ACG Insights: Tariffs and Trade

Executive Summary

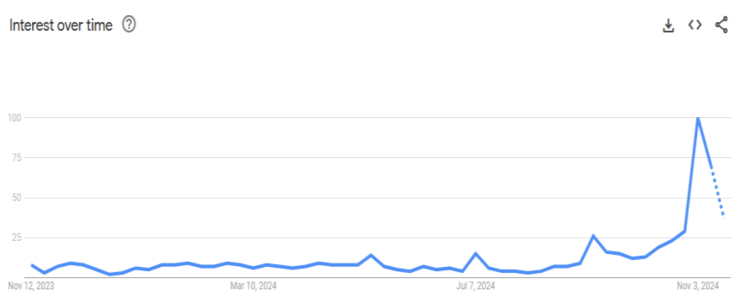
- **Tariffs and trade policy are back in the news as President-elect Trump prepares for a second term.**
- **Tariffs equate to a tax on imports, paid by the importer to the government, levied for various policy goals like protecting domestic industry or economic leverage.**
- **For the economy, tariffs on balance are generally associated with lower GDP growth, higher prices, and less competition.**
- **For markets, reaction to tariff policy was muted during Trump's first term, but risks are prevalent should campaign promises translate into actual policy.**

What/Why/How on Tariffs

We will stay as far away as possible from politics, other than to say that tariffs are back in the headlines after campaign season and the recent US presidential election (Exhibit 1). The bigger question for this discussion is to consider how trade policy may impact investment allocations. The unsatisfying answer for investors is that the impact is extremely murky. No one really knows what policies will come to fruition and how markets will react, but it is still worth considering the range of outcomes and portfolio implications.

Before moving to investment themes, it is worth a refresh on tariff basics. In short, a tariff is simply a tax on imported goods, paid to the government by the company importing the goods. Tariffs are generally administered as a percentage of the value of the imported goods, but, per the Council on Foreign Relations: "There are also "specific tariffs," which are charged as a fixed amount on each imported good (for example, $2 per shirt) and "tariff-rate quotas," which are tariffs that kick in or

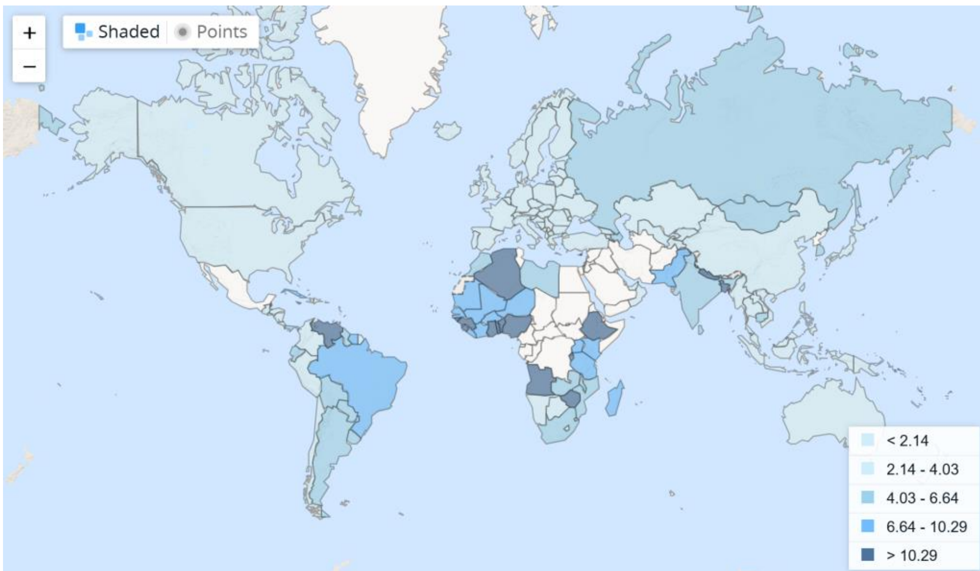
Exhibit 1: Google Searches for "Tariffs"[1]



[1] Google Trends (one year timeframe)

