Mitch on the Markets

The Perils of a Trade War

By Mitch Zacks
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Trade has been in the spotlight lately, but not necessarily in a good way. NAFTA negotiations remain tense, and rhetoric suggests the U.S. could potentially walk away from the agreement. Over the last month, a 30% tariff landed on solar panels imported from China and a 20% tariff was slapped washing machines from South Korea. Before that, tariffs were aimed at Canadian lumber. Many market participants wonder what's next.

The idea behind tariffs is a noble one – if you make imports from other countries more expensive, manufacturing and jobs will shift back to the U.S., which is a win for the economy… right?

If only it were that simple.

The Winners and Losers of Tariffs and Trade

In the case of solar panels, for instance, we believe it's important to note that most American jobs related to solar panels involve *installation*, not manufacturing. So, while a tariff may give a small boost to manufacturing jobs in the solar panel industry, installation and maintenance jobs may be lost in the process. On net, the tariff may actually hurt more people more than it helps.

For washing machines, a slight bump in manufacturing jobs here in the U.S. is welcomed, but it could be accompanied by higher prices for domestic consumers. More money spent on washing machines means less discretionary cash to spend elsewhere in the economy.

You get the idea here – there are winners and losers when it comes to trade and tariffs. But, in my view, there are more winners at the end of the day when trade is freer. I believe that when a government issues a tariff, it is meddling in the free market, essentially designating who the winners and losers are. When trade barriers fall and tariffs disappear, companies may be able to benefit from efficient supply chains, more production volume, and much broader end markets (more customers). But most importantly, the American consumer can potentially reap the benefits of *cheaper goods and more choices*. And with roughly two-thirds of U.S. economy comprised of consumer spending, in my view, it's a benefit that is vital to growth.

The refrain against free trade is that millions of jobs are lost overseas to cheap labor – a valid point. But, what I believe is missing from that refrain is the number of jobs gained in the process when a company scales up and sells more. One trade metric that gets little attention – but which could be important for understanding the U.S.'s role in global trade – is the "Trade in Value-Added (TiVA)" statistic, produced by the WTO and the OECD. In their words, TiVA is "*the value added by each country in the production of goods and services that are consumed worldwide*." In other words, TiVA defines a countries' role in the global production of goods.

A look at some of the findings may surprise you:

- The United States adds more value to China's exports than China does to ours;
- Foreign countries add about 15% of value to our total exports, with the rest coming from domestic production
- While most people see China as "making everything," they actually source over 30% of the value of their production from other countries
- Even Mexico relies on foreign value adds more than the U.S. does

Bottom Line for Investors

In my view, raising tariffs and/or nixing free trade agreements can easily result in a protectionism backlash, which could mean higher input costs, tighter profit margins, and higher prices for goods and services. I see all of those outcomes as negative, and believe a trade war would be bad for the economy and bearish for stocks. For investors, a key risk to watch in 2018 will be how far tariffs go and whether free trade deals survive. My guess: the tough talk on trade is more bark than bite.

About Mitch Zacks

Mitch is a Portfolio Manager at Zacks Investment Management. Mitch has been featured in various business media including the Chicago Tribune and CNBC. He wrote a weekly column for the Chicago Sun-Times and has published two books on quantitative investment strategies. He has a B.A. in Economics from Yale University and an M.B.A in Analytic Finance from the University of Chicago.

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