Protectionism through a Corporate Lens

Ronald Temple, CFA, Co-Head of Multi-Asset and Head of US Equities

Summary

• Assessing the impact of protectionism is more complicated than in the past given the interconnectivity of global supply chains.

• As a result, protectionist policies will likely be even more meaningful for corporate profits and markets than for the economy. Many companies also have significant overseas revenues and assets which could be exposed.

• The combination of US protectionism and Fed monetary policy tightening could trigger the next bear market in equities and perhaps even the next economic recession.

Since the beginning of the year, the Trump administration has announced a series of increasingly aggressive trade policies. While much remains uncertain about the future direction of these policies, we believe the risk of further escalation is high and that a sustained move toward protectionism could derail economic growth. Furthermore, corporate profits are even more at risk than GDP due to how integrated the global economy has become. Reorienting global operations and supply chains could be difficult, disruptive, and costly for many businesses. Understanding how a business and its competitors are exposed to this risk is critical to evaluating the potential impact of protectionism on profits.

Profits in Peril

To date, the administration has introduced tariffs on imported washing machines, solar cells and modules, steel products, aluminum products, and nearly 7,000 products imported from China, ranging from basic commodities to finished automobiles. Cumulatively, these products accounted for about $285 billion in 2017 imports into the United States.

On top of the tariffs already implemented, the administration has threatened tariffs on an additional $565 billion of imported goods, primarily consisting of imported autos and auto parts and all remaining imports from China. The cumulative value of imports covered or threatened by new tariffs is $850 billion (Exhibit 1), or roughly 35% of all US imported goods.1
While these headline numbers for covered imports sound large, they are relatively small in the context of a $20 trillion US economy. That said, the impact on the companies and industries subject to protectionist measures is likely to be more significant for a number of reasons.

First and foremost, the size of implemented and threatened measures are bigger relative to corporate profits than to the US economy. The $850 billion in threatened imports is only about 4.4% of the nation’s GDP and the cost of an illustrative 25% tariff on this volume of trade would be just 1.1% of GDP. However, when measured against pre-tax corporate profits rather than GDP, these ratios rise to 36.4% and 9.1% respectively (Exhibit 2).

Second, the globalization of businesses and their supply chains means the potential for disruption is large. Third, this potential disruption and the uncertain policy environment means that corporate executives are faced with many difficult questions, which could impact strategy and their ability to commit to expansion plans.

**Initial Tariffs Primarily Hit Producers**

However, while we believe these risks are large, we also believe that they have been underestimated by markets, both because they are hard to evaluate and because protectionist trade policies have ramped up slowly over the course of the year. Furthermore, tariffs have not yet become highly visible from a consumer perspective.

Until 24 September, the bulk of tariffs put in place did not cover finished consumer goods. Even after that round of tariffs, covered products are disproportionately goods used by producers: capital equipment and intermediate goods. For example, just 18% of the US imports from China subject to new tariffs are consumer goods, while 32% are capital equipment and 48% are intermediate goods (Exhibit 3). In other words, the vast majority of tariffs to date have raised the cost of goods sold to American companies. It is not obvious how long it will take for cost increases that are not absorbed by these producers to channel their way to consumers.

Corporate profits also are affected by retaliation by US trade partners. These retaliatory tariffs have generally been proportional to US tariffs. As the largest exporter of steel and aluminum to the United States, Canada initially was most aggressive, because US steel

**US Tariffs Have Focused on “Producer” Goods, So Far**

Before the latest round of US tariffs put in place, approximately $9.8 billion in 2017 imports are categorized as “other.” Chart is based on 2017 import values and is for items on the published Section 301 tariff lists. It excludes imports from China subject to Section 201 or Section 232 tariffs.

Source: US ITC Dataweb, Peterson Institute for International Economics
and aluminum tariffs preceded tariffs directed solely at China. China has since responded to the US tariffs. In response to the first $50 billion of tariffs announced by the United States, China retaliated proportionately. In the case of the most recent addition of tariffs on $200 billion of Chinese exports to the US, China retaliated with tariffs on $60 billion of US exports to China (Exhibit 4).

Because the value of China’s exports to the United States is nearly three times the value of its imports from the United States, its ability to put in place tariffs on the same volume of trade as the United States is limited. While Chinese authorities could make up for this shortfall by putting in place higher tariffs, they also could impose an array of non-tariff measures in an escalating trade conflict. Reports indicate that the Chinese government is considering offering subsidies, tax reductions, and regulatory relief to affected producers.

Other potential forms of “positive retaliation” could include reducing tariffs or extending other preferences to non-US companies exporting to or operating in China. In extreme circumstances, authorities could impose embargoes on exports of goods vital to the US domestic economy or restrict the operations of US companies in China, an important and growing market for many companies—although reports suggest the latter may be unlikely.

