trade is underway as the US President seeks to implement the 'America First Trade Policy' and trigger a restructuring of the global economic and geopolitical order. Given the negative impact these policies will have on both US and global growth, the question this begs is if these policies will create a tariff-induced recession? The America First Trade Policy has seen market volatility soar and has raised 'stagflationary' fears of weaker growth and higher inflation.

It is our view that the downside risks to growth will dominate the upside risks to inflation. There has, for decades, been a progressive freeing up of markets with a global approach to reducing protectionism in favour of free trade. This policy is now being turned on its head with the President of the United States referring to the word "tariff" as the "most beautiful word in the dictionary." The America First Trade Policy is more universal and at a cumulative higher rate than initially indicated, and this has seen the average tariff rate rise to around 20% rocking financial markets. This Administration says that they are much more concerned about 'Main Street' rather than 'Wall Street,' however strains in financial markets are very likely to spill over to the real economy should they be sustained.

We examine the ‘nature of tariffs’ and assess their impact on growth and inflation (notwithstanding their evolving implementation) to suggest that **tariffs will result in a more material negative hit to growth than they will cause persistently higher inflation outcomes**. Tariffs, at their core, are a form of policy tightening, which takes income away from the private sector and transfers it to government – withdrawing liquidity. Tariffs will, in this context, likely cause a ‘price level’ hike if the tariff costs are passed on, however, the risk of higher inflation only emerges if tariffs are *repeatedly* imposed for a longer period causing sustained ‘price growth.’ This combination of factors solidifies MAM Fixed Income’s Global Strategic Forum (“Strategic Forum”) **outlook for a step-down in US growth, without significantly raising the likelihood of longer-term inflation**. The US economy enters this episode with several key supports, with private sector balance sheets in a relatively healthy position, fiscal policy remaining supportive, and the US Federal Reserve (“Fed”) having plenty of room to cut rates should the economy start to seriously falter. So, while a ‘technical’ recession is certainly possible in coming quarters, we would expect US growth to be better supported in the medium term.

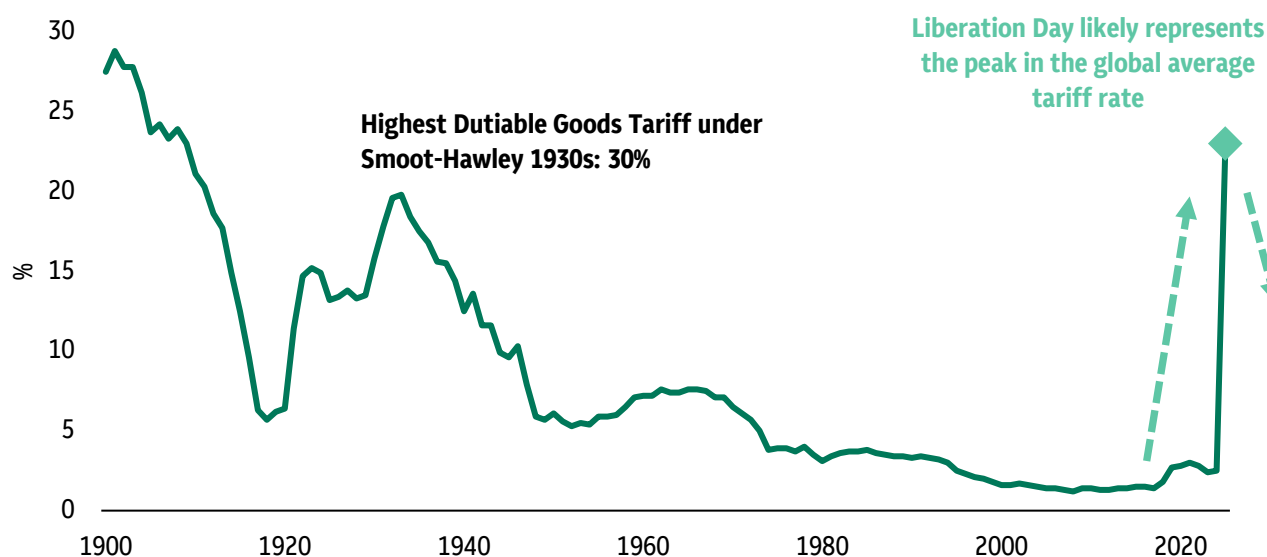
Introduction

The US Administration’s reimagining of global trade and its impact on growth and inflation has seen policy uncertainty soar, and its evolving nature has led to debate and discussion about its potential impact on the global economy. There has been a multi-decade reduction of trade barriers with a global approach to walking away from protectionism in favour of free trade. This policy backdrop has now been turned on its head, raising the question will it create a tariff-induced recession?

