CLOUGH CAPITAL
THE MACRO COMPASS

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The Controversial Impact of Tariffs: Inflationary or Deflationary?

The global economic landscape is shaped by a complex interplay of tariffs, regulatory reforms, and market dynamics. While securities markets have primarily focused on the potential bearish consequences of tariffs for the economy, there are more nuanced implications to consider.

Tariffs and Their Economic Impact

Contrary to popular belief, tariffs may not be as inflationary as commonly perceived. After the implementation of retaliatory tariffs and subsequent substitution effects, incomes in both exporting and importing countries tend to decrease, potentially leading to deflationary pressures. The falling prices of agricultural commodities, oil, and copper evidence this. Two years after tariff implementation in 2018, the ten-year bond yield was ~75 basis points ("bps") lower at 1.8%, while the two-year bond was ~50 bps lower yielding 1.6%.

The effects of increased tariffs on the economy are likely to be muted for several reasons:

1. Manufactured goods represent only 10% of the economy, with about half imported.
2. Not all countries exporting goods to the US are subject to increased tariffs.
3. We estimate that 3-5% of manufactured goods are subject to higher tariff costs, less than 3% of gross domestic product ("GDP").

The most significant price pressures would affect goods imported from Mexico, primarily automobiles and farm produce. China, the largest exporter, faces only a 10% tariff increase. We estimate the net effect of new tariff charges would raise the cost of imported goods by less than 1%.

Potential Policy Shifts and Market Adaptation

President Trump may reconsider his stance on tariffs, particularly if equities continue to decline. A strong stock market is crucial to his own assessment of his performance in office. Historical precedent suggests that exceptions to tariffs may evolve, allowing importers to avoid duties for strategic and other reasons.

The negative impact on employment in industries like auto manufacturing and construction has forced adjustments. Meanwhile, consumer spending on electronics and durables has shifted towards private label goods, and other nations have reduced tariffs to equalize relative costs.

Interest Rates and Economic Sectors

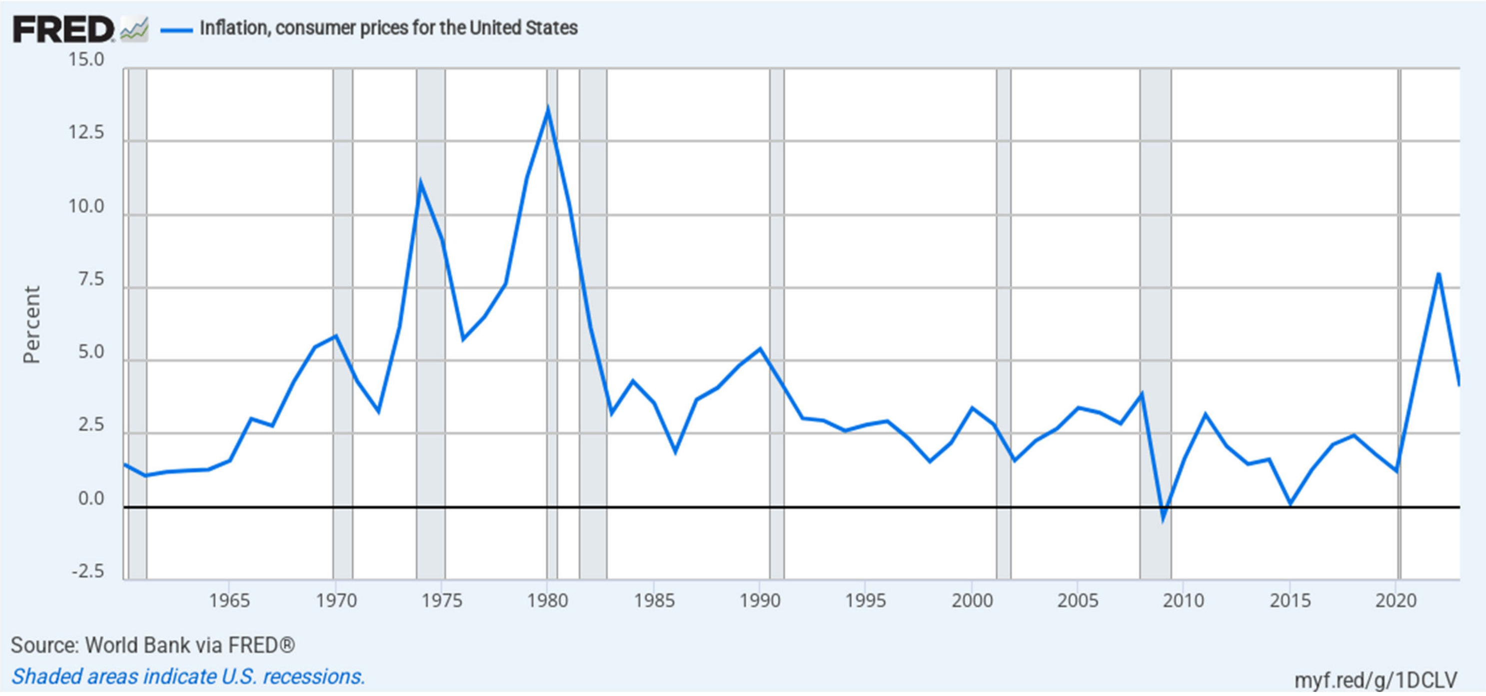
If tariffs are sustained in their entirety, interest rates are likely to fall. This could lead to decreased housing financing costs, potentially spurring demand for housing and other interest rate-sensitive goods, given the existing backlogs of need.

Higher costs invariably drive substitution, with the real impact of tariffs falling on companies importing tariffed goods with limited options for substitution. Harley-Davidson is a prime example, facing increasing cost pressures and having little flexibility to raise prices due to its dependence on low-margin sales of imported bikes.

Market Dynamics and Pricing Strategies

Few goods are price inelastic, and with consumers already stretched, importers face challenges in raising prices arbitrarily. Auto manufacturers, for instance, have limited flexibility in pricing. The market's focus may shift from the perceived bearish consequences of tariffs to the more bullish possibilities of regulatory reform.

In conclusion, while tariffs have been a primary focus of market concerns, their economic impact may be more nuanced than initially perceived. As markets adapt and policies evolve, attention may shift towards the potential benefits of regulatory reforms and the complex interplay of global economic factors. The coming months will likely reveal a more balanced perspective on the long-term implications of current trade policies and economic strategies.



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