FMA FINANCIAL MANAGEMENT ASSOCIATES, LLC.
P.O. BOX 957 ■ ANDOVER, MA 01810-0016 ■ 978-687-2867

FINANCIAL PERSPECTIVES

HOW TARIFFS WORK

China's government and companies in China do not pay U.S. tariffs directly.

How tariffs really work
U.S. Customs and Border Protection collects the tax on imports. The agency typically requires importers to pay duties within 10 days of their shipments clearing customs. Tariffs are a tax on imported products and are paid by U.S.-registered firms to U.S. customs when goods enter the United States.

From early 2018 through May 1, Washington has assessed $23.7 billion in tariffs, according to data from the CBP. Total tariff revenue rose by 73% year-on-year in the first half of 2019, to a total of $33.9 billion, according to U.S. Treasury data.

Do Chinese suppliers bear the costs of US tariffs?
Chinese suppliers do shoulder some of the cost of U.S. tariffs in indirect ways. Exporters sometimes, for instance, may offer U.S. importers a discount to help defray the costs of higher U.S. duties and maintain their contracts and market share.

Chinese companies are losing business as U.S. importers are scouting for cheaper, tariff-free sources of the same goods outside China.

Trump and top members of his Cabinet have said that the tariffs are accelerating a move of manufacturing out of China as companies seek to relocate in countries that are not subject to U.S. import tariffs. U.S.-based importers, meanwhile, are managing the higher tax burden in a number of ways that hurt U.S. companies and customers more than China.

Such strategies include accepting lower profit margins; cutting costs - including wages and jobs for U.S. workers; deferring any potential wage hikes, in addition to passing on tariff costs through higher prices for U.S. consumers or companies. Most importers use a mix of such tactics to spread the higher costs among suppliers and consumers or buyers.

What do companies in China pay?
China has retaliated against U.S. tariffs by imposing its own tariffs on imports from the United States. Most importers in China are Chinese. So in the same way the U.S. government collects import taxes on Chinese goods from U.S. importers, the Chinese government takes in taxes on U.S. goods from Chinese importers.

Mary F. Calvert | Reuters

© 2019 CNBC LLC. All Rights Reserved. A Division of NBCUniversal

The Impact of an Inverted Yield Curve

The term yield curve refers to the relationship between the short- and long-term interest rates of fixed-income securities issued by the U.S. Treasury. An inverted yield curve occurs when short-term interest rates exceed long-term rates.

From an economic perspective, an inverted yield curve is a noteworthy event. Below, we explain this rare phenomenon, discuss its impact on consumers and investors, and tell you how to adjust your portfolio to account for it.

Interest Rates and Yield Curves

Typically, short-term interest rates are lower than long-term rates, so the yield curve slopes upwards, reflecting higher yields for longer-term investments. This is referred to as a normal yield curve. When the spread between short-term and long-term interest rates narrows, the yield curve begins to flatten. A flat yield curve is often seen during the transition from a normal yield curve to an inverted one.

Figure 1 – A normal yield curve

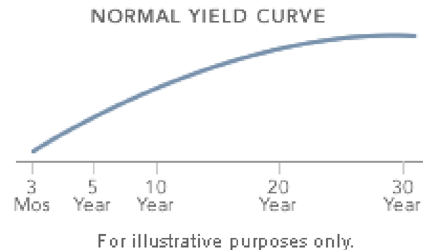
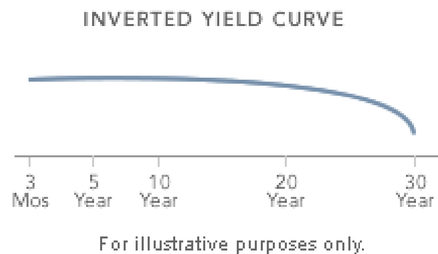


Figure 2 –An inverted yield curve



What Does an Inverted Yield Curve Suggest?

Historically, an inverted yield curve has been viewed as an indicator of a pending economic recession. When short-term interest rates exceed long-term rates, market sentiment suggests that the long-term outlook is poor and that the yields offered by long-term fixed income will continue to fall.

