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Kevin Hebner, PhD
Managing Director,
Global Investment
Strategist, TD Epoch

Trump, Tariffs and Trade:
Toward a New Global Economic Order

President Trump is often portrayed as being mercurial and transactional, but his economic policy framework flows from tangible principles that he has venerated for decades. For a start, Trump maintains the U.S. has been too magnanimous in providing other countries with access to the American consumer and our defense umbrella. He believes this should be conditional on balanced trade and a level playing field, otherwise tariffs are justified. Similarly for defense, where several Presidential administrations since Eisenhower's including those of Kennedy, George W. Bush and Obama have commented that numerous NATO countries are free riding on American mettle. Further, Trump deplores the decline of domestic manufacturing jobs and is resolved to propel a revival.

Reasonable people can debate the above framework. There remains many open questions about tariff policies and the global economic order that Trump has in mind. This is important for investors because Trump's trade policies will be key drivers of discount rates, free cash flow (FCF) and market volatility over the next four years.

This paper examines tariffs and is structured to answer the frequently asked questions we have received. The first set of FAQs are concerned with the American perspective, while the second group focuses on China's leading role in the ongoing trade war. The final set emphasizes the macro and market consequences, and then we conclude with implications for investors.

Why does Trump love tariffs?

Four reasons: he does not need Congress, and tariffs provide him with bargaining power, while also generating revenues and incentivizing homeshoring.

Trump's first rationale is that he has unilateral power with enormous discretion, so he can quickly impose tariffs and does not need approval from Congress. He is especially partial to the International Emergency Economic Powers Act (IEEPA) of 1977 which authorizes the president to regulate international commerce after declaring a national emergency in response to an unusual and extraordinary threat to the national security, foreign policy, or economy of the U.S. that has its source in whole or substantial part outside the U.S.[1]

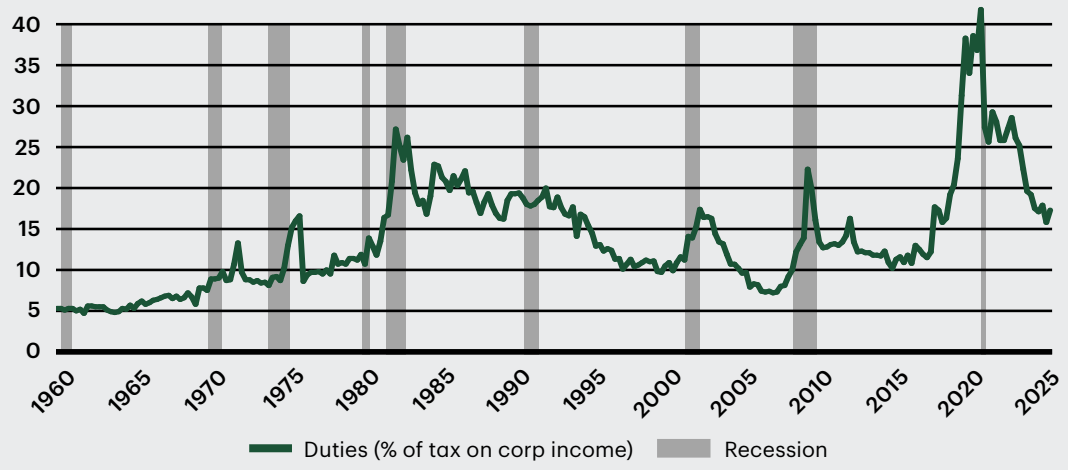
Second, just the threat of large and universal tariffs provides Trump with a great deal of bargaining power to negotiate on both trade and non-trade issues (it also provides Trump with his desired photo ops, usually at Mar-a-Lago). With Canada and Mexico, he emphasizes illegal immigration and drug smuggling. With trading partners in north-east Asia, he stresses trade surpluses and with EU countries Trump highlights NATO spending arrears. While this approach has produced some middling concessions, it often appears performative and has been much less successful with larger countries like India and China.

Next, tariffs were initially imagined as a tool to raise revenue. From the founding of the nation until the civil war, tariffs raised about 90% of the federal government's revenue (although expenses then were tiny relative to today's leviathan). During the youth of America, a tariff was simply the only tax it could hope to enforce.

Additionally, history suggests tariffs could rise by a lot. The average effective duty on manufactured imports is currently only a fraction of the pre-1950 range (20% to 50%).[2] Tariffs are then a tempting source of funds, especially as Trump and Congress negotiate over tax policy and 2025's "big, beautiful bill." He could make a credible case that tariffs will add over $100 bn to government coffers, which would go a long way to fund policy priorities, such as reducing the corporate tax rate to 15% for companies producing in the U.S. **(Figure 1)**.

Trump's fourth reason for loving tariffs is they could help restore America's manufacturing heartland. He believes the U.S. needs tariffs to prevent a tsunami of subsidized exports from continuing to hollow out critical sectors. Tariffs could also incentivize homeshoring of investment, production, and jobs. Conceptually this makes sense but is there any evidence that this is already happening?

Figure 1: During Trump 45, custom duties doubled to $80 bn. An even bigger increase is likely during Trump 47, potentially helping to fund tax cuts.



Source: Bloomberg Finance L.P.

[1] The IEEPA is extremely attractive to President Trump, but he still has several other routes. In his first term, Trump used sections 201 and 301 of the Trade Act of 1974, as well as section 232 of the Trade Expansion Act of 1962. However, these legal avenues take roughly eighteen months as the USTR must first conduct an investigation and then adhere to a notice-and-comment period.

[2] The authoritative source is: "Clashing over Commerce: A History of US Trade Policy," by D. Irwin, Dartmouth, 2017.

Is reshoring manufacturing even possible?

Yes, and it is already happening, although manufacturing will never return to 30% of the U.S. economy.

Although it is still early days, there is already compelling evidence of an American manufacturing renaissance **(Figure 2)**. However, little of this can be attributed to the 2018-2019 tariff hikes. Rather, it is driven by industrial policies, such as the Chips and Science Act of 2022, as well as the perception that global supply chains have become riskier and more vulnerable (due to COVID, the Ukraine War and rising tensions around Taiwan).

