Torsten Slok

Tariffs and Financial Turbulences

On Wednesday, April 9, Torsten Slok joined Markus' Academy for a conversation on "Tariffs and Financial Turbulences." Torsten Slok is a Partner and the Chief Economist at Apollo.

A few highlights from the discussion.[1]

- **A summary in three bullets**
    - It is correct that the U.S. has lower tariff and non-tariff barriers to trade than many countries. Yet the decline in U.S. manufacturing is not entirely attributable to China, and may be due to long-term trends in productivity, technology, and manufacturing efficiency
    - 6 downside risks in the U.S. economy: (1) Consumer and (2) Corporate confidence are deteriorating, (3) Negative tariff impact on earnings, (4) negative impact from retaliation, including from a decline in tourism, (5) (temporary) $10 trillion drop in the S&P 500, (6) DOGE-related layoffs
    - Historical correlations are breaking down across equity, rates, and credit markets. The last week saw a much smaller sell off in credit markets compared to equity markets, and, in contrast with prior crises, Treasury yields have not come down as stocks have declined

- **[0:00] Markus' introduction**
    - Uncertainty about tariffs can be worse than tariffs; it's like a tax without revenue
    - In standard models the country-optimal tariff for a country is not zero, as it can exploit its monopoly power. They become suboptimal as other countries retaliate, and as tariff shocks might amplify throughout the economy
    - It is usually better to tariff final rather than intermediary goods, so as not to distort relative prices along the supply chains
    - Trade deficits are offset by capital account surpluses. The U.S. can sustain its trade deficits due to its ability to issue safe assets (exorbitant privilege)
    - A safe asset is like a good friend, with a stable value during idiosyncratic shocks and risky times (Brunnermeier et al., 2025). If the safe asset status of American debt is put at risk, the U.S. might lose this privilege
    - The E.U. could decide to issue a synthetic safe asset, ESBies (Brunnermeier et al. 2016); the loss of a global safe asset would entail a huge global welfare loss
    - A transition from a global multinational order to a fragmented global "unorder" carries the risk of J-curve dynamics—if the dip is too steep and crosses a tipping point, it could derail the global system. The same risk applies to a transition among global safe assets

[1] Summary produced by Pablo Balsinde (PhD student, Stockholm School of Economics)

- [8:40] **Trade and Tariffs**
    - In 2000, the U.S. was the main trade partner for most of the world. Today it is China. The share of Chinese exports that go to the U.S. has declined from ~20% in 2000 to ~15% today
    - China's share of world exports has grown dramatically—from around 2% in 1991 to roughly 12% today. Meanwhile, the U.S. and Germany have seen their shares shrink
    - 43% of U.S. imports and 40% of its exports come from China, Mexico, and Canada. The U.S. runs both a goods trade deficit and a service trade surplus with the E.U.
    - The U.S. has lower average tariffs than the EU and many other countries. he OECD Trade Restrictiveness Index also confirms that the U.S. has maintained relatively low non-trade barriers
    - Emerging markets tend to impose higher tariffs because they have fewer industries and thus stronger incentives to protect them
    - The average tariff rate on U.S. imports hovered around 30% during the 19th century, higher than the recently announced 20%
    - Cars are by far the most significant U.S. import. They are the most important import from Mexico, Germany, Japan and others (from China it is cell phones)
    - A large portion of U.S. trade is intra-firm. About 20% of the value added in U.S. car exports is foreign
    - The U.S. has seen a steady decline in manufacturing's share of non-farm employment (from ~40% during WWII to ~10% today). Such a long-term trend suggests it may not be driven solely by China's entry into the WTO, but also by gains in U.S. productivity and manufacturing efficiency
    - Some states are more exposed to trade than others. Exports plus imports as a share of GDP peaks at 21% in Michigan, where the auto industry is. In the majority of states it is around 5%, borders states tend to be more exposed
    - 85% of federal government workers are located outside of D.C., Maryland and Virginia. For every direct federal employee, there are two contractors, so there are 9–10mn government employees in total (Kamarck, 2025)
    - The decline in consumer confidence may be influenced by this workforce's fears over potential job losses due to DOGE reforms

- [29:11] **Market turmoil dynamics**
    - 6 downside risks: (1) Consumer and (2) Corporate confidence are deteriorating, (3) Negative tariff impact on earnings, (4) Negative impact from retaliation, including from a decline in tourism, (5) (Temporary) $10 trillion drop in the S&P 500, (6) DOGE-related layoffs
    - Even before the tariff announcement, consumer sentiment about the economy and unemployment was at levels last seen during the 2008 recession. Higher-income households have seen an especially large decline in confidence
    - The CEO confidence index and surveys of planned capital expenditures initially jumped following Trump's election—but these have reversed sharply
    - Elevated uncertainty makes it harder to value companies: loan issuances, IPO activity, and M&A deals have declined

    - Economic policy uncertainty has historically tracked corporate bond spreads, but spreads haven't widened significantly this time. Credit spreads between CCC and BB-rated bonds remain at normal levels
    - The last week saw a disconnect between credit and equity markets, with only a modest sell-off in credit compared to the drastic decline in equities, especially when measured against their typical relationship in past crises
    - Typically the credit market is a better predictor of the economy than the stock market, which is largely driven by the magnificent 7 (35% of the S&P 500)
    - Typically when the stock market goes down Treasury yields also go down. In contrast, over the last week rates have been going up: the 10-year treasury yield has grown by 50 bps
    - It is not clear why this has happened. It is probably not because of foreigners selling treasuries and moving their money abroad, as we have not seen an analogous decline in the dollar. U.S. exceptionalism is not being challenged, but it is possible that foreigners have sold treasuries and held onto the dollars
    - There are two other possible explanations. First, with the VIX extremely elevated, portfolio managers may have needed to liquidate treasury positions to raise cash for margin calls or to rebalance their portfolio
    - Second, hedge funds may be unwinding their "basis trades"—strategies where hedge funds exploit small differences between cash Treasury bonds and futures (typically 5–10 basis points), often with 50x to 100x leverage
    - When margin calls hit, hedge funds are forced to sell cash Treasuries, putting upward pressure on long-term rates
    - There is an estimated $800bn - $1tr in basis trades. Kashyap et al. (2025) recently argued that a Fed facility may be needed to unwind the basis trade

- [49:52] **Conclusion and the Fed**
    - It's hard to quantify the impact of tariffs on earnings and inflation. Historical correlations are breaking down across equity, rates, and credit markets. This could be a sign of forced selling across different asset classes
    - There are downside risks to the S&P 500 and to lower-quality credit, with volatility expected to remain high
    - The Fed is unlikely to respond directly to the stock market and will wait for signs of rising unemployment. A trade war that leads to higher inflation and lower GDP will leave the Fed with a difficult policy choice in its dual mandate
    - If the Fed decides to cut rates, it will need to clearly communicate its inflation outlook. Although U. Michigan survey data shows inflation expectations are rising, the Fed may feel comfortable with the long-term inflation expectations implied by TIPS breakevens (the difference between nominal Treasury yields and TIPS yields)
    - In the long term, inflation is expected to decline due to slowing growth. A very important part of the debate is that Jerome Powell's term ends in May 2026
    - Elevated uncertainty appears likely to persist. Most research suggests that sustained uncertainty increases the risk of an economic slowdown

Timestamps:
[0:00] Markus' introduction
[8:40] Trade and Tariffs
[29:11] Market turmoil dynamics
[49:52] Conclusion and the Fed