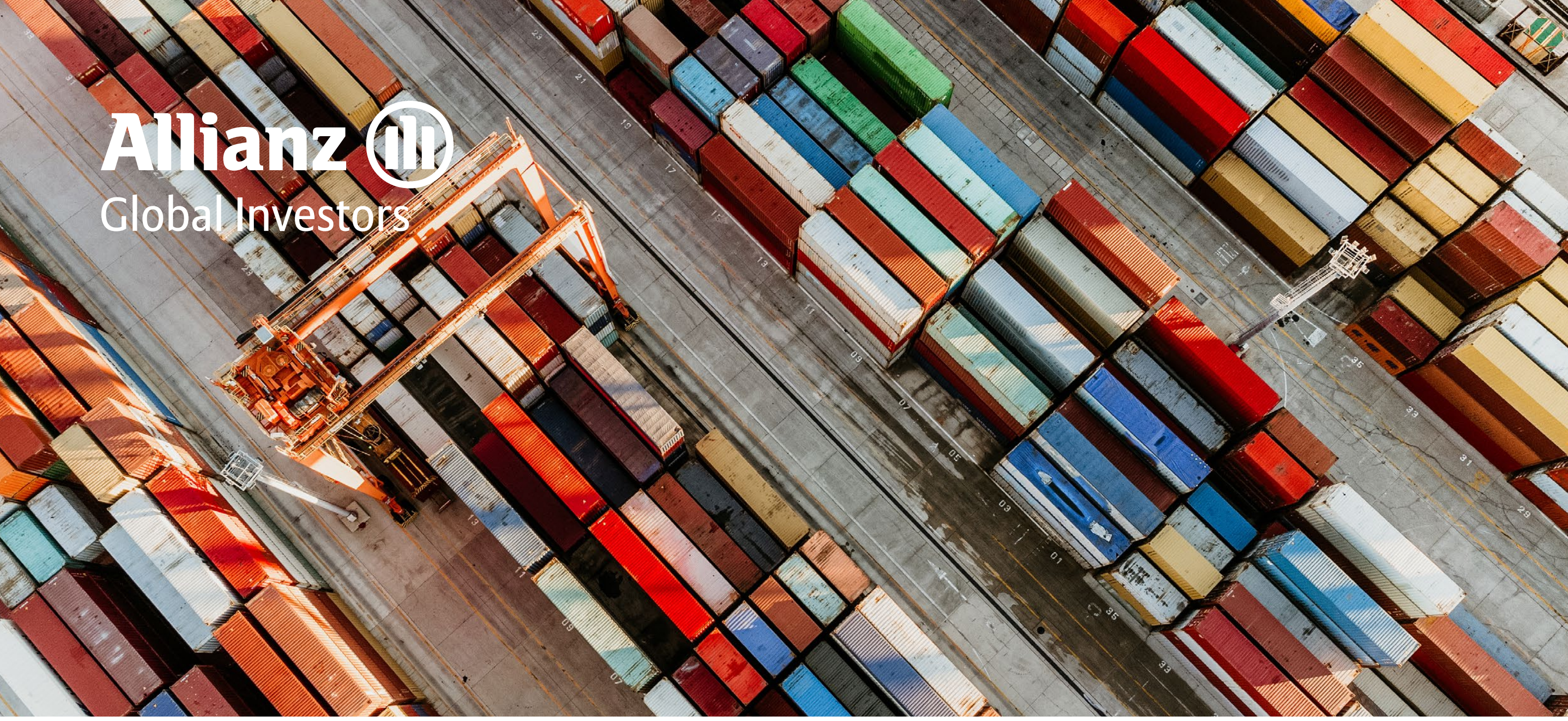

Allianz Global Investors

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New world re-order: how Trump's tariffs will reshape global supply chains

Despite the global economy being more prepared for potential supply chain disruptions than it was in the run up to, and start of, the first Trump administration, Trump 2.0 is likely to present a new set of issues to be navigated by global corporates. Given the President's mercurial nature – we have already seen, in just a few days, 25% tariffs levied on Canadian and Mexican goods, then abruptly "paused" – there are likely to be many twists and turn in the coming months and years. Indeed, we are currently seeing the ground being set for the administration's relationship with China – 10% US tariffs have been met with retaliatory measures on US coal, liquid natural gas (LNG), and agricultural machinery. And now we are seeing the US Postal Service declining to accept parcels from China or Hong Kong amid a row over the so-called "de minimis" tax loophole.