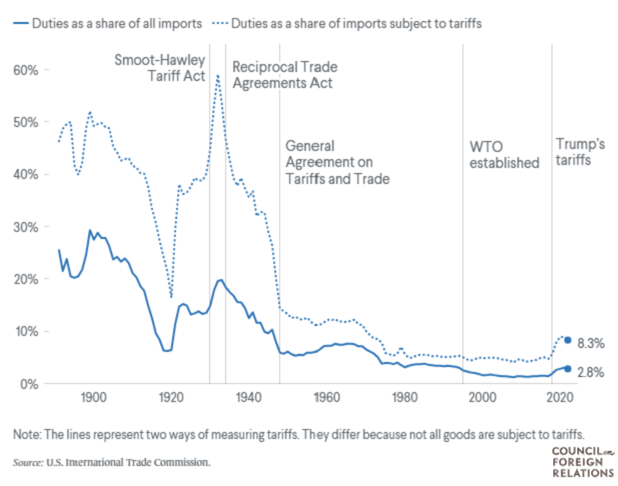
rise significantly after a certain level of imports is reached (e.g., fifty thousand tons of sugar)".[2] In the US, tariffs are collected by the customs service at the point of entry, usually a coastal port. As a crude example say the US levies a 10% duty on all olive oil from Italy. A grocery chain, maybe Kroger, now pays an extra $10 (to the government, not the olive oil manufacturer) for every $100 of Italian olive oil they want to keep on the shelves. Kroger now faces choices including passing on price increases to customers to maintain margins or re-shaping their product offerings. For certain products, companies can also alter supply chains to move production to countries without tariff restrictions. We saw this process in practice starting in 2017 when imports from China started to shift to countries like Mexico, Vietnam, and Taiwan.[3]

Exhibit 2: Tariff Rates Globally[4]



Why would trade policy target a specific product, industry, or country? The broad answer is to protect and/or promote domestic industries and goods. Developing countries may rely on tariffs to protect industry from foreign competition until local firms can establish themselves. Tariffs can also be used as economic leverage or to combat theoretically unfair trade practices. It is worth noting here that tariffs are used globally to different extents (Exhibit 2 above), with weighted average tariff rates averaging around 2% for high income countries and closer to 10% for low-income countries, according to data from the World Bank. Early/developing America relied on tariffs for a large share of government revenue and the US continued utilizing relatively high tariff rates into the 20th century (Exhibit 3). Tariffs are not a significant source of government revenue in the US or abroad post-WWII, and replacing other sources of revenue with tariffs is not realistic.

Exhibit 3: 100+ Years of US Tariffs[5]

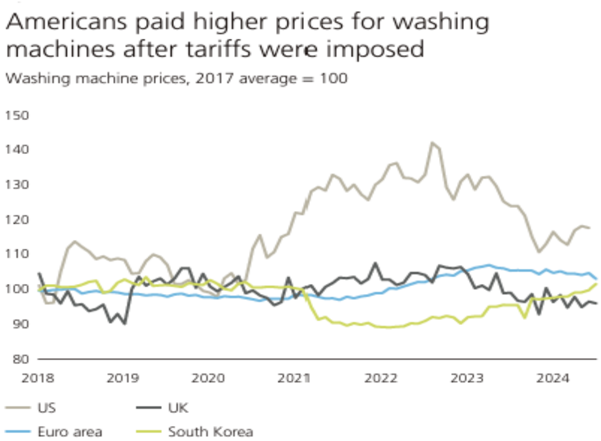


[2] Council on Foreign Relations: https://www.cfr.org/backgrounder/what-are-tariffs
[3] Wall Street Journal: https://www.wsj.com/economy/trade/how-trumps-tariffs-on-china-changed-u-s-trade-in-charts-bb5b5d53
[4] World Bank: https://data.worldbank.org/indicator/tm.tax.mrch.wm.ar.zs?end=2021&start=2021&type=shaded&view=bar
[5] Council on Foreign Relations

Economic Implications

With the caveat that the modern economy is extremely complex and that the impact of trade policy can take years to decipher, most discussions about tariffs view them as inflationary and negative for growth. Tariffs tend to reduce competition, and businesses often pass on price increases to customers. Price increases are more likely with lower margin goods where a company has less ability to absorb tariff costs. Exhibit 4 is a good example of a tariff on washing machines imposed during President Trump's first term and carried through much of President Biden's term. Prices in the US rose more than in other countries before falling when the tariff was removed in early 2023 but have still settled at higher levels. Regarding economic growth, projections based on the proposed policies of the new administration forecast a reduction in real GDP around -0.5% to -1.5%.[6] Most of the economic projections assume a level of universal or widespread tariffs on all imports. It remains to be seen if campaign rhetoric will translate into actual policy, or if more targeted tariffs are utilized for various reasons, similar to Trump's first term. For a more detailed discussion of tariff scenarios and possible outcomes, written pre-election but still relevant, see the UBS piece *The Economic and Investment Implications of Higher Tariffs*, referenced in the footnotes.

