Opinion: Here’s one more threat to the stock market that investors should really fear

Tesla's global sales chief leaving for Lyft

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Protectionist trade war could be a big blow to the bulls

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Lions Gate/Courtesy Everett Collection

Almost all economists agree that a trade war would be a Very Bad Thing. That's noteworthy, since economists hardly ever agree on anything.

Yet the U.S. seems hell-bent on going down the path of restricting trade and thereby increasing the odds of a full-scale trade war. That would lead to significantly reduced economic growth and, in turn, an end to the bull market for stocks.

You'd think investors would be gravely concerned. On the whole, they're not. But they should be.

That the risks of a global trade war are higher today than in many years there would seem to be little doubt. One of the defining themes of President Donald Trump's campaign was railing against free trade pacts that he said were unfair to the U.S. Since taking office the U.S. has withdrawn from the Trans Pacific Partnership (TPP) and Trump is threatening to do the same with the North American Free Trade Agreement (NAFTA).

In January, the Trump administration imposed 30% tariffs on solar panels and 50% tariffs on washing machines. Last year the Trump administration imposed tariffs of 20% or more on Canadian lumber. Additional tariffs on the import of foreign steel and aluminum have been promised, among others.

Yet the global financial community seems curiously unconcerned. Take the "Global Risks Report 2018," recently issued by the World Economic Forum in advance of its gathering of the rich and famous in Davos, Switzerland. Each year's report includes results of a survey of "the World top 10 list of “Global Risks in Terms of Impact.” In the WEF’s 2009 report, in contrast, it was No. 5 in terms of perceived likelihood and No. 2 in terms of perceived impact. (Specifically, I focused on the risk category the WEF called “Retrenchment from globalization.”)

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The economic impact of free trade and protectionism can be addressed without taking sides in the intensely polarized political debate about the topic. Even though free trade is a net positive, for example, there is a widespread consensus that the benefits of free trade do not always accrue to those who are hurt by it. That is undeniably a problem.

But the stock market, for better or worse, doesn’t care about the distribution of costs and benefits of free trade. It focuses on the general level of corporate profits. So there’s nothing inconsistent about arguing that free trade is good for the economy as a whole, and the stock market in particular, and at the same time acknowledging that many in society are worse off because of it.

Note carefully that the tariffs on Chinese solar panels and washing machines, or on Canadian lumber, will not — in and of themselves — put the stock market into even more of a tailspin than it’s currently experiencing. The problem instead is that trade restrictions imposed by one country lead to retaliatory actions by other countries, and so on. Dennis Gartman, editor of the institutional advisory service The Gartman Letter, and one of the few advisers I monitor who worries about protectionism, argues that “small, supposedly marginal trade protectionist policies evolve into full scale trade wars all too often.”

properly, devolved... into the brutal trade protectionist inspired Depression."

In this regard, it is worth noting — ominously — that our trading partners have quickly responded to the recent U.S. actions by threatening retaliation. Canada earlier this month filed a broad complaint with the World Trade Organization alleging unfair trade practices on the part of the U.S., for example. China and other countries affected by this week's tariffs on solar panels and washing machines have threatened a number of retaliatory actions.

How much would the stock market suffer from a full-scale trade war? Campbell Harvey, a finance professor at Duke University, told me that he is not aware of any academic study that specifically looks at the relationship between tariffs and the stock market. But, he added, there are plenty of studies showing that free trade translates into a faster-growing economy.

He referred me to one study from a decade ago authored by Harvey and Geert Bekaert of Columbia University and Christian Lundblad of the University of North Carolina. They measured the impact on GDP growth of an economy's openness to trade (exports plus imports as a percentage of total economic activity) as well as the openness of a country's financial markets to foreign investment. Both were significantly correlated with a country's rate of economic growth.

Financial market liberalization alone led to a 1% increase in annual real economic growth. That's huge, and it gives a good indication of how much is at stake from a trade war.

Why, then, is the threat of protectionism not being taken more seriously? One is that we are approaching the ninth birthday of the current economic expansion, and memories of the 2008-09 financial crisis are receding. Worries about a downturn seem theoretical and distant.

Another is that it's easier to see the benefits of protectionism than of free trade. Gartman explains: "There is no question but that the American lumber industry... suffered as freer Canadian lumber... made its way southward, but [was]... the American housing industry well served and [were]... American consumers better off even as the American lumber industry [was] ... disturbed? Of course; however, the benefits [of free trade] are catholic and shallow while the detriments are parochial and deep even if the ultimate effect is for the better for the nations as wholes."

For now, at least, protectionism remains more of a threat than a reality. But you should add it to the list of things you have on your investing radar screen, and be prepared to act quickly if and when a trade war appears to be escalating.

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