This sharp rebound has surprised many. There is a common belief that Americans just are not good at making stuff, especially compared to Germany and north-east Asian countries. However, this view is contradicted by several recent successes in EV's rockets, satellites, and drones. Further, there is strong momentum in strategic industries such as solar, batteries and semiconductors. Most economists are skeptical regarding tariffs and industrial policies (more on this later), but there is unambiguous evidence such policies are already bearing fruit, and that America is well on its way to rebuilding its manufacturing base.[3]

Figure 2: U.S. investment in manufacturing facilities has soared since 2022 after having languished for decades

Source: Bloomberg Finance L.P.

Why the obsession with manufacturing?

Domestic manufacturing capabilities remain critical given supply chain vulnerabilities and national security imperatives. Further, it takes decades to develop manufacturing excellence, even in a services economy driven by digital tech and AI. The case for industrial policy is particularly compelling in sectors that are strategically critical.

There are two economic reasons why we should not just outsource "archaic" activities like manufacturing. The first is the inherent fragility of hyper-efficient global supply chains. That is, the type of risk experienced through COVID (critical medical supplies) and the Ukraine War (natural gas), and could occur around Taiwan (semiconductors).

Further, countries are increasingly weaponizing interdependence. A key vulnerability for America is critical dual-use minerals, for which its import dependence on China is often 80%. It also strikes us as fatally naïve to be so dependent on China for the entire EV supply chain, as well as dual-use goods such as drones.

[3] "Yes, reshoring American industry is possible," by N. Smith, January 2025. Smith believes the overvalued USD and Chinese subsidies explain most of America's deindustrialization and recommends U.S. industrial policies embrace pro-manufacturing aspirations.

A second reason concerns Wright's Law and learning curves. Manufacturing excellence requires modern infrastructure, a deep network of suppliers, a skilled workforce and profound expertise (intellectual property) honed over decades. This is emphasized by Wright's Law, which expresses the relationship between experience and manufacturing efficiency. Almost a century ago, Theodore Wright found that every time aircraft production doubled, the required labor time for a new plane fell by 20%.[4]

The classical economist David Ricardo viewed natural resources, farmland, and climate as the critical determinants of competitive advantage. However, in the modern economy they have been superseded by industrial policy and Wright's Law. This explains the rise of the manufacturing sector in Germany and Japan following WWII and by South Korea and Taiwan from the 1980s. More recently, China's leaders have dialed industrial policy up to eleven, applying it mercilessly to the production of EVs, batteries, solar panels, drones, and so on. However, the implications of Wright's Law were largely ignored in the U.S., where manufacturing became an afterthought. This resulted in domestic capabilities atrophying and productivity faltering **(Figure 3)**. This is clearly untenable in the new global economic order.

Figure 3: U.S. manufacturing productivity growth averaged 3.4%/year from 1950-2000. However, it slowed to 0.6% since then and productivity has actually declined by 9% from its peak in 2012.

Source: Bloomberg Finance L.P.

How does the American public view trade and tariffs?

Views have shifted sharply against free and unfettered trade since China entered the World Trade Organization (WTO). Further, 83% of Americans have a negative opinion of the Chinese government, up from 29% in 2007.

Public attitudes have exhibited a sharp U-turn over the last two decades and become decidedly pro-tariff.[5] According to a 2024 survey by Pew Research, 59% of American's believe the U.S. has lost more than it has gained from international trade. This share is particularly high among Republicans (73%, up from 65% in 2021). Moreover, a recent Global Affairs poll found that 56% of Americans see trade with China as weakening U.S. national security.

[4] "Factors Affecting the Cost of Airplanes", Journal of the Aeronautical Sciences, 1936. More recent studies suggest values of 15-25% for aerospace, shipbuilding, and advanced machine tools.

[5] "Majority of Americans take a dim view of increased trade with other countries," July 2024, Pew Research Center, "American Views of China Hit All-Time Low," Oct 2024, Chicago Council on Global Affairs and "Americans Are Critical of China's Global Role," April 2023, Pew Research Center.

Related to their views on trade, 83% of Americans have a negative opinion of the Chinese government, up from 47% in 2017 and 29% in 2007, according to a 2023 survey by Pew Research. While this perception is shared across the aisle, Republicans have stronger negative views (88% vs 81% for Democrats). Moreover, 53% of Republicans see China as an enemy (41% view it as a competitor and only 5% as a partner). Further, 61% of GOP supporters believe China is the main beneficiary of U.S.-China trade, with only 6% responding that America is. Reflecting these dramatic shifts, a solid majority of Americans now favor increasing tariffs on Chinese imports.

Until recently U.S. companies were the one holdout, arguing strenuously against tariffs. However, they have largely gone silent about the importance of the U.S.-China relationship. This is largely because American businesses no longer see China as the land of opportunity. Additionally, they view the damage from the 2018-2019 tariff hikes as having been limited and this time U.S. firms are better prepared to weather a trade war.

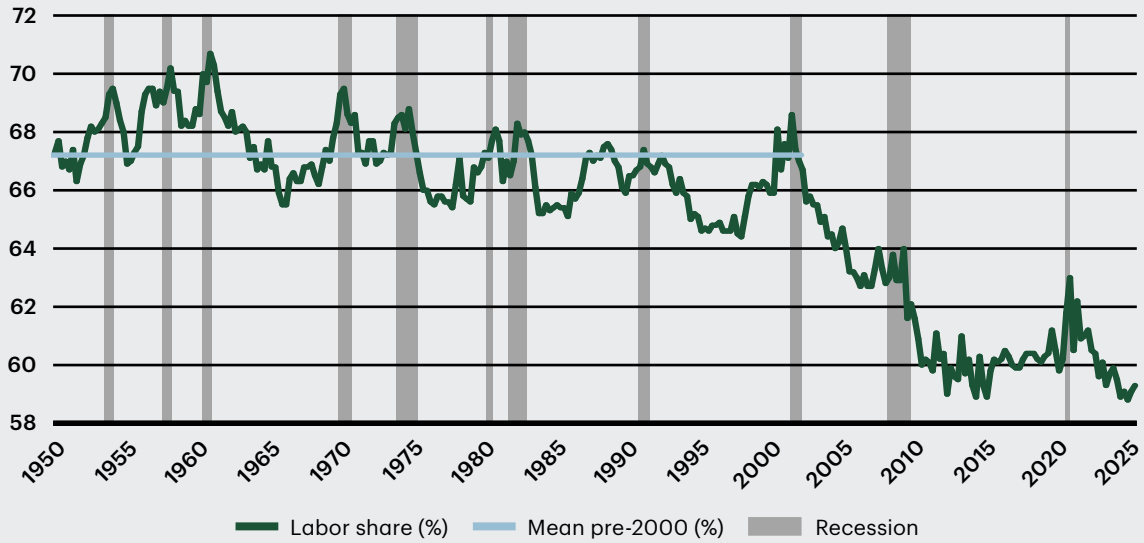
Will tariffs help lower income workers?

