ALPINEMACRO
A Unique Mind On The Markets

GLOBAL FIXED INCOME & CURRENCY STRATEGY

November 22, 2024

Tariffs, The Trade Deficit, The Dollar & Inflation

- President-elect Trump wants to raise tariffs to narrow the U.S. trade deficit and revive the manufacturing sector.
- Tariffs failed to have the desired effect during Trump's first term and are unlikely to succeed in his second term.
- Tariffs do not address the U.S. economy's underlying macro savings and investment balances, which determine the trade deficit.
- If Trump eases fiscal policy, the result would be an even larger trade deficit.
- Policies of higher tariffs and large budget deficits could lead to a stronger dollar.
- Tariffs and trade wars are not inflationary. They can lead to a contraction in total trade, which is ultimately deflationary.

In President-elect Trump's view, trade is a zero-sum game. In his black and white world, surpluses are good and deficits are bad. Trump sees the U.S. trade deficit as a sign that foreigners are "ripping off" Americans. To him, the trade deficit signifies a hollowing out of the U.S. manufacturing sector and a loss of jobs (**Chart 1**). Never mind, that U.S. employment is at a record high and the jobless rate is near a multi-decade low.

Chart 1 Trump Does Not Like These Trends

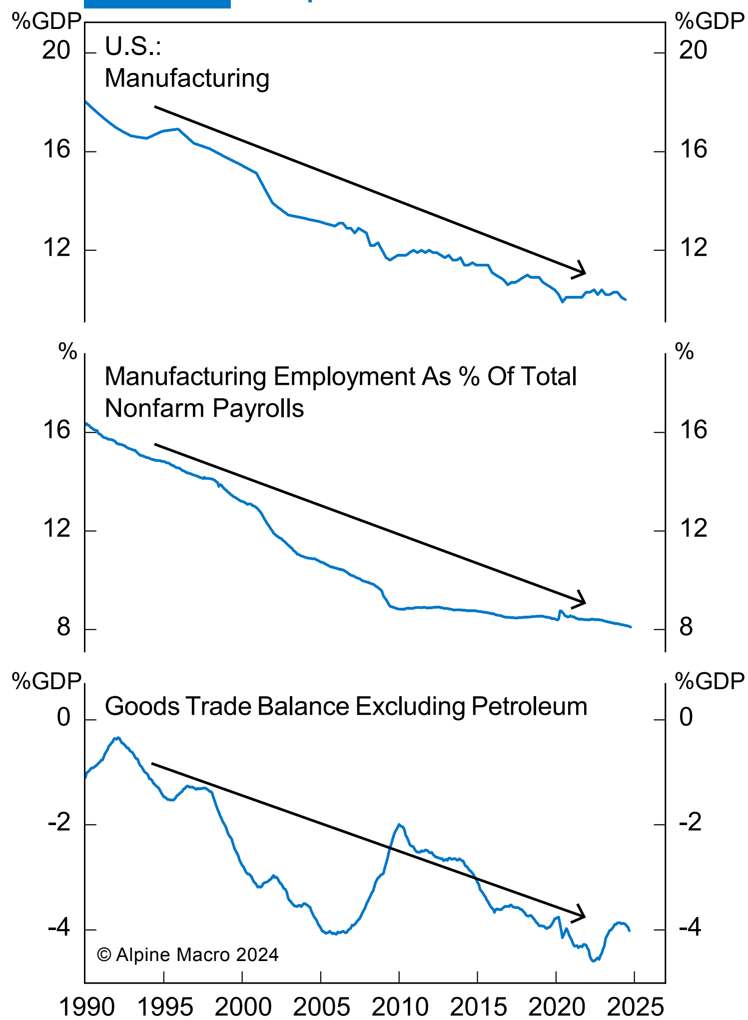
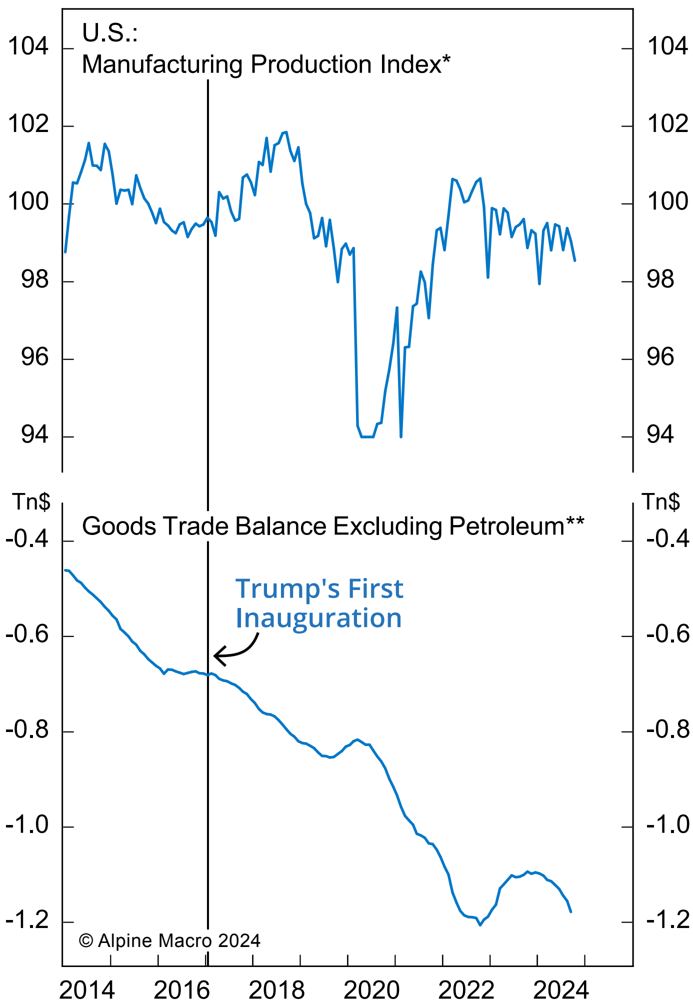
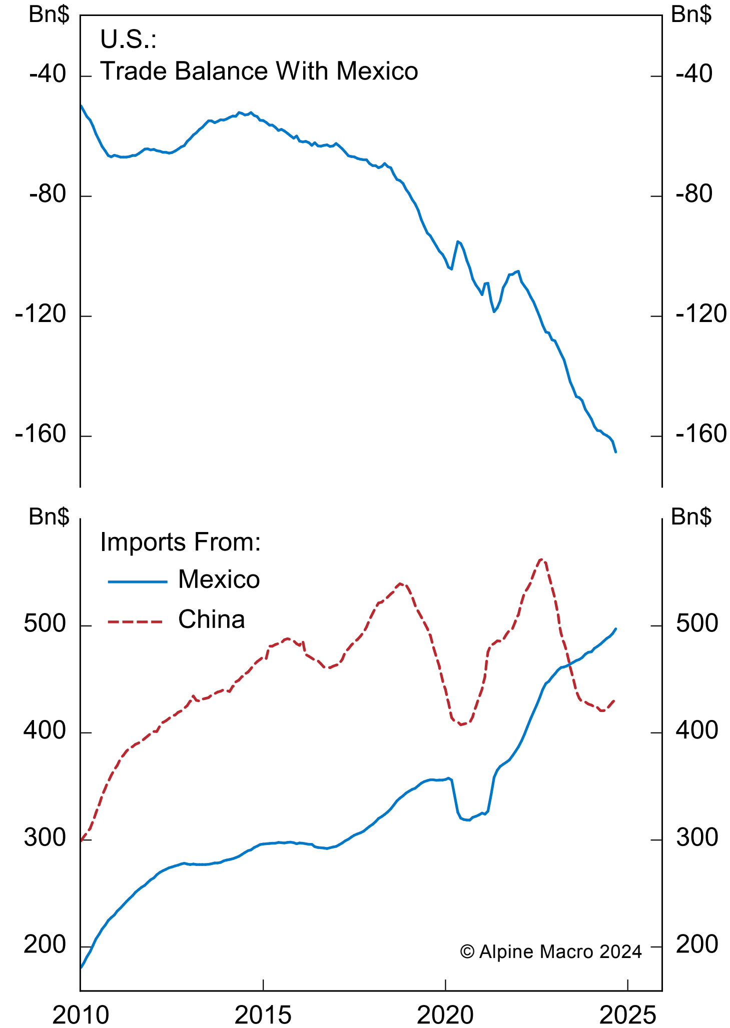


Chart 2 Trump's Trade Policies Did Not Succeed



*Truncated at 94
**Shown as 12-month moving sum

Chart 3 Trump Will Target Mexico



Note: Series are shown as 12-month moving sum

During his first term in office, Trump tried to reverse the tide by imposing tariffs and renegotiating trade deals, such as NAFTA. However, the policies did not have the desired effect. Since his first inauguration, U.S. manufacturing output has stagnated and the trade deficit has only widened (**Chart 2**).

