Goldman Sachs Exchanges

Will higher tariffs result in higher interest rates?

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Allison Nathan: Donald Trump is set to take office in a month and a half, so what are investors expecting from the second Trump administration? I'm Allison Nathan, and this is Goldman Sachs Exchanges. Here with me today is David Mericle, chief US economist with Goldman Sachs Research. David, welcome back to the program.

David Mericle: Thank you very much, Allison.

Allison Nathan: So obviously we've seen a very positive market reaction post the election of Donald Trump, at least in US equities. But here at Goldman Sachs, we took the initiative to actually try to survey investors to see what they are expecting. So before we get into the findings of that survey, talk to us a little bit about the survey, how you made it, who did it go to? Give us some details.

David Mericle: Sure. So we have our own policy expectations for what might change under the second Trump administration, but we wanted to understand what are investors thinking? What assumptions underlie market pricing? And so in conjunction with our Marquee team, we surveyed over 500 people, and we asked them about the whole range of issues that we think are most macroeconomically significant -- immigration policy, trade policy, and fiscal policy -- to try to get a sense of are they looking for more or less the same policy changes as us? Or where might views differ?

Allison Nathan: And so what are investors most nervous about in that survey?

David Mericle: So we actually asked this question. Which of the potential policy changes worry you the most in terms of their macroeconomic consequences for 2025? The runway winner with 60% of the vote was the prospect of a universal 10 or 20% tariff on all goods from all countries. That's not our baseline. It's not most investors' baseline either, but that was cited as the top risk.

Other big risks which came in quite a bit lower on the ranking were concerns about fiscal sustainability being triggered by some sort of fiscal move or concerns about deportations of unauthorized immigrants having a negative effect on growth and a positive effect on wages and inflation.

Allison Nathan: Trump already announced 25% tariffs on all imports from Mexico and Canada. I don't think we were expecting that. Were investors expecting that? Or they might be nervous about the universal tariff. Are they actually expecting a universal tariff?

David Mericle: No. So we asked two questions. First, what was your baseline expectation for the combination of tariffs we might see? And second, what probability do you put on that universal tariff?

Most investors are looking for basically what we're looking for. Some additional tariffs on imports from China and some additional imports on autos because autos, as we've seen in the recent election, is a very politically sensitive industry. There is a substantial minority of investors who said that their baseline also includes some version of the

universal tariff -- all goods from all countries -- but that was not the modal view at the very least.

Now, in the follow-up question, where we asked what probability would you put on a universal tariff, the average response was 35%, so a little bit below our own 40%. And I think that just captures this is a serious proposal and it is a serious risk. And that's why people are very focused on it, but it's not the modal view in markets.

Allison Nathan: Even that 25% announcement was unexpected and important.

David Mericle: Yeah. It's a threat. It's not yet been implemented. There were a lot of things that were proposed at one point during the first Trump administration that didn't get fully enacted. So I think still not part of our baseline that those 25% tariffs on imports from Mexico and Canada will go into effect. But I imagine we'll hear a lot of proposals like this along the way.

Allison Nathan: Interesting. So obviously immigration policy is also at the top of Trump's list. It's on investors' minds, as you've said. Trump's been quite vocal about

wanting to tighten immigration policy, so what are investors expecting and how does that compare to what we are expecting on immigration policy?

David Mericle: Sure. Let me just give a little bit of background because we included this question in part because it's an important policy issue for the president-elect, but also because it has been an important macroeconomic issue for the US over the course of the last couple of years.

Pre-pandemic, total net immigration, unauthorized plus authorized, into the US was about a million a year. Little bit higher sometimes, little bit lower sometimes. Nothing too dramatic. Higher typically when the US economy is booming and jobs are readily available. Lower, for example, after 2008 when, if you come here, you're certainly not guaranteed to get a job.

Now, in 2023, net immigration was about, we think, 3 million into the US, so triple what it would have been in a normal year. At the very peak in late 2023, the annualized rate got up to about 3.5 to 4 million. We've already seen that come down very sharply to an annualized rate of about

1.75 million. So it has already, even before Trump takes office, been roughly cut in half. So that's just a little bit of background to help you make sense of the numbers.

Now, we're assuming that, under the second Trump administration, net immigration will average -- and this is total authorized plus unauthorized -- will average about 750,000 a year. Relative to 2023, a lot lower. Relative to the pre-pandemic norm, a little bit lower but not dramatically lower. It turns out that's also what most investors expect. The most frequent answer from about half of the people we polled was half a million to one million. And then the vast majority of people were either in the bucket just below that or just above that. Only about 6% of poll respondents expected net immigration to turn negative.

Now, one thing that trips people up is that they read in the news about deportations, and they say, "Oh, so you don't expect deportations?" I think everybody does. There are always some deportations of unauthorized immigrants taking place. Those will probably be at the high end of the range, we've seen over recent presidential administrations, if not a bit higher. But bear in mind, there's always

probably some inevitable inflow of unauthorized immigrants. And authorized immigration amounts to about 750,000 a year.

So our estimate and the median investors' estimate would suggest maybe authorized immigration stays roughly unchanged. The unauthorized part gets down to about net zero.

