Zacks Investment Management

Mitch on the Markets

Latest Tariff Threats Could Lead to Recession

By Mitch Zacks
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The global stock market had a challenging May, and news last week that the Trump Administration was planning fresh tariffs on Mexico didn't help. The plan: Impose a 5% tariff on all Mexican imports starting June 10 and ratchet up the tariffs by 5% each month until reaching 25% by October.[1]

I'm an avid believer in the resiliency of the U.S. economy, with all of our diversity of production and diversity of goods and services. But 25% tariffs on *all* Mexican imports, in my view, might be enough to hamper growth down to zero. If we got to 25%, Zacks Investment Management would strongly re-assess the likelihood of a recession in the next six months, which as of today we continue to believe is relatively low.

25% tariffs on Mexico and China would amount to a full-on trade war, in my view, and it's difficult to assess what exactly that would mean in terms of effect on the U.S. economy. The U.S. hasn't been in a full-on trade war since the 1930's, and our economy is much different today than it was then.

The 1973 Arab oil embargo may offer some clues, given the parallels we may end up seeing in terms of supply disruptions[2] – since China and Mexico provide a great deal of the raw materials and low skilled labor needed to produce goods. The cost of producing goods would rise, cutting into margins and essentially forcing businesses to raise prices. Higher prices would mean hitting consumer spending and consumer confidence, and perhaps even purchasing power with higher inflation. This chain reaction could weigh on growth in the short to medium term, in my view.

The United States imported $346.5 billion of Mexican goods last year, which napkin math tells us amounts to over $86 billion of tariffs at the 25% rate.[3] The tug-of-war between Mexican producers needing to lower prices and U.S. corporations needing to pass on higher costs to consumers would eventually make its way into higher end prices at the register, in my opinion.

By some estimates, the current U.S. tariffs on steel, aluminum, solar panels, washing machines, and on China at-large amount to around a $200 billion annual hit on GDP, and 25% tariffs on Mexico by this fall could add another $86 billion (by my estimate above).[3] Those numbers start to drift into flat growth territory, and they also don't yet account for retaliatory actions.

In a sign of the market's disdain for the newly proposed tariffs, automakers got pummeled on the news, with shares of Mazda Motor, Honda Motor, and Toyota Motor all falling at least 2% on the news.[3] Mazda assembles passenger cars in Mexico for sale in the U.S. market.

The agricultural sector also appears nervous about the prospect of higher tariffs. The sector has been under pressure over the last year due to unfavorable weather patterns and volatile price swings for crops largely driven by trade disputes. According to the American Farm Bureau Federation, American farmers had largely been holding out hope that the new trade deal between the U.S. and Mexico, dubbed the USMCA, would bring certainty and stability to crop prices. But a new trade dispute with Mexico could place the deal's ratification in jeopardy – or at least on hold.[4]

Where the Tariff Issue Stands Now, and What to Watch For

For Mexico's part, the Economy Minister Graciela Márquez and other officials appear intent on reaching a deal to avoid tariffs, but have also said the Mexican government could take the issue to the World Trade Organization or impose retaliatory tariffs themselves, as China did. Market-watchers should pay close attention to these talks this week, as President Trump has said that tariffs would likely be implemented next week even if talks are ongoing, unless a major breakthrough is reached.

Bottom Line for Investors

To date, the Trump administration has had a mixed track record following through on tariff threats. Some, like steel and aluminum levies and tariffs on China, have been implemented and remain in effect to this day. Others, like auto tariffs and tariffs on the European Union have been floated but not acted upon, used instead as a negotiating tactic. Here's to hoping tariffs on Mexican imports fall into the latter category.

Either way, I suggest investors hope for the best but prepare for the worst, and that means ensuring your portfolio can ride-out any potential economic slow-down, which is what we aim to do for our clients.

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.

[1] The Wall Street Journal, May 30, 2019. https://www.wsj.com/articles/trump-threatens-5-tariff-on-mexican-imports-beginning-june-10-11559260679?mod=article_inline

[2] The Wall Street Journal, June 5, 2019. https://www.wsj.com/articles/as-tariffs-bite-get-ready-for-a-1970s-style-supply-shock-11559734362

[3] The Wall Street Journal, May 30, 2019. https://www.wsj.com/articles/trump-threatens-5-tariff-on-mexican-imports-beginning-june-10-11559260679?mod=article_inline

[4] The Wall Street Journal, May 31, 2019. https://www.wsj.com/articles/u-s-farmers-see-more-trouble-in-fresh-mexico-tariff-threat-11559319022