As Trump looks to begin his second term as president, he is planning to "double-up" on his old trade policies. He is proposing a 10% tariff on all U.S. imports, with a much higher 60% duty on imports from China. Additionally, the USMCA (i.e. NAFTA's replacement) will be up for review in 2026. Mexico will almost surely be a target for Trump. America's trade deficit with Mexico has exploded as its southern neighbor has overtaken China as the largest source of U.S. imports (**Chart 3**).

This raises several important questions. Will Trump's trade policies have more success this time? What will be the implications of the policy measures for the dollar, inflation, and interest rates?

Trade Policy Versus Fiscal Policy

Trump's trade policies during his first term failed to narrow the trade deficit because they did nothing to address the U.S. economy's underlying macro savings and investment balances. Instead, the fiscal policies of Trump (and President Biden) have contributed to the widening trade deficit.

The best way to understand the impact of the budget deficit on the trade balance is through a simple accounting exercise.

Start with the national GDP accounting identity:

$$Y = C + I + G + (X - M) \qquad (1)$$

Or alternatively:

$$Y = C + S + T \qquad (2)$$

Substituting (2) into (1) and rearranging gives:

$$(X - M) = (S - I) + (T - G) \qquad (3)$$

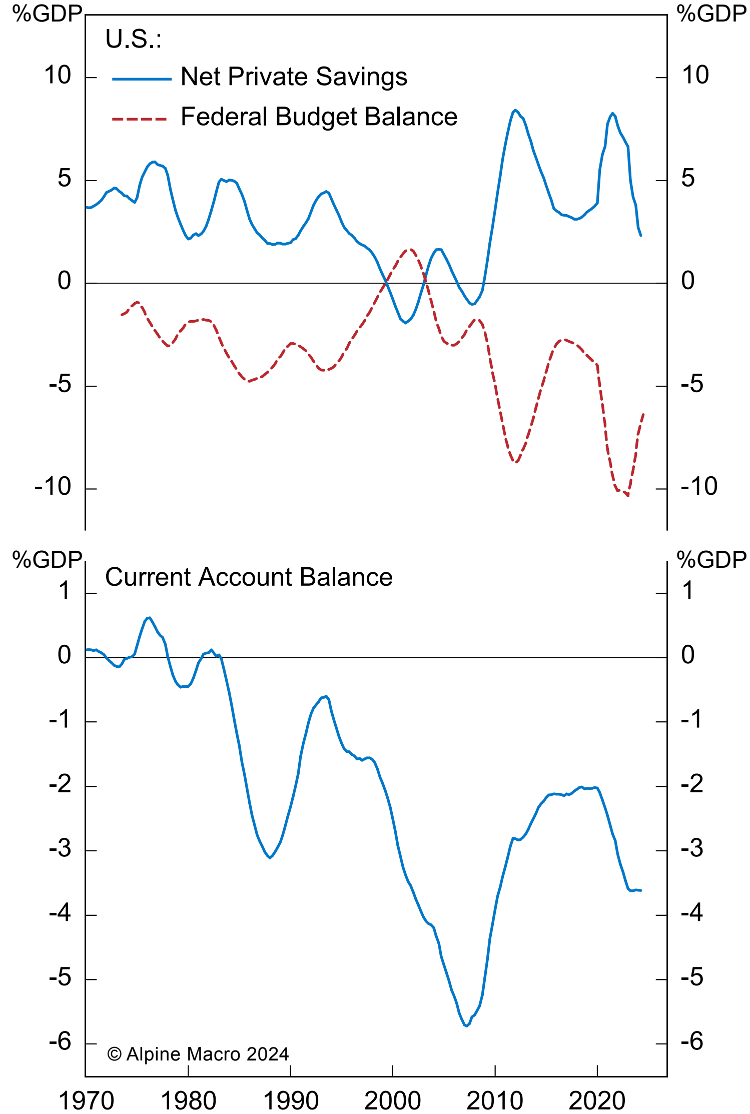
Equation (3) states that the trade or current account balance, $(X - M)$, equals the sum of the private sector's savings less investment balance, $(S - I)$, plus the government's fiscal position, $(T - G)$.[1] In short, a bigger government deficit will lead to larger trade and current account deficits, all else being equal.

