



Basis Points June 28, 2018

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Above the Fold

The shares of Harley-Davidson plunged this week after the iconic American motorcycle company said it will begin shifting some production overseas to offset the impact of retaliatory European tariffs on certain U.S. goods. The decision is the first by a major U.S. company to imply that the recently announced retaliatory tariffs will force it to produce overseas. In response to U.S. duties on European steel and aluminum, the EU enacted tariffs Friday on more than \$3 billion worth of U.S. goods including bourbon, yachts and motorcycles. The EU duties on U.S.-made motorcycles were raised to 31 percent from 6 percent. No production will be moving to Europe as a result of the tariffs, as Harley already has overseas manufacturing plants in Brazil, India, Australia and Thailand. Harley has been expanding production overseas for decades, due to the higher cost of production in the U.S. Harley said it will not raise retail or wholesale prices on its bikes, but expects an incremental cost of \$2,200 per motorcycle exported from the U.S. to the EU. The Harley story is a great example of the ramifications of a global trade and tariff war. This is not

1810. The global trade market is a very fluid one in 2018, and manufacturing can easily be shifted to factories in countries around the world in order to minimize costs and maximize profits. Politicians can make bold statements, but focused corporate chiefs will do what is best for the health of their businesses and bottom line.

Supreme Court Justice Anthony Kennedy, 81, announced yesterday that he will retire from the highest court. Kennedy has long been the decisive vote in many closely divided cases. Justice Kennedy's voting record was moderately conservative, but Kennedy was the court's leading champion of gay rights, and he joined the court's liberal side in cases of abortion, affirmative action and the death penalty. His retirement gives President Trump the opportunity to fundamentally change the course of the Supreme Court, and a Trump appointee would very likely create a solid five-member conservative majority that could impact abortion and gun rights. And in the current political environment, the Senate approval process for the new justice promises to be an epic circus.

Three Things

- Oil prices spiked yesterday to \$73 a barrel, the highest price for crude since 2014. The pop in price was caused by a larger than expected drop in U.S. crude stockpiles, combined with outages in some major global supply chains. U.S. commercial crude inventories dropped by 9.9 million barrels last week, while analysts expected a drop of only 2.6 million barrels. Problems in Canada also added to very low inventories, as Syncrude, which produces 350,000 barrels per day, is now offline. Repairs will not be completed until at least the end of July. With renewed sanctions on Iran cutting most of its oil production, the global oil market is concerned that there will not be enough production to meet the ever-rising demand for energy. Potentially offsetting the lack of supply coming from Iran is surging crude exports from the U.S., which topped 3 million barrels per day last week, the first time the U.S. has ever exported that much crude per day. However, pipeline shortages in the Permian Basin have been a struggle as producers try to get their product to market, and the pipeline shortage will not begin to clear until late-2019.
- The Dallas Fed Manufacturing Activity Index advanced to +36.5 in June from +26.8 in May. The details were solid with new orders climbing to 29.6, the highest level seen this year. Employment rose to +23.9, the highest since February 2012. Capital spending plans rose to +33.9, a three-month high. So far, the regional PMIs have been mixed in June with the Empire and Dallas Fed rising but the Philly Fed index slipping.

- Companies repatriated \$296 billion in corporate profits in the first quarter of 2018, which is 17.6 percent of the estimated total of \$1.7 trillion of unrepatriated corporate profits of U.S. companies, so there is still a lot of cash to come back to the U.S. in the rest of the year. Also, corporate share buyback activity rose steeply in the second quarter, with companies buying back shares worth \$150 billion, three times larger than in the first quarter of 2018. Companies are still flush with cash, so they stand ready to aggressively buy back their own shares this summer if there is increased volatility or market downdrafts leading up to the fall election season.

Did You Know

A flour salesman walked into a bakery one day and said to the owner, "Hello sir, my company produces the best flour in the world. We produce it with raw materials from my country, so your own wheat stores are not depleted. We mill it in our factories, so your air is not polluted. My workers grind it and pack it, so your citizens can be employed in higher-value work. We ship it to you on our ships, so your ships are free for other purposes. Lastly, I want to sell my product to you for below the cost at which you could produce it yourself. Would you like to buy some?". The bakery owner thought for a minute, and replied, "Fine, as long as I can pay you in store credit only." The flour salesman readily agreed, and both men walked away happy.

Does this sound like a good deal for the salesman or his company? It certainly does not. Yet this is exactly the good deal that the U.S. receives when we run a "trade deficit," or what may be more accurately called a "goods surplus" if you are transacting on the side of the U.S. While all the talk these days seems to be around the subject that running a trade deficit is detrimental to the U.S. and its workers, there are many arguments that have been made over the last few hundred years that go against the idea of trade protection.

The "store credit" idea is a very powerful part of the deal above, and one that is rarely thought of as a significant benefit to the buyer of foreign goods. When we purchase foreign-made goods, we purchase them with dollars. What then happens to those dollars? They can be spent immediately in the U.S. to purchase other goods, or they can be shipped back to the goods-producing country. They may even be used to purchase goods in other countries. However, even if the dollars bounce around the world economy for a while, they will eventually find their way back to the U.S. to purchase our goods and services. This is the only country where they have purchasing value, so the "store credit" that we used to buy goods from other countries will eventually be redeemed at our "store." The dollars may even be used to purchase goods made from the cheap raw materials that were sold to us below cost in the first place.

Then why have the perceived benefits of tariffs and protectionist trade policy continually endured over the preceding many centuries? Because the benefits of tariffs are small but visible, while the detriments and costs are large but invisible. If we protect our domestic steel industry, then a small

group of steel workers may not lose their jobs, and steel workers are an identifiable voting bloc that can show up at the polls. The much larger group of “consumers who will pay an extra ten dollars per washing machine due to tariffs” is not a distinct voting bloc. This group is not identifiable, and no one will march on Washington D.C. to get their ten dollars back. A small group with strong incentives can usually outmaneuver a large group with small incentives, at least in the short term. However, the essence of protectionist tariffs is that they benefit a small group of workers at the expense of a large group of consumers. The essence of free trade is that it benefits a large group of consumers at the expense of a small group of workers.

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