Beaumont CAPITAL MANAGEMENT

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Trade, Tariffs and Tirades: a Primer on What Has the Markets in a Dither

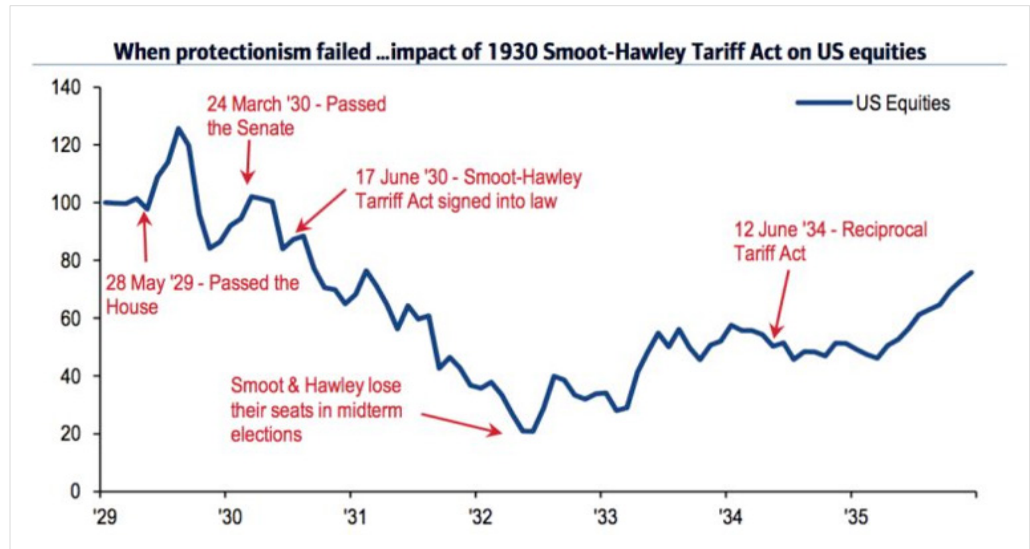
By David Haviland, Managing Partner and Portfolio Manager

The following is an excerpt from our 1Q18 quarterly market commentary we posted yesterday:

"Another contributing factor to the market's froth has been the prospect of a global trade war brought on by the Trump administration's desire to lower the United States trade deficit with China. While noble in intent, the use of such a blunt instrument rarely, if ever, works. In fact, they often bring on many unintended consequences including increased prices for both U.S. producers and consumers alike. As you can see from the chart below, these policies are particularly damaging to the multinational corporations making up a large part of the S&P 500. Historically, just over 40% of the S&P 500's revenue is derived from outside of the U.S. In addition, China will undoubtedly counter any U.S. tariffs with tariffs of their own. If our two countries, the first and second largest economies in the world, engage in a tit-for-tat exchange of tariffs, the ultimate result could devastate the global economy. With any luck, this will just be a tactic to engage in meaningful negotiations with the Chinese. Recently it was reported that these types of negotiations are taking place. We shall see."

Action-Reaction

One of the first things that struck me about this chart is the fact that the American electorate did what they were supposed to do when politicians fail them. Note both Smoot and Hawley lost their seats in Congress during the 1932 midterm elections and President Hoover was soundly defeated in the 1932 presidential election. The Great Depression was the last time that tariffs were imposed on a large scale and they clearly contributed to the downward spiral of both the U.S. and world economies during the Great Depression.



Source: Bank of America Merrill Lynch

What is a Tariff?

