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EM outlook: Navigating in the fog of trade war

Trade policy uncertainty may be at its peak right now. The trade review on 2 April should help shine more light on the likely path going forward, but uncertainty will linger, clouding the outlook for emerging markets.

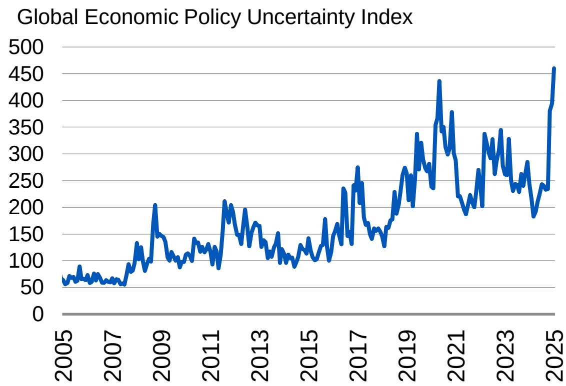
Key Takeaways

- The emerging market (EM) outlook is clouded by US policy uncertainty, with tariffs threatening to re-wire the global trading system.
- What is clear is that following the Trump administration's 2 April trade review, EMs will face higher tariffs.
- We expect that reciprocal and sectoral tariffs will be the primary levers. But there is a risk that the US assessment of non-tariff barriers and VAT rebates for exporters could be used to justify sharply higher tariffs, pushing up trade barriers erratically, and introducing significant variation in the shock faced across EMs.
- EMs will have some scope to make trade deals, while lowering their own tariffs on US imports offers a route to limit reciprocal tariffs. Few countries will be willing to reduce protections on politically sensitive industries, such as agriculture, however.
- Mexico and emerging Asia stand out as most vulnerable, relative to the commodity exporters in Latin America or parts of emerging Europe. But, while the recent volatility of trade actions against Mexico and Canada has been hard to look past, ultimately these countries are likely to be the biggest reshoring 'winners' as actions against China ramp up.
- Growth dynamics are already mixed, and near-term investment is likely to be constrained by trade uncertainty. Market pressure could add to EM central bank caution but slowing activity and the ongoing easing of underlying inflationary pressure suggest that EM central banks will resume their easing cycle.

Emerging markets are in midst of a global policy uncertainty shock

The emerging market (EM) outlook is shrouded by the policy uncertainty emanating from Washington. Since President Donald Trump's inauguration in January, a flurry of executive orders and a continual stream of tariff threats, announcements, and reversals, have caused global policy uncertainty to spike to its highest ever level (see Figure 1).

Figure 1: Global policy uncertainty has surpassed the pandemic peak



Source: Aberdeen, Haver, http://www.policyuncertainty.com/, March 2025

There are several channels through which EMs will be impacted by his policy agenda, but trade tensions are already shaping up to be the most significant in 2025.

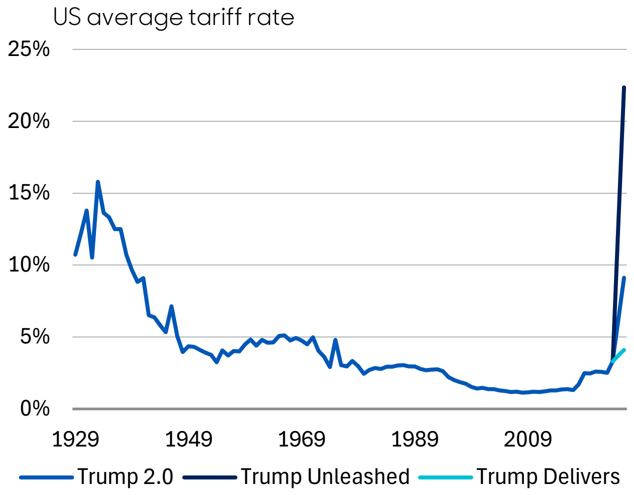
Tariffs are unavoidable, but deals can be struck

Our baseline scenario, 'Trump 2.0' (50% probability), envisages the US average weighted tariff rate increasing from 3% at the start of Trump's term to 9% (see Figure 2).

This is three percentage points higher than we expected before he took office, illustrating that we now think tariffs will be used more widely and more of them will become permanent.

Since these estimates show the end point, they take account of substitution effects, as US consumers buy fewer tariffed goods, and deals are struck; hence, tariffs are likely to rise more sharply than shown here, before settling at these levels.