Trade Conflict in the Modern Economy

However, while tariffs and protectionist policies are often discussed in terms of the countries implementing them, from a market perspective it is important to recognize that supply chains and companies themselves are far more global than in the past. One important implication is that tariffs directed at a specific country can impact companies from many different countries. For example, a study by the Peterson Institute for International Economics (PIIE) estimates that many of the goods targeted in the first round of US tariffs were produced by non-Chinese multi-national companies. In the PIIE study, 87% of the computer and electronic products subject to the first round of tariffs were produced by non-Chinese companies (Exhibit 5).
Two examples help illustrate how complex global supply chains can complicate analysis of protectionist policies and their impact on corporate profits. Boeing, headquartered in Chicago, manufactures one of the most advanced airliners in operation today, the 787 Dreamliner. Its airframe alone consists of parts from suppliers from eight different countries (Exhibit 6). Similarly, in a recent teardown of the iPhone X, IHS Markit found that the phone, assembled by a Taiwanese company in China, used components from Korean, Japanese, German, Dutch, Swiss and US companies. The estimated value of these components was $370 for a phone that retails in the United States for $1,000. This implies that the Bill of Materials was relatively low value add and that any demand destruction as a consequence of higher prices resulting from tariffs could jeopardize higher value activity that takes place in the United States. Moreover, China also is an important market for Apple, exposing its business to the risk of non-tariff retaliation against US trade policies if trade tensions continue to escalate.

Regional Supply Chains Are Complex

These examples draw a stark contrast between current trade tensions and the auto trade conflict between the United States and Japan in the 1980s. In the 1980s, putting trade restrictions or tariffs on a Japanese car meant exactly that. It was a car produced largely, if not entirely, in Japan by Japanese companies using Japanese workers. Today, that is no longer the case.

In a 2017 story, Bloomberg tracked the journey of a capacitor, an electronic seat-adjustment component about the size of a joint on an adult pinkie finger. Travelling from suppliers in Asia to final assembly in a Ford or GM SUV, the component crossed international borders as many as six times (Exhibit 7).

This journey is illustrative of how increasingly global supply chains have resulted in highly specialized regional patterns of production in certain industries. From a practical standpoint, putting a tariff on the full product each time it crosses a border compounds the cost of trade and is incredibly cumbersome administratively. From a more general standpoint, it also demonstrates how complicated it could be to re-orient supply chains due to punitive tariffs.
Narrow Benefits, Broad Costs

Some US companies might come out ahead in a prolonged trade dispute. Among the potential beneficiaries are companies that a) operate in protected industries, b) have domestic supply chains, c) have primarily domestic sales, and d) sell products for which customers are less sensitive to price. Many others, however, could face significant challenges.

The first challenge for companies harmed by protectionism is figuring out if the new US trade rules are likely to be temporarily or permanently altered. The answer to this question would then determine whether companies might have to make important strategic choices. These decisions might include reconfiguring supply chains to remain competitive within their home market. Companies might also face the prospect of losing market share to overseas competitors with different supply chains that are less exposed to protectionist policies. Firms may even have to write down stranded assets as their investments in foreign production become uneconomic or foreign governments put roadblocks in the way of ongoing operations. Likewise, choices like the timing of expansion plans in new markets or investing in supplier relationships or foreign facilities are far more difficult against such an uncertain backdrop.

Looking ahead, we see four potential directions for US trade policy:

1. Resolution of the trade conflicts that reverses the tariffs imposed so far and mitigates harm to companies.
2. Resolution of outstanding trade issues related to US allies, including renegotiation of the North American Free Trade Agreement (NAFTA) and potential tariffs on imported autos and auto parts, but ongoing conflict with China.
3. Further escalation of protectionist trade policies, targeting not just China but also other trade partners, and drawing in NAFTA, auto and auto part imports, and other products.
4. An iteration of the second or third outcome in which current trade conflict ultimately undermines the multilateral trade system. For example, it is reported that President Trump believes the United States would be better suited by negotiating one-on-one with trade counterparts than by continuing to participate in the World Trade Organization. Such a situation could be very complex and costly for companies operating across national boundaries, as they potentially would face new trade rules for every country that deals with the United States.
In our view all four directions for trade policy remain possible, and investors and corporate management teams ought to assess their exposures and implications under each. While the first direction would clearly be optimal, we believe the second and third are most probable, with negative implications for many businesses.

**Understanding Company Exposures Is Critical**

The potential outcome of current trade tensions is highly uncertain and the impacts are complicated. While protectionist policies implemented to date remain small relative to the size of the US economy, they could have a much larger impact on corporate profitability. Additionally, trade challenges easily could escalate sufficiently to undermine confidence and derail the ten-year-old US bull market and economic growth.

In addition to these general risks, it is important for investors to assess what is potentially exposed and how at a company level. Doing so is difficult, due both to the globalization of business and supply chains and to inadequate disclosures at the company level. However, understanding these exposures, as well as competitive positioning, is critical to evaluating risks and rewards and positioning portfolios appropriately.
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Notes
1. All dollar amounts are based on 2017 US general imports as reported on the US ITC Dataweb. Dollar amounts may not correspond to those cited in official announcements. Data was downloaded on 18 September 2018.
2. Based on an illustrative tariff rate of 25%. Imposed tariff rates vary and threatened tariff rates have yet to be announced.
3. IHS Markit, 8 November 2017. “iPhone X Costs Apple $370 in Materials, IHS Markit Teardown Reveals.”

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