The U.S. budget deficit started to widen with Trump's Tax Cuts and Jobs Act of 2017 and the bottom gave out once the pandemic struck in 2020:

- Trump signed the CARES Act in March 2020, which was followed up by the Consolidated Appropriations Act later in the year.

- President Biden continued the largesse with the American Rescue Plan Act of 2021. Even once the pandemic was over, Biden pushed for more spending with the Infrastructure Investment and Jobs Act, the CHIPS and Science Act, and the Inflation Reduction Act.

Chart 4 **The Fiscal Deficit Is The Culprit For The Current Account Deficit**



Note: Series are shown as 1-year moving averages

As per equation (3) above, **Chart 4** decomposes the U.S. current account deficit into private sector's

1 For the discussion in this report, we use the trade balance interchangeably with the current account balance.

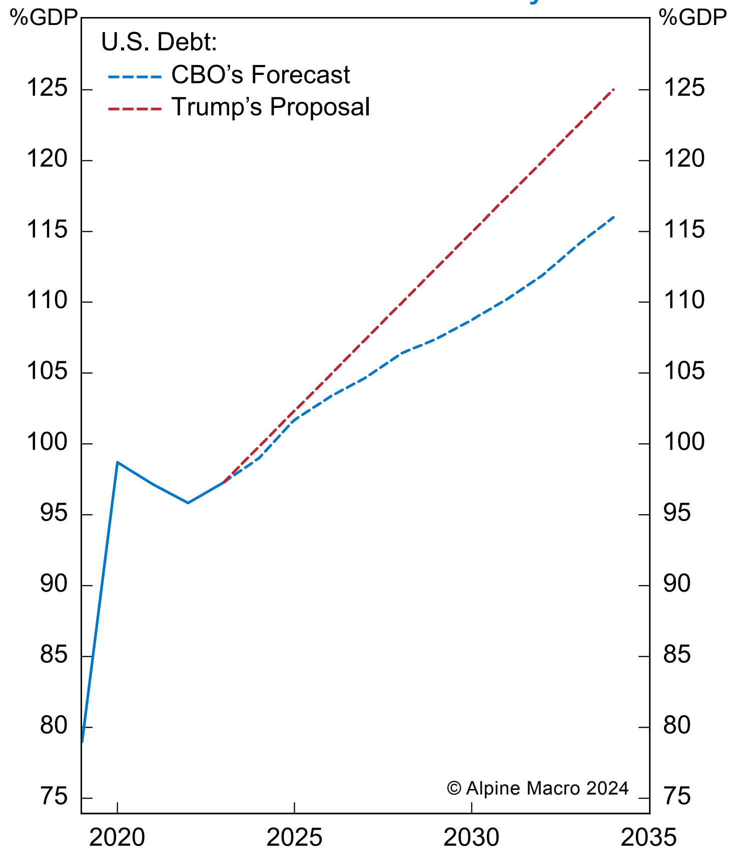
savings less investment balance and the government's budget balance. As seen in the chart, the U.S. private sector is in a net surplus position. Except for a few brief periods, the private sector has generally run surpluses for the last five decades. Therefore, the trade and current account deficits can be largely attributed to the government's fiscal deficit.

If Trump is serious about narrowing the trade deficit, then the appropriate course of action is to tighten fiscal policy, which would also have knock-on effects on interest rates and the dollar. Tighter fiscal policy should allow the Fed to cut rates more aggressively. In turn, a combination of tighter fiscal policy and easier monetary policy would lead to a weaker dollar. In other words, Trump can achieve the trifecta he wants by tightening fiscal policy: a narrower trade deficit, lower interest rates, and a weaker dollar.

But rather than fiscal austerity, Trump has campaigned on cutting taxes further. To begin with, he wants to extend the Tax Cuts and Jobs Act of 2017 that is set to expire at the end of next year. Trump also wants to reduce the corporate tax rate from 21% to 15%. Additionally, he is offering tax breaks to individuals, such as exempting tips, overtime pay, and social security benefits from income tax and removing the cap on state and local tax (SALT) deductions.

