Tariffs


Michael Cook on an AGCO Corp. (AGCO) plant tour.

Recently, government regulation has dominated U.S. headlines: first with the Tax Cuts and Jobs Act of 2017; and more recently with tariffs, namely on steel and aluminum imports, announced in 2018. Previous presidential administrations have announced and enforced similar tariffs; we think with political and electoral motivations. In fact, steel tariffs were announced at approximately the same point, chronologically, during President George W. Bush's first term in 2002. Presidents Ronald Reagan and George H.W. Bush also pursued steel tariffs during the last 40 years. We find a review of political, historical and company specifics useful in our assessment of and preparation for the impact of the recently announced tariffs. We believe that our companies have managed through these periods in the past, that any challenges have been temporary, and that they have thrived both during and following the tariff period.

Politics

We contend that these tariffs have been largely politically motivated. The steel-producing states of Ohio, Pennsylvania and West Virginia are historic presidential election battleground states. In fact, John F. Kennedy in 1960 was the last president to win an election without carrying Ohio, and few accomplished this before him. George W. Bush enacted steel tariffs in 2002 and once reelected in late 2004 did not pursue them further. President Trump carried these states in 2016, and we assert that together they can contribute to an electoral college victory in 2020.

History & Economic Impact

Similar tariffs have had a mixed impact in the past. U.S. steel producers have been able to raise prices with support from the tariffs, in the short term while steel consuming industries have faced higher input costs. According to research from the New York Federal Reserve Bank, past similar tariffs have generally eliminated more jobs than they have helped create over time. We contend that the initial news and hype have failed to lead to any lasting economic impact, historically.

Our Companies[1]

What does this mean and what has it meant for SouthernSun's portfolio companies? We believe that roughly 25% - 30% of our holdings, across our Small Cap Strategy Composite and our SMID Cap Composite, are significant users of steel or aluminum. Companies in this category held in both strategies include long time holdings **AGCO Corp. (AGCO)** which manufactures agricultural equipment, **Timken Company (TKR)** which makes tapered roller bearings and related products used along the drive train, and **Trinity Industries, Inc. (TRN)** which makes rail cars and other construction and transportation-related products. **Thor Industries, Inc. (THO)**, a leading manufacturer of recreational vehicles, is a more recent portfolio addition that is a buyer of steel and aluminum. Each of these stocks has been under pressure since the tariffs were announced in early March 2018. The majority of **AGCO's** facilities, sales and supply chain are abroad, yet its stock has responded negatively in the wake of the announcement and enactment of U.S. steel and aluminum tariffs. **THO's** stock performed well during the last round of tariffs in 2002, advancing nearly six-fold during the three years following enactment, and we believe that the company has demonstrated the ability to pass along price increases to customers and to mitigate inflationary pressure through management of its supply chain. **TKR** has raised guidance twice in 2018, once before the tariffs' announcement and once since, suggesting to us that the current strength of its business may offset these potential input price increases. We assert that **TRN** remains a leader in rail car manufacturing and our investment thesis continues to emphasize its flexible manufacturing and demonstrated profit improvement over the course of multiple business cycles; it raised guidance earlier this year and has maintained it in the wake of the tariffs. We contend that the portion of our portfolio exposed to tariffs is positioned to weather what has proven to be a temporary and politically-motivated action in the past.

Conclusion

Steel tariffs have come and gone several times over the last 40 years. They are usually short-lived, lasting no more than two or three years with little overall positive impact on the economy, employment or industry. We contend that the current round may be less the final word but more the first piece of a prolonged negotiation between the U.S. and some of its trading partners. President Trump made the trade agreements the U.S. has entered over the last 25 years, including the North American Free Trade Agreement (NAFTA), a focus of his 2016 campaign, and we assert that these recent actions fulfill, in part, campaign promises. We believe that the steel-consuming businesses in our portfolios are well-positioned to mitigate higher steel and aluminum costs in the coming months due to existing supply agreements, attractive cost structures, and the competitive position that many of them enjoy in their industries.

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[1]The specific securities identified herein were selected based on them being significant users of aluminum and steel and are not representative of all of the securities purchased, sold, or recommended for advisory clients. It should not be assumed that an investment in the securities identified has or will be profitable. Actual holdings will vary for each client, and there is no guarantee that a particular client's account will hold any or all of the securities listed. Past performance does not guarantee future results.