While the landscape will likely continue to change often and rapidly, the President's rhetoric – as well as lessons from Trump 1.0 – means that we can draw inferences as to what some of the probable effects on multinational corporations and their supply chains will be. The good news is that we view a global trade war as a highly unlikely worst-case scenario. As the chart below shows, there are multiple potential off-ramps before this scenario is reached and – as recent weeks have shown in the cases of Mexico and Canada – threatened tariffs do not always translate into concrete action.

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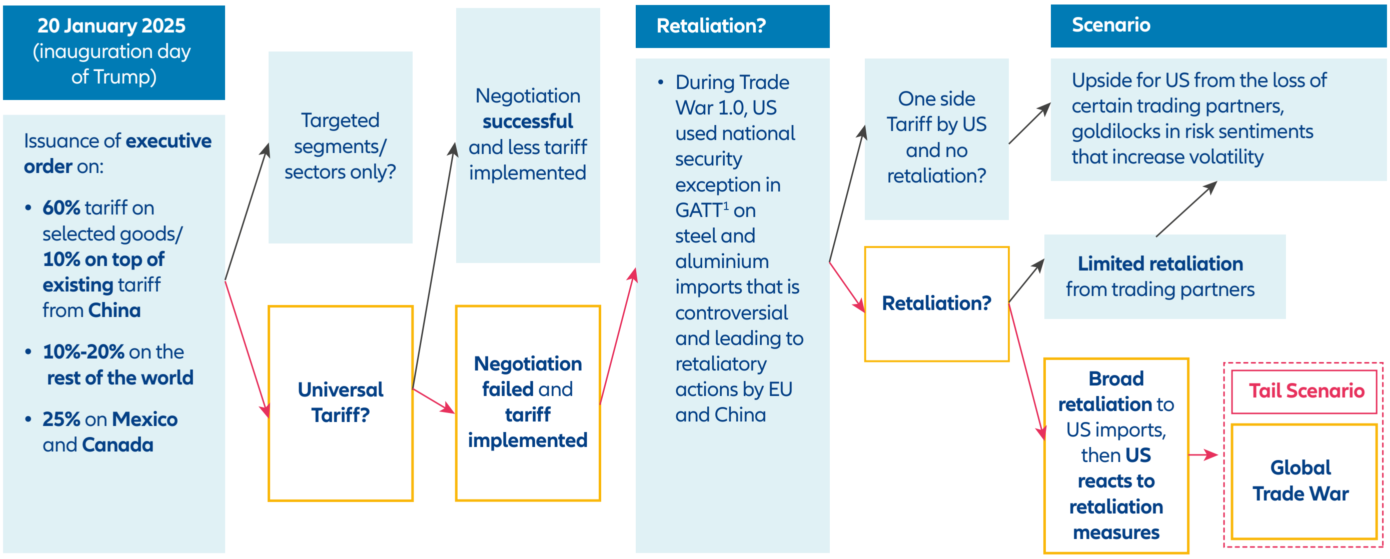
Possible scenarios on tariff



