

Is It Time to Worry About a Trade War?

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On March 1, 2018, President Trump announced that the U.S. plans to impose tariffs on steel and aluminum imports. Markets around the world were shocked by the news, with major U.S. indices declining more than 1 percent just when it looked like they were recovering from the February downturn. Why did markets react so strongly? Is this a more serious threat going forward? In a word, yes.

First, let's define what's going on and why it matters.

A closer look at tariffs

The good. Tariffs are a charge on imports—essentially, a tax. Say a ton of steel costs \$100. The 25-percent tariff Trump proposed would require the seller to pay \$25 to the U.S. government. That would, in effect, mean the seller has to choose between selling the steel for \$75, raising the price to \$125 to net the same amount, or doing something in between. Practically, sellers will raise prices. This is the desired outcome, as it will allow producers here in the U.S. to sell their products for higher prices. Therefore, these tariffs are good for the steel and aluminum industries.

The bad. The problem is that they are bad for anyone else that uses steel or aluminum, such as car manufacturers, builders, and the energy industry. Their input costs have just gone up substantially. According to a UBS analyst, Ford's costs just went up by \$300 million, while GM's went up by \$200 million. Other companies will be similarly affected.

Companies like Ford and GM will have two choices here:

1. They can raise prices, which will start to push up inflation; or
2. They can eat the higher costs and make less money.

Either way, this is bad for the stock market, as it plays out across the economy. Both higher inflation and lower profits make stocks worth less—hence, the market reactions around the world.

Waiting for the world to react

These are only the first-order effects, of course. The next shoe to drop will be how other countries respond. If we are lucky, they will take legal action through multilateral bodies such as the World Trade Organization, which will result in negotiations. If we are unlucky, they will start imposing retaliatory tariffs of their own, targeted to cause maximum pain to the U.S. economy. We don't know what those will be. But we can be quite sure they will be designed to hit the U.S. economy as hard as possible, in order to force us to remove the tariffs. This is how trade wars start, so it will be critical to watch those responses.

The next set of effects will be geopolitical. When you look at the actual sources of steel and aluminum imports, Canada tops the list. By angering and damaging our closest neighbor—at the same time as we are trying to renegotiate NAFTA—the possible damage just increases.

The net effect of the tariffs, then, will be economic damage, higher inflation, and greater geopolitical uncertainty. On the corporate side, it will be lower profits for the vast majority of companies. On the consumer side, it will be higher prices for many goods and, likely, lost jobs in export industries. That is why this issue is worth watching closely.

Pay attention, but don't panic

That said, there is a real possibility that this is either a trial balloon or a negotiating tactic. The U.S. has tried to impose tariffs before, only to pull back as the costs became clear. Trump's announcement is not the same as actual action. This could all pass away, particularly as the rapid market response shows very clearly the potential costs. It is too early to be overly concerned, but we should definitely pay attention.

Certain sections of this commentary contain forward-looking statements based on our reasonable expectations, estimates, projections, and assumptions. Forward-looking statements are not guarantees of future performance and involve certain risks and uncertainties, which are difficult to predict.

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