Of Tariffs and Treaties

For almost 1-1/2 years, President Trump's tariff initiative has confused and roiled the markets. The following discussion examines why markets have been volatile and makes some predictions about future market reactions.

In our first white paper after the 2016 election -- *How Will Trump's Policies Affect Taxes, Investments, and the Markets?* -- we cautioned that President Trump's populist views could lead him to impose tariffs on imported goods. In March 2018, that prediction came true, as Trump imposed the first of what became a series of tariffs on U.S. imports, particularly imports from China.

Tariffs are taxes. They raise the effective price of imports, making prices charged by domestic manufacturers comparatively low and thus more attractive. The power to impose tariffs lies with Congress. But Congress long ago delegated that authority to the president in cases of national emergency or to protect national security.

Trump is employing tariffs in large part to force our trading partners, particularly China, to negotiate new trade treaties more favorable to the U.S. This process has confused the markets and caused volatility.

Generally speaking, the markets dislike tariffs because they can impair economic growth. Tariffs lead to higher prices and fewer U.S. exports, as our trading partners reduce their purchases of U.S. products or impose their own tariffs on U.S.-produced goods. For instance, China's refusal to buy U.S.-produced soybeans has caused significant damage to the farming sector.

Although markets dislike tariffs, they view trade agreements favorably. Trade agreements, particularly agreements favorable to the U.S., facilitate the efficient worldwide movement of U.S. goods and services, boosting economic performance. Vacillation between the two potential outcomes causes volatility, as the markets react to which result -- higher tariffs or new trade agreements -- appears ascendant at the time.

President Trump and President Xi's agreement to reopen trade talks caused a sigh of relief and a market rally. But their handshake only restored the status quo. The risk remains that negotiations fall apart and Trump increases tariffs further. If the lack of progress becomes apparent -- or if businesses report lower earnings due to tariff-induced cost increases -- a market pullback may follow.

Complicating matters further, as we have seen, a lack of progress or lower earnings may prompt the Fed to continue to lower interest rates -- turning a negative situation into a positive one.

For now, we recommend that investors view the China trade negotiations with a wary eye.

On a related front, Congress is considering whether to replace NAFTA with the new North American trade treaty negotiated by the administrations of the U.S., Canada, and Mexico (the USMCA). Democrats are concerned that the new treaty offers insufficient protection for U.S. workers. Generally speaking, the treaty requires manufacturers in the three countries to pay workers the same minimum wage. Because Mexican workers would receive the same pay as their U.S. counterparts, U.S. companies would have less incentive to outsource production to Mexico, thereby protecting U.S. jobs. But, in the Democrats' view, the treaty does not enforce these rules by, for instance, imposing penalties on non-compliant Mexican manufactures.

The administration is trying to rework the treaty to meet the Democrats' concern. At this point Congressional approval of the USMCA looks doubtful, a result the markets appear to have taken into account. But if negotiations move forward and Congressional ratification becomes more likely, a positive market reaction could follow.

Andrew H. Friedman is the founder and principal of The Washington Update, LLC and a former senior partner in a Washington, D.C. law firm. He and his colleague Jeff Bush speak regularly on legislative and regulatory developments and trends affecting investment, insurance, and retirement products. They may be reached at www.TheWashingtonUpdate.com.