Macro Comment US

From trade conflict to economic war?

Tariffs are starting to bite - trade is down, growth slowing and inflation on the cusp of picking up. Add to this the next disruptive policy from the White House: Section 899 in the "Big Beautiful Bill", which introduces a "revenge tax" on countries with "discriminatory" taxes on US companies. The macroeconomic effects could be notable: bad for the world but worse for the US itself. The proposal's supply shock could drag down GDP, stoke inflation, add to bond market worries and lift market interest rates. Hence, we judge Fed governor Waller's multi rate cut scenario as too optimistic and expect the Fed to be more vigilant. A dovish policy mistake would risk a steeper yield curve. Overall, this is in line with our forecast of a weaker USD with further diversification away from US assets.

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Fed challenged as tariffs start to bite; cue Trump's next disruptive policy

Tariff bite: Trade down, growth slowing, price increases picking up

How much more do we know about the tariff impact on the US since our 21 May Global Macro Forecast? A little, but not enough to draw decisive conclusions. Trade with China is plummeting, underlying GDP growth appears to be slowing down, while price rises have started to pick up (see Data Watch section).

The Fed's Waller strikes a dovish rate-cut tone, drawing the market's attention

The Fed is responding by standing its ground, continuing to signal unchanged, somewhat restrictive policy rates for the near term, even though US President Donald Trump is on the offensive and publicly calling for sharp cuts. In light of this, Fed governor Waller's deviation from other Fedspeak, with a dovish speech charting a path to multiple rate cuts, has attracted attention. Our view, however, is that the Waller scenario is too sanguine on the outlook, as it relies on:

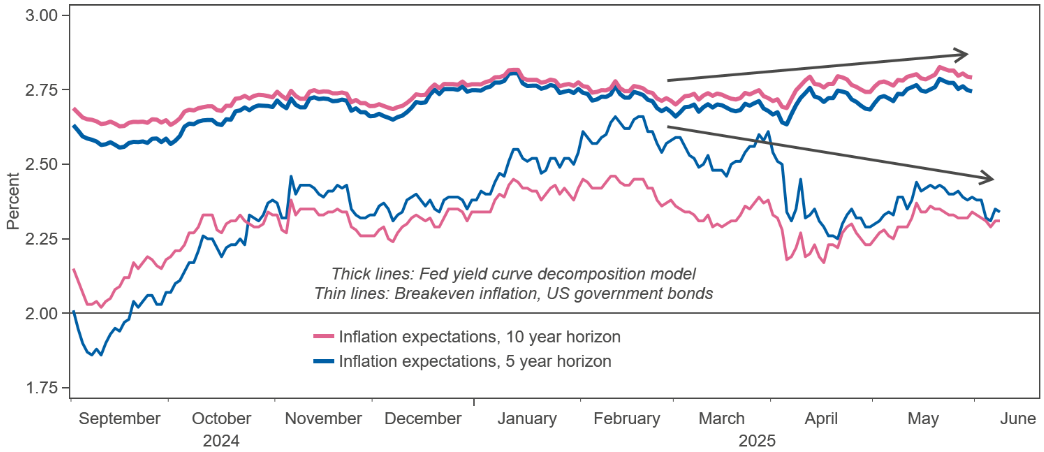
Relies on disinflation, anchored expectations, good news on tariffs

- Disinflation to progress towards the 2 percent target; transitory tariff-induced inflation impulse
- Anchored inflation expectations; downplaying consumer expectations, focusing on markets
- "Good news" also on the trade conflict front, with lower tariffs ahead

We judge Waller's scenario to be too sanguine, since each of his three conditions may stay unfulfilled

Firstly, we are now on the cusp on seeing how big the initial inflation impulse will be and how it propagates throughout the US economy – our base case is also for a transitory impulse, but it is too early to tell. Secondly, inflation expectations may not be so well anchored after recent concerning developments. Shorter-term measures have risen to significantly elevated levels and longer-term measures are on the move too, while (so far) printing at acceptable levels. We find Waller's downplaying of consumer-based expectations and touting of market-based measures problematic, as the latter also have shortcomings of their own: the recent sharp rise in term premiums in the market results in an underestimation of the "true" inflation expectations priced into markets (see graph).[1] Lastly, as political analysts' commentary has stated, at least since the autumn: Tariff rises are here to stay, and they are just the beginning of the disruptive policies that Trump will deliver in his second term. This implies a low probability for Waller's "good news". In addition, the next step in the reshaping of the world economic order may now be on its way, as Trump and the Republicans are teeing up a new tax provision – *Section 899* in the current budget proposal – which could have a similar stagflationary impact on the US as the tariffs, albeit on a smaller scale, see analysis below.