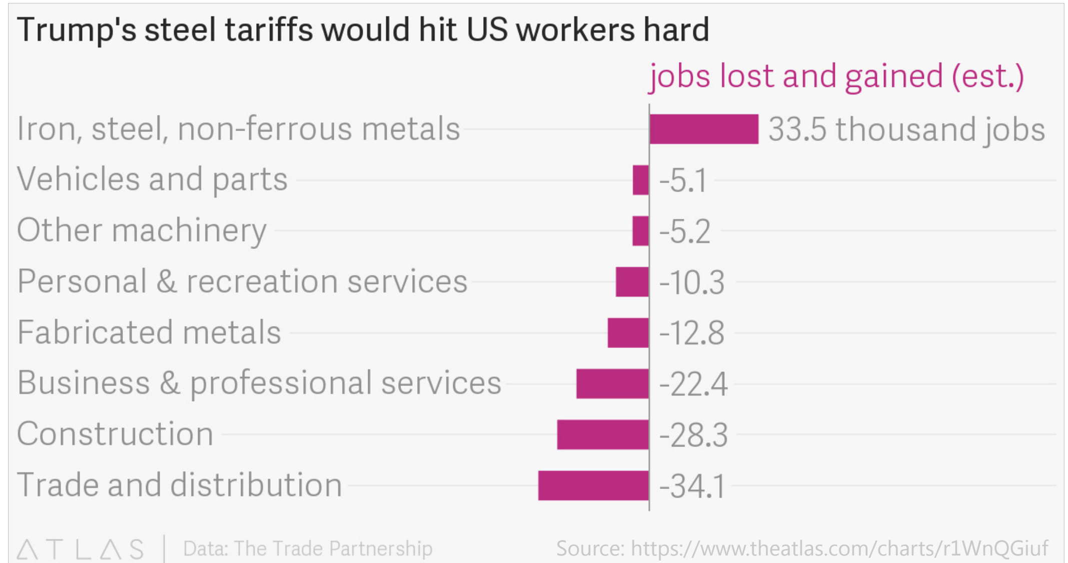
A tariff is a tax imposed by a government on an imported good or service. The intent is to make the product more expensive so less of it will be imported by producers and/or consumers. Tariffs are generally used to protect emerging industries, aid ailing mature industries from foreign competition, or reduce trade deficits that are perceived to be the result of unfair trade practices.

The problem is that proponents of tariffs often cite their desired benefits but rarely mention the steep costs. Tariffs increase the cost of the targeted goods/services, but ultimately no economic benefit is derived for a producer or consumer. The cost of goods sold increases by the tariff amounts (if not more) and these costs are unlikely to be passed through to consumers without a reduction in demand. So, what happens? Less economic activity, jobs are lost, and sales and earnings decrease.

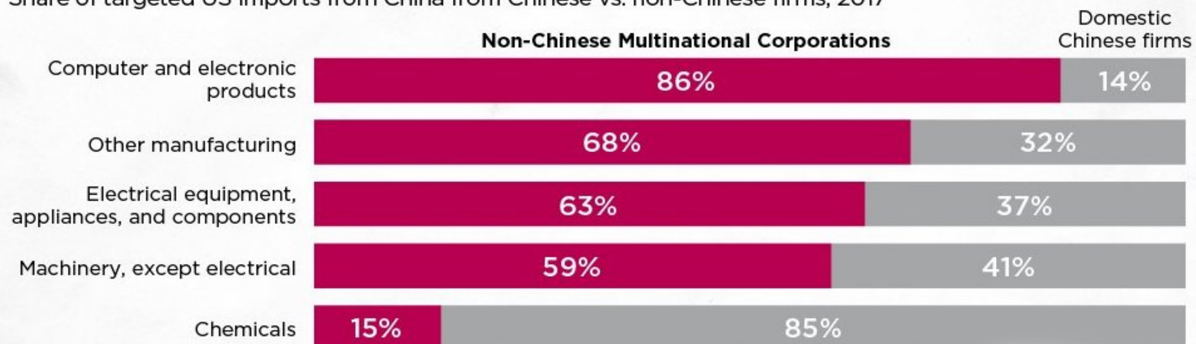
Let's look at the recent aluminum and steel tariffs: costs just increased 10% and 25% respectively. Any company that uses these raw materials, from car manufactures, soft drink distributors to toaster manufacturers, all suffered a major increase in their cost of goods sold. Their profits will fall accordingly. If margins are thin, employees get laid off. Ironically, if these U.S. companies, forced to use raw materials with artificially inflated costs, try to raise prices, their products become more expensive versus their foreign competitors. In this scenario, consumers may end up buying more international goods which could potentially increase the trade deficit.

Now, whatever country is being targeted with a tariff won't take it lying down…they will impose tariffs of their own targeting U.S. goods and services. China has retaliated by putting their own tariffs in place on pork and other agricultural products. Now the costs of targeted U.S. products, like pork, rise for Chinese consumers. As the Chinese buy less pork, the U.S. farmers sell less pork, and thus suffer in lower sales and profitability. Some economists, as noted in the chart below, have estimated that five U.S. jobs will be lost for every one gained in the steel & aluminum industries[1].

Tariffs are a lose-lose proposition and they can have devastating effects on the global economy. A great example of the unintended consequences can be found in Europe. Now that the U.S. has imposed its tariffs on steel and aluminum, the Europeans are worried that China will export the excess supply to Europe. This would damage their indigenous steel and aluminum producers. Do the Europeans retaliate with tariffs of their own? Against whom—the U.S., China, or both?



