Investment Insights

Trade, Tariffs, Manufacturing Jobs and your Investments

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The Model Wealth Program
Principle-Based Investing

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Key Points

- Historically, trade wars usually only last one round. Both countries think things over and understand further escalation only serves to hurt both sides.
- It's important to remember that the U.S. has important structural advantages in a trade war. The U.S. economy is the largest in the world, and it is not overly dependent on trade.
- Making investment decisions based on the latest turn of events regarding the trade war is, in our opinion, a fool's errand. As the trade war has escalated, the market has rebounded to new highs, primarily in response to further easing of interest rates by the Federal Reserve.
- As volatility in the market increases, this gives the managers we employ in the Model Wealth Program the opportunity to buy good stocks at lower prices.

Trade and Tariffs

As most investors know by now, the president is using tariffs to encourage other nations to change their policies on trade. In this issue of Investment Insights, we would like to address some of the most common questions related to tariffs and the trade war.

What is a trade war?

A trade war is when countries attack each other's trade with taxes, quotas, or other restrictions. A tax on another country's imported goods is called a "tariff."

What started this?

During the campaign, the president talked about doing more to reduce the country's trade deficit and bring back manufacturing jobs. The U.S. has a trade deficit with China, meaning the Chinese sell more goods in the U.S. than we sell in China.

Is the trade deficit a serious problem?

No. The U.S. has run a trade deficit for 44 consecutive years. The trade account turned to deficit in 1975. Over that time, the U.S. economy tripled in real terms, real manufacturing value added quadrupled, and the number of jobs in the economy almost doubled.[1] The idea that the trade deficit is a problem or will have to be paid back some day is a myth.

Here is how one observer explains:

"Those who do not understand this say that the trade deficit reflects economic "leakage." When Americans purchase more goods and services from foreigners than foreigners purchase from Americans – the argument goes – U.S. factories, farmers and service providers are deprived of potential sales, suppressing domestic output and employment. But that argument relies on the assumption that the dollars sent to foreigners to purchase imports do not make their way back in the U.S. economy – an assumption that is flat wrong. It may be true that when Americans purchase from foreigners those things that could be purchased from domestic producers, there is some degree of temporary leakage. But remember that much of what Americans purchase from foreigners is *not produced in the United States and about half the value of all U.S. imports consists of intermediate goods – the purchases of U.S. producers, who rely on those inputs to manufacture their own output.* Moreover, when Americans choose to purchase the import over the domestic product, they are consciously maximizing their own value. If they get imports for lower prices, they have more resources to spend elsewhere in the economy, or to save." [1]

We think while they sweat

Let's think of a specific example. When an iPhone arrives in the U.S., it is recorded as an import at its factory cost of about $240, which is added to the U.S. trade deficit with China. iPhones look like a big loss to the U.S. One estimate suggests that imports of the iPhone contribute $15-$20 billion a year to our trade deficit with China. But this number does not reflect the reality of how much value China actually gets from its iPhone exports – or too many of the brand-name electronic goods that run through China's part of the global supply chain.

Let's look a little more carefully. The touch screen, memory chips, and microprocessors on the iPhone come from a mix of Japanese, Korean, and Taiwanese companies, such as Intel, Sony, Samsung and Foxconn. Almost none of them are manufactured in China. Apple buys the components (which adds to our trade deficit) and ships them to China. China then assembles the iPhone and ships it back to the U.S. One researcher estimated the "value added" by China to the iPhone (assembly) is about $8.46, or 3.6% of the total. The rest of the $228.99 goes elsewhere. The U.S. and Japan each take roughly $86, Taiwan gets about $48, and a little under $17 goes to South Korea. The rest of the gross profit from the retail price – about $649 for an iPhone 7 – goes straight to Apple in Cupertino, California. In short, China actually gets about $8.50, not the $240 that shows up as a Chinese import to the U.S. The use of China as a giant assembly floor has been good for the U.S. economy, but not good for the U.S. factory worker. But Apple needs this highly efficient global supply chain to compete on the world stage. [2]

How much is the trade deficit?

