NorthStar
ASSET MANAGEMENT

FIRST AVENUE
INVESTMENT MANAGEMENT

Market Report

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Closer to the truth

The double-edged sword of tariffs: lessons from history and their economic impact

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"Those who cannot remember the past are condemned to repeat it". - Spanish philosopher George Santayana

This article focuses on tariffs; we unpack the motivation for applying them, their efficacy and impact, and we scour history, to appreciate the consequences of using them as an economic weapon.

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What are tariffs and how do they work?

A tariff is a tax imposed on imported goods that raises the cost of those goods in the country into which those products are being exported. It is a location-based tax, focusing on where a product is produced rather than on the product itself.

For example, Mexican tequila brand, El Jimador manufactured by Grupo Herradura in Amatitan, Jalisco, Mexico might have a 25% tariff levied upon it when exported into the United States, but should Herradura produce El Jimador in San Diego, the tariff would not apply.

Why do governments impose tariffs?

Governments that impose tariffs do so for several reasons – to protect domestic manufacturers that produce at a higher cost to the imported item; to address unfair trade policies (such as foreign governments subsiding their industries which causes dumping e.g. electric vehicles from China into Europe); to earn tax revenues (albeit that this has proven inconsequential) and, for ideological reasons, a show of force.

But all the above does not actually fully explain the raison d'etre as to why governments impose tariffs. Trade protection has its foundations in politics, in the need to appease powerful minority lobby groups that are experiencing economic pain.

The political roots of trade protection

If we look back to the 1920's, US farmers had taken-on extensive debt to invest in land and equipment to raise output because of high commodity prices after World War I. A subsequent decline in commodity prices ensued, farmers could not keep up with loan repayments, their response was to demand tariffs to protect their output. Similarly, the US Steel Manufacturers Association and the United Steelworkers Union, want to protect their industry in 2025, by maintaining tariffs on steel imports.

Do tariffs actually work?

Do tariffs work? Professor of Economics Thomas Grennes from North Carolina State University in his paper, The Economics of Tariffs: Can restricting international trade be good for the economy, argues that they do not.

Imports account for 16% of the US economy's GDP whereas exports account for 11%. Any trade policy that effects the consumer risks hurting consumption which is 68% of US GDP.

Mark J. Perry from the American Enterprise Institute in his 2016 paper on US trade, quotes Dartmouth economist, Doug Irwin, that officially, 53% of US imports are so-called intermediate goods, but he believes this number to be understated.

The impact of tariffs on intermediate goods

Intermediate goods are unfinished products and fall into categories such as capital goods - machinery, equipment, aircraft parts, semiconductors; and industrial equipment such as lumber, chemicals, aluminium, and copper. These products are critical to manufacturing in the US.

Tariffs increase the prices of intermediate goods, forcing domestic manufacturers to shift their purchases to higher cost local alternatives. But tariffs not only increase the price of the imported good, they also lead to the domestic substitute product rising in price. Of course, tariff imposition seldom goes unpunished, and the consequence is counter tariffs. This all results in reduced levels of trade, and in turn falling incomes for all trading partners.

The case for free trade

Against this, free trade allows countries to focus on their core competencies, adding value to society and enriching all partners.

Tariffs and job creation: a historical perspective

The proponents of tariffs argue that they create jobs for the country imposing them. We have the benefit of history to evaluate this thesis. We mentioned earlier that powerful lobby groups persuaded the US government to impose tariffs in the 1920's. This took the form of the Fordney-McCumber Act, which raised the average tax on agriculture and industrial imports into the USA by 40% in 1922. The Europeans immediately retaliated. In 1929, due to the Federal Reserve hiking interest rates to stem stock market speculation, stocks collapsed, precipitating further protectionist thinking in America. Despite one thousand economists petitioning against it, President Herbert Hoover signed the Smoot-Hawley Tariff Act on the 17th of June 1930, further raising tariffs by 20%. This led to more reprisals and a full-scale global trade war ensued.

The Great Depression: the cost of protectionism

The combination of draconian trade policies, high interest rates, a stock market crash, and subsequent bank failures, resulted in the onset of the Great Depression in the summer of 1929. US industrial production fell 47%, GDP fell 30%, wholesale prices collapsed 33% and unemployment ballooned 20%.