More recently, this viewpoint has been called into question, as foreign purchases of securities issued by the U.S. Treasury have created a high and sustained level of demand for products backed by U.S. government debt. When investors are aggressively seeking debt instruments, the debtor can offer lower interest rates. When this occurs, many argue that it is the laws of supply and demand, rather than impending economic doom and gloom, that enable lenders to attract buyers without having to pay higher interest rates.

Inverted yield curves have been relatively rare, due in large part to longer-than-average periods between recessions since the early 1990s. For example, the economic expansions that began in March 1991, November 2001 and June 2009 were three of the four longest economic expansions since World War II.

During these long periods, the question often arises as to whether an inverted yield curve can happen again.

Economic cycles, regardless of their length, have historically transitioned from growth to recession and back again. Inverted yield curves are an essential element of these cycles, preceding every recession since 1956. Considering the consistency of this pattern, an inverted yield will likely form again if the current expansion fades to recession.

Upward sloping yield curves are a natural extension of the higher risks associated with long maturities. In a growing economy, investors also demand higher yields at the long end of the curve to compensate for the opportunity cost of investing in bonds versus other asset classes, and to maintain an acceptable spread over inflation rates.

As the economic cycle begins to slow, perhaps due to interest rate hikes by the Federal Reserve Bank, the upward slope of the yield curve tends to flatten as short-term rates increase and longer yields stay stable or decline slightly. In this environment, investors see long-term yields as an acceptable substitute for the potential of lower returns in equities and other asset classes, which tend to increase bond prices and reduce yields.

Inverted Yield Curve Impact on Consumers

In addition to its impact on investors, an inverted yield curve also has an impact on consumers. For example, homebuyers financing their properties with adjustable-rate mortgages (ARMs) have interest-rate schedules that are periodically updated based on short-term interest rates. When short-term rates are higher than long-term rates, payments on ARMs tend to rise. When this occurs, fixed-rate loans may be more attractive than adjustable-rate loans.

Lines of credit are affected in a similar manner. In both cases, consumers must dedicate a larger portion of their incomes toward servicing existing debt. This reduces expendable income and has a negative effect on the economy as a whole.

Inverted Yield Curve Impact on Fixed-Income Investors

A yield curve inversion has the greatest impact on fixed-income investors. In normal circumstances, long-term investments have higher yields; because investors are risking their money for longer periods of time, they are rewarded with higher payouts. An inverted curve eliminates the risk premium for long-term investments, allowing investors to get better returns with short-term investments.

When the spread between U.S. Treasuries (a risk-free investment) and higher-risk corporate alternatives is at historical lows, it is often an easy decision to invest in lower-risk vehicles. In such cases, purchasing a Treasury-backed security provides a yield similar to the yield on junk bonds, corporate bonds, real estate investment trusts (REITs) and other debt instruments, but without the risk inherent in these vehicles. Money market funds and certificates of deposit (CDs) may also be attractive – particularly when a one-year CD is paying yields comparable to those on a 10-year Treasury bond.

Inverted Yield Curve Impact on Equity Investors

When the yield curve becomes inverted, profit margins fall for companies that borrow cash at short-term rates and lend at long-term rates, such as community banks. Likewise, hedge funds are often forced to take on increased risk in order to achieve their desired level of returns.

In fact, a bad bet on Russian interest rates is largely credited for the demise of Long-Term Capital Management, a well-known hedge fund run by bond trader John Meriwether.

Despite their consequences for some parties, yield-curve inversions tend to have less impact on consumer staples and healthcare companies, which are not interest-rate dependent. This relationship becomes clear when an inverted yield curve precedes a recession. When this occurs, investors tend to turn to defensive stocks, such as those in the food, oil and tobacco industries, which are often less affected by downturns in the economy.

The Bottom Line

While experts question whether or not an inverted yield curve remains a strong indicator of pending economic recession, keep in mind that history is littered with portfolios that were devastated when investors blindly followed predictions about how "it's different this time."

By James McWhinney

The FMA ADVISOR is published quarterly for the exclusive use by clients and associates of Financial Management Associates, LLC. The information herein was obtained from sources that we believe are reliable, but we do not guarantee its accuracy. Neither the information, nor any opinion expressed, constitutes a solicitation of the purchase or sale of any securities, commodities, or funds. Please note that past performance is no guarantee of future results.