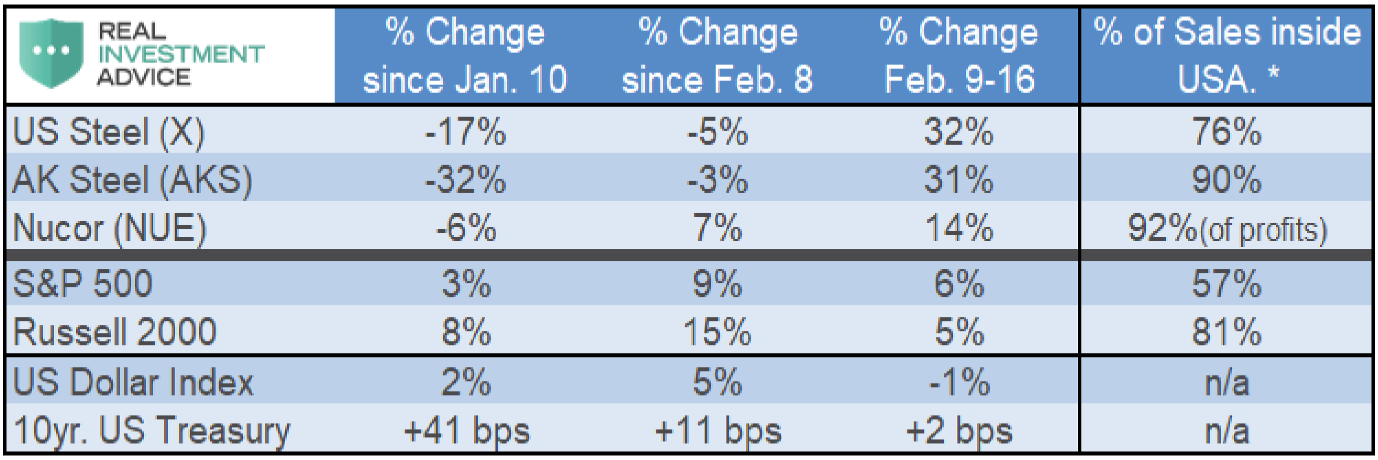
Have Tariffs Worked As Planned?
Part 2

?Peter Cook is the author of the ***?Is That True??*** *series of articles, which help explain the many statements and theories circulating in the mainstream financial media often presented as ?truths.? The motives and psychology of market participants, which drives the difference between truth and partial-truth, are explored.?*

In Part 1, Are Tariffs Working as Planned?, it was demonstrated that the 25% tariff on steel imports in early 2018 produced a 50% increase in the domestic price of steel. This result is as expected; tariffs are designed to boost the domestic price of the targeted commodity. We then examined the stock performance of steel producers and steel consumers (auto and RV sectors), between January 11, 2018, the date the Commerce Department issued the report justifying tariffs, and August 3, 2018. Over that time horizon, the stock prices of the steel consumers we examined were down between 16% and 38%. While some may question the magnitude of these declines, the direction is plausible for industries experiencing an increase in a primary manufacturing input. Over the same time horizon, the stock prices of steel producers were down between 6% and 32%, while the S&P 500 and Russell 2000 indices were up 3% and 8%, respectively. The extremely poor performance of steel stocks on both an absolute and relative basis is anomalous. Tariffs are designed to boost the income of domestic producers in the targeted industry, which would presumably be reflected in stock prices. In summary, the stocks of steel consumers AND producers have both nosedived since the tariffs were introduced, which couldn?t have been the intended result of government policy makers. What could explain the divergence between the expected and actual performance of the stocks of steel producers? First, let?s review the data for stock, index, currency, and bond prices for the periods January 11 through August 3, which show:

- *Steel stocks are down significantly since the January 11th Commerce Department report, both on an absolute basis and relative to stock market indices, which are up.*
- *Steel stocks are down even though they experienced a surge higher during a week in February when word of the upcoming 25% tariff was leaking.*
- *Steel companies should be prime beneficiaries of the tariff on U.S. imports because their operations are highly focused on the U.S. market*
- *The U.S. dollar and bond yields are up modestly during 2018, but probably not enough to cause large changes in equity and commodity markets*



