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Smoot-Hawley

A Tale of a Tariff Tussle Gone Wrong

The great American author Mark Twain once said, "History does not repeat itself, but it rhymes." The enduring truth of that observation looms large as we consider Washington's current trade skirmishes with China, Canada, Mexico and Europe in the context of the past.

The historical moment reverberating now is one that occurred 89 years ago, thanks to Senator Reed Smoot (pictured on right) and Congressman Willis Hawley. The pair have the distinction of forever being remembered as the architects of a now-infamous piece of legislation credited with propelling the U.S. into economic disaster. The Smoot-Hawley Tariffs were enacted by President Herbert Hoover in 1930 to defend American farmers and industry against imported products. They were predicated on the mistaken belief that protectionism rather than free trade would benefit the country. Unbeknownst to all three men, the murky economic picture at the time would prove to be the start of a traumatic epoch in American history known as The Great Depression, an era that had been triggered only a few months earlier by the stock market crash of October 1929.

In what can only be described in hindsight as a lapse in good judgement, Hoover ignored the counsel of hundreds of economists and industry leaders who advised him against the tariff scheme and on June 17, 1930, eight months after the Wall Street crash, signed Smoot and Hawley's legislation into law. The new bill imposed taxes on 20,000 products imported into the United States from around the world.

The result was catastrophic. The import levies reduced trade between the U.S. and its trading partners by as much as two-thirds. Almost two dozen countries imposed retaliatory tariffs against the United States. Smoot-Hawley effectively slowed world trade and accelerated the global economic contraction that had recently started. What might have otherwise been a run-of-the-mill economic recession in the U.S. deepened into a depression over the next four years.

Hoover's decision and the economic depression it helped to create ultimately prompted the Federal government under Hoover's successor, Franklin Delano Roosevelt, to adopt a host of fiscal, monetary and social rescue measures that lasted the better part of the 1930s. The profound impact of Hoover's political miscalculation was a catalyst for sweeping legal and regulatory changes that affect us to this day.

Back to the Future and Beyond

Almost ninety years after Smoot-Hawley, we are now in a tariffs and trade "rhyme" of sorts. While the good news is that we have not cut trade relations with two dozen countries, the bad news is that the scale of the impact may well be equally far-reaching, as our main sparring partner this time is China, the world's second-largest economy after ours, and our largest trading partner.

After centuries of dormancy China is now spreading its wings globally through initiatives to expand its economic and political influence around the world. It is also threatening American technological supremacy with its China 2025 initiative aimed at leapfrogging the U.S. in technological know-how and capabilities. These are very real threats to the American system, and Washington's main soft power weapon at the moment is tariffs.

From a national security standpoint, China is no friend of the U.S. Its authoritarian one party rule, extensive state-supported business enterprises, and disregard for intellectual property rights are the antithesis of our capitalist, free enterprise system. China's global expansion risks bumping into the American world system at every turn.

Yet, while tariffs may be useful as a political tool, they can be harmful to our economy, to the consumer, and to corporate earnings—and that means harmful to the stock market and to investors.

Tariffs Are a Lose-Lose Proposition

We know from Smoot-Hawley that tariffs are a double-edged sword: they may undercut an ideological enemy, but they can also cause significant collateral damage to us, particularly when imposed on a major trading partner. The reason is straightforward: tariffs hurt American companies and consumers, and are ultimately paid by American individuals and households through higher prices. They are intended to discourage businesses and consumers from buying foreign made products.

Since the start of 2018, Washington's tariffs have affected a range of U S companies, from industrial concerns to retail chains. Recently 600 American companies and industry trade associations warned of the damaging effects of the China tariffs on their businesses and their member companies. Major U.S. corporations such as Walmart, Costco, Gap, and Foot Locker penned a letter to Washington urging a quick end to the tariffs. The consequence, they warned, is that "both sides will lose". (Source: Reuters)

Washington has also extended tariffs beyond our ideological and economic foe, China, to our friends and neighbors. Tariffs on countries with which the U.S. shares borders and, in many cases, long-standing political good-will, have been imposed or threatened with large import duties on their products. Among those are our fellow North Americans, Canada and Mexico, as well as the E.U, Germany, and Japan. The economic aim of these actions is unclear; flexing America's geopolitical muscle seems the likelier reason.

Whatever Washington's motivation may be, these countries have responded by imposing their own tariffs on U.S. products, and perhaps more importantly, are now beginning to form economic and political alliances that exclude the United States. Japan and China, for example, are setting aside their ancient animosities to form stronger economic bonds in the event that U.S. tariffs hit both of them more forcefully - it is a form of mutual economic defense. Germany and Russia, historically wary of each other, are moving closer - Germany relies heavily on Russian energy imports and feels spurned by American tariffs after 70 years as America's close ally in Europe. Mexico as well has started to forge stronger ties with China as a hedge against American uncertainties.

