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Trade, Tariffs and the iPhone

The economy is seemingly strong. The Atlanta Federal Reserve Bank is estimating Q2 GDP growth to be 4.7%, significantly more than the 1-2% readings over the past 9 years. Unemployment rates are at record lows. The allusive growth in incomes has finally ticked up. Consumer confidence is high. Business spending on capital goods is strong. Inflation is at or near the Federal Reserve's FOMC's inflation target. And then there are the talks of trade war and tariffs.

The market gets anxious upon heightened trade war rhetoric. When the Wall Street Journal on June 25th reported that the U.S. would restrict key technology exports to China, the Dow Jones Industrial Average dipped as low as 497 points. The sharp declines sent administration officials scrambling to calm investors. Once it was brought to light that the previous day's reporting was not completely accurate, that is, restrictions on trade may not be put in place, the Dow turned around from the declines of the day before and ended up. A large two-day swing, presumably all brought about by concerns of trade.

When talk is tough on trade, stocks are sent lower, and when there is no talk of trade, stocks rise - that has been the norm recently. So why is the president, who uses the stock market as a proxy to the success of his policies, so obsessed with tariffs, when the talk of such sends stocks down? The answer lies in his other obsession, that being trade deficits.

By looking at a simplified example of how the iPhone, the most successful consumer product ever, is manufactured and affects trade numbers, one can see why deficits alone don't tell the whole picture on trade and how tariffs may not fulfill the intended effect. Global supply chain manufacturing of the iPhone adds to the deficit that we incur with China, and since China has been the main ire of the administration, it is another good reason to look to it as an example.

It is well known that the iPhone is assembled in China. The component pieces are imported to China from places like the European Union, Japan, South Korea and yes, the U.S. and then assembled by Chinese companies. The Federal Reserve Bank of San Francisco looked at the input costs for the assembly of the 2009 iPhone, and how those costs relate to the Chinese trade balance on each iPhone "sold" in the United States. They found that for each iPhone shipped back to the U.S., $179 was added to the Chinese trade deficit. Even without adjusting for inflation into today's dollars, that sounds bad. But, looking deeper, $172.50 of the $179 Chinese export was due to the components that were manufactured and subsequently imported into China from other countries, and then passed through to the U.S. import. Interestingly, most of the component making countries are our economic allies, whereas China is an economic adversary. The import dollars related to the components of the iPhone don't get apportioned by country; the whole $179 import is attributed to China. China only added $6.50 in labor input to the value chain, yet when you look at the import data it reflects a $179 deficit with them. The net trade number in isolation doesn't tell the whole story. Let's not get in a trade war with the second largest economy because we run a deficit with them (or any other country for that matter).

You might ask, why not assemble the iPhone in the U.S? If it was then Apple would still need to import in the 172.50 2009 dollars for the components from the other countries. Using this one product economy, the U.S. would still run trade deficits, those deficits would just transfer to another country other than China. U.S. consumers would not benefit from domestic assembly either. In fact, the MIT Technology Review estimates that $100 would be added to the retail price of the iPhone if it was assembled in the U.S. and all the components were manufactured in the U.S. too. U.S. assembly would do little to correct the deficit "concern", nor would it benefit U.S. consumers.

And on tariffs of the iPhone, it is easy to see that a tariff would simply either add to the retail price of the iPhone for U.S. consumers, or Apple would have to absorb the increased cost brought about by the tariff, thus reducing the income of the largest market cap U.S. company, which negatively affects the savings, investments and retirement funds of Americans.

Tough trade rhetoric sends our fund positions lower. It has yet to be seen, and hopefully we will not experience it, how a full-blown trade war will impact the investments. For the sake of the fund's performance, let's hope all this trade talk ends well. And speaking of performance:

I am pleased to announce that *The Jensen Opportunity Fund* increased 13.43% from the previous quarter. Meanwhile, the S & P 500 index fund only increased 2.9%.

Until next time,

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