Investment Insights

Trading Thoughts

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Highlights

- Equities sold off sharply this week on fears that an escalating trade war could follow the U.S.' decision to levy tariffs on up to $60 billion worth of Chinese products.
- Trade and other policy-related uncertainties are starting to be felt among the business community — this is worth monitoring as a deterioration in confidence could feed through to actual economic activity.
- We are closely monitoring these developments; at this juncture, our base case is that a broad, sustained trade war is unlikely — thus we are not recommending any material adjustments to asset allocation beyond changes we have already made over the last several months, which were driven by our expectation for increased market volatility (which has obviously transpired).

U.S. equities sold off sharply this week, with the Dow Jones Industrial Average (DJIA) falling more than 720 points (2.9%) on Thursday alone, on rising policy-related fears. Fueling the apprehension in particular was an announcement by U.S. President Trump that he intended to impose tariffs on up to $60 billion worth of Chinese goods. China, for its part, responded within hours, announcing it would consider tariffs on $3 billion worth of U.S. goods and promising further action as required. (We note that China's $3 billion retaliatory move is very small in comparison and, at this point, seems more like a face-saving measure than a real attempt at pushing back.)

We have to closely watch this unfolding situation, as we believe that trade wars are stagflationary; that is, they weigh on growth while pushing up prices. Historically, such economic backdrops have been negative for equities.

For now, though, our base case remains that a full-blown, global trade war remains unlikely. As such, we are not recommending any material changes to asset allocation at this time. (We are already modestly defensive, with neutral equity exposure versus strategic benchmarks and some defensive mandates within equities.) Additionally, as we have discussed in prior pieces, we expected that global equity markets would remain choppy as the business cycle extends, and we positioned our portfolios accordingly, which has contributed to some of the firm's relative outperformance so far this year.

There are at least three main reasons we do not feel a need to get significantly more defensive in portfolios for now.

1. **The global economy remains healthy.** Economic data in recent weeks continues to reflect a global economy that is robust, even if the pace of growth has slowed a touch from the end of 2017 (Exhibit 1 reflects synchronized global growth via PMI business confidence surveys). Just in the last week or so, the U.S. reported business and consumer confidence figures around cycle highs and stronger-than-expected industrial production. At the end of the day, a solid growth backdrop drives corporate health, which in turn drives equity valuations. As long as our view on the growth outlook doesn't meaningfully change, we can view the policy ups and downs as more tactical in nature and, at times, an opportunity to put capital to work.

