Tariffs & trade wars, what are they good for?

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What are tariffs and trade wars good for? Many economists say: “absolutely nothing.” Escalating trade wars are painful and could harm an economy, but they are not a zero-sum game. To date, the actual tariff amounts currently being imposed are not necessarily exorbitant, but if recent events are an indication of escalating tit-for-tat policies, that would be concerning.

Last week, U.S. President Donald Trump announced a 25% tariff on up to $50 billion worth of goods from China. These goods range from dishwashers to aircraft tires. Similar tariffs are being imposed on Canada, Mexico, and other trading partners within the European Union as well. This week, the administration is threatening to target another $200 billion of Chinese goods. This puts the U.S. and some of its largest trading partners at odds with each other, to put it mildly. But what exactly is a trade war? What are tariffs and quotas and trade deficits? Most importantly, how will all of this affect investors?

What is a trade war?

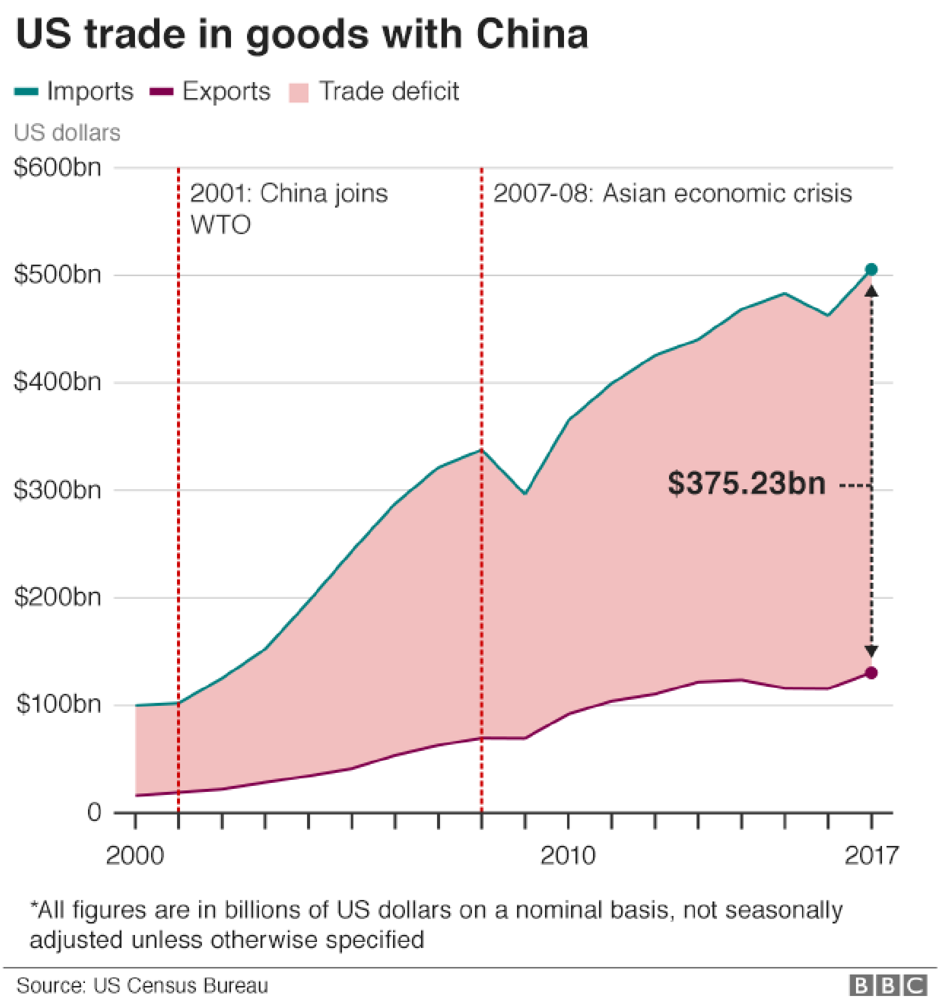
A trade war is when countries attack each other’s trade practices by implementing tariffs and quotas. Typically, when one country raises tariffs or quotas, other countries will respond, resulting in a tit-for-tat escalation. A tariff is a tax or duty that the government places on a class of imported goods. In theory, the tariff will make the foreign good more expensive, and therefore less desirable to consumers. At the same time, domestic manufacturers of the product benefit because they don’t have to pay the tax. A quota, on the other hand, is a government-imposed limit on the quantity or prices charged on goods and services that may be imported or exported over a given period.

What is the motivation for the tariffs with China?

The decision to impose tariffs on China is primarily a response to the alleged theft of U.S. intellectual property (IP). Intellectual property refers to inventions, designs, and symbols used in commerce according to the World Intellectual Property Organization. IP is protected by patents, copyright, and trademarks, enabling people to earn recognition or financial benefit from what they invent or create. According to the U.S. Trade Representative, which led the seven-month investigation into China’s intellectual property theft, the estimated “annual cost to the U.S. economy continues to exceed $225 billion in counterfeit goods, pirated software, and theft of trade secrets could be as high as $600 billion.” In return has announced its own tariffs of $35 billion worth of U.S. goods. The president and administration are convinced this is hurting U.S. manufacturing, and are using the tariffs as a tool to reduce our trade deficit.

How bad is the trade deficit?

A trade deficit is an economic measure of international trade in which a country's imports exceed its exports. In other words, we spend U.S. dollars buying cheaper goods from China instead of spending those dollars at home. In 2017, the trade deficit between the U.S. and China stood at $375 billion, according to the Census Bureau. The trade deficit has ballooned since China entered the World Trade Organization in 2001. The administration is keenly focused on reducing this deficit by using tariffs as a potential negotiating tactic.



How will this impact investors?

Given the ever-changing rhetoric, it's difficult to predict what will happen in the market on a given day, or even a given week. At this point, trade remains among the key negative sentiments driving market action and possibly extending deeper into the economy. In the near term, we expect multinational corporations, such as those listed within the Dow Jones Industrial Average, will likely be impacted more than smaller domestic stocks. This disparity has manifested itself in the divergence in returns for 2018, as small cap stocks have outperformed larger cap stocks. Small cap stocks are more domestically aligned and somewhat insulated from the tariff and trade war tantrums. On the other hand, we have also seen bond yields fall, driving up prices, as investors reach for higher quality investments to reduce volatility within their portfolios.

While no one can say for sure where the administration may head next, one thing seems clear: markets do not like uncertainty and will likely remain volatile. Investors should invest for the long term and build a strategic portfolio that is defined by their risk tolerances and long-term goals. The U.S. equity markets have had a very nice run since the Great Recession, and we have now entered the late stages of the economic cycle. As such, it is best to avoid taking large cyclical bets in any investment category, and to remain disciplined with adequate diversification.*

*Diversification does not ensure a profit or guarantee against loss.