What Tariffs and Trade Wars Mean for Long-Term Investors

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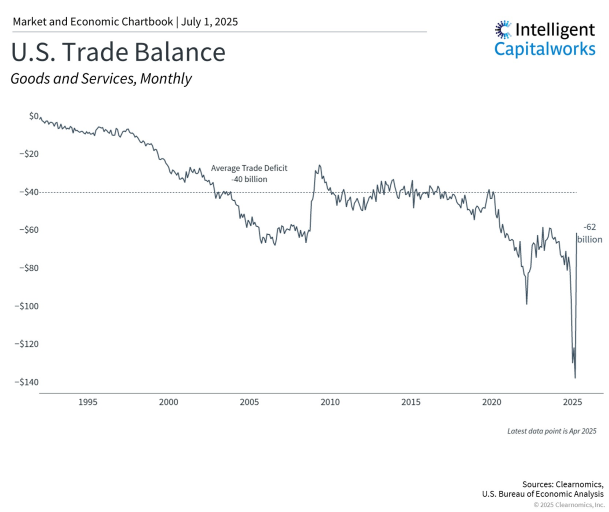
Investors have faced several market concerns early in the year around tech stocks, interest rates, and government policy. Among these factors, it’s no surprise that trade policy has emerged as particularly significant for markets. President Trump has launched various trade measures, including tariffs on Canada, Mexico, China, and the European Union. How should investors react to these news headlines?

The U.S. runs a significant trade deficit



For long-term investors, it's important to maintain perspective as the situation evolves and to stay focused on what you can control. Recent events have shown how quickly headlines can shift, and tariff threats are not a guarantee that they will be enacted. This is because the Trump administration has multiple objectives when imposing tariffs beyond protecting American industries. Tariffs are also used as a means of negotiating with other countries to impose border control, prevent the influx of illegal drugs, and to raise government revenue.

The U.S. has a long history of using tariffs to protect domestic industries, a concept known as protectionism. This dates back to at least the Industrial Revolution when tariffs supported American manufacturing. Later, the McKinley Tariff of 1890 raised import duties to nearly 50% on many goods, marking one of the highest tariff rates in U.S. history. The Smoot-Hawley Tariffs of

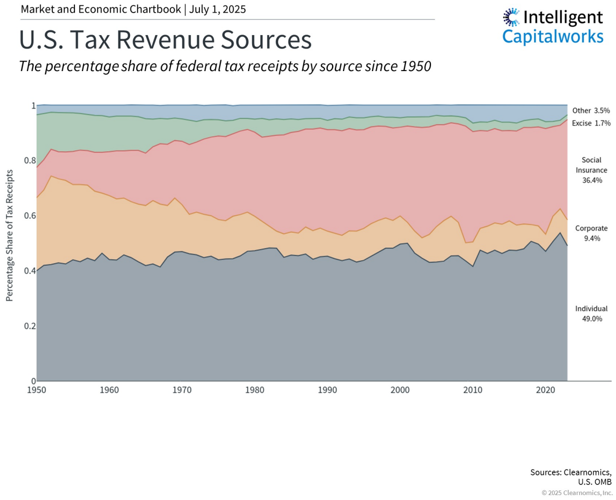
1930 still serve as a cautionary tale since they slowed global trade and are thought to have worsened the Great Depression.

These historical experiences led to decades of more open trade, including the establishment of international trade organizations. In theory, free trade works well when each country can focus on what it does best, selling its products and services to benefit all nations. While this fueled global economic growth, it also had the negative effect of displacing American workers as manufacturing shifted to countries with lower labor costs.

In many ways, the pendulum has swung back toward protectionist policies, with President Trump's renewed focus on using tariffs as a key policy tool, just as he did during his first administration. The chart above shows that the U.S. operates with a significant trade deficit since we import far more than we export.

Recent trade actions include a new 25% tariff on steel and aluminum that could apply to all trading partners, reciprocal tariffs on those that impose duties on American goods, postponed tariffs on Canada and Mexico, and additional tariffs on China. China's counter-response includes new 15% tariffs on energy imports and 10% on various U.S. industrial and agricultural products, echoing the 2018-2019 trade disputes. This pattern of escalating tariffs has sparked concerns of an emerging "trade war."

The role and importance of tariffs have changed over time

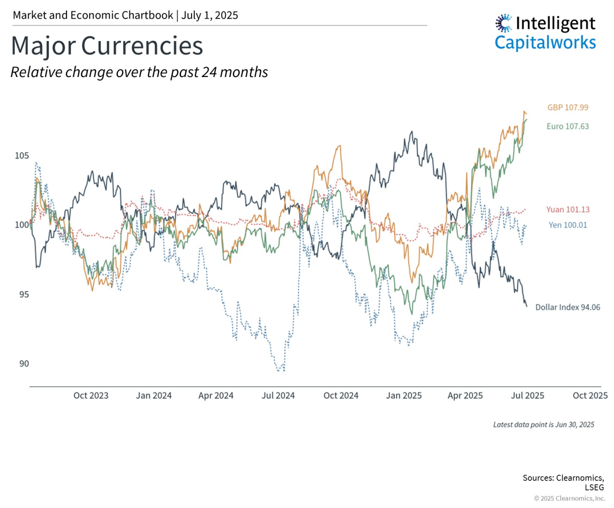


Market reactions to tariff announcements often prove more dramatic than their actual economic impact. During Trump’s first term, markets generated healthy returns despite fears of trade wars. The trade disputes of 2018 and 2019 did not result in the severe global consequences many anticipated. Tariffs during this time were used as a negotiating tool, resulting in the United States-Mexico-Canada Agreement (USMCA) and a trade deal with China.

In the chart above, tariffs fall under the “Other” category and contribute only 1% to 2% of total government revenue, highlighting how insignificant they are relative to taxes. That said, many politicians and economists would like to see the trade balance improve. This could potentially strengthen domestic manufacturing, increase employment in export-oriented industries, and reduce reliance on foreign borrowing.

On the other hand, the trade deficit also reflects the underlying strength of the U.S. economy and consumer purchasing power. When Americans have more disposable income, they can afford to buy more imported goods, naturally leading to a larger trade deficit. Furthermore, the deficit is partially offset by significant capital inflows into U.S. markets, as foreign investors seek the stability and opportunities available in American assets. This investment helps fund innovation, business expansion, and job creation domestically.

The dollar has strengthened since the election



Trade concerns have also led to a stronger dollar since last year's presidential election. This is because trade and currencies are fundamentally linked. Importing foreign goods requires selling dollars to buy other currencies, so reducing these imports strengthens the dollar. As the chart above shows, the dollar has risen in value against many major currencies over the past several months.

Another impact of tariffs is the potential effect on consumer prices and inflation. When tariffs are imposed on imported goods, businesses often pass these additional costs on to consumers in the form of higher prices. This inflationary pressure is particularly noticeable in sectors heavily reliant on international trade, such as consumer electronics, automobiles, and household goods.

So, it's important for investors to keep these developments in perspective. Tariffs have multiple objectives, not all of which should affect financial markets in the long run. While they can cause financial uncertainty, impact the U.S. dollar, and potentially lead to higher consumer prices, past episodes also show that markets can perform well in spite of these concerns.

The bottom line? While trade and tariffs are important for the global economy, history shows that their effects on financial markets are often overstated. Investors should continue to focus on their long-run financial goals and not overreact to short-term headlines.

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