Quarterly Point of View
Tariffs & Trade

April 16, 2018

English economist David Ricardo promulgated the principle "Comparative Advantage" in his book *On the Principles of Political Economy and Taxation* in 1817, and for the last 200 years the world has seen that trade principle play out in greater practice. The famous example he uses to explain the theory looked at Great Britain and Portugal, and how both countries would benefit if they specialized in products for which they had the greatest relative efficiency: Great Britain in the production of cloth, and Portugal in the production of wine. By selling wine and buying cloth, Portugal obtains more of both, as does Great Britain. This holds that global trade is, fortunately, not a zero-sum game, and though not all individuals within a country benefit, nations as a whole are best served practicing free-trade that benefits both parties. Improvements in standards of living globally, particularly post WWII, are not coincidental with growth in international trade.

With that concept in mind, we had held out hope the topics of protectionism, tariffs, and trade wars wouldn't need to be seriously addressed. Given recent events, however, it's clearly time to circle back to something we had only hinted at in a past letter. In our July 2016 Quarterly Point of View letter, titled "Brits Boogie," we wrote:

> *The major candidates for U.S. President espouse policies that would be considered protectionist, even radically so, by measures of the recent past. One in particular recently pledged, if elected, to withdraw the U.S. from global trade alliances, and referred longingly to centuries old economic policy that relied predominantly on tariffs of foreign imports to fund the federal government. In response to the speech in which trade details were outlined, Holman Jenkins Jr., a member of the Wall Street Journal Editorial Board, remarked, not admiringly, that it may go down as "one of the great protectionist speeches in American History" - and this by a candidate in 2016, not 1816.* [1]

The "one in particular" referred to above ended up getting elected, and despite our hopes that Donald Trump would surround himself with wise counsel who would dissuade him from his protectionist leanings, those hopes appear to have been in vain. More accurately, he did have counsel that countered his tendencies initially, but most all have been pushed out of the administration. Most importantly Gary Cohn, White House chief economic advisor, who resigned in early March after losing a battle with the President over his intention to implement steel and aluminum tariffs, targeted predominantly at China. Cohn, the former President of Goldman Sachs, had strongly voiced his opposition to tariffs.