US: Market-based inflation expectations



Sources: Macrobond, Federal Reserve and Handelsbanken

Note: Model refers to a nominal yield decomposition using the DKW-model, Board of Governors of the Federal Reserve System.

Market breakeven inflation distorted by rising term premium - underestimates "true" inflation expectations priced into markets

All told, in contrast to Waller's speech, we expect the Fed as a whole to be more vigilant on inflation and the inflation expectations front, much in line with our warnings last autumn (see Macro Comment, 19 November 2024). If not, a dovish policy mistake by the Fed could result in a yield curve steepening as markets price in the possibility that the Fed eventually realises its mistake and is forced to act decisively to correct it. Or worse, today's jittery market could conclude that a dovish Fed is the first step towards accommodating the federal government's fiscal profligacy. This would risk sparking a sharp sell-off in US government bonds, with soaring term premiums and more negative swap spreads, making longer-term bond yields go *higher* despite the falling policy rate.

Expect the Fed to be more vigilant than Waller's scenario - if not, a dovish policy mistake risks resulting in a steepening of the yield curve when the Fed cuts its policy rate

Section 899 adds revenge tax on foreign business and investment

Section 899 is raising concerns in markets, global business and among law firms – is the trade conflict broadening into an economic war? In short, the tax proposal would mean that individuals, companies and investors, as well as government organisations based in countries with a – in the eyes of the United States – discriminatory tax system, will pay an additional "revenge tax" from 5pp up to 20pp on dividends, royalties and income from capital, such as rents from real estate (see Financial Times, 30 May 2025, and sources therein). "Fair", one might think: the US should be allowed to defend itself against "rogue states" that are feeding off the profits of American companies operating in their countries, right?

Section 899 says individuals and companies in countries with "discriminatory" taxes on the US will pay additional taxes...

Not clear. The problem is that it is European countries and other US allies that are the "rogue states" here, and these countries hardly agree with the US view that their tax systems discriminate against American companies. One example is digital services taxes that affect global tech companies, which happen to be mainly based in the US. Another is the principle of a global minimum tax for multinational companies with the aim of counteracting tax evasion – a pillar of the OECD that 140 countries have signed, several countries such as Sweden have implemented, but which the US opposes (see Republican view in op-ed, Bloomberg, 9 June 2025).

...but European countries and others hardly agree with the US view that their tax systems discriminate against American companies

Our overall assessment is that *Section 899* is a significant change that could have noticeable macroeconomic effects and would potentially have a more dramatic impact on individual players. However, there is uncertainty about whether the proposal will survive in its current form, due to political splits and pressure from lobby groups (see Financial Times, 8 June 2025).[2] Nevertheless, the intent resembles other "America First" policies and other actions from the Trump Administration, and so if the provision is watered down now, it may return in greater force in the future (see also Macro Comment, 3 April 2025, about Trump policies).

Section 899 could have noticeable macroeconomic effects and a potentially dramatic impact on individual players

In order to estimate the macro impact of the proposal, we must consider a number of uncertainties, exceptions and details: among other things, some tax treaties that ease the overall tax burden will continue to apply in the future, while others seem to be taken out of play, contributing to increased tax collection. Furthermore, there is ambiguity about how the bond market is affected – on the one hand, interest rates appear exempt from extra tax, but on the other, government organisations

To estimate the macro impact, we first need to wade into the details and uncertainties surrounding Section 899 would lose their tax exemption, which would be a big blow to large holders of bonds, such as central banks and sovereign wealth funds, potentially causing sell-off pressure. Another uncertainty is the speculation that *Section 899* would never be used in practice and is merely a bargaining chip in the US's negotiations with the rest of the world, but that hypothesis risks being irrational exuberance as it does not fit well with the experience of Trump's tariff policy this year – which rather than leading to concessions has led to escalating conflict. Nor does it square with the fact that the budget bill expects the provision to bring in USD 116bn to the Treasury; not a huge sum in this context, but not negligible, and a budget item forecast with wide confidence bands, of course.

