December 2024

Navigating Tariff Risks in U.S. Industrial and Logistics

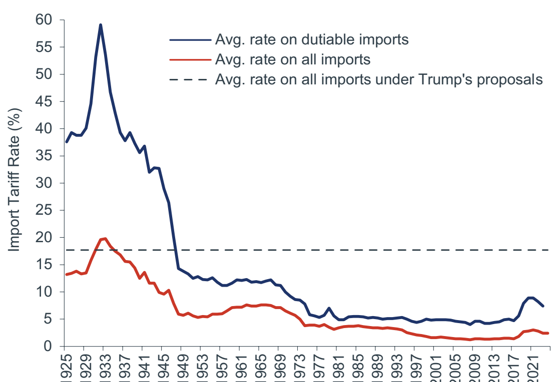
EXECUTIVE SUMMARY

- Trump campaigned on dramatically raising tariffs which could accelerate decoupling with China and re-ignite trade wars.
- There is still a lot of uncertainty around tariff levels, policy timing, and the net impact to industrial markets.
- We believe regions including East and Southeast Asia (excluding China) and Mexico will continue to capture important share, though we could also see a surge in U.S. manufacturing.
- Consumption trends have remained healthy and port volumes and e-commerce sales continue expanding, which should support growth for U.S. industrial logistics.

President-elect Trump campaigned on dramatically raising tariffs to 10%-20% on all trading partners, including Mexico, Canada, and the E.U., and has also notably threatened to increase tariffs on the $500 billion of annual imports from China to as high as 60%.[1] This would be an escalation of the first set of Trump tariffs that were held in place by the Biden administration and even expanded at certain points. However, the new proposal is substantial and could accelerate the decoupling between the world's largest manufacturing and consumption superpowers and re-ignite trade wars.

There is still uncertainty around what the Trump administration will do, the level of tariffs, policy timing, and the net impact to industrial markets, but a drastic rise in tariffs (to levels not seen since the Great Depression) would almost certainly have a ripple effect on multiple layers of the economy, including inflation, consumption, investment, interest rates, exchange rates, and overall domestic output.

HISTORICAL U.S. TARIFF RATE



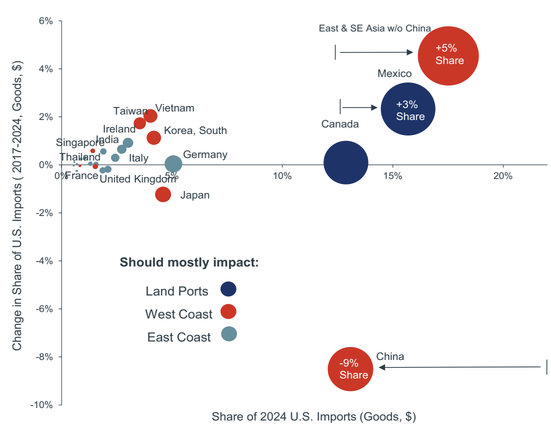
Source: The Tax Foundation, November 2024.

While the impacts could be both positive and negative depending on the industry and its position within the economy, the net risk could be mostly negative because of trade retaliation, business uncertainty, and consequential inflation. What could this mean for the industrial and logistics sector? It is our view that certain regions will continue to capture import share, including East and Southeast Asia (excluding China) and Mexico, and we could also see a surge in U.S. manufacturing investment, both of which should continue supporting growth for the U.S. logistics market.

LOOKING BACK FOR DIRECTION

Recent 'trade war' policies added up to an estimated $79 billion in annual tariffs, most of which came from China. As a result, China has lost a nearly 9% share of U.S. imports (goods) since 2017, or a 30% decline in import dollar volume when adjusted for inflation.[2]

