
Commentary

Rising Protectionism is Weakening the U.S. Growth Outlook

Morningstar DBRS

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Key Highlights

- The imposition of tariffs over the last six months marks a historic shift in U.S. trade policy. The effective tariff rate reached 8.8% in May, its highest level since 1946.
- With a series of recent trade deals and the August 1 deadline approaching, U.S. tariffs are set to increase further. While the scale and timing of tariff costs are uncertain, we expect recent trade developments to marginally weaken the growth outlook.
- So far, the tariff-protection provided by the USMCA has shielded all three North American economies from most U.S. tariffs. In that context, USMCA negotiations, which look set to get underway in the second half of the year, will be important in shaping the near-term growth outlook.

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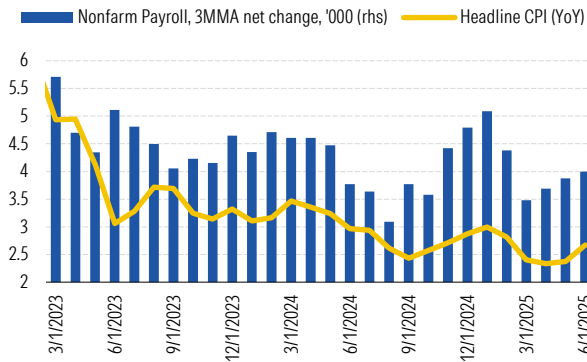
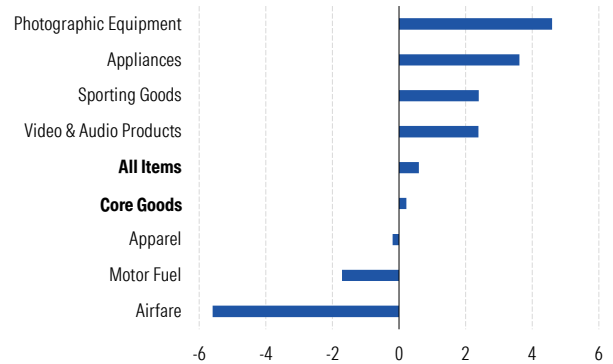
President Trump has announced a growing list of tariff increases on countries and products during the first six months of his second term. In the latest round of trade brinksmanship, the European Union agreed to a deal in which the U.S. would impose a 15% tariff on most EU imports. Other countries have either reached similar agreements or face potential tariff increases on August 1. At the same time, the U.S. Commerce Department is moving ahead with nine investigations that lay the ground for higher levies on products ranging from copper to pharmaceuticals.

The U.S. economy has been resilient to tariff hikes so far, although we think the full impact is yet to be felt. If the announced trade deals hold and the threatened August 1 duties are applied, the impact on the U.S. economy would likely be slower economic growth in the second half of 2025 and 2026 relative to current expectations. The scale of the damage would depend in part on whether countries retaliate against U.S. exports. U.S. trade policy will remain center stage later this year as USMCA negotiations get underway. Without an extension of the agreement underpinning intra-North American trade, the effective tariff rate on U.S. imports would rise even higher and inflict greater costs on the U.S. economy.

Fears of the Tariff Shock Have Not Materialized But the Impact Is Still In The Pipeline

The U.S. economy powered through the first half of the year despite rising concerns around U.S. protectionism. The impacts on headline inflation and economic activity were largely imperceptible. Annual CPI inflation decelerated to 2.7% in June, down from 3.0% in January. Monthly job gains picked up in the second quarter while layoffs remained low. Against this backdrop, consumers continued to spend at a healthy pace, which will likely contribute to a moderate rebound in GDP growth in the second quarter. The resilience partly reflects the fact that the early fears of the tariff shock diminished when the U.S. administration postponed most tariffs and rolled back triple-digit levies on China. Moreover, few trading partners retaliated in hopes of finding a negotiated settlement.

But the imposition of tariffs over the last six months— which includes a universal baseline tariff of 10%, elevated duties on goods from China, and product levies on autos, steel and aluminum – marks a historic shift in U.S. trade policy. U.S. customs duties jumped to \$24.2 billion in May, which is nearly a fourfold increase over the same month one year ago. The effective tariff rate, which is calculated as duties levied as a share of imports, reached 8.8% in May. That is the highest rate since 1946. Data on the daily flows to the U.S. Treasury suggest customs duties continued to rise in June and July.

Exhibit 1 Headline CPI and Monthly Job Gains**Exhibit 2** Inflation: Select Goods (percent change from March to June)

Source: U.S. Bureau of Labor Statistics; Macrobond; Morningstar DBRS.

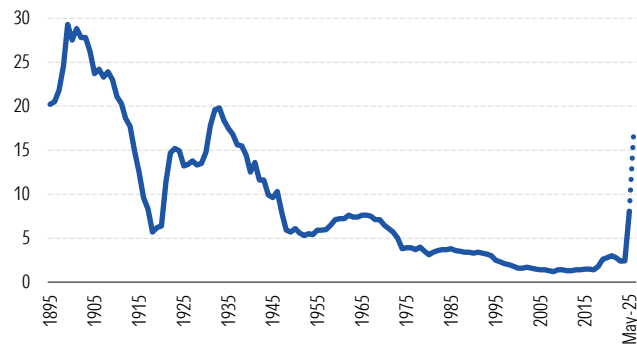
Looking below the headline data, there are signs that tariffs, combined with trade policy uncertainty, are starting to bite. As noted in the [North America Macroeconomic Update - June 2025](#), the tariffs have competing effects on prices. The initial effect of the April 2 announcement was disinflationary, as diminished growth expectations quickly led to lower energy and energy-related prices (e.g. gasoline and airfares). However, consumer prices for some products exposed to new levies increased sharply from March to June. This includes appliances, sporting goods, and audio equipment.