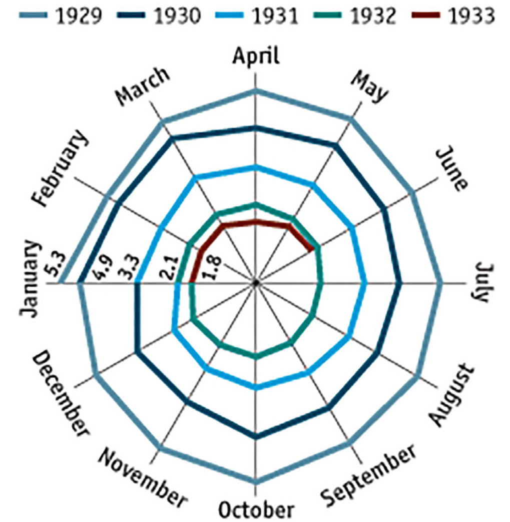
Furthermore, tariffs are very hard to target against a specific country without collateral damage. There is a second round of proposed tariffs by the United States which aims to protect U.S. intellectual property (again a noble goal in our age of intellectual piracy). As the chart below illustrates, in the industries needing the most protection, the broad use of the tariff applies to more countries and companies outside China than within! So now the lobbying and negotiating, similar to what occurred when the aluminum and steel tariff was proposed, begins with all our trading partners. The process quickly degrades into a fool's errand. Tariffs are just the wrong instrument to effect meaningful and constructive change.



Source: See table 3 in Policy Brief: *Trump Tariffs Primarily Hit Multinational Supply Chains, Harm US Technology Competitiveness*
Note: These are sectors classified by the US Department of Commerce as patent-intensive and are some of the most heavily targeted by the Trump administration's proposed Section 301 tariffs based on the US Trade Representatives' report released in April 2018. Learn more at https://piie.com/publications/policy-briefs/trump-tariffs-primarily-hit-multinational-supply-chain-harm-us

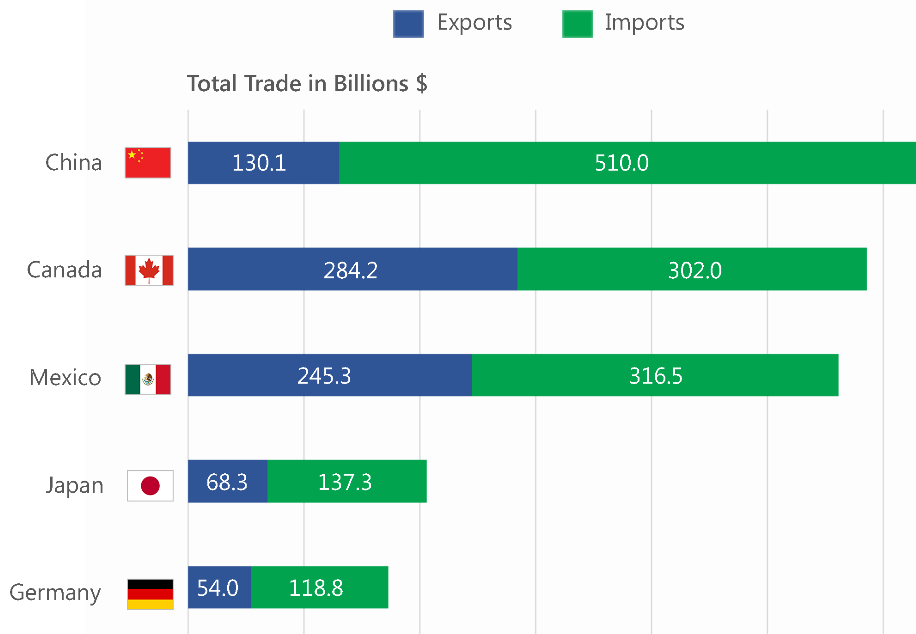
Historical Perspective

The last time the United States tried to use tariffs was after the stock market crash in 1929. The U.S. implemented hundreds of tariffs in an effort to close the fiscal budget gap and to protect domestic farmers and industries. The world discovered how devastating tariffs could be. Prices on some goods initially rose until demand faltered. When demand faltered and the tariffs stayed in place, sales and profits declined and world trade plummeted. Ultimately people got laid off and could no longer afford to consume goods and services. The whole global economy spiraled downward. The following chart shows this effect in detail as world trade plummeted from $5.3 billion in 1929 to $1.8 billion in 1933, a 2/3rds decrease.