Revenge tax's familiar macro impact: Bad for the world, worse for the US

A blow to US GDP as investment cools, hurting productivity growth. Supply shock could stoke inflation and that in combination with bond market worries, could lift market interest rates

The revenge tax's likely macro impact follows what is becoming a familiar pattern for the White House's policies: It will be bad for the world, but even worse for the US itself. The first-order macroeconomic effect of S*ection 899* would be weaker GDP growth in the United States, also in the long run. This follows from higher taxes increasing the cost of capital and dampening foreign fixed investment, which reduces the productive capital stock of the economy and hurts productivity growth – which also slows down employment and wage growth (see for example American Enterprise Institute, 3 June 2025). A negative supply shock like this will, on the margin, stoke inflation until the economy adjusts to its new (lower potential GDP) equilibrium, because of sticky wages, contracts and prices. This implies that the Fed may not be able to cut interest rates to mitigate the drag on economic activity from lower foreign investment growth. In addition, this disruptive economic policy could add to the surge in market risk premiums since autumn and directly dampen foreign demand for US treasuries. All told, market interest rates could rise.

Rest of the world suffers lower returns on US assets, but GDP is also undermined

For the rest of the world, the return on US investments decreases, particularly after-tax returns, and to make matters worse, risk-adjusted returns fall even more when we consider that S*ection 899* also breeds uncertainty and risk about which countries may be subject to "revenge taxes" in the future. Thus, it would become less attractive for foreign investors to hold US assets, leading to downward pressure on asset prices. Of course, this affects not only foreign investors, but also American ones, who notably own the majority of the assets – thus another wound that Trump's policies inflict on the US itself. Overall, global GDP is undermined due to fewer opportunities to benefit from 1) economies of scale from expansion into more regions, and 2) specialisation, based on countries' relative advantages.

Strengthens our forecast of a weaker USD, as the US economy underperforms and diversification away from US assets continues

In summary, this is well in line with the assumptions behind our current macro forecast. Higher risk premiums in the US fixed income market due to economic policy risk will keep long-term market interest rates up, even if the Fed cautiously cuts its policy rate in the coming years. The US economy has its unique strengths, but the anti-growth impact of S*ection 899* strengthens our view that the US economy will relatively underperform peers in the coming years, while the stagflationary impulse creates risks of policy mistakes from the Fed. We expect the dollar to be weakened by these factors in the coming year, and the depreciation pressure to be exacerbated by the White House's disruptive policies weakening the dollar's function as a safe haven. In summary, investors' gradual diversification away from US assets continues (see our Global Macro Forecast, 21 May 2025, pp. 9-11).

Avoiding the largest tax rise in history by introducing a similarly big one

Apart from S*ection 899*, some comments on overall budget developments are also warranted, as the "One Big Beautiful Bill" makes its way through Congress. The budget has passed the House of Representatives and is currently being reviewed and changed by the Senate, cheered on by the White House. The independent authority CBO has now given its verdict of the House version of the OBBB and joins the chorus of experts that basically see the bill as another nail in the coffin for US public finance sustainability by increasing the already bloated budget deficit. Separately, however, the CBO concludes that if today's high (despite pauses and de-escalation) US tariffs remain in place this coming decade, the income to federal coffers (USD 2.8 trillion) will more than offset the budget's total deficit impact (USD 2.4 trillion).

That might sound good, but remember that the tariff increase is a gigantic tax rise on the US and the protectionism will dampen long-term GDP potential, implying that consumers and businesses will be worse off. House speaker Mike Johnson makes the case for extending the expiring TCJA tax cuts by telling Bloomberg TV what would happen if Congress were to fail to pass the budget: "Every American would receive the largest tax increase in US history, all at once, it will be devastating for the economy" (5 June 2025). All told, while Congress is busy avoiding the largest tax hike ever, the White House has implemented another similarly large one (given where tariffs stand now). We also note that both Penn Wharton and the Yale Budget Lab have reached significantly worse conclusions than the CBO about the OBBB's impact on public finances and GDP, in stark contrast to the optimistic Republican view, including GDP-boost claims that lack support in academic research.

US data watch: Tariffs starting to bite

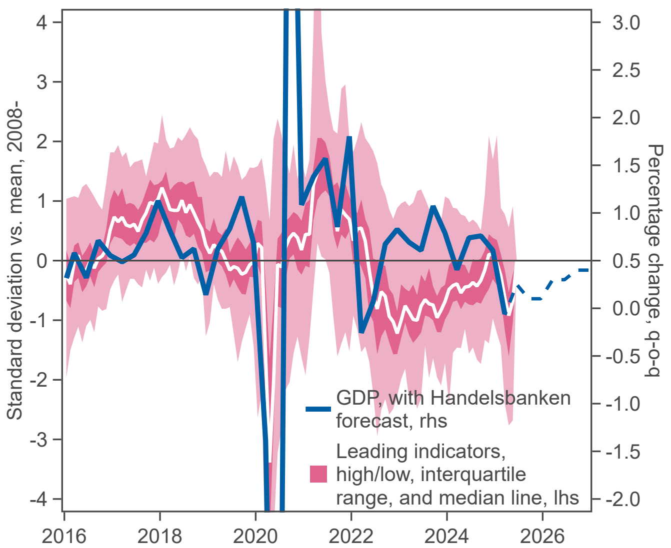
Underlying growth momentum slowing, labour market doing OK, inflation picking up again, worries around anchoring of inflation expectations – We only see one cut from the Fed in 2025