Exhibit 1: Markit Manufacturing PMIs

	Feb16	Mar16	Apr16	May16	Jun16	Jul16	Aug16	Sep16	Oct16	Nov16	Dec16	Jan17	Feb17	Mar17	Apr17	May17	Jun17	Jul17	Aug17	Sep17	Oct17	Nov17	Dec17	Jan18	Feb18
Global	50	51	50	50	50	51	51	51	52	52	53	53	53	53	53	53	53	53	53	53	54	54	55	54	54
U.S.	51	52	51	51	51	53	52	52	53	54	54	55	54	53	53	53	52	53	53	53	55	54	55	56	55
Canada	49	52	52	52	52	52	51	50	51	52	52	54	55	56	56	55	55	56	55	55	54	54	55	56	56
Japan	50	49	48	48	48	49	50	50	51	51	52	53	53	52	53	53	52	52	52	53	53	54	54	55	54
European Union	51	52	52	51	53	51	52	53	53	54	55	55	55	56	57	57	57	56	57	58	58	60	60	59	58
U.K.	51	51	50	51	53	48	53	56	54	53	56	55	55	54	57	56	54	55	57	56	56	58	56	55	55
Eurozone	51	52	52	52	53	52	52	53	54	54	55	55	55	56	57	57	57	57	57	58	59	60	61	60	59
Austria	52	53	52	52	55	53	52	54	54	55	56	57	57	57	58	58	61	60	61	59	59	62	64	61	59
France	50	50	48	48	48	49	48	50	52	52	54	54	52	53	55	54	55	55	56	56	56	58	59	58	56
Germany	51	51	52	52	55	54	54	54	55	54	56	56	57	58	58	60	60	58	59	61	61	63	63	61	61
Ireland	53	55	53	52	53	50	52	51	52	54	56	56	54	54	55	56	56	55	56	55	54	58	59	58	56
Italy	52	54	54	52	54	51	50	51	51	52	53	53	55	56	56	55	55	55	56	56	58	58	57	59	57
Netherlands	52	54	53	53	52	53	54	53	56	57	57	57	58	58	58	58	59	59	60	60	60	62	62	63	63
Spain	54	53	54	52	52	51	51	52	53	55	55	56	55	54	55	55	55	54	52	54	56	56	56	55	56
Emerging Markets	49	50	50	50	49	50	50	50	51	51	51	51	51	52	51	51	51	51	52	51	51	52	52	52	52
Brazil	45	46	43	42	43	46	46	46	46	46	45	44	47	50	50	52	51	50	51	51	51	54	52	51	53
Mexico	53	53	52	54	51	51	51	52	52	51	50	51	51	52	51	51	52	51	52	53	49	52	52	53	52
Czech Republic	56	54	54	53	52	49	50	52	53	52	54	56	58	58	58	56	56	55	55	57	59	59	60	60	59
Greece	48	49	50	48	50	49	50	49	49	48	49	47	48	47	48	50	51	51	52	53	52	52	53	55	56
Poland	53	54	51	52	52	50	52	52	50	52	54	55	54	54	54	53	53	52	53	54	53	54	55	55	54
Russia	49	48	48	50	52	50	51	51	52	54	54	55	53	52	51	52	50	53	52	52	51	52	52	52	50
Turkey	50	49	49	49	47	48	47	48	50	49	48	49	50	52	52	54	55	54	55	54	53	53	55	56	56
China	48	50	49	49	49	51	50	50	51	51	52	51	52	51	50	50	50	51	52	51	51	51	52	52	52
India	51	52	51	51	52	52	53	52	54	52	50	50	51	53	53	52	51	48	51	51	50	53	55	52	52
Indonesia	49	51	51	51	52	48	50	51	49	50	49	50	49	51	51	51	50	49	51	50	50	50	49	50	51
Malaysia	48	48	47	47	47	48	47	49	47	47	47	49	49	50	51	49	47	48	50	50	49	52	50	51	50
Myanmar	50	52	51	50	49	49	47	48	49	50	49	52	52	53	53	52	49	49	49	49	51	52	51	52	53
Philippines	54	54	57	56	56	56	55	58	57	56	56	53	54	54	53	54	54	53	51	51	54	55	54	52	51
South Korea	49	50	50	50	51	50	49	48	48	48	49	49	49	48	49	49	50	49	50	51	50	51	50	51	50
Taiwan	49	51	50	49	51	51	52	52	53	55	56	56	55	56	54	53	53	54	54	54	54	56	57	57	56
Thailand	50	49	50	50	49	49	50	49	49	48	51	51	51	50	50	50	50	50	50	50	50	50	50	51	51
Vietnam	50	51	52	53	53	52	52	53	52	54	52	52	54	55	54	52	53	52	52	53	52	51	53	53	54

As of February 28, 2018. A reading above (below) 50 indicates an expansion (contraction) in business activity.

Source: Bloomberg, Markit

2. **The (voting) business community does not want a trade war.** Friday, CNBC business television released a survey of chief financial officers (CFOs). The quarterly poll, representing some of the largest public and private companies in the world (more than $4.5 trillion in market capitalization), put U.S. trade policy at the top of the list of "external risks," at 27.3% of total respondents versus 11.6% late last year. The poll was taken after the steel and aluminum tariff announcements but before this week's China-focused tariffs, suggesting those results could be even more extreme today.

We believe that the high-profile nature of these trade actions is at least in part aimed at the president's "base" supporters, especially those who have been disenfranchised by globalization and technology. Put another way, how these actions have been delivered is partly for political show ahead of November midterm elections. We doubt that the president, or Republican members of Congress, would want to act in a way that upsets another, potentially much larger bloc of key voters and financial supporters, or in a way that risks undermining the economic stimulus unleashed by fiscal policy at the turn of the year. It's worth noting that foreign governments, including but not limited to China, have threatened to retaliate against U.S. protectionism by targeting specific U.S. goods and firms — often in key Republican voting districts. Members of Congress and business leaders are well aware of how a trade war could impact their companies and communities.

