Trading Tariff Threats

June 26, 2018

In the wake of increasing trade tensions and escalating tariff threats between the United States, China, and the European Union which have rattled markets, the Investment Strategy Committee shares its thoughts:

Jeff Saut, *Chief Investment Strategist*

A well-known physicist and scientist in England, Sir Isaac Newton, was also an investor, though not a great one. A little known fact about Isaac Newton is that he lost £20,000 ($2.72 million in today's money) due to his speculation in the South Sea Company stock in the 1720s during the bubble. "I can calculate the motions of heavenly bodies, but not the madness of people" is the quote on his abilities of calculation after the loss of his investment. It is not clear whether his loss on the stock market was a monetary loss or an opportunity cost loss. Similarly, that's kind of how Andrew and I feel currently given yesterday's fallout from the Trade Tiff between the U.S. and China. Obviously, we did not see this coming. In fact, up until the past few sessions we have had a really good "call" on the equity markets this year. Clearly, the trade squabble has knocked the indices off kilter and left us with egg on our face. Of interest, however, is that when I look at my portfolio most of my stocks have not really declined by all that much, at least as of yet. Also interestingly, the purchasing managers we talk to are preparing for a trade war, but they are always preparing for the worst (as they should), but our D.C. contacts continue to say that is not going to occur.

Meanwhile, the media was replete yesterday with the news that the D-J Industrial Average (INDU/24,252.80) fell through its 200-day moving average (DMA). Interestingly, the last few times this has happened in 2018 (April and May) the stock market signal has been a BUY. Also of note is that the S&P 500 (SPX/2,717.07) has not done the same! We did find it interesting that Ralph Acampora tweeted out this yesterday, "Dow Theory Update: So far this year's pull-back is called a correction within a primary bull market. If the DJIA & DJTA break below their closing lows of 23,533.20 & 10,119.36 respectively, then a primary bear market signal will be flashed." Recall that we wrote about the Dow Theory "sell signal" registered a number of weeks ago, and like the false "sell signals" of May 2010 and August 2015, we chose to ignore it because we thought it to be an aberration. We still feel that way, although we are on alert. **(Read More)**

Scott Brown, Ph.D., *Chief Economist, Equity Research*

Speaking at a European Central Bank forum, Fed Chair Powell said that "the case for continued gradual increases in the federal funds rate is strong." In recent weeks, Powell has deferred on commenting about trade policy (much as the Fed avoids making comments on fiscal policy), but has said that trade policy could be disruptive to the economy. Tariffs on $50 billion in Chinese goods are set to go into effect on July 6. These apply mostly to machinery and industrial inputs. The proposed $200 billion in additional tariffs on Chinese goods (which sent the stock market down last week – this is U.S. retaliation against Chinese retaliation against U.S. tariffs) would presumably go into effect some time later and focus mostly on consumer goods. Beyond that, we may see tariffs on imported motor vehicles and parts, which would be much more disruptive to the economy. It's difficult to put a precise handle on the direct impact of tariffs, but worst-case scenarios are on the order of shaving 1-2% from GDP growth over the next year (not enough, by themselves, to cause a recession). However, we may also see higher inflation, greater uncertainty for business fixed investment (at home and abroad), and possible financial market disruptions. **(Read more)**

Ed Mills, *Washington Policy Analyst, Equity Research*

The Trump administration is reportedly preparing to unveil by Friday, June 29 the next proposal aimed at combating China's intellectual property violations in the form of inbound investment restrictions for firms with at least 25% Chinese ownership along with export controls targeting China's domestic technology "Made in China 2025" initiative. The final details of the proposal continue to be debated and could be expanded more broadly to not solely target China but to target critical technology transfers in general. The president is expected to declare an economic emergency situation under the International Emergency Economic Powers Act (IEEPA) to implement new restrictions, as we wrote about in April (background available here). Originally due in late May, the recommendations had been delayed as the administration's free traders and "China hawks" battled over influence on next steps. Attention will move to the Treasury and Commerce Departments who will cooperate on developing a list of critical technologies and appropriate export control restrictions through the Commerce Department's Bureau of Industry and Security (BIS).

