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Trade and the markets: China takes center stage

CARILLON TOWER ADVISERS

One of the main goals of the Trump Administration has been to reduce the trade deficit with China. But two years into the administration, the deficit is larger than it ever has been, reaching $375 billion last year. In response, the United States has levied 10 percent tariffs on $250 billion of Chinese goods. It plans to increase these tariffs to 25 percent on $200 billion of Chinese goods on January 1, 2019 and is considering tariffs on all remaining Chinese imports. Trade and tariffs will be the central issue of discussions between President Trump and Chinese leader Xi Jinping when the two leaders meet at the G20 Summit in Argentina in late November.

For those wondering how this might affect their portfolio, the answer is not straightforward. Given negotiations between senior U.S. and Chinese officials are taking place behind the scenes, this is a fluid situation that requires investors to take a broader macro view, according to **Abe Sheikh, FSA, MAAA, chief investment officer of Cougar Global Investments**, an affiliate of Carillon Tower Advisers. "If the U.S. economy continues to hold up – strong real GDP growth, low inflation – then the U.S. stock market should do just fine. If the weakness in the global economy drags on, and if there are signs that the U.S. economy is also faltering, stocks are in trouble," Sheikh said.

While the United States' economic outlook is good, there is concern about an economic slowdown in China and whether these tariffs might weaken the economic giant even further. **Here are Sheikh's insights on the evolving situation:**

Key events to watch for

Experts are split on whether Trump's 25 percent tariff will actually materialize. If the U.S. and global economy were to weaken further, that potentially changes the calculus. While the U.S. economy is more likely to withstand a 25 percent tariff on Chinese goods, such a tariff could be disruptive to global supply chains and would likely create significant financial market volatility. In addition, China will find it difficult to redirect its product to the rest of the world given the United States is the biggest consumer of Chinese-made goods. The tariffs will – depending on their exact implementation – be more disruptive to certain industries and certain sectors than others.

"It's unlikely that this trade war with China will completely resolve anytime soon, given the wide range and gravity of some of the issues involved. However, there is scope for progress," Sheikh said.

About Abe Sheikh

- 15+ years of investment industry experience
- Joined Cougar in 2017 as head of research
- B.S., actuarial science, London School of Economics; master's, computational finance, Carnegie Mellon University
- Fellow of the Society of Actuaries (FSA), member of American Academy of Actuaries (MAAA)

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How does it affect equity investments?

Downside risks have gone up as a result of the slowdown in China and the trade war. About 44 percent of revenues of the S&P 500 come from outside the United States, so no one is immune from what happens in China. China is about 20 percent of global GDP or over $12 trillion of the world economy.

Part of the reason that markets are experiencing volatility is because there is concern about a global economic slowdown.

"Cougar Investments exited all our international holdings -- for instance, Europe, Japan and emerging markets. This turned out to be a good decision in hindsight as the divergence between U.S. stocks and international stocks has been significant," Sheikh said.

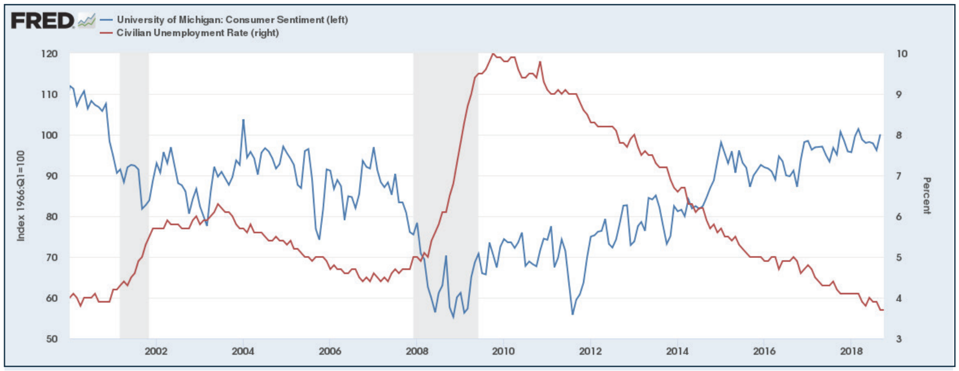
A lot of investors have also fled to small caps – to the protection of equities that had limited international exposure.

Back to the future

"Our view right now is that the U.S. economy holds up and rides this through," Sheikh said. "Low unemployment, high consumer confidence – together with reduced political uncertainty due to gridlock in Washington – could be good for U.S. stocks. However, we evaluate the data as it comes in, so our bullishness may change over 2019."

With a strengthening U.S. dollar, and positive interest rate differential between the United States and the rest of the world, capital is flowing into the United States from other countries. A strong dollar set-up allows overseas investors to earn significant returns by investing in U.S. dollar-denominated assets. In many ways, the current situation is reminiscent of the U.S. economy during the latter half of Ronald Reagan's first term as president. Back then a stronger dollar, trade and budget deficits led to an economic boom and rising stock market. A stronger dollar has the potential to boost the U.S. economy by putting

Exhibit 1: High consumer sentiment and a low unemployment rate – together with reduced political uncertainty – could be a positive for U.S. stocks.



Source: University of Michigan, University of Michigan: Consumer Sentiment [UMCSENT], retrieved from FRED, Federal Reserve Bank of St. Louis; https://fred.stlouisfed.org/series/UMCSENT, November 8, 2018. U.S. Bureau of Labor Statistics, Civilian Unemployment Rate [UNRATE], retrieved from FRED, Federal Reserve Bank of St. Louis; https://fred.stlouisfed.org/series/UNRATE, November 8, 2018.

downward pressure on inflation, while a budget deficit can provide stimulus for the economy. If the current set-up continues, and the U.S. economy stays strong, then domestic stocks should perform well. The U.S. consumer is key.

In the end, U.S. consumer spending comprises 70 percent of the U.S. GDP. That is what drives the economy, and we are looking closely at how consumer spending holds up.

While China is the most important trading partner for the United States, the recent revamp of NAFTA, the U.S./Mexico/Canada agreement (USMCA), bodes well for North American trade. "Everyone was relieved that the USMCA was agreed to. However, it still needs to be passed by Congress," Sheikh said.

While ratification of the replacement for NAFTA seems like a done deal, we're unlikely to see a resolution of the trade war with China anytime soon. This will likely be a protracted effort that will have to resolve a number of complicated and contentious issues between the two largest economies in the world.

About Cougar Global Investments

Cougar Global Investments is a globally oriented macro asset-class portfolio manager that uses a disciplined portfolio-construction methodology which combines macroeconomic analysis with downside-risk management. Cougar Global's guiding belief is that the goal of investing is to generate consistent compound growth, primarily achieved by seeking to minimize loss.

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Carillon Tower Advisers is a global asset-management company that combines the exceptional insight and agility of individual investment teams with the strength and stability of a full-service firm. Carillon Tower believes providing a lineup of institutional-class portfolio managers – spanning a wide range of disciplines and investing vehicles – is the best way to help investors seek their long-term financial goals.

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To learn more about Cougar Global:
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