It is our view that the **US is likely to suffer a more significant reduction in growth than a significant sustained increase in inflation**. The current prevailing conditions of the US economy ahead of the introduction of these tariffs have been ‘resilient’ but far from ‘robust.’ When combined with the tightening in financial conditions from the significant risk aversion in financial markets, the downside risks to the US growth outlook have materially increased.

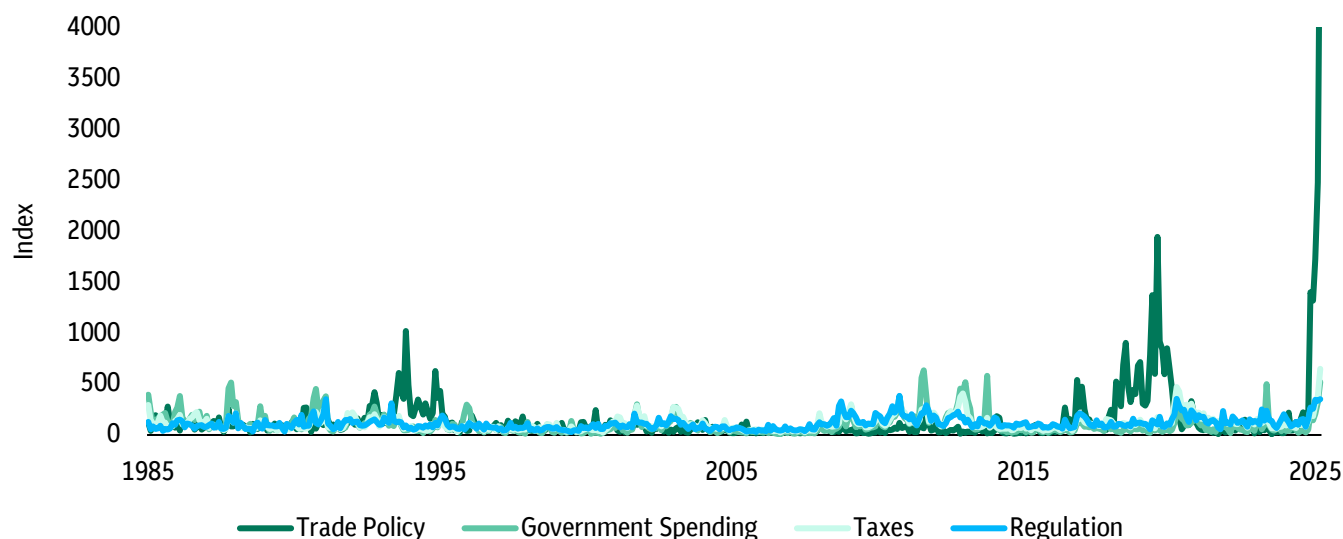
Our Strategic Forum view has been for a step-down in US growth into a 1.0%-2.5% range, and these measures suggest **outcomes in the lower end of this range are now more likely in coming quarters, with an increasingly material risk that we see outcomes lower than this at some point over the next few quarters**.

Figure 1: US Average tariff rate on all imports (1900 - Today)



Source: US Tax Foundation (April 2025)

Figure 2: US Economic policy uncertainty indices



Source: Economic Policy Uncertainty (April 2025)

The uncertainties around these measures – and their unprecedented scale and scope – complicates attempts to model their impact, however **our calculations suggest any temporary inflation spike in the US Core PCE should be limited to around 1.0-1.5%**. How other countries respond, and the reaction of the US dollar, remain major question marks. The extent to which the resulting softening in US and global demand weighs on the ability of cost increases to be passed on to end-consumers also introduces considerable uncertainty to these calculations. We are particularly alert to the risk of deteriorating financial markets amplifying the growth impact of tariffs via a sustained tightening in financial conditions.

