The Capitulation Trade

The markets seem persuaded that we are past the peak of Trump tariff lunacy. But the path back down Mount Stupid will be long and bumpy, while some of the damage of these last weeks will be permanent

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A degree of calm has returned to the markets after the chaos of the last few weeks. Investors appear to have taken Donald Trump's decision to call off his demented attack on the independence of the Federal Reserve and his claim that to be negotiating on trade with China as a sign that we are past peak tariff lunacy. The result is that the S&P500 has rebounded and is now just 10 percent below its peak, while the US 10-year Treasury yield is back broadly in the range where it traded before "Liberation Day". So is this evidence that there was and is a "Trump put" after all? Here are a few thoughts:

1. Trump has yet to lift a single tariff. Most of the tariffs he announced on "Liberation Day" have only been paused. No one knows, including most likely Trump himself, what will happen when the 90 day hiatus is up. Permanently removing the "reciprocal" tariffs is still officially contingent on countries reaching new trade deals with America. But while Trump insists that 75 countries want to "kiss my ass", there is so far little evidence of any progress. Trade talks with Japan, which Trump had initially touted as going well, broke up last week with no deal amid reports that Japanese negotiators were struggling to make sense of what Trump wanted from them.
2. On the other hand, Scott Bessent, the Treasury secretary, says that a deal with India may be close on the basis, bizarrely, that India does not

engage in much protectionism. According to Bloomberg, the agreement under discussion will cover 19 categories, including greater market access for farm goods, e-commerce, data storage and critical minerals. Whether a substantive deal can really be wrapped up by July is an open question. After all, the EU has been trying to reach a trade deal with India for 18 years and Britain for three. But a quick deal that exempts India from the threatened 26 percent "reciprocal tariff" in return for not very much would send a welcome signal that the administration is indeed in full capitulation mode. But we're not there yet.

3. A deal to end the trade war with China still looks much further off. Trump may say that he wants a deal with Beijing and Bessent may have admitted that the current 145 percent tariffs on China are "unsustainable" (in the process blowing apart the administration's claim last week that its cunning plan was to isolate China), but the path to a deal looks highly uncertain. Trump says negotiations have already started; everyone else says that they haven't. Who to believe? Trump has ruled out cutting tariffs unilaterally; Beijing says, not unreasonably, that Trump having started the trade war must jump first. China's plan to exempt some US imports from 125 percent tariffs may be a concession, more likely it is just a step to protect critical supply chains.

4. Even if the "reciprocal" tariffs are entirely dropped, the 10 percent universal tariff looks likely to remain, while tariffs on China are certain to remain much higher, even if a deal is reached. Then there are the 25 percent tariffs on autos and steel and aluminium, plus further tariffs threatened on pharmaceuticals and semiconductors. All this will only add to the complexity and uncertainty over-hanging the global trading system, while likely still leaving the US with the highest average tariffs since the 1930s.

5. All this uncertainty is hitting the global economy. The International Monetary Fund this week downgraded its forecasts for global growth this year to 2.8 percent, down 0.5 percentage points on what it was forecasting as recently as January. Of course, even these forecasts are highly tentative. But one thing seems clear enough: it is the US itself that is likely to be hit hardest by Trump's tariffs. The IMF has downgraded its forecast of US growth this year by nearly a full percentage point to 1.8 percent while raising the risk of a US recession to 45 percent. That will

feed through to corporate earnings as US companies have been making clear in results calls this week.

6. That suggests that US stocks could have further to fall, despite recent rallies in response to Trump's rhetorical U-turns. Indeed, Goldman Sachs reckons that after this week's rally, investors may be underpricing the risk of a recession. Meanwhile, US stocks remain expensive on most metrics relative to the rest of the world, trading at 19.5 times next year's forecast earnings, compared to 13.5 times for European stocks and 10.7 times for UK stocks. What's more, given that the dollar has been sliding, any decline in US stocks translates into much steeper falls for international investors.

7. Indeed, there are good reasons to expect the slide in the dollar to continue. As Jan Hutzius, chief economist at Goldman Sachs, notes in the Financial Times, Federal Reserve data shows that the real value of the dollar still stands nearly two standard deviations above its average since the start of the floating exchange rate era in 1973. The only two historical periods with similar valuation levels were the mid-1980s and the early 2000s. Both set the stage for depreciations of 25-30 per cent. What's more, non-US investors currently hold an estimated $22 trillion in US assets, perhaps accounting for one-third of their combined portfolios. If they decide to reduce their US exposure, says Hutzius, it would almost certainly lead to significant dollar depreciation.

8. Meanwhile wider questions about the conduct of US policymaking have not gone away. Trump may have backed away from his astonishingly reckless assault on the Federal Reserve and its chairman Jay Powell, who he has branded a "total loser". Indeed, he even went as far as to deny that he had ever contemplated sacking Powell, despite well-sourced reports that he had considered doing exactly that. That may have helped calm markets, preventing what threatened to become another destabilising sell-off, as investors contemplated the dismantling of one of the few remaining institutional guardrails. But Powell is due to step down in any case next year and the administration is currently challenging the very Supreme Court precedent that has for decades protected Fed independence.

9. Much of the focus of debate regarding the Fed has been on Trump's demands that it cut interest rates. But a deeper anxiety among

international policymakers concerns how a MAGA-sympathising Fed might act with regard to its broader role in the financial system. In particular, there is concern as to whether central banks can still rely on the Fed to provide dollar liquidity in a crisis. I understand that such concerns lay behind Canada's decision last month to issue dollar-denominated bonds to boost its own dollar liquidity. As with Nato's Article 5 mutual defence clause, the fact that Fed swap lines are even being questioned is itself destabilising and obliges other jurisdictions to take actions to shore up their own defences.

10. That suggests that even if Trump was to execute a U-turn on his grotesque policy error, the path down Mount Stupid is likely to be long and bumpy and much of the damage may be permanent. The reality is that two things can both be true: Trump has not had a new idea since the 1980s, when he first embraced his crackpot theories about trade. On the other hand, he is capable of changing his mind on a daily basis, depending on his whims and who spoke to him last. So long as he remains president, US policymaking is going to remain capricious and guided by flawed ideology. So while stocks and bonds and the dollar may gyrate in response to the latest social media post, the downward trend is likely to continue. To the extent that there is a Trump put, it is likely only to control the speed of the descent.