Potential spending cuts and increased government revenue from higher import tariffs will not be enough to offset the lower taxes that Trump is proposing. The Penn Wharton Budget Model suggests that Trump's campaign policy proposals would add an

Chart 5 Trump's Campaign Proposals Will Loosen Fiscal Policy



additional 14 percentage points to the debt-to-GDP ratio over the next decade compared to the CBO's baseline projections (Chart 5).

Even with full Republican control of Congress, Trump may not get everything he wants. The Republicans do not have a filibuster-proof majority in the Senate. In the House, a few fiscal hawks could stonewall new legislation. Nevertheless, there should still be some easing of fiscal policy as long as some of Trump's policies get adopted.

Bottom Line: Raising tariffs will not lead to a narrower U.S. trade deficit. If Trump is able to ease fiscal policy, the result would be an even larger trade deficit.

Chart 6 Trump's Trade War Led To A Stronger Dollar

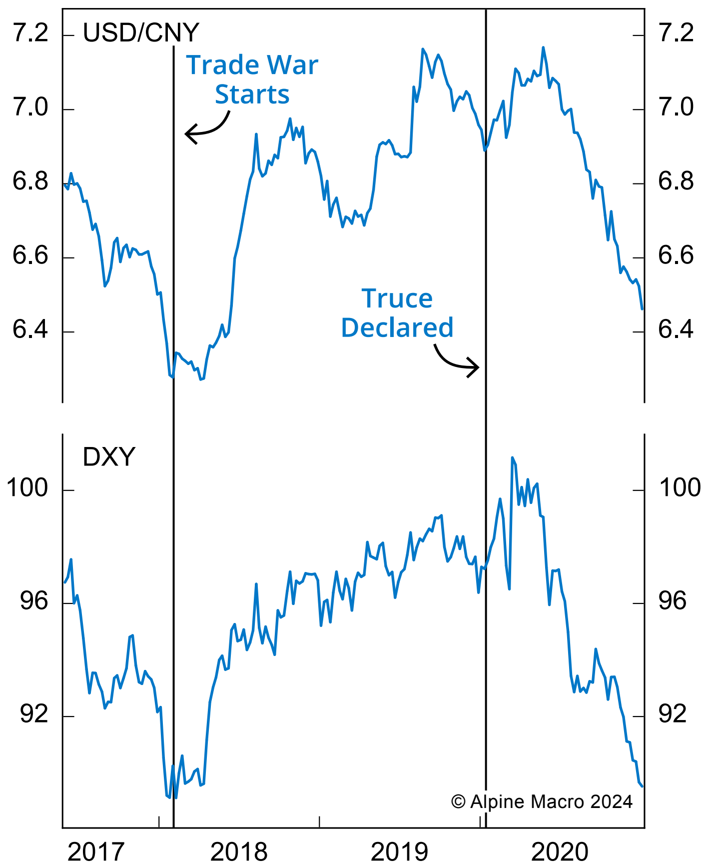
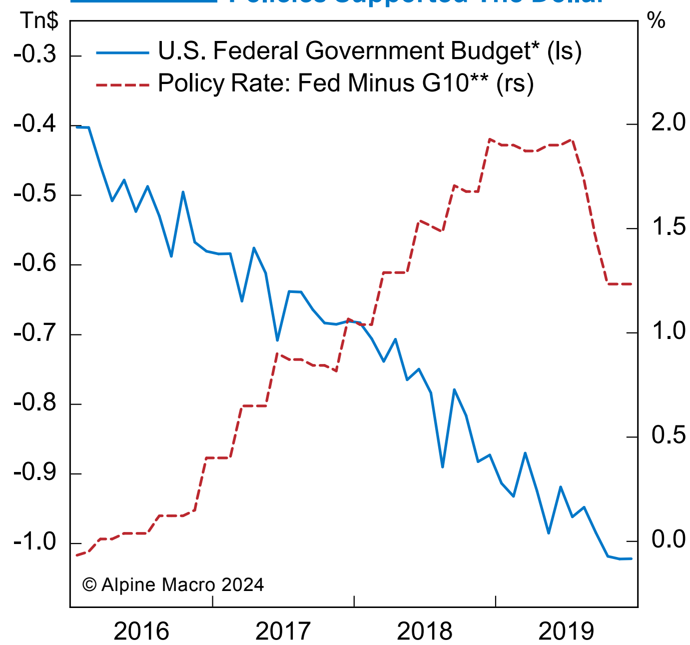


Chart 7 Easy Fiscal & Tight Monetary Policies Supported The Dollar



*Shown as 12-month moving sum
**Equally-weighted average of G10 excluding U.S.