Maybe, but only at the margin. A tariff comprises two distinct policies – an industrial subsidy plus a sales tax. The former encourages homeshoring and could help lower income workers. The latter clearly does not, so the overall impact is ambiguous. Regardless, onshoring will not create enough high-paying blue-collar jobs to offset the ongoing negative impact of digital tech and AI.

A key reason for the populist backlash against Chinese mercantilism is the plummeting labor share, which coincides with China's entry into the WTO **(Figure 4)**. Over the last three decades, workers have been hit by the double whammy of offshoring and digital tech. While the former is moderating, at least in sectors critical to national security, the latter continues to accelerate and is likely to further exacerbate income inequality.

Further, tariffs are similar to a sales tax and the 2018 hikes were partially passed onto consumer prices, reducing national income by a negligible $1.4 bn per month, but disproportionately hurting lower income workers.[6] Over the last two decades, voters have become increasingly angry about an economy they feel does not work for them. Regrettably, we believe the labor share will remain subdued and continue to be a key driver of populism and other challenging trends.

Figure 4: From 1950-2000 the labor share averaged 67%. However, with China's entry into the WTO it has plummeted to 59%.



Source: Bloomberg Finance L.P.

[6] "The Impact of the 2018 Tariffs on Prices and Welfare," by M. Amiti (FRB NY) et al, Journal of Economic Perspectives, 2019.

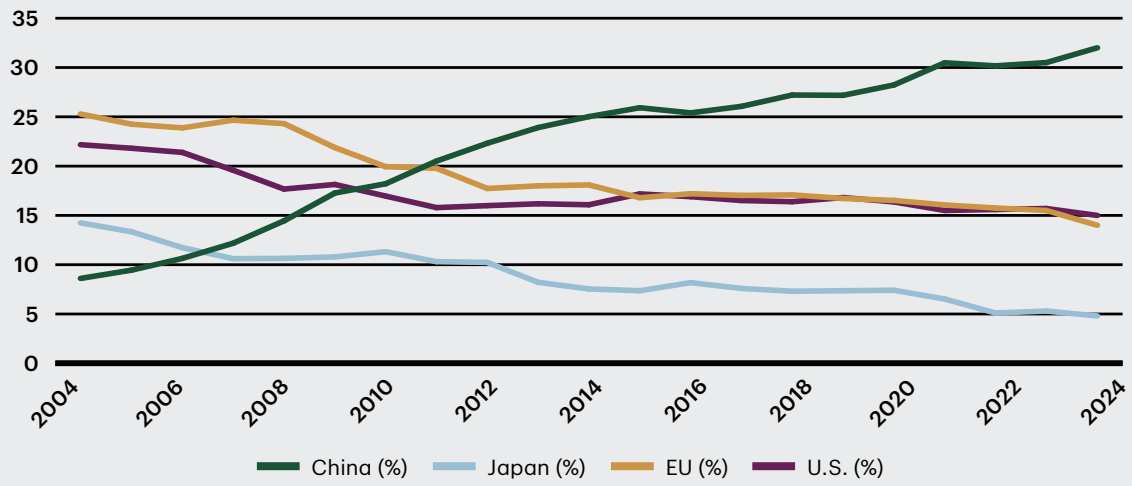
How did China become the global manufacturing superpower?

Through an extreme form of mercantilism, featuring massive subsidies, relentless industrial policy, and aggressive five-year plans like "Made in China 2025."

Over the last two decades, China has quadrupled its share of global manufacturing while America's has declined by a third **(Figure 5)**. To illustrate, China's share of global car production has increased twenty-fold, from 2% to 39%, while everyone else's has collapsed: Europe's from 33% to 13%, Japan's from 21% to 12% and America's from 14% to 3%. China was a net importer of autos until 2022, but its auto exports have increased six-fold since 2020 reflecting massive capacity expansion (over twice domestic demand). Even more egregious, China's shipbuilding capacity is now 232 times greater than the U.S.

Of course, this did not just happen organically due to free markets and naturally occurring comparative advantage.[7] Rather, it was the result of China's lavish export subsidies, onerous import restrictions and formidable state-directed lending, as well as a massively undervalued currency and favorable tax treatment. These have all been part of the mix since the 1990s, when China was still a relative minnow. However, it is now a whale, and these subsidies amount to roughly $500 bn annually. Domestically, this has required excessive investment and weak consumption. Externally, this has resulted in trading partners who are increasingly resentful and pugnacious.

Figure 5: Global manufacturing value added (share, %)



Source: World Bank

The Second China Shock: Is its economic model incompatible with the post-War global trading system?

Yes, China's extreme form of mercantilism is unsustainable and has resulted in enormous backlash from its export markets.

A recent article in the WSJ argued that China broke the post-Cold War order through its growing role as a geopolitical rival and its extremely mercantilist policies.[8] While such policies have been in place for decades, they shifted into a much higher gear in May of 2015 when the State Council issued its "Made in China 2025" plan. The explicit objective was for China to become the #1 global manufacturing

[7] The 19th century English phrase, 'comparative advantage', rings a bit archaic but can be translated into modern English as 'relative efficiency'. That is, do what you are best at, and import the rest.