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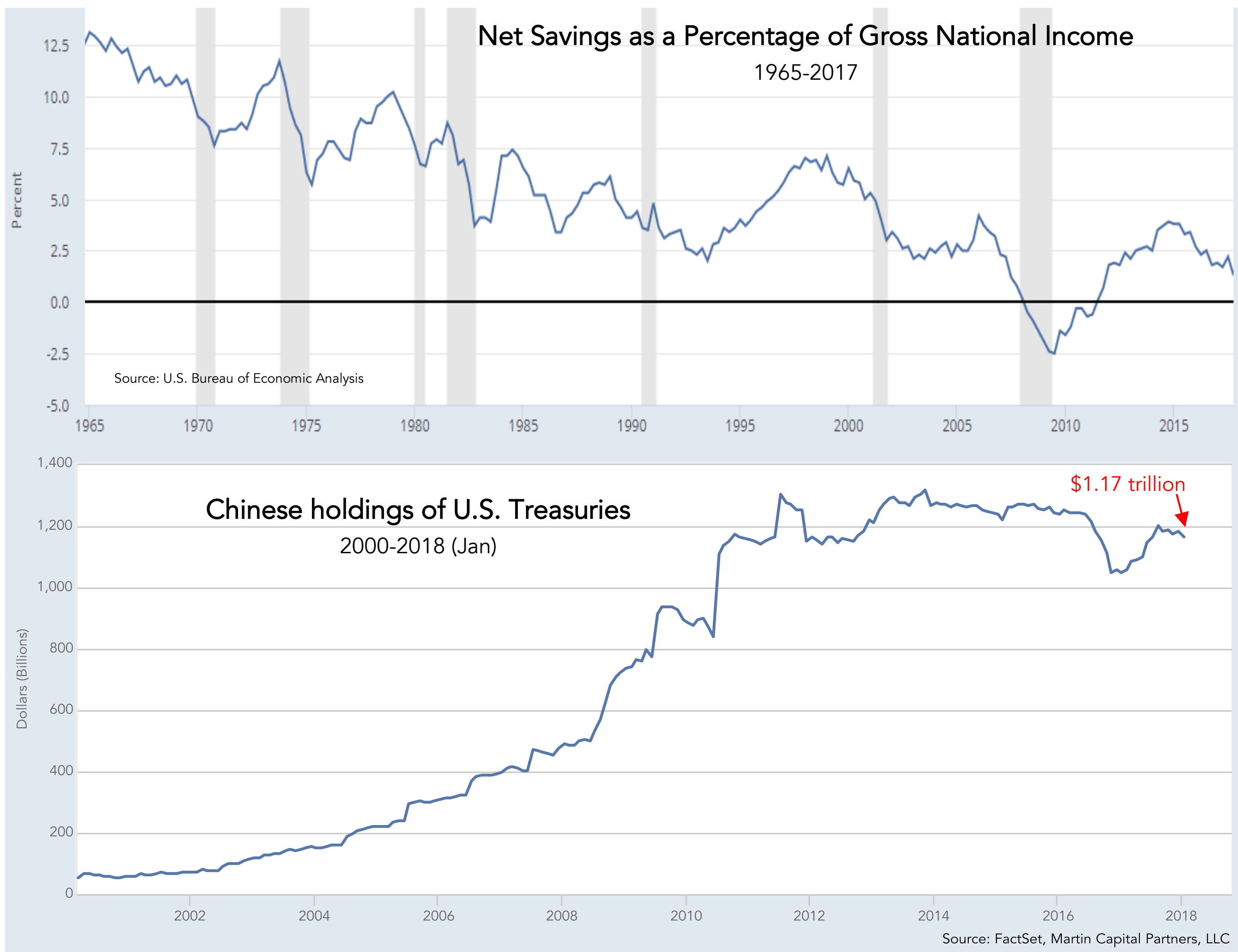
A tariff is a tax levied at a national border and raises the cost of imports, reducing the standard of living of consumers, and increasing costs to businesses who buy foreign inputs to make finished products. A domestic producer who could replace a foreign input at the same cost, wouldn't see any harm, but then again if that were true there wouldn't be demand for the import in the first place. Given that President Trump, prior to being elected, had outsourced to China some of the production of the goods in his Donald J. Trump Collection, he must be familiar with this concept.

Before we go further, the President deserves some credit for addressing very legitimate concerns surrounding trade. Barriers, including tariffs, implemented around the globe are often not fair to the United States. Intellectual property is frequently stolen and rights not enforced, while the opportunities to own companies in some countries are not equal. Addressing fair trade is important, as this simply hasn't been done with forcefulness and clarity in the past. But we are a nation of laws, and we can't afford to operate outside the scope of the rules-based global trading system that the United States participated in creating. U.S. Policy-makers should aggressively seek remedies to unfair trade practices through the World Trade Organization (WTO) and other such entities, working jointly with other aggrieved nations to put legal pressure on offenders such as China to address and correct unfair trade practices. Without doing this, it makes the U.S. a practitioner of unfair trade practices itself, greatly diminishing our credibility in opposing the practices of others.

The means of addressing unfair trade through tariffs and quotas, won't work – unless it is simply a dangerous game of negotiating chicken, with China backing down. That end result is highly unlikely, and therefore brings on the possibility of a worst-case scenario, sparking a trade war in which no one wins, least of all the United States. The market's recent volatile swings, after an extended period of confidence and calm, show the extent to which investors are worried about how far the President's protectionist policies will go. As of this writing, tariffs have been issued on a figure equal to about $50 billion in imports from China alone, with a recommendation for $100 billion more.[2] The $150 billion worth of imported goods proposed for levies is equivalent to roughly 1/3rd of all Chinese imports – a massive sum. In response, the Chinese Commerce Ministry said it will "hit back forcefully," fight back "at any cost" and "won't rule out any option."[3] Even before the latest round of proposed tariffs, the new Chairman of the Federal Reserve, Jerome Powell, responded to a question about a looming trade war by saying "this is a new risk… a low-profile risk that has become a more prominent risk to the outlook."[4]

