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Understanding the Impact of Tariffs: Economic, Social, and Market Implications

Dear clients and friends:

We hope you had a pleasant Thanksgiving holiday and that this newsletter finds you well. As we reflect on the recent election results and the emerging policy agenda of the incoming Trump administration, tariffs have become a focal point of concern for investors. What do President-elect Trump's proposed tariff policies mean for the markets and the broader economy? In this edition, we explore the potential implications of these policies across various market sectors, provide historical context, and assess the potential social and economic consequences.

In a post on Truth Social on December 2, President-elect Trump outlined plans to implement significant tariffs on Mexico, Canada, and China on his first day in office. He described these tariffs as part of a broader strategy to address illegal immigration and drug trafficking. Under the proposal, all imports from Mexico and Canada would be subject to a 25% tariff, while China would face an additional 10% levy on top of existing tariffs.

Following the announcement, the U.S. dollar strengthened, while stock markets showed mixed reactions. Throughout his campaign, Trump suggested further measures, including a 60% tariff on certain Chinese goods and a blanket 10% tariff on all imports to the U.S. He argued that these tariffs would bolster domestic manufacturing and generate revenue to support government spending in other areas.

At first glance, this may seem overwhelming. To begin, let's define what a tariff is: tariffs are taxes imposed on goods as they cross international borders. They play a pivotal role in trade policy, serving two main purposes: protecting domestic industries from foreign competition and generating government revenue. By making imported goods more expensive, tariffs can encourage consumers to choose domestically produced alternatives. However, they also have the potential to increase consumer prices and disrupt supply chains. Additionally, the impact of tariffs varies across industries and sectors. Below, we examine those most and least affected.

Industries Most Affected by Tariffs

Manufacturing

Manufacturing is particularly vulnerable to tariffs, especially for those that rely on imported components. Sectors like automotive, heavy machinery, and consumer electronics, which are deeply integrated into global supply chains, face significant challenges. In many cases, the increased costs of these imports are passed on to consumers through higher prices, as seen with materials like aluminum and steel.

Agriculture

The agricultural sector is also heavily impacted, especially by tariffs imposed on U.S. exports such as soybeans, dairy, and pork. Retaliatory tariffs by major trade partners like China, a leading consumer of these products, have significantly reduced demand, creating economic strain for producers.

Least Affected Industries

Tech and Software: Emphasis on Digital Products

The technology and software industry, with its heavy reliance on digital products and services, has largely been shielded from the direct effects of tariffs. Digital offerings such as software, cloud services, and online platforms typically fall outside the scope of traditional tariff regulations. However, areas of the tech sector dependent on physical components — such as hardware manufacturing, semiconductor production, and electronics — are more exposed. For example, companies producing smartphones, laptops, and networking equipment often rely on parts sourced globally, leaving them vulnerable to tariffs on imports like chips and screens.

In contrast, businesses centered on software and cloud infrastructure, such as Google and Microsoft, are less affected by tariffs on physical goods. That said, they could still face challenges from broader trade restrictions, including data localization laws or digital service taxes, which could indirectly impact their operations.

Healthcare and Pharmaceuticals

The healthcare and pharmaceutical industries are largely insulated from the effects of tariffs. Many of their products and supplies are domestically manufactured or exempt from tariffs due to their critical importance. Additionally, existing trade agreements often provide protections that minimize the impact of tariffs on this sector.

Retail and E-Commerce: Mixed Impacts

The retail industry faces mixed impacts from tariffs. Retailers relying on imported goods such as clothing, electronics, and consumer products have encountered higher costs due to increased tariffs. However, the rise of e-commerce and digital shopping platforms has enabled many businesses to mitigate these challenges by diversifying their supply chains, sourcing products from non-tariffed regions, or shifting production to countries outside the scope of U.S. tariffs.

Historical Perspective: The Economic Impact of Tariffs

While tariffs can have varying effects across sectors, examining their historical impact provides valuable context. Between 2002 and 2018, tariffs have often yielded mixed or negative economic results, highlighting the complexities of such trade policies.

Historical analysis underscores that while tariffs aim to protect specific industries, their broader economic impacts often include unintended consequences, such as increased costs for consumers and strained international trade relationships.

U.S. Steel Tariffs of 2002

In March 2002, President George W. Bush imposed tariffs on selected steel products in an effort to protect the U.S. steel industry. However, the policy had unintended consequences. Key trading partners responded with threats of retaliation against American goods, and the broader economic impact was unfavorable. More jobs were lost than saved, as industries reliant on steel faced higher costs. Former U.S. Senator Lamar Alexander (R-Tenn.) noted, “We found there were 10 times as many people in steel-using industries as there were in steel-producing industries. They lost more jobs than exist in the steel industry.”

