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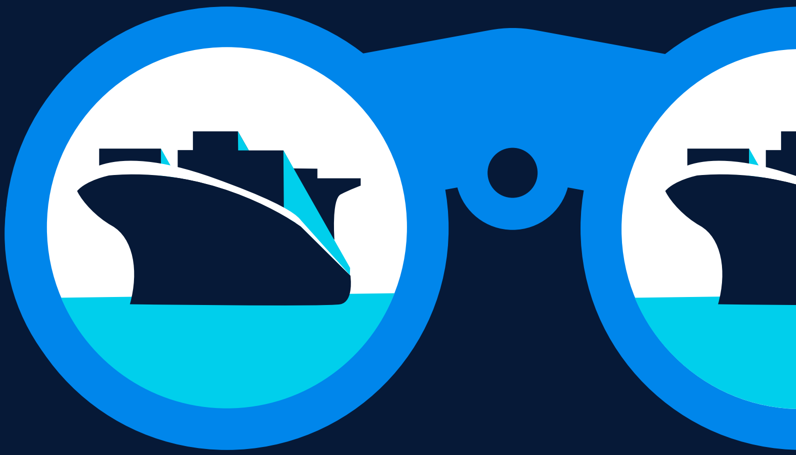

Trump's tariffs: More bite than bark?

Key Insights

- Market reaction to Donald Trump's tariff announcements indicates a general view that the measures will have little long-term impact, but this may be mistaken.
- While the tariff announcements may partly be a negotiating tactic, they could aim to raise revenues and reduce the U.S.'s trade deficit.
- The impact on asset prices is likely to be more significant and long lasting than markets are pricing in.

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Markets appear to be underpricing the possibility of a protracted trade war. If you blinked, you may have missed its reaction to Donald Trump's announcement of tariffs against the U.S.'s neighbors, Canada and Mexico: The cold chill that followed the Friday, January 31, announcement had turned into a warm front by the following Monday as tariffs were delayed and market losses quickly reversed. So is Trump somebody who will take a sledgehammer to crack a nut or a misunderstood, deceptively pragmatic president who simply loves a deal? Tariff man has come out swinging.

Understanding tariff objectives

A framework for thinking about the staying power—and hence the asset price impact—of tariffs is to consider their three main goals: first, to strengthen your negotiating position—go in hard and then cede some ground once the other side gives you something (or claim victory if they don't give you much); second, to raise revenues—applying a universal tariff at the so-called optimal rate that maximizes revenues offsets the deadweight loss that consumers endure through higher prices and the loss of trade (as tariffs are a tax, think of this as the equivalent to the Laffer curve[1]); and third, to restructure trade balances by forcing manufacturing to relocate.

> “Tariff man has come out swinging.

[1] The Laffer curve is a curve depicting the relationship between tax rates and revenue. It assumes that there is a tax rate between 0% and 100% at which government tax revenue is maximized.

On the policy spectrum, the first goal is a means to an end, while the latter two tend toward ends in themselves. On the spectrum of market outcomes, the latter are more protracted and therefore the effect on asset prices more pernicious. The market's phlegmatic response to Trump's tariffs suggests it regards them as primarily a means of extracting political concessions and therefore cursory in nature. I'm not so sure.

Economic implications

One of the first-order economic effects of tariffs is to distort the relative price of goods as demand switches from good A to good B (as with any other tax hike, new tariffs are a demand shock). Another—despite the Trump administration's stated aim of a weaker dollar—is to appreciate the home currency. The impact on inflation and rates is more ambiguous: By definition, inflation is a persistent increase in pace at which prices are adjusted—a tariff is a one-off increase in price level assuming no change to inflation expectations.

The second-order effects of Trump's tariffs are anybody's guess, depending on responses from the U.S.'s trading partners. Retaliatory measures, including potential capital nationalism and delayed capital expenditure as confusion reigns over supply chains, are all potential adverse outcomes.

Weighing market responses

Risk assets hate uncertainty, but equity market conditioning is still to buy the dips. The stock market tends to act as a brake that prevents tariffs from becoming a permanent fixture. Here, we face a paradox: President Trump will not abandon his fondness for tariffs unless the stock market falls significantly, but the market will not fall significantly while investors believe a major trade war will be avoided.

I suspect this delicate equilibrium will not last.

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