Spring 2018

An American president, proclaiming a need to strengthen and unify the country, is concerned a foreign country is flooding US markets with products priced so low it makes domestic competition impossible. Fearing this could drive domestic manufacturers out of business, the president implements a controversial tariff, stressing the need for America to be commercially and economically independent.

The president, of course, is ... James Madison.

In 1816, shortly after signing the Treaty of Ghent, which ended the War of 1812, America was heavily reliant on Britain for its goods, and the young American manufacturing sector couldn't come close to matching prices. (Remember, the vast majority of US citizens were farmers.) Madison and his followers believed the US needed to become self-sufficient, for the good of its economy and its national security (sound familiar?). Their solution was "The American System" (which placed America, um, first). The most significant aspect of the plan was the country's first tariff, placing a 20-25% tax on all foreign goods, aimed at protecting American manufactures from overseas competition.

And it worked. US manufacturing was revolutionized, and a huge growth in mills, factories, and distilleries ensued.

Despite what the current climate might have you believe, tariffs are neither new, nor inherently bad. Simply taxes on goods or services coming into a country, used to raise revenue or favor domestic industry. Even today, every nation uses them to various extents. Last year, according to data from the U.S. International Trade Commission, import duties totaled $33.1 billion - equal to 1.4% of the total value of all imported goods, and 4.7% of the value of all imports subject to duty. (Most goods imported into the US carry no duty at all. Only 30.4% of the $2.33 trillion, about $708.6 billion, in total imported goods were taxed.)

The markets' volatility and investors' concerns are largely based on the country the "Trump Tariffs" target. Have you heard the massive outcry over the 20% surcharge on Canadian soft lumber that enters the United States? We're guessing no. Yet Canadian lumber producers pay a tax at the border before their product can be sold on the US market. The US Commerce Department in November of 2017 issued a final determination that Canada subsidizes its forestry industry and sells lumber on the U.S. market at unfairly low prices. This of course is disputed by the Canadian government and it is challenging the findings. (In 2016, Canada exported approximately $5 billion worth of soft lumber to the US.)

But China's a different story, and the proposed tariffs are broader and, to our mind, much riskier. In 2016, U.S. goods and services trade with China totaled an estimated $648.5 billion. Exports were $169.8 billion; imports were $478.8 billion. The U.S. goods and services trade deficit with China was over $309 billion. The US wants what China is selling (and benefits by low cost goods) and China wants to sell to the insatiable US consumer (what would they do if the US didn't buy?). The two countries need each other.

While there are legitimate concerns about the way China does business, especially when it comes to intellectual property theft, a problem the Chinese government does little to address, tariffs aren't the answer. China's response, a combined $150 billon in taxes on US exports, makes that clear. Businesses and consumers will suffer, and the increased costs in raw materials and components will likely slow down the entire global economy.

To compound things, the US is also looking to make changes to the North American Free Trade Agreement (NAFTA). Canada and Mexico are the US's second and third largest trading partners. In 2017, trade with Canada was over $673 billion, while Mexican trade was over $616 billion. The balances between imports and exports were much closer. The US runs a trade surplus with Canada of just over $8 billion and a trade deficit of just over $64 billion with Mexico. Shaking things up too much could have wide spread affects for all countries involved. China exports to the US represent only 25% of the country's total, and less than 5% of its GDP. On the other hand, the US receives 65% to 75% of the total exports from Canada and Mexico, respectively, representing over 22% to 25% of their total GDP.

By most historical accounts, Madison's Tariff of 1816 was a stroke of genius, spurring invention and helping to usher in the "Era of Good Feelings." The markets' reactions to Trump's proposed tariffs, and China's retaliatory measures, coupled with targeting NAFTA, however, indicate we've entered the "Era of Uneasy Feelings" (OCM copyright pending). While we're prepared for the worst, it's highly unlikely either of these two situations will amount to much. There will be modifications made to protections and structures. And all parties involved, most especially Trump, will declare victory. Investors will refocus on a strong global economy, low absolute interest rates, good employment numbers, and profitable companies trading at very reasonable rates.