The Dollar Adjusts

2018 was an important year in Trump's first term as president for two reasons:

- First, the Tax Cuts and Jobs Act came into effect, resulting in looser U.S. fiscal policy.
- Second, Trump launched his trade war.

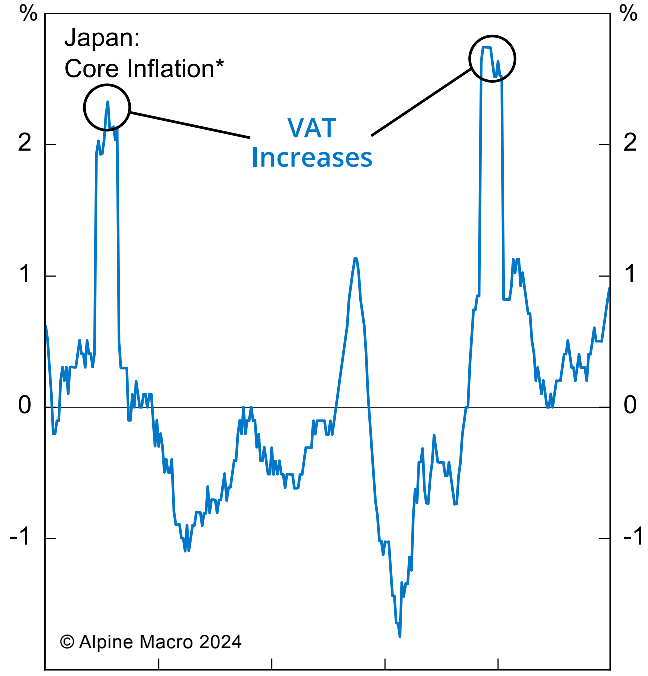
The trade war began in February 2018 with the U.S. announcing a 30% tariff on solar panels and a 20% tariff on washing machines. Trade frictions, especially with China, continued to escalate for the next two years as tit-for-tat tariff hikes became the norm.

A truce was finally declared in January 2020 when the U.S. and China signed a "Phase One" trade deal. The U.S. agreed to roll back some tariffs and China committed to increase its purchases of American products.

A key outcome of easier U.S. fiscal policy and higher tariffs during this period was a stronger dollar. Chart 6 shows that both USD/CNY and the DXY index trended higher from the beginning of 2018 to early 2020. The strength of the dollar can be attributed to two main factors:

- First, the easing in fiscal policy emboldened the Fed to raise interest rates. A mix of looser fiscal policy and tighter monetary policy is a classic recipe for a stronger currency (Chart 7).
- Second, as the tariffs did not address the fundamental savings and investment imbalance in the U.S. economy, the dollar needed to strengthen as a counterbalance. A stronger dollar kept imports

Chart 8 Tax Hikes Did Not Lead To Sustained Inflation



*Excluding fresh food and energy

attractive and it penalized exports. This neutralized the effect of the tariffs on the trade balance.