Modern echoes of protectionism

Fast forward to 2025 and Donald Trump's utterances ring loud "Tariff is the most beautiful word in the dictionary.'' Against this, we juxtapose the genius of Milton Friedman ''tariffs diminish the efficiency of the international division of labour, by imposing them, you hurt yourself'' and then of course, Warren Buffett's views expressed only a few weeks ago. Tariffs are ''an act of war'', ''over time they are a tax on goods'', ''I mean, the tooth fairy doesn't pay for them''.

At Northstar, we certainly know whose opinion we share.

Asset allocation: Modern Portfolio Theory

Mark Seymour
Director Fixed Income

Northstar's purpose is to deliver consistent, risk-appropriate returns for our clients. Central to this mission is our application of Modern Portfolio Theory (MPT), a framework pioneered by Nobel Prize-winning Harry Markowitz in the 1950s. MPT offers a structured, quantitative approach to optimising the balance between risk and return. By leveraging this time-tested methodology, we position the Northstar multi-asset portfolios to target the highest possible returns for a given level of risk tolerance, maximizing the efficiency of our clients' capital allocation.

MPT teaches us that diversification is not solely a risk management exercise but a strategic advantage. By strategically diversifying across companies and asset classes, we mitigate portfolio volatility while preserving return potential. We achieve this through rigorous fundamental analysis of the markets, resulting in a clear risk and return perspective for each company and instrument we cover. This information is distilled into buy lists, which form the foundation of our monthly portfolio optimisation process, ensuring our clients' portfolios target the highest possible returns within a robust risk framework.

Our approach goes beyond static models. We actively research, model, and value companies on a continuous basis while also monitoring global economic trends, interest rate shifts, and geopolitical developments to ensure our buy lists remain up to date. This monthly cadence allows us to adjust portfolios appropriately, ensuring that our clients remain on track to achieve their financial goals.

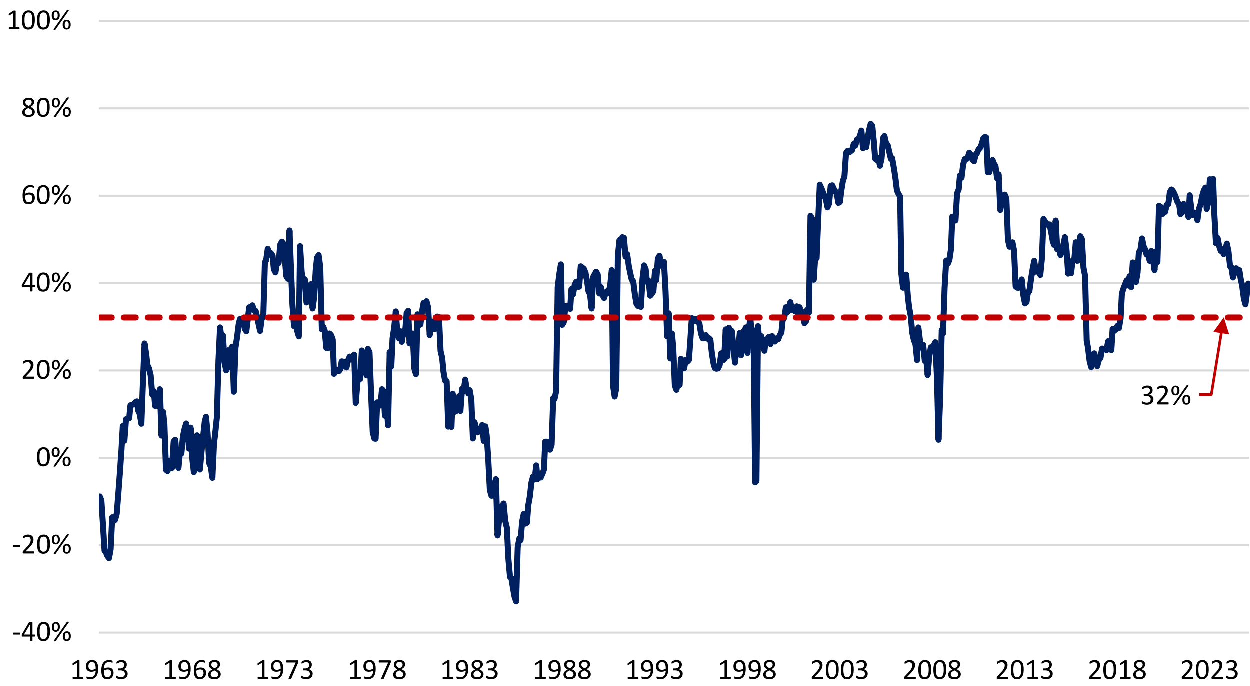
In this quarterly report, we demonstrate how we apply MPT, unpack the latest key performance drivers for the Northstar BCI Managed Fund, and outline our outlook for the months ahead.