Allison Nathan: Interesting. Okay, so 750 is all authorized, essentially, in our expectations.

David Mericle: Exactly. And again, it's a big change relative to 2023. It's not necessarily a big change relative to what we saw in the pre-pandemic decades.

Allison Nathan: Let's talk tax cuts. I think it's widely expected that the 2017 tax cuts are going to continue, but what else are investors expecting on top of that? Are they more optimistic that we'll see more tax cuts?

David Mericle: So nearly everyone expects the 2017 tax cuts to be extended. About two thirds of our survey respondents experienced them to be extended in full.

About one third expected them to be extended in part. Now, above and beyond that, there are a bunch of other potential tax cuts because there were a lot of proposals that were brought up during the campaign. No tax on tips, no tax on overtime, no tax on Social Security, and various other proposals like this. There are also some that are always part of the discussion like increasing the state and local tax deduction.

Our assumption -- and this turns out to also be the assumption of most investors -- is that there will be some additional tax cuts, but that they won't be huge in size. So we're assuming something like 0.2% of GDP or about $60 billion in additional tax cuts because we suspect that Republicans would be concerned that, if they don't deliver on some of the campaign proposals, that would antagonize voters and it would cost them in the next election.

Why not something even bigger? Why not the full-blown tax cut agenda? To my mind, the main reason for that is that the starting point for US fiscal sustainability is very different and a lot more concerning than the first time that Trump took office. We already have a primary, or ex-interest, federal fiscal deficit that is about 5% of GDP wider

than it has historically been when the economy's been equally strong, and the unemployment rate's been around 4%. We have a debt-to-GDP ratio that is quickly closing in on a new all-time high. And the thing that arguably gets us into the most trouble of all, we now have interest rates across the curve that are about double what most people were assuming the last time President-elect Trump was in office.

And so you take all of those things together, it makes for a not-great outlook for the debt-to-GDP ratio, for interest expense as a share of GDP, and I think that will probably constrain what Congress is willing to do in terms of further unfunded tax cuts or spending increases. Something to make good on campaign proposals but not enough to really shake up the macroeconomic picture. That's our view, and that turned out to also be most investors' view.

Allison Nathan: Let me just ask a quick follow-up question on corporate taxes. Are investors expecting corporate tax cuts? That was such a big policy shift when Trump first came into office.

David Mericle: Yeah, so many were, although I guess I

would caution that could mean different things to different people. So maybe we should have phrased this question a little bit better. Last time Trump was in office, there were proposals to lower the corporate tax rate all the way down to 15%. They lowered it to 21%. We think it's very unlikely that will go all the way to 15%. So if that's what people had in mind, I guess I'd say we disagree with that. But it is possible it could be reduced to 20%, and we also think it's pretty likely that the manufacturing tax rate, that specifically could come we to 15%. That's not the entire economy; that's just one sector. But that part we think is plausible.

A lot of people did expect further corporate tax rate cuts, but that could have meant something more substantial or more moderate. And if people meant more moderate then I would say I think that's reasonable.

Allison Nathan: So in the context of these fiscal issues that we're already facing, obviously there's a lot of focus on the other side of the ledger in terms of government spending. And there is this new government efficiency department. We don't really know what that's going to look like at this point. What are investors expecting from that?

And what are you expecting from that, given how new that initiative is?

David Mericle: I would say this is definitely the question where people had the least sense of what to make of it, where views were the most widely varied. Answers were really pretty spread out. I would say a lot of people, probably about 45% of people, expected either insignificant cuts or quite small cuts. That probably aligns most closely with our view.

Beyond that, it was not a popular view that this would save a huge amount of money, but I would say there's probably 10% of the survey response in each of several buckets from 25 to 100 billion, 100 to 200 billion, 200 to 300, 300 and above. So wide-ranging views. Understandable for something that's so new.

Allison Nathan: And you've actually pointed out that there are some real limits to cutting spending. Tell us about that.

David Mericle: I think, if you're not interested in cutting defense spending and you're not interested in

cutting entitlement spending, then certainly getting to the kinds of numbers that they've been talking about seems very unlikely. But the remaining part, I think it would be more challenging to cut an amount that's substantial enough to really have a large macroeconomic impact.

Allison Nathan: So that's the policy expectations. How does this all read through to inflation?

David Mericle: Sure. So on inflation, I think by far the most important policy is tariffs. Now, I would emphasize that tariffs are a one-time effect on the price level, but just in terms of -- and therefore a one-time inflationary effect. But just quantitatively in terms of the impact on prices next year, I think that's likely to be much more significant than changes to fiscal and immigration policy.

Under our baseline where we get further tariffs on imports from China at an average rate of 20 percentage points or an average increase of 20 percentage points, plus some additional tariffs on autos -- most likely from the EU -- we think that would raise the US's effective, or average, realized tariff rate by 3-4 percentage points. Now, we've run this experiment before, of course, during Trump's first

term, and we've looked back at the lessons learned from the impact of tariffs on prices back then. And our rule of thumb is that every 1-point increase in the effective tariff rate is worth about one tenth of a percentage point on the price level.