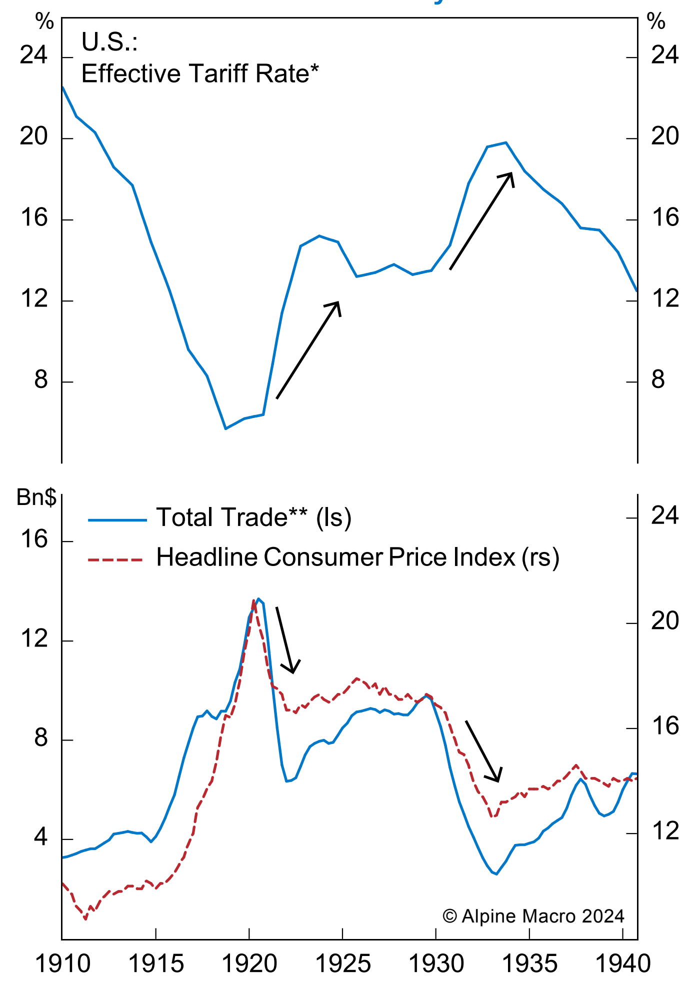
If Trump repeats the policies of his first term, a replay of 2018-2020 could be in store for the dollar. Easier fiscal policy will mean less scope for the Fed to cut interest rates, which will support the dollar. A stronger dollar will also be needed to offset higher tariffs. This would keep the trade deficit wide in conjunction with the large fiscal deficit.

Bottom Line: Trump's policies of higher tariffs and hefty budget deficits could lead to a stronger dollar.

Are Tariffs Inflationary?

Investors are worried that rising tariffs will lead to much higher inflation. We believe that these fears are misplaced.

Chart 9 Higher Tariff In The 1920s & 1930s Were Deflationary

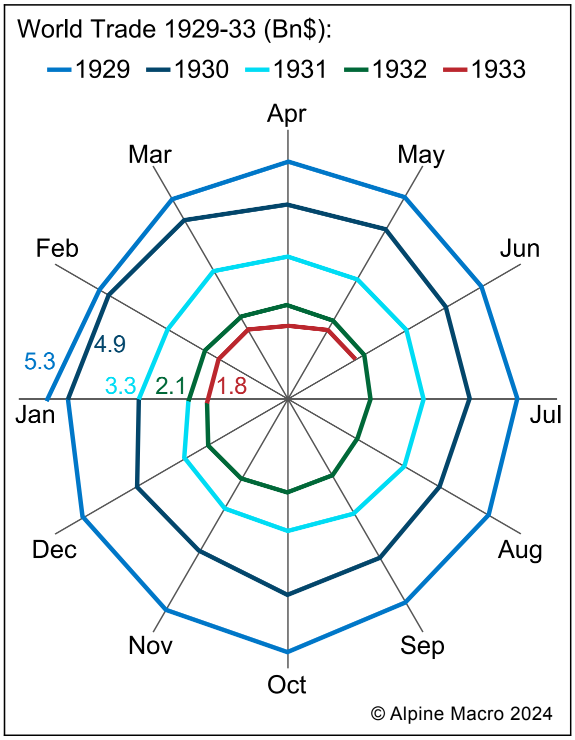


*Total import duties as a % of the total value of imports
**Sum of imports and exports; shown as 12-month moving sum

A tariff is like a consumption tax. Therefore, raising tariffs is equivalent to hiking taxes. If cutting taxes boosts real spending, tariff hikes reduce it. The overall impact of rising tariffs is contractionary for disposable incomes and disinflationary for prices over time.

