THE Wealth REPORT

President Trump campaigned on his and his voters' belief that the U.S. was being taken advantage of by global trading partners such as China, Mexico and Canada by flooding the U.S. market with cheap steel, aluminum and other commodities and products using unfair trading practices. As of early spring, Trump has begun to fulfill his campaign promises to make trade fair again.

TARIFFS AND INVESTMENT STRATEGY

Overview

In an effort to establish a new global trade policy, the Trump Administration announced it would impose a 25 percent tariff on imported steel and 10 percent on aluminum.[1] That dictum was shortly followed up with an additional 25 percent tariff on approximately 1,300 Chinese exports worth about $50 billion annually.[2]

Free Trade

These new policies mark a departure from the global free trade movement over the last two decades. Free trade enables goods and services worldwide to compete with domestic products and services without imposing taxes. The increased competition is designed to lower prices and enhance productivity and efficiency, creating better value for both manufacturers and consumers. Free trade has long been a favored policy within the Republican party.

However, when the global economy started taking off around the turn of the millennium, many facets of American industry began to suffer. In an effort to reduce costs and generate higher profit margins, some U.S. companies moved their manufacturing operations to other countries for reduced labor and overhead costs. This resulted in the loss of many American jobs, particularly those represented by labor unions.

The goal of the Trump Administration is to reduce the number of imported goods — via high tariffs — in an effort to return manufacturing jobs to the U.S.

"I don't think people should overreact right now. This is a negotiation using all the tools."[3]

\- Larry Kudlow, White House chief economic adviser

Impact of Tariffs

For context, note that a tariff is simply a tax levied on foreign imports. For example, if imported steel normally costs $10 per pound, it would cost $12.50 per pound once the tariff is imposed. Major steel and aluminum consumers include auto, heavy equipment and airline manufacturers, among others.

According to The Brookings Institution, there are several possible outcomes that could emerge from the U.S. levying these tariffs.4

To date, other countries are taking a wait-and-see approach before initiating efforts to negotiate new trade agreements with the U.S. or launch their own retaliatory tariffs.

1. The tariffs are designed to thwart foreign producers of aluminum and steel from continuing to flood the U.S. market, and thus may provide a boost to American companies that produce these products.

2. However, American companies do not produce enough steel and aluminum to meet domestic demand across a wide spectrum of industries. Therefore, tariffs will likely create a ripple effect in terms of higher prices charged to consumers to make up the difference. Higher prices on American products also will make them less competitive with foreign rivals.

3. Texas, California, Illinois, Michigan, Louisiana, Pennsylvania, Ohio and New York combined import more than $2 billion annually in steel and aluminum products, representing more than half (60 percent) of the nation's total consumption. Given the size of these state economies, trade disruptions could result in lower national economic growth in key industries such as automotive manufacturing, chemicals, and oil and gas production.

4. Retaliatory tariffs from other countries would serve to increase consumer prices on key American export industries, notably agriculture. Canada, China and the European Union (EU) have indicated that they plan to respond with their own retaliatory measures on American-made products, potentially curbing the export market.

Retaliation: Chinese Imports

The Trump Administration is particularly focused on reversing the U.S. trade deficit with China. In 2017, Chinese goods imported into the U.S. totaled $505 billion, while U.S. goods exported to China totaled $130 billion, leaving the U.S. with a $375 billion deficit on goods. A portion of that is further offset by America's surplus in services trade of about $38.5 billion, shrinking our total deficit to about $336.5 billion.5

By early April, China's finance ministry announced it would impose tariffs on $50 billion in American exports to China, escalating the trade war. The list of more than 200 affected products includes soybeans, automobiles and certain types of beef, corn and wheat.

Economic Impact

Tariffs are nothing new in America or other countries. In recent history, Presidents Richard Nixon, Ronald Reagan, George W. Bush and Barack Obama all instituted tariffs with varying degrees of effectiveness. Part of President Trump's strategy is to use tariffs as a negotiating tool with our largest trading partners for the North American Free Trade Agreement (NAFTA) and with other countries to procure trade agreements that are more beneficial for the U.S.

As for the initial steel and aluminum tariffs, Trump indicated he was open to excluding certain countries willing to strike a deal with the U.S. There also have been indications that China is in talks with U.S. officials to create a mutually beneficial accord that would ease the impact of the trade war, if not eliminate tariffs altogether.

