Soybeans, Rivets and Plastic Trucks – what's it to you?

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There's been much talk over the last few months of trade wars and the U.S. and China implementing additional tariffs on imports and exports. In reality, increased tariffs are likely to affect both Chinese and U.S consumers as they drive up inflation, lower GDP growth and stall the stock market.

Earlier this month the current administration announced that they had more than doubled U.S. tariffs (from 10% to 25%) on various Chinese imports in response to the ongoing issues surrounding the theft of American intellectual property. They also threatened to add a 25% tariff on almost all of the remaining $325 billion in goods imported from China. Intellectual Property theft includes the use of patents, trade secrets, trademarks, and copyrights without permission and may seem trivial to many, but according to the Harvard Business Review it represents big money. Intangible assets, which include intellectual property, make up 80% of the value of S&P 500 companies and U.S businesses are, understandably, fuming. In 2018 the U.S. imported $539 billion in goods from China. During the same year the U.S. exported $120.3 billion to China. To say that our economy is heavily intertwined and dependent on the pricing of Chinese imports is an understatement.

Tariffs on imports affect consumers and producers in different ways. Take for example an American dad who wants to buy a (Chinese made) toy truck for his son. Prior to the tariff increase the truck cost $5. Now with the additional tariffs in place, that truck should cost $5.75. Fortunately for dad, plastic trucks are pretty much indistinguishable, so he can save himself the price hike and buy a similar looking truck that costs less without disappointing his son. The Chinese toy-maker knows that, and rather than risk losing the sale is likely to absorb the 75c increase and continue to sell the truck for $5. This results in less profits for the Chinese toymaker, and the tariffs have successfully penalized the Chinese economy enough that they should cease their poor business practices. Great!

But what if the "dad" is US company ABC that creates construction equipment and the "truck" he wants is a rivet that fits ABC's machinery. ABC imports rivets from China. Their production lines are predetermined, and only that exact sized rivet fits their machinery specifications. Without that rivet, ABC will have to replace large assembly lines already in place. These changes cost money and time. In this scenario, the Chinese company has significantly more pricing power than in the truck example and ABC is willing to pay up for the rivets rather than source a different rivet. The increased cost of the rivets, and the machinery it is used in can be absorbed by ABC however this affects the company's earnings and its stock price will drop.

Alternatively, ABC can pass the cost on to the construction company who in turn passes it on to the consumer. This drives up prices which results in inflation.
The Chinese government has retaliated to the higher tariffs by threatening to impose a 25% tariff on multiple U.S. exports including soybeans, which is currently the largest agricultural export from the US to China. Adding tariffs to soybeans means that Chinese companies will have to pay more for them since part of the price they pay will go to the Chinese government. As with the previous two examples, they will either pay a higher price or replace American soybeans for another country's. The problem here is that an American soybean and a Brazilian soybean are identical, which forces US farmers to lower their sales prices on exports. Add to that an ongoing epidemic of swine flu (soybeans are the main food for pigs) in China, and one sees the demand for U.S. soybeans falling dramatically.

So now we have a situation with higher prices, squeezed margins, and extra money being scarce all around. Individuals spend less on goods, companies invest less in their businesses as they use savings to meet day to day expenses, the agricultural sector has less income, and exports decrease. All of these contribute to growth in Gross Domestic Product, or GDP, declining. The relationship between the stock prices and GDP is important, and for investors, annual growth in the GDP is vital. If overall economic output is declining or merely holding steady, most companies will not be able to increase their profits, which is the primary driver of stock performance.