A Unique Mind On The Markets

SPECIAL REPORT

February 24, 2025

A Dog Chasing Its Own Tail...

President Trump is a staunch trade protectionist, famously declaring that *"tariff is the most beautiful word."* His actions have matched his rhetoric. While tariff hikes on Canada and Mexico have been delayed, Trump's protectionist initiatives continue unabated, with recent announcements of tariffs on steel and aluminum, reciprocal tariffs, and the looming possibility of new tariffs on semiconductors, pharmaceuticals, and automobiles.

Financial markets have grown jittery over Trump's tariff threats, leaving investors to wonder what comes next. The president has made it abundantly clear that he is serious about raising tariffs. The only unknowns are which countries or industries will face these duties and by how much. Investors must now grapple with the financial market implications of Trump's trade policies and their intended outcomes.

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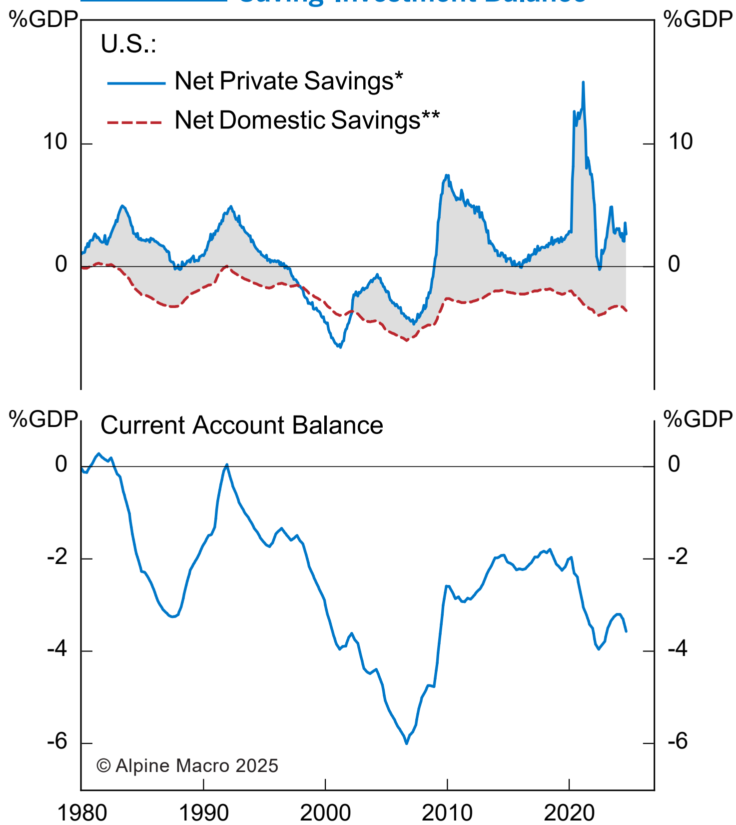
The Objectives Of Protectionism

Trump's view of trade is rooted in mercantilism, a zero-sum philosophy where a nation is considered to gain wealth by selling more goods abroad than it buys. Mercantilism traces its origins to 16th-century bullionism, which equated national wealth with the accumulation of gold and silver. Bullionists believed trade deficits led to bullion outflows, effectively reducing wealth – and *vice versa*.

While the gold standard is long gone, Trump's trade policies echo mercantilist principles. His trade policy has two key components: The first is using tariffs to reduce trade deficits. Countries having trade surpluses with the U.S. are seen as stealing American jobs and wealth, making them targets for higher tariffs.

Chart 1 The Breakdown Of Domestic Saving-Investment Balance



*Private sector savings minus investment
**Net private savings plus government budget balance
Note: Shading denotes government budget deficits

The second is to bring manufacturing home and promote U.S. exports. Trump believes that manufacturing jobs are better than other jobs and has set out to revitalize the U.S. manufacturing industry.