[1]GATT: General Agreement on Tariffs and Trade

Global considerations

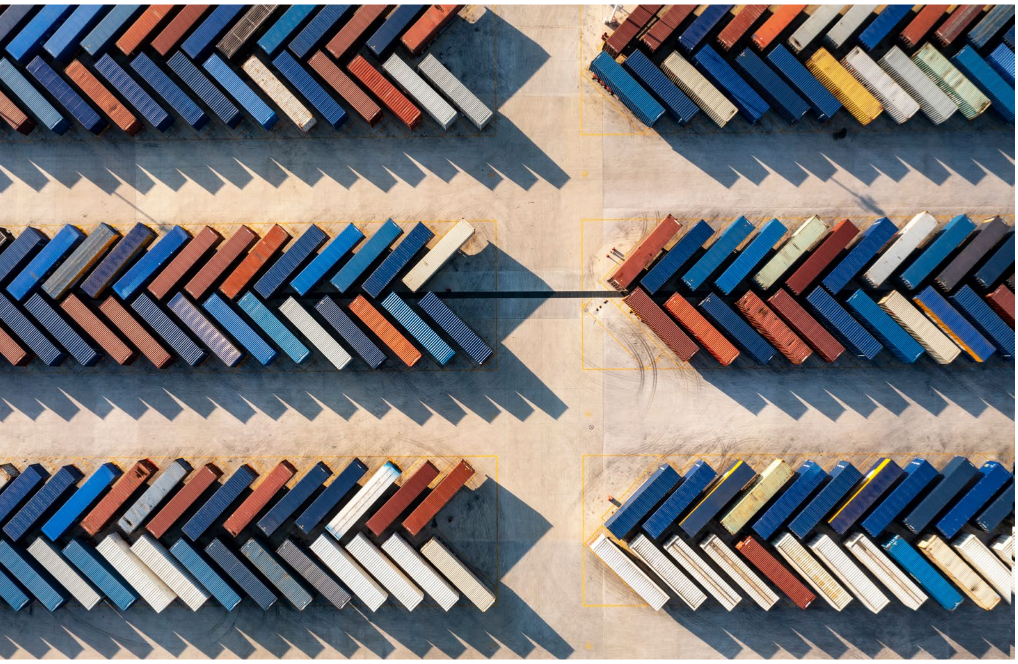
Given Trump's previous pronouncements, when the dust settles, we expect Trump's trade policy to have the greatest effect on countries where the US has the largest trade deficit, including China and Asia more broadly. In his first term, we saw targeted tariffs on certain Chinese materials– notably on steel and aluminium, but also on other industrial goods such as, for example, aircraft parts and semiconductors. These measures saw retaliation from China, with tariffs placed on a range of mainly consumer goods, including food and alcohol products.

While these measures had some effects on the US, Chinese, and global economies, the overall consequences were relatively small and did not prompt any large-scale disruption to supply chains or trading arrangements. Interestingly, during Trump 1.0, currency moves – i.e. a strong USD –alleviated a sizeable part of the impact. One of the risks this time around is the possible escalation of tariffs globally, as the US is now viewing all its trading partners as potential targets. Indeed, alongside disruption to trade flows, we also expect that new tariff measures will impact cross-border direct investment flows as manufacturers strive to direct investment towards destinations – in Asia and beyond – that will be least affected by Trump's protectionist measures. This may, in fact, have a positive impact on economies on the receiving end – for example, since the first wave of tariffs, India and Vietnam have benefited from the redesign of the global supply chain.

Turning to the domestic situation in the US, the imposition of new tariffs on imports and the extension of the 2017 Tax Cuts and Jobs Acts – commonly referred to as the "Trump tax cuts" – are both likely to be inflationary and cause US government debt as a percentage of GPD to rise significantly. Indeed, we are already seeing the yields of long-duration US treasuries rising to reflect updated inflation expectations, as well as an additional risk premium based on a deteriorated discal outlook. While these measures may potentially be domestically pro-growth, they are also leading market participants to scale back their expectations in terms of Fed rate cuts for the coming year.

Looking at domestic US corporates, companies that have a combination of low gross margin, high COGS (cost of goods sold) exposure to China, and limited pricing power will be worst hit by tariffs. These could include major hardware manufacturers of both servers and PC products. Many of these companies have already diversified their supply chains and might feel better prepared, but they could still suffer depending on how the tariff situation plays out. In the most extreme scenarios, some may be forced to move production into the US.

In Europe, we see the automotive sector as being at the highest risk from potential tariffs. For example, Porsche AG has no US production, but has over 25% of its sales in North America. While some European car producers do have manufacturing capacities in the US, there is still a great deal of trade flow between the continents in terms of parts and components, which would be at risk of disruption.



