

Tariffs & Market Volatility

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In case anyone hasn't noticed, tariffs are back in the news and so far, have wreaked havoc on capital markets. If the first Trump term took a chisel to trade policy in 2018, primarily on China, then the second term has picked up the sledgehammer. Mexico, Canada, China, and Europe are all in the crosshairs, with seemingly no end in sight.

Tariff Basics and a (Brief) Historical Context

A tariff (sometimes also referred to as a duty, although there are nuanced differences) is a tax imposed by a government on imports. The three primary objectives of tariffs are:

1. **Generating government revenue** – Tariffs are a tax, and just like any other tax we pay, it generates revenue for the government.
2. **Protecting domestic industries** – Tariffs can encourage consumers and businesses to buy domestically produced alternatives by making foreign goods more expensive.
3. **Affecting Global Markets and/or Imposing Sanctions** – Tariffs can be used as a sanction to prohibit trade with a country (like US sanctions on Russia after the invasion of Ukraine) or affect global trade balances by making a country's goods more expensive/less desirable.

Beyond these traditional purposes, the Trump administration has also highlighted other strategic goals of tariffs, including:

- **Tariff reciprocity** – Aligning U.S. tariff rates with those of trade partners.
- **Foreign policy leverage** – Using tariffs as a negotiation tool in broader international discussions, such as border control (especially regarding fentanyl) and trade agreements.

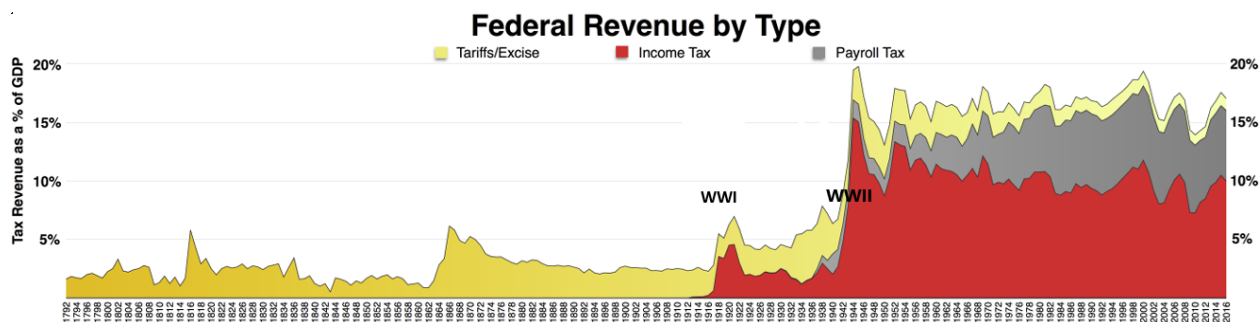
However, it is important to note that **tariffs are paid by the importer, not the exporter**. When a U.S. company imports goods from a foreign supplier and a 10% tariff is imposed, the U.S. company (importer) pays a \$10 tariff (tax) for every \$100 of imported goods. This tax is collected at the time of customs clearanceⁱ. The cost of the tariff is "covered" by some combination of the exporter (lower export prices to maintain trade), the importer (US company takes a hit to profits), and the consumer (higher costs at the counter).

History provides several examples of tariffs. In the 1930s, the Smoot-Hawley Tariff Act raised U.S. tariffs on numerous goods to protect domestic industries during the Great Depression.ⁱⁱ Post WWII, Japan used tariffs and other trade barriers to protect their emerging industries. In 2018, President

Trump also imposed tariffs on China, citing unfair trade practices. While there is still debate around the effectiveness of these tariffs, the key takeaway is that businesses adapt to tariff changes, whether through supply chain adjustments or cost restructuring. While the immediate effects can create volatility, markets and industries find ways to evolve.

