Tariffs, by definition, increase the cost of goods, so it would seem that they should lead to higher inflation. Yet during the recent U.S.-China trade war, inflation has actually fallen in the U.S.

**Why Tariffs Have Not Raised Inflation**

To explain this apparent paradox, we examined the forces at play. What we found was a tug-of-war between the ostensibly inflationary effects of tariffs and their indirect deflationary impact as they have slowed global growth, strengthened the USD and dampened commodity demand.

Tariffs were first implemented by the Trump Administration in March 2018. To date, $250 billion worth of tariffs have been applied, driving the Chinese share of total U.S. imports down from over 20% historically to 17.5%. By the end of 2018, more than 46% of Chinese imports were subject to tariffs.

And yet, the U.S. has seen a downward trend in both headline and core inflation since July 2018. The trend is particularly apparent in U.S. headline inflation (*Display 1*), which fell to 1.6% in June 2019.

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1 Source: U.S. Census Bureau, data as of 31 May 2019

2 Datastream.
In one corner: Tariffs and wage growth

Comparing the year-over-year (YoY) change in import prices shows that the after-duty price paid by U.S. importers did in fact jump following the implementation of each tariff wave, while the industries that were not subject to tariffs did not see any spikes. A recent study estimates that U.S. domestic manufacturing prices were 1.1% higher in 2018 due to tariffs, via two channels:

1. **THE INPUT CHANNEL:** An increase in prices due to the increase in cost in imported intermediate goods

2. **THE OUTPUT CHANNEL:** Pricing decisions made by producers in reaction to tariffs, including price hikes made by domestic producers who seek to match higher-priced “tariffed” goods

At the same time, wage growth has been on an upward trend since 2016, thanks to a tight labour market. The employment cost index is now close to 3% YoY growth, its highest level since the global financial crisis. All things being equal, this should also add to inflation pressures.

In the other corner: USD strength and oil weakness

Pulling against the inflationary pressures of tariffs and wage growth have been the collective strength of the USD and weaker oil prices. The US dollar Index (DXY) is up 5.9% compared to end of June 2018. At the same time, West Texas Intermediate (WTI) crude is down 17.4% since the end of June 2018, with the sharpest drop in the final quarter of 2018 when economic growth expectations weakened (Display 1).

The inflationary pull of tariffs was also partially muted due to the fact that the first two tranches did not include any consumer goods, and only 25% of the third related to consumer goods. With most tariffs falling on intermediate goods, which are typically components of finished goods, producers have been able to cushion consumers by absorbing some of the price increase.

Furthermore, even though prices for intermediate goods have risen, they account for only a small percentage of the producer price index (PPI). The prices of services, which account for about 60% of the PPI in the U.S. have been remarkably stable. U.S. import prices, which have a strong positive relationship with China’s

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**DISPLAY 1**

Two recent downward trends

![Graph showing Headline Inflation (YoY%) (LHS) and WTI Crude (YoY%) (RHS) from 2009 to 2019.](Source: Datastream, Data as of 30 July 2019)
PPI, are down 2.0% YoY as of June 2019 (Display 2). A lack of imported inflation is also having a dampening effect on the overall U.S. PPI (Display 3).

U.S. import prices have been falling due to several factors:

- **CHINESE MANUFACTURING PPI:** Softening U.S. import prices have coincided with a material correction in Chinese manufacturing PPI which fell from 4.6% YoY in June 2018 to 0% YoY in June 2019 (a 3 year low). This trend is largely a reflection of ongoing muted industrial demand.

- **A WEAKER RENMINBI (RMB):** The combination of a stronger USD and a weaker RMB has also blunted the net effect of the tariffs. Last year’s USD gains continue to keep a lid on core import prices, while the 7% depreciation of the RMB vs the USD over the past 12 months has helped offset the face value of Chinese tariffs.

Against this backdrop, the U.S. consumer’s resiliency has been further bolstered by low unemployment and broad wage gains. In a roundabout way, the U.S. has been lucky in its timing—weaker global growth (which has contributed to PPI deflation) and a strong USD have served to buffer the impact of tariffs.

**What happens next?**

Until industrial demand picks up, the tariffs’ effect on inflation is likely to remain muted. Furthermore, the latest data suggests that industrial activity is continuing to slow around the world, particularly in trade-oriented regions. As of the end of June, Japanese machine tool orders were down 38% YoY, a rate of deceleration last seen in October 2008. German industrial activity has slumped to a seven-year low and the July Manufacturing PMI fell to 43.1.

