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Not All Tariffs Are The Same

Tariffs, and the uncertainty surrounding them, have been the focus of the market's attention for the last several weeks. Tariffs are threatened or imposed. Affected trading partners retaliate. Tariffs get removed or modified. Throughout this, the stock market gyrates as short-term traders seem to believe that important information about the direction of the economy is being revealed.

Offit Capital last wrote about tariffs in July 2024. The history of tariffs was discussed, reminding readers that since the 19th Century, revenue from tariffs has represented a tiny fraction of government revenue, despite both candidates last summer citing the need for more revenue as a rationalization. We also noted that there was a high probability that after the election trade barriers would expand no matter what the outcome.

Our final point was that the resulting economic disruption and losses to consumers were entirely avoidable, but here we are, at the start of Spring 2025 living through the uncertainty. This month's commentary is not to remind readers of how we got the future trade picture mostly right last July. Instead, as we are in the middle of a transition in trade policy, a discussion is needed about why certain kinds of tariffs create more uncertainty than others. This may help reduce the temptation to modify portfolio allocations in real time.

Tariffs to Protect Specific Industries. Interference with trade comes in many forms. Tariffs, subsidies, and quotas are alternative ways to change the competitive landscape. Alexander Hamilton was an early proponent of tariffs on imported manufactured goods to allow emerging industrial enterprises in the new U.S. to develop until they matured, became more competitive and were able to compete with foreign products. This model, in the same spirit, has been used in developing countries ever since.

A simple, narrow example of sheltering a specific industry is the U.S.' structure of quotas limiting the import of sugar from 40 different countries. These were established decades ago to protect U.S. cane producers in Florida, Louisiana and Hawaii and beet producers primarily in the upper Midwest. Quota sugar is allowed into the country with a modest tariff. Any imports above the quotas are assessed punitive tariffs that largely cut them out of the U.S. market. The net result is that about 15 percent of sugar consumed in the U.S. is imported, today at a price near $0.20 per pound while the domestic price of sugar is $0.37 per pound.

This program was designed to protect politically connected farmers in many states. The cost is primarily borne by any domestic consumer of sugar. There was

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Table of Contents

no motive to punish Brazil, the Philippines, or the Dominican Republic that hold the largest quotas, or any other eligible export countries. It is likely that this program will persist for decades to come with the transfer of billions more dollars from consumers to domestic producers because the costs on each person are small relative to the meaningful benefits to the few producers. If the program was modified or eliminated the broader market would not notice.

Such tariffs are widespread around the globe. Europe has for many years had a 10% tariff on imported vehicles from the U.S., while the reciprocal tariff for European cars coming to America was 2.5%. Such disparities provide fodder for the political dialogue that trade rules are unfair.

Tariffs to Protect National Security. Certain raw materials and manufactured goods are considered essential to a nation's security. Despite the U.S. having considerable wealth and resources of its own, where those essential goods are produced is often dictated by relative cost. Rare earth metals are a case in point. Rare earths are a category of minerals used in defense and chip applications. China currently produces almost 70% of global output, not because it is uniquely advantaged geologically but because its costs are lower than producers like the U.S., Burma, and Australia.

As trade disputes between the U.S. and China escalated, China banned the export of four rare earth metals to the U.S.. Alternative, but more expensive, sources can be found but issues of national security quickly rose in what was otherwise an economic discussion. This most recent dispute is not resolved, but past similar episodes have given rise to import tariffs on strategically important products to shelter U.S. producers and encourage a safer supply chain.

An imposition of any tariff will raise that product's price, captured in monthly CPI and PPI data, but it should be a once and for all event and not a sustained increase in the rate of price change, which is inflation.

The national security trump card has often been played as a justification for specific industry protection discussed above. This can be a political fig leaf to disguise outright favoritism. Any impact on the equity market is usually limited to identifying specific winning and losing companies. Despite the ominous sounding national security label, concerns about these types of tariffs rarely rise to a systemic level.

Tariffs to Affect Foreign Policy. A 200% tariff on European wines has nothing to do with protecting west coast vineyards or securing national security. It is a response to the EU putting 50% tariffs on American whiskey, which in turn was a response to aluminum and steel tariffs imposed by the U.S. Many have suggested that those tariffs were a wake-up call to the EU that they should spend more of their national budgets on their own defense.