The Asian supply chain

While the reality since inauguration has not matched the rhetoric – we have so far only seen an additional 10% blanket tariff on Chinese goods rather than the suggested 60% – markets are prepared for a more significant trade war, with the expectation that harsher measures are to come. And we are already seeing the situation escalate – China has responded with its own targeted tariffs, and postal rules governing shipments to the US appears to be latest front in this back-and-forward. However, despite the uncertainty, looking back at the effects of the Trump 1.0 tariffs still gives us some idea what to expect. For instance, we saw some Chinese producers increase production in locations such as Mexico, Thailand, and Poland, in order to avoid US import duties.

This time round, it is perhaps too early to point to specific expected measures, especially as the situation in Washington is still rapidly developing and changing on a daily basis; however, it is clear that any sustained imposition of new tariffs on Chinese goods will lead to the manufacturers of these goods seeking to broaden their supply and manufacturing bases in order to avoid potential additional costs.

Indeed, the China+1 theme will intensify under Trump 2.0, with Asian firms already looking towards new capacity expansion in locations such as Vietnam, Indonesia, Malaysia, and Thailand. Indeed, we are already seeing booming semiconductor sectors in areas such as Penang, Malaysia, and this is leading to the development of local supply chains to support these multinationals, creating attractive investment opportunities in the process. Moreover, many forward-thinking local manufacturers have already made plans to mitigate risks under Trump 2.0, by securing land and government approvals to relocate their production.

Turning to the region's other economic behemoth, India's net exports to the US represent a negligible part of its economy – less than one percent of GDP. While this has historically been considered a weakness in the Indian economy, Trump 1.0 turned this into an advantage as India became a neutral ground for many corporates to do business, driven by China+1 tailwinds. In the time since the first Trump administration, technological evolution in India has means the cost differential with China has narrowed, while COVID led many Indian companies, across sectors, to try to localize key parts of their supply chains.

These developments mean that India is now well positioned to potentially become an even bigger beneficiary of Trump 2.0. And while there are risks in terms of India's service exports to the US, many Indian firms have taken efforts to hedge these risks. For example, while the largest Indian IT providers previously had around 30% of their payroll in the US, this is now around 60% for the key players.

Finally, a word on Taiwan. Taiwanese exports to the US around the time of Trump 1.0 represented around 13% of its total, while this has now risen to around 23%, and Taiwan now has one of the largest trade deficits with the US – sixth in the world, last year, ahead of Japan and Korea – and this continues to grow quickly. These factors mean that Taiwan may indeed become a target of trade sanctions from the US. Given that exports constitute around 60% of Taiwanese GDP – and around a quarter of these exports go to the US – Taiwan will almost certainly be negatively affected by any potential trade war, though we currently very much view this is a tail risk scenario. However, a situation where tariffs are threatened in order to achieve some other goal – as we recently saw in the case of Colombia and the acceptance of returning migrants – cannot be ruled out.

Investor implications

Trump 2.0 will drive the global supply chain realignment that has been apparent since the first administration, and accelerated by both COVID and the Russian attack on Ukraine. Higher levels of automation at lower costs are driving corporates' abilities to "on shore", contributing to both what we have called Digital Darwinism – an intensification of competitive forces via the technological divide – and the emergence of rival tech hemispheres on either side of the Pacific.

The current animation around tariffs will certainly cause market volatility, and it will take some time for the dust to settle before we can understand specifically, company by company, how revenues and margins will be affected. Companies with significant manufacturing bases in the US will likely gain some competitive advantages, and we may see tariffs encouraging greater foreign direct investment to compensate for cost increases.

For investors, it will remain important to think about the sources of resiliency in portfolios – not only from geographic and sector perspectives, but also in terms of innovation and overall competitive advantage. For instance, as the recent example of DeepSeek R1 has shown us, trade restrictions can drive resolve from the parties targeted, leading to great productivity and innovation. It will thus certainly take some time before the real winners and losers of the current round of trade turbulence can be identified.

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