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How Could Tariff Policies Affect the Economy?

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Over the last several weeks, the Trump administration has made good on the President's campaign promises to wield the threat of tariffs on allies and adversaries alike as leverage to advance both economic and national security agendas. The administration has said it is prepared to levy hefty taxes on goods coming into the country from Colombia, Mexico, and Canada, while setting expectations for additional measures against the European Union. However, to date, Mexico and Canada have reached short-term agreements that have delayed the implementation, leaving markets oscillating with each headline.

The on-again/off-again nature of the President's tariff threats has created significant volatility in the markets as investors grapple with rapidly shifting narratives. Investors have found themselves feeling a range of emotions: panic, relief, and euphoria – sometimes all within a single trading session.

What's a tariff?

Simply put, a tariff is a tax on goods imported into the country. When U.S. retailers and manufacturers purchase goods from other countries, a duty (similar to a sales tax and paid to the federal government) is added to the cost of the goods before delivery. On the surface, the buyers pay the tax.

However, the tariff's impact likely extends beyond the original buyer. To compensate for the additional cost of goods, the foreign seller may lower their prices, squeezing their own profit margins. As buyers shift toward other supply chains, the currency of the seller falls and thus lowers the effective price (and raises the cost of U.S. exports). Finally, the buyer often passes on the additional cost to the consumer to preserve their profit margins.

Trade hawks argue that tariffs make domestic producers more price competitive. Historically, however, domestic manufacturers have raised their prices in concert with the tariffs, reducing the relative benefit to consumers while increasing their own margins.

Are tariffs inflationary?

This is an area where economists disagree. While the expected outcome of an increase in tariffs is higher prices, destructive inflation is generally associated with a persistent increase in price levels rather than a one-time increase. We have a recent historical example from the first Trump administration. In January 2018, the U.S. imposed tariffs on residential washing machines. While the initial reaction was an increase in prices for the U.S. consumer, the long-term deflationary trend in place for household appliances quickly reverted. In our view, the Federal Reserve and most investors will likely overlook these one-time price adjustments.

However, if the initial tariffs are followed by further escalations, the cumulative impact of one-time price adjustments could become undistinguishable from true inflation, compelling the Fed to further slow its pace or even reverse course on interest rate policy.

How should investors be positioned?

While we remain constructive on the trajectory of the economy, the potential for rising input costs presents a clear risk. Sustained higher prices could dampen demand for both foreign and domestic products and put pressure on corporate earnings. Goldman Sachs estimates that every five percentage-point increase in the tariff rate could shave 1%-2% of earnings per share from the S&P 500.

As we've noted before, however, economic policy never happens in a vacuum. The administration has also promised lower corporate and individual tax rates and decreased regulations, which have the potential to offset some of the trade-related pressures.

Companies that are more geared toward domestic demand and production are better positioned than those deeply reliant on global supply chains. Within the U.S., markets may favor smaller, industrial companies, because they are more isolated from trade wars, while larger, multi-national firms could be at risk. Incidentally, many of these same firms are more exposed to the proposed tax reductions, which might allow them to benefit from both the disease and the cure.

Sources: Consumer Price Index, Major Appliances, Bureau of Labor Statistics.