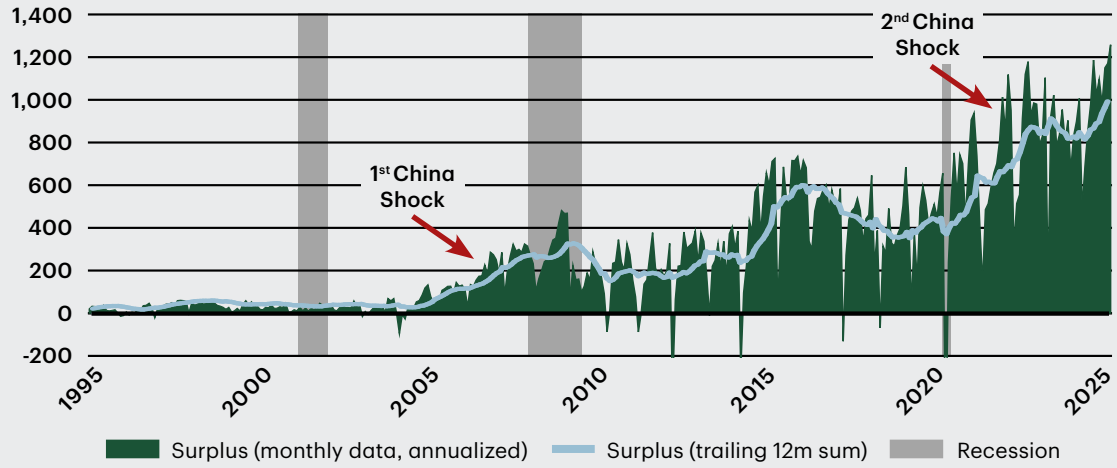
[8] "We are all mercantilists now: China's emergence as an economic power helped fuel the rise of protectionist views on trade worldwide," by Greg Jensen, Bridgewater Associates, WSJ, December 2024.

powerhouse and to dominate the industries of the future (such as EVs, batteries, solar panels, and drones). The Economist estimates state subsidies committed to "Made in China 2025" add up to over $3 tn in the decade since 2015.

One consequence has been China's massive and accelerating trade surplus, with a run rate of $1.2 tn **(Figure 6)**. This has more than doubled from its pre-COVID level, which was already the largest experienced anywhere in history, and is increasingly referred to as the "Second China Shock."[9] To illustrate its magnitude, Chinese companies now produce 90% of the world's solar panels, 70% of its batteries and 90% of consumer drones. Further, during the last three years, car exports have tripled, with China becoming the world's largest car exporter by units. One result is that even Germany is now facing a China shock, with industrial production plummeting 15% since 2017 and GDP flat since 2021.

Given this, no one in Beijing should be surprised that their export strategy is facing significant challenges, including trade barriers, outright bans, and the threat of much higher tariffs. In some ways China's big bet on industrial policy has paid off, however, it has resulted in an enormous and growing backlash from abroad.

Figure 6: China goods surplus (USD bn), to infinity and beyond



Source: Bloomberg Finance L.P.

As developed markets turn protectionist, where can China grow exports?

China is pivoting toward EMs; however, they are becoming increasingly aware that China is suffocating their domestic industrial base and creating unacceptable national security vulnerabilities.

Michael Pettis from Peking University has been pleading for decades that China needs to rebalance its economy.[10] Although Beijing frequently makes public statements agreeing with Pettis, it has yet to put his advice into action. To illustrate the degree of imbalance, we believe all of China's growth in 2024 was accounted for by net exports (a roughly 2 percentage point (ppt) contribution), plus the investment required to produce those exports.[11] This export-reliant growth model might be sustainable if China was the size of Vietnam or Indonesia but is clearly untenable for the world's second-largest economy.

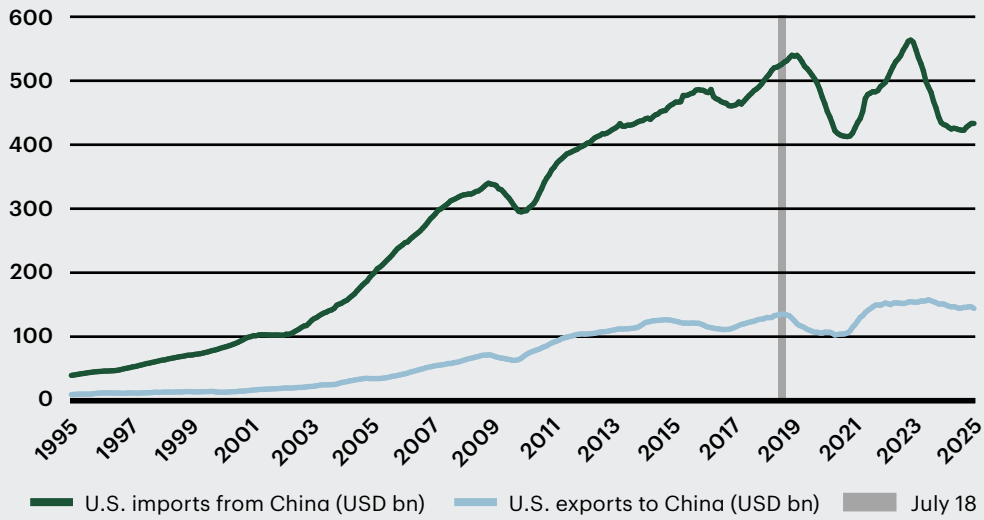
The backlash from developed markets (DMs) is intensifying, with the U.S. leading the charge **(Figure 7)**. Note that exports to the U.S. have not grown

[9] The first "China Shock" occurred from 2000-2007 when rising Chinese exports reduced U.S. manufacturing employment by an estimated 550,000 to 2.4 million jobs. Some sectors and communities were hit particularly hard. For example, furniture industry employment fell by around 300,000, or 45%. The sector was concentrated in the North Carolina piedmont, employing roughly one in every six workers. Source: "China's Very Bad, No Good Trillion-Dollar Trade Surplus," by Paul Krugman, January 2025.

[10] He is a prolific author, as you can see here: https://carnegieendowment.org/people/michael-pettis

[11] According to official statistics, China's GDP grew by 5.4% last year. We have more confidence in the 2.4-2.8% estimate from Rhodium Group. Regarding other components of GDP, housing is likely to remain a growth headwind through 2030 and even China bulls believe consumption's contribution to growth is no greater than 1 ppt.

Figure 7: U.S. imports from China are down 20% from July 2018 when Trump's tariffs first came into effect. This raises the question of where China plans to export its excess production.

