FINANCIAL FOCUS

PETERSON FINANCIAL SERVICES

Limited Liability Company ♦ Registered Investment Advisory Firm

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TARIFFS ARE TAXES ON AMERICAN CONSUMERS AND WILL PUNISH ALL OF US, NOT THOSE INTENDED.

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- All the benefits of recent reductions in regulations and stimulation from lower tax rates may be nullified by poor trade policy.

QUARTERLY MARKET RECAP

Everything was going just fine – and then President Trump tweeted. The first quarter of the year was a wild ride. Huge gains in January gave way to the first real correction in years in February – including the largest-ever point decline for the DJIA (although in percentage terms it didn't even make the top 20). By March, stability returned early on, but it then dived again. All but one of the indexes ended up retreating. For the quarter, GDP growth for 4Q17 was revised up from 2.5% to 2.9% and corporate earnings do remain strong.

Last quarter, the DJIA dived 2.49%, the S&P 500 retreated 1.23%, the NASDAQ gained 2.32%, and the Russell 2000 edged down 0.40%. Foreign markets moved sympathetically by declining 1.44%. The Federal Reserve continued to raise rates so the Dow Jones Corporate Bond Index lost 2.63%. The good news is the new federal tax law's revised withholding tables took effect mid-quarter, so we're only now beginning to see the effects of the lower tax rate levels and the decision-making and incentives that will result in higher levels of economic activity.

Offsetting those positives is a very real concern for a trade war, which is the subject of this letter. Economic fundamentals remain strong, but all that can be dashed aside in a trade war.

TRADE WARS HAVE A DEFINITE TRACK RECORD OF HORRIBLE RESULTS FOR ALL SIDES

Since before President Trump was even nominated for president - well before his inauguration - our biggest fear about him was that he'd start an economically-destructive trade war. Are we there?

Trump announced tariffs early in March of 25% on imported steel and 10% on aluminum. This is what is causing grief in the markets. His rationale is simplistic and incorrect, but he expects he is helping save American jobs. But he's not. Our steel-producing industry employs about 140,000 while our steel-using industries employ about 6.5 million workers, or over 46 times. These tariffs will do one of two things, or both: increase costs and decrease supplies. Basic economics suggests this is a losing proposition. And even the national security argument doesn't hold up. National defense-related production uses only 3% of domestically-produced steel and 10% of aluminum – and that's what *we* produce. Six of the top ten metals-producing nations have mutual defense agreements with the United States and our main military competitor, China, isn't even in the top ten producing nations, so national defense is not at risk. On the raw economic side, we import less than 5% of our steel from China. If the argument is that we have a too-large trade deficit with China, this won't put a dent in that.

Let's also recognize what tariffs do. They are essentially taxes paid at the border by domestic consumers. They are not paid by foreign companies or countries. We hurt ourselves by increasing the prices of goods we Americans buy. Some of these goods do not even have a viable American alternative to purchase. The integrated global supply chain is far more complicated now than it was even 30 years ago. Trade deficit calculations are derived from the country where final product assembly is performed. But before that "foreign-made" product is shipped to America for sale, its components came from numerous other countries – including here in America.

These published trade deficits are merchandise trade figures, or a tally of goods. They do not take into account services and non-tangible assets. As our economy moves increasingly into the area of services and intellectual property, we move from goods production.

One example of this is our trade relationship with Canada. We have a substantial merchandise trade deficit with Canada, but when services are considered, we have a substantial overall trade surplus with Canada.

It might also surprise some people to know how the balance of accounts works in trade between nations. All accounting transactions must balance. If you buy a car from a dealership, you pay money for that car. You give up the cash and get the car. And the dealership gives up the car, but gets the cash. Who has a "deficit" with whom? A trade "deficit" is equally a current account "surplus". That is called investment. If we have a trade deficit with another country, we have a current account surplus with them, which translates into them investing in our economy at that exact level. This is a good thing.

Proof of this economically-benign condition is that no country has ever had fundamental problems resulting from trade deficits – no reduction in GDP growth or employment, no higher debt levels or lower standards of living. But many countries who close off their markets to competitors have miserably-performing economies. Free economies trade liberally.

The real risk here is retaliation. There are 138 countries that have trade deficits with America. What if they get together and apply Trump's logic against us? Who says just because we impose tariffs on their products, which they don't pay but increase the cost of their goods to us here thereby lowering demand for them, that they won't do the same against our other products? In fact, the EU has already laid out a list of items scheduled for retaliation.

We impose steel tariffs and they impose agricultural tariffs on our wheat and other food products. Once you get started on that feeding frenzy, you can't control it.

One of the main reasons global prosperity has so increased in the post-WWII generations is due to low trade restrictions. Allowing the economic law of competitive advantage to take root, aids all consumers and producers. This concept was offered by Adam Smith in *The Wealth of Nations* in 1776. It essentially states that if one entity (country) has some sort of advantage in the production of a given product which makes its provision of that product more economically efficient, you should buy that product from that country because of its lower cost. Use the wealth created by your selling of your goods or services resulting from your competitive advantage to fund that purchase. Not all countries have the same type of work force, same raw materials, same climate, and a host of other factors rendering some nations more suitable than others for the provision of a given good or service.

Lastly, our persistent manufactured-products trade deficit is not primarily the result of bad trade agreements as seems to be the prevailing notion. It largely has to do with our unique status of having the world's reserve currency. High demand for US dollars has tilted the playing field away from American exporters and workers. But it has not done so to our overall detriment.

"In time of war, we blockade our enemies in order to prevent them from getting goods from us. In time of peace we do to ourselves through tariffs what we do to our enemy in time of war."

- Henry George – 19th-century economist

ABOUT PETERSON FINANCIAL SERVICES, LLC

As an aside, we wish to remind our clients of our various services. While we've specialized in portfolio management over the last several years, we continue to provide financial planning and insurance services. Longtime clients may have forgotten this, and newer clients may not be aware of this. Additionally, we build our business through referrals, and much appreciate them. Please keep us in mind as you come across friends, family and colleagues who might benefit from our financial services. We appreciate your business.

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