<u>Tariffs Discourage Consumer Spending</u>

If we look at America's China tariffs from a purely top-down point of view, we can say they are not very significant to the U.S. economy as a whole. In 2018 our net trade with China was approximately $550 billion. A 25% tariff on all these products would add an extra $138 billion to their cost. In our $21 trillion economy this indeed appears to be an insignificant sum.

Yet, when viewed from the average consumer's perspective, these tariffs add up. In May, the Federal Reserve Bank of New York published a projection that estimated that tariffs will cost an extra $831 for the typical American family. Another projection from Bloomberg indicates that the cost of tariffs per family would be closer to $4,000 annually if tariffs against Mexico and others are added to those that are on China. Either figure would offset the roughly $2,800 refund that eligible taxpayers received in 2019, on average, from the 2017 tax cuts.

And while employment is at a high level nationally, workers may not be seeing large enough pay increases to offset the negative effects of tariffs. The risk to workers and consumers is that Washington will further ramp up the tariffs war with a number of countries, including China, making tariffs a larger unintended de facto tax on the U.S. population than they have been so far. Less money in the average person's pocket means less spending to boost economic growth in an economy that is 70% consumer driven. In June, the Conference Board's Consumer Confidence Index fell to 121.5. It had been 131.3 in May. While the index remains positive, the Conference

Board states that the month-over-month decline indicates that "the escalation in trade and tariff tensions earlier this month appears to have shaken consumers' confidence."

China Tariffs May be Here for a While

At the end of June, the presidents of the United States and China met at the G-20 Summit in Osaka Japan and agreed to a truce in their ongoing tariffs tussle. A truce is not an end, but a pause. For months prior, the U.S. Administration's position had been that tariffs on China are a short-term tool designed to extract trading concessions from the Chinese. That would make sense except that China's emerging threat to America's global hegemony in the economic, political, and military spheres requires effective long-term containment strategies by the United States. Short-term fixes will not work, making it all the more likely that tariffs against China will not go away anytime soon unless those tariffs are replaced by more permanent strategic tools.

For their part, the Chinese have little reason to quickly give in to U.S. demands. The U.S. presidential election is only 16 months away, and the winner is not a foregone conclusion. It makes sense for China to heed the advice of their historical military strategist, Sun Tzu, to wait or to stall until the circumstance becomes favorable for their victory. Unless China capitulates soon and agrees to American demands for a lower trade imbalance, among other demands, the trade spat may last much longer and have a much more substantial effect on American companies, consumers, and on U.S. GDP. China's historically long-term view of events, makes Chinese capitulation to American demands unlikely in the near-term.

Tariffs Create Uncertainty for CEOs and Fog Up the Corporate Earnings Windshield

Beyond the dollars-and-cents impact that tariffs have on consumers, tariffs also create an atmosphere of uncertainty for corporate CEOs whose job is to run their companies as efficiently as possible and to make capital deployment decisions for future growth. Businesses and their managers need certainty about laws, regulations, and market conditions in order to operate efficiently. Tariffs that are on-today, off-tomorrow, or that are threatened in a nebulous way with no timelines attached to them, complicate and deter business activity.

The ultimate result can be harmful to corporate earnings, the drivers of stock prices. In fact, the first quarter of 2019 has already seen a decline in corporate profits growth (please see chart below), and second quarter results are expected to be weak as well. Uncertainty leads business managers to delay investments into new plant and equipment, and to delay new contracts that might obligate them financially in a murky operating and investing environment.

Are We in a Smoot-Hawley Moment?

For investors, there is only one bottom line on tariffs, or any act of political will: how will the market respond? Are we on the precipice of a Smoot-Hawley juncture in our history, where titfor-tat retaliations threaten to seriously derail U.S. and global economic growth and to saddle the stock market with worries?

My answer? Probably not yet, but vigilance is warranted.

As Twain said, history does not repeat itself, at least not exactly. Unlike 1930, our economy today is not in a depression after a devastating stock market collapse and tariffs against us are mostly contained to a few countries. In 1930, twenty four countries imposed retaliatory tariffs against the U.S., making efficient trade between nations difficult, impractical, and unprofitable. Today, it is more like a handful, albeit a handful of large and significant ones.

But one of the rhymes we are hearing now is the refrain that tariffs are a way to protect American industries, such as steel and aluminum, ostensibly to secure vital national security interests and simultaneously to reduce the large trade deficits we have with much of the world, especially with China. Both points have some merit from a political perspective, but less so from an economic one. Two reasons come to mind.

