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Weekly Market Commentary

What is it good for?

By Michael Crook, Chief Investment Officer

> Trade war, huh, yeah
> What is it good for?
> restructuring the global financial system, uhh
> - Nerdy Edwin Starr

In what appeared to many observers as haphazard, ad-hoc policy-making, President Trump brought tariffs to the forefront last week. We covered the economic impact of tariffs in "Touch and Go," so we won't rehash it here, but the tariff coverage we've seen from the media and many financial analysts has been, to put it kindly, superficial.

Yes, it is possible that the President's tariff focus is poorly conceived, short-sighted, and ignorant of basic economics. However, an examination of the writings of his closest advisors indicates that the Trump Administration sees tariffs as a starting point for significant changes to the global financial system. It behooves us as investors to look past headlines and understand their playbook. As always, this analysis is meant to be what economics call *positive analysis* – descriptive, factual statements about the world and the actors within it. It is not a prescriptive, value-based analysis of political priorities.

We believe that President Trump's economic agenda can be broadly characterized as focused on:

1. maintaining US defense and reserve currency hegemony,
2. deregulation,
3. energy production,
4. extending his 2016 tax cuts, and
5. revitalizing US industrial competitiveness.

Tariffs are not equally conducive to every part of the administration's agenda and, as best we can tell, are not an end to themselves but rather a negotiating mechanism for achieving his other economic objectives.

As recently-confirmed Treasury Secretary Scott Bessent said in an early-2024 letter[1] to clients of his hedge fund, "tariffs are inflationary and would strengthen the dollar—hardly a good starting point for a US industrial renaissance. Weakening the dollar early in his second administration would make US manufacturing competitive."

Taking a step back to understand what he means, the US dollar plays an important role as the world's reserve currency. To a large extent, any foreign actors (countries, institutions, or individuals) seeking a safe haven end up purchasing US dollars or US dollar-denominated assets. Demand for dollars results in lower borrowing costs for US Treasuries and the US running a current account deficit, which would be resolved for most countries by currency depreciation. However, the ever-growing demand for US dollars results in a perpetual current account deficit.

The result of the dollar's role as the reserve currency is a US dollar that is generally overvalued, which makes exports more expensive and imports cheaper than would otherwise be the case. Hence Secretary Bessent's statement that weakening the dollar would make US manufacturing more competitive.

To the extent that maintaining reserve status for the US dollar, tariffs, and a manufacturing renaissance are mutually inconsistent goals, how can the Trump administration square this circle? Trump's nominee to chair his Council of Economic Advisors, Stephan Miran addresses this issue in his November 2024 report "A User's Guide to Restructuring the Global Trading System."[2] At a high level, Miran suggests tariffs can be used to bring trading partners to the table for a new currency accord, much like the Plaza Accord in 1985.

The Plaza Accord was a currency agreement to weaken the value of the US dollar Treasury Secretary James Baker III orchestrated in 1985. Our major trading partners at the time agreed to sell dollars on the currency markets, which caused the dollar to decrease in value by 32 percent (Fig. 1). The result was a boost in US exports relative to imports. For context, the US dollar is not as strong as it was in 1985, but it is currently stronger than it has been at any point since then.

The prospective "Mar-a-Lago Accord," as Miran refers to it, would have the same end goal. In exchange for being part of the US's defensive security umbrella, the Accord would require trading partners to sell US Treasury bills and hold long-term US Treasury bonds. The net result would be to lower the value of the dollar, maintain its status as the world's reserve currency, and benefit the US fiscal outlook by keeping long-term interest rates subdued.

While it might feel like a stretch from where we are today to the hypothetical Mar-a-Lago Accord, this is the guidebook suggested by President Trump's nominated CEA chair and Treasury Secretary. They clearly see last week's tariff chatter as the starting point, not an endgame.

[1]https://assets.realclear.com/files/2024/02/2353_keysquare.pdf
[2]https://www.hudsonbaycapital.com/documents/FG/hudsonbay/research/638199_A_Users_Guide_to_Restructuring_the_Global_Trading_System.pdf

Fig. 1: US Fed Trade Weighted Real Broad Dollar Index

Source: Bloomberg, Mill Creek.

Portfolio Positioning

Another Bessent line from his February 2024 letter is worth considering: "The tariff gun will always be loaded and on the table but rarely discharged." It's dangerous to have a loaded gun sitting on a table, particularly if the person that controls the gun keeps saying "I'm about to pull the trigger!"

One section in our 2025 Outlook was titled "The increasing likelihood of unlikely events." We'll stick with that view. The Trump Administration might pull off a historic currency agreement, but there's also a chance we'll end up in a tit-for-tat trade war that leads to lower economic growth, higher inflation, and benefits no one. It is too early to know how this will play out, but to reiterate what we said in the outlook: too much concentration in anything – and public stocks and bonds in particular—gives us pause at this juncture. To the extent possible, we prefer to see portfolios with public and private equity, high-quality fixed income, diversified private credit, and some exposure to real assets.

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