U.S. Tire Tariffs of 2009

In September 2009, President Barack Obama implemented a 35% tariff on Chinese tire imports. The results were mixed: while the tariff saved approximately 1,200 jobs in the domestic tire industry, it cost U.S. consumers an additional $1.1 billion in higher prices. This decrease in consumer purchasing power led to reduced spending on other goods, indirectly lowering employment in the retail sector. Although the tariff aimed to revitalize the U.S. tire industry, it also brought unintended economic consequences.

U.S. Tariffs of 2018

In 2018, President Donald Trump imposed tariffs on solar panels, steel, aluminum, and washing machines to protect the U.S. manufacturing base. However, the effectiveness of these tariffs remains a subject of debate, according to Sina Golara, a professor at Georgia State University. The 2018 tariffs increased costs by $51 billion per year, a burden carried primarily by U.S. companies and consumers. In addition to hurting firms in the protected industries, retaliatory Chinese counter-tariffs also hurt non-protected U.S. firms, particularly those in the agricultural industry.

Impact on the Market and the Economy

Based on a review of various research papers and articles, tariffs present both advantages and disadvantages. The potential benefits are often linked to long-term social gains, such as encouraging domestic production and fostering confidence in "American Made" products, which may also yield economic benefits. However, the immediate negative consequences tend to be economically driven, including a decline in domestic output and productivity, higher unemployment in specific sectors, and a stronger dollar. If not managed effectively, these challenges could also result in long-term social drawbacks.

The Potential Positives of Tariffs

Revenue Generation/Reducing trade deficit: Implementing tariffs could significantly boost federal revenue and reduce trade deficit. Estimates suggest that a 10% universal tariff could generate approximately $2 trillion from 2025 through 2034. Specifically, tariffs on Canada, Mexico, and China could yield nearly $300 billion annually. Together, these three countries account for 43% of U.S. imports: Mexico (15.4%), Canada (13.6%), and China (13.9%).

Year	U.S.-China Trade Deficit (USD Billion)
2018	$418 Billion
2019	$345 Billion (17% reduction)

Source: U.S. Census Bureau

Encouraging Domestic Production: By increasing the cost of imported goods, tariffs may incentivize both consumers and businesses to opt for domestically produced alternatives, potentially revitalizing U.S. manufacturing sectors and fostering job creation. A stronger manufacturing base also drives innovation and technological advancement.

Trade Negotiation Leverage: Sometimes tariffs can serve as a strategic leverage point in trade negotiations, as put forth by the incoming Trump administration, pressuring trade partners to address U.S. concerns such as illegal immigration and drug trafficking, ultimately strengthening national security.

Supply Chain Diversification: Tariffs may encourage businesses to diversify their supply chains, reducing reliance on specific foreign markets and enhancing overall economic resilience. This diversification can also mitigate risks associated with over-dependence on particular countries.

Non-Economic, Long-Term Benefits: Beyond their immediate economic effects, tariffs can help mitigate the long-term consequences of offshoring manufacturing. By incentivizing domestic production, tariffs can strengthen national security by ensuring resilient supply chains and sustaining the defense-industrial base. Moreover, a thriving manufacturing sector plays a key role in fostering sustained economic growth. As Ricardo Hausmann, director of the Growth Lab at Harvard, aptly stated, “Countries grow based on the knowledge of making things. It’s not years of schooling. It’s what the products that you know how to make are.”