While tariffs are likely to weigh on US growth in coming quarters, there are a number of key supports for the US economy that should provide some offsets. Private sector balance sheets are in a relatively healthy position – household debt for instance is around 70% of GDP compared with nearly 100% of GDP going into the Global Financial Crisis (GFC). Moreover, fiscal policy remains supportive, and the Fed has significant room to cut rates should the economy start to seriously falter. So, **while a ‘technical’ recession is certainly possible in coming quarters, we would expect US growth to be better supported in the medium-term.**

Assessing the impact of tariffs

The America First Trade Policy is a centrepiece of this Administration’s economic plan, rather than just a negotiating tool in foreign relations, with the view to:

Figure 3: America first trade policy



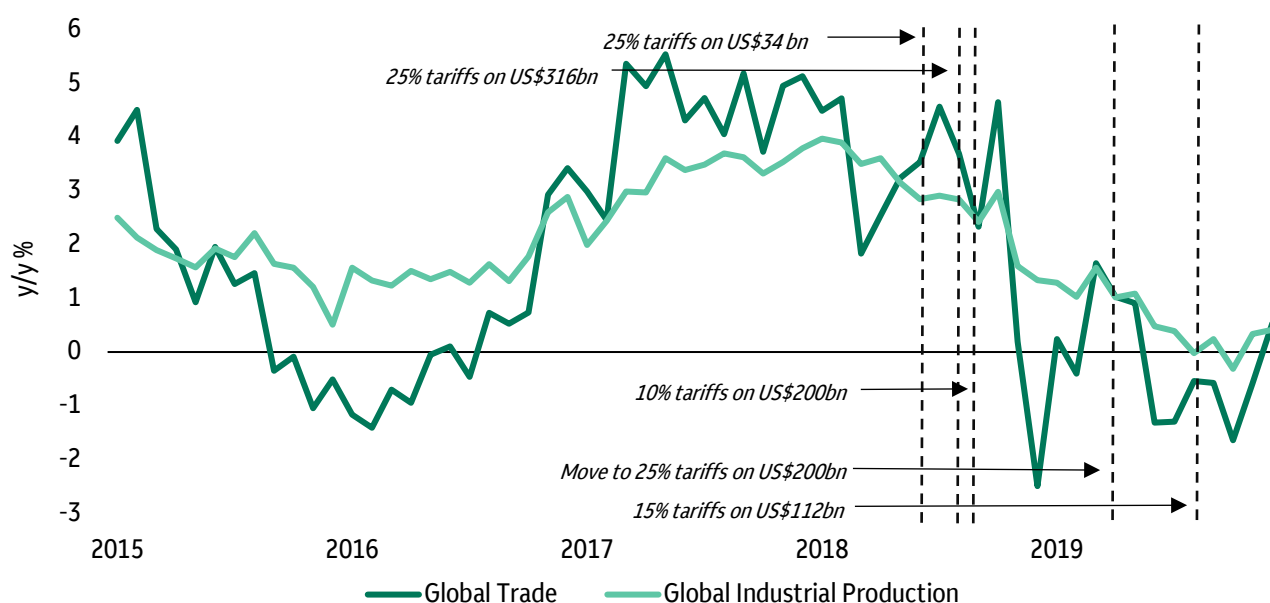
Source: White House, Trump Campaign Plan (April 2025)

These tariffs are a form of 'policy tightening' which takes income away from the private sector and transfers it to government – withdrawing liquidity. It is our view that the overall assessment of the macroeconomic impact and how the broader economy ends up will not only depend on the actual tariff policy, but also on subsequent second round responses, which, in turn, will depend on prevailing economic conditions.

Our Framework for assessing the impact of tariffs on growth and inflation examines the:

- **Size** of tariff rate imposed
- **Scale** of application (e.g. across-the-board or more country and/or product specific)
- **Persistence** of the tariff (e.g. once-off or frequent applications, and for how long).

Figure 4: Global trade and industrial production growth



Source: CPB Netherlands Bureau for Economic Policy Analysis (April 2025)

Tariffs would have the most impact if the rate imposed is higher, more across-the-board and more persistent, but ultimately **it is the subsequent-round effects in response to the tariff that determine the final inflation and growth outcomes.**

These key subsequent-round effects in responses to tariffs can be summarised as:

- Nature of product and market structure of import (e.g. essential versus discretionary and competitive versus monopolistic)
- Availability and viability of access to alternatives/substitutes (e.g. domestically or internationally)
- Prevailing economic conditions.