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Investment Impact

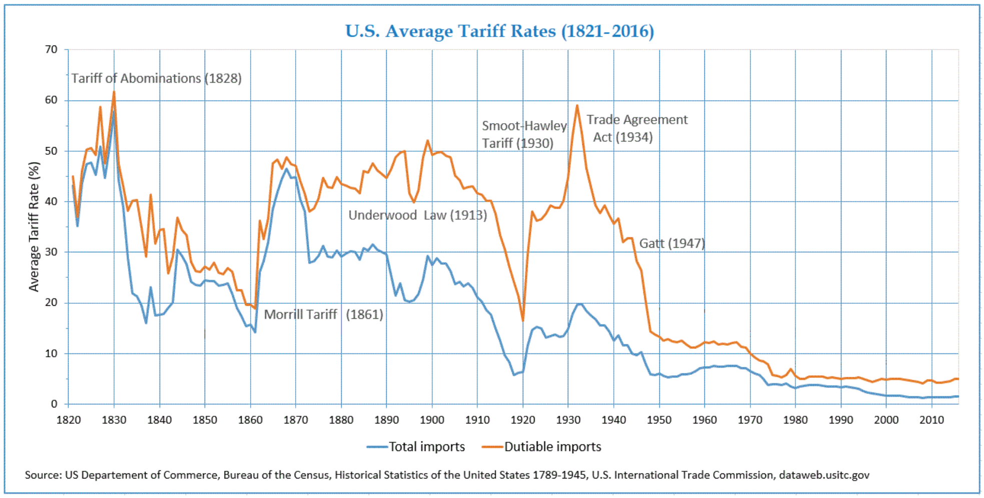
The investment markets experienced some initial fluctuation, but volatility eased, and trading returned to normal levels in the first days and weeks of the tariff announcements. It is important to be aware that, as tariffs are implemented, there likely will be an impact in market performance, with some industries more affected than others.

With that said, the equity markets have proven remarkably resilient despite a slew of political shocks over the last year and a half, demonstrating that fundamentals remain strong. The bond market, however, could see more impact. The recent tax cut bill was designed to stimulate consumer spending and spur higher economic growth. The Federal Reserve Board has already responded with small interest rate hikes. However, the new tariffs and threat of a global trade war could push prices up further, causing higher inflation. This could lead the Fed to accelerate its planned increase for interest rates.

In this scenario, new bond issues will have higher coupon rates, so existing bonds with lower yields would then sell at a discount rate. Note that as long as an investor holds on to his bond investment until maturity, it will continue to pay out its current yield and will receive 100 percent of its original value.

Final Thoughts

The United States economy generally relies little on exports and, as the world's largest consumer of final goods, tariffs have been effective at reducing imports in certain instances. In the past, America's largest trading partners usually paid them without responding in kind.



However, as we have seen in recent months, the market is waking up to the fact that trade spats may become more frequent. While we don't want to understate the potential risks of trade disputes in the long run, it's important to recognize that all of these moves have played out in the past.

What is most important for today's investors, particularly retirees, is to stay on course with their long-term investment strategy. Appropriate asset allocations and vetted investment managers should be able to manage tariff and trade war risks over the long run.

In other words: Stick to your plan.

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[1] Max Bouchet and Joseph Parilla. The Brookings Institution. March 6, 2018. "How Trump's steel and aluminum tariffs could affect state economies." https://www.brookings.edu/blog/the-avenue/2018/03/06/how-trumps-steel-and-aluminum-tariffs-could-affect-state-economies/. Accessed April 4, 2018.
[2] Maegan Vazquez and Abby Phillip. CNN. April 4, 2018. "Trump pushes back against market fears of trade war." https://www.cnn.com/2018/04/04/politics/trump-no-trade-war-china/index.html. Accessed April 4, 2018.
[3] Ibid.
[4] Max Bouchet and Joseph Parilla. The Brookings Institution. March 6, 2018. "How Trump's steel and aluminum tariffs could affect state economies." https://www.brookings.edu/blog/the-avenue/2018/03/06/how-trumps-steel-and-aluminum-tariffs-could-affect-state-economies/. Accessed April 4, 2018.
[5] John Kruzel. PolitiFact. March 28, 2018. "Did the U.S. have a $500 billion deficit with China in 2017?" http://www.politifact.com/truth-o-meter/statements/2018/mar/28/donald-trump/did-us-have-500-billion-deficit-china-2017/.Accessed April 11, 2018.