Whether these objectives are right or efficient is beside the point. The real question is whether Trump can achieve them – and what the economic and financial market consequences will be.

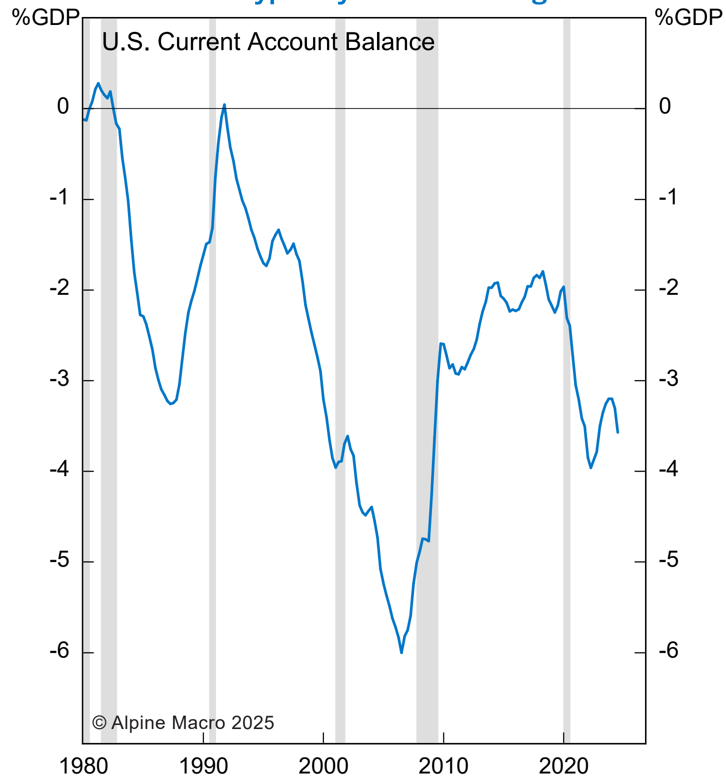
A Neoclassical View Of Trade

Neoclassical economics treats trade as part of a general equilibrium, where the current account balance is determined by the domestic saving-investment balance. If gross domestic savings fall short of private investment and public sector deficit, a nation must borrow from abroad, resulting in a current account deficit. Conversely, if savings are bigger than investment plus public sector dissaving, a surplus emerges.

Since the 1990s, the U.S. has consistently run current account deficits, reflecting insufficient domestic savings to meet both investment demand and public sector dissaving. Since 2000, private sector savings have begun to exceed investment, meaning the current account deficit primarily mirrors large public sector deficits. Chart 1 breaks down savings, private investment, budget deficits, and net exports.

Arithmetically, closing the U.S. current account deficit requires either weaker domestic investment, higher savings, a smaller budget deficit, or some combination of all three. Obviously, any of these three developments would entail a major growth slowdown or even a recession.

