Trump Tariffs, Business Chaos, and Valuation Adjustment

The world was blindsided on April 2nd by the magnitude of President Trump's tariffs and the threat of a global trade war with allies and adversaries alike. In this quarter's commentary, we will provide an overview of our strategy given current market conditions and discuss the economics of tariffs and trade in the context of the administration's policies.

Strategy and Current Market Conditions

US tariffs and global retaliation have caused economic uncertainty, major market declines, and recession concerns. ACR believes de-escalation is likely: the idea is that a political self-preservation "put" (or Trump public popularity "put") is more likely than persistent, insensibly high tariff rates which cause significant economic disruption, including job losses. In the near term, uncertainty around economic policy could cause a recession. Recession, however, should not dramatically alter our valuations and estimated strategy returns, as we normalize earning power for economically sensitive companies.

In the long term, a secular trend toward de-globalization could affect growth, productivity, and inflation. Precise forecasts are impossible to construct. Economic complexity and the law of unintended consequences are likely to overrule any attempt to predict these future events. Nevertheless, we believe the economy will muddle along its historical trajectory and see no reason to change our long-term estimates for GDP per capita growth of 1-2% or inflation of 2-4%. The global economy has weathered more disruptive events than today's tariffs and nonetheless managed to return to its long-term trend.

ACR continues to evaluate the impact of tariffs on our holdings. In our flagship Equity Quality Return (EQR) strategy, we estimate 50% of companies will experience little to no impact, 30% will be moderately impacted, and 11% could be highly impacted (the remaining 9% is in cash equivalents). ACR investment strategies are properly diversified, and EQR strategy market values are positive for the year as of April 25th. Interestingly, equity market declines have undergone a valuation adjustment that appears unrelated to tariffs. Many companies whose stock prices have declined considerably have had higher valuations. As our long-time readers know, we believe a valuation reset is long overdue. ACR strategy relative returns are likely to benefit if this dynamic persists.

The tariffs have had a chaotic impact on business. We will continue to adjust portfolio company values as necessary. In early March we wrote down the value of the company most impacted by tariffs in our EQR strategy by 18%, which reduced total portfolio fundamental value by approximately 1%. More write-downs are possible. Nevertheless, the potential impact is not significant enough to materially alter our long-term ACR strategy and equity market return assumptions.

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On a positive note, volatility creates opportunities to put our excess cash to work in underweighted current holdings and new opportunities. ACR has added several new positions across our strategies, and we reduced the cash balance in our flagship EQR strategy from 13.4% at year-end to 9.0% as of April 25th. ACR investors who have followed our cash balances recognize this is relatively low. Cash holdings are solely a reflection of our ability to own a sufficiently diversified portfolio of companies at reasonable prices, not a reflection of overall market values. Note at the market peak in April of 2000, EQR was fully invested and went on to earn its highest absolute and relative returns during the ensuing bear market. Over the years we have found it best to avoid market timing and instead to remain focused on buying sound companies at attractive prices.

Tariffs and Trade

"Comparative advantage" is a foundational theory in economics found in your typical first-year macroeconomics text. The general concept was originally introduced by the father of free markets, Adam Smith, in *The Wealth of Nations* (1776), and formally developed by David Ricardo in the early 1800s. Assuming free markets, when a country exports a good that it produces more efficiently than another country, both the exporting and importing countries gain with more efficient production and higher consumption. Ricardo showed how the theory holds even when one country is more efficient at producing *every* good than another country. Free market enthusiasts swear by comparative advantage, which has been both supported and challenged by hundreds of academic studies over the years. It is safe to say that today most economists believe the case for free trade and comparative advantage holds under many conditions, though not all.

There are reasons why a country would want to engage in policies that might forgo some benefits of free trade and comparative advantage. National security interests are the clearest. A nation state does not want to rely on adversaries, and even allies in some cases, to produce goods and services necessary for national security. The US and our allies have serious national security vulnerabilities today, most notably in high-end chips produced in Chinese contested Taiwan and in a dearth of rare-earth mineral production at home. Another reason to impose restrictions on free trade is to protect infant industries. The idea of dynamic comparative advantage posits that some industries require protection until they reach the scale and expertise needed to be globally competitive. Absent such policies it is feasible that many nations would fail to foster the development of more diverse and advanced economies. The US may not have many infant industries to support but could subsidize rare-earth mineral production for national security purposes.

