CLOUGH CAPITAL
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Navigating Tariff Turbulence with Perspective

The securities markets are still focused on the bearish implications of tariffs, rather than the bullish possibilities of regulatory reform. The consensus thinks tariffs are inflationary, but we believe the opposite is true. The U.S. economy is huge and subject to countless influences, so initial price shocks are likely to be reversed as adjustments occur. Retaliatory tariffs will likely come on and substitution effects should take place, reducing incomes in both the exporting and importing countries. This would be deflationary for both. Demand is already weakening. Airfares, prices for residential homes and agricultural commodities, such as oil and copper are already falling. Two years after tariffs came on in 2017, the ten-year U.S. Treasury bond yield was 1.8% and the two-year U.S. Treasury bond yielded 1.6%[1, 2]. Here is our reasoning as to why the selloff offers opportunities.

1. Tariff events are man-made and could turn on a dime. Pushback against tariffs will intensify and the administration will likely change its mind about the more extreme tariffs, particularly if equities continue to sell off. That happened in 2017. The sun had not yet risen on April 3rd before foreign requests to renegotiate Trump tariffs exploded, isolating China and the mercantilist and authoritative economic model it follows. In past instances, exceptions evolved and increasingly importers were able to reduce or avoid tariffs. The negative effect on employment in industries like auto manufacturing and construction quickly forced adjustments; tariffs on consumer electronics have already been delayed. In the meantime, consumer spending on electronics, autos and other imported products should move toward private label goods. Current auto prices are already at the consumer's fiscal breaking point. We think inflation concerns are overstated.

2. We believe the effect of tariffs on the overall price level would be muted in any event. Manufactured goods represent 30% of final sales in the U.S. and 30% of those are imported[3]. Since not all countries that export goods to the U.S. will be subject to increased tariffs, it works out that perhaps 4-5% of total sales of manufactured goods will be subject to higher tariff costs, reducing the amount of tariffed goods to less than 3% of gross domestic product ("GDP"). The biggest cost pressures would impact goods imported from Mexico, largely automobiles and farm produce. If fully passed through, we estimate the net of new tariff charges would raise the cost of imported goods by less than 1% of GDP.

3. Higher costs always spur substitution, so the cost impact of higher tariffs will largely fall on companies importing tariffed goods with many options for substitution. Harley-Davidson Inc is a good example. Today, the company is dependent upon low margin sales of imported bikes as it loses sales of the high profit "Hog" machines which were so popular with aging baby boomers, so the company faces increasing cost pressures with little flexibility to raise prices. Few goods are totally price inelastic and with consumers so stretched, importers cannot raise prices simply because they want to.

4. A popular view is that investors are selling U.S. securities to invest elsewhere, the so-called "sell America" trade. This trade could be late in this game, for two reasons. For one, the bear case for the dollar rests on the concern heavy U.S. government borrowings will drive U.S. interest rates higher and the dollar downward. But this ignores the fact that a rise or fall in dollar supply depends upon the rise in credit creation by both government and private borrowers, including households and businesses.

[1]Source: Bloomberg
[2]Bond yield is the annual return from interest and price appreciation/depreciation, expressed as a percentage of the bond's face value.
[3]Source: Federal Reserve Bank of St. Louis

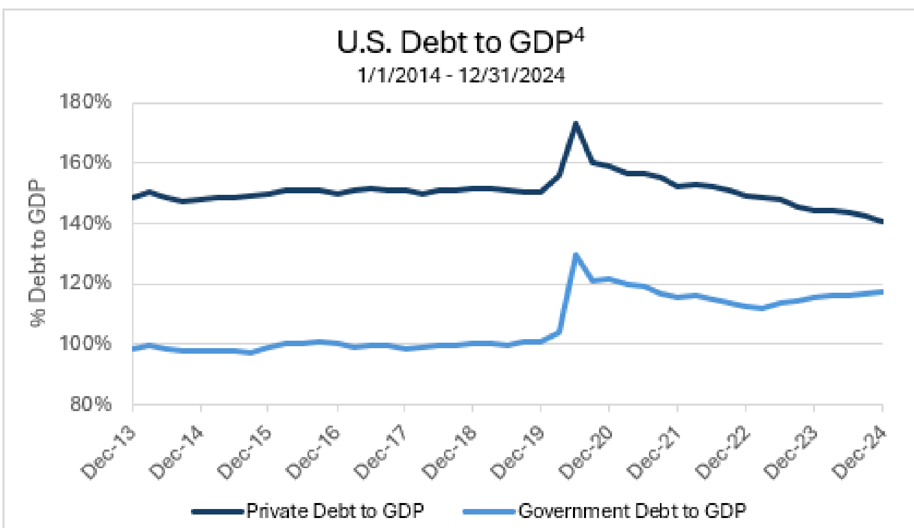
This is important because the stock of private debt is 35% higher than the government total and it has slowed to the point where it is now growing at a rate less than nominal GDP[4]. While both are falling as a percentage of GDP, private debt is falling more rapidly. If the total amount of U.S. dollar debt is growing more slowly than domestic GDP, the supply of dollars for global growth could easily fall behind normal global trade needs. This suggests it is possible that a shortage of dollars might emerge in the years ahead.

The chart below demonstrates that the total level of the business and household outstanding debt exceeds government debt. Both are declining as a percentage of GDP.

5. The decline of mercantilism, the economic model by which countries such as China sustain cheap currencies and high tariffs to keep exports strong, would support U.S. manufacturers, The more the Chinese yuan and euro rise against the dollar, the more attractive it is to invest in the U.S., and once a final tariff structure is in place, a lower dollar would be bullish for U.S. equities. Should the U.S. economy weaken, interest rates would fall, the cost of financing housing would decline, and given the backlog of needs, that would spur demand for housing and other interest rate sensitive goods and provide an economic support.

6. Stockpiling to avoid tariffs may strengthen the economy for a moment, allowing for an initial pass through of imported cost increases, but final sales will likely soon fall. Disinflationary pressures will likely cause long-term interest rates to decline, and the U.S. Federal Reserve (the "Fed") to react to any economic weakness. If foreign investors are really selling U.S. assets out of pique, it could be a mistake. A decline in the dollar's foreign exchange value will quickly improve the incentive to invest in U.S. assets because the U.S. should become far more competitive.

Equities declined into the beginning of April. Like so many other selloffs, it is feeding on itself as the threat of tariffs rise and repeated selling programs tethered to quantitative strategies kick in. This decline is likely to soon burn itself out. Far less attention is being paid to the benefits coming from the elimination of duplicative and often pointless regulations which are tough on profits.



[4]Source: U.S. Federal Reserve

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