The problem with these kind of protectionist policies is that history has been clear – they don't work. The most infamous example being the anti-trade Smoot-Hawley Act of 1930, sponsored by Senator Reed Smoot and Congressman Willis Hawley. It raised U.S. tariffs to the highest levels since 1828 and sparked a devastating trade war in which many countries retaliated, greatly exacerbating the impact of the Great Depression.

Like many problems we address in this country, we seemingly are only looking to treat symptoms, and not dealing with the root of the issues. What is the root of the issue? As a nation we are not saving; we are still spending and consuming. What does someone do when they don't have savings? They borrow. In our nation's case we are borrowing from other countries and running massive current account deficits. We would direct your attention to the following two charts, first illustrating the unfortunate trend in our net national savings the last half-century, followed by the incredible levels of outstanding borrowing we have amassed with just a single country, China.



Economist Stephen Roach put it succinctly in a recent piece titled, "How to Lose a Trade War."[5]

> *…the Trump administration's narrow fixation on an outsize bilateral trade imbalance with China continues to miss the far broader macroeconomic forces that have spawned a US multilateral trade deficit with 101 countries. Lacking in domestic saving and wanting to consume and grow, America must import surplus saving from abroad and run massive current-account and trade deficits to attract the foreign capital. Consequently, going after China, or any other country, without addressing the root cause of low saving is like squeezing one end of a water balloon: the water simply sloshes to the other end. With US budget deficits likely to widen by at least $1 trillion over the next ten years, owing to the recent tax cuts, pressures on domestic saving will only intensify. In this context, protectionist policies pose a serious threat to America's already-daunting external funding requirements – putting pressure on US interest rates, the dollar's exchange rate, or both.*

President Trump must surely realize what matters is the multilateral trade deficit, and not bilateral deficits involving just one trade partner. Reducing imports from one country – in this case China – will not create U.S. jobs or reduce our total trade deficit. Rather, without an increase in net savings, American individuals, companies and the government will simply replace their consumption with goods produced

in a different country, at a higher price. This will result in rising prices, effectively reducing Americans' standard of living, not enhancing it.

Any influence these actions would have on inflation would be most unwelcome now. This year's market volatility began in reaction to a sharp rise in U.S. bond yields, particularly the Two-Year and Five-Year Notes, which hit ten and eight-year highs in yield, respectively. Protectionist tariffs are added fuel to that fire. U.S. import inflation already jumped to 3.5% in February, after dipping close to 1% in 2017.[6] This not only will affect consumers, but the rising interest expense on America's borrowings could turn out to be very significant and very painful.

In our view, the risk-reward ratio for America in any trade war, battle, or skirmish, is ridiculously unattractive. It is the responsibility and obligation of leadership not to delude us with false remedies, but to direct our nation's focus and resources to the root causes of our problems, and the implementation of sustainable solutions.

Please feel free to call or email with questions you may have regarding our strategies or Martin Capital Partners in general. You can also find information on our website at www.martincp.com.

It is a sincere privilege serving those that have entrusted us with their capital.

Respectfully,

Cameron K Martin
Chief Investment Officer
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1. *Brits Boogies*, Martin Capital Partners July 2016 Quarterly Point of View
2. *US to Consider another $100 Billion in New China* Tariffs, Wall Street Journal, 4/5/2018
3. CNBC, 4/6/2018
4. FOMC Press Conference Transcript, Chairman Powell, 3/21/2018
5. *How to Lose a Trade War*, Stephen S. Roach, Project Syndicate, 1/26/2018
6. *The Big Risk of a Trade War: Inflation*, Wall Street Journal, Richard Barley, 4/5/2018

Statistical and analytical data provided by Factset.

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