These effects depend on the degree of tariff 'pass-through' and the 'responses' to that pass-through.

MAM Fixed Income's Global Tariff Matrix summarises the expected growth and inflation outcomes from an imposition of tariffs given the prevailing conditions of the economy. In our view, the **US economy is likely to be in a weaker, rather than stronger, demand position, with access to substitutes not readily available but with the potential to add capacity if the right policy were enacted.**

Figure 5: MAM Fixed Income Global tariff matrix | Impact on growth and inflation

Global Tariff Matrix	Essential Goods	Non-Essential Goods
Strong Economic Conditions	Growth  Inflation 	Growth  Inflation 
Weak Economic Conditions	Growth  Inflation 	Growth  Inflation 

Source: Macquarie

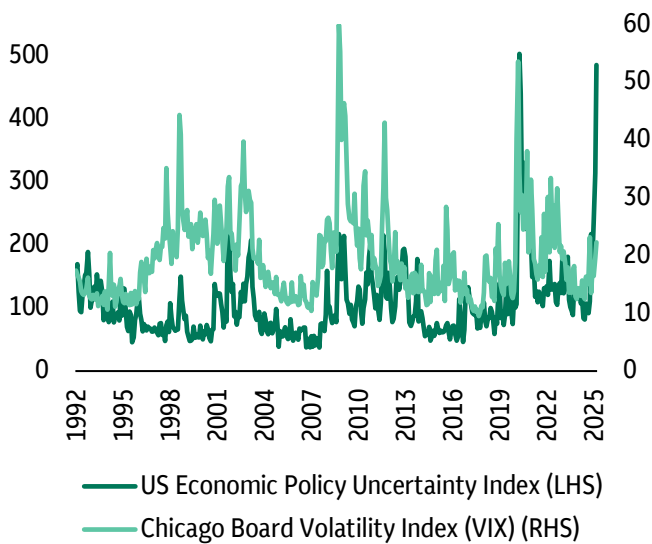
Tariffs alone cannot lead to a *sustained* rise in inflation, and at worst, can lead to a *temporary* increase in inflation that will give way to renewed disinflation. Tariffs are like a 'consumption tax' where the impact is washed out of the annual inflation rate after a year, and without commensurate increase in nominal incomes, the higher taxes act as a drag on consumer's spending power and inflation. Higher tariffs, like all tax increases, are a drag on disposable income and lead to less household consumption, which over time is disinflationary.

Tariff costs represent a loss of income to the private economy – no matter how they are divided and absorbed by the importer, intermediate user (mainly import-reliant producers), end consumer or the exporter in the country of origin. The reaction from domestic producers tends to see a reduction in 'supply' over time, usually slower than a contraction in 'demand,' as the availability and viability of access to alternatives sources for tariffed goods are not always immediate (nor even always available in the longer-term). There are other factors such as quick access to raw material inputs, labour supply, and supporting transport logistics which could impede the ability of domestic producers to sufficiently meet the switch to domestic substitutes. US production capacity today, especially in manufacturing (except for high tech and energy), has generally not grown sufficiently to replace key imported goods, especially consumer related goods. If imports are essentials, and consumers are cautious, then there is likely to be a reduction in spending on discretionary items to maintain spending on essential goods.

Our 1-2-year outlook for growth and inflation

In our view, the **US is expected to suffer a more significant growth slowdown than a sustained higher inflation outcome**, as the downside risks to growth will dominate the upside risks to inflation. The prevailing conditions of the US economy have been 'resilient' but far from 'robust,' and when combined with the tightening in financial conditions from the risk aversion in financial markets, the downside risks to the US growth outlook have materially increased.

