ECONOMY AND POLICY | OTHER VOICES

Mr. Trump, Meet Smoot and Hawley

By
David R. Breuhan

July 06, 2018, 6:24 pm EDT

The U.S. stock market peaked on Jan. 26, 2018, the day President Donald Trump gave a speech at the World Economic Forum in Davos, Switzerland. He stated that "America is open for business," and threatened to levy tariffs against China.

On Friday, the U.S. slapped tariffs on $34 billion of Chinese goods —and China responded in kind. The Trump administration has also imposed tariffs on steel and aluminum imports from Mexico, Canada, and the European Union, which have threatened to retaliate. And it has placed tariffs on Canadian softwood lumber, leading lumber prices to soar.

Stock markets don't react well to tariffs, which lift costs, result in shortages, and hurt corporate profits. History suggests that the market won't top its January record until the trade spat is fully resolved.

There is a primary lesson here for nations: Impose tariffs on others, and they will do the same to you.

Following the passage of the Smoot-Hawley Tariff in June 1930, the U.S. raised tariffs to an average of 59% on more than 25,000 imports. Our trading partners retaliated. Spain increased tariffs by 150% on American autos. France restricted the import of more than 3,000 goods, via quotas. Britain passed the Import Duties Act of 1932, its first major tariff legislation in 100 years.

Part II of this act raised tariffs 100%. Italy and Switzerland both boosted tariffs. By 1935, 34 nations had imposed exchange controls limiting their citizens' ability to obtain foreign currency for travel or trade. Globally, exchange controls of this magnitude hadn't been imposed in nearly 400 years.

Trump's desire to negotiate through force will be met with equal or greater force. The post–World War II trading order has been established over decades through numerous rounds of talks with many nations. The new protectionist action threatens the foundation on which the General Agreement on Tariffs and Trade was established.

The irony is that Trump's actions could undermine the very structure that the U.S. helped establish to prevent another world war. Trade means peace. You don't declare war on your customers.

The stock market crashed on Oct. 28, 1929, on news that the Smoot-Hawley Tariff would become law, in either the then-current or next session of Congress. Markets discount future earnings or the lack thereof. The Dow Jones Industrial Average fell from 381 in September 1929 to 41 in July 1932, a decrease of 89%. U.S. imports and exports both dropped to the 1905 level. By 1934, global trade had decreased by more than 60%. A full-blown depression ensued. Economic nationalism rose and led to World War II.

Some 70 years later, the administration of President George W. Bush imposed tariffs that also harmed stocks. The post–Sept. 11, 2001, stock market peak occurred on March 19, 2002, when the Dow industrials hit 10,635. Steel tariffs took effect the next day. Lumber tariffs and crop subsidies were implemented in May of that year.

During this first year of tariffs, the S&P 500 lost more than $2 trillion in market capitalization.

Many people hope that Trump's tariffs and trade talk are simply a negotiating ploy consistent with those described in his book *The Art of the Deal*. Others note that exports account for only 14% of gross domestic product, and that a trade war might reduce growth by less than 1%.

The same types of arguments were made about Smoot-Hawley and its impact on the U.S. economy in the 1930s. But the issue isn't the impact of tariffs on GDP; it is the impact on corporate earnings, which support the price of stocks. A trade war could send earnings down 5% to 10%.

Additionally, a trade conflict could wipe out all of 2017's market gains. Most Americans have some type of stock market exposure, directly, or indirectly, through a 401(k) plan, an IRA, or 529 college accounts. Protectionism on both sides of the ocean will cause these accounts to lose value.

The president boasts that America will win a trade war. But everyone will lose. The U.S. can't control the actions of other nations. Worse, we risk driving our allies into the hands of a welcoming and aggressively expanding China. That country's president, Xi Jinping, is a proponent of global trade and could be the primary beneficiary of America's unwise actions.

In 2003, the Bush administration came to its senses, after it asked the right question: "What would happen to the U.S. markets if we don't lift the steel tariffs and the Europeans retaliate?"

The answer was a market decline of several thousand points. The tariffs were lifted, and stocks recovered. Ultimately, the president's advisors understood the wisdom of the adage that "my prosperity is dependent on the prosperity of my neighbor."

Thus far, the Trump administration shows no intention of asking any questions. Officials are unapologetic and dismissive of facts that illustrate the secondary consequences of their actions on America's businesses, consumers, and allies. This is a dangerous way to lead the free world.

David R. Breuhan is vice president of Schwartz & Co., a Bloomfield Hills, Mich., investment firm. He is the author of *Spread the Wealth: More Haves Fewer Have-Nots*.

Guest commentaries like this one are written by authors outside the Barron's and MarketWatch newsroom. They reflect the perspective and opinions of the authors. Submit commentary proposals and other feedback to ideas@barrons.com.