The U.S. trade deficit increased to $621 billion in 2018, or about 3% of Gross Domestic Product (GDP), roughly half of where it was during the Great Recession. For goods only, the U.S. deficit with the world rose to a record $891 billion. The merchandise trade deficit with China hit a record of $419.32 billion in 2018. The surplus in services continues to rise and reached $279 billion last year. [3]

What drives the trade deficit?

The trade deficit with the rest of the world has been driven entirely by a trade deficit in goods. The U.S. is actually a net exporter of services and has experienced a sharp increase in the surplus of trade services since the 2000s. In fact, between 2000 and 2016, the trade surplus in services in the U.S. increased by 145 percent in real terms, though it has tapered off recently. The main contributor to the surplus in services has been payments for intellectual property rights, meaning foreign companies making payments to use U.S. technologies. Another contributor has been "medical tourism," where travelers come to the U.S. to seek the high-quality services of the U.S. health system. The third contributor is financial services.

As the U.S. economy has advanced, services have overtaken manufacturing and agriculture and now account for 80 percent of private-sector gross domestic product and jobs.[4]

Are the Chinese playing by the rules?

One reason for the large trade deficit with China is the tremendous buying power of U.S. consumers relative to the Chinese. The Chinese produce an enormous number of products at a low cost that American consumers and businesses like to buy. On the other hand, China limits access to its markets in many ways. Also, the president has accused China of engaging in the theft of U.S. intellectual property and "forced technology transfers" meaning U.S. companies are forced to handover U.S. technology in order to gain access to Chinese markets. These activities are a violation of World Trade Organization rules. The tariffs are designed to force China to do a better job of playing by the rules.

What tariffs have been put in place?

The United States has levied tariffs on a total of $286 billion of Chinese imports, global steel and aluminum imports, and shipments of washing machines and solar panels since January 2018, when Trump's administration levied its first trade tariffs.

A tariff timeline

5/31/19: President Trump threatened to impose tariffs at a rate of 5 percent on all imports from Mexico, worth $346.5 billion, until, he said, illegal immigration across the southern border was stopped. The tariffs were scheduled to rise to 25 percent on October 1, but have since been delayed.

5/22/19: The Trump Administration has announced that the U.S. will lift steel and aluminum tariffs on Canada and Mexico. In response, Canada and Mexico have announced that they will lift their retaliatory tariffs on the U.S.

5/17/19: President Trump delayed a decision to slap duties or quota restrictions on imports of automobiles and auto parts, but said he still has the right to impose them in another six months as his administration pursues trade deals with the European Union and Japan.

5/10/19: President Trump announced that the U.S. will raise tariffs on $200 billion worth of imports from China from 10 percent to 25 percent. President Trump also threatened to impose an additional 25 percent tariff on $325 billion worth of imports from China.

Who pays for tariffs?

The President says China foots the bill for U.S. tariffs on imported goods. But a tariff is a tax on imports. According to U.S. Customs and Border Protection (CBP), importers are required to pay the duties within 10 days of their shipments clearing customs. So, the tariffs are paid to the U.S. government by importing companies. Most importers of Chinese-made goods are U.S. companies, or the U.S. registered units of foreign companies that import goods from China.

Do U.S. importers pass on the costs of tariffs to their suppliers in China?

Some of them do, yes. So Chinese companies pay some of the cost. An importing company paying tariffs can manage the cost in several ways:

- Pay the full cost and live with a lower profit margin
- Cut costs to offset higher tariffs and maintain profit margins
- Ask suppliers in China for a lower price to offset the higher tariff
- Seek an alternative supplier outside of China
- Pass the costs on to consumers by raising retail prices

In a recent study, Amiti, Redding, and Weinstein (2019) found that the impact of the trade war in 2018 has been a complete pass-through of the tariffs into domestic prices of imported goods. Overall, they found that the full incidence of the tariffs fell on U.S. domestic consumers, with a reduction in U.S. real income of $1.4 billion per month by the end of 2018.[5]

How will higher tariffs impact the economy?

