TRANSITIONS

THE IMPACT OF TARIFFS WITH CHINA

The economic wisdom of implementing tariffs in a global economy is fleeting. An advisor to another U.S. President expressed the viewpoint that there should be two requirements met before anyone became an economic advisor. First, they ought to have taken a basic economic course; second, they ought to have passed it.

My Georgetown University business education incorporated an economics minor, so I know firsthand that the study of international economics can be obtuse. In an open market free economy, free trade permits full advantage of international specialization. However, China has not evolved from Chairman Mao's communist state-run economy into the open market free economy that we experience in the United States. One thing China does well is stealing intellectual property across all industries. An outcome is many businesses find themselves competing with a Chinese knockoff product that often does not meet exacting product standards that include consumer safety.

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The imposition of tariffs is designed to change the way China does business in terms of their grand theft of intellectual property, forced technology transfers, and access to Chinese markets. By design, China made it difficult to export products into their country. Their imports of goods and services from the U.S. were $179 billion in 2018, which is less than 1% of the U.S. GDP. Meanwhile, in 2018 China enjoyed the economic benefits of exporting $1.6 trillion of goods and services to the U.S., which is near 18% of China's GDP.

The United States imposed a 25% tariff on $200 billion of Chinese imports. China's retaliatory tariffs are on $60 billion of U.S. imports. China's problem is they have built an economy that brought workers into cities to work in factories. Their leaders cannot afford the instability and social unrest of hundreds of millions of people out of work.

In the United States, the tariff costs ultimately are passed on to the consumer, which can result in a decline in consumption. Being a consumer-based economy, this may bring on a mild recession. Yet, it is important to

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note that a tariff on certain components within a finished product does not conclude that the cost of the product we buy as consumers has to increase. The main impact to businesses is the supply chain disruption, as they will have to locate goods not made in China to complete their finished products. With ongoing tariffs, there will be a push to manufacture goods in lower cost, economically depressed areas of the United States.

A clear outcome of these tariffs is turbulence across all markets. The stock markets will be volatile, and while ongoing tariffs may trigger a needed correction, it is important to remember commerce continues and businesses will thrive regardless of the headline news.

What I find fascinating is the bond market reaction. Six months ago, the ten-year Treasury bonds were yielding 3.2%. Today they yield around 2.2%. This means investors are willing to accept 30% less of a return on this benchmark bond than they did just a few months ago. Part of this is a predictable, temporary, flight to quality into treasury bonds. Another part of this are supply issues where the Federal Reserve still owns a lot of treasury bonds that normally would be in circulation. Whatever the reasons, the result is an inverted yield curve where the shorter-term bonds yield a higher return than ten-year bonds. Although this can point to a future recession, we are mindful that a settlement of the issues behind the tariffs may correct this yield curve distortion, rendering any yield curve conclusion meaningless.

There is a lot at stake for both China and the United States in this tariff war. We reached a point where something had to happen to bring world trade into a more equitable process. With tariffs imposed, either both countries negotiate towards an imperfect trade deal that rectifies the grievances of doing business with China, or the United States economy adjusts to higher costs of some raw materials and forges ahead. With our long-term view, we stay the course.

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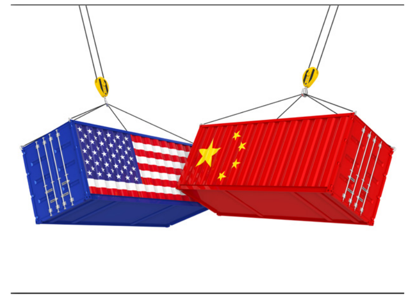

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