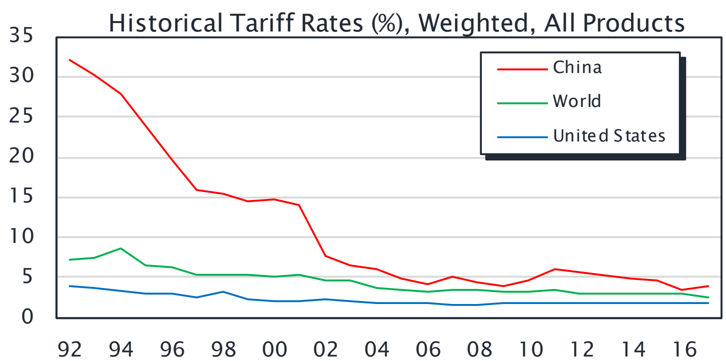
Agincourt Capital Management, LLC

# INVESTMENT UPDATE

For the third time in a little more than a year, a failure to advance trade negotiations with China has led to the US announcing that it would increase tariffs on imported Chinese goods. This comes as unwelcome news, as global economic growth has already slowed from its pace in 2017 and 2018. Our fear, which is beginning to show up in falling asset prices, is that these trade disputes will continue to escalate to the point that they trigger a global economic recession.

The US has a long history of tariffs. In fact, the second piece of legislation passed by the US Congress was the Tariff Act of 1789, which was viewed as a necessary step to protect emerging US industries. Over time, tariffs on imported goods became an essential source of revenue for the Treasury. By the late 19th century, tariffs on imports stood at over 50% and provided 95% of federal revenue, at a time when there was no federal income tax. In contrast, our major trading partners in Europe largely shunned tariffs, but the US persisted, claiming that tariffs were necessary to keep US wages high.



Source: World Bank

By the start of the 20th century, the populist reform movement, which sought to break up the large industrial trusts, also viewed protectionist tariffs as a corrupting influence that provided the largest corporations with excess profits. After a period where tariffs were lowered (and federal income taxes were initiated), Congress once again raised them in the wake of the Great Depression; in 1930 the Smoot-Hawley Tariff Act was passed, which raised duties from the mid-20% range back to the mid-30s on imported goods. Once again, the idea was to protect domestic producers, in this case the agricultural industry, which was in tatters as a result of the collapse in demand among US consumers.

| Tariffs | 2017 Import Value ($ Bln) | Tariff Rate | Est. Revenue ($ Bln) |
|---|---|---|---|
| Steel | 29.0 | 25% | 7.3 |
| Aluminum | 18.7 | 10% | 1.9 |
| June 2018, Part One | 32.3 | 25% | 8.1 |
| June 2018, Part Two | 14.1 | 25% | 3.5 |
| Sep. 2018, Part One | 160.3 | 25% | 40.1 |
| Sep. 2018, Part Two | 28.6 | 25% | 7.2 |
| September 1, 2019 | 101.1 | 10% | 10.1 |
| December 15, 2019 | 151.2 | 10% | 15.1 |
| **Total** | **553.2** | **17%** | **93.2** |

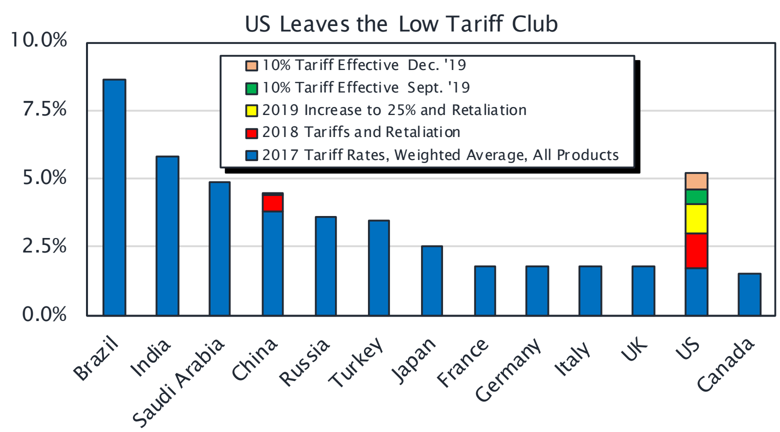
Source: Deutsche Bank

Instead of protecting US industry, these new higher duties decimated domestic producers, as other countries retaliated with tariffs of their own, drying up foreign demand for US exports. For decades, the Smoot-Hawley Act marked the last era of tariffs, as these duties were widely recognized as a strong contributing factor in the exacerbation of the Great Depression. After World War II, and for the next 75 years, the US dismantled its tariff structure, as did nearly every developed economy. By the early part of this century, under the supervision of the World Trade Organization (WTO), barriers to trade worldwide had all but been removed for developed countries, bringing down (as the chart shows) global trade-weighted tariffs to an all-time low of less than 3%.