SHARE OF U.S. IMPORTS BY COUNTRY



Source: U.S. Census Bureau, Clarion Partners Investment Research, October 2024

This effectively knocked China from the top importer position it held for over 14 years and cleared the way for Mexico (+3% import share gained, +26% gain in real dollars) and other East and Southeast Asian countries (collectively +5% share, +35% gain in real dollars) to capture share. The response from Chinese firms has been noteworthy with the rise of Asian 3PLs in the U.S., the shipping of smaller packages directly to consumers from China (below taxable threshold), and investments into assembly and logistics facilities outside of China in places like Mexico – all of which are likely an attempt to avoid or reduce additional costs

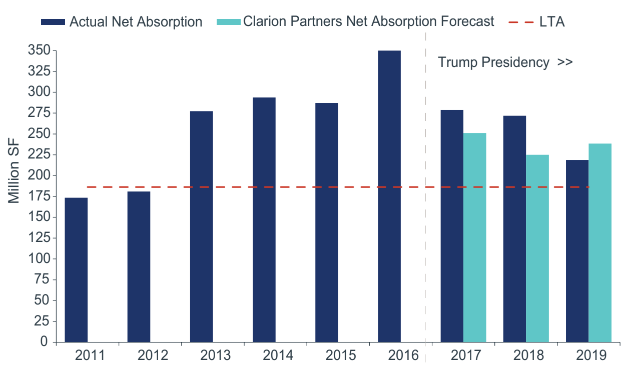
[1] Reuters, November 2024.

[2] U.S. Census Bureau, Federal Reserve Bank, Clarion Partners Investment Research, October 2024.

brought on by tariffs. Despite the shift in trade volumes, these developments and a resilient U.S. consumer have lessened the negative impact on the U.S. industrial market.

The shift in trade patterns has also stirred discussions about industrial demand, market selection, and the long-term viability of existing gateways. It remains our view that while a decoupling or material reduction in trade with China could negatively impact near-term demand in markets like Southern California, the sharp rise observed in trade with East and Southeast Asia (excluding China) could soften the shortfall and preserve occupancy in gateway markets. Additionally, the perceived risk of higher tariffs, along with other possible supply chain disruptions like the recent port strikes, appears to have started a push to stockpile inventories which could subsequently improve warehouse utilization and warehouse demand as firms try to minimize supply chain disruptions. This may result in increased reliance on third-party logistics across a broader range of tenants as they look to outsource the complexity of supply chain logistics. In fact, actual net absorption was higher in 2017 and 2018 than we originally expected, which is when the initial Trump tariffs were put in place.

U.S. INDUSTRIAL NET ABSORPTION



Source: CBRE-EA, Clarion Partners Investment Research, Q3 2024

The market remained above Long Term Average (LTA) net absorption while vacancy rates remained near record lows through 2019 given the resiliency of the U.S. consumer and including robust e-commerce sales growth.[3]

Mexico's proximity to the U.S. market and appealing relative manufacturing costs have positioned the country to benefit as a viable near-shore alternative. Today, Mexico is the largest source of imports into the U.S. This has increased the investor appeal for markets like El Paso, Texas, which have seen notable growth recently.[4] Despite increased attention to these rapidly growing small border markets, our analysis of GPS logistics transportation data suggests that incoming goods from Mexico largely flow through established markets, such as Dallas-Fort Worth and Houston, but also less obvious markets like Phoenix, Southern California, and several U.S. Southeast and Midwest markets given their logistics infrastructure and demographic reach. Similar markets are also a top origin of exports to Mexico, often for intermediary goods that are part of a greater bilateral value-add manufacturing supply chain. We believe investment in these more established markets provides exposure to growing Mexico manufacturing (see markets table on the right).

SCENARIO A: A CONTINUATION

Under this scenario tariffs are increased modestly, and the decoupling trend continues, impacting import growth rates similarly to what has been observed since the initial Trump tariffs. We estimate that China imports continue decreasing at an average annual rate of 5%, or just over 20% over the next five years. This would decrease China imports to levels not seen since the early 2000s, effectively erasing more than a decade of growth after adjusting for inflation.

Making the same continuous growth assumption, however, for East and Southeast Asia (excluding China), or 5.5% growth annually and just over 30% over five years, would more than offset the drop-off from China. After all, the region's import dollar volume has remained above China's since 2022.[5] Mexico would also be poised to see volumes grow more than 20% over five years, keeping it at the top position by individual country and likely benefiting the markets mentioned earlier.