If we get the policies we're looking for in our baseline, that 3-4 percentage point increase would be worth three to four tenths on the price level. And if that all happens pretty quickly, as it probably would, that would mean, at the peak, you get a three to four tenths boost to inflation. That's not huge. It shouldn't be that hard to say, at least in the case of the consumer tariffs, this is roughly the effect of the tariff and we know that by comparing tariffed items to non-tariffed items. And the inflation boost would come on top of an underlying trend that we think would otherwise be declining from the high 2's to the low 2's. So this would cause us to wind up more in the mid 2's than the low 2's, but certainly not to take us back to the levels that we saw in prior years.

Now, if we do get the universal tariff, the impact of that on the average tariff rate is about triple the impact of the other two policies combined. So that gives you a good sense of

why this is the key risk, the key wild card for 2025. It's simply much larger than the other tariff policies we're talking about. And the impact of that on prices would also be roughly triple. We think that would raise the price level by about 1% and probably push inflation at the peak a little bit above 3%. Although again, I would emphasize this is still a one-time effect.

Allison Nathan: And how about economic growth?

David Mericle: In terms of the impact on growth, the impact of the policy changes that we've talked about today we think on a 2- to 3-year horizon would be roughly offsetting. The catch is that the things that would have a negative impact on GDP -- namely, just fewer immigrants, fewer workers, and tariffs -- those can be done more through the White House's authority, so that can happen more quickly. Whereas the things that would have a positive impact on GDP -- namely, the tax cuts -- that has to go through Congress, so that's not going to happen as quickly.

That probably means that in 2025, you get more of the negative effects and, in 2026, you get more of the positive

effects. But on a multiyear horizon, we would say these things are roughly offsetting. But they don't really substantially change the growth trajectory of the US economy.

Allison Nathan: And so we think about the implications of this for the Fed, our views versus investors' expectations, are we differentiated?

David Mericle: I think this is probably where our views differ than most. On policies, what I learned from doing this survey is that actually the market consensus is pretty close to our view on what will actually happen. Where I think we differ is on the assumption, the inference, that many investors seem to make that tariffs mean higher inflation and therefore higher interest rates. Obviously there's a lot of appeal to that logic. I just think that the risks are a little bit more two-sided than people are appreciating. And I say that for three reasons.

First, if we get the tariffs we have in our baseline, again, the impact on inflation is just not that big. We're talking about 30 to 40 basis points. It would be on top of an otherwise falling underlying trend. And the effects should

be pretty discernable in the category-level details.

Second point I would make is this is clearly a one-time price level effect. So at some level, the Central Bank is not supposed to respond unless this really unsettles inflation psychology or inflation expectations. And if we're talking about inflation actually coming down from where it is on net now, just coming down less, it's not clear why that would unsettle inflation expectations.

The third point I would make is that the assumption that tariffs mean higher interest rates, that's exactly the opposite of what happened in 2019. The last time that the first Trump administration imposed tariffs, the equity market really didn't take it well, financial conditions tightened quite a bit, and the Fed decided to prioritize the risk to growth from a tightening in financial conditions, the risk to the labor market from that tightening in financial conditions, over the impact of a moderate one-time price level increase.

Some things are different. The rate of inflation is higher now than it was back then, of course. The threatened tariffs are probably larger than they were back then. It's

not clear to me that the risks are as one-sided as people think. So I would say, in the very near term, we're expecting the Fed to cut in December. I think it's a little bit ambiguous what they'll do immediately after that. We have additional consecutive cuts in our forecast for Q1.

Recent Fed commentary suggests they're thinking about trying to find the right point in time to slow the pace of cutting. Could be when we're forecasting; could be a little bit earlier. But I am comfortable with the message from our Fed forecast relative to market pricing that market pricing looks a little bit too hawkish. And I think expectations about the economic and monetary policy consequences of the policy changes that we've discussed today is probably at the heart of the disagreement. Most people take fewer immigrants, tax cuts, tariffs to be inflationary and therefore imply higher rates. There is of course some logic to all of that that does make a good amount of sense.

But I would just say the consequences to us look like they're not big enough that it would be prohibitive for the Fed to cut, and I think people are underweighting the potential risks to the downside to the economy and to

markets that could trigger another episode comparable to the 2019 insurance cuts when the Fed basically said, "We're not in a recession yet, but there is a substantial risk to the economy that we want to counteract by easing monetary policy a little bit." In other words, providing insurance against a further downturn. And that risk should really be reflected in market pricing, too. So our views are a bit more dovish than market pricing, and, over the medium term, I'm quite comfortable with that message.

Allison Nathan: David, thanks so much for joining us.

David Mericle: Thank you very much for having me.

Allison Nathan: This episode of Goldman Sachs Exchanges was recorded on Wednesday, December 4th, 2024. I'm your host Allison Nathan, and tune in this Friday for the final episode of our 4-part series on the changing dynamics at the intersection of sports and finance. We'll be discussing the business forces driving the growth in women's sports, which have seen record-breaking game attendance and viewership. Thanks for listening.

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