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BREAKING NEWS
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The trade war heats up...again

Market optimism surrounding the U.S./China trade negotiations helped global equity prices recover from their late-2018 swoon. But instead of resulting in a trade agreement, the talks have broken down and both sides have announced another round of tariffs. How is Nuveen investing through this latest period of uncertainty?

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KEY POINTS

- On Sunday, May 5, U.S. President Donald Trump unexpectedly announced plans to raise tariff rates on $200 billion of imports from China.
- China announced further retaliatory measures on May 13, sending global equity markets sharply lower.
- The impact to U.S. GDP growth over the next year could rise to 0.3% to 0.4%, while the hit to China's growth rate may be as high as 0.5%.
- The drop in equities since the May 6 open has been part of a larger tightening of financial conditions.
- The Fed might see the higher inflation generated by tariffs as a reason to stay put as the rest of the economy expands at a moderate pace.
- Investments that derive a greater percentage of their return through income or exhibit lower correlations to stocks may be set to outperform in the coming months.

WHAT HAPPENED?

On Sunday, May 5, U.S. President Donald Trump unexpectedly announced plans to raise tariff rates on $200 billion of imports from China. The news came as a shock to an investing public that had been repeatedly told negotiations between the two countries were moving constructively toward an eventual deal. As it turned out, neither side was prepared to risk agreeing to a pact that could be perceived as a clear victory for the other.

Trade has been a key risk for financial markets since early 2018, when the U.S. administration began placing tariffs on specific categories of goods including washing machines, solar panels, steel and aluminum. The U.S. trade strategy shifted when it applied a broad tariff to a larger basket of goods coming from China. Most of that basket has been taxed at a 10% rate since the summer of 2018. As of May 10, however, those goods are subject to a 25% tariff. The U.S. is also already in the process of widening the scope of the tariff to include all imports from China.

For its part, China has placed import restrictions on U.S. agriculture and other goods, and it announced further retaliatory measures on May 13, sending global equity markets sharply lower. Public comments from President Trump this week seem to

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indicate that further escalation is likelier than not in the near term.

THE ECONOMIC IMPACT

Higher tariffs mean higher prices for consumers and businesses who buy imports. A recent paper by economists at the Federal Reserve Bank of New York, Princeton University and Columbia University concludes that the burden from the last round of tariffs in 2018 was largely borne by U.S. consumers, as imports rose despite the new taxes. U.S. consumer price inflation will be 0.2% to 0.3% higher over the next year because of the higher tariffs rates now going into effect.

Tariffs' impact on gross domestic product (GDP) growth is more difficult to measure, because it can occur through a number of channels. Real consumer spending may suffer from higher prices, while business investment growth may continue its recent downward trend amid uncertainty about overseas supply chains and consumer demand. Last year's tariffs and the retaliation from China and other nations probably shaved 0.1% to 0.2% off of U.S. growth.

The new higher tariff rate will likely create even more distortion. Companies will have difficulty swallowing the higher cost while preserving their profit margins, but they may find it equally challenging to pass the tax onto customers. This may lead to supply chain rerouting and avoidance of Chinese imports, which in turn will discourage new capital expenditures and dampen real consumption. Therefore, the impact of tariffs on U.S. GDP growth over the next year could rise to 0.3% to 0.4%, while the hit to China's growth rate may be as high as 0.5% given their expected loss of U.S. market share.

THE RISKS OF ESCALATION

While the effects of the latest batch of tariffs have yet to be felt, another larger round is already in the works. The U.S. is considering a 25% tax rate for all goods imported from China, which would more than double the number of affected goods. It would also mean more tariffs on consumer goods like apparel and mobile phones, so the impact on both inflation and real growth could be far larger, +0.5% for inflation and -0.5% for growth. Similarly, a 25% tax on all exports to the U.S. could reduce China's GDP by up to 1%. While hits of this magnitude to growth in the world's two largest economies would clearly be painful, we do not believe they would be sufficient to trigger a global recession.

President Trump will meet with President Xi Jinping of China at the next G20 meeting in late June. We are cautiously optimistic that the two will agree to delay further escalation at that time. However, that optimism wavered after President Trump praised higher tariffs as a standalone policy measure rather than as a negotiating tool. We do not expect a final trade deal in the coming months, but we would view a delay in further escalation as a positive sign for talks as well as for the global economy and financial markets.

WHAT ARE WE WATCHING?

