LPL RESEARCH

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TRADE TENSIONS PLAYBOOK

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KEY TAKEAWAYS

We have maintained our positive stock market outlook in part because we expect resolution with China on trade, and only minimal economic damage to the U.S. and abroad.

We acknowledge that trade tensions may escalate further, potentially leading to additional market volatility.

When volatility occurs, we plan to reinforce our tactical and strategic positioning in portfolios, including favoring stocks over bonds, small caps over large, value over growth, cyclicals over defensives, and U.S. and emerging markets over developed international.

Escalating trade tensions have made for a difficult investing environment. This is not news to anyone at this point. But investors' angst was ratcheted higher last week after the Trump administration played its next card—announcing tariffs on an additional $200 billion in Chinese goods—sooner than many expected. Certainly the stock market expressed displeasure, though the 0.9% drop in the S&P 500 for the week still leaves the index with a respectable 4% total return this year. Here we provide our playbook for trade tensions. For additional insights on the subject, see today's *Weekly Economic Commentary*.

WHERE WE ARE

The latest $200 billion salvo directed at China garnered the most headlines last week, but there was more: retaliatory tariffs from India, a profit warning from a European automaker blaming tariffs, President Trump's call for a 20% tariff on EU auto imports, and threats over the weekend to restrict Chinese investments in U.S. technology and certain technology exports to Beijing.

Late last week, reports that the U.S. was prepared to go back to the negotiating table with China before the next round of tariffs go into effect July 6 offered hope that some near-term progress could be made. We will have to wait and see if the influence of the White House's moderates on trade (Treasury Secretary Steve Mnuchin and National Economic Council Director Larry Kudlow, who plans to go back to work this week after a health scare) prevents the United States from following through on all of its threats.

OUR STANCE

We have maintained our positive stock market outlook in part because we expect resolution on trade, including with China, and only minimal economic damage to the U.S. and abroad. Our confidence is driven by the following:

- **No one wins a trade war:** China and the United States each care about their own respective self-interests. Shutting off trade channels between the countries would do significant economic damage to both and is in neither's best interest.
- **Fiscal stimulus kicking in:** The amount of stimulus going into the U.S. economy from tax cuts and deficit spending dwarfs the value of the tariffs announced to date. In addition, the impact of repatriating overseas cash as prescribed by the tax law is just starting to be felt.

