Donaldson
CAPITAL MANAGEMENT

This Week in the Market
5-27-19

Tariffs Being Weaponized

In another unexpected move, President Trump announced that a 5% tariff on all Mexican imports would be instituted on June 10 and raised in increments to 25% until Mexico halts "illegal migrants" headed to the United States. Tariffs now appear to be the go-to weapon in the President's foreign policy arsenal. With a new front opened up in the Trade War, the equity market has taken another leg lower and bonds are signaling that growth will be stifled. The S&P 500 is roughly 6.5% off of its early May highs. The US 10 year treasury yield has broken to its lowest level since 2017 and sits at 2.14%.

While the recent data shows that consumers have largely been unfazed by tariffs, these consumer confidence surveys took place before the escalation. 2 of the 3 largest U.S. trading partners are now facing substantial import duties. This is bound to have an impact on prices in time. There is a limit to how much firms are willing and able to internalize. Strategas points out that tariffs are inflationary over the short run, but deflationary in the long term. Meaning that consumption and manufacturing alike would slow with higher costs and higher uncertainty. We are already seeing this in manufacturing, but not yet in consumption. This feels especially dangerous with parts of the yield curve already inverted.

In response, the bond market continues to increase its probabilities for 1 to 2 rate cuts by year end. Doing so would take some of the pressure off the curve, but even still, we've questioned the true simulative impact of cuts with rates still low on a relative historical basis. The weight of the tariffs on our economy is increasing with each escalation. For growth to continue on trend, the course needs to be reversed. But, reaching a deal also becomes more difficult with each escalation. The ratification of the USMCA is certainly more difficult now and the incentive for the Chinese to enter into a good faith agreement with the US is deteriorating, at best.

While the situation is becoming more serious, we shouldn't lose sight that there are winners and losers. Some manufacturing is bound to make its way back to the U.S., if this persists. It will be leaner and smarter and there are plenty of companies profiting off of these notions to the extent that their supply chains are unaffected. In addition, we shouldn't forget the service driven nature of the U.S. economy. Many of today's most exciting companies don't provide physical goods, thus tariffs aren't of as much importance. There will certainly continue to be buyable growth stories in this group as well. Staples have seen a resurgence of late given their defensive nature. These are just a few examples.

From a portfolio level, our strategies continue to act as they are designed. The companies we hold are built for volatility and their performance over the last several weeks has been a testament to that. We can continue to take comfort in the strength and stability of the great names we own. We can always look to shift on the margin, but our core is very much intact.