WILLIS INVESTMENT COUNSEL
principled investing

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> *"The question is simply whether you prefer to conserve the home market and protect American wage earners or let the products of low-paid foreign labor destroy the home market for the American producer."* Congressman Fish addressing Congress in 1929 on tariff legislation.

TARIFFS COULD BE A DRIVING FORCE OVER THE NEXT FEW YEARS

President-elect Trump made tariffs a centerpiece of his campaign. During his first term, he significantly increased tariffs. Recently, he has said that on his first day in office he will further increase tariffs on imports from Mexico and Canada up to 25%, and add an additional 10% for imports from China. Countries and companies are already reacting to the risk of increased tariffs. This memo will explain tariffs, discuss how we think about the possible impact of tariffs on our companies, and point out how tariffs have been part of U.S. economic history since the late 1700s. From 1790 to 1860, tariffs comprised approximately 90% of federal revenue. The opening quote from Congressman Fish reminds us the perceived need for "protective tariffs" has been part of the political economy for decades. The current political sentiment is not new. Later in this memo, we will recount some history showing how the country's views of international trade and tariffs have ebbed and flowed over many decades.

TRUMP'S EMBODIMENT OF TARIFFS

One can look at the tariff decisions Trump made, and that were enacted, during his first term for clues about where *he* is headed. As president, *he* has substantial Executive Branch power to essentially direct tariff policy.[1] During the campaign, Trump indicated he intends to use tariffs as a means to address:

- Immigration
- Drug traffic into the U.S.
- The trade deficit
- Unfair trade practices of selected countries
- Offshoring of American manufacturing (to protect manufacturing jobs)

[1] While maybe not technically correct as to the full legislative process, the president has significant influence.

Tariffs are essentially a tax (or think in terms of an *entrance fee)* on goods coming into the U.S. from a foreign country. This tax/entrance fee is paid by the U.S. company that has purchased goods from a foreign company. The U.S. Customs and Border Protection Department – on behalf of the U.S. Treasury – maintains operations at U.S. ports and collects the tax. For example:[2]

- Walmart buys TVs from a Chinese company for $500 each
- Those TVs travel from China to Savannah on a cargo ship
- They arrive on a Savannah dock and are logged in/evaluated by U.S. Customs and Border Protection agents
- Based on their $500 value, a tax is collected before they are loaded on Walmart trucks or shipped to distribution centers via rail or other means
- If the tariff tax is 20%, a $100 entrance fee/tax is collected from Walmart
- This $100 tax is an additional cost to Walmart increasing its cost per TV to $600

Tariffs are often described as being a *tax* because the tariffs U.S. companies pay ($100 in the Walmart example) are deposited into U.S. Treasury accounts as U.S. government revenue. How that tariff revenue is used is a function of Congress.[3]

THINKING ABOUT TARIFFS – THEORY VERSUS REALITY

So how will all of this play out? Who will be the "winners and losers?" How should WIC interpret and reflect the tariff policy changes afoot?

WIC's series entitled *Just A Theory* looks at economic and investment concepts and principles through skeptical lenses; not necessarily disbelieving lenses, but questioning-where-is-the-evidence lenses.[4] Our September 18, 2023 issue titled *Why Basing Investment Decisions on Economic Trends and Forecasts is Unreliable* said this about the reliability of economic policy and related forecasts:

> … changes in the political winds, including a Congress or White House that becomes more or less business-friendly, can impact … policy. This integration of economic strategy, … policy, … can work to alter, redirect, or eliminate a given economic policy/strategy.
>
> **The political winds are always changing**; geopolitics inevitably change; the mood of the populace inevitably changes; and the relative influence of torchbearers comes and goes. All of that together with the above, makes economic modeling and forecasting extraordinarily difficult.

[2] The exact payment system is more complex and nuanced, but this is the essence of the transaction.
[3] In the sense that Congress and the budget process direct expenditures.
[4] We use the word *theory* more in a conceptual manner than a purely scientific manner. This *Just A Theory* series can be found on our website or by contacting us for a copy.

