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The Tariffs Saga

Twists & Turns

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Now that Liberation Day, President Trump's day of tariff announcements, has come and gone, followed by many twists and turns in the evolving tariff policy, investors are trying to discern the economic and market implications. Unfortunately, as aggressive tariffs have been announced, only to be walked back, delayed, or paused, the result has been tremendous confusion among consumers, businesspeople, and investors, leading to hesitation on the part of each of these groups. Until there is more clarity surrounding the eventual landing place of the tariff program, answers to "what next" will be hard to come by. Even though our thoughts are incomplete, we offer points of discussion that we hope will be helpful.

As of this writing, here is where the tariffs sit, as best we can tell. There is a 90-day pause on all reciprocal tariffs, China excluded. However, an across the board 10% tariff on all countries remains in place. China is now subject to tariffs of 145% by us, and they have retaliated with tariffs on our products of some 120%. With China, we are in a full-scale trade war.

It may be best to begin with an understanding of what the use of tariffs is trying to achieve. Here again, it is not entirely clear, but several goals can be derived from comments from various members of the Trump administration. Taken in the aggregate, there is the assumption that trade deficits are a bad thing. In addition to restoring "fairness" to trade, raising revenue to help reduce the budget deficit is a goal, as is bringing jobs back to America by restoring manufacturing. These barriers to trade are designed to put a wall around America, make us self-sufficient, and in the process become a wealthier nation. Importantly, to achieve all of these goals, the tariffs would have to remain in place for a long time, something the markets would not be happy about.

The basic logic of tariffs has long been questioned by economists. It is conventional wisdom that tariffs are inflationary, at least on a one-time basis, and that they slow economic growth. Assume a company imports machinery parts from Germany. If those parts are under tariff, that company pays the tariff to the U.S. government. Now the eventual product is more costly to produce, and the company can either absorb the additional cost and accept a reduction in profit margin or pass it along to the consumer. Most will pass it along, at least partially. In turn, the buyer of the machinery may hesitate to pay the higher price, thus, in the process, inflation is higher, and growth is slower. The combination of more inflation and slowing growth is not a desirable condition, in fact it is the definition of stagflation. Under stagflation, higher inflation reduces real incomes, leaving consumers strapped, thus further contributing to less growth in the economy.

At this point, the proposed tariffs cover some twenty percent of total imports. This is an unprecedented number and comes as a severe shock to our economic system. Tariffs are a shock to consumers who, fearing higher inflation, may suspend spending; to companies that are hesitant to invest in new facilities until there is clarity on how severe the impact of the tariffs will be to their business; to foreign trade partners who must adapt to a new system; and to investors who worry about slowing growth and the effect of this on company earnings. It is fair to say that stock investors have spoken with incredible clarity as to their judgment on the merits of these tariffs and how harmful they believe they will be.

It is also important to consider the timing of this shock to the system. They are being implemented at a time of slowing growth in our economy. This trend is apparent in retail sales, housing, and investment. Soft data, such as consumer confidence and expectations of future inflation seem likely to eventually translate into hard data that shows a slowing economy. Unemployment has yet to rise substantially, but the job market is softening, perhaps a harbinger of higher unemployment. As a result, recession risks are rising fast. The primary reason a recession is more likely is that confusion and hesitation rob the economy of its natural momentum as consumers halt spending and businesses do not invest. Loss of momentum can result in negative Gross Domestic Product (GDP) growth: a recession.

There is another complicating factor in this picture. Ordinarily, when economic growth slows, the Federal Reserve (Fed) can be expected to come to the rescue by lowering short-term interest rates. This time, however, the Fed's flexibility has been hampered by the twin effects of tariffs: higher inflation and slowing growth. Keep in mind that the Fed has a dual mandate: maintain full employment and low inflation. Over the last couple of years, the Fed has been implementing a restrictive monetary policy to bring inflation down to its 2% target. And while considerable progress has been made toward that goal, the decline in inflation has halted in recent months, leading to a suspension of federal funds reductions. If the economy really weakens or goes into a recession, the Fed may act to restore growth by lowering interest rates, but they do so at the risk of destroying all the progress made toward the 2% target for inflation. This tariff program puts the Fed in a box. Their job will not be easy, and the knowledge of this adds just one more element of uncertainty.

Unfortunately, the troubling issues don't stop here. Currently, the budget deficit of the U.S. government is almost 7% of GDP. This is unsustainably high. If a recession were to occur tax receipts would be lower, thus making the budget situation all that much worse. Which brings us to another issue: the bond market and long-term interest rates. Normally, when recession fears rise, as they are doing now, long-term interest rates decline, reflecting the expectation of lower short-term interest rates from the Fed and lower inflation because of less economic demand. This time, however, after an initial drop, longer-maturity interest rates have been rising. Why is this? It is not clear, but obviously the budget issues noted above are in the minds of investors. Also, foreign buying of U.S. government debt has been a significant factor in financing our debt, but in a trade war environment, they may not be looking at the U.S. favorably. They may suspend purchases, putting upward pressure on our longer-term interest rates.

We noted above that our thoughts on all of this are incomplete, and our discussion confirms it. We have not addressed the geopolitical implications of high tariffs and our standing in the global community. That is for another day. Running through what we have discussed is the constant subject of uncertainty that we are all exposed to. What we can agree on is that confusion, derived from a lack of clarity on policy, is not a good thing because it reduces economic activity in many ways. Investors, consumers, and our trading partners need clarity. Are the tariffs permanent or just a negotiating tool? How long will it be before it can be decided if the tariffs are working to our advantage or disadvantage?

Our best hope is that in the coming days and weeks some clarification of these issues will emerge, and of course, we will be monitoring all this closely. As we have in the past, when we find ourselves in an environment that poses so many unanswered questions, we rely on two things. First, we assume that our economy, with its deep resources and proven resiliency, will be able to withstand the challenges of the day and eventually return to its natural state of expansion. Second, we will continue to invest according to our long-held investment philosophy: investing for the long term with the primary emphasis on quality.