Figure 6: US economic uncertainty policy index & VIX



Source LHS: Economic Policy Uncertainty, Chicago Board Options Exchange (CBOE) (April 2025)
 Source RHS: Economic Policy Uncertainty, US Department of Treasury (April 2025)

Figure 7: US economic policy uncertainty & US Corp BBB Spread

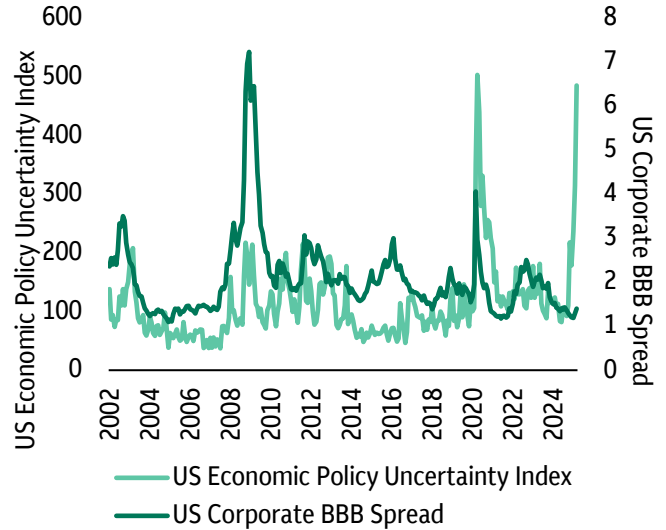
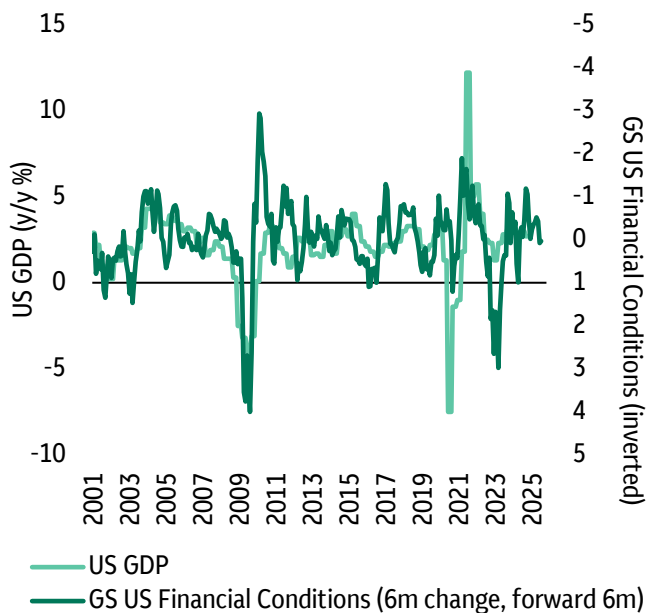
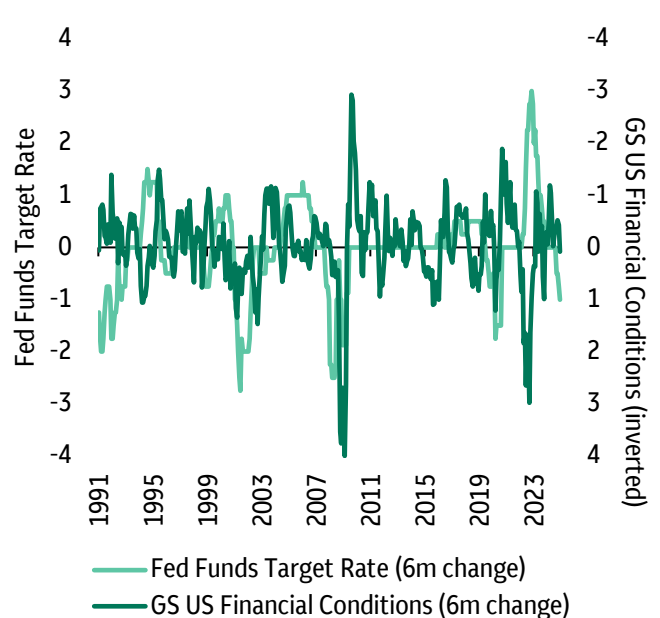


Figure 8: Tighter financial conditions reducing upside to growth



Source LHS: US Bureau of Economic Analysis, Bloomberg (April 2025)
 Source RHS: US Federal Reserve, Bloomberg (April 2025)

