Quarterly Point of View
Trump, Smoot and Hawley

July 17, 2018

The United States announced on July 10th an additional round of tariffs on $200 billion of imports, aimed again at China. This follows a round of levies on $34 billion of Chinese goods, including machinery and electronics, that were put into effect just after the end of the quarter.[1] The new wave of tariffs, deepening the dispute with Beijing, won't take effect for another two months, allowing for a "comment" period by U.S. industry and presumably, time for China to come to the negotiating table. United States Trade Representative Robert Lighthizer said, "the United States is willing to engage in efforts that could lead to a resolution of our concerns." Officials in both countries, however, said there are currently no negotiations scheduled.

In a statement of response to the announced border taxes, China's Ministry of Commerce called them unacceptable and warned of countermeasures. China had already retaliated on the U.S.'s first wave, with its own tariffs on $34 billion of U.S. aircraft and agricultural products, amongst other items, and said it will match the second round of tariffs dollar for dollar.

For some time now, many market participants and other followers have said this is all just a negotiating tactic of the President, consistent with his standard operating procedure and the ways of doing business he described in his book, *The Art of the Deal*. Unfortunately, that viewpoint could be a bit complacent.

We haven't yet written back to back *Point of View* letters on essentially the same topic, but feel this subject requires more attention. In our last letter we discussed "Comparative Advantage," espoused by economist David Ricardo 200 years ago. The principle states countries benefit when each specializes in products for which they have the greatest relative efficiency, and that both trading partners receive economic benefits by doing so. Since Ricardo promulgated this theory, the world has seen it play out in greater practice, lifting improvements in standards of living globally. We also pointed out that a fixation on an outsized bilateral trade deficit with one country misses broader macroeconomic issues – mainly that as a nation, we are not saving; we are spending and consuming (we do, after-all, have a trade deficit not just with China, but with a total of 101 countries). This is evident in net savings as a percentage of gross national income which has dwindled from 13% a half century ago, to essentially 2% today.[2] We will always have bilateral trade deficits in a scenario where we don't materially save.

There are legitimate concerns regarding open and fair trade, as we also pointed out, but our country would be much better off dealing with these issues through the rules-based global trading entities the U.S. participated greatly in creating. A prime example of this is the Trans-Pacific Partnership, a trade agreement with a group of 12 countries from Asia and the Americas (including the U.S.), that was

established in part to reduce the participating nations' dependence on Chinese trade and bring them in closer alliance with the United Sates. The TPP contained measures to lower barriers for trade, including tariffs, and established a dispute mechanism to settle grievances. The Partnership took over a decade to develop and was signed in 2016. President Trump withdrew the U.S. from the agreement in 2017, seemingly as a symbolic act given his prior assertions on the campaign trail that our country had previously made bad trade deals. This decision has left a vacuum of economic power that China will now fill.

We think a coalition of countries putting pressure on China as a group could be much more effective, and with a lot less at risk. The President seems to be going in the opposite direction lately, directly targeting - and alienating - allies such as Canada and Germany in verbal assaults that indicate they are next in line to receive an enhanced level of tariffs. Last month, initial levies were placed on those countries' products, including steel, aluminum and farm goods. These actions and threats pose the risk of unraveling a post-World War II trading order that has been established through many administrations, over many decades, with many nations.

The Tariff Act of 1930, otherwise known as the Smoot-Hawley Tariff Act, implemented protectionist trade policies put forth by Senator Reed Smoot of Utah and Congressman Willis Hawley of Oregon, and was signed into law in June of 1930. The Act was intended to help American workers at the onset of the Great Depression, raising tariffs to the highest levels in over 100 years, by an average of 59% on 25,000 imports. It instead sparked a devastating trade war in which many countries retaliated. Spain increased tariffs by 150% on American autos, France restricted more than 3,000 goods via quotas and Britain passed its first major tariff legislation in a century.[3] Unemployment in the U.S. was 8% at the time the bill passed, jumping to 16% a year later and 25% by 1933. The United States exported just $1.68 billion worth of goods that year, down from $5.24 billion in 1929[4], while world trade declined more than half. The Act did not cause the Great Depression, but the consensus among historians is that tariffs and other trade barriers significantly contributed to magnifying its effects. Henry Ford, of Ford Motor, at the time called the tariffs "economic stupidity."

Within five years of the Act's passage, 34 nations had imposed exchange controls limiting their citizens' ability to obtain foreign currency for trade, or travel. Exchange controls of that magnitude had not been imposed on a global basis in the previous 400 years.[3] As Thomas Lamont of J.P. Morgan later wrote of Smoot-Hawley, "that Act intensified nationalism all over the world."

Both Smoot and Hawley were voted out of office in 1932 as the public recognized the detrimental impact of the high tariffs. In 1934, the Reciprocal Trade Agreement Act was passed as part of New Deal legislation, with the intent of lowering the levies and marking a departure from the previous protectionist policies. It also contained a major structural reform, in that it transitioned handling of tariff negotiations with individual nations to the President, instead of unilateral rates imposed by Congress. The power shift in negotiating responsibility is certainly evident in today's trade drama.

The point to this discussion is that a constructive knowledge of history, we believe, is a critical attribute of successful investors. Though no two periods of time are identical, an understanding of history provides a very beneficial frame of reference. A trade war is a lose/lose proposition, demonstrated by history. The President may succeed in making China lose a trade war, but the United States will most certainly lose as well.

We would suggest that President Trump and his inner circle study the historical ramifications of these kinds of decisions, but the chances of that happening do seem smaller given that diverse points of view have repeatedly been pushed out of the administration. The biggest example being former White House chief economic advisor, Gary Cohn, who advocated for free-trade until his resignation in March. The thought process on trade policy is looking insular, and behavioral biases (such as groupthink) could be playing an unfortunate role within White House decision-making. Both sides of the aisle seem bewildered at this latest stage of tariffs. Senate Finance Committee Chairman, Orrin Hatch (R-UT), opposed the new tariffs, saying on the day they were announced, "Although I have supported the administrations targeted efforts to combat China's technology transfer regime, tonight's announcement appears reckless and is not a targeted approach." [1]

The current bull market is now well over 9 years old and barring a steep drop within the next several months, could become the single longest in history. Unemployment recently ticked to its lowest levels in half a century. These facts have likely emboldened the President in his hawkish trade stance. This is unfortunate and potentially destabilizing, and though the probabilities of a full-on trade war may still be somewhat small, it's becoming a risk the markets may need to take much more seriously.

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Respectfully,

Cameron K Martin
Chief Investment Officer
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1. *U.S. Unveils Additional Tariffs on $200 Billion More in Chinese Imports*, Wall Street Journal, 7/10/2018
2. *Tariffs & Trade*, Martin Capital Partners April 2018 Quarterly Point of View
3. *Mr. Trump, Meet Smoot and Hawley*, Barron's Magazine, 7/11/2018
4. *Smoot-Hawley Tariff: A Bad Law, Badly Timed*, Barron's Magazine, 7/12/2018

Statistical and analytical data provided by Factset.

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