

## The Toll of New Trade Tensions and Your Portfolio - June 2019

*It was hard to miss the headlines about escalating trade tensions between the U.S. and China this week—and hard not to notice the up-and-down market activity that went along with it. But what, if any, long-term impact does trade policy have on the economy and, by extension, our portfolios? **The BAM ALLIANCE'S Director of Investment Strategy Kevin Grogan** explores this topic in the following article, and reminds us, once again, that although it remains to be seen how the events of this latest news cycle will play out, your evidence-based financial plan is built to anticipate and withstand market risk.*

[News of an escalating trade war](#) between the U.S. and China dominated headlines in recent days as the government imposed new tariffs on \$200 billion of Chinese imports when the latest round of talks broke down. Per Bloomberg, the [U.S. has set a deadline](#) of “three to four weeks” for negotiations to produce a deal before the U.S. imposes additional tariffs. The most recent impasse follows a series of negotiations over the past 18 months. The S&P 500 is down about 3% so far this month in response to the news.

The Trump administration's apparent goal with its various tariff programs is to 1) secure what it sees as a better trade balance, and/or 2) procure more advantageous trade terms by using U.S. tariffs as a tactic for compelling other countries to eventually lower their own tariffs on incoming U.S. products.

It is important to point out that, trade terms aside, a negative trade balance isn't necessarily the same thing as being on the losing side of a trade relationship. Consider the following analogy: You buy (import) produce from, but don't sell (export) produce to, your local grocer. This opens a negative “trade balance” with the store. Nevertheless, you probably don't see yourself as somehow coming out short in a deal where the store gets your cash and you get dinner.

What long-term impact the Trump administration's tariff policy will have on the economy remains to be seen. For instance, we don't know whether even higher tariffs on even more goods imported from even more countries will be levied (or not), or how long reciprocating tariffs could be in effect. In addition, tariffs that in theory should represent only a minor drag on the economy may have an outsized influence, depending on how consumers perceive and respond to them. What we do know is that tariffs raise prices, effectively amounting to a tax on consumers. There [is evidence](#) that the tariffs already in place have had an impact on consumers since they went into effect. That is why, in the end, no one “wins” trade wars, making them a detrimental prospect for all involved. We are well aware that such events, however unpredictable, can and will happen. That's why we build long-term, evidence-based financial plans to anticipate and incorporate market risks.

Before considering any drastic action with your portfolio, it may be helpful to recall that the stock market is forward-looking, so it already has incorporated its best guesses for how the current tariff situation will (and a lengthy trade war would) play out. And this information already is reflected in prices. Furthermore, we simply do not know how the game will end. If the Trump administration's strategy to confront U.S. trade partners works, and all tariffs come down, it would be a huge win for the world, not just domestically. If the strategy precipitates an even bigger, all-out, long-term trade war, it likely would lead to lower economic growth around the world, with the consolation prize being that the U.S. would likely be affected the least.

In a trade war, relatively speaking, the U.S. tends to weather the storm better because trade is a much smaller percentage of U.S. gross national product than it is for most countries. This likely explains much of U.S. stocks' outperformance over the past couple years. In the event of a trade war, small-cap stocks tend to do better than large-cap stocks because, in general, they are exposed to less global trade. Again, this likely helps to explain small-cap stocks' outperformance since the beginning of 2018. Moreover, the dollar tends to strengthen as investors flee to safety and liquidity.

Conversely, international stocks tend to do worse in a trade war, and emerging market stocks tend to do the worst of all because their economies often are more reliant on global trade and their currencies take a

hit from investors' flight to safety. This can be a double whammy for foreign economies, as much of their debt tends to be in dollars (which are appreciating relative to other currencies, making debt financing more expensive). That is exactly what has happened as the risk of an extended trade war has increased.

If the market anticipates that the odds of a full-blown, long-term trade war are rising, investors likely will see more of this type of action. When the odds of a bad outcome seem to decrease, likely the reverse will occur. Indeed, an increasing risk of continued trade conflict likely explains equities' relative performance (that is, it helps explain why U.S. stocks, particularly U.S. small-cap stocks, are outperforming).

In virtually all cases, economic or geopolitical news is not value-relevant information, unless you have a copy of tomorrow's newspaper. The prudent course of action remains to adhere to your comprehensive financial plan, ignoring [speculation in the financial media](#). The only time you should alter your plan is when your assumptions about your ability, willingness or need to take risk have changed.

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