MARKET INSIGHTS

The Consequences of Tariffs

GLOBAL INVESTMENT STRATEGY

March 2018

OVERVIEW

On March 8, 2018, President Trump signed a proclamation that imposes 25% tariffs on steel imports and 10% tariffs on aluminum. The measure will not apply to Canada or Mexico conditional on ongoing NAFTA renegotiations, and with some possibility for a future exemption for Australia. The economic consequences of the steel and aluminum tariffs are negative and the greatest risk is the potential for back-and-forth retaliation between the U.S. and its trading partners.

While the tariffs on steel and aluminum in and of themselves will likely have a small, though negative, effect on prices and growth, the impact is exacerbated by what the tariffs symbolize for the president's heretofore pro-business agenda and the global economy. The pro-business policy priorities in the first year of the Trump administration have been critical to the upswing in business and investor sentiment since Trump was elected and businesses are mostly united in opposing this action.

Further, the initial negligible economic effects of the tariffs are compounded by the likely retaliation of other countries, including allies, which would magnify the negative effects of this first move. The key here is that the retaliation may be directed to industries and states not of the U.S.'s choosing. Retaliation will be meant to send an economic and political message by affected countries. And there is no guarantee that retaliatory trade moves are finished after one round. The bottom line is that protectionism shrinks markets, raises costs, stifles innovation and ultimately reduces how fast a country can grow without generating inflation.

The benefits of the tariffs are concentrated while the costs are diffused. Industries that buy steel and aluminum and vulnerable agricultural exporters employ many times more workers than the industries that the tariffs are meant to protect.

Congress has constitutional powers over tariffs and trade. However, in the case of the proposed steel action, the president is using a Cold War-era law that allows an administration to unilaterally impose trade restrictions and tariffs based on national-security grounds. Congress gave the president that power through Section 232 of the Trade Expansion Act of 1962. Therefore, the administration can legally have a heavy hand in trade actions and protectionist factions can have an outsized influence without the mitigating factor of Congress.

SUMMARY HIGHLIGHTS

- The economic consequences of the steel and aluminum tariffs are negative and the greatest risk is the potential for back-and-forth retaliation between the U.S. and its trading partners.
- Retaliation may be directed to industries and states not of the U.S.'s choosing.
- The benefits of the tariffs are concentrated while the costs are diffused.
- The president is using a Cold War-era law that allows an administration to unilaterally impose trade restrictions and tariffs based on national-security grounds.
- The indications are that the tariffs would be applied to most countries, including some allies, and the list of countries included in the decision will likely change in the future.
- At the margin, the tariffs create upward inflation pressure for consumers.
- Rather than hitting their intended target, China, which is mainly responsible for the steel overcapacity, the tariffs are hurting several U.S. allies.

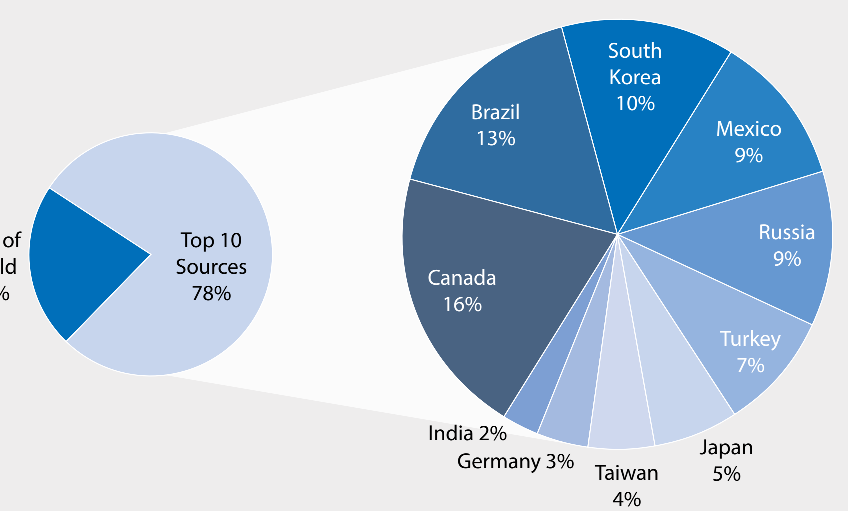
WHAT HAPPENED

- On March 8, 2018, President Trump signed a proclamation that imposes 25% tariffs on steel imports and 10% tariffs on aluminum. The measure will not apply to Canada or Mexico conditional on ongoing NAFTA renegotiations, and with some possibility for a future exemption for Australia.
- The tariff announcements exposed a growing internal tension within Trump's team of advisors
  - Reports have highlighted the disagreement between those aligned with protectionist policies and those globally focused.
  - The departure of Trump's chief economic advisor, Gary Cohn, is negative for the market given his Wall Street credentials and traditional business-friendly policy recommendations.

