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As Trade Tensions Escalate, How Can Investors Safeguard Their Portfolios?

The US administration is sending a message to trading partners around the world that the US will not back down from a trade fight.

In the latest trade war salvo, the US has threatened a 10% tariff on an extra $200 billion of imports from China, encompassing 6,031 products. Beijing vowed to retaliate.

This time a wide variety of consumer goods were targeted, including apparel, furniture, and leather goods. The proposal was more than 200 pages long and hearings will be held from August 20-23 before reaching a final decision after August 31.

The new tariffs will not be enacted until September at the earliest. There is plenty of time for the administration to engage in a Twitter feud and potentially bring both sides together for a fresh round of talks. This is partly why the markets have focused on the upcoming earnings season and interest rates rather than the escalating tensions. It is not easy for threats to derail solid economic fundamentals. Most investors do not believe that the trade conflict will reach a boiling point and that the latest threat is simply more political maneuvering.

There are no winners in a full-blown trade war. Historically, trade wars within a Fed tightening cycle have had disastrous outcomes for markets and the economy, slowing global growth.

Cooler heads more than likely will prevail in the trade conflict in the second half of the year, but it could get worse before it gets better. The Specialized Strategies Group recommends the following three strategies to help protect your portfolio as volatility resurfaces in the trade conflict:

Overweight US stocks with most revenue derived domestically, particularly small capitalization companies

Small cap stocks have been outperforming large cap stocks this year. More factors are pointing to continued outperformance in the second half of 2018. The trade conflict will be an overhang on markets at least through the end of summer, which will benefit small cap stocks on a relative basis.

One advantage of small cap stocks in the current environment is that they are less exposed to international revenues than large cap stocks. It is difficult to determine precisely which companies have direct revenue exposure to China since most companies opt not to disclose such detail. If we use the S&P 500 as a proxy for large cap and the Russell 2000 as a proxy for small cap, 79% of S&P 500 companies have some international revenue exposure compared to 53% of Russell 2000 companies. Further, the S&P 500 derives around 29% of its total revenue from overseas as compared to the Russell 2000 at around 19% (Source: RBC US Equity Strategy). While small caps are not completely shielded from trade conflicts, the lower international revenue exposure will help continue to make small caps shine as tensions have investors in search of safe havens.

Another advantage of small cap arises from a strengthening dollar. The dollar gained approximately 5%

from April to June of this year (Source: Bloomberg). Small cap outperforms large cap during periods of sustained dollar strength since smaller companies are more levered to the domestic economy than larger companies. Therefore, they tend to be more insulated from the currency translation impact of a strong dollar. On the other hand, as the dollar strengthens, large multi-national companies face headwinds as their products will be more expensive to foreign buyers.

Lastly, although the Trump administration had previously said they wanted to spare consumers from the impact of tariffs, given the sheer scale of Chinese imports now subject to tariffs, it is next to impossible to insulate consumer from higher prices. Today's CPI data indicates we are already at the highest level of prices since 2012.

Signs of tariff-induced inflation are nascent and uncertain at this time, but potentially higher inflation could eat away at household spending and may cause the Fed to act more quickly. History has shown that small caps tend to outperform large caps in an inflationary environment.

Increase allocations to high quality assets, particularly municipal bonds

High quality assets such as munis are in strong demand as trade tensions heat up. After an inconsistent first half of performance for munis, the asset class is well-positioned to benefit from lower supply and new issuance, coupled with good demand from investors who fear investing in the crosshairs of growing trade tensions.

Federal Reserve Chair Jerome Powell recently acknowledged rising concerns from business leaders about trade friction. Although the uncertainty has not yet made its way into the performance of the economy, a worsening outlook could ultimately impact the Fed's plan to normalize monetary policy. The Fed will not act on political news, but only if there are signs of a slowdown. If interest rates are nearing their peak and the 10-year Treasury tops out in the low-to-mid 3% range, the case for investing in munis strengthens. Currently, national munis are yielding 91% of Treasuries at 15 years (Source: Bloomberg), which indicates that muni valuations remain attractive for taxable investors.

Increase allocations to private equity

Short-lived periods of heightened market volatility are becoming more frequent. In fact, there were 36 trading days in the first half of 2018 in which the S&P 500 traded up or down by at least 1% (Source: Bloomberg). There were just eight sessions with at least a 1% move in all of 2017. Private equity investments can be advantageous to portfolios for several reasons. First, it can increase portfolio diversification, potentially gaining exposure across different markets, strategies, styles, and managers. Next, it can provide uncorrelated returns throughout the market cycles, exhibiting historically stable and low correlation to traditional asset classes. Last, it may dampen volatility, helping to reduce overall volatility within a portfolio of traditional investments.

The *Wall Street Journal* reported earlier this week that private equity firms are hoarding records amount of cash globally. As of mid-year, private equity funds have a stockpile of $1.1 trillion available for investment (Source: Preqin). Part of the reason for the sharp increase in cash is that private equity investors are seeing fewer opportunities with attractive valuations with markets close to all-time highs this year.

Market volatility typically brings in smart buyers with dry powder. Although private equity funds are not specifically waiting for bad headline news to deploy cash, they will be in a great position to make investments on the cheap should an unexpected event occur such as a full-blown trade war that snags markets in the second half of the year.