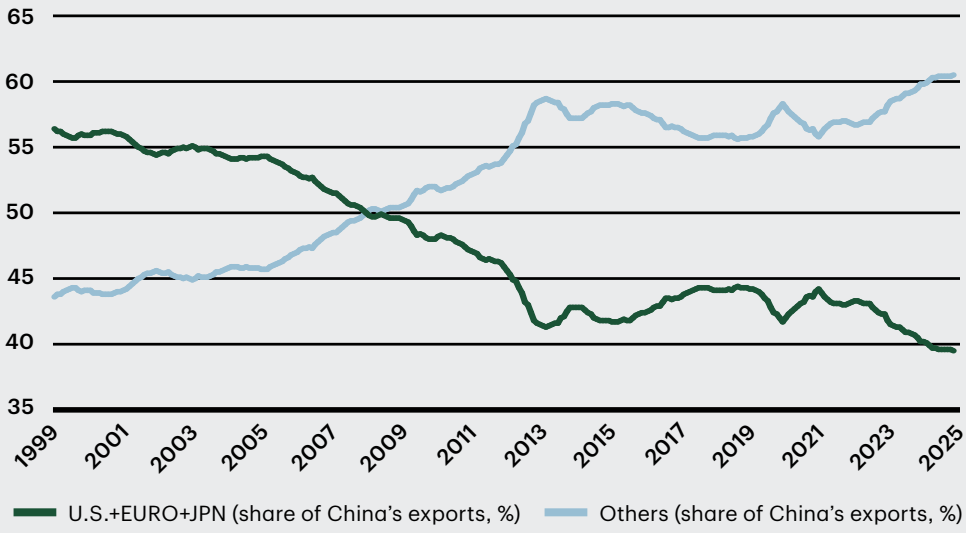


Source: Bloomberg Finance L.P.

in over a decade. However, this might be partially explained by China relocating production to Vietnam or Mexico, which is why the Trump administration is examining the feasibility of tariffs based on the origin of each component within an imported product.

With the U.S. and other DMs increasingly pushing back on the export tsunami, China is pivoting to EMs **(Figure 8)**. However, EMs are increasingly aware that China is suffocating their domestic industrial base and creating unacceptable national security vulnerabilities. This means, at some point Beijing will have no choice but to finally rebalance away from exports and investment, and toward consumption. Economic growth will only prove sustainable when policy makers ditch their mercantilist obsession.

Figure 8: China's exports are increasingly destined for EMs rather than DMs



Source: Bloomberg Finance L.P.

Weaponizing access to the U.S. consumer: Which countries will be affected by Trade War 2.0?

During Trump 45 there was a lot more talk about tariffs than there was action, except in the case of China. Trade War 2.0 is again 80% about China: But Mexico, Canada and Germany are also targets.

Countries that rely on large and persistent trade surpluses to drive growth are the most exposed in an increasingly mercantilist world. China has been, by far, the biggest beneficiary of hyper-globalization and has the most to lose as we play the movie backwards. We predict the effective tariff rate on imports from China to rise by 20 ppts (beyond the 10 ppts already announced). This is one reason we expect the Chinese economy to continue to struggle (tariff hikes are likely to reduce GDP growth by 0.3 to 0.4 ppts over the next 12 months) and Chinese equities to keep underperforming.

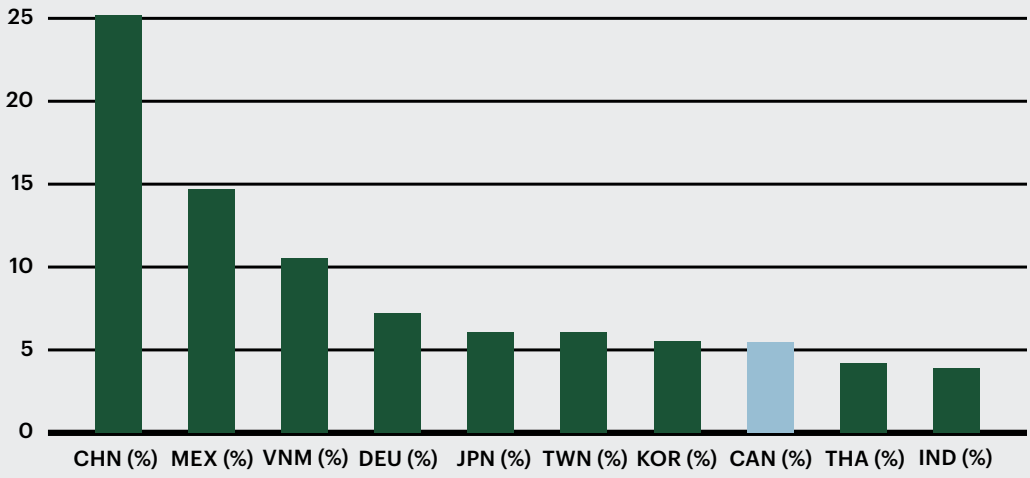
Next in line is Mexico, which represents 15% of America's overall trade imbalance, just behind China's sizeable 25% **(Figure 9)**. In addition, 83% of Mexico's exports travel north of the border, exports to the U.S. represent 25% of GDP and Trump is determined to renegotiate the United States-Mexico-Canada Agreement (USMCA). Further, there are several vexatious issues beyond conventional trade (most notably drugs and undocumented immigration). If 25% tariffs were placed on imports from Mexico, they would reduce GDP by 2% and increase the level of the Consumer Price Index (CPI) by 2.25 ppts.

Trump often criticizes Canada in the same breath as Mexico. This is because it is also part of USMCA and is similarly exposed, with 75% of exports flowing to its southern neighbor and exports to the U.S. represent 19% of GDP. However, Canada's bilateral surplus with America is relatively paltry and entirely driven by energy (notably heavy oil, which U.S. refineries require). Canada actually has a manufacturing trade deficit with its neighbor. If 25% tariffs were placed on imports from Canada, they would reduce GDP by 1.0% to 1.5% and increase the level of CPI by 1.5 ppts.

Germany is also in the crosshairs, as it has a large bilateral surplus, and we expect the tariff on European autos to increase by 20 to 25 ppts. The EU has several policy options to deal with the threat of U.S. tariffs: retaliation (as occurred in 2018), a credible commitment to buy more U.S. products (especially energy), scaling up defense spending and capabilities, and adopting a more restrictive stance on trade with China. We expect all of the above to be in play this year.

Beyond these four countries, betting sites believe there is a 60% chance of tariffs against Japan and Taiwan being implemented during 2025. The corresponding percentage for South Korea is 45%. All these countries have large bilateral trade surpluses and major manufacturing centers.