Figure 2: We expect a sharp increase in US tariffs in our base case, with risks they go substantially higher still



Source: Aberdeen, Haver, March 2025. Note: increase in effective tariff rate estimated post-carve outs and post-substitution effects

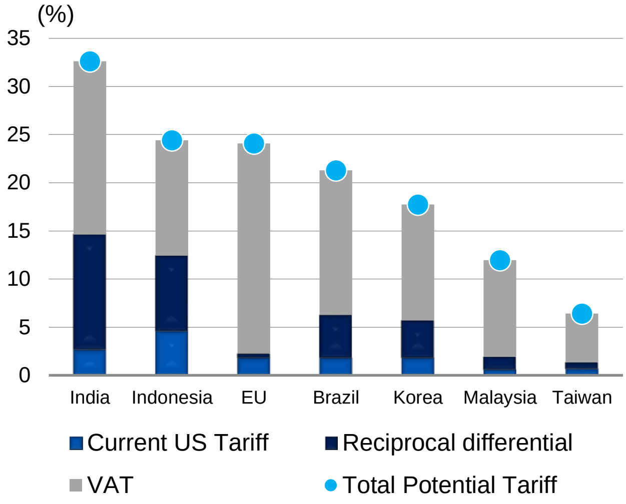
Most, if not all, EMs will soon face reciprocal tariffs, likely to be introduced on or shortly after the US' 2 April trade review. The exact format that these will take remains unclear. But, even if the US seeks to equalise tariffs, we still do not expect it to lower its tariffs in cases in which its own rates are higher. Sectoral or other tariffs would be stacked on top.

Given wide-ranging differences in export composition and sectoral tariff rates, this threatens to introduce a wide variation in the reciprocal tariff-shock faced across EMs (see Figure 3).

In many cases, EMs will be able to lower their tariff rates on imports from the US to avoid higher reciprocal tariffs. Tariffs are often designed to protect domestic producers from competition from other EMs, not US firms. Any concern that US-specific carve-outs violate the World Trade Organisation's (WTO) most favoured nation (MFN) rules are likely to be brushed aside.

That said, countries will generally not be willing to open up all their sectors to competition from the US, suggesting some proportion of reciprocal tariffs will become permanent. India, for example, is highly unlikely to lower tariff barriers for its agricultural sector, given political sensitivities.

Figure 3: The reciprocal and VAT tariff threat varies significantly across markets



Source: Aberdeen, WTO, US Census Bureau, PWC, March 2025. Note: Current and reciprocal tariff rates are based on trade-weighted MFN rates. VAT rates are estimated based on general domestic rates.

Additional tariffs, which could be imposed due to US judgements on non-tariff barriers, such as subsidies, and the treatment of VAT rebates for exporters are an additional wild card for EMs. These countries, particularly China, could be judged to be unfairly supporting domestic firms, while limiting access by the US.

US complaints about VAT rebates have traditionally been aimed at the EU, but we cannot rule out this being used to justify sharply higher tariffs across EMs. For most countries, this would push tariffs up by more than reciprocal tariffs, while offering little scope for an easy rollback.

Meanwhile, we continue to expect a variety of product-specific tariffs. In addition to the announced 25% tariff on all US imports of steel and aluminium from 12 March, we think US tariffs of up to 25% on autos, pharmaceuticals, and semiconductors are likely, even if carve-outs and trade deals should allow tariffs to settle at a lower level, particularly between the US and its allies.

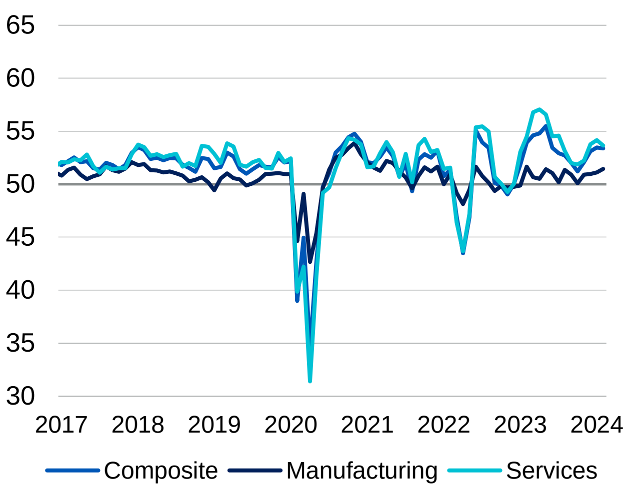
Finally, we continue to think US-China tariffs will move at least 10% higher. The 20% tariff already applied is likely to be permanent, partly because China may struggle to deliver initiatives to assuage the administration's fentanyl concerns. Moreover, it is almost certain that the 2 April review concludes China's trade surplus is the result of unfair competition across several dimensions (subsidies, currency manipulation, non-tariff barriers).

A trade deal is not impossible – and Trump recently implied a visit by President Xi is likely – but the credibility of any purchase agreement or a 'grand bargain' is likely to be coloured by the failure of the 'Phase 1' deal.