It is almost universally accepted that higher tariffs raise prices and reduce economic growth.[6] If the trade war is short-lived, the impact on the economy should be limited. A team of economists at leading American universities found that the trade war so far has created an aggregate loss of just $7.8 b, or 0.04% of GDP due to higher tariff revenue and gains to domestic producers from higher prices.[7]

However, if the tariffs are longer-lasting, historical evidence shows that tariffs raise prices and reduce available quantities of goods and services for U.S. businesses and consumers, which results in lower income, reduced employment, and lower economic output.[8]

According to the Tax Foundation, the tariffs planned and imposed so far by the Trump administration would reduce long-run GDP by 0.20 percent ($50 billion) and wages by 0.13 percent and eliminate 155,879 full-time equivalent jobs. If the Trump administration acts on threats to place new tariffs on automobiles and parts and additional tariffs on products from China, GDP would fall by an additional 0.45 percent ($112.23 billion), resulting in 0.30 percent lower wages and 347,988 fewer full-time equivalent jobs.

Other countries have announced intentions to impose tariffs on U.S. exports. If these tariffs are fully imposed, U.S. GDP could fall another 0.09 percent ($21.53 billion) and cost an additional 66,725 full-time equivalent jobs.

If all tariffs announced thus far were fully imposed, U.S. GDP would fall by 0.74 percent ($184.07 billion) in the long run, effectively offsetting about 44 percent of the long-run impact of the Tax Cuts and Jobs Act. Wages would fall by 0.48 percent, and employment would fall 570,591.[8]

It's important to remember that the U.S. has important structural advantages in a trade war. The U.S. economy is the largest in the world, and our economy is not overly dependent on trade. According to the U.S. Census Bureau, the U.S. exported $1.66 trillion of goods and services this year and imported $2.54 trillion in 2018. Total U.S. GDP is $21.0 trillion.[9] While a prolonged trade war can lead to somewhat higher prices, intense global competition is currently holding inflation down at very low levels.

How does it all end?

We believe there are four possible outcomes to the trade war:

- A grand compromise on trade, technology transfers, IP theft
- An agreement on trade but not on tech (uneasy truce)
- A continuing extension of deadlines
- No deal/escalation

Historically, trade wars usually only last one round. Both countries think things over and understand that they are both hurting, so further escalation only serves to hurt both sides. Given the amount of political capital expended and the economic damage after round one, we think it is likely that both sides find a face-saving deal and submit to WTO rules. In this case, we think an "uneasy truce" is the most likely outcome. However, if President Trump were to slip in the polls, the Chinese may simply decide to "wait him out," with the hopes of dealing with an easier partner after the U.S. elections.

It’s also worth pointing out that, as volatility in the market increases, this gives the managers we employ in the Model Wealth Program an opportunity to buy goods stocks at lower prices. We don’t spend a lot of time worrying about the trade war because of our confidence in our managers’ ability to navigate storms like this, which come-and-go with common frequency over the years.

Implications for Investors

Making investment decisions based on the latest turn of events regarding the trade war is, in our opinion, a fool’s errand. As the trade war has escalated, the Dow Jones Industrial Average has rebounded to near new highs, primarily in response to the anticipation of further easing of interest rates by the Federal Reserve. The lesson here is simple: The trade war is just one of many factors effecting the short-term outlook for financial markets, nearly all of which are unpredictable.

Important Disclosures

Footnotes

1 Dan Ikenson, Forbes, August 23, 2016
2 HIS Market data 3 HIS Markit data, CBS News, China makes $8.46 from in iPhone, that’s why a trade war is futile, July 9, 2018
3 Commerce Department data, Bloomberg, March 6, 2019
4 Source: Bureau of Economic Analysis, U.S. Federal Reserve Bank of St. Louis: U.S. Trade Deficit Driven by Goods, Not Services, Ana Maria Santacreu, June 27, 2017.
5 Source: Amiti Mary, Stephen J. Reding, and David E Weinstein “The Impact of the 2018 Trade War on U.S. Prices and Welfare,” CEPR Discussion Paper 13564, May 2, 2019.
6 L. Alan Winters, “Trade Liberalisation and Economic Performance: An Overview, “The Economic Journal 114, no. 493 (February 2004)
7 Source: NBER Working Paper No. 25638, The Return to Protectionism, Goldberg, Kennedy, Khandelwal
8 Erica York, “Lessons from the 2002 Bush Steel Tariffs,” Tax Foundation, March 12, 2018
9 U.S. Bureau of Economic Analysis, St. Louis Federal Reserve

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