Trade Wars One Year Later

By John J. Petrides, MBA,
Managing Director and Portfolio Manager

Trade wars continue. The US recently ratcheted up the tax rate on $200bil of Chinese imports from 10% to 25%. The Chinese have retaliated by increasing the tax rate on $60bil of US goods from 5-10% up to 20-25%. Those industries already feeling the impact can expect more pressure on their profitability. Stock market indices have responded by selling off 4% from their recent peak.

Now What?

1. The longer trade wars continued at elevated levels, the more pressure it will put on the global economy, particularly the Chinese economy. China is 15% of the world’s GDP and given its economic growth rate, is the most significant in terms of the overall global economy. So, when the Chinese economy sneezes, the global economy (ex-the US) typically catches a cold.

2. President Trump shows no signs of backing down. With the S&P 500 up double-digits to start the year, the US economy growing above 2%, and the Federal Reserve seemingly on hold with interest rates, Trump will continue to play hardball with the Chinese, especially entering the 2020 campaign year. As for the Chinese, they are not one to back down from threats, so the divide between the nations will continue.

What’s Different Now vs Last Year?

1. Global central banks are back into Quantitative Easing (QE) mode. Last year when the US engaged in trade wars, the biggest looming variable was that the Federal Reserve was embarking on four interest rate hikes. Not only was the market fearful of trade wars slowing the economy, but of the Fed pouring gasoline on the fire by trying to slow it further. Now, the Fed has taken a neutral stance on interest rates for 2019, with some in the market expecting the Fed to possibly cut rates by year end. In addition, central bankers around the world are ready, willing and able to further increase QE if necessary.

2. Corporate America has navigated through the initial rounds of tariffs in decent shape. By and large companies were able to cut costs and or pass through prices to consumers to offset the tariff impact. During earnings season, many large cap multinational companies mentioned they have been working through their P&L in efforts to fend off rising costs from tariffs.
latest round of increases, although painful to a company’s bottom line, are not as entirely unexpected as they might have been last year. The bigger issue corporate America will need to deal with in terms of earnings growth is the rising US dollar. 30% of earnings of companies in the S&P 500 are outside the US, so a continued strong USD will be a currency headwind to earnings results.

3. A fallout in the Eurozone could be an unintended consequence of prolonged trade wars between the US and China. The flaw in the EU experiment was exposed during the Greek crisis in 2011. However, with the third largest economy in the EU, Italy, under pressure, any further slowdown in the global economy will add further pressure on the EU. This should lead to the European Central Bank (ECB) back into QE mode and possibly to inject capital into the European banking system.

Be Active With Your Portfolio

Volatility acts as a useful stress test on your portfolio. When the equity market sells off, it allows you to test if your portfolio has been skewed too far to one side of the boat. Do not react to the headlines, tweets, or sell off in stocks. Properly diversify your portfolio ahead of time, so when the unexpected happens, you do not have to react to it. That being said:

1. With the Federal Reserve on hold, earnings continue to come in above expectations, valuations near long term averages, the banking system flush with capital, and inflation under control, stocks continue to be the best place to invest. So, selloffs should be viewed as a buying opportunity, not as a sign to run for cover.

2. Despite the US 30 Year bond yielding 2.9%, times like this are when high quality bonds earn their place in the portfolio. When volatility escalates, high quality bonds act as the defensive portion of the portfolio. View the bond market of today for what it is: a safe haven, not a source of income.

3. Technology stocks continue to dominate the weight of index funds. Ensure that your portfolio is properly weighted across the various sectors. If you are too concentrated in one sector, look to rebalance into other sectors where there could be better value, such as: Financials, Energy and Healthcare.