Chart 2 U.S. Current Account Deficit Typically Shrinks During Recessions

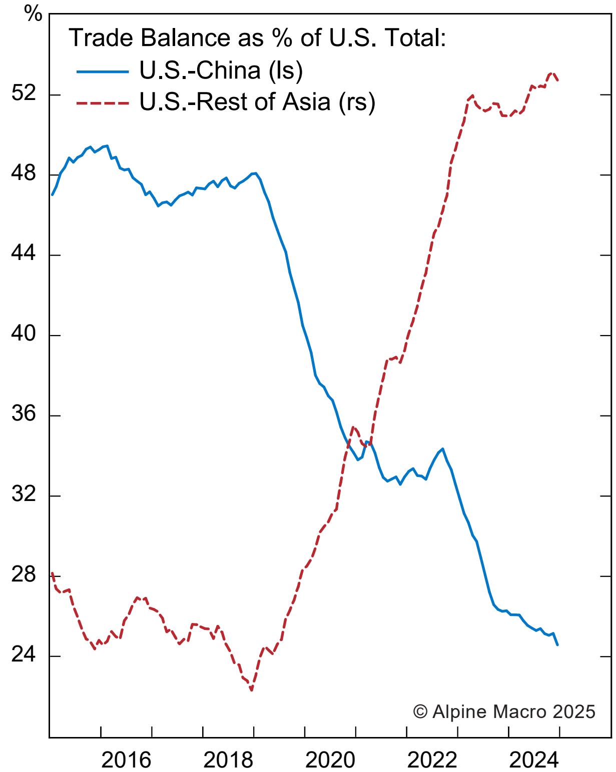


Note: Shading denotes U.S. recessions

Chart 2 shows that U.S. current account deficits usually shrink during recessions where savings tend to rise and investment falls. While governments often increase budget deficits to mitigate shocks, such efforts are often insufficient to offset the rise in private sector savings. As a result, recessions typically lead to smaller current account deficits.

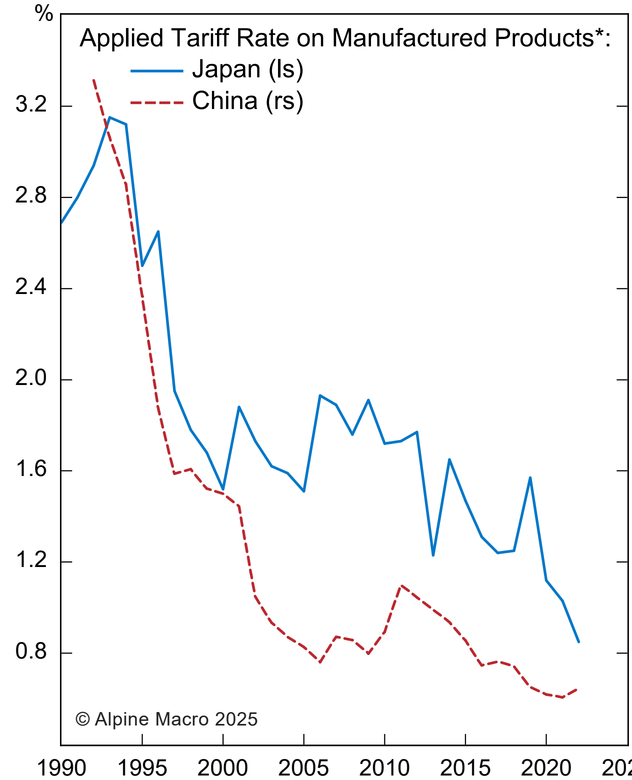
Furthermore, the neoclassical framework suggests that as long as the saving-investment balance remains unchanged, the current account deficit will persist – no matter how high tariffs are raised. The 2018 U.S.-China tariff war illustrates this. While aggressive U.S. tariffs and Beijing's retaliation

Chart 3 A Dog Chasing Its Own Tail



Source: U.S. Census Bureau

Chart 4 Japan & China: Moving Away From Mercantilism



*Weighted mean; source: World Bank

reduced America's trade deficit with China, its imbalances with the rest of Asia soared (**Chart 3**). Attempting to close trade gaps without altering domestic demand is akin to a dog chasing its tail.

Will Mercantilist Policies Work?

Mercantilists treat trade as an independent variable, ignoring its role in general equilibrium. They view trade surpluses as inherently good and deficits as bad, striving to sell more abroad than they buy. In practice, this means restricting imports through tariffs or non-trade barriers while promoting exports *via* subsidies or other incentives.

Some Asian nations, including Japan in the 1960s-1980s and China in the 1990s-2000s, pursued mercantilist policies, achieving periods of rapid export-led growth. However, Asia has since embraced deep trade liberalization, with tariffs falling dramatically since the 1990s (**Chart 4**).

Can – and should – the U.S. adopt mercantilist policies to build an export-led growth model? The answer is no. Japan and China had unique historical opportunities: Japan rebuilt its war-torn industrial base in the 1960s, while China transitioned from an agrarian society with per capita income below $500 in the 1980s. The U.S., however, has long moved into a post-industrial economy, with innovation and services driving growth.