REAL INVESTMENT ADVICE	% Change since Jan. 10	% Change since Feb. 8	% Change Feb. 9-16	% of Sales inside USA. *
US Steel (X)	-17%	-5%	32%	76%
AK Steel (AKS)	-32%	-3%	31%	90%
Nucor (NUE)	-6%	7%	14%	92%(of profits)
S&P 500	3%	9%	6%	57%
Russell 2000	8%	15%	5%	81%
US Dollar Index	2%	5%	-1%	n/a
10yr. US Treasury	+41 bps	+11 bps	+2 bps	n/a

Data through 8/3/2018 * Company annual reports

It is impossible to completely untangle and quantify all the influences on stock prices, but the following items potentially explain the dramatic underperformance of steel stocks in the face of a rise in domestic steel prices:

- *The Fed?s interest rate hikes*
- *The economy isn?t as strong as believed*
- *Dormant corporate buyback programs*
- *Tariffs don?t work as intended*

Fed Rate Hikes

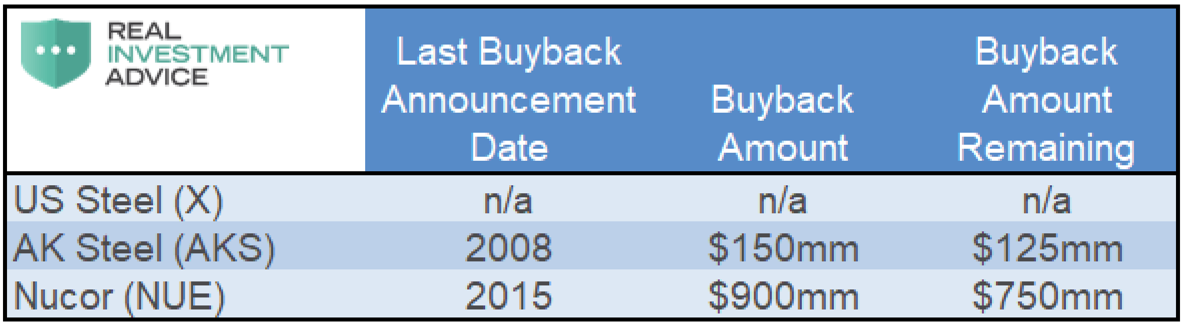
As explained in The Fed?s Real Target, the Fed manipulates interest rates to influence the behavior of borrowers, not of investors. When interest rates rise, borrowing costs to finance capital expenditures rise, which discourages capital investment and increases the cost of existing capital investment. Steel production is capital-intensive, as are the main steel-consuming businesses, which are construction, vehicles, and oil exploration. Since 2015, the Fed has raised short-term interest rates seven times, for a total of 1.75%. Fed Chair Powell?s recent comments reveal a determination to continue raising rates to3.00% - 3.50%, in response to a ?strong? economy. So far, the Fed?s actions have had less of an impact on long-term interest rates. In fact, the yield curve has been flattening, a signal that the Fed?s rate hikes will suppress future GDP growth and inflation, possibly to the point of inducing a recession. Reinforcing the bond market?s message, stocks of companies that require large capital investments (e.g., industrial and basic materials sectors) have significantly lagged the market indices. The stocks of steel, auto, and RV stocks are not only lagging market indices; they are down significantly 2018 YTD.

The Economy Isn?t as Strong as Believed

The U.S. Bureau of Economic Analysis recently announced the real growth rate for Q2 2018 GDP was 4.1%, much higher than economic growth over the past decade, which has averaged roughly 2%. Other economic statistics, such as an extremely low unemployment rate, support the notion of above-average economic growth. In addition, stock prices are pushing higher, supporting the idea that higher growth is ahead. However, economists at Morgan Stanley have estimated that supply-chain adjustments (inventory hoarding) in advance of looming tariffs may have boosted GDP growth by roughly 2%. If so, the U.S. economy is plodding along at the same rate as in previous years. The automotive sector, a major consumer of steel, is no longer growing, and has plateaued at roughly 17 million units per year. Rising mortgage rates are taking a bite out of new home sales activity. Economic growth outside of the U.S. appears to have peaked in Q3 2017, which counters the narrative that global economic growth is in a synchronized upswing, a narrative that has been dominant for almost a year. The decline in the price of copper, down 16% YTD, supports the thesis of declining global growth. Finally, as explained in ?The Next Recession Is Closer Than You Think,? since 1970 the combination of a 200 basis point rise in short-term interest rates plus a doubling of crude oil prices has always resulted in a recession, with no false signals. That combination will be present as soon as the Fed hikes rates, which is widely expected in September. Perhaps the poor performance of cyclical stocks and the flattening of the yield curve are market-based signals that GDP growth will not be as robust as many expect.

