COMMENTARY

New Tariffs Are the Last Thing the Stock Market Needs

By David R. Breuhan

Dec 21, 2023, 3:29 pm EST

Bottles of Brown Forman Corp. brand Jack Daniel's Single Barrel Select Tennessee Whiskey move along a conveyor at the company's distillery in Lynchburg, Tenn. LUKE SHARRETT/BLOOMBERG

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Whiskey drinkers and distillers have been spared, for now.

The European Union is pausing plans to impose tariffs of 50% on imported whiskey that were due to begin on Jan. 1 in retaliation for U.S. tariffs on imported steel. Harley Davidson motorcycles, Levi's jeans, and orange juice are also on the list of the EU's suspended tariffs.

But this is a suspension of a tariff dispute, not the cancellation of one. And it is only one example of an ongoing fight among nations. Every decade brings new trade disputes, which increase prices and cause shortages. The most devastating impact of tariffs occurs in the stock market.

Three major global trends have benefited the U.S. since 1945: falling political barriers, increased technological development and increased trade. These trends intensify two factors: decreased transaction costs and increased resource mobility. As the world becomes more interconnected, prices fall due to increased competition. This provides benefits globally as consumers purchase the best product at the lowest price.

The recent backlash against trade is partly due to open markets as being viewed as a revolutionary process, rather than an evolutionary one. Much of the world was blocked from trade during the "75-year emergency": World War I, the Great Depression, World War II, and the Cold War. After the fall of the Berlin Wall, nations re-established trading patterns that existed before the First World War. The overriding benefit of trade is peace. You do not declare war on your customers.

Ricardo's idea of comparative advantage is not only true in theory, but it also works in practice. Ask a consumer to check the tag on the coat they are wearing. Chances are it was not made in the United States. A consumer asks two basic questions: Do I like it and can I afford it? Very few if any shoppers look for nation of origin on a good or service. Protectionism may work well at the ballot box, but it rings hollow at the cash register.

There are three instances in the last century when the market tanked because of American tariffs on imports: the great crash of 1929, the steel and lumber tariff of 2002, and the 2018 trade dispute with China, Mexico, Canada, and the European Union.

The stock market collapse began on Oct. 28, 1929, as news spread that the Smoot Hawley Tariff bill would become law. The New York Times headline read: "Leaders Insist Tariff Will Pass." This caused markets to react immediately, as markets discount future earnings. The gold standard did not cause the market to correct, but the myth of this belief remains the gospel in modern economics. The tariff's passage would amount to a tax on over 20,000 imports into the United States.

Once the bill became law, nations of the world retaliated. The agricultural sector was among the worst affected, as farmers could not competitively export their crops. By 1932, the Dow Jones Industrial Average declined 89% from its 1929 highs and by 1934, global trade dropped 66%. There certainly was a credit crisis, but it was caused by the lack of trade, which resulted in the money supply decreasing by 33%. The Great Depression ensued, increasing economic nationalism, allowing radicals to come to power, resulting in the Second World War. The adage proved true: when goods cannot cross borders, armies will.

A similar event affecting the market occurred seven decades later. The Dow Jones Industrial Average reached a post-Sept. 11, 2001, peak on March 19, 2002, at 10,635.25. President Bush imposed steel tariffs the next day. Lumber tariffs followed in May. The DJIA did not recover until the steel tariffs were lifted on Dec. 4, 2003. From March 2002 to May 2003, the S&P 500 lost $2 trillion in market cap following one full year of having these commodity tariffs in place.

Stating that "America is open for business," another president took tariff action on U.S. trading partners in January 2018, causing the market to peak. President Trump announced tariffs on China and China responded in kind. He also imposed tariffs on steel and aluminum imports from Mexico, Canada and the European Union. Canadian lumber also received a tariff, resulting in higher domestic prices. The market retreated and did not reach its January high until August 2018.

With the election one year away, the leading Republican candidate vows to impose a 10% tariff on all imports if he is elected. The markets have provided irrefutable historical evidence that when tariffs are imposed to support specific industries, the stock market is immediately affected, as is every investor. American importers and consumers ultimately pay the tariff, with some taxes levied by Customs at the port of entry. American exporters are impacted, as well.

Trade requires an honor system that must be rigorously enforced through existing bodies, developed to resolve disputes in front of panels rather than on battlefields. If a nation violates the rules established for fairness and integrity, it should be addressed, but not by using tariffs. Denial from market access, loss of most favored nation trading status, or expulsion from the World Trade Organization are only a few of many options. Repeating failed actions of the past will only result in lower performing equity markets and economic distortions.

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