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"Trump's Trade War: A March of Folly?"

By Jefferson V. DeAngelis, CFA®, Chief Investment Officer

Just a month ago markets appeared enamored with President Trump's agenda for deregulation, tax reform and fiscal stimulus. The prospect of protectionism was viewed as mere rhetoric from a president in perpetual campaign mode. Even now as open trade hostilities erupt between the U.S. and its major trading partners, investors remain skeptical that such will amount to anything. Most believe that it is all a negotiating tactic on the part of the U.S. Administration to extract unilateral concessions. But given the fervor of the president and his advisors for further escalation, the market's skepticism may be misguided.

President Trump fundamentally holds that the U.S. is disadvantaged in dealing with many of its trading partners across a wide array of goods and services. His arguments are largely based on the sheer size of the U.S. trade deficit and the asymmetrical nature of tariffs imposed on traded goods. In addition, there is also a concern for the protection of intellectual property rights in dealing with foreign nations. For President Trump, it is a matter of fairness. At least, that is what he has sold his political base.

In truth, trade wars are never fought over issues of fairness. They are fought over national self-interest. Each country assumes when entering into trade agreements that there is an underlying benefit to its economy in terms of improved wealth, productivity or efficiency. It makes sense because in trade one plus one can equal three. Comparative advantage assumes that trade can be additive. A country can produce certain goods and services more efficiently and cost effective than its neighbor. It can then barter with its neighbor to obtain other goods that it demands and its neighbor has a competitive advantage in producing. Tariffs, in theory, counteract comparative advantage to even out the playing field. Free trade would be a far better choice but it is easier said than done in getting there from here.

With all the bashing of global trade, it is important to remember that perhaps nothing has been more positive for improving living conditions globally than trade. Improved transportation, communications and technology greatly expanded the opportunity set. Each nation has been able to formulate a strategy of comparative advantage and use its resources to obtain needed goods and services that it lacks. The standard of living across the world has been a byproduct of trade. Smaller and emerging economies have the most to gain if current trends persist and the most to lose if trade restrictions are enacted. The developed world has less at risk in a trade war because it has built a greater safety net. Nevertheless, the developed world is not immune to a precipitous drop in growth. To service increasing debt burdens, the developed world needs to produce income.

Nationalism and protectionism may appeal to a political base angry over lost jobs and opportunities. It is too simple to assume that foreign trade policies are the primary cause of the threat, however. Undermining the opportunity to exploit the rise in wealth and equality of emerging markets may be counterproductive. An example from history of just such a counterproductive action is The Tariff Act of 1930, infamously known as the Smoot-Hawley Tariff. While not causing the Great Depression, it had a profound impact on the ultimate recovery. It took decades to reestablish a global trading mechanism to leverage comparative advantage.

Before we panic it is important to analyze the differences between the conditions that existed during the 1930's and today. Economic conditions were more fragile in 1930 and tariffs had a more significant impact on growth. The magnitude of the Administration's proposals is likely to have a much smaller impact on domestic and global GDP. The U.S. imports over $500 billion from China while the Chinese import only $140 billion from the U.S. Although these are large numbers, tariffs of this size are unlikely to impact either the U.S. or Chinese economies materially. They are perhaps more meaningful in understanding the relationship between these two superpowers.

Today, as income per capita expands in places like China, U.S. goods and services are well positioned to obtain significant market share. Many large U.S. companies are depending on an increase in emerging market demand for their growth. A contraction in growth caused by Trump's expanding trade war may be small in statistical terms, but it has the potential to shut down borders and restrict trade. It is difficult to determine the impact on strategic planning and capital budgeting for most of the world's companies. The global economy depends on open borders and access to markets. Uncertainty over trade could significantly alter the way in which companies do business and the domicile that they choose to do it from. Rather than strengthen the nation-state it may ultimately lead to its gradual decline in importance.

It is true that President Trump, as he likes to point out, can impose tariffs on more goods and services than the Chinese. He incorrectly assumes that his policies will have a far greater impact on the Chinese economy than ours. Though, the numbers do not necessarily mean that he is in a stronger position to negotiate. The Chinese have several options which would significantly upset the U.S. economy. The nuclear option would be the disposition of its U.S. Treasury holding. This is very unlikely since it would result in the Chinese shooting themselves in the foot. The likely rise in interest rates could cause the value of their holdings to decline. More likely, the Chinese could choose to ignore intellectual property rights altogether, stall the approval of new products and businesses to their markets or tie up business in an endless bureaucratic snag.

President Trump believes that the U.S. has entered many bad trade deals over the last several decades. It is a difficult argument to prove. Low-skilled American jobs were indisputably lost to cheap foreign labor. However, American consumers benefitted though lower prices on quality goods. Further, the U.S. became dependent on foreign savings to finance its growing trade deficit. Yet, interest rates have steadily fallen depriving foreigners of high returns on their savings. In effect, we traded goods and services for paper. In the end, it is the value of the paper in U.S. dollars that will determine the success of the trade.

It is always difficult to pinpoint the precise start of a war or its definitive cause. Justifications for wars transform as the battles evolve and escalate. There are certainly signs of an escalating trade war developing between the U.S. and its major trading partners. Hopefully, these threats and posturing are mere negotiating techniques learned through the "art of the deal." Yet, while walking away from a real estate deal might make sense, doing so with global trade arrangements seems imprudent. The effects on relationships, business, supply chains and economies are long lasting and significant. While every war has winners and losers, history suggests that victory is often hollow and fleeting.

172 N Broadway, Suite 300 | Milwaukee, WI 53202 | 414.755.0461 | www.nwpcapital.com