• US-China trade plummeted in May after previously elevated volumes, due to front-running of tariffs, and US-bound container shipments from China remain low in June. The foreign trade whipsaw implies headline GDP will likely be a poor guide in Q2 too – after exaggerating the weakness in Q1, it is instead on track to overstate growth. The Atlanta Fed's GDPNow model is soaring, but its estimates of final domestic demand components like household consumption are waning as the model has started to digest the April data (see graph). As expected, sentiment partly rebounded in May but remains weak, suggesting that core domestic demand will be muted ahead.

• Unemployment remains low but is grinding higher, while employment growth has eased, in line with our forecast (see graph). Job openings and small business hiring plans are trending down, as businesses face elevated uncertainty from tariffs and economic policy.

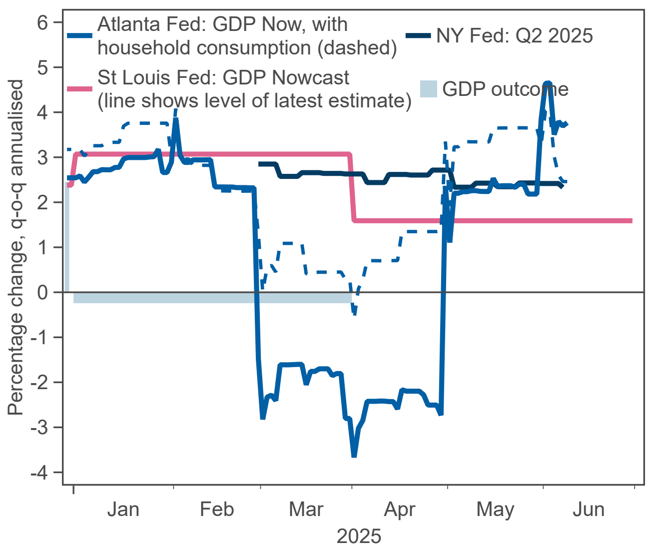
• Inflation has made progress towards target, according to underlying inflation indicators (see graph). Less comforting for the Fed, inflation expectations are on the rise and the first tariff-induced price spikes appeared in the April data. Our Fed policy rate forecast of one cut in September 2025, implying a year-end range of 4.25–4.0%, is more hawkish than the market, and as we noted at the latest policy rate decision, the Fed is bracing for stagflation.

GDP outlook versus leading indicators



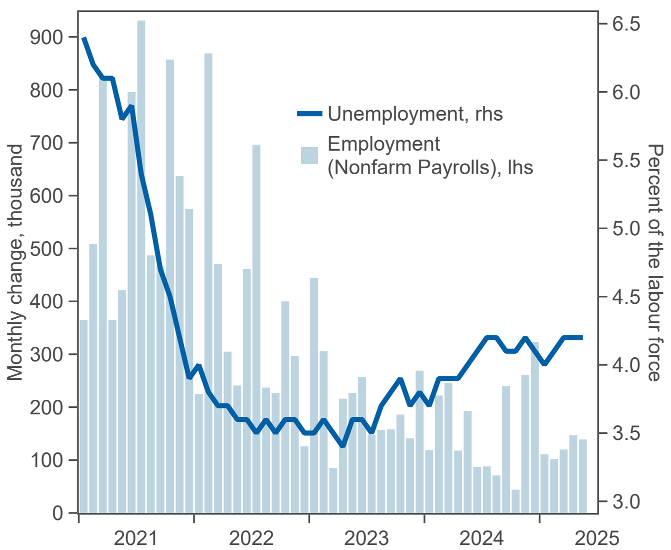
Sources: Macrobond, BEA and Handelsbanken

