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MACROCOSM

Tariffs: How Scared Should We Be?

Friday, March 2, 2018

Donald Luskin

A correction without a cause now has one: Trump the protectionist takes the stage.

We said from the day after the 2016 presidential election that the big economic risks with Donald J. Trump were (1) protectionism and (2) selecting a poor Fed chair (see "Our Hot Take on the Trump Upset" November 9, 2016). *We got through the whole first year with nothing but wins – lots of deregulation and a large corporate tax cut. But now, suddenly, both those risks have come home to roost.* In Jerome Powell, we have an inarticulate dilettante running the Fed (see "On Jerome Powell's Testimony" February 27, 2018). And now we have large tariffs being imposed on US imports of steel and aluminum. Maybe the early February mini-crash was cause-free (see "Crash Without a Cause?" February 6, 2018). But the stock market correction of which it was a part now definitely has a cause – two causes, actually. *There's a lot of uncertainty here that is going to have to get processed, prolonging the correction.*

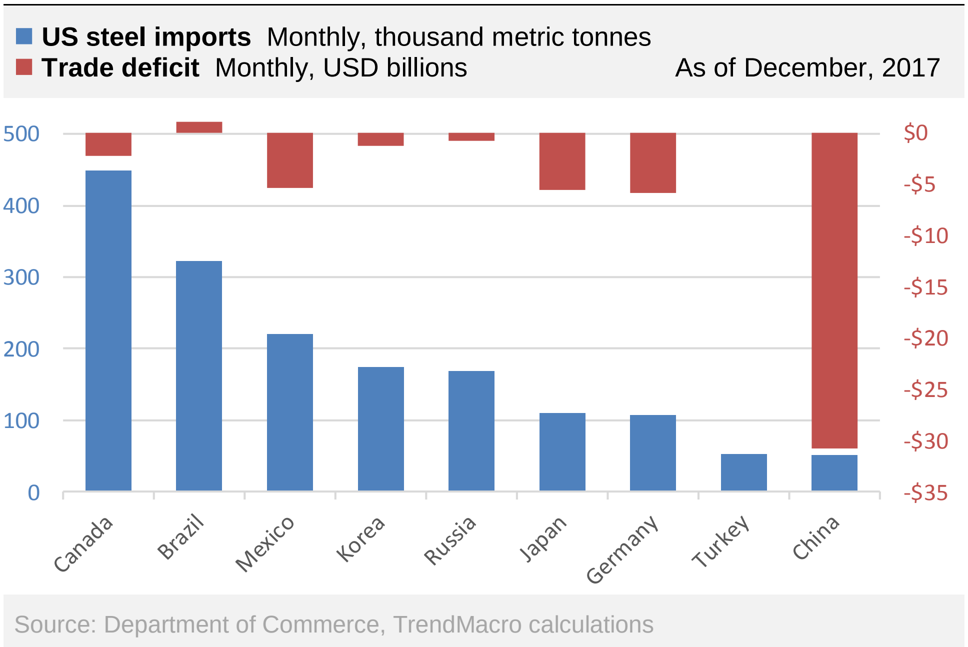
- Let us say at the outset that it is axiomatic that tariffs are taxes that suck wealth out of the private economy, and that restraints on free trade diminish economic efficiency, expand government control over the private economy, create opportunities for corruption and rent-seeking, and can lead to a beggar-thy-neighbor race-to-the-bottom vicious cycle of retaliation. *This news scares us. Seriously. We respect the risks here.*
- But let's let this play out a bit before we completely panic, or fall prey to the confirmation bias by which many investors may let themselves be fooled: "See, I told you Trump would be a disaster." This certainly appears to be Trump's first big economic policy mistake. And its suddenness has re-awakened, with a vengeance, the media narrative about "chaos in the White House."
- *Trump's economic record has been excellent, and we draw assurance from that. But the very fact that this is his first big mistake requires markets to let him know he's making it – which is one reason we think this has to prolong the present stock market correction. Considering that Trump has bragged so often about the rising stock market, presumably he would listen when it sends him a message.*

- But the reality is we have no details on this yet, and keeping the details hanging is very possibly part of Trump's intention. Yesterday's announcement consisted of a pre-market tweet and

Update to strategic view

US MACRO, US STOCKS, US FED: The news that Trump will announce tariffs next week on steel and aluminum creates large uncertainties that will prolong the present equity markets correction, compounding skepticism about our new dilettante Fed chair. We have respect for the very real risks here. We don't know the details of the tariffs yet, and they might be significantly watered down next week. At worst, the total tax bill is only about $8 billion per year. Retaliation is possible, but counterparties are not in a strong position to carry it out. Trump is constrained by WTO, by powerful vested interests, and by broader US interests – which explains why there have been no protectionist moves till now – so it's not clear that this is the opening shot in a trade war.