Mexico and Canada are the U.S.' most important trading nations, but it is far from a balanced partnership. 75% of Canadian and Mexican exports go to the U.S. In comparison, exports from the U.S. to those countries are only 30% of our total, roughly equally split between the two. More than half of Canada's and Mexico's imports come from the U.S., with machinery and electronics important for both countries. Canada's largest import category from the U.S. is motor vehicles and parts, and Mexico imports large amounts of and refined petroleum products.

Given the large and long-standing trading relationships among these three North American neighbors and historical allies, what is the objective of broad 25% U.S. tariffs on all imports from Canada and Mexico? Among several policy matters that concern the U.S., it is likely that Washington wants them to be tougher on Chinese trade themselves, limiting any attempt by the Chinese to circumvent direct U.S. tariffs by first shipping their exports to Canada or Mexico. Given the percentages of imports and exports discussed above, there is a belief in Washington that the U.S. has the bigger lever in negotiations.

What are the results of such policy tariffs? Just like the sugar trade policy discussed above, these tariffs impose the biggest burdens on the consumers of the imported products. But instead of just touching a tiny sliver of the consumer's budget like sugar quotas, they could potentially have a major impact on consumer prices. Commentators are saying that broad tariffs will increase inflation, but that shows a confusion between high prices and rising prices. An imposition of any tariff will raise that product's price, captured in monthly CPI and PPI data, but it should be a once and for all event and not a sustained increase in the rate of price change, which is inflation. Since most people do not distinguish between high prices and the rate of inflation, a broad application of tariffs will likely still be a politically losing proposition.

The other big losers will be U.S. companies with a global presence. Brown-Forman is a prime example. Best known for their Jack Daniels, Woodford Reserve and Old Forester brands of American whiskey, they have many other brands. Some like their tequila and Scotch whisky are sourced abroad. In 2024 only 46% of Brown-Forman's revenue came from U.S. buyers. Import tariffs on their foreign products would reduce U.S. consumption. Retaliatory tariffs on their exports would hurt the other 54% of their revenues. It is perhaps not surprising that from a mid-December share price of $45, by mid-March it had fallen to a low of $30.65 before recovering to $34.43 when this commentary was written.

Proponents of trade restrictions often say they protect and create good jobs. That may be true for the firms that benefit from reduced competition, but it ignores the many Brown-Formans of the country that could lose on multiple fronts, resulting in layoffs. Analysts will try to forecast the broader macroeconomic impact of tariffs, but the vast interconnections that have developed around the globe make it almost impossible to do with assurance.

Collateral Damage. The impact of any of the above tariffs on affected consumers is obvious. Sorting through the winners and losers among companies is much more complicated as tariffs move from narrow and specific to broad and foreign policy motivated. The bigger challenge is the great uncertainty of policy that splashes over into the stock market. Tariffs are announced. Affected countries retaliate. The original plan can get softened, ramped up, postponed or dropped entirely. How some stock market traders believe they can translate all of this into a clear signal for market movements is beyond explanation.

In January and February, the VIX Index, which captures a measure of stock market volatility as revealed in traded S&P 500 Index option prices, fluctuated roughly between a historical normal reading of 15 and 20 but began to rise in the last two weeks of the period as tariff talk heated up. It approached 28 by mid-March, the highest level since August of last year, but has moderated back to 24 to end the month. The swings in the stock market have not been out of the ordinary, but many investors find the source of the uncertainty to be more than unsettling.

Uncertainty and the staccato pace of policy announcements and modifications have led to heightened volatility in the stock market, which can be expected to continue if tariffs keep being used as a foreign policy tool.

The following article was previously published in the Fall 2016 issue of The Linneman Letter.

The Linneman Letter Look-back: The True Impact of Banking Compliance (2016 Reprint)

Increased financial regulation has led to a unique situation, whereby bank employment is largely unchanged over the past 8 years, even as the number of bankers has plummeted. This is because bankers have been replaced by lobbyists and regulatory compliance employees. Banking is now about lobbying and currying regulatory favor, rather than serving the local business community.