Tariffs matter more for global equity markets than for the global economy, especially in relatively closed economies like the U.S. Up to half of S&P 500 companies' revenues come from overseas, while little more than 10% of GDP is comprised of exports. The drop in equities since the May 6 open has been part of a larger tightening of financial conditions that includes a stronger U.S. dollar (particularly against the Chinese renminbi), lower global interest rates and wider corporate credit spreads. Certain commodity prices are also lower, particularly those grown in the U.S. that are susceptible to further import restrictions from China.

There is considerable doubt as to how the Federal Reserve (Fed) will respond. While policymakers in China are already countering the impact of higher tariffs through fiscal stimulus and lower interest rates, the Fed might see the higher inflation generated by tariffs as a reason to stay put as the rest of the economy expands at a moderate pace.

We are also focused on the outlook for corporate earnings. First quarter profits have come in better than expected in most parts of the world, but

executives continued to flag trade risks as headwind to their outlooks even before the news of the past two weeks. U.S. companies operating in the technology or industrials sectors have undoubtedly planned for this contingency, but their stock prices have still been punished most harshly in the wake of the new tariff announcements.

OUR INVESTMENT APPROACH

We expected a tougher climb for investors heading into 2019. Through the first four months of the year, however, volatility sharply declined and risk assets went on a tear. Thus far in May, our more cautious approach—staying invested while looking for ways to be more defensive—has turned out to be the right one. A key part of our downside case for markets—an unexpected escalation in the U.S./China trade war—has now moved into the base case. A trade deal at this point would represent upside risk to markets, particularly emerging markets

Geopolitical events can temporarily elevate risk-off sentiment, but are often short lived. Thus, we maintain our view that investors should remain invested and tilt towards asset classes that will benefit from continued late cycle dynamics. Given heightened uncertainty surrounding trade negotiations, investors may also consider additional near-term defensive positioning.

We continue to believe **U.S. large cap growth** will outperform large cap value over the next 6 to 12 months. However, investors who prefer to reduce portfolio risk while waiting for more clarity on a trade deal could reduce equities in favor of **short-term fixed income** – an asset class that offers attractive income and liquidity – while waiting to deploy capital back into risk assets. Of course, this trade presents a different type of risk: the risk of missing out on a potential relief rally. News of a trade agreement or dovish Fed rhetoric could result in a quick recovery of global equity prices.

We also prefer **emerging market equities**, funded by an underweight to U.S. small cap equities. Given that China is the largest country weight in the MSCI Emerging Markets Index, this position has performed poorly over the past week. EM equities still look attractively valued with beatable earnings expectations, but their relative performance now unquestionably hinges on no further escalation in the trade war. Thus, more risk-averse investors could remove EM as a tactical overweight position. We also prefer hard-currency **emerging market debt** (EMD), as we believe it is better insulated from China turmoil and is still preferable to U.S. speculative grade credit.

While trade risks remain in the headlines, a flatter but choppier trajectory for global equity markets seems likely. Investments that derive a greater percentage of their return through income or, like the bulk of our real estate and farmland portfolios, exhibit lower correlations to stocks, may be set to outperform in the coming months. The one thing were are certain of at the moment is that the so-called risk-free rate of return one receives for being uninvested has not improved as the trade war has flared up again.

While unlikely to plunge the world into recession or create a bear market for global stocks, the U.S./China trade war has reemerged as the single greatest risk to investors for the balance of 2019. We plan to navigate that risk by remaining invested while continuing our move toward assets that can perform well in the later stages of economic cycles, even when equity market returns are flat.

High conviction valuation ideas

- Hard currency, emerging markets debt
- Defensive growth sectors in the U.S. like health care and consumer staples
- U.S. financials as a more cyclical value play that avoids trade risks
- Non-correlated, income-generating assets like farmland, infrastructure and real estate

Assets most exposed to a trade war escalation

- Emerging markets stocks led by China
- U.S. technology, industrials
- U.S. agriculture – corn, soybeans
- Eurozone, via economic exposure to China

For more information, please contact visit us at nuveen.com.

Endnotes

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Glossary

A **tariff** is a tax on imports or exports between sovereign states. It is a form of regulation of foreign trade and a policy that taxes foreign products to encourage or safeguard domestic industry. The **MSCI Emerging Markets Index** captures large and mid-cap representation across 24 emerging markets countries. The index covers approximately 85% of the free float-adjusted market capitalization in each country.

A word on risk

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