OPINION

No matter what happens in this trade war, interest rates are moving up over the long haul

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U.S. President Donald Trump speaks during an event with auto racing champions at the South Portico of the White House on April 9.

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Mike Tyson's one-liner, "Everyone has a plan until they get punched in the mouth," comes to mind when I think of the predicament U.S. President Donald Trump may have to confront sooner or later.

The "plan" by the Trump administration is to lower interest rates and keep them low for an extended period. Mr. Trump is not getting much help from the Federal Reserve on that front. So, in my opinion, I think he wants to cause a tariff-induced recession to global economies, which would force interest rates lower. He's motivated by the need to refinance US$7-trillion of debt maturing over the next six months.

The "punch in the mouth" is the higher short-term inflation that may result from tariffs. And the bigger problem is all this will only amplify the long-term underlying secular inflation trends, ultimately leading to sustainably higher interest rates and lower economic growth. In other words, stagflation.

In recent days, recession fears had caused investors to rush to buy bonds in global markets. Consistent with the Trump administration's hopes that buying pushed yields lower, the 10-year U.S. Treasury yield by the end of last week dipped to near 3.9 per cent, down more than half a percentage point from late March levels.

But that didn't last long. The 10-year is now back to where it was just a couple weeks ago – 4.410 per cent, as of midday Wednesday.

The "punch in the mouth" – inflation-inspired higher interest rates – is being priced in even sooner than I had been expecting, as the tyranny of financial markets makes itself apparent.

It's telling that in the first quarter of 2025, bond issuance by corporations rose sharply from the same quarter a year earlier. This suggests corporate CFO's weren't expecting rates to decline – if they were, they would hold off until interest rates dropped. This aligned with signals from the U.S. Federal Reserve that it was in no rush to trim its key lending rate.

It is reasonable to expect that during a recession shrinking demand for capital will suck the air off economic growth, driving interest rates down in the short term. And normally, inflation will follow suit. But this time may be different. Inflation may rise because tariffs in many cases will cause consumer prices on goods to increase.

Regardless of short-term inflationary trends, I believe that in the long run inflation is going to rise for these reasons:

1. **Productivity**: We may be reaching a peak in productivity growth as less experienced workers who will nevertheless be in high demand because of low population growth replace retiring experienced baby boomers. They will demand higher wages. Lower productivity and higher wages mean higher inflation down the road.

2. **Taxation**: Pandemic-related deficits and ballooning debt will encourage governments to increase taxation. Many have likened the pandemic to a war. The pandemic, like the two world wars of the last century, has been expensive. And as did those conflicts, it will require higher taxes to address the related deficits and accumulated debts. No matter what politicians are promising, it is hard to see another way around it. Tariffs are a form of taxation on imports; namely, a tax increase on consumers.

3. **Structural changes**: De-globalization could trigger higher inflation, as companies, trying to guard against supply chain interruptions, will be bringing production back to North America, characterized by a higher production cost environment. Trump policies are intensifying de-globalization and putting a death nail in the coffin of globalization. Moreover, U.S. consumers love to buy foreign-made goods, be it cars, electronics and so on. This will keep the trade deficit at elevated levels, regardless of the tariffs, and hurt the economy because of diminishing trading activity and the inflationary effect that these tariffs will have piggybacking on the secular underlying inflationary trends.

4. **Demographic trends**: COVID-19 related deaths, retiring baby boomers, and a slowing birth rate in the Western world, exacerbated by hawkish immigration policies, will result in labour shortages in the future. Scotiabank Economics reports that one in five manufacturers in the U.S. is already experiencing labour shortages. Twenty-one per cent of U.S. manufacturers indicated that lack of workers kept them from operating in full capacity. Accelerated reshoring to the U.S. means greater demand for labour. Lack of capacity is also inflationary. The need to attract workers by offering higher salaries is also inflationary. And, in my opinion, the effect of the AI

revolution on the need for workers and productivity enhancement is highly exaggerated.

5. **Regulation & related policies**: Years of underinvestment in the oil and gas industry, heavy regulation and ESG policies have shifted not only the oil price dynamics, but also that for all commodities. For example, mining companies are returning capital to investors rather than investing to increase production out of fear of ESG regulations. This implies major shortages in metals down the road at a time when demand will be increasing owing to renewable energy, AI and electric vehicle production.

Inflationary expectations are already rising. They have gone up from less than 3 per cent a few months ago to over 4 per cent in a recent survey by the University of Michigan.

How will markets react to all of this and what will the Federal Reserve do in the presence of the building up of the long-term inflationary pressures I've described?

The extreme market volatility we've seen in recent sessions may be just a taste of what's to come.

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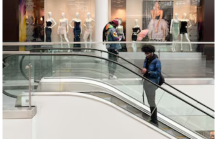

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