We suspect that the full impact of the levies already on the books is still working its way through the economy. There are several reasons that the passthrough of tariffs to prices and activity may take time. Businesses can temporarily compress profit margins or draw down inventories to delay price increases. Supply chains can also adjust to mitigate higher production costs. But the scale of customs duties now flowing into the U.S. Treasury suggests there will be a cost over time through higher prices and weaker real consumer spending. Amid rising protectionism and trade policy uncertainty, U.S. growth forecasts have been downgraded. The IMF expects the U.S. economy to expand 1.9% in 2025 and 2.0% in 2026, down from its January forecast of 2.7% and 2.1%, respectively.

Tariff Shock Could Intensify While Uncertainty-Driven Demand Shock Lingers

U.S. tariffs look set to increase on August 1. Absent a trading agreement, countries could see the U.S. tariff rate on their exports increase 10- to 40-percentage points relative to the baseline rate. Even in countries that have reached a deal with the U.S., the baseline tariff remained in place (e.g. United Kingdom) or increased (e.g. European Union, Vietnam and Japan). The Yale Budget Lab calculates that the overall effective tariff rate, including the announced trade deals and the August 1 threats through July 27, would rise to 17.3% after taking into account substitution effects (18.2% pre-substitution based on 2024 import shares). This would be the highest effective tariff rate since 1935 in the aftermath of the Smoot-Hawley Tariff Act of 1930.

Exhibit 3 Historical Effective Tariff Rate (%)



Source: U.S. International Trade Commission, Office of Analysis and Research Service; Yale Budget Lab; Macrobond; Morningstar DBRS.

Exhibit 4 Tariff Rates by Country (%)

	Share of U.S. Imports (2024)	Effective Rate in May 2025	Announced Tariff Rates as of		Status
			...9-Apr	...1-Aug	
European Union (EU)	14.6%	6.7%	10%	15%	Deal
Mexico	12.2%	4.3%	25%	30%	Talks
China	10.6%	45.6%	104%	51%	Talks
Canada	10.0%	1.9%	25%	35%	Talks
Japan	3.6%	14.0%	10%	15%	Deal
Vietnam	3.3%	7.0%	10%	20%	Deal
South Korea	3.2%	12.1%	10%	25%	Talks
Taiwan	2.8%	2.6%	10%	32%	Talks
India	2.1%	5.7%	10%	26%	Talks
United Kingdom	1.6%	6.8%	10%	10%	Deal
Thailand	1.5%	5.9%	10%	36%	Talks
Switzerland	1.5%	4.8%	10%	31%	Talks
Malaysia	1.3%	3.9%	10%	25%	Talks
Brazil	1.0%	7.8%	10%	50%	Talks
Singapore	1.0%	2.2%	10%	25%	Talks

While markets may find some relief from the recently announced trade deals, we think U.S. trade policy will remain uncertain post-August 1. With regards to the deals already announced, there is not much clarity on their timing or implementation, thereby leaving scope for the agreements to unravel. The U.S. administration may also resort to tariffs in the future as a way to create leverage on a wide array of non-trade issues ranging from fentanyl trafficking to digital services taxes. In addition, U.S. courts may ultimately rule that the White House does not have the authority to impose country-wide tariffs under the International Emergency Economic Powers Act (IEEPA), although the Section 232 tariffs look more likely to withstand legal challenges.

Overall, the imposition of higher tariffs - combined with lingering policy uncertainty - will continue to weigh on the U.S. economy. While the scale and timing of tariff costs are uncertain, we expect recent trade developments to lead to marginally slower economic growth in the U.S. in the second half of 2025 and in 2026 relative to current expectations. Some tariff increases are likely to be passed on to consumers, and the incremental impact on inflation could delay monetary easing. The extent of the damage will depend on the size of the post-August 1 tariffs as well as the degree of retaliation. Positively, the agreement with the EU did not include any retaliatory measures. Yet three of the four largest purchasers of U.S. exports (Canada, Mexico, China) have yet to strike a deal. In that context, USMCA negotiations, which look set to get underway in the second half of the year, will be important in shaping the near-term growth outlook.

So far, the tariff-protection provided by the USMCA as well as some product-specific exemptions have shielded all three North American economies from the most disruptive scenarios. Despite facing a nominal rate of 25%, the effective tariff rate in May for Canada and Mexico was 1.9% and 4.3%, respectively. If USMCA-compliant goods are subject to U.S. tariffs, the effective tariff rate would materially increase. The USMCA has spurred intra-North American trade and fostered large cross-border investment for three decades. If the regional economy fragments under the weight of protectionism, all three economies would suffer significant damage.

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