SHOULD BOARDS TAKE THE TARIFF THREAT SERIOUSLY?

FIDELIO OVERTURE

INTRODUCTION

In November 2024 the question of tariffs is firmly on the Board Agenda.

*Fidelio asks **Advisory Partner, Simon Irwin**, for his views on the risks facing companies; the risk of higher cost and disrupted trade; and the implications for Boards.*

Please read on for Simon's perspective on why Board should take the threat of tariffs seriously.

SHOULD BOARDS TAKE THE TARIFF THREAT SERIOUSLY?

OVERTURE BY SIMON IRWIN

Yes. The last Trump administration was hawkish on trade, notably with China, but didn't enter office with a clear agenda and unified team. This administration appears to have a much better articulated set of strategies than the last. The key appointments are clearly aligned with this strategy and the Republicans should have control of both houses.

With tariffs in particular, several outlets report that Robert Lighthizer, the hawkish US Trade Representative from 2017-2021, has been actively formulating strategy and plans for implementation, and his protégé Jamieson Greer will be the new Trade Representative. In addition, Senator Marco Rubio, the pick for Secretary of State, has historically been hawkish on China, and was sponsor of the Uyghur Forced Labour Prevention Act, which became law in 2021.

Members of the incoming administration have discussed imposing 10-20% blanket tariffs on all imports and 60-100% on products made in China. It also seems likely that there will be specific tariffs on certain products (raw materials, cars, semiconductors, solar panels) and more recently Trump has threatened 25% tariffs on the USA's biggest trading partners Canada and Mexico (and an additional 10% on China) if they don't do more to control illegal immigrants and the supply of Fentanyl into the US.

The previous Trump administration used executive powers to enable tariffs, although this time there has been discussion of using legislation, to ensure more longevity. Theoretically these would contravene WTO rules, but the US may argue national security exceptions, and the WTO disputes mechanism is relatively ineffective. In any case, it seems that some form of trade war would break out with countries imposing corresponding tariffs on US products, and services.

Although the intention behind these policies is essentially political, there is also an explicit expectation that these tariffs will fund tax cuts elsewhere. The appointment of hedge fund manager, Scott Bessent, as Treasury Secretary is seen as a pragmatic move. He may use the threat of tariffs to extract policy concessions from partners, and will be wary of the impact on inflation. Nevertheless, with the need to fund tax cuts, it seems reasonable to assume that some of these tariffs will be enacted, that trading partners will respond with tariffs of their own and that the environment will be volatile.

SUPPLY CHAINS ARE CHANGING RAPIDLY

For companies involved with multi-national supply chains, the timing could be a lot worse. For much of the past thirty years, companies shifted manufacturing to the lowest cost locations, and introduced just-in-time techniques to get products to customers with the least stock risk. This resulted in significant cost savings and reduced working capital but was high risk and inflexible. Many companies did not feel the need to take on the cost of de-risking supply chains in what was seen as a benign environment.

However, since the start of the first Trump administration in 2017, with Covid disruption, political instability, war in Ukraine, shipping delays and increasingly extreme weather, it has become clear to companies that the world is becoming increasingly disrupted, and that they should have strategies in place to make supply chains more resilient.

Consequently just-in-time schedules have been de-risked to allow for shipping or port delays and many companies have looked at near-shoring and ensuring multiple sources of supply. This is often less efficient, in terms of unit cost of manufacturing and distribution, can give higher stock losses, and may be a contributory factor to worsening productivity trends. However, it is undoubtedly more robust.

In practice, many companies have been reducing their reliance on China for some time, especially in labour intensive industries, where minimum wages are notably higher than in Vietnam or Bangladesh, which also tend to benefit from more favourable tariff treatments into Europe and USA, depending on the product category. Component supply chains and manufacturing expertise have gradually grown to allow this, especially in high volume, low margin categories such as clothing and footwear.

However, there are many other product categories where moving production out of China has proved much more challenging, such as the manufacture of electronic and electrical products, homeware etc, where supply chains of sub-components have not moved, unit volumes are lower and buyers have become reliant on local design and manufacturing expertise.

Where possible, many companies have started to establish near-shoring options (Eastern Europe/ Turkey for Europe or LatAm/Caribbean for North America) and/or deriving secondary sources of supply in Asia (Vietnam/Bangladesh/Indonesia). However, raw material and components may not be reliable, labour supply can be an issue and political regimes can also be unstable.

WHAT ARE COMPANIES LIKELY TO DO?