The administration's tariff objectives, in addition to protecting national security interests, appear to be twofold: (1) restore American jobs and a strong middle class (especially in manufacturing) hollowed out by globalization and low-cost foreign labor, (2) impose fair trade on countries who have erected both tariff and non-tariff trade barriers against the US. Extraordinarily high tariff rates were presumably levied as a negotiating tactic. It is unclear what level of tariffs the administration is willing to accept in the long term. Taking the second goal first, a pure free market advocate such as Milton Friedman would argue countries

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that subsidize national industries are doing the US a favor at their own expense by lowering the price for the goods the US buys from them. Others convincingly respond that the US allowed Japan, Korea, and now China to subsidize and protect their auto industries while they perfected production technologies and eventually outcompeted American automakers. Worse, US companies were required to build plants overseas where their intellectual property was then stolen. Protecting intellectual property is an essential policy goal. Another broader macroeconomic issue relates to the connection between trade deficits and capital account surpluses, two sides of the same coin as a deficit in one must be offset by a surplus in the other. Running a trade deficit by trading goods and services necessarily leads to an inflow of savings from the rest of the world. This additional saving can help finance new capital investment at home, raising productivity over time. There are many moving pieces to the dynamic between trade deficits and capital account surpluses beyond the scope of this commentary. The point is touching on just a few issues like these (there are more) reveals that trade is complicated. Effective policies require analysis, debate, policy development, and enforcement. Bringing trading partners to the negotiating table with unsustainably high tariffs is highly debatable and becoming more economically disruptive by the day. Time will tell what the result will be.

Related to the first goal, the aims of protecting national security interests and fostering a strong middle class are not debatable. The hard part is how to get there. Some would contend that industrial policy such as targeted subsidies would be a much better conduit than tariffs. Others like American Compass public policy commentator Oren Cass claim that tariffs, although blunt, are more consistent with a free-market approach than industrial policy since tariffs are a broad tax on trade rather than more precise government meddling. Still, he advocates low tariff rates. We think the administration is on shaky ground if the policy prescription is balanced trade through a weaker dollar as proposed in a paper by economist Steven Miran who some say has the President's ear. Another controversial issue centers on the intricate and highly efficient North American free trade zone. Mexico and Canada are allies, and even in the highly improbable event that they became adversaries, it is hard to see how they could threaten US national security interests. On the question of low-cost labor, exactly what the US wants to manufacture and the type of jobs this requires must be strategically considered. Much of the manufacturing in Mexico involves tedious, low-skilled labor, not a prescription for elevating the US middle class. Policy debates and congressional action are needed, and the articulation of a strategic plan is overdue.

We will conclude with some concerns and final thoughts on the economic impact of current policy. The US does not want autarky – to produce everything it consumes. The goal of a bilateral trade balance with every country in the world is nonsensical and infeasible. Even proponents of a lower overall trade deficit would acknowledge there are benefits to having surpluses with some countries and deficits with others. Similarly harmful, especially in the near term, is policy volatility. Hardball negotiations can make sense, but they must be carried out in a way that allows businesses to operate and plan. Causing businesses and nonprofits to retreat from investment is counterproductive. Uncertain planning horizons are also harmful. For example, expecting all US auto and parts manufacturers to move production from Mexico back to the US is, in our view, a bad idea. Expecting it to happen in weeks or months rather than years is impossible and destroys massive amounts of valuable capital investment in which American asset owners and workers have an interest. Policies leading to higher prices and less production also lead to less work.

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Moreover, we are not living in the Victorian Age when capital and labor were separate islands of contention. Many of today's workers are also "capitalists" via their pension plans and personal investments.

As indicated previously, complexity and unintended consequences are likely to render precise economic forecasts futile. Still, understanding the economic dynamics as they play out can be helpful. The first order impact relates to the nature of tariffs. Tariffs are a tax on imports that raise prices. We estimate the tariff impact on inflation to be a few percentage points if the overall tariff rate was 10% on US imports which are currently at 14% of GDP, and retaliatory tariffs were 10% on exports currently at 11% of GDP. Even doubling the tariff rate on both imports and exports is not catastrophic, at least at the macroeconomic level. We believe there would also be a headwind to GDP growth from a reduction in the benefits of comparative advantage, slowing the transition to a more efficient economy. Conversely, there could be offsetting economic dynamics, such as an increase in aggregate demand if China resorts to stimulating consumption or Europe spends more on defense. The ACR investment team will be monitoring these events as they unfold at both the national and company levels. The ability to pass on cost increases is an indicator of economic strength we look for in companies. Their ability (or inability) to do so will be telling.

Live long enough and you will see many strange things. Today's radical tariff policy is but one in a long line.

Nick Tompras
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