Applying Modern Portfolio Theory?

Modern Portfolio Theory is based on the principle that portfolio stability is enhanced by combining uncorrelated portfolio holdings. For example, an unexpected increase in inflation may cause inflation-linked bonds to perform well while equities underperform. By holding both inflation-linked bonds and equities, returns can remain stable despite unforeseen inflationary pressures. Similarly, diversifying exposure to both local and global equities can significantly reduce portfolio volatility.

As shown in Chart 1, the average correlation between local equity (ZAR) and global equity (ZAR) is substantially below 100%, typically ranging between 0% and 60%.

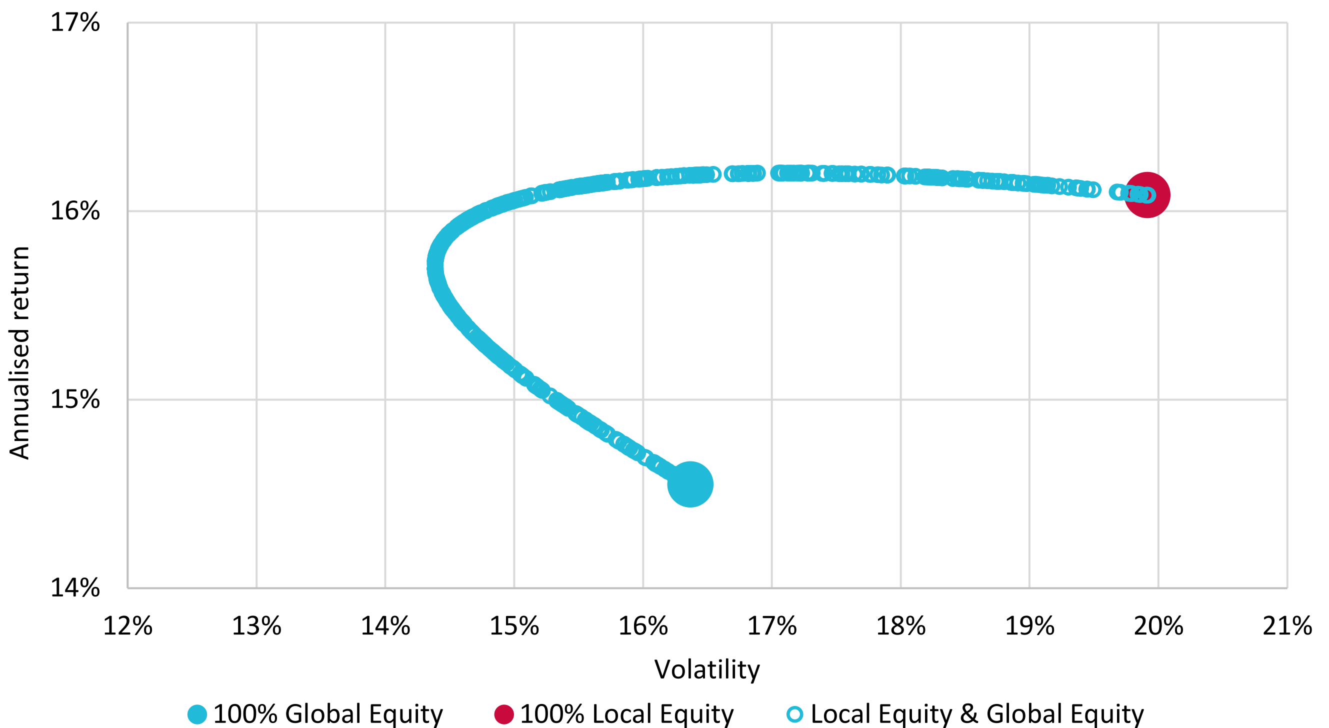
Chart 1: 3 year rolling correlation - local equity vs. global equity



Source: Iress, Bloomberg and Northstar Asset Management (as at 31 January 2025)

The relatively low correlation between local and global equities significantly enhances the portfolio's risk-adjusted returns, as demonstrated by the risk-return series for different blends shown in Chart 2.

