Summer 2024

Back in the 1960s, there was a belief among some weather statisticians that long-term weather forecasts could be predicted by analyzing historical records to see what happened when conditions were similar. A meteorology professor at MIT, Edward Lorenz, wasn't buying it.

Lorenz was running a computer program to test various simulations and discovered that rounding a variable even the slightest amount, say 0.506127 to 0.506, drastically changed the two months of weather predictions he'd simulated. Further tests continued to bear this out.

Lorenz concluded that long-range weather forecasting was therefore a fool's errand. It was impossible to measure the scads of variables, even tiny ones, in nature that might cause things to change. He initially termed this "sensitive dependence on initial conditions." Later, presumably for those of us unable or unequipped to attend MIT, he coined it "the butterfly effect." Famously, he described it this way: "When a butterfly flutters its wings in one part of the world, it can eventually cause a tornado in another."

Like nature, the global financial markets are complex and interconnected. And singular, concise actions can have much broader implications—including causing economic hurricanes for industries not directly involved.

One such action is a tariff, oft-discussed this election cycle. As a quick refresher, a tariff is tax imposed by one country on the goods and services imported from another country, and it may be used to influence policy, raise modest revenues, or protect competitive advantages.

Using the latter of those reasons, in 2018, President Trump introduced tariffs on steel and aluminum imported from Europe. As is almost always the case when tariffs are levied, retaliation followed. The EU not only imposed tariffs on U.S. steel and aluminum, but also added new tariffs on motorcycles and bourbon. (The two additions were not random—Harley-Davidson headquartered in the former Republican Speaker of the House Paul Ryan's home state of Wisconsin, and Kentucky, the home state of former Republican Senate Majority Leader Mitch McConnell, is a massive producer of bourbon. So, yeah, tariffs can be both politicized and punitive.)

The moves were a double whammy for Harley-Davidson. The price of raw materials needed to make motorcycles would likely increase at home, and the price of finished products would rise dramatically in Europe. As a work-around, the company moved much of its manufacturing of bikes for Europe to Thailand in an effort to avoid tariffs imposed on the U.S. When President Biden came into office and left Trump's tariffs largely in place, the EU declared that the bikes made in Thailand would still be charged a tariff, an insane 56%.

Both sides agreed in December 2023 to extend a pause of these tariffs until 2025. But this example scrapes the surface of why potentially protecting and boosting domestic industries needs to be weighed against the potential collateral damage of tariffs.

Likely, and understandably, you've come to associate U.S. tariffs with China. But they've recently been levied on countries big and small, near and far, including Austria, Brazil, India, Italy, Spain, Turkey, and Vietnam, to name a few. In fact, in 2017, Trump imposed headline-grabbing tariffs on our closest of friends, Canada. We'll get to why in a moment, but it wasn't to distance himself from poutine. (Sorry.)

But first, for the record, at One Capital Management, we are firm believers in the free flow of goods and services, and the long-term benefits to all parties. Better and more efficient use of resources. Cheaper prices paid by consumers. The ability for poorer countries to participate in the global economy and improve the lives of their citizens. As long as all play by the rules, everyone can benefit.

But tariffs have a long history: they have been around since the ancient Greeks, and they have been used by the U.S. for hundreds of years. And, for better or worse, they seem to be a favored economic and political tool of many countries at the moment. That doesn't mean, as we often say about economic situations, there aren't opportunities for diligent investors.

Which brings us back to 2017, and the U.S. tariffs imposed on Canada. The Trump administration, rightly or wrongly, believed the Canadian government was subsidizing domestic lumber companies, giving them a price advantage over U.S. producers. In order to level the playing field, the U.S. levied tariffs of up to 24% on all Canadian softwood lumber, such as pine and cedar used in construction. To no surprise, this caused the stock prices of Canadian lumber companies, including one called West Fraser Timber (WFG), to drop.

While most investors were focused on West Fraser's Canadian roots, One Capital's investment committee noticed the company had acquired significant lumber tracts and mills in the United States. So, while it would be subject to the tariffs on Canadian lumber, its vast U.S. holdings and lumber had just become more valuable. The newly imposed tariffs had WFG trading at just 8.8 times expected earnings, a 41% discount to their industry peers. We saw an opportunity to buy a financially sound company that was momentarily swept out in a riptide of panic, and this investment helped our clients grow their wealth. (Please note that we no longer own WFG in our portfolios; we continue to monitor the company for future consideration.)

You're likely to hear a lot about tariffs between now and Election Day. It's important to remember that, like any tax, they are not inherently good or bad. Their effects depend on many variables, big and small. Lorenz's famous quote refers to a tornado as a result of the butterfly's fluttering wings. But his point would have remained the same had he used sunny skies.

We wish you a great rest of your summer.