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Tariffs Don't Just Change the Next Quarter's Earnings

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The implementation of tariffs by the current U.S. administration will likely have significant long-term implications, not only in how countries negotiate with the United States, but also in how both domestic and international businesses realign their approach to international markets. By simply focusing on the near-term impact on profits and trade volumes, the attention thus far has been on next quarter's earnings but fails to consider what is likely to be a significant long-term change in corporate behaviour. Similarly, framing trade in a bilateral context misses the multilateral aspects of trade and how those relationships will change in the future. It is likely that regardless of the resolution to the trade issue, the U.S. will be worse off for embarking on this strategy.

To start, we wanted to restate that, despite what politicians may say, tariffs are a tax on the nation's consumers. It is not Chinese producers who are paying the tax, it is the American consumer. To illustrate this point, consider the case of the 20% tariff on imported washing machines. The idea was to stimulate U.S. manufacturing and protect domestic manufacturers, such as Whirlpool, from what was perceived as unfair competition from foreign competitors, like LG and Samsung. From 2012 to 2018, American consumers experienced annual price declines of 3% to 5%. However, after the tariffs were implemented, the price of washing machines increased almost 15%. Not surprisingly, the demand for washing machines fell 3% after the price increase and even Whirlpool saw its domestic demand drop by just over 2%. Ultimately, the U.S. consumer ended up with the same washing machine but at a much higher cost. If the U.S. had production capacity that could fulfill domestic demand at a price close to the import price, then imposing tariffs might make more sense. Unfortunately, in the case of washing machines, the U.S. consumer ends up worse off because prices have risen with no corresponding gain. It is the administration's hope that by imposing tariffs, decreased sales will start to pressure Chinese firms as they become less profitable and lay off employees. Indeed, some U.S. business owners who are experiencing declines in profits due to the trade war continue to support this policy because they view it as a patriotic issue. Meanwhile in China, with an authoritarian regime, they are likely able to create jobs for laid off workers. The end of this trade war, like all wars, will have its share of casualties. We suspect that, over time, the U.S. will end up in the worse position and thus far, there is no evidence that this approach is working to stimulate production in the U.S. or causing undue pain in China.

Conversely, if the tariffs are lifted, it is by no means a guarantee that the demand for U.S. production will return to levels seen before the trade conflict. It seems likely that U.S. producers have undue confidence in a quick return to the status quo because businesses will need to seek alternative sources of supply as protection against arbitrary changes in the terms of trade. In life, as in business, trust once broken is very difficult to rebuild. Historically, the U.S. has been a staunch defender of trade agreements and lived up to the deals they signed. The current administration, however, has eliminated this trend by unilaterally changing deals after they have been signed. For example, the U.S. president reached an agreement with Canada and Mexico (USMCA) and now seems to be seeking ways to implement tariffs to curtail immigration from Mexico. This decision can only serve to further reduce trust in the U.S. as a trade partner.

Over time, both U.S. and foreign corporations will change how they operate in world markets. U.S. corporations will seek to realign their research and development activities and production to the markets they serve. Instead of satis-

fying global demand from just their U.S. production facilities, U.S. corporations will set up abroad to ensure that their production for global markets will not likely be impacted by arbitrary trade tariffs. The result will be an erosion in the U.S. tax base as more economic activity takes place outside the purview of the U.S. tax department. For an example, look no further than Harley Davidson. In response to tariffs between the U.S. and Europe, the iconic motorcycle manufacturer will be moving production for its world markets outside of the U.S. (and satisfy only U.S. demand from its domestic production facility). This decision results in not only a loss of federal, state and local tax revenue but also the loss of higher-paying jobs that the U.S. covets.

Finally, the focus of the discussions of tariffs has been largely on the U.S. versus China, essentially framing the issue as bilateral. However, by doing so, observers fail to see the relationships China has with its other trading partners. When removing the U.S. from the big picture, China has a more balanced trade picture with the rest of the world. During the disputes with the U.S., China has been gradually reducing tariffs with its other trading partners as those countries are actively soliciting supply relocation from China. Just as U.S. businesses relocate to other jurisdictions, so too will Chinese industries. By reducing tariffs, China actively fosters this type of movement. As such, we have recently seen seven of ten major Asian economies show stronger growth. Countries like Korea, Singapore, Taiwan, Malaysia and Vietnam are all growing as supply chains start to adapt to a new trade reality. The U.S. trade tariffs are indeed helping create jobs, just not in the U.S.

As the U.S. pursues a policy of tariffs, trade flows around the world will gradually shift and set new patterns for decades to come. From an investment perspective, we expect that the stimulus from trade will move away from the U.S. and toward Europe, South America and Asia. By implementing tariffs, the administration has likely undermined its past position as a trading partner of choice toward becoming a trading partner that is viewed with caution.

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