Figure 9: Financial conditions not suggesting large cuts needed



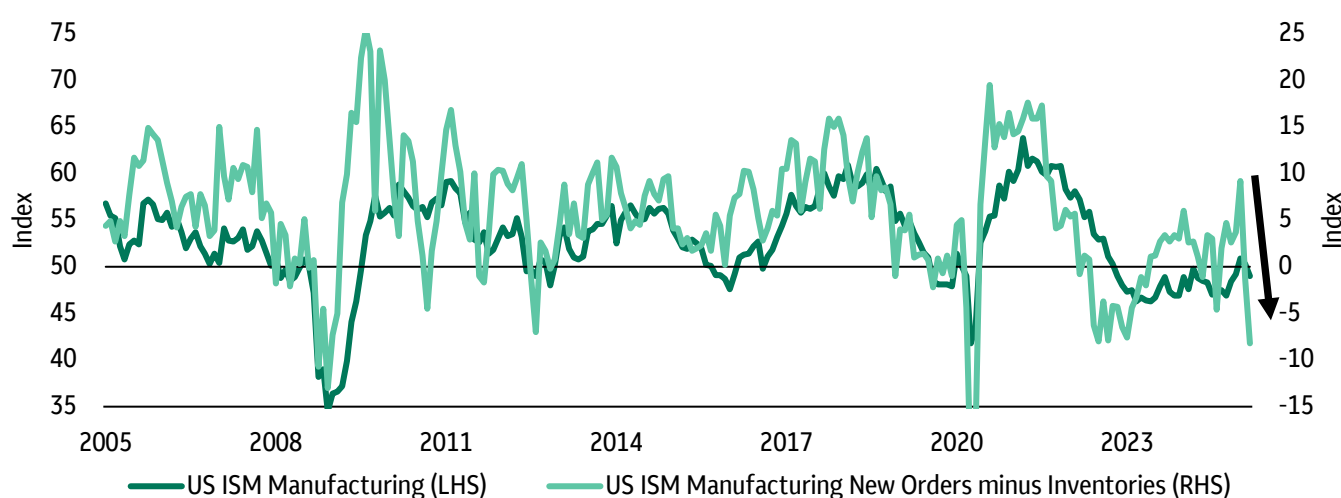
The US economy has been growing above expectations since the recovery from the COVID pandemic, however this has **largely been due to prolonged fiscal policy support**. The traditional engines of growth have been contributing less to this outperformance – households might seem ‘resilient’ but are far from ‘robust,’ while producers remain profitable yet are reluctant to shake off the caution since the GFC. US domestic demand is therefore hovering slightly above average trend, but remains prone to weakness, with the likelihood of recession greater than that of overheating.

The US may be adequately supplied in key essential items like food and energy, but its critical industries can still be materially impacted, generating significant negative spillover effects to the broader economy. The bulk of US imports are intermediate inputs into core industries (e.g. steel for the automobile industry, rare earth minerals and electronic components for defence manufacturing), and as we saw during COVID the loss of easy access to small but crucial components such as semiconductors contributed and prolonged a significant contraction in activity.

Recent data suggests the US has already entered a period of economic weakness even before the implementation of any major tariffs. **If Q2 is also weak as widespread tariffs come into effect, the US economy could experience a technical recession in H1 2025** (though not necessarily the NBER's classification of one).

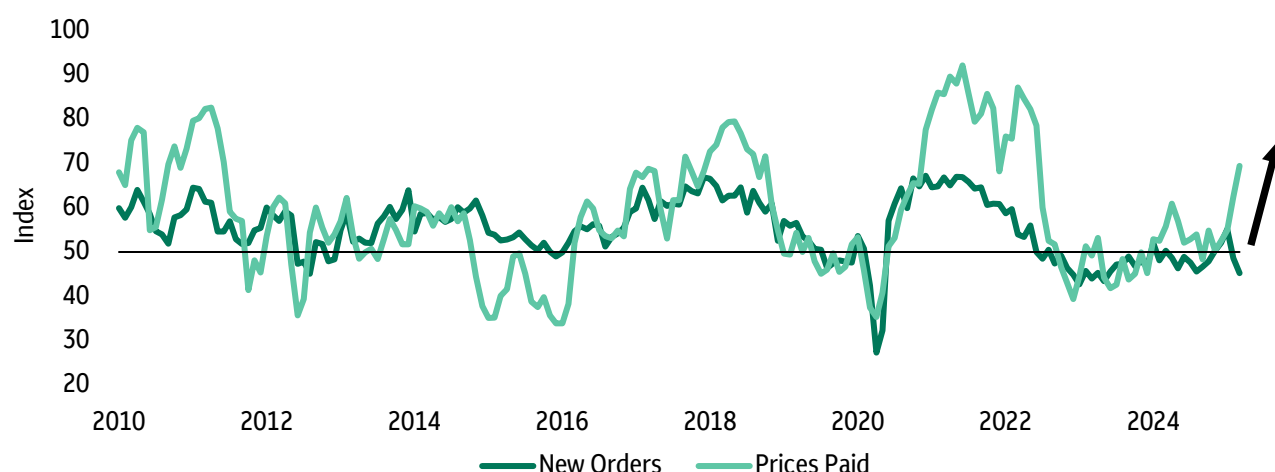
The US Administration believes that tariffs will lead to a revival in the US industrial sector, however the US ISM Survey points to a manufacturing downturn. The most recent ISM Index has not only dipped back below 50, but the collapse in the new orders/inventories ratio points to more weakness ahead (see below).