While we have little doubt tariffs will be imposed and increased, we don't know the impact, or the consequences, of the various possible paths and permutations. This is especially true given the highly-charged political sentiment surrounding tariffs and the long history of those sentiments changing over time. More on this later.

Notwithstanding the unknowability of tariff policy and related implications, WIC has to make decisions. We have to think about how the changing landscape might impact our portfolio decision-making.

<u>Macro Economic Perspective</u>. Looking first at the overall economy, how might tariffs impact inflation, Federal Reserve policy, the financial health of the populace, geopolitical relations, etc.? What might be some domino consequences? Some initial macro thoughts follow:

- If companies increase the price of their goods and services due to tariffs increasing their costs, that could worsen inflation

- If the larger tariff increases impact basic consumer needs such as food and automobiles, that could hit the low-to-middle income class especially hard

- If countries restrict the flow of key components (e.g., chips and rare earths), key industries that rely on such components/materials could suffer (e.g., medicine)

- If the Federal Reserve perceives renewed inflationary pressures from a more aggressive tariff policy (and its domino effects), that could cause the Fed to pause its plans to reduce interest rates; or perhaps increase rates

- If foreign countries retaliate with more aggressive trade policies, a trade war could ensue, further restricting trade

- If dislocations in trade reach a point of causing societal unrest in some countries, that could lead to heightened geopolitical tensions

The above is an incomplete list, but it provides a sense of the far-reaching implications of trade policy and tariff rate increases.

<u>Micro Economic Perspective.</u> Turning to how a more aggressive tariff policy might impact the *companies* WIC owns – which is our primary concern – the following provides some of our initial thoughts:

- Increased cost of raw materials; this could potentially erode profits if not offset with higher prices. Increased shipping cost. Increased inventory carrying costs associated with front-loading.

- Retaliatory sanctions and tariffs for export-focused companies. These may be targeted by foreign governments to prove their strength to their constituents.

- Disrupted supply chains; companies may have logistical issues and/or higher costs, particularly if certain tariffed-items become difficult to source. Locating new supply chains is complex and expensive, as is building trust with new partners. All of this will likely increase input and operating costs.

- Decreased demand for products could lead to permanent market share loss. This could occur in the U.S. (or for exports) if tariffs cause prices to be unaffordable or unattractive relative to substitutes.

Again, it is impossible to know the path of these potential outcomes, or if they will even materialize. That crystal ball does not exist. But we still have to think about a range of possible outcomes – that is fundamental to risk management.

There could be some positive benefits. Over time, supply chains could improve and become more diversified and resilient. As companies move to new suppliers, that could spur growth in local manufacturing, potentially increasing the reliability of supply with future production. Stronger companies could take market share from weaker companies who fail to adapt.

In the coming months, we will be writing more about how tariffs impact our companies and our decision-making.

TARIFF THEORY VERSUS REALITY – HISTORICAL PERSPECTIVE[5]

Free trade is a misnomer because truly *free trade* with no barriers, no tariffs, no special tax code provisions, and no governmental subsidies does not really exist. With that clarification, most economists believe it is beneficial to minimize the barriers to international trade to approach *free trade*. This belief is rooted in the basic principle of economic specialization – each country does what it does best, produces what it is best suited for, and that generates the best overall economic outcomes among nations. What does history tell us about tariffs?

Studying and understanding history is always important. Evaluating what was anticipated, planned and supposed to happen – versus what actually did happen – is an important part of any policy analysis. This is especially important when evaluating economic policy. WIC must likewise study history when evaluating potential tariff risk and opportunities.

We find economic history interesting and enlightening. It is an incomplete and uninformed economic analysis not to study history. Here are some examples of how studying tariff history can provide important context, and a reminder of **the range of outcomes, including unanticipated outcomes** (i.e. risk):

[5] See Cato Institute's *The Problem of the Tariff in American Economic History*, September 2023, by Phillip Magness; and *Historical Perspectives on U.S. Trade Policy* by Douglas A. Irwin.