First, in a conflict-free world there would be little *economic* benefit to protecting our high-cost, inefficient heavy industries, and much more benefit to buying from lower cost producers such as those in China and elsewhere. Without question, for national security, a domestic steel and aluminum industry is vital, particularly in wartime where reliance on foreign suppliers becomes impractical or unwise. We currently do have a substantial steel and aluminum manufacturing sector in this country, just not one that is particularly cost-effective when compared with China's state-supported sector.

And second, tariffs have also been used as a justification for tackling the large trade deficit we have with China and with other nations. If the U.S. were an average country whose currency is *not* the world's reserve currency, as the American dollar is, then it could make much more sense to worry about the trade deficit.

However, the United States has a currency whose status in the world is like no other. The U.S. dollar is *the* preferred currency for international transactions and is, therefore, sought after by nations and individuals. The Chinese are just as dependent on their U.S. dollar holdings to transact international business and investments as any other country, even as they work longer-term to elevate their own currency to reserve status.

Because the U.S. dollar is so important to the Chinese, when we buy goods from them with our currency they in turn use the dollars we pay them to invest in our Treasuries. These Treasury securities are so trusted globally as safe investments that they are considered risk-free assets. That coveted risk-free status helps us to finance our government's domestic fiscal deficit at very low interest rates while giving the Chinese a secure place to park their dollars. There is a clear benefit in this to the United States at a time when our federal government operates on fiscal deficits. If we did not have the world's major reserve currency, then a trade deficit with China would have been much more problematic for us as it may have meant a loss of our wealth to the Chinese. But that is not the case.

In short, the current tariff campaign is less about economics and more about geopolitics, making it easy to understand why the markets are concerned.

Tariffs are Beginning to Slow the Economy - The Inverted Yield Curve is Signaling Caution

Tariff-induced inertia could potentially devolve into economic weakness. While the economy continues to be good and is still growing, we may be seeing the first hint of a recession down the road. The onset of a recessionary period is usually understood only in hindsight, after economists and Washington policymakers have analyzed the data and made a determination for history. As of this writing, we do not know if we have crossed the line into a recession.

However, we are now getting a signal from the bond market that may indicate a slowing of the national economy in the months ahead. The yield difference between the 10-year Treasury Note and the 3-month Treasury Bill has been "inverted" consistently since May 23, signaling potential economic weakness in the near future. Campbell Harvey, the Duke University professor who is credited with identifying the association between the inverted yield curve and the onset of recessions, believes that the yield curve has to be inverted for at least a full quarter in order to have a high predictive value. So far, this yield curve (there are several, depending on which two maturities you use) has been inverted for less than that timeframe. Suffice it to say, however, that we have gotten an important signal from the bond market and we must pay attention to it.

A word about the inverted yield curve. Under normal economic conditions, long-dated fixed income securities such as the 10-year Treasury Note, carry a higher interest rate than short-dated fixed income securities, such as the 3-month Treasury Bill. This normal up-sloping yield curve indicates that investors believe economic growth prospects in the near-term are better than they might be in the future. As a result, they require a lower interest rate on short-dated treasuries, and a higher interest rate on longer-dated treasuries in order to compensate them for potentially higher risk down the road.

But when bond investors see economic trouble in the near-term, they demand to be paid a higher interest rate for short-dated securities in order to compensate them for higher near-term risk. Consequently, the supply/demand scenario for treasury maturities reverses the yield curve and causes it to be "inverted". The yield curve therefore is a signaling mechanism that lets the markets know how investors are thinking about the future. With the 10-year/3-month spread now negative, the signal is emerging as a sign that investors expect slower economic growth in the months ahead. According to Harvey, on average, recessions start 12 to 18 months after an inversion has held for a full quarter. If that formula remains valid, we could see a recession by mid-2020 or early 2021.

Stock Market Valuations are Still High

Where does all this tariffs and inversion talk leave us and our portfolios? For the moment, it leaves us where we have been since early 2018 when the stock market went into a sideways correction while still being in the 2009 secular bull market. With the 10-year/3-month yield curve now inverted, a potential recession signal has been triggered and will need to be watched carefully. And with the China tariffs in a type of truce, we cannot rule out the possibility that unpredictable actions by Washington or Beijing might not have further damaging effects on the U.S. economy. We have no certainty yet on this subject.

Along with tariffs and the inverted yield curve, stock market valuations continue to be an area requiring careful monitoring. Valuations have been climbing for some time and are once again at levels that are well above their historical averages. The Shiller P/E, which measures the long-term valuation of the stock market, is now above 30. Its historical average is about 16. High valuations can persist for long periods, and indeed I have been cognizant of high valuations for nearly three years. The cash levels I have maintained are reflective of continued overvalued conditions. Yet, I believe that for the sake of prudence it makes sense to be early and safe, rather than late and regretful whenever possible.

