



THE DANA VIEWPOINT

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Tariffs

Much has been said about tariffs being inflationary, but we actually worry about them for a different reason: because they are contractionary. They tend to create a combination of reduced trade, consumption, and output. In some cases they reduce all three. Take the example of BYD, a Chinese electric car manufacturer. Think of a BYD as a cheaper version of a Tesla, more utilitarian, with lower performance, but with a greater range and efficiency. In 2024, the tariff on Chinese electric cars was raised to 100%, effectively delaying or preventing the entrance of BYD into the American car market. This reduced trade, as the cars were not imported to the U.S. It also decreased consumption, because if you had been able to buy a BYD instead of a less efficient and more costly form of transportation, you would have had thousands of dollars left over for other consumption. It also reduced output, because the cars that would have been sold in the U.S. were never built.

Tariffs are a cost and a drag on the economy because they increase the cost of an item without increasing its value or utility. So why aren't they inflationary? Because if a household has a set amount of discretionary dollars to spend, they do not blindly accept the cost increase without making other changes to their behavior. There are three ways consumers and businesses react to tariffs. You can substitute if you can replace one good with another. If you cannot substitute, you buy less of the good. If you can't substitute or buy less of a good, you buy less of something else to offset the higher cost. The last time we had widespread tariffs in the United States was in the 1930's, and we did not get inflation, but we did get deflation and an economic contraction. This should be the main worry with tariffs.

Trump says he can use widespread tariffs to raise funds. Trump says a lot of things; we hope this one is not true. If increased tariff revenues were used to cut other taxes, that would help, but we know that's not how government works. Depending on the elasticity of supply and demand, the producer may bear part of the tax to maintain sales by not raising prices to cover the tax. But, enough with economic theory. So far, it appears as if Trump wants to use the threat of U.S. tariffs to get other countries to reduce their tariffs and increase free trade. That would be a positive accomplishment, but we will have to see how the game of chicken, or the game of who has more economic leverage, plays out.

(CONTINUED ON REVERSE SIDE)

There are many positives to mention. The economy and the markets continue to show resilience in the face of the current policy uncertainty. The stock market is higher than when tariffs became a real concern at the end of January, and the ten year Treasury yield is slightly lower. Positive earnings surprises in the S&P 500 are the highest in three quarters. Corporate bond spreads are at multi-year lows. Bank stock prices are at multi-year highs. All of this is good news.

What gives us concern? Job openings in the economy are at a two-year low, although still far higher than they were pre-COVID. A larger amount of job openings drives higher real wages, a positive for employees. It also counteracts the effects of inflation. A lower number of job openings, like we are currently experiencing, could start to slow employment and wage growth. Inflation has become sticky around 3%. If we had to choose between 3% inflation and a healthy economy, or 2% inflation and a weaker economy, we would take the former. We hope Jerome Powell will keep this in mind. Existing home sales were at a multi-year low last year. Low housing turnover could lead to lower home prices, a benefit for those looking to buy their first home, but a negative wealth effect on those who already own a home.

We will watch closely both the positive tailwinds and potential negative headwinds in the market and the economy. For better or worse, Trump may bring real and permanent change at the Federal government level; it is still too early to tell. We will react to that change with the goal of both preserving and growing the portfolios we manage.

Random Thought: “Under our scheme of government, the waste of public money is a crime against the citizen.” - Grover Cleveland

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