The administration's announcement is expected to propose invoking IEEPA to place restrictions on Chinese firms' ability to invest in or purchase emerging technology companies in the U.S. to guard against what Trump officials have described as China's long-term plans to "dominate" critical technology sectors. The investment restrictions are reportedly set to prohibit firms with at least 25% Chinese ownership from buying or investing in U.S. technology companies that are deemed critical. Controls on deals with less than 25% Chinese holding are also said to be considered if technology transfers could be achieved through licensing agreements or board seats. The administration also plans on proposing export restrictions on inputs targeting China's domestic tech industry development "Made in China 2025" initiative. Export controls will likely target the priority sectors in which China aims to increase domestic production, as outlined below. If the proposal does not ultimately specifically target China, the overarching goal of the export controls and investment restrictions is to impact competitors' development of related technological capabilities.
(Read more)

Michael Gibbs, *Managing Director of Equity Portfolio & Technical Strategy, and* **Joey Madere**, *Senior Portfolio Analyst, Equity Portfolio & Technical Strategy*

*T*rade tensions have intensified over the past couple of weeks, following the U.S. Administration's decision to levy $50B of tariffs on China, China's decision to retaliate, and the U.S.'s follow-up threat of an additional $200B in Chinese products to target with 10% tariffs. Elsewhere, the U.S. remains in ongoing negotiations with the EU and NAFTA as well. It has been this Administration's tactic to apply maximum pressure in pursuit of a grand bargain, and it appears the President is expected to invoke the International Emergency Economic Powers Act (IEEPA) to implement new restrictions directed at China. While the back-and-forth on global trade can obviously impact short term volatility (especially considering the front page nature of these discussions), we continue to believe that this is part of a negotiation process and that the odds of a full scale escalation "trade war" remain low (as no one wins in that situation).

U.S. economic activity and earnings growth remain supportive of equity markets. The second quarter ends this week and Q2'18 earnings season will begin soon. S&P 500 estimates for the quarter have trended slightly higher since the end of a very strong Q1 earnings season; and now reflect sales growth of 8.4% and earnings growth of 20.2%. Margin estimates have held steady as well at the highest levels in over 15 years.

Despite stellar fundamentals, we still remain comfortable with our short term base case trading range for the S&P 500 near ~2600-2800 due to the headwinds/concerns surrounding trade negotiations, interest rates, global economic momentum, and rising input costs. The index is near the mid-range currently following its sharp selloff yesterday, able to hold its 50 DMA for now. Key levels of support include 2716 (50 DMA), ~2700 (yesterday's intraday low, 50% Fibonacci retracement of Jan-Feb selloff, horizontal support), and 2667 (200 DMA). We would view pullbacks opportunistically, as intermediate term trends remain intact.

Our next 12 month fair value range includes a base case of 2978 +10% ($165 NTM EPS est., 18.0x P/E). This compares to the next twelve month consensus S&P 500 earnings estimate of $168 and a current trailing 12M P/E of 18.8x. In a bull case scenario (upside to fundamentals, trade resolutions, status quo interest rates), we use 3192 +17% ($168 current consensus EPS est. and 19.0x P/E); and in a bear case scenario (escalation of trade concerns, margin pressures, higher interest rates), we use 2474 -9% ($159.58 EPS and 15.5x P/E).

The sectors likely to be weakest during setbacks in the negotiations are Information Technology, Industrials, and Materials. Energy will be weak in soft equity markets due to higher betas across the sector. During periods of weakness, we favor Energy (global energy markets are likely to be undersupplied despite increased production from OPEC + Russia). E&P is the preferred subsector. Technology, fundamentals are exceptionally strong. Industrials are still favored but less so than the previous two until Q2 earnings are reported. Many companies across the sector raised the issue of rising freight costs as a headwind during Q1 reporting. We are eager to hear commentary now regarding the financial impact going forward. Transports are our favored subsector. For those that wish to play defense, of our overweight sectors, we favor Health Care. Managed Care, and Device and Equipment are preferred subsectors. But, we would pay attention to trading patterns of the out of favor health care subsectors due to attractive valuations and slightly improving price momentum.

In light of recent developments impacting the oil markets, Pavel Molchanov shares his thoughts:

Pavel Molchanov, *Senior Vice President, Energy Analyst, Equity Research*

Even with OPEC's unwinding of production cuts, we forecast a third consecutive draw in global petroleum inventories in 2019. Last week, OPEC signaled its decision to begin unwinding its oil production cuts that date back to the beginning of 2017. Even as OPEC's Persian Gulf members plus Russia move forward with boosting supply, the effect of that is canceled out by Venezuela, and to a lesser extent, Iran. Looking out to 2019 versus the current baseline, we are forecasting an incremental 350,000 barrels per day (bpd) of supply from Saudi Arabia, and approximately 150,000 bpd each from the UAE, Kuwait, and Russia. On the flip side, Venezuela falls by 590,000 bpd as its oil industry continues to collapse; furthermore, Iran loses 210,000 bpd due to the partial effect of U.S. secondary sanctions. On a net basis, we envision essentially zero supply uplift from the group as a whole. Alongside our existing assumptions for global demand and non-OPEC supply, our model shows a 2018 global inventory drawdown of 920,000 bpd, followed by a further draw (the third consecutive annual one) of 280,000 bpd in 2019. This represents a bullish picture for oil market fundamentals, and in fact the inventory data looks even more bullish on a days of consumption basis.

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