- The first foray into tariff policy began on April 9, 1789, when Madison introduced a bill to the House of Representatives proposing duties on alcohol imports.

- From 1789 to 1934, it was common for industries to lobby Congress for preferential tariff rates and use bribes to accomplish that.

- During the 19th century, tariffs represented as much as 90% of federal revenue.

- The 1888 presidential campaign was mainly about tariffs.

- Some economists believe, with the exception of slavery, tariffs were the most contentious policy issue of the 19th century through the Great Depression.

- Because tariff policy became so special-interest-driven and lobby-laden, the 16th amendment to the Constitution allowing a federal income tax was ratified in 1913 – more on this below. The beginning of the lobbying industry can be traced to tariff-related lobbying.

- The infamous protectionist Smoot-Hawley trade policy in 1930 backfired and deepened the Great Depression, especially hurting farmers and triggering a farm loan crisis.

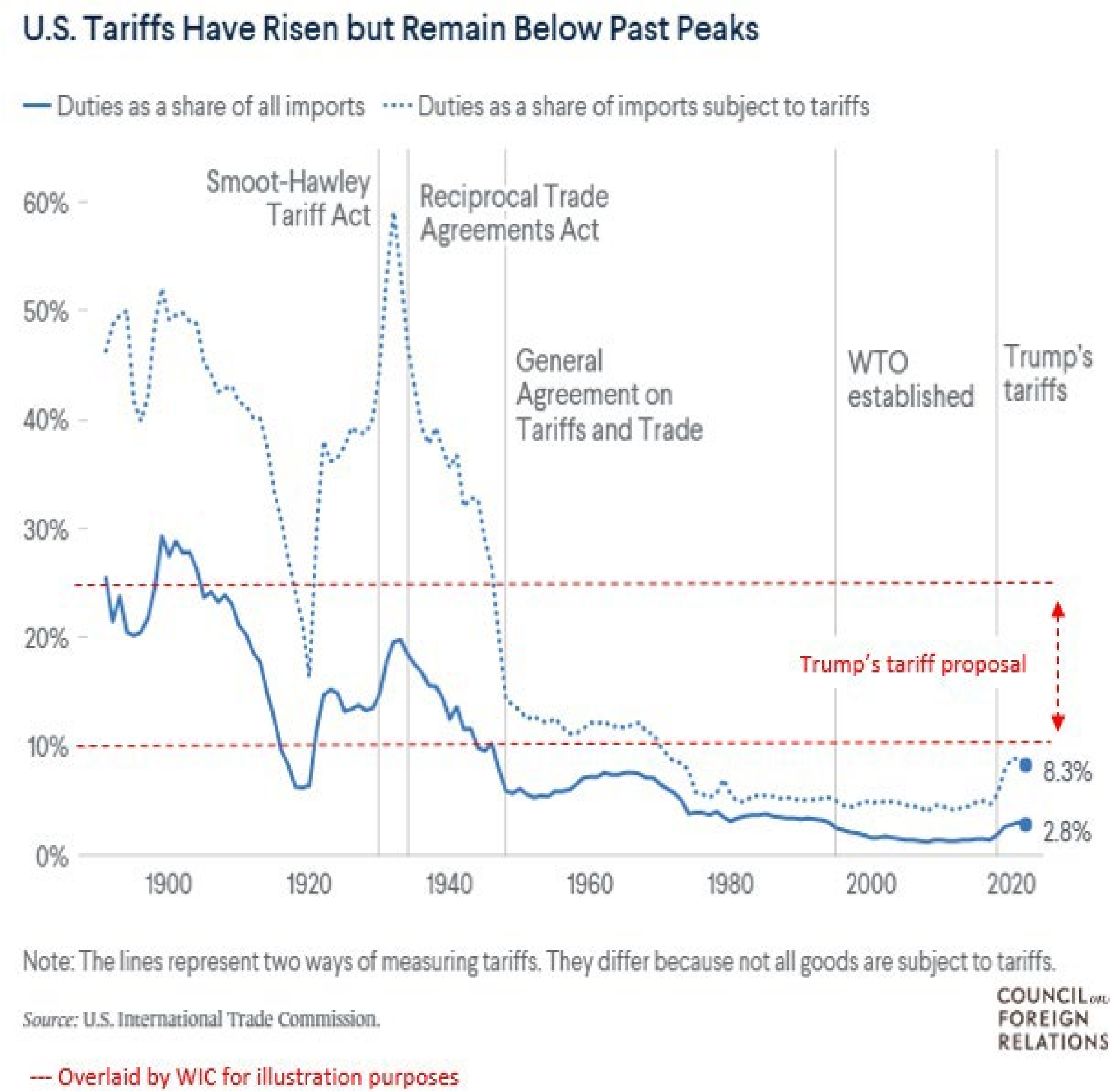
- After World War II eliminated significant U.S. competition (e.g. European factories), an ideological change emerged; there was an abrupt move away from protectionism to free markets and international trade as U.S. manufacturers wanted access to foreign markets, especially Europe.