I am a believer in the concept of "reversion to the mean" in stock market valuations, the idea being that anytime valuations rise beyond their long-term averages, they become increasingly likely to snap back to their mean (average) levels if investors are faced with bad news that might affect corporate earnings. High valuations are an indication that investors have high expectations for earnings growth and stock market returns. Unreasonably high expectations are always susceptible to disappointments.

Is the 2009 Bull Market Done?

At this point in this quarter's investment letter I must pause and offer you a moment to exhale after you have digested my summary of concerns. Tariffs, the inverted yield curve, slowing corporate earnings growth, and valuations are indeed real factors to be aware of and to watch closely as they pose potential threats to stock market returns.

That said, it is important to emphasize that current economic conditions in the U.S. continue to be good for equities.

From a big picture standpoint, GDP growth is still positive. Economists on average expect annualized GDP growth to be somewhere in the 2% range when the second quarter figure is released on July 26. A growth rate of 2% to 3% could help to keep inflation in check, interest rates low, employment steady, and corporate profits healthy. In the first quarter of this year, GDP growth was 3.1% annualized. The absolute level of GDP stands at $21 trillion, up 2.7% from 2018. These are signs of health in the overall economy.

With unemployment at an historically low 3.7%, consumer confidence and consumer spending continue to be healthy as well. The most recent figures show that the Conference Board's consumer confidence index stands at a positive 121.5, while consumer spending is up 3.4% year-over-year, both beneficial to economic and corporate growth. The Conference Board's leading economic indicator stands at a positive 111.8, signaling continued expansion in the economy.

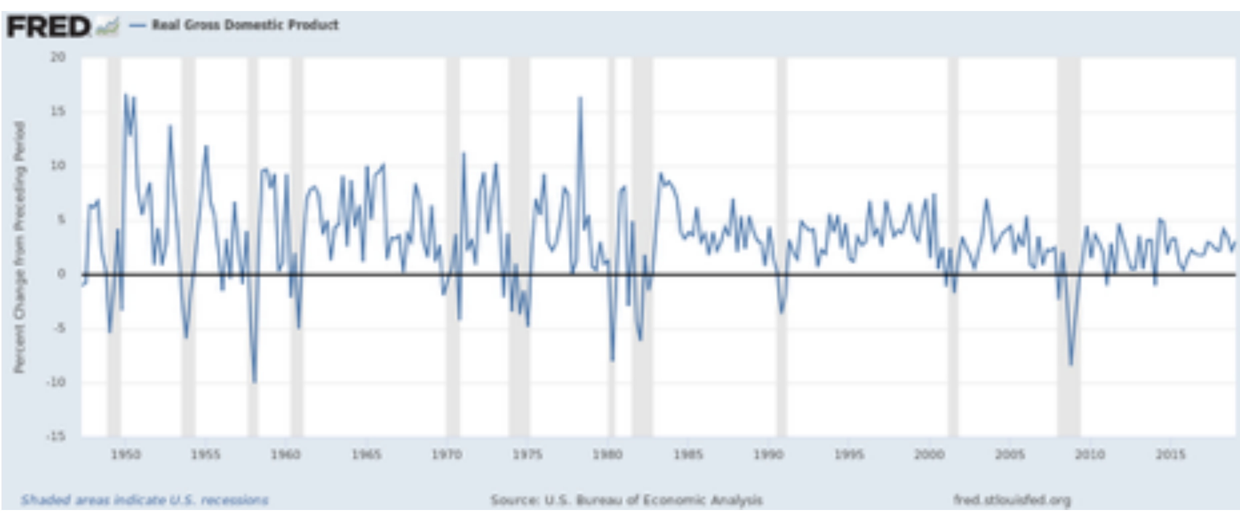
Interest rates also continue to support economic and corporate growth as they remain historically low. Whether the Fed will lower rates at the end of July as some now expect, is debatable. What seems clear however is that unlike last quarter, the consensus view no longer expects rates to rise because of the strong economy. Jerome Powell, the chairman of the Fed, has indicated that international trade tensions are having a slowing effect on economic activity and that the Fed may react by reducing interest rates to bolster growth. Yet that is not a certainty. For the moment, the economy remains strong enough not to warrant a rate cut.

Mind the Rhyme

These positive economic factors are not the makings of a recession, and they are not the environment in which bear markets typically start. Yet, in the continuum that is the stock market, we need to be mindful of Mark Twain's observation that history does not repeat itself precisely, but that it rhymes. Listening for that rhyme and never assuming that history, the economy, or stock market conditions repeat themselves exactly as they have in the past will serve us well over time.

S&P 500 Earnings Growth

Real Gross Domestic Product (GDP) Growth



Yield Curve: 10 Year Treasury Note / 3 Month Treasury Bill

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