Figure 9: Share (%) of overall U.S. trade deficit in 2023. China stands out, followed by Mexico



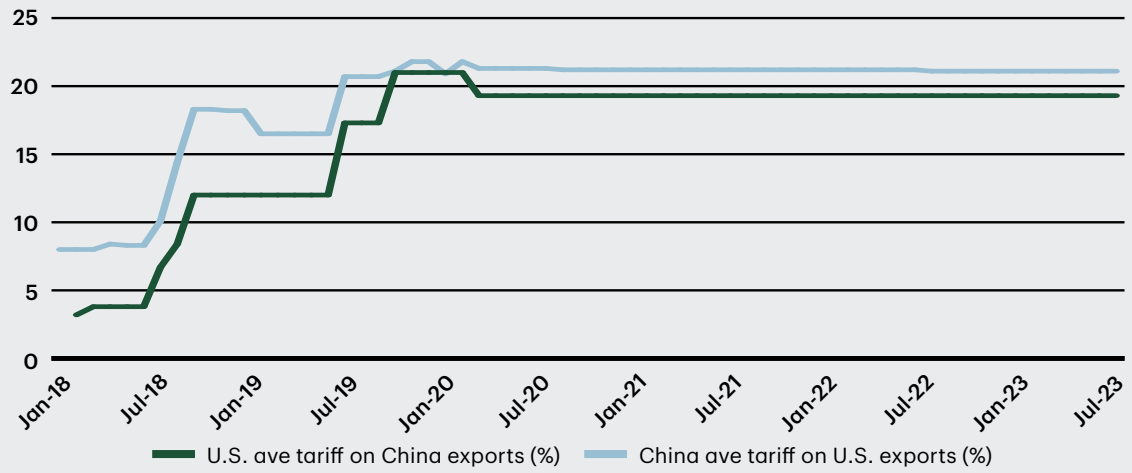
Source: Bloomberg Finance L.P.

Weaponized interdependence: How will China retaliate?

Similar to 2018-2019, proportionately and immediately. China's main source of leverage this time is its dominance of critical dual-use minerals.

China is not to be bullied and will retaliate promptly, as occurred in 2018-2019 **(Figure 10)**. Which American sectors could take a hit as a result? U.S. exports to China largely consists of oil, agricultural products (soybeans, corn, and chicken), pharmaceuticals, autos, and aircraft.[12] However, China's main source of leverage this time is its dominance of critical dual-use minerals. They are required for America's industrial and defense sectors, and for which U.S. import dependence on China is often 80%.

Figure 10: China will respond immediately and in kind to U.S. tariff hikes



Source: Bloomberg Finance L.P.

What will be the impact of higher tariffs on U.S. growth, inflation, and corporate earnings?

U.S. GDP could be reduced by 0.4 to 0.8 ppts, with the level of consumer prices increased by 0.4 to 0.6 ppts and SPX EPS diminished by $4-$8.

We expect the escalation of tariffs to reduce U.S. GDP by 0.4 to 0.8 ppts. The lower bound, 0.4 ppts, is the impact from the 2018-2019 tariffs on imports from China (as estimated by the Peterson Institute for International Economics).

We also predict a ceteris paribus increase in the level of consumer prices, by 0.4 to 0.6 ppts.[13] However, this represents a rise in the price level and will have a much smaller impact on inflation. Tariffs only result in a sustained, ongoing rise in prices if additional, continuous tariff hikes are threatened and become imbedded into consumers' expectations.[14]

The hit to U.S. corporate earnings could be significant. Globalization has been a key factor driving U.S. margins higher and boosting offshore revenues. S&P 500 margins could fall by 25 to 50 bps, which is worth between $4 to $8 to forward EPS estimates. Mentions of tariffs in S&P 500 transcripts have tripled since October, especially for cyclical and consumer sectors: industrials, materials, consumer discretionary, consumer staples and heath care.

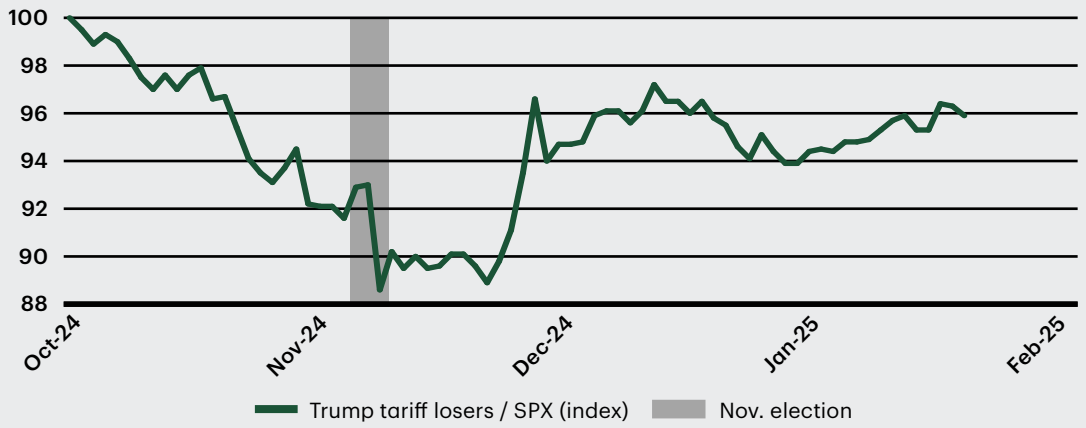
However, reflecting the elevated level of uncertainty, tariffs are not yet fully into market prices **(Figure 11)**.

[12] In 2018-2019, Trump authorized payments of $28 bn to U.S. farmers (70% was soybeans) to offset their losses from Chinese trade retaliation. This represented a large share of tariff revenues.

[13] Back-of-the envelope calculations: Imports represent roughly 11% of U.S. personal consumption (that is, $2.2 tn divided by $20.2 tn) and the current average effective tariff is 1.5%. If this tariff rose by 4 ppt, the level of PCE prices would increase by just over 0.4 ppt (assuming little short-run substitution away from more expensive imports).

[14] For estimates of the effects on various products' prices please see, "The Economic and Fiscal Effects of the Trump Administration's Proposed Tariffs," The Budget Lab at Yale, January 31, 2025.