Figure 10: US ISM manufacturing | Tariffs will lead to weaker manufacturing



Source: Institute of Supply Management (ISM) (April 2025)

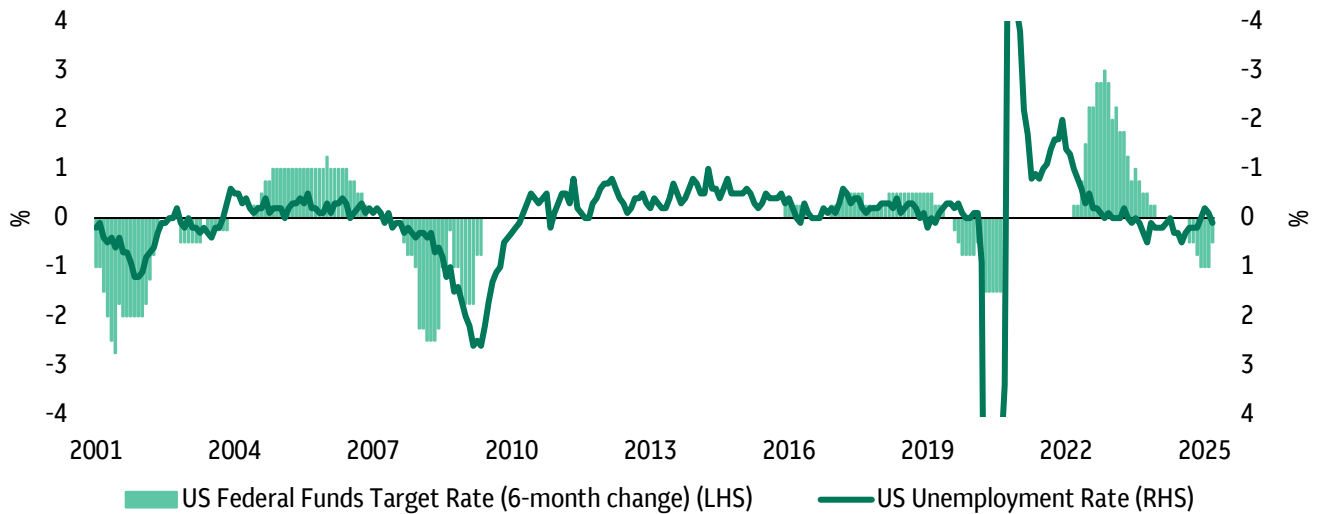
Figure 11: US ISM manufacturing | New orders down, prices paid up



Source: Institute of Supply Management (ISM) (April 2025)

Lower production and spending would eventually mean fewer jobs. The US unemployment rate has crept up from around 3.5% to a little over 4%, however this remains consistent with the Fed's estimate of full employment. The risk is that the labour market could soften to the point that it will no longer meet the Fed's objective of 'maximum employment' and how firms respond with their hiring and firing decisions in coming months will be critical in determining whether the current business caution has turned into more outright pessimism. This is something the Fed would likely respond to rapidly.