Vulnerabilities and opportunities often go hand-in-hand

The good news is that EM growth appears decent heading into the 2 April tariff shock, after moderating through much of 2024. PMIs suggest activity picked up in the last two months of 2024, with services remaining at a high level in January and February this year, while manufacturing has continued its steady gains (see Figure 4).

Figure 4: PMIs signal that EM growth is robust



Source: Aberdeen, Haver, March 2025

However, the protectionist shift by the US and disruptions to the global trade system will undoubtedly impact growth across EMs. In the immediate future, investment plans will be delayed until the trade landscape becomes clearer and this uncertainty could spill over into hiring and saving decisions. There is also some risk that the recent improvement in manufacturing is due to attempts to front-run tariffs.

The trade shock will not fall evenly across EMs.

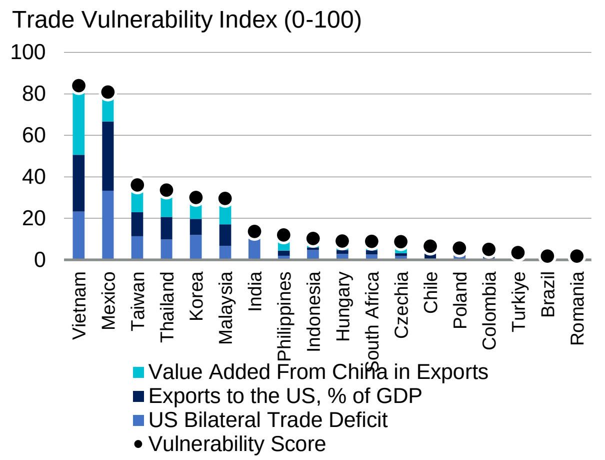
Mexico has borne the brunt of Trump's trade-related ire among EMs (outside of China) so far in 2025. This was widely anticipated, with Mexico placing near the top of our Trade Vulnerability Index (see Figure 5) in part due to its large trade surplus with the US, a point of contention for Trump alongside issues tied to border security. However, the magnitude of tariffs and the scale of uncertainty generated by on-again, off-again actions so early in 2025 has exceeded prior expectations.

A blanket 25% tariff on all Mexican and Canadian goods from 4 February announced by the Trump administration was delayed for a month. Tariffs applied on 4 March were then moderated three days later, to include only goods deemed 'non-compliant' with the USMCA (potentially impacting around half of Mexican exports to the US) until 2 April, so as to let US firms better prepare according to Washington.

Mexican authorities have claimed that they can make most goods (perhaps 90%) compliant with the USMCA. However, the timeframe for this action is unclear, while the efficacy of broader concessions in reducing trade tensions also remains in question.

Meanwhile, many countries in Asia are also highly vulnerable due to their large trade surpluses, strong links to Chinese supply chains, and high reliance on US import demand.

Figure 5: Mexico and EM Asia stand out as most vulnerable to a trade war

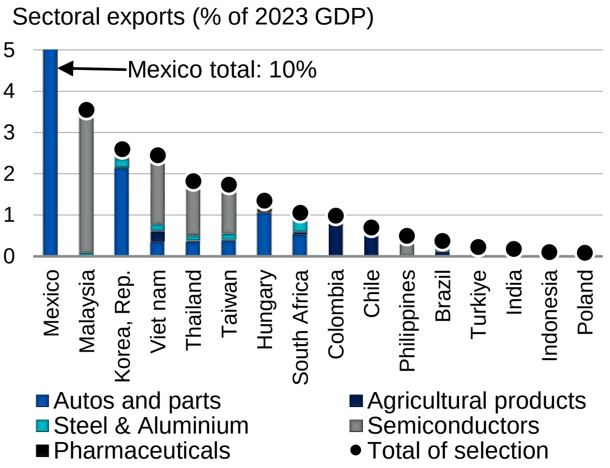


Source: Aberdeen, Haver, March 2025

On the other hand, LatAm commodity exporters and Türkiye rank low in our Vulnerability Index. Indeed, Brazil has already been a 'winner' of China's soy demand as the latter diverts its imports away from the US. These markets' low vulnerability is also supported by our analysis of exposure to potential sectoral tariffs (see Figure 6).

As noted, Mexico's strong integration into the US autos supply-chain resulted in the sector receiving carve-outs from tariffs to reduce the impact on US consumers. However, markets such as Malaysia, Vietnam, Thailand and Taiwan are vulnerable unless exceptions are made for semiconductors.

Figure 6: Sectoral tariffs suggest a similar pattern of vulnerability, but carve-outs will matter



Source: Aberdeen, Haver, March 2025

More broadly, judging potential vulnerabilities continues to be challenging given the potential for sudden flare-ups over non-trade issues such as migration or military dependency.