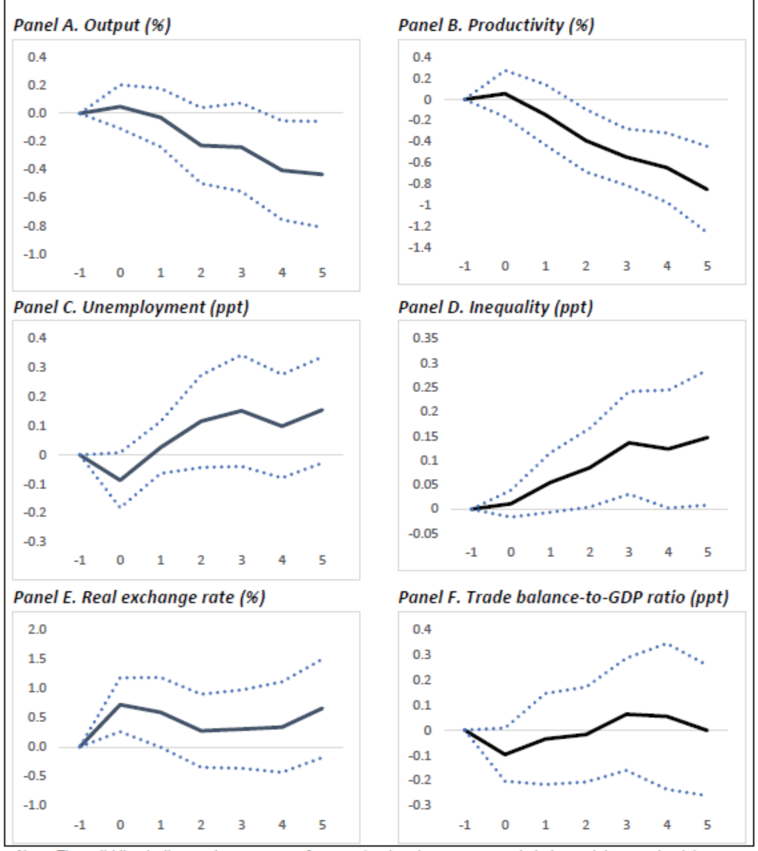
The Potential Negatives of Tariffs

A comprehensive study by the IMF on the macroeconomic consequences of tariffs across various industries reveals several important findings that align with our expectations:

- In the medium term, tariff increases result in a significant decline in domestic output and productivity, both economically and statistically.
- Tariffs contribute to higher unemployment, increased inequality, and a real exchange rate appreciation (a stronger dollar).
- There is a minimal impact on the trade balance.
- The effects on output and productivity are particularly pronounced when tariffs are imposed during periods of economic expansion in advanced economies.

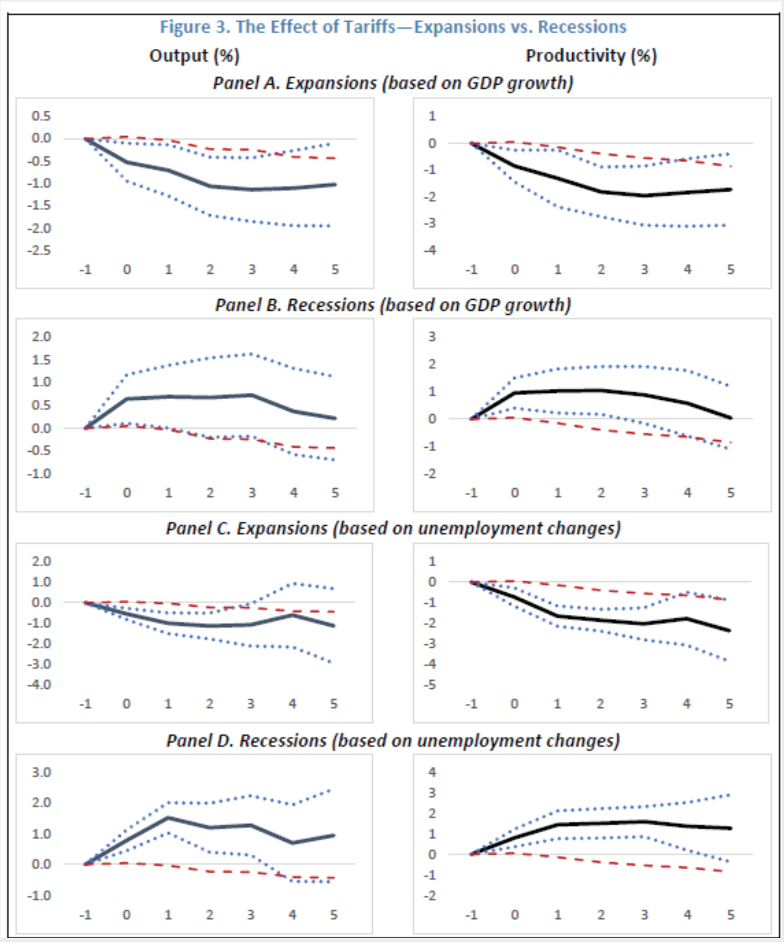
Below are the supporting graphs that illustrate these findings.

Figure 1. The Effect of Tariffs



Note: The solid line indicates the response of output (real exchange rate, trade balance, labor productivity, unemployment, inequality) to a one standard deviation increase in tariff; the dotted lines correspond to 90% confidence bands. The x-axis denotes time. t=0 is the year of the change. The estimates are based on equation (1)

[IMF Working Papers Volume 2019 Issue 009: Macroeconomic Consequences of Tariffs (2019)]



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In summary, much remains uncertain about Trump's proposed tariff policy 2.0, and it is unclear whether it will be used primarily as a negotiation tool or actually implemented. While the immediate economic effects may be mixed and potentially negative in the short term, the revival of the "American Made" concept could benefit domestic manufacturers and provide long-term social advantages. This, in turn, may boost public confidence and stimulate economic activity.

We hope you found this newsletter educational, and as always, feel free to reach out if you have any questions or need further clarification.

Sources:

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