Meanwhile, companies are starting to feel margin pressures from rising labour and input costs. After years of healthy margins hovering at or above the 20% mark, there appears to be little potential for margins to expand (Display 4). Although they started with a base of healthy margins, a number of S&P 500 companies cited margin pressures arising from higher labour costs and higher material input costs in their Q2 2019 earnings call.4

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* Source: Factset.

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**DISPLAY 2**

U.S. import prices track China’s PPI index closely . . .

![Chart showing U.S. import prices and China's PPI index](chart1)

Source: Bloomberg, Datastream. Data as of 30 July 2019.

**DISPLAY 3**

. . . therefore, falling prices in China are curbing the effect of tariffs

![Chart showing PPI trend](chart2)

To protect margins, companies have two choices: They may raise prices if they feel confident in the growth outlook; or they may seek to cut costs. Based on the latest PMI data, corporate sentiment and capital expenditure forecasts, the second of these choices looks more likely in the near term.

**A dovish Fed and other forces in play**

In the absence of tariffs, we would have had much stronger growth, higher inflation—and the Fed would not be easing. So, despite being *directly* inflationary, the tariffs have also been *indirectly* deflationary because they have dampened growth.

Investors are hoping a dovish Fed can get businesses to invest again, alleviating current deflationary pressures. And President Trump has been aggressively pushing for a more dovish Fed, despite its independence. The upcoming U.S. election could also influence fiscal policy. If economic growth remains sluggish, there will be political incentive for the administration to enact some sort of fiscal stimulus.

The strong USD has also been a drag on growth. China’s efforts to offset tariffs by devaluing their currency has contributed to USD strength. Looking ahead, two other factors may put continued upwards pressure on the dollar: Brexit uncertainty and the rising likelihood of a German recession. Nevertheless, through further rate cuts, the Fed could offset these pressures.

Oil prices could also dampen growth if they climb from last year’s lows. Manufacturing remains weak, but there is always a risk of an oil-related price shock (e.g., if tensions with Iran increase) that could push prices up.

Wage growth is unlikely to trigger inflation unless U.S. growth accelerates. Lastly, if growth does accelerate, then businesses will need to ramp up investment to meet demand. Margin pressures could then force them to pass on full cost increases to the consumer, rather than absorbing a portion of it themselves.

**The risk of tugging too hard**

Under normal conditions, rising tariffs and wages would fuel expectations of higher inflation. They have in fact increased price pressure, but that pressure has not been sufficient to offset weak global (and in particular Chinese) growth, falling oil prices, a strong dollar and the intentional absorption of price increases on intermediate goods by producers. These factors could be reversed by a dovish Fed and an election-focused government stimulus.

The Fed’s current cutting could thus entail future risks. Typically, the economic outcomes of Fed action are not observable until 12-18 months after the action. During that lag period, some of the factors that have been depressing inflation could dissipate or reverse. If the Fed goes too far in responding to weak inflation today, it may find itself having to backpedal aggressively.

**And the winner is . . .**

In the near term, we expect the inflation-limiting forces to win the current tug-of-war, keeping inflation in the 1.6%-2.0% range. President Trump’s recent threat to impose a 10% tariff on the outstanding $300bn of Chinese imports presented a real risk of more rapid inflation pass-through given 60% of these imports are consumer goods. In contrast, the latest macro data continues to highlight strong deflationary trends in producer prices (PPI declined 0.3% and 0.6% YoY in July in China and Japan respectively). For the moment the deflationary demand shock is still outweighing the inflationary impact of tariffs. That said, tariff tensions are unlikely to go away, but may rise and fall substantially.

Considering this, the lack of fundamental catalysts and yet another blow to business confidence, we are maintaining defensive positioning with relatively low exposure to equities. Therefore, though investors may not “love” tariffs, at least their inflationary effect currently appears muted, given the other dynamics at play.
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Employment Cost Index (ECI) is a quarterly economic series published by the Bureau of Labor Statistics in the U.S., that details the growth of total U.S. employee compensation. The United States Dollar (USD) is the official currency of the United States of America. The US Dollar Index (DXY) is an index of the value of the United States dollar relative to a basket of foreign currencies, often referred to as a basket of US trade partners’ currencies. The Ren Min Bi (RMB) is the official currency in China. The capital expenditure or capital expense (CapEx) is the money a company spends to buy, maintain, or improve its fixed assets, such as buildings, vehicles, equipment, or land.

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