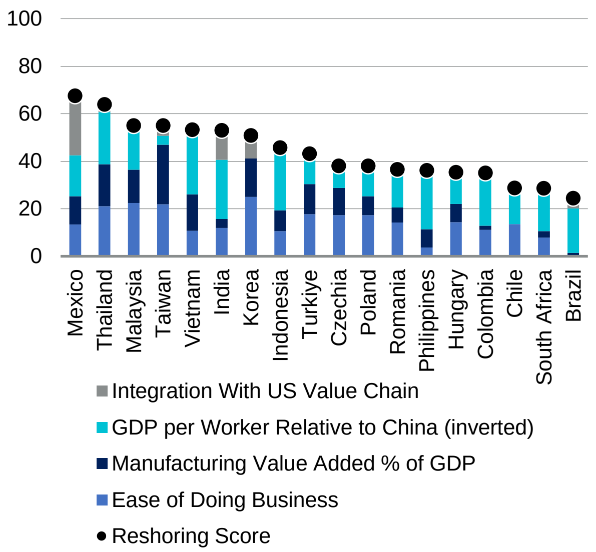
Colombia has already faced the threat of tariffs due to a dispute over US deportations. The US also expelled the South African ambassador and froze aid to the country over a dispute about the Expropriation Act.

Reshoring is still more likely than onshoring

Despite these vulnerabilities, the likelihood that tariff increases on China are more extreme and the potential for deals to be struck to roll back tariffs on EMs, point to some continuation of the reshoring trend.

The most vulnerable countries are also likely to be reshoring beneficiaries in the long run, given their already strong trade ties with the US, favourable business environments and the depth of their existing manufacturing supply chains (see Figure 7).

Figure 7: The most vulnerable EMs also tend to be the most likely 'winners'



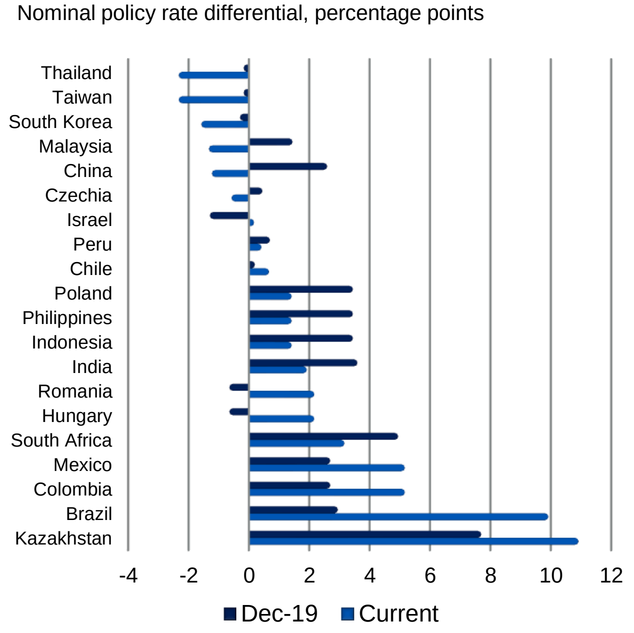
Source: Aberdeen, Haver, March 2025

The large and erratic tariff increases on Mexico and Canada do suggest a risk that the Trump administration is willing to endure economic pain to promote the onshoring of manufacturing back into the US. If this is a true ideological commitment, this would imply that reshoring may not be as much of the long-run tailwind for EMs as we expect.

EM easing cycle to cautiously continue

Amid the uncertainty around trade policy, we expect the Fed to remain on hold in the near-term, waiting for more clarity on inflation and growth. We forecast the Fed to cut once in September, which could mean extended pauses for some FX-sensitive central banks, such as Bank Indonesia, while more limited policy rate differentials may also factor into continued caution across many other EMs (see Figure 8).

Figure 8: The Fed remains in no hurry to cut rates, adding to EM caution



Source: Aberdeen, Haver, March 2025

The persistence of core inflationary pressures alone will hold back some EMs with ample rate differentials vis-à-vis the US. Underlying inflationary pressures appear acute in Brazil, Colombia, Hungary, Poland and Mexico.

That said, in the cases of Colombia and Mexico, still elevated ex-post real policy rates suggest the central banks will continue to cut, albeit gradually. And outside these highlighted countries, inflation has generally returned to target, allowing central banks to increasingly turn their focus to the growth outlook.

As such, with growth risks skewed to the downside due to global trade uncertainty and the upcoming 2 April tariff shock, we see the potential for EMs to deliver more cuts in the medium- to long-term than markets are anticipating.

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