TOP DESTINATIONS OF IMPORTS FROM MEXICO	TOP MARKETS THAT ARE PART OF MEXICO'S IMPORT SUPPLY CHAIN	TOP ORIGIN OF U.S. EXPORTS TO MEXICO
Southern California	San Antonio	Houston/Beaumont
El Paso	Dallas/Fort Worth	El Paso
Phoenix	El Paso	Southern California
Dallas/Fort Worth	Houston	Detroit
San Francisco	Southern California	Laredo
New York/New Jersey	Austin	Chicago
Houston	Phoenix	Dallas/Fort Worth
Chicago	Atlanta	Portland
Laredo	Chicago	New York/New Jersey
Detroit	Memphis	Brownsville-Harlingen

Source: Clarion Partners Investment Research, U.S. Department of Transportation, International Trade Administration, Advan, Q3 2024. Southern California includes Los Angeles, Riverside, San Diego, and Orange County. First column is based on imports through Otay Mesa, El Paso, and Laredo.

SCENARIO B: AN ESCALATION

A scenario where all imports from China see a 60% tariff could have a drastically different outcome. Building from the changes seen since 2017, a 60% tariff would mean four to five times the tariff cost burden on Chinese suppliers, importing U.S. companies, and possibly consumers to the sum of $250 billion based on 2023 goods imports, equivalent to roughly 3% of U.S. total retail sales.[6] While East and Southeast Asia (excluding China) and Mexico should continue to capture growth as sourcing diversifies, it could be disproportionate to recent periods given the possible tariffs that each could face and their inability to respond to those levels quickly given time and cost constraints. This could also accelerate India's export market given its relative low-cost structure and large workforce. It is also worth noting that the Chinese government is likely to step in with support (fiscal, monetary, exchange rate controls, and regulatory policies) given the importance of manufacturing and exports for Chinese GDP growth.

[3] CBRE-EA, U.S. Census Bureau, Clarion Partners Investment Research, November 2024.
[4] CBRE El Paso, Q3 2024.
[5] U.S. Census Bureau, Federal Reserve Bank, Clarion Partners Investment Research, October 2024.
[6] U.S. Census Bureau, Clarion Partners Investment Research, October 2024.

U.S. domestic manufacturing is likely to see considerable growth and investment through policies and subsidies under this scenario, but this will likely be focused on high value-add industries and will come with a lag. Adding this level of capacity to U.S. manufacturing would require a substantial amount of time and hefty investment into areas like automation, ultimately forcing companies to absorb much of the tariff cost in the interim at different points of the supply chain. At least a portion of those costs would likely be passed on to consumers through price increases. The long-term impact depends on which policies remain in place after 2028 and the severity of the bilateral fallout between the U.S. and its import partners as well as the economic impact.

CONCLUSION

U.S. consumption ultimately drives growth for industrial and logistics real estate, and it has remained resilient over the last six years despite historically higher tariffs and inflation, as well as elevated interest rates and macroeconomic uncertainty. Real retail sales have increased 20% since 2017 with real e-commerce sales alone doubling over the same period.[7] This has supported rapid growth in import TEU volumes and lifted the ratio of both e-commerce sales as a percentage of retail and real e-commerce sales per industrial square foot. If consumption continues on a healthy path, the growth prospects for industrial remain bright. However, a pullback in consumer spending from inflation or an economic slowdown could have a short-term negative impact on the market. While there is a wide range of uncertainty on future policy, it is our view that certain regions should continue to benefit from the U.S. / China decoupling, including East and Southeast Asia (excluding China) and Mexico. We also expect additional growth in U.S. manufacturing investment which should benefit the warehouse sector. Additionally, consumption trends have remained healthy and port volumes and e-commerce sales continue expanding, all of which should support growth for the U.S. industrial logistics market.

[7] U.S. Census Bureau, Clarion Partners Investment Research, October 2024.