Trump's Tariff Goals

As we consider the feasibility of Trump's stated goals, let's look at the goal of tax cuts. The administration has floated using tariffs as a means of replacing tax cuts, such as abolishing income taxes. Looking at the breakdown of tax revenue, this is not something that appears feasible or realistic, at least not right away. For starters, tariffs are a miniscule percentage of revenue when compared to income and payroll taxes, as we see below:



It's going to take a lot more than tariffs to replace lost tax revenue from abolishing or even reducing income and payroll taxes. Another big issue for reducing taxes is legislation. Reducing taxes requires legislation passed by narrowly held Republican majorities of the House and Senate, and not all of the President's own party is on board.

However, it is positive that conversations have started that hopefully lead to addressing the Federal government's unsustainable deficit spending. Most economists and even many politicians seem to agree that government spending is too high, but very few agree on how to do it. Tariffs are at least an idea to get the ball rolling, although the effects may not be as intended.

The other stated goal of the Trump administration is tariff reciprocity, meaning that the US charges the same tariff on each country's imports that other countries charge for US exports. On this subject, there is some credence to Trump's claim that tariffs are not "fairly" imposed.

An economically ideal world has no trade barriers, but the world is not ideal. Trade barriers and taxes are a reality of modern economies. Somehow, governments need to raise revenue and maintain a certain level of self-sufficiency. Trade policy is part of accomplishing these goals for all

countries. If countries are going to have tariffs, it seems there should be a more level playing ground for all countries.

Below is a table on tariff data for 2022 based on data from the World Bank website on trade flows:
<https://wits.worldbank.org/CountryProfile/en/Country/USA/Year/2022/TradeFlow/Import>

Country	US Import Tariff Rate	Country Import Tariff Rate on US	Import - Export Tariff Rate Difference	US as % of Country's Exports
China	2.86%	7.13%	-4.27%	16.22%
Mexico	0.01%	5.17%	-5.16%	78.29%
Canada	0.12%	1.08%	-0.96%	76.88%
Japan	1.58%	3.90%	-2.32%	18.72%
Germany	1.65%	1.80%	-0.15%	9.82%
Vietnam	4.63%	2.85%	1.78%	29.51%
Korea, Rep.	0.01%	14.39%	-14.38%	16.12%
India	2.99%	9.45%	-6.46%	17.72%
Ireland	1.83%	1.97%	-0.14%	30.33%
Italy	3.05%	1.12%	1.93%	10.39%
United Kingdom	1.32%	0.69%	0.63%	12.07%
Thailand	0.85%	6.19%	-5.34%	16.58%
Switzerland	2.21%	0.52%	1.69%	16.26%
France	1.90%	1.25%	0.65%	7.94%
Malaysia	0.72%	1.84%	-1.12%	10.80%

When President Trump mentions the US getting “ripped off” and demanding reciprocity, he’s referring to this large imbalance in tariff rates. However, Trump wants “dollar for dollar” reciprocity, not just the same rate. International trade is very complex, and this daunting task would entail numerous calculations, rewriting bilateral trade agreements, measuring currency manipulation, and accounting for several other factors. In an age where “fair” is thrown around as a sacrosanct goal, American producers do seem to be at a disadvantage. A regime of some sort of trade reciprocity, where partners pay a comparable tariff rate, is much more “equitable” for the US than the current regime.

Market Implications and Investment Perspective

Uncertainty around tariffs, economic policy, and global trade can create market stress, and investors around the world dislike change. Sometimes it happens without effort and sometimes it happens on purpose. The second- and third- order effects will take time and there will likely be adjustments, negotiations, and changes to these policies. Market stresses come and go. While we

expect your preference is to hurry up and go, volatility, especially to the downside, provides opportunities to reposition assets and take advantage of better values. Let's talk soon.

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ⁱ <https://www.trade.gov/import-tariffs-fees-overview-and-resources>

ⁱⁱ https://www.senate.gov/artandhistory/history/minute/Senate_Passes_Smoot_Hawley_Tariff.htm