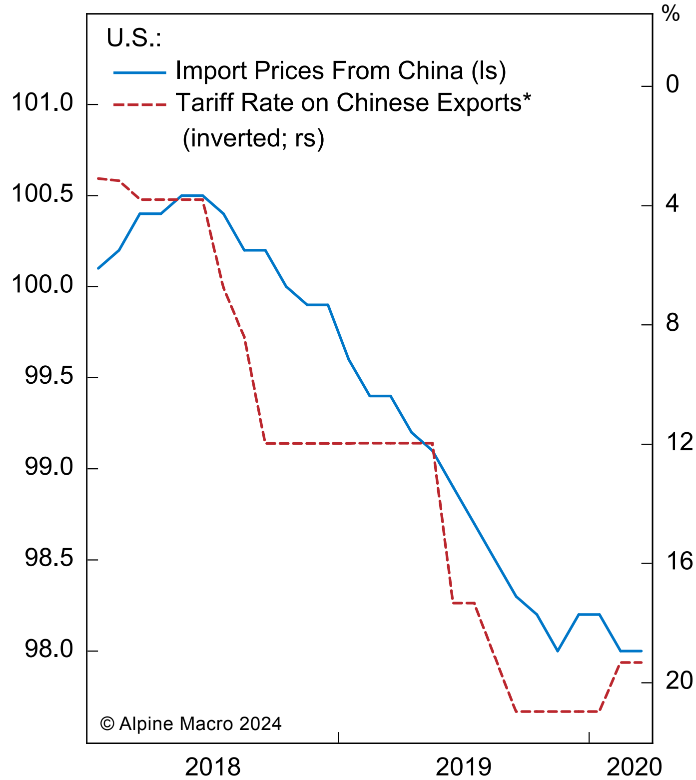
Japan offers a useful case study in how tax hikes lead to a temporary rise in inflation, but eventually they turn out to be disinflationary. As seen in Chart 8, periodic increases in the VAT led to spikes in Japanese inflation. However, the effect washed

Chart 10 Trade Wars Led To A Collapse In Global Trade



Source: League of Nations' World Economic Survey 1932-33

Chart 11 U.S. Import Prices From China Fell In 2018/19



*Source: Peterson Institute for International Economics

out of the annual inflation rates after a year. Without a commensurate increase in nominal incomes, the higher taxes acted as a drag on consumers' spending power and led to a sharp decline in inflation.

In a more extreme example, there is the lesson from the 1920s and 1930s. The tariff hikes in the inter-war years resulted in price deflation (**Chart 9**). In particular, the 1930 Smoot-Hawley Tariff Act is widely believed to have worsened the Great Depression. It triggered retaliatory actions that led to a downward spiral in global trade and exacerbated the economic woes (**Chart 10**).

Can argue the effects will be more pronounced now that consumption makes up a larger share of the economy than it did back then

Finally, there is the recent U.S. experience of 2018/19. Despite the tariff war between the two countries, U.S. import prices from China declined during this period (**Chart 11**). This was due to the offsetting impact of a stronger dollar and importers taking a hit on their profit margins.

Bottom Line: Tariffs and trade wars are not inflationary. They can lead to a contraction in total trade, which is ultimately disinflationary.

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Currency Outlook

Vs THE DOLLAR	1-3 Months	9-12 Months
EUR	FLAT	DOWN
JPY	FLAT	UP
GBP	FLAT	DOWN
CHF	FLAT	FLAT
CAD	FLAT	DOWN
AUD	FLAT	DOWN
NZD	FLAT	DOWN

Vs THE EURO	1-3 Months	9-12 Months
JPY	UP	UP
GBP	UP	UP
CHF	UP	UP
SEK	FLAT	UP
NOK	FLAT	UP

Fixed-Income Outlook

OVERALL PORTFOLIO DURATION

AT BENCHMARK

COUNTRY ALLOCATION*	
U.S.	3
Japan	1
Eurozone	4
Core	5
Periphery	2
U.K.	2
Switzerland	2
Norway	4
Sweden	3
Canada	3
Australia	4

* Numbers denote allocation where 1 = maximum underweight and 5 = maximum overweight

Currency Positions

Recommendations	Open Date	Open Level	Target	Stop	P&L		
					Spot	Carry	Total
Long AUD/NZD	2019-04-29	1.0574	1.2000	-	5.05%	-4.08%	0.97%
Long Gold	2022-03-04	1,928	-	-	38.50%	-	38.50%
Short EUR/JPY	2024-11-08	165.17	-	Rolling -3%	1.96%	-0.12%	1.85%
Short EUR/GBP	2024-11-08	0.8318	-	Rolling -3%	-0.03%	0.06%	0.03%
Short EUR/AUD	2024-11-08	1.6172	-	Rolling -3%	0.51%	0.05%	0.56%

Fixed Income Positions

Recommendations	Open Date	Open Level	Target	Stop	P&L
Long 2-Year/Short 10-Year U.S. Treasuries	2022-12-02	4.24%/3.51%	-	-	80.23 bps

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