Unfortunately, the available data from the World Bank ends at 2017, before the Trump administration began placing tariffs on Chinese imports. The initial volley last year came in the form of duties on imported steel and aluminum—a relatively small but highly visible class of imports to the average American. The table below shows how the list of targets has grown, and the tariff rate applied to each successive group. It's clear that the US turned up the heat significantly last September, adding new products totaling nearly $190 billion—more than double the dollar volume of products previously subject to tariffs.

On August 1st, after the most recent round of trade negotiations failed to resolve ongoing conflicts, the administration announced, via Twitter, that approximately $250 billion in additional Chinese goods would be subject to a 10% tariff beginning in September. What made this round of new goods notable was not just its size or breadth (covering 3,800 product categories), but the fact that these products make up the majority of the US' consumer imports from China. According to *Barron's*, the top five broad categories based on dollar value of imports are electronics, machinery, toys, apparel, and plastic products. Within electronics is cell phones, which by itself accounted for $45 billion in imports from China in 2018. For many of these categories, China represents a huge share of the total imports of those products: 82% of our cell phones come from China, 98% of video games are Chinese imports, more than 80% of our monitors, toys, and small office machines are imported from China. Nearly all these goods have, up to now, been free of tariffs, as previous rounds have concentrated on intermediate and capital goods, and not on consumer products.

It now looks like the implementation of roughly $150 billion of these tariffs—including the five major consumer categories listed above—will be delayed until December, presumably to allow goods from China to be imported tariff-free ahead of the holiday shopping season. That is very good news for several reasons. In December, if all these new duties on Chinese goods go through, the US' average tariff rate with China will rise to 17%, and since China is such a big part of US imports, the US will have the highest tariffs among any developed country (see chart). Further, if the US decides to follow up on threats made earlier this year and increase the tariffs on all imported goods from China to 25%, our average tariff rises to roughly 7%, on par with countries like Cuba and Egypt. The escalation of these tariffs has the US looking more like a struggling emerging economy, keen to protect an obsolete industrial infrastructure, and not like a global superpower. We will set aside the political ramifications of that and focus on what matters most to our clients—the economic effects.




As mentioned above, the partial delay in the implementation of this latest round of tariffs will help fourth quarter sales here at home, since tariffs force retailers to hike prices (or else absorb the higher costs of these products and accept lower profits). That's because tariffs act exactly like a tax on consumers; they are not paid by the exporter, but by the company that imports the goods, and that money is collected by the government. Tariffs have two main economic impacts on the importing country: producer/consumer price inflation, and slower economic growth.

We've already seen a slight uptick in the consumer price inflation figures as a result of the tariffs already in place. In the just-released July CPI data, there was an estimated three basis point (0.03%) impact from tariffs, and that figure will likely double in the coming months due to existing tariffs. The bigger impact will come in early 2020 if no deal is reached to avoid the tariffs scheduled to go on the books in December.

The threatened additional hike which raises tariffs to 25% on all Chinese imports could mean an increase in consumer price inflation in the neighborhood of 50 basis points within the next year. The good news is that price hikes from tariffs, while keeping prices elevated, are largely a one-time effect; they don't lead to further price increases in subsequent periods. In any case, inflation in the US has been so low over recent years that policymakers won't be too bothered by a temporary increase in year-over-year prices.

A much bigger concern for policymakers, businesses, and consumers is the impact of tariffs on the economy. Currently, the collective global economy is struggling with typical late-cycle issues of credit contraction, slowing demand (and thus a slowing manufacturing sector) and high debt burdens for both private and public institutions. Add to that non-cyclical challenges such as aging populations and increased political instability (Brexit, Japan-South Korea conflict), and we find ourselves in a vulnerable period for a trade war between the world's two largest economies. While it's true that the tariffs are likely to do more damage to the Chinese economy than ours, that doesn't mean that the US will be immune from their effects.

As the chart above demonstrates, China has already put in place retaliatory tariffs of their own, and have used other methods to restrict their imports of US products, including virtually halting the purchases of US soybeans and certain other agricultural goods. In early August, China allowed its currency to depreciate overnight by 2%, allowing the yuan to dollar exchange rate to rise above 7:1, an important threshold, in order to counter the impact of US tariffs. There's every indication that continued escalation of US tariffs will result in further retaliatory measures by China. So while the US isn't an export-dependent economy like China, slowing exports of US goods will have a measurable negative impact on our economy, especially the industrial and agricultural sectors.

Goldman Sachs research points to additional direct and indirect impacts of the planned tariffs, with a combined hit to US GDP of at least 0.6%. These include the income effect of higher prices, weakening financial conditions (e.g., credit restrictions), reduced capital investment due to policy uncertainty, negative business sentiment on production and hiring, and supply chain disruptions as a result rising costs for US businesses. It's a pretty grim picture, but one that accurately accounts for why tariffs make bad economic policy.