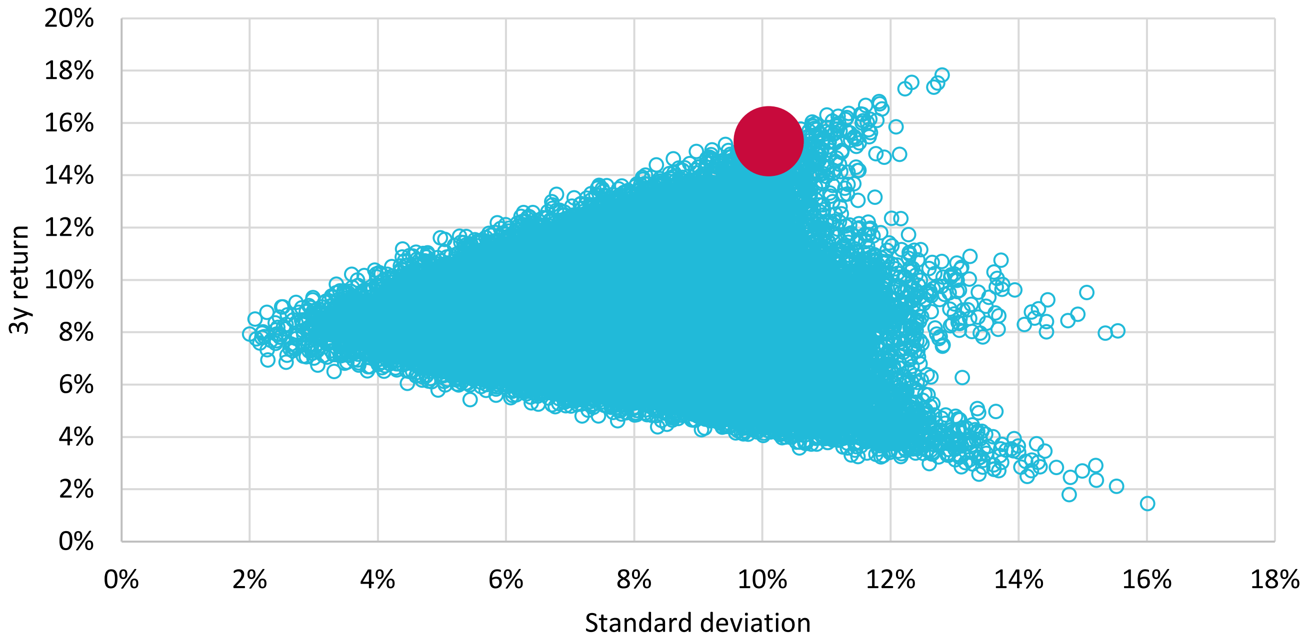
Chart 2: Risk versus return for a blend of holdings in local and global equities (ZAR)



Source: Iress, Bloomberg and Northstar Asset Management (31 December 1959 to 31 January 2025)

Expanding on this principle, we integrate a full spectrum of asset classes represented by the suite of Northstar buy lists. These include buy lists for: 1) local equities, 2) global equities, 3) local fixed income, and 4) global fixed income. Armed with this data, we assess the optimal weightings for each asset class to ensure the best risk-adjusted returns. This computationally intensive process results in an optimized asset allocation for each Northstar multi-asset portfolio. Chart 3 illustrates the range of expected risks and returns based on the latest Northstar buy lists and the optimized positioning for the Northstar BCI Managed Fund.