Nowcasts for next quarterly GDP release



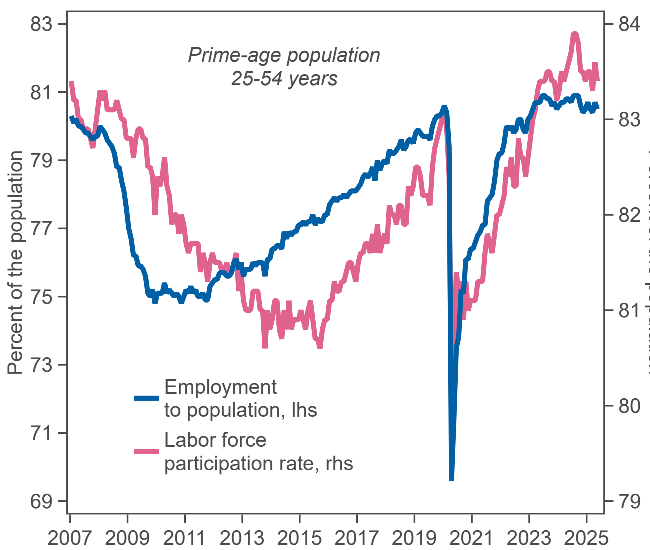
Sources: Macrobond, FRBs of Atlanta, New York and St Louis, and Handelsbanken

Headline labour market statistics



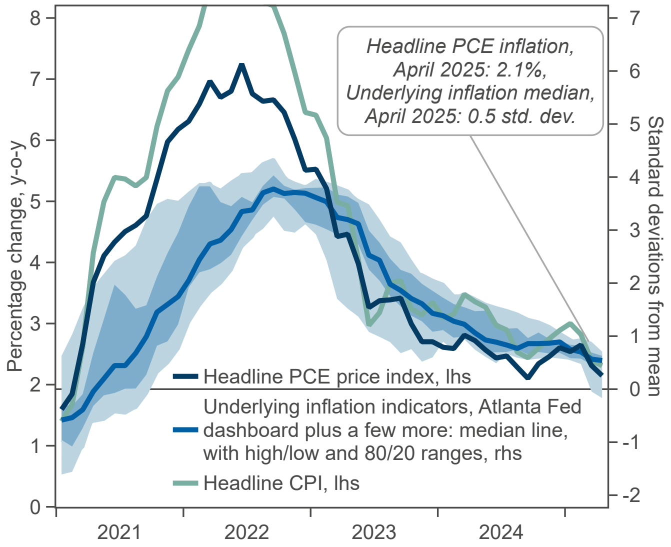
Sources: Macrobond, BLS and Handelsbanken

Core employment rate and labour force participation



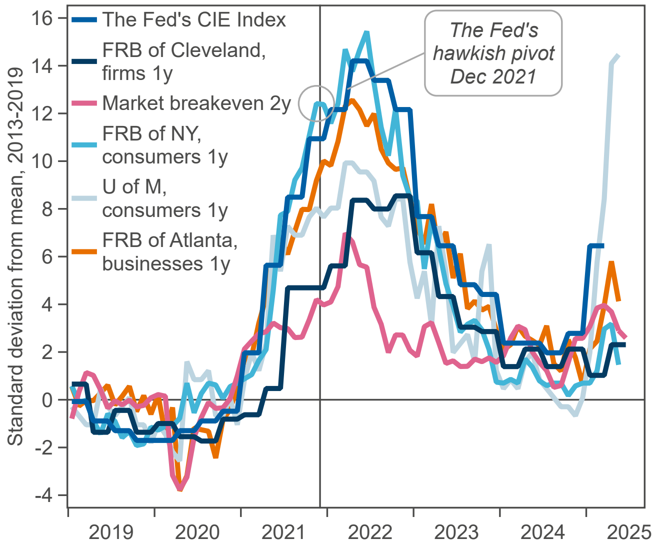
Sources: Macrobond, BLS and Handelsbanken

Underlying inflation indicators vs. headline inflation



Sources: Macrobond, BLS, BEA, Fed Reserve Banks of Atlanta, Cleveland, Dallas, NY and SF, and Handelsbanken

Short-term inflation expectations, standardised



Sources: Macrobond, Fed, University of Michigan, FRBs of Atlanta, Cleveland and NY, and Handelsbanken

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Footnotes

1 Other central bankers, like ECB's Isabel Schnabel, have instead argued that consumer expectation were surprisingly correct about the inflation surge in 2021–22, and that we may need to take more signal from that category of measures. ↩

2 An initial Senate inquiry into whether the proposal was eligible to remain as part of the federal budget reconciliation process has confirmed *section 899* can remain in the "OBBB". ↩

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