While certain manufacturing sectors can be revitalized in the U.S., a large-scale return to a

Chart 5 U.S.: The Decline In Manufacturing Has Persisted

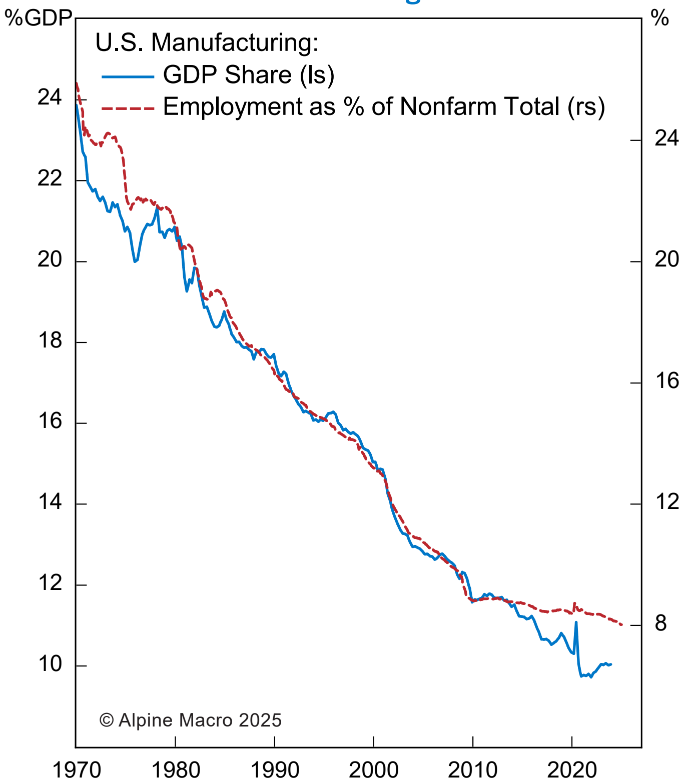
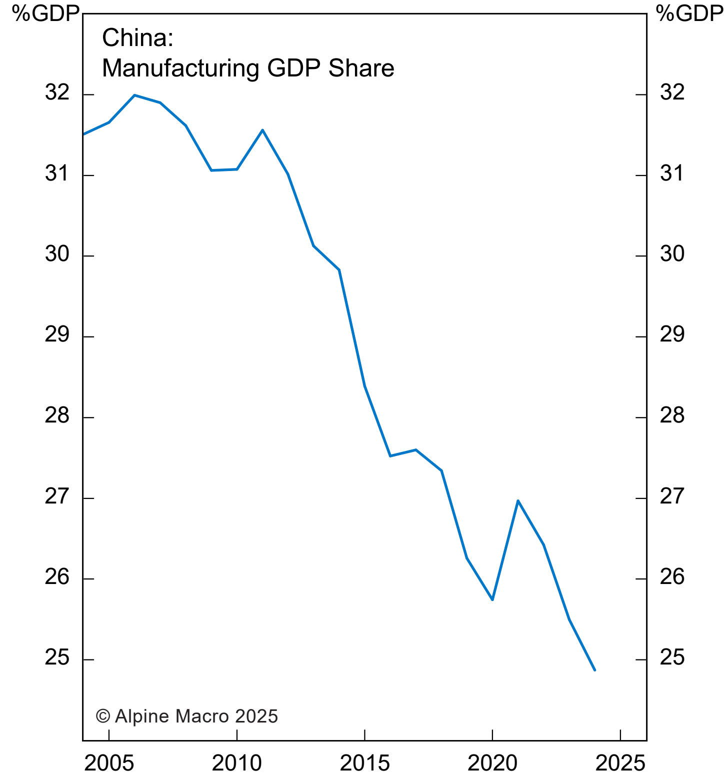


Chart 6 China: Manufacturing Is Also In Relative Decline



manufacturing-based economy is neither economical nor feasible. Chart 5 shows that U.S. manufacturing as a share of GDP continues to decline, despite efforts by both the Trump and Biden administrations to incentivize domestic production since 2016.