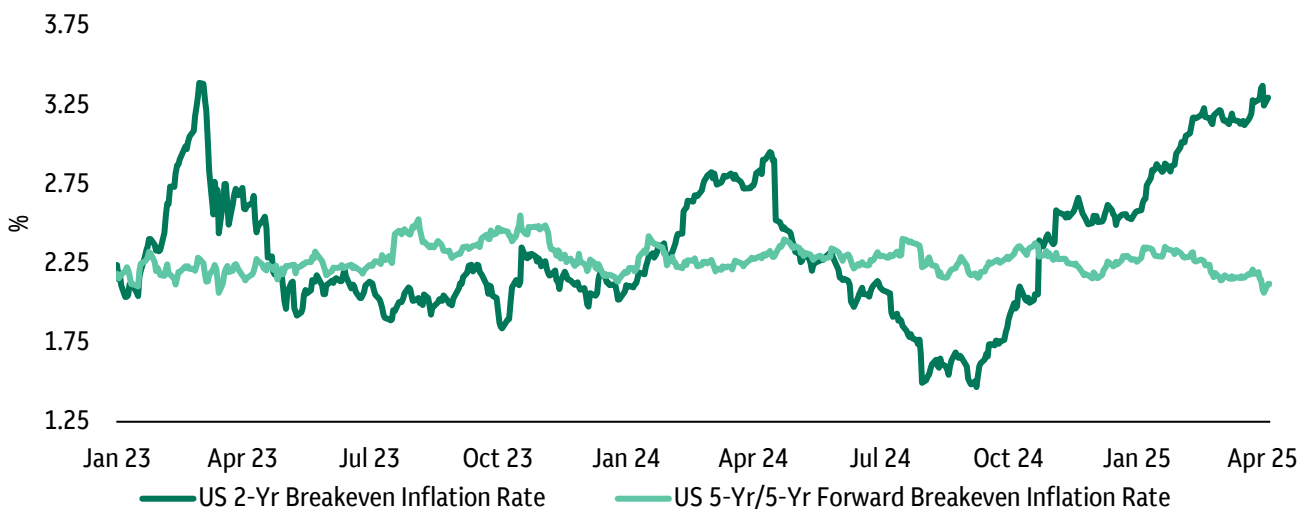
Figure 12: US labour market key for further Fed action



Source: US Federal Reserve, US Bureau of Labor Statistics (April 2025)

As noted above, tariffs alone cannot lead to a sustained rise in inflation, and at worst, can lead to a temporary increase in inflation that will give way to renewed disinflation. We expect in all scenarios a hike in US price levels, where our calculations suggest any temporary inflation spike in the US Core PCE should be limited to around 1.0-1.5% – thus worsening the cost-of-living stresses. Importantly, this rise in inflation would not be on a long-term basis unless tariffs are hiked repeatedly. Giving us greater confidence in this view is that inflation expectations, for the most part, have remained well anchored. Longer-term inflation expectation as measured in the rates market have remained well contained. While longer-term inflation expectations in the University of Michigan consumer sentiment survey have risen markedly in the past few months, other surveys such as the New York Fed's survey of consumer expectations have shown no such rise. This indicates that beyond the short-term increase, inflation is not expected to overshoot the Fed's 2% inflation target in the long-term.

Figure 13: US Long-term inflation break-evens are well-anchored



Source: Bloomberg (April 2025)

Conclusion

Our analysis shows that tariffs will cause more significant negative growth reactions than sustained higher inflation outcomes. This is because imposing tariffs is fundamentally a tax increase – it is effectively policy contraction because it removes income from the private sector and transfers it to the government. There should also be a negative impact on financial asset market values as income removed reduces power in acquiring financial assets – in other words, tariffs will lead to a loss of market liquidity (this is above and beyond any impact these measures will have on valuations due to the negative effect they will have on corporate profitability).

These expectations are consistent with the prevailing economic conditions in the US where household and business demand remain cautious amidst uncertain income prospects. If trade counterparties retaliate, especially if they go beyond tariffs and impose quantity restrictions/quotas, then the negative impact on growth will be further amplified. To be sure, as long as some degree of tariff increase is passed through, price levels will increase. For inflation to arise, however, it is crucial that demand be persistently strong. Therefore, the prevailing weaker than average demand should result in lower pricing pressures.

The imposition of tariffs in the US is likely to solidify our Strategic Forum outlook for a step-down in growth without significantly raising the likelihood of longer-term inflation – albeit with more volatility and bumpiness on the path to lower inflation targets.

Important information

This research paper was written by Macquarie Asset Management Fixed Income (MAM) and represents the perspectives of the MAM Fixed Income team.

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