3. **The art of the deal.** Since last year's inauguration, the White House has repeatedly made large pronouncements, often to have the eventual reality of the policy at hand prove smaller in scope. Trade has seen this pattern as well. Steel and aluminum tariffs were initially launched as global. However, within days, the White House started to grant exemptions — first to Canada and Mexico, both countries in the midst of North American Free Trade Agreement (NAFTA) talks with the U.S. More recently, Australia, South Korea, the European Union, and others secured temporary reprieves (currently through May 1) while talks continued with Washington. On NAFTA itself, the White House has materially scaled back its demands on the U.S.' neighbors. And earlier this year, a 30% solar panel import tariff announced by the White House was followed by a decision to let overseas firms seek exemptions.

   Frankly, we do not know if this is an artful negotiating tactic — with the White House never seeking to achieve its most extreme demands — or just the result of loud pushback to the White House from various interested parties. Either way, the pattern suggests to us (and probably to U.S. trade partners) that time and discussions can at least reduce "worst-case scenario" risks to the global economy. It's worth noting here that Thursday's China tariffs are not immediate. From Thursday, U.S. Trade Representative Robert Lighthizer will have 15 days to draft a list of specific products for the tariffs. Subsequently, there will be a public comment period; government officials have suggested they want to make sure U.S. consumers are not hurt by the tariffs. We would expect a lot of lobbying during this comment period, the result of which could be a smaller, more nuanced list of tariff-prone imports.

While these public trade actions seem more likely than not to be watered down, with a global "tit-for-tat" escalation only a modest risk, that doesn't mean the global economy is in the clear. The U.S. continues to pursue other avenues to protect domestic interests. Two in particular are worth noting.

- **CFIUS.** The Committee on Foreign Investment in the U.S. is a panel of government officials from different agencies that reviews deals involving foreign companies to assess whether risks are posed to national security. This committee's scope is currently under discussion in Congress, with a bill being considered that would considerably increase CFIUS oversight. Even now, the White House is using CFIUS, especially with U.S.-China related acquisitions.

- **Reciprocity.** The U.S. Administration is continuing to consider how it might use reciprocity with China in particular. The idea behind reciprocity is that the U.S. would only allow foreign companies to invest in certain U.S. industries if the U.S. got the same treatment in the respective foreign country. By pursuing such a strategy, the U.S. could try to force other countries to open industries to the U.S. that currently are more restricted.

Overall, we see these tactics, especially CFIUS, as chilling cross-border M&A and potentially weighing on the dollar as foreign investors become relatively less interested in having substantial capital moving to the U.S.

Beyond trade, there is another aspect of U.S. policy that has been less prevalent in the media but increasingly on our radar screen and "risk watch list": geopolitics.

Late Thursday, President Trump named John Bolton as national security advisor, replacing Lt. Gen. H.R. McMaster. Bolton will be the third national security advisor of this administration, as McMaster replaced Michael Flynn in 2017. The move was widely seen among D.C. policy analysts as another hawkish development on the foreign policy front, which comes on the heels of the recent replacement of Rex Tillerson by Mike Pompeo at the State Department.

On net, these moves are being interpreted by policy analysts and investors as increasing the probability that the U.S. will withdraw from Iranian nuclear deal, which is formally known as the "Joint Comprehensive Plan of Action," or JCPOA. If this were to occur, the timing and method are still unclear, but it's not likely that this move would be warmly received by markets. Our understanding is that the next formal JCPOA review is scheduled for May.

Bessemer portfolio managers have moderately increased exposure to commodities (including oil and metals) over the past several months, which was partially driven by expectations for the improving economic environment, industry fundamentals, but also the broader macro environment, including geopolitics.

Again, we continue to watch policy developments closely — there are a lot of moving parts these days with multiple implications for the economy and financial markets. We feel portfolios are positioned appropriately, but we will never hesitate to make a change if we see developments as meaningfully impacting our broader economic views.

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