Figure 11: Trump's tariff threats are not yet priced into equities



Source: Bloomberg Finance L.P.
Note: "Trump tariff losers" represents a basket of 38 stocks likely to decline if tariffs are implemented.

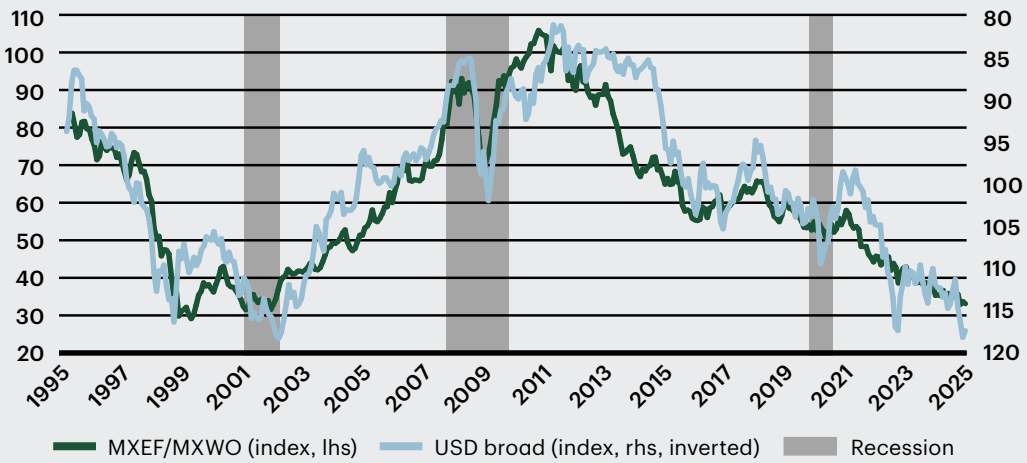
What is the likely impact of tariffs on the USD?

Tariffs will probably result in a stronger USD in the short term, but the greenback is extremely overvalued.

Treasury Secretary Scott Bessent has testified that, "Historically, 40% to 50% of the tariff is recovered in currency appreciation." This is somewhat higher than the consensus among economists that USD/CNY absorbed about 30% of the impact in 2018-2019. Regardless of the exact amount, we expect additional tariffs will drive the USD even higher. This reflects three fundamental factors: interest rate momentum, which is the key short-term driver of currency pairs; the vulnerability of countries like China that rely on exports for growth; and the equilibrating role of currencies in the balance of payments. However, the USD has already appreciated by 6% since early October suggesting that this might already be partly in the price.

A stronger greenback implies tighter financial conditions, and not just for the U.S. EMs are especially vulnerable, reflecting the tightening in funding markets and an increased burden from USD-denominated debt **(Figure 12)**. Beyond EMs, dollar appreciation is negative for equities broadly, but especially cyclical sectors such as materials.

Figure 12: A stronger USD is bearish for Emerging Markets: -91% correlated since 1995



Source: Bloomberg Finance L.P.

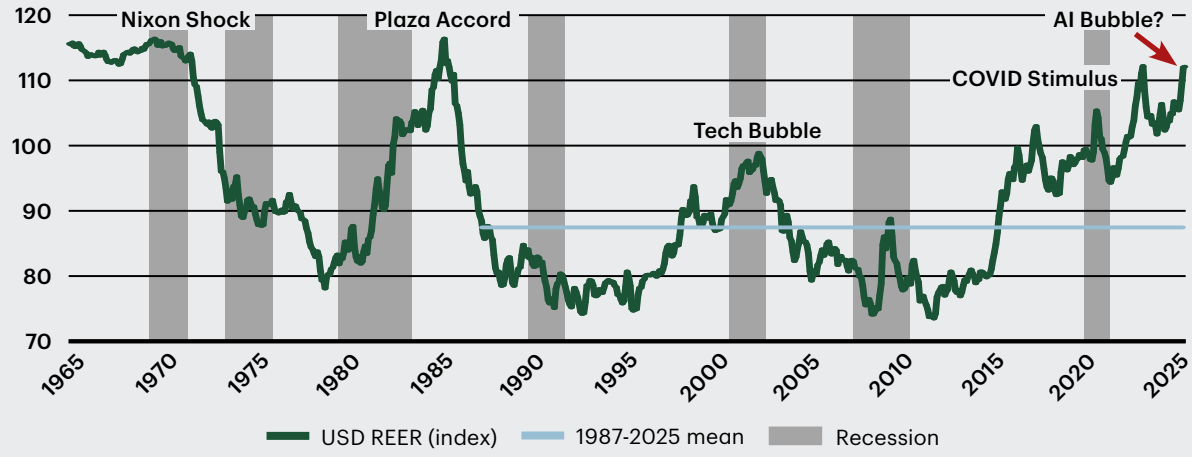
Weaponizing the dollar: Can the Trump administration do anything about the overvalued USD?

Yes, but it is exceedingly difficult, will take years and could cause enormous market volatility. So, the greenback is likely to get even more expensive before it gets dramatically cheaper.

Trump gripes that the greenback is exorbitantly priced and a key reason for the deindustrialization of America. It is hard not to agree with him on this point. The USD is at the highest level it has been since 1985, just ahead of the Plaza Accord **(Figure 13)**. This premium partially reflects policies by China and other northeast Asian countries to keep their currencies undervalued to subsidize exports. Such currency debasement policies are likely to come under increasing fire during Trump 47. However, a replay of the Plaza (1985) and Louvre (1987) accords, multinational agreements to depreciate and then halt the depreciation respectively, is untenable in today's G-Zero world (a world order in which no single country or durable alliance of countries can meet the challenges of global leadership).

As emphasized by the nominated chair of Trump's Council of Economic Advisors, the U.S. has historically pursued multilateral approaches to currency adjustments.[15] However, this requires active cooperation from trading partners such as China, implying a Mar-a-Lago accord (or a multinational agreement to depreciate the U.S. dollar) is highly unlikely in today's environment. There are also unilateral tools available, such as taxing Treasuries held by China and others. However, such solutions would drive a structural increase in market volatility and intensify efforts to find alternatives to the USD-based financial system.[16]

Figure 13: USD is extremely overvalued, currently 30% above 1987-2025 mean



Source: Bloomberg Finance L.P.