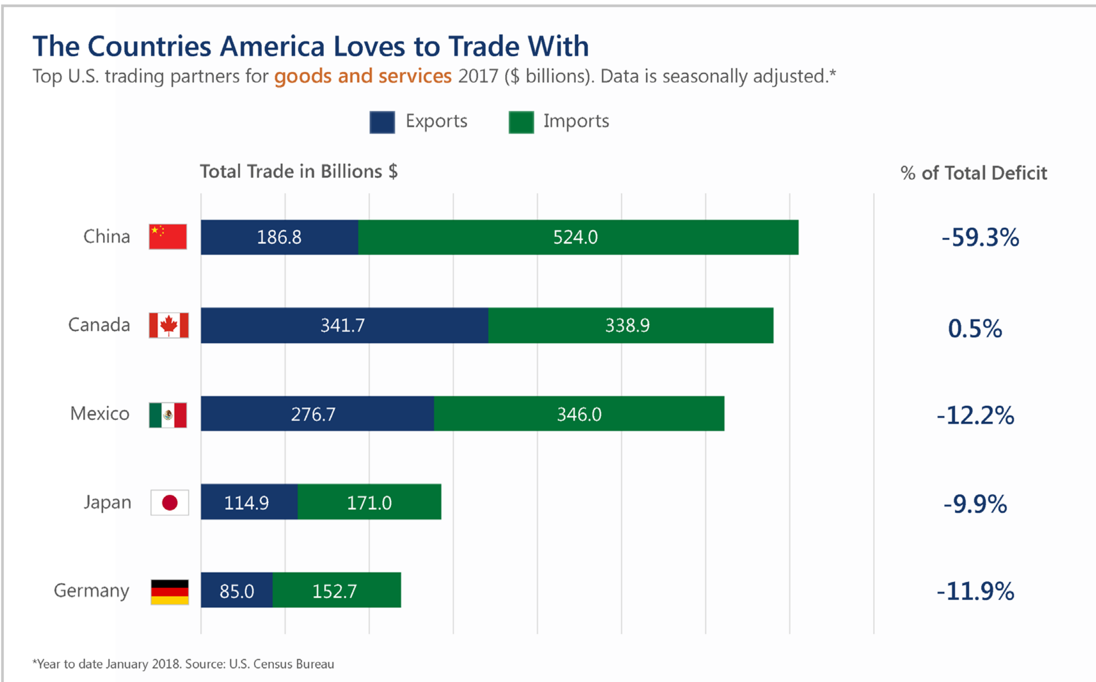


Quantifying the Issue

Let's back up and review what the Trump administration is really looking to accomplish. In 2017, the U.S. trade deficit for goods was $806.5 billion, up from $502.3 billion in 2016. As the charts below show, China has the largest trading surplus of any nation. President Trump has also made headlines criticizing the North American Free Trade Agreement (NAFTA), among others, with Mexico and Canada as being unfair. The trade deficit in goods with our two neighbors is much more modest and in more balance than with China, Japan or Germany.



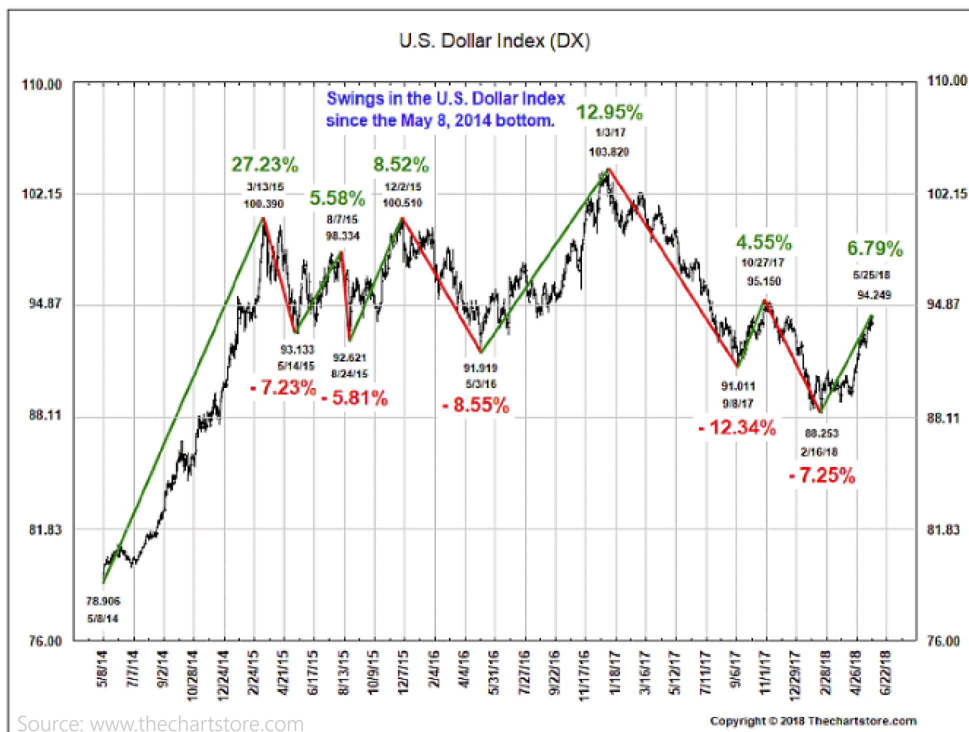
However, while the trade deficit in goods alone is more sensational, it is not a complete picture. The world trades more than goods, we also trade services. Services include banking and insurance, travel, telephony, computer and information services, maintenance contracts, and other consulting, technical and trade related business services. These services include some of the largest sectors in our economy. When trade of services is combined with the trade of goods, the picture looks a little different:



Canada goes from an $18 billion deficit to a $2.8 billion surplus! Germany's deficit grows by $3 billion. China's deficit drops by $43 billion, but is still a massive $337 billion deficit which is 59.3% of our entire trade imbalance. Now quantified, may we agree the purpose of President Trump's initiatives are worthy? The instrument being used, tariffs, is not.

What Can Work?

1. A weaker U.S. Dollar (USD). A large part of the deficit problem has been due to the appreciation of the USD. As the chart below shows, from May 2014 through March 2015, the USD appreciated over 27%. When the USD strengthens, it makes international goods and services cheaper for U.S. citizens and U.S. made goods and services more expensive for our trading partners.



If the USD were to weaken, the costs of foreign goods would rise, and US producers and consumers would import less. Conversely, American goods and services would be less expensive and exports would increase. The net is that our trade deficit would decrease. We would not suggest an outright currency devaluation, especially given the USD's status as the world's reserve currency, but there are more subtle ways to "talk the dollar down". Conversely, if the Chinese were to let the Yuan appreciate, which recently has been happening, their goods and services would become more expensive and ours would become less so. The net effect is that the trade deficit would shrink. To do this, both countries, and all our trading partners, need to work together.

2. Claim a larger piece of China's oil imports. Could it be this simple? The U.S. now produces almost 11 million barrels of oil per day, mostly from shale oil deposits, and should soon become, once again, the world's largest oil producer. Grossly over-simplifying a complex situation, the U.S. exports light, sweet crude from shale and still imports heavy, sour crude mostly from Canada and Saudi Arabia. The reasons are varied, but they include refinery set-up and capacity, and support for our Canadian and Saudi Arabian allies. About one third of Canada's economy is related to energy production and distribution and this number is much higher for Saudi Arabia. Politically, economically and militarily, we are not about to abandon two of our most staunch allies.

So, what does this have to do with tariffs on China and our trade deficit?

In 2017, China imported ~$162 billion worth of oil.[2] Instead of buying it from other countries such as Russia, Iran, Angola and Iraq, China could significantly reduce its imbalance with the U.S. by buying more, or even most of their oil from the U.S. For reference, China only bought 2% or $3.2 billion from the U.S. in 2017, although this is a massive increase (+1,994%!) from 2016.[3] They could easily close a quarter or even a third of their trade surplus by buying their oil from the U.S. versus other oil exporters.

3. Increase savings, reduce consumption and live within our means. Societally, if we consume less, then we will have less need to borrow from abroad. This concept applies to our governments (federal, state and municipal), our businesses and our consumers. Next year's federal budget deficit is estimated to be ~$2 trillion. Much of this shortfall must be financed from abroad. Without discussing the merits, one way to "force" Americans to live within our means is to implement a consumption tax used by many nations today. By taxing Americans on what they actually use, we would be discouraging unnecessary consumption, encouraging savings and helping close our government's massive budget deficit.

If we are truly serious about reducing our trade deficit, we are also going to have to be serious about closing our government's budget imbalance. Put simply, as long as Americans consume more than we produce, our imports must exceed exports. Politicians are going to have to stop kicking the can down the road, blaming others for our excesses, and start making some tough choices for all of us. As citizens, we should heed the call to save 15% of our income each year. We all need to reverse our excessive consumerism and live within our means. Without meaning to sound melodramatic, our futures depend on it.

For more insights like these, visit BCM's blog at blog.investbcm.com

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[1] http://tradepartnership.com/wp-content/uploads/2018/03/232EmploymentPolicyBrief.pdf
[2] http://www.worldstopexports.com/top-15-crude-oil-suppliers-to-china/
[3] http://www.worldstopexports.com/top-15-crude-oil-suppliers-to-china/

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