Dormant Corporate Buyback Programs

Most of the largest U.S. companies engage in corporate buyback programs, typically buying a specific number of shares over a specific time-frame. In almost all cases, company buyback programs are price-insensitive, and probably victims of front-running by algorithmic traders, which pushes ate QE. Meanw n below. Per regulatory filings, U.S. Steel has not authorized a buyback program and AK Steel bought back a de minimus amount of stock during 2018, while Nucor bought back $29 million, which is small compared to its $20 billion market capitalization. In contrast, U.S. companies are buying back stock at the highest rate in history during 2018, which is undoubtedly pushing their stocks to higher prices than they would otherwise would be. The divergence in buyback activity explains some of the underperformance of steel stocks relative to the market indices.



REAL INVESTMENT ADVICE	Last Buyback Announcement Date	Buyback Amount	Buyback Amount Remaining
US Steel (X)	n/a	n/a	n/a
AK Steel (AKS)	2008	$150mm	$125mm
Nucor (NUE)	2015	$900mm	$750mm

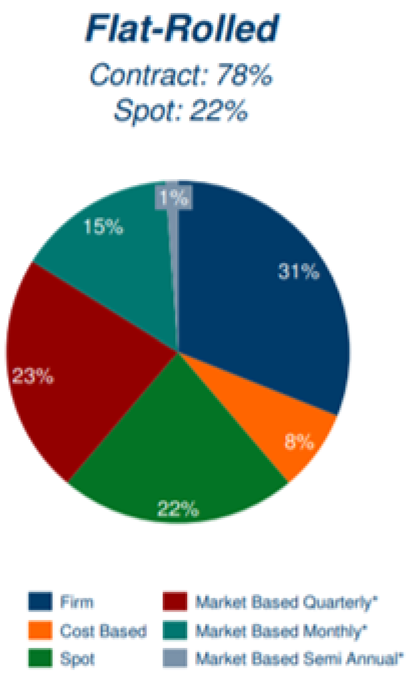
Tariffs Don?t Work As Intended

According to the Law of Supply and Demand, what happens when price rises? Consumers don?t buy as much at the higher price. Accordingly, if import tariffs cause the price of domestic steel to rise, the demand for steel is reduced. This behavior would be aggravated by increases in the cost of financing capital purchases due to Fed rate hikes. One wrinkle in the steel market is that producers sell to consumers in the spot and contract markets. In the spot market, prices adjust immediately, as tariff induced price increases are felt immediately by producers and consumers. In

in for a fixed quantity over a fixed time. In its Q2 2018

rted the breakdown of its sales as shown below. The chart

ease in spot steel prices to flow through to users.



But if the economy is weaker than believed, the race is on.

In coming quarters, can price increases stick and increase the cash flow of steel producers, or will higher prices be negated by a slower economy and declining volumes? The price of steel stocks points to the latter, not the former.

Conclusions

Import tariffs on steel have produced an expect result; a 50% rise in the price of domestic steel. The purpose of import tariffs is to improve the profitability of steel production in the United States. However, the stocks of steel companies are mysteriously producing negative returns during a year in which stock market indices are in positive territory. Reasons for this anomalous performance include:

- *The Fed?s rate hikes, which harm borrowers in capital-intensive businesses*
- *The economy isn?t as strong as believed, particularly in goods-producing industries*
- *Dormant corporate buyback programs by steel producers, compared to record-breaking buyback activity by other companies*
- *Tariffs don?t work as intended*
    - *Steel is traded in both spot and contract markets, so revenues lag price changes*
    - *Large price increases cause a reduction in demand, so there is a conflict between higher revenues and lower economic activity in the steel sector.*

The Fed believes the economy is ?strong,? warranting a series of interest rate increases. However, the bond market is reinforcing the message of stocks in the vehicle, homebuilding, and industrial sectors, warning that economic growth and inflation may not be as strong as commonly believed.