In the end, it is the profit motives that dictate corporate investment, and as TSMC estimates, moving semiconductor production to the U.S. would increase costs by over 50%.

The simple fact is that the American wage structure is simply not compatible with a large swath of global manufacturing business, which is the key reason why U.S. manufacturing remains in a downtrend in the economy despite various incentives to lure manufacturing investment into the U.S. Even Chinese manufacturing as a share of GDP has begun to decline since 2010, as Chinese firms find it more profitable or less risky to produce elsewhere (Chart 6).

The key takeaway is that mercantilism's focus on trade surpluses as wealth creation is misguided. As Adam Smith discovered a long time ago, national wealth is measured by a nation's ability to produce, possess or mobilize goods and services. By this metric, a current account deficit is not a loss but a gain.

Don't Forget Seigniorage

Seigniorage refers to the non-inflationary income earned by a central bank through issuing currency, as there is always demand for fiat currency. Globally, the U.S. enjoys a unique form of seigniorage as the michael pettis argues against this, definitely recommend reading that piece

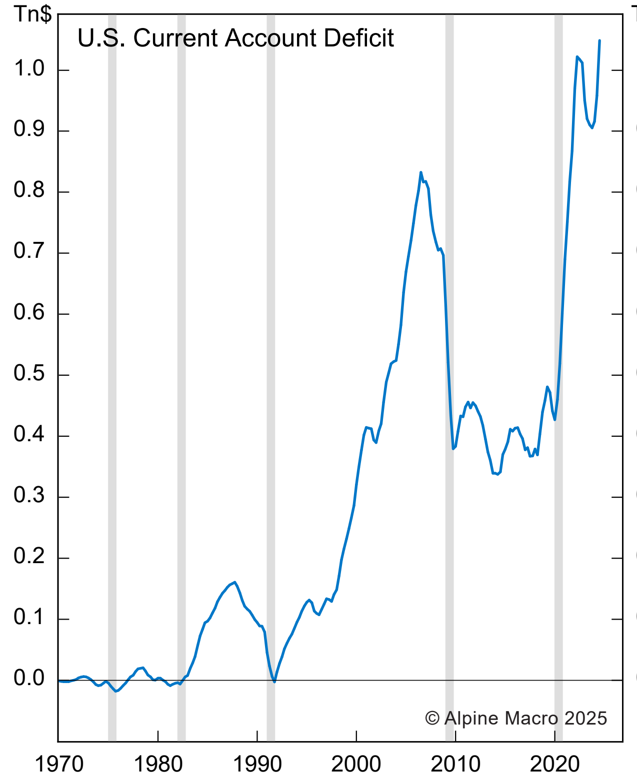
issuer of the world's hegemonic reserve currency. This can be seen as a risk-free national income, which is reflected as America's accrued liabilities that are effectively costless due to the global demand for dollars.

This risk-free income is represented by a certain amount of the U.S. current account deficit. After all, the U.S. current account deficit is the primary source of dollar supply for the rest of the world. In simple terms, the world's demand for dollars grants Americans the privilege of consuming more than they produce.

Moreover, as the global economy expands, so too does the demand for dollars — and, consequently, the size of the U.S. current account deficit. Therefore, far from being a disadvantage, this seigniorage is a significant benefit to U.S. businesses and consumers. It stands in stark contrast to the mercantilist view, which wrongly portrays the current account deficit as a sign of the rest of the world taking advantage of America.

This dynamic means the U.S. current account deficit will persist unless the dollar loses its status as the global reserve currency, or the world experiences a deep contraction in trade and financial flows. Indeed, the U.S. current account deficit typically shrinks during global recessions, as seen in historical data (Chart 7).