Immediately, we assume that companies will look to speed up shipments into the US, to ensure there are an additional month or two of buffer stocks, and accelerate orders from non-China locations.

THE DEVIL IS IN THE DETAIL

Following that, much depends on the details and the response from global trade partners. It's reasonable to assume there will be tit for tat responses to US tariffs, although these could also target US services. Much will also depend on the extent that rules of origin are applied to product manufactured outside China, but using Chinese made raw materials or components. This would significantly increase the complexity of tariff imposition, and again change sourcing decisions.

UNINTENDED CONSEQUENCES AND ENFORCEMENT

There are also the unintended consequences. For example, the US currently has a de-minimis import exception of $800, so all individual packages under that level are currently free of tariffs and local sales taxes. Assuming that tariffs are all passed on, this would make direct imports below the de-minimis exception remarkably competitive, benefitting Shein and Temu amongst others. This exception might need to come down to $25 to really make a difference. High tariffs might also encourage small scale imports of luxury goods, like China's Daigou network. All this change begs the question of how the CBP (Customs and Border Protection) and other agencies are going to enforce all these new regulations and the huge increase in imported goods potentially subject to tariffs.

LOOKING FURTHER OUT

We believe most jobs are much more likely to end up in low-tariff locations in Central/South America or SE Asia. It seems very unlikely that manufacturers will invest in plant and machinery in the US solely based on the apparent benefits of high tariffs, which could change at any time. The exceptions may be in areas where tariffs, incentives and other regulations already apply (i.e. batteries, chips, etc).

Moreover, most products require layers of supply chains, which need to be flexible, and a ready supply of cheap labour. America does not have the supply chains, labour force or the experience. Less than 8% of US workforce is engaged in manufacturing (source FT) and cheap labour supply will be notably tighter if the new administration goes through with its threatened plans to conduct large-scale deportation of undocumented migrants.

Tariffs will be passed on, as were higher prices during the recent spike in inflation. The US is already a comparatively high-cost country to do business in, and multi-national companies will not want to make significantly lower margins in the US than in the rest of the world.

WHAT ARE THE BOARD IMPLICATIONS?

The sheer variety of geo-political risks show that companies' strategy and execution need to be increasingly agile, whether they are international or have a domestic focus.

BUILDING CAPABILITY

Fidelio sees the Boards we are working with respond in practical ways to heightened geo-political risk:

- **Composition:** We have commented in previous Overtures on how effective some global Boards are at bringing diverse global perspective into Board composition. This gives comfort to the Chair that knotty geo-political issues are being considered from different viewpoints. It also provides an opportunity to open doors in relevant markets. We are seeing some of this thinking and practice cascade down to smaller companies. Against this backdrop Fidelio has experienced a renewed interest in advisory Boards, one dimension of which is geo-political insight.
- **Contribution:** Fidelio has also seen a pushback against well-meaning Board discussions at the level of "*the average Economist reader*." Companies need a Board capable of linking geo-politics to the business and its markets. If the Board is to provide guidance and challenge, Non-Executive Directors need a much deeper understanding of geo-politics and the implications for the business. This will shape composition but also create a sharp learning curve for all on the Board.

- **Risk Appetite:** Heightened geo-political risk is clearly one business challenge that is prompting many Boards to review the adequacy of risk processes. This includes empowering the Audit & Risk Committee, as well as strengthening the Board's contribution to strategy formation. While geo-politics is typically seen as a threat, risk aversion cannot be the whole answer. Fidelio is seeing Boards have robust conversations about the opportunities created by instability and uncertainty. Establishing risk appetite is not just for Financial Services Boards!

Fidelio fully expects this heightened focus on geo-political risk to continue. Boards of all organisations need to be well-informed, not just in a generalised way, but with a specific and practical focus on the implications of geo-politics for the business.

Please contact Simon Irwin if you would like to discuss the content of this Overture further.

Simon Irwin, Advisory Partner

E: sirwin@fideliopartners.com

ABOUT FIDELIO

Fidelio Partners advises and supports Chairs to build and develop high performing Boards. We have an international track record in advising Chairs, building Boards, creating value for shareholders and stakeholders and effecting change through:

- **Chair Advisory**
- **Board & Executive Search**
- **Board Review**
- **Development & Succession**

For further information about how Fidelio can support your Board learning and effectiveness, such as navigating the dynamics of current geo-politics, please contact Gillian Karran-Cumberlege.

Gillian Karran-Cumberlege
Head of Chair Advisory

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T: +44 (0)20 7759 2200
M: +44 (0)77 6608 4638
E: gkarrancumberlege@fideliopartners.com