Over the past 15 years, bureaucrats and legislators have swamped the U.S. banking industry with regulations. Starting with the anti-money laundering laws post-9/11 and compounded by the horribly (almost non-) written Dodd-Frank Act, financial institutions increasingly find their hands tied by regulations that both they, and those enforcing the regulations, struggle to understand. And worse, the regulations are never complete. For example, the Dodd-Frank Act, which was passed in 2010, now totals over 22,000 pages and approximately 80 of its rules (out of 285) remain unwritten. This is the environment in which bank executives are forced to live.

In order to avoid hefty fines for non-compliance, banks have allocated significant portions of their budgets to lobbying, compliance, and regulatory efforts. Rather than putting resources toward core business activities, such as lending to firms and consumers, banks are forced to assume a defensive stance, which negatively impacts productivity. With new regulations gushing out of D.C. at an alarming rate, bank executives are unable to ensure that these booming compliance departments are using their budgets efficiently and productively. Instead, they are employing a "better safe than sorry" philosophy, in the hopes that more resources protect them from yet undefined liabilities. No better example exists than the unspecified "black box" stress tests which money center banks must pass without knowing the standards to which they are being held. This is like strictly enforcing speeding laws without telling drivers the speed limits (and changing them throughout the day, week, and year).

This is seen in the massive hiring in the areas of compliance, anti-money-laundering, and internal risk management. From 2012 to 2014, JPMorgan Chase added over 4,000 compliance staff, and an additional 8,000 employees focused on money-laundering alone. As of 2015, the firm was reported to have nearly 43,000 employees working in regulatory and compliance-related roles. Citigroup announced in 2015 that nearly half of $3.4 billion in efficiency savings were diverted to regulatory and compliance activities, as they added 6,000 risk management, compliance, and anti-money-laundering employees between 2011 and 2014. In addition to higher regulatory and compliance costs, commercial banks have also been spending more on lobbying. The commercial banking industry as a whole spent $65 million (0.0004% of GDP) in lobbying efforts in 2015, up from $47 million (2015 dollars) in 2007, a 39% increase. With an average increase of 4.2% per year, the overall banking industry has spent over $566 million (0.003% of GDP, 2015 dollars) on lobbying since 2007. An interesting note is that during this period, nearly every major bank (and certainly those mentioned above) saw a net decrease in overall employment. This means that not only is the number of regulatory-related hires increasing, but core business employees are plummeting. Thus, compliance and legal staffing accounts for an increasing share of total employment in the banking industry.

Not only are banks being forced to hire more regulatory employees to understand and manage the ever-changing regulatory landscape, but the increased demand for compliance employees has pushed up wages by approximately 5% year-over-year in 2014, with approximately 60% of all compliance staff reporting higher wages. As a group, the largest 6 banks (by assets) spent nearly $70 billion on compliance in 2013, almost double that in 2012. As compliance-related costs rise, banks are responding by attempting to cut costs by reducing core services and product offerings. Earlier this year the American Bankers Associates reported that 46% of banks were scaling back efforts to grow loan and deposit accounts, while others shutter areas such as student loans and mortgage-related businesses.

About Dr. Peter Linneman

Dr. Linneman, who holds both Masters and Doctorate degrees in economics from the University of Chicago, is the Principal of Linneman Associates. For nearly four decades, he has provided strategic and financial advice to leading corporations. Through Linneman Associates, he provides strategic and M&A analysis, market studies, and feasibility analysis to a number of leading U.S. and international companies. In addition, he serves as an advisor to and a board member of several public and private firms.

Dr. Linneman is the author of the leading real estate finance textbook, *Real Estate Finance and Investments: Risks and Opportunities*, edition 5.3. His teaching and research focuses on real estate and investment strategies, mergers and acquisitions, and international markets. He has published over 100 articles during his career. He is widely recognized as one of the leading strategic thinkers in the real estate industry. Most recently, Dr. Linneman co-authored (with Dr. Michael Roizen and Albert Ratner) the best-selling book *The Great Age Reboot: Cracking The Longevity Code For A Younger Tomorrow*.

He also served as the Albert Sussman Professor of Real Estate, Finance, and Business and Public Policy at the Wharton School of Business at the University of Pennsylvania until his retirement in 2011. A member of Wharton's faculty since 1979, he served as the founding chairman of Wharton's Real Estate Department and the Director of Wharton's Zell-Lurie Real Estate Center for 13 years. He is the founding co-editor of *The Wharton Real Estate Review*.