THE GHOST OF SMOOT-HAWLEY

March 16, 2018

Thankfully, I can tell you that I was not around for the enactment of the Smoot-Hawley Tariff in 1930. Economists have since taught students that this tariff was the biggest single contributor to the Great Depression of the 1930's. Granted, there were other contributors, i.e., a tax hike, but this tariff was recognized as precisely the wrong tactic to be used against an on-coming recession.

Why did we opt for such a poor tactic? Americans at that time felt that it was necessary to protect our many industries and the American jobs that went with them. Advocates sang an attractive "siren song" to convince people to arrive at that infamous political decision …the rest is history.

Today, 88 years later, we are hearing a similar refrain, sung by the director of the White House National Trade Council. Mr. Peter Navarro is an economist from the University of California, Irvine. He has authored several books, all aimed at reducing our trade deficit. He is also an environmental activist and a registered member of the Democratic Party.

Mr. Navarro's primary view is that trade deficits are bad and must be eliminated, at almost any expense. His arguments include protecting American jobs, wealth and industry. (Sound familiar?) This tune plays well to President Trump's intuitions, which emanate from the unfair tactics employed by many of our trading partners over the years. Mr. Navarro advocates the use of broadly applied tariffs against our trading partners, designed to eliminate any trade deficit that may exist. This is the genesis of Trump's recent steel and aluminum tariffs. Fortunately, these tariffs have been watered down with exemptions, mitigating any serious economic bite that would have occurred. Nevertheless, Mr. Navarro's philosophy is ever-present and very dangerous. Now, we are considering a $100 billion tariff against China.

Our views on trade deficits are polar-opposite. Over the past century, trade deficits always increased during our most rapidly improving periods of prosperity. One must remember that deficits in trade are always complemented by a surplus in payments, so the money that goes out to pay for the deficit always comes back, as the recipient must invest the dollars in the U.S. to earn a return. The dollars do not permanently leave with a trade deficit. Typically, the most prosperous nations incur the largest trade deficits. In the words of our economist, Vic Canto, in answer to Mr. Navarro's view, "If he's right, then presumably, all countries would want to eliminate a trade deficit, and if they were to become successful, we would have no trade at all!"

When looking at the trade issue, the motive of the President seems to be the most important determinant. Is Donald Trump a protectionist because of perceived unfairness, or does he believe that all trade deficits are bad?

Trying to make trade terms more equitable, fair, and reciprocal is not necessarily bad. However, this is a different objective than simply trying to eliminate trade deficits through tariffs. We hope the President understands this difference and has other tactics in his bag for negotiations. If he attacks each disparity, "eyeball to eyeball" with each head of state, we can achieve progress toward fairness without undermining global trade and global economic prosperity.

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Where we go from here is unknown. Simply put, if Donald Trump attempts to negotiate "out" the unfairness within each specific trade agreement, the result could be quite positive. If the President uses tariffs as a means to simply eliminate trade deficits, the result will likely be very negative.

As you know, we have been positive on the investment outlook for over a year. Our current outlook can best be described as "cautiously bullish," and your portfolios reflect this caution. The tariff issue is the reason for our change, and while our President pursues his trade tactics, we will keep a watchful eye on his every move and comment.

Enter Larry Kudlow. Donald Trump's appointment of Larry Kudlow as Chief Economic Adviser introduces a voice of sanity and reason. We know Larry personally and know his thinking. He is a supply-sider and would view tariff and trade deficits as we at Cadinha & Co. would. Hopefully, Larry's persuasiveness will be at its best to keep President Trump focused on the right issue. If he succeeds, we will move our targets for the markets higher. Let's keep our fingers crossed.

Please feel free to call us if you would like to discuss these views in greater detail. As always we appreciate your continued loyalty.

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