Special Market Missive

Tariffs: Adding Chaos to Financial Markets

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In the 1940s, the U.S. declared war on two fronts, one against the Axis powers in Europe and the other against the Japanese in the Pacific. Over the past two weeks, the U.S. has declared war on the rest of the world through tariffs — essentially taxes imposed on exports to the U.S. So far, the initial losers of this war are investors. One reason for this unusual volatility is the projected impact of these levies on the economy. If the tariffs substantially raise the price of an import, consumers might not purchase that product, may wait to buy the product, or may purchase a substitute. As a result, there will be a combination of an uptick in inflation and a decline in output. Most economists oppose tariffs because they usually generate retaliation that slows the global economy further. Rising inflation and falling demand for higher-priced products have become a double-edged sword that hurts investors, consumers, and producers.

Fortunately, unlike the uncontrolled impact of the COVID pandemic and the government's knee-jerk response, tariff wars can be stopped as quickly as they started. Strangely enough, a reversal of these duties would come sooner, rather than later, if the uproar from consumers and their representatives forced a turnaround. Recently, one representative submitted a bill in Congress to assume the legal responsibility of determining tariffs. However, such a bill will need more than 60 supporters in the Senate to pass such legislation. Another negative factor is that most economists do not know the Administration's end game, nor do we. Would the Administration be satisfied if every country eliminated its tariff barriers?

The outlook remains uncertain despite yesterday's announcement that tariffs will be postponed for 90 days since 70 countries have agreed to negotiate these duties. The administration proposed a tariff of only 10% on these countries. Meanwhile, due to continued aggression by China, the administration has retaliated with a 145% tariff on its imports. Therefore, a return to a typical stock market environment may still be some time away until there is more clarity around the specifics of the tariff wars.

What should investors do? The investment strategy for long-term investors with exposure to only domestic equities remains intact — stay invested. Retired investors with exposure to equities should also stay put and not sell assets at these lower levels and perhaps increase exposure to government bonds. Investors with a diversified portfolio of asset classes, including fixed income and foreign market exposure, have been fortunate to experience less volatility and should come out ahead once all this mayhem settles down. Diversification usually wins in the end.

These unexpected events have occurred in the past and will happen again. That is the nature of investing in equity markets. The key to success is to focus on the long term and ignore the interim noise.

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