Economists hate tariffs: What are their *laissez-faire* models missing?

Economists emphasize efficiency and let markets work their magic unless there is a clear rationale for intervening. For tariffs, the key reason is critical supply chain vulnerabilities (historically just arms and farms, but now also includes semiconductors, energy, and essential medical supplies). Some economists argue that models should recognize that consumers are also producers, and additionally allow a role for tariffs to incentivize countries like China to rebalance their economies.

Free trade is the closest thing to a universally held value among economists. And it is not hard to understand why, as economists estimate trade has lifted U.S. GDP by up to 8%.[17] We believe this is actually a significant underestimate as it does not incorporate several key channels (that are,

[15] "A User's Guide to Restructuring the Global Trading System," by Stephen Miran, November 2024.

[16] "Underground Empire: How America Weaponized the World Economy," by H. Farrell (Johns Hopkins) et al, 2023.

[17] "The U.S. Gains from Trade," by A. Costinot (MIT) et al, Journal of Economic Perspectives, 2018.

admittedly, hard to estimate empirically). For example, relative to purely domestically oriented firms, exporters are more innovative and productive, because they face greater competition and are more exposed to new products and techniques.

However, the *laissez-faire* consensus among economists is beginning to fray. Comparative advantage is clearly a critical guide to production decisions and trade patterns, but only in a risk-free global economy.[18] As supply chains become riskier and more vulnerable, there is increasing agreement that economic efficiency should be part of the decision-making process, but not the only consideration.

Is Ricardo's theory still valid in a world with supply chain vulnerabilities and national security risks?
Supply chains are vulnerable to geopolitical conflicts (as in the Middle East, Ukraine or potentially, Taiwan), as well as natural disasters (such as the Japanese tsunami of 2011) and pandemics (COVID). Indeed, this has always been the case, especially for critical sectors like farms and arms. However, during the last decade the list of sectors viewed as critical to national security has expanded to also include semiconductors, energy, the EV supply chain, and critical medical supplies. This means Ricardo is still valid, but we need to balance the benefits of comparative advantage and economic efficiency with the imperatives of resilience and security.

In addition, a minority of economists argue that governments need to recognize that consumers are also producers.[19] The logic is that too much offshoring can weaken working class wages and cripple consumption. Economic theory suggests this is acceptable (Pareto efficient) as losers from globalization can receive transfers and retraining, but in the real world this rarely happens. Further, many communities get destroyed, as occurred during the China Shock of 2000 to 2007. As local infrastructure deteriorates and skills atrophy, it becomes increasingly difficult to rebound leading to extended periods of economic decline.

Further, some economists argue that tariffs can incentivize the U.S. and China to rebalance their economies. The U.S. economy suffers from excess consumption, low savings, and a declining manufacturing share. China has the opposite problem, overinvestment, and surplus capacity, which results in massive trade imbalances that are extraordinarily far from the free trading world of Econ 101. Michael Pettis argues that tariffs, along with other types of industrial policy, can address the causes of these conditions and help reverse them.

Finally, tariffs are winning the debate because other policy options are not realistic. In a perfect world, the IMF would impose currency adjustments, and the WTO would enforce fair trade. However, the experience of the last two decades has left Americans contemptuous of multilateral organizations.

What exactly is "the new global economic order"?

With the rise of China, we have moved from a unipolar to a bipolar world, with both countries determined to dominate the industries of the future. Further, increasing supply chain vulnerabilities and China's extreme form of mercantilism have forced the U.S. to embrace industrial policies and tariffs.

Presidents Trump and Xi are both determined to redefine the global economic order but have quite different ideas of what that means. However, the two superpowers do agree on two things: that the industries of the future will be centered around digital tech, AI, and advanced manufacturing; and that dominating these industries is critical to their economic strength and national security. For investors, this has induced the most disruptive and challenging macro environment since the end of the first Cold War

With the rise of China, we have moved from a unipolar to a bipolar world. China is becoming increasingly assertive, insisting its economic and military heft merits a commensurate voice in defining the rules and institutions of the new global economic order. In many ways, that is entirely reasonable. However, since President Xi's ascension in 2012, China has ramped up a host of mercantilist policies that are incompatible with WTO norms. The intended result was export-driven growth to compensate for weak domestic consumption and an imploding real estate sector. Unfortunately, though, China's

[18] "Is comparative advantage valid in a geopolitical world," by Richard Baldwin, IMD, January 2025.

[19] "Economists' Way Out of the Wilderness: They must stop treating production as an afterthought," by J. Galbraith, U Texas, 2025.

mercantilist behavior has undermined support for free trade and the WTO has withered into irrelevance.

The two behemoths now view interdependence as a risk to both global supply chains and national security. This especially applies to semiconductors, energy, the EV supply chain, and critical medical supplies, as well as the defense industry. For the U.S., the new global economic order features a much more expansive and intrusive role for the state, with greater emphasis on national security and resilience and markedly less on comparative advantage and market efficiency.

An America First Trade Policy: Implications for investors.

We are at the beginning of a new high tariff era. Even though markets have been focused on tariffs for months now, we believe they are not yet priced in. Our base case assumption is that tariffs will reduce U.S. GDP by 0.4 to 0.8 ppts, with the level of consumer prices increased by 0.4 to 0.6 ppts and SPX EPS diminished by $4 to $8. Most impacted will likely be cyclical and consumer sectors: industrials, materials, consumer discretionary, consumer staples and health care. Additionally, we expect roughly one-third of the tariff to be recovered through a stronger USD.

We believe tariffs will constitute a key investment theme through 2028. However, we should be careful about analyzing the impact of tariffs in isolation. Trump's overall agenda is pro-growth, emphasizing tech, deregulation, and tax cuts. We will be writing about each of these during the next few months and believe policies regarding tech and deregulation could be especially impactful.

We expect above trend volatility in equities, rates, and FX, reflecting the transition to the new global order, the acceleration of AI and digital trends, and rising geopolitical tensions. To our eyes, this is the most disruptive and challenging macro environment since the end of the first Cold War. Given this, investors should be wary of today's highly concentrated equity markets. We believe investors can benefit from holding a more diversified portfolio, across both countries and sectors, while maintaining a focus on companies that generate sustainable FCF and are superior capital allocators.

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