Exhibit 4: Example of Prices Post-Tariff



Investment Implications

Any attempt to predict policy over the next four years, much less the market impact of any policy, is nothing more than speculation. We can make somewhat educated guesses based on predicted economic impact and some of the market movement during Trump's first term. If we accept that broadly higher tariffs equate to broadly higher prices, it is reasonable to expect that longer term interest rates will remain higher, and the Fed may slow the path of easing over the short-to-intermediate term.[7] On balance, equity markets have tended to dislike expectations of a higher for longer Fed Funds rate. If the Trump tariff policies turn out to be similar in his second term to those of his first term, it is reasonable to expect that market reaction will be muted. Charles Schwab has a good chart (Exhibit 5) that shows equity market performance

Exhibit 5: Market Reaction Around Tariff Announcements

2018-2019 Trade war escalations	MSCI All Country World Index 1 day change %	MSCI All Country World Index 1 week change %
1/22/2018 US announces tariffs on all imported washing machines and solar panels	0.5%	0.8%
3/8/2018 US announces 25% tariffs on steel imports and 10% on aluminum	1.1%	0.6%
4/2/2018 China to impose retaliatory tariffs of up to 25% on 128 US exports	0.5%	0.9%
4/3/2018 US announces plans for 25% tariffs on about $50 bn of Chinese imports	0.4%	1.8%
5/31/2018 US steel and aluminum tariffs expanded to include EU, Canada and Mexico	0.8%	2.2%
6/15/2018 China announces retaliatory tariffs on about $50 bn of US imports	-0.4%	-1.1%
7/5/2018 Mexico imposes retaliatory tariffs on dozens of US goods	0.8%	1.6%
7/10/2018 US announces tariffs on $200 bn of goods from China	-0.9%	0.0%
7/25/2018 EU prepares retaliatory tariffs on dozens of US goods	0.0%	-0.5%
8/1/2018 US raises tariffs from 10 to 25% on $200 bn of Chinese imports	-0.3%	0.6%
9/24/2018 China imposes retaliatory tariffs on $60 billion of U.S. goods.	0.0%	-0.2%
5/10/2019 US enacts tariff increase from 10 to 25% on $200 bn of Chinese imports after talks fail	-1.9%	-0.9%
5/16/2019 US bans China's Huawei from buying parts and components from US companies	-0.6%	-1.9%
8/1/2019 US announces 10% tariff on $300 bn of Chinese imports after talks fail	-1.2%	-1.5%
8/5/2019 Chinese currency fell to the lowest point since 2008, passing a key level	0.5%	0.9%
8/23/2019 China raises tariffs on $75 bn of US goods	0.3%	2.0%
10/11/2019 US announces Phase 1 trade deal with China	-0.1%	0.8%
Average	**0.0%**	**0.4%**

[6] Tax Foundation: https://taxfoundation.org/blog/trump-tariffs-impact-economy/
[7] JPMorgan: https://am.jpmorgan.com/us/en/asset-management/adv/insights/market-insights/market-updates/notes-on-the-week-ahead/the-investment-implications-of-the-republican-sweep/

both one day and one week after tariff announcements in 2018/2019. Remember that worry surrounding a US/China trade war was one of the top concerns for market participants at the time. Equity markets are notably forward-looking, so tariff and trade war fears may have been priced into stocks prior to official announcements, but it is reassuring for equity investors that markets basically shrugged off tariff enactments.

Conclusion

Nuance is often lacking in today's black and white political environment. Much of the impact on the economy and markets will depend on the level and breadth of tariff policy during Trump's second term. We can reasonably predict based on his first term and campaign promises that there will be additional tariffs on top of those currently in place. It is also reasonable to say, both empirically and theoretically, that incremental tariffs would be a net negative for the economy in the way of higher prices, lower growth, and reduced competition and consumer choice.[8] From a markets perspective, if the days after the election are any indication; traders expect higher Treasury bond yields, a stronger US Dollar, and rotation to areas like US Small Caps (which may be more isolated from tariffs due to more domestic supply/demand). Probabilities are high that markets currently expect tariff policy that is diminished over time from campaign promises. Any follow-through on a universal tariff program of 10+% on all imports including high restrictions on China presents a risk to equity markets. Market reaction could be swift in a world where policy expectations can change on a whim and a social media post. The nuance that markets will need to grapple with is how much trade policy may impact trends like the relative dominance of US Large Caps and the US Dollar. If current positioning is geared towards low recession risk, continued strong US GDP and earnings growth, and a lower rate path, any small change in narrative can lead to broad revaluation in asset classes that are richly priced.

Additional References:
Tax Policy Center: https://taxpolicycenter.org/taxvox/what-tariff-and-who-pays-it
Fordham Law School: https://news.law.fordham.edu/jcfl/2019/03/17/a-brief-history-of-tariffs-in-the-united-states-and-the-dangers-of-their-use-today/

[8] Tax Foundation: https://taxfoundation.org/research/all/federal/tariffs/

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