IMPLICATIONS

- The White House will likely receive strong pushback from Congress, the business community, and several economic advisors over the next several weeks.
- Higher tariffs will result in rising input costs squeezing key industries in the U.S., including industrial equipment, construction, beverage production and automobiles. At the margin, the tariffs create upward inflation pressure for consumers.
- Rather than hitting their intended target, China, which is mainly responsible for the steel overcapacity, the tariffs are hurting some U.S. allies, such as the European Union, the most. China is the 11th largest exporter of steel to the U.S., although integrated global supply chains mean that China-sourced imports are higher than this figure.

U.S. STEEL IMPORTS - TOP 10 SOURCES (YTD 2017 - Percent of Volume)



Data based on U.S. steel imports volume (from various countries) YTD through September 2017.
Source: Capital Economics and The International Trade Administration.

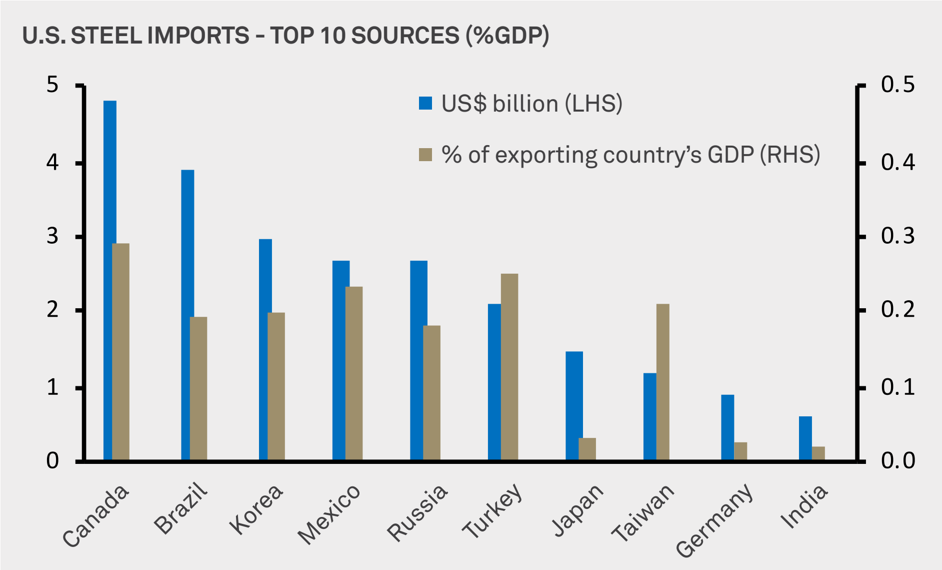


Chart shows estimated values of each country's exports of steel to the U.S., divided by the exporting country's estimated 2017 nominal GDP. Estimated values are based on each country's market share of U.S. steel imports and the average price of steel.
Source: Capital Economics.

- U.S. geopolitical allies have urged the administration to treat them differently from adversaries.
- Retaliatory measures from China and the European Union could target U.S. industries ranging from agribusiness to aerospace and services.
  - Countermeasures could be aimed at industries in the U.S. that are heavily reliant on exports.
  - The European Union has already put together a specific package of penalties that would hit U.S. exports, targeting particular industries for countermeasures and message-sending, including Harley-Davidson (manufactured in Wisconsin, House Speaker Paul Ryan's state); bourbon (manufactured in Kentucky, Senate Majority Leader Mitch McConnell's state); and blue jeans (nothing more American than that).
  - China imports $14.2 billion in U.S. agricultural products and this industry could be a target of retaliation.
- China may move more quickly to curb its overcapacity, the root of the import surge and price pressure that is hurting U.S. producers.

BIG QUESTIONS ON GLOBAL TRADE

- The Trump administration is using the steel and aluminum tariffs to pressure Mexico and Canada during the NAFTA renegotiations.
- The proposed tariffs directly undermine international trade institutions.
- The recent recovery in emerging markets has in part been due to expanding global trade in the last two years. Emerging market economies therefore are exposed to risk if there is a contraction of global trade. Many emerging market countries rely on exports and raw materials to sustain their economies, making them vulnerable if the U.S. adopts protectionists measures.

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