Principal Global Investors

Principal Global Perspectives

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Portfolio strategies to cope with trade tensions

Escalating global trade tensions can affect regions and asset classes differently. The investment experts at Principal Global Investors examine what strategic steps you can take to help insulate your investment portfolio.

The big picture

Seema Shah – senior global investment strategist
Principal Global Investors

The interconnected nature of modern global business and financial markets makes it almost impossible to completely remove the effects of trade tensions from an investment portfolio, but there are some strategic ways to add insulation and dampen the effects.

To uncover those options, I look at the three main ways trade development can affect investments:

- **Direct effects.** These are the sectors, industries, or companies that will be directly affected by tariffs or quotas.
- **Broader effects.** These are felt through the complex global supply chains that many firms have built up over the last 40 years. Domestically built goods may have components imported from half a dozen or more countries. In this category, it's the trade restrictions on input materials that tend to have the most influence: steel, aluminum, and the like.
- **Increased inflation.** Companies vary in how much of the tariff-influenced cost increases they're able to pass along to consumers in the form of higher prices. That variability can impact how much inflation is injected into the system as a trade war escalates. Additionally, if inflation expectations build, the Federal Reserve may also have to respond with sharper monetary tightening.

In general, the hardest pill for investment markets to swallow is increasing uncertainty in the tone of global trade discussions and the doubt it introduces into business and consumer sentiment. Investment markets like certainty, and as the Trump administration moves to change a global trade regime that's been essentially stable for decades, markets are going to react with volatility.

To help reduce volatility and lend some certainty to portfolios, I'm looking for areas with defensive characteristics around global trade tensions, and assets and sectors that can minimize the direct and indirect factors.

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Seema Shah | senior global investment strategist at Principal Global Investors

Right now, a few of the areas I'm looking at for insulation are U.S. small-cap stocks, municipal bonds, and real estate. As the situation currently stands, the U.S. economy is relatively well insulated from trade escalations. These are the types of assets that could benefit from that insulation.

U.S. small-cap equity

Phil Nordhus – portfolio manager
Principal Global Equities

U.S. small-cap stocks benefit from a combination of domestically focused revenues, benefits from recent tax-law changes, and a more favorable regulatory environment.

- **Domestically focused.** For investors concerned about trade tensions, we believe U.S. small-caps offer some cover from the direct trade tensions. Looking at a diverse universe of stocks like the MSCI All Country World Index, on average, U.S. small-cap companies get only around 21% of their sales from outside the United States. U.S. large-cap companies are closer to 40%.[1] This means that, compared to a large-cap company, the average small-cap company has half the exposure to non-U.S. markets that could be potential sources of trade tensions, tariffs, or quotas. For U.S. small-caps, this also means that around 80% of their revenues come from U.S. customers, which may help them weather any global trade fluctuations.
- **Smaller size and scope.** U.S. small-cap companies are also somewhat insulated from the broader effects of escalating trade tensions because of their business models. Small-cap companies tend towards domestic supply networks, which limits the exposure to inputs subject to tariffs. And where U.S. small-caps have overseas operations, those tend to supply the local market, so exposure to tariffs is limited there, too.
- **Earnings effects.** The recent U.S. tax break on repatriation of foreign earnings won't have much impact on small-caps, but the lower rates and other changes will mean that small-cap companies are getting a bigger bang for their buck. The deregulatory environment also disproportionately affects small-cap companies, where the costs of compliance are a bigger proportion of their bottom lines than with larger companies. Specifically, within the financial sector, we're likely to see a more even playing field.

Municipal bonds

James Welch – portfolio manager
Principal Global Fixed Income

Municipal bonds are often seen as a safe haven in times of uncertainty. Also referred to as munis, these are fixed income securities issued by state or local municipalities. Normally, investors are attracted by the high quality and diversification munis can provide, but with rising trade tensions, munis can gain some additional luster.

- **Diversification.** Munis can help add diversification to a portfolio because of their lack of correlation with other types of assets. You're going to see negative correlations when you compare returns of municipal bonds with U.S. equities or U.S. high yield bonds. That lack of correlation helps mitigate portfolio volatility. Right now, we're seeing the lowest volatility in benchmark muni yields since 2010.

[1]Source: MSCI, as of June 30, 2018

- **Domestic focus.** We look for bonds tied to domestic demand: assets like utilities, toll bridges, hospitals, and highways. These don't depend on imports or exports or face any kind of offshore replacement, so they help protect the asset class from increasing trade tensions.

- **Active management.** There's a potential for repercussions in the muni space if a trade war escalates and extends. At some point tariffs and quotas can start affecting state and local governments. If there's a tariff on soybeans, and your state exports soybeans to China, then eventually you'll start to see some effects through lower tax revenues. Similarly, coastal ports, another issuer within the muni space, can be affected if the level of global shipping is affected. When a trade war breaks out, you'll first see other beta assets take the initial brunt. The effects on munis would then tend to lag other asset classes. That said, because we tend to overweight these domestic-demand assets, we're able to avoid some of that eventual impact as well.

We're also examining the various fronts where a U.S. trade war could play out. Trade disputes with Canada and Mexico are the bigger issue because of the higher volume of trade with those NAFTA partners. But, because we're actively researching those connections and managing the portfolio, we feel that we're able to stay ahead of the problems.

Real estate

Indraneel Karlekar – senior managing director of global research and strategy
Principal Real Estate Investors

Commercial real estate has defensive characteristics that may help shield investors from some volatility in times of uncertainty.

- **Volatility, diversification, and current income.** Since 1980, U.S. real estate has been negatively correlated to U.S. bonds and only modestly correlated to U.S. stocks. That means that adding relatively illiquid real estate can help add diversification to a portfolio during periods of market volatility. Plus, the volatility of real estate total returns since 1978 been about half of that in equities and fixed income. And real estate is also a good source of current income, which generally hasn't been affected by volatility. Having a nice stable set of income returns can give investors a further degree of insulation.

- **Multiple ways to access.** Investors can also gain U.S. real estate exposure through liquid, publicly traded real estate stocks and real estate investment trusts (REITs). Most of the fundamental factors behind direct real estate's attractiveness also hold for REITs. Many sectors own exclusively domestic assets and offer low economic sensitivity to global trade issues. And while REITs exhibit some volatility like equities, on average, the beta* on REITs has been about 40% less than that of overall equities. This means adding REITs can potentially lower the overall equity beta of your portfolio.

- **Unanticipated inflation.** If escalating tariffs begin to raise prices and stoke inflation, new development will reflect the higher cost pressures and could help protect a portfolio by offsetting some of the unexpected inflation. Another additional benefit would be the curb on new supply if cost pressures via imported inflation start to build. One important consideration in real estate investing is replacement cost analysis, which looks at the value of a property through the lens of what it would cost to build something similar from the ground up. Increased costs for new construction may make such a replacement cost analysis less favorable to new development and help support values of existing real estate and REIT assets.

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*Beta - a measure of the covariance of returns of a security or a portfolio in relation to a market index.

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