AGFINSIGHTS

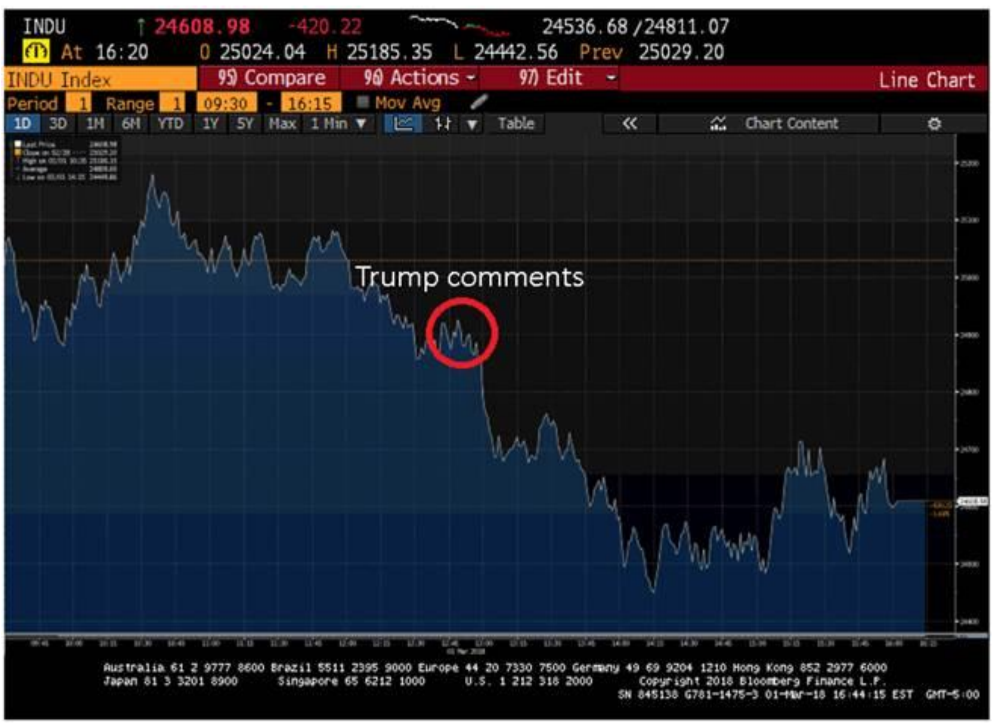
MARKETS

March 2018

Trump’s Tariffs and the Equity Market’s Response

On the afternoon of March 1st, U.S. President Donald Trump announced that his administration will impose tariffs on steel and aluminum imports next week. ***Trump said the U.S. will impose a 25% tariff on steel imports and a 10% tariff on aluminum***. Details aren’t yet immediately available, as there may yet be some exemptions for certain countries. In response, equity markets began selling off on trade worries, with the Dow falling as much as 586 points before finding its legs later in the afternoon. The Dow ended up closing down 420 points on March 1st, losing 1.7%. Capital goods, autos and aerospace were among the sectors that fared the worst.

Dow Jones Industrial Average Intraday Chart (March 1, 2018)



Source: Bloomberg, as of March 1, 2018

For context, on February 16th, the Commerce Department completed a report that implied imports were compromising American national security by degrading the industrial base. The three resulting recommendations involved either a flat quota on all imports, a quota/tariff combination or a blanket tariff on all steel and aluminum. As such, the market began pricing in some degree of response, though Trump's revelation of tariffs today (25% for steel, 10% for aluminum) were more severe than the recommendations and the strongest indication yet of potential trade protectionist headwinds.

A few key points include:

- **Impact on consumers and the U.S. economy** – The big loser from a tariff will likely be aluminum and steel consumers – companies that use these metals. A supply response in the supply chain would take a significant amount of time to materialize, so the tariffs in effect will mostly act as a tax on those companies. Sectors like beverages, aerospace, autos and several others are users of steel and aluminum, and therefore would be negatively impacted. The question therefore is whether or not these companies will pass the higher costs onto consumers. If they do not, it will negatively impact their margins. If they do, the result will be inflationary for consumers and raise the odds of more hawkish monetary policy from the Fed (i.e. higher rates, sooner). ***Either way, tariffs are not good for equities (higher inflation, or lower corporate margins)***.

- **Impact on producers –** For U.S. steel producers, the knee-jerk reaction has been positive with steel stock prices up around mid-single digits on March 1st. However, our channel checks within the sector indicate steel producers have not been overly enthusiastic either, as they remain cautious to see if there will be a backlash on U.S. produced steel overseas.

- **Impact on Canada** – From a Canadian perspective, the biggest question is whether Canada will be exempt from the tariffs. This is particularly true for the aluminum sector – the U.S. imports approximately 80% of their aluminum needs (about 5 mt), but approximately half comes from Canada. With respect to exemptions, there is a precedent – in 2002, U.S. President George W. Bush imposed tariffs of up to 30% on steel imports, but exempted Canada and Mexico. However with ongoing NAFTA negotiations bogged down and ongoing rhetoric coming from the Trump administration, precedence means little to market participants trying to anticipate this administration's next move. As such, Canadian steel producer Stelco Holdings was down 5% on March 1st in response to the news.

Remember the Art of the Deal

"The worst thing you can possibly do in a deal is seem desperate to make it. That makes the other guy smell blood, and then you're dead. The best thing you can do is deal from strength, and leverage is the biggest strength you can have. Leverage is having something the other guy wants. Or better yet, needs." - Donald Trump, in *The Art of the Deal*

Might this be just posturing? After all, the President can take unilateral action on trade, which makes it tailor-made for Trump-style anchoring – staking out radical positions (and disrupting markets in the meantime), only to ultimately settle on terms amenable to both sides but more advantageous to the U.S. With round seven of NAFTA negotiations currently ongoing in Mexico, it would not surprise us if this was part of the calculus. More likely is that this might have been geared towards China, though we would point out that China is merely the 11th largest exporter of steel to the U.S. (recall, Canada is first). Market participants will be watching for any retaliation coming out of China (and other impacted countries) in response as details unfold.

All of this serves as a reminder to expect a more volatile environment than we have become accustomed to in previous years. ***With mid-term elections coming up in November 2018, Trump is motivated to appeal to his base, which includes trade policies that he campaigned on such as "Buy American" and other protectionist measures.*** As such, we would not be surprised to see more instances of volatility in the coming days and months, with the caveat that this comes amidst a backdrop of still-strong macroeconomic conditions. Stay tuned.

Published date: March 2, 2018