Chart 7 The Rise And Fall In America's Current Account Balance



Note: Shading denotes global recessions

Economic Consequences And Market Implications

First, tariff hikes are inherently deflationary, as they restrain or reduce real income. The costs of tariffs can be absorbed in three ways: passing them on to consumers, reducing corporate profits, or demanding price cuts from foreign suppliers. The first two options directly lower real income, while the third shifts the burden elsewhere. In practice, all three outcomes occur, but any reduction in real income is deflationary.

Financial markets have confirmed this dynamic. The 2018 U.S.-China tariff war led to a stock market sell-off but a rally in bonds. Similarly, recent tariffs on Canada and Mexico caused sharp declines in both stock prices and bond yields.

Second, a large-scale inflow of foreign direct investment (FDI) could bolster economic strength but also heighten overheating risks, given the U.S. economy is already at full employment. Large inflows of FDI would boost domestic aggregate demand but also generate wage and inflationary pressures.

Our hunch is that a substantial FDI inflow would be bullish for the dollar but bearish for bonds. Under this circumstance, the Fed may have to raise rates to compensate for a possible investment boom as FDI escalates. This may cause some problems for equity prices. Regardless, it remains unclear whether Trump's efforts to lure inward investment will succeed, so any assessment of how the Fed would react is premature.

Finally, even with a full-blown mercantilist trade policy — levying heavy tariffs while promoting exports — the U.S. is unlikely to narrow its current account deficit anytime soon, but will drive up the dollar sharply. However, steep, widespread tariff hikes plus a soaring dollar could sharply increase recession risks by curtailing income, spending and exports.

Again, investors should remember that the U.S. current account deficit reflects both the domestic saving-investment balance and the seigniorage benefits derived from the dollar's role as the global reserve currency. A strong U.S. economy relative to the rest of the world almost always leads to a bigger current account deficit.

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Investment Recommendations						
Tactical Investment Positions (3 - 6 months)						
Recommendations	**Open Date**	**Open Levels**	**Stop**	**Closing Date**	**Closing Levels**	**P&L Since Inception**
Long U.S. Financials ($IYF)	08/19/2024	101.30	101.3	-	-	14.9%
Long 10-Year German Bunds/ Short 10-Year JGBs	10/07/2024	2.3%/0.93%	-	-	-	9.4%[1]
Long Gold ($GLD)	12/09/2024	245.36	-	-	-	29.2%[2]
Short EUR/JPY	12/11/2024	160.00	-	-	-	2.0%
Long S&P 500 Energy ($XLE)/ Short WTI Crude Oil ($USO)	01/13/2025	90.3/82.2	-	-	-	9.1%
Long S&P 500 Energy ($XLE)/ Short Dow Jones Alternative Energy Index	01/13/2025	90.3/257	-	-	-	16.0%
Long S&P 600 Industrials ($PSCI)[3]	01/27/2025	140.03	-10%	02/20/2025	134.75	-10.0%[4]
Long Chinese Tech Stocks ($CQQQ)	02/17/2025	47.16	-	-	-	4.9%

Note: P&L is calculated using daily closing prices.

[1] Return is calculated based on a continuous Long 10-Year German Bunds/Short 10-Year JGBs position, first initiated on 08/07/2023 and stopped out on 08/05/2024.

[2] Return is calculated based on a continuous Long GLD position, first initiated on 04/01/2024 and stopped out on 11/11/2024.

[3] The stop point at -10% for our Long S&P 600 Industrials ($PSCI) trade was triggered on 02/20/2025.

[4] Return is calculated based on a Long S&P 600 Industrials/Short S&P 500 Specialty Retail position, first initiated on 01/13/2025 and closed on 01/24/2025, and a Long S&P 600 Industrials/Short MSCI Mexico ($EWW) position, where the short leg was removed on 02/14/2025.

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