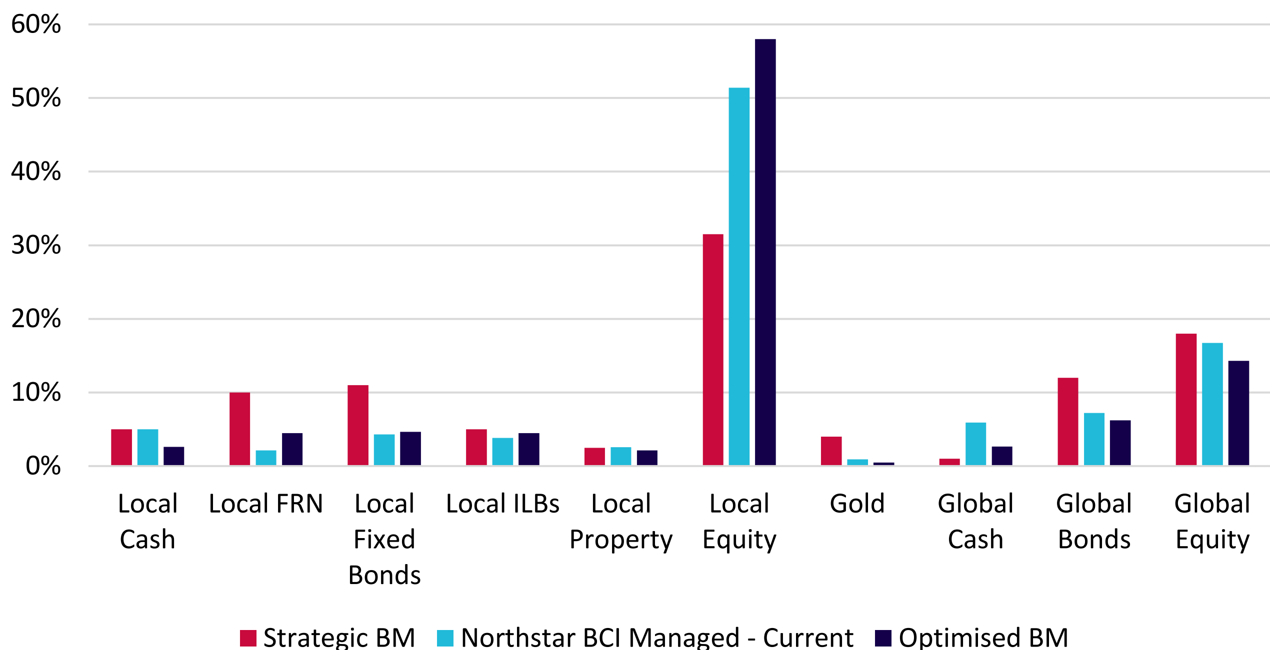
Chart 3: Northstar BCI Managed Fund - optimised expected risk vs return



Source: Iress, Bloomberg and Northstar Asset Management (as at 28 February 2025)

Following the optimisation process, the target asset allocation (optimised BM) for the Northstar BCI Managed Fund as of 28 February 2025 is provided below.

Chart 4: Northstar BCI Managed Fund - asset allocation vs strategic benchmark and optimised benchmark



Source: Iress, Bloomberg and Northstar Asset Management (as at 28 February 2025)

Key performance drivers

Over the last quarter, the Northstar BCI Managed Fund benefited from a strategic shift in asset allocation, reducing exposure to local fixed income in favour of local equities, particularly by decreasing local fixed bond exposure. This adjustment came as the local bond market experienced strong gains following the 2024 elections, with bond yields trading below fair value.

Additional performance gains were driven by increased allocations to companies such as MTN, Naspers, Prosus, Goldfields, Richemont, and Anheuser-Busch, while avoiding exposure to Nvidia and Tesla and reducing exposure to Microsoft. Additionally, a meaningful allocation to USD cash and, more recently, US treasuries contributed positively to returns. The fund also achieved strong alpha generation in global stocks, delivering significant positive attribution versus the world index and even more so against the S&P 500.

Despite these strong relative gains, some detractors included increased exposure to local banks, industrials, and retailers. However, the fund sees compelling value in selected companies within these sectors and plans to further increase exposure in the coming months.

Outlook for Q2 2025

With local bond yields returning to fair value, the case for increased exposure is likely to come under scrutiny. However, inflation-linked bond yields remain attractive, offering strong real returns in an environment of persistent inflation, which should support favourable performance. At the same time, valuations in local cyclicals—including banks, insurers, retailers, property, and general industrials—are becoming increasingly compelling. As a result, our portfolio optimisation process is expected to maintain exposure to these opportunities, with the potential for further increases.

On the global front, equity valuations have recently become more attractive, likely drawing capital away from global cash and US treasuries, which have benefited from strong capital gains. Meanwhile, rising global uncertainties—including geopolitical tensions, the threat of tariffs, and signs of a weakening global economy—continue to create market volatility. To safeguard against potential market downturns, a portion of our local equity exposure is strategically hedged.

Through rigorous fundamental analysis of companies on our local and global equity buy lists, combined with a macroeconomic overlay and careful assessment of expected risk and return metrics, the Northstar multi-asset portfolios—such as the Northstar BCI Managed Fund—will continue to be optimised to achieve the best risk-adjusted returns in the most efficient manner.

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