[Strategy dashboard]



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[About us]

some improvised mid-day remarks at a White House meeting with metals industry executives.

- At worst, with the steel and aluminum tariffs we're talking about a tax of less than $8 billion per year, and it's not at all clear where the incidence of the burden of it will fall. To be sure, that's not good. Call it taking back about 5% of the December tax cuts.
- But now comes a feverish week of deal-making, which is sure to blunt it to some extent, hopefully revealing it as the classic "big ask" gambit in the art of the deal, designed to wring concessions out of counterparties. The negotiations will overlap with the ongoing NAFTA wrangling, as Canada and Mexico are the number one and number three exporters of steel to the US, respectively (please see the chart above).

- This morning's Trump tweet on trade would seem to point in this direction, especially if you believe he is consciously pursuing the Nixonian "madman theory" of game-theoretic negotiation. It has "fire and fury" written all over it (see "Thoughts on North Korea, Fire And Fury Edition" August 11, 2017).
- The loose talk about a "trade war" – which, to be sure, Trump is deliberately enflaming this morning – reminds us of the hysteria in the wake of the Brexit referendum. Sabers are already rattling about retaliation, but our counterparties are not in a powerful position – all top steel exporters but Brazil run trade surpluses with the US (again, please see the chart above). And the standard logic of free trade, which argues that tariffs are always a mistake, also argues that retaliating is a mistake.
- Finally, while the president has a lot of powers over trade conferred by the Trade Expansion Act of 1962 (the ironically-named statute used in the case of the steel and aluminum tariffs), the Trading

With the Enemy Act of 1917 or the International Emergency Economic Powers Act 1977, he is still ultimately constrained by the US's membership in the World Trade Organization. More important, the president is constrained by powerful vested interests, and by broader US interests. These explain why Trump, who campaigned as a rabid protectionist, has done nothing until now, even passing up two chances to have the Treasury secretary declare China a currency manipulator (thus twice breaking an explicit campaign promise). And as we have seen in the domain of border control, seemingly absolute executive authority can be significantly thwarted by the courts. So as shocking as yesterday's news may have been, there are limits on how fast and how far it can go.

- Not all historical examples of protectionism have been bad. No, we're not about to try to be open-minded about the 1930 Smoot-Hawley Act. But it's pretty evident to us that the 1985 Plaza Accord was quite successful.
- *We're aware that we probably sound like apologists. But it makes sense to at least consider something other than the orthodoxy that you're hearing everywhere else today, which treats free trade as an unalloyed good at all times and all places, with near-religious conviction, against which any deviation is a dangerous heresy.*
- The orthodoxy of free trade is surely correct in the main. But the real world is not a neat and tidy as a seductive text-book explanation of the principle of comparative advantage. There are very important qualifications and exceptions that are not often mentioned or understood – the most salient being the case when there are very different labor costs between counterparties. Anyone who seriously wants to critically examine the orthodoxy should read Paul Samuelson's 2004 paper, "Where Ricardo and Mill Rebut and Confirm Arguments of Mainstream Economists Supporting Globalization." Samuelson argues powerfully that while gains from trade increase global output per the standard model, they may well reduce *per capita* real income in some counterparties.
- Gains from trade can be far from mutual when one side engages in subsidies of its exporters, or erects import barriers. How is adaptation and equilibrium possible under such conditions? Surely it makes sense for the counterparty getting the short end of the stick to renegotiate.
- A purely practical – but enormously consequential – problem is the issue of transition, as economies move from less-free trade to more-free trade. No adaptation to a new equilibrium can be achieved if the shock is rapid and large enough, as evidently it has been for many OECD nations over the last two decades of warp-speed globalization. The work of David Autor and colleagues has documented the deep and enduring US regional effects of trade shocks. Surely it makes sense for industries – or whole nations – adversely affected to try to tap the brakes on globalization.
- None of that is to say that taxing domestic steel and aluminum consumers with a tariff, to create competitive advantages for domestic steel producers, is itself a good idea. It's probably not. But it's useful amidst all this volatility to have a more nuanced view.

Bottom line

The news that Trump will announce tariffs next week on steel and aluminum creates large uncertainties that will prolong the present equity markets correction, compounding skepticism about our new dilettante Fed chair. We have respect for the very real risks here. We don't know the details of the tariffs yet, and they might be significantly watered down next week. At worst, the total tax bill is only about $8 billion per year. Retaliation is possible, but counterparties are not in a strong position to carry it out. Trump is constrained by WTO, by powerful vested interests, and by broader US interests – which explains why there have been no protectionist moves till now – so it's not clear that this is the opening shot in a trade war.