- Protectionist tariffs have contributed to diplomatic turmoil, international retaliation, and worsened recessions.

<u>Tariffs Spawned the U.S. Income Tax System</u>. The Federal Reserve System and the U.S. income tax system came into existence in 1913. Before 1913, federal revenue was largely dependent on tariff tax revenue. Because of pervasive tariff-related lobbying and graft, Congress decided in 1912-1913 to seek a constitutional amendment to allow tax on income. Before that amendment – the 16th amendment – the constitution did not allow an income-based tax. Accordingly, tariffs, and the associated power of selected industries, financiers, power brokers, and special-interest groups, along with the associated back-room-under-the-table-deals, brought about the need for an alternative source of revenue. In turn, that essentially gave rise to the 16th amendment and an income tax system.

The graph on the next page shows the long history of tariffs in the U.S. and how the tariff rate has changed significantly over time. The proposed Trump tariff policy would take tariffs to their highest rate in decades. Notice how 1900 – 1940 was basically a protectionist period; and how after World War II a far less restrictive, less protectionist period ensued (a more open, *free trade* political economic period). History teaches us that over long periods of time, the tariff sentiment of the country, and the leanings of politicians, continuously moves along the protectionist - free trade continuum.

WIC will be mindful of how the tariff political winds are always changing. When evaluating proposed and enacted policies, we will remember policies can (i) be short-lived, including due to Congressional or Executive Branch changes (ii) have unplanned and unanticipated consequences, and (iii) result in retaliatory actions by foreign governments. Oftentimes, the impact of policies does <u>not</u> follow the cause-and-effect linear path many talk about.



ADAPTABILITY IS THE KEY

In many ways, a change in tariff policy is just a change in the overall competitive landscape; a change in the cost of doing business; yet another "new issue" that companies must deal with. Perhaps tariff risk is just added to these macro risks:

- Tax policy and regulations
- Environmental policy and regulations
- Intensifying competition
- Technology obsolescence
- Artificial intelligence-driven competitive pressures, including robotics

The competitive landscape is always changing. Successful companies effectively adapt and compete. It often comes down to how well we believe our companies can adapt. We look for indications of adapting. For example, some of our companies are already planning for re-routing their supply chains. Others are pre-buying critical raw materials and parts ahead of the anticipated tariff increases. Global companies are planning on selling more goods in the foreign countries in which they produce to avoid tariffs. Companies are refining their manufacturing strategies by producing goods in countries such as China or Mexico and selling them locally, thereby reducing tariffs. To avoid the "made-in-China" tariff target, some companies are arranging for assembly, especially final assembly, in more "friendly" countries. There will be companies that strategically absorb the increased tariff cost and do not raise their prices to maintain or increase market share; and others will raise prices to protect profit margins.

A common theme of our analysis and monitoring of companies will be fundamental balance sheet strength, liquidity, and staying power. The stronger a company's balance sheet; the more manageable and flexible its debt structure; the more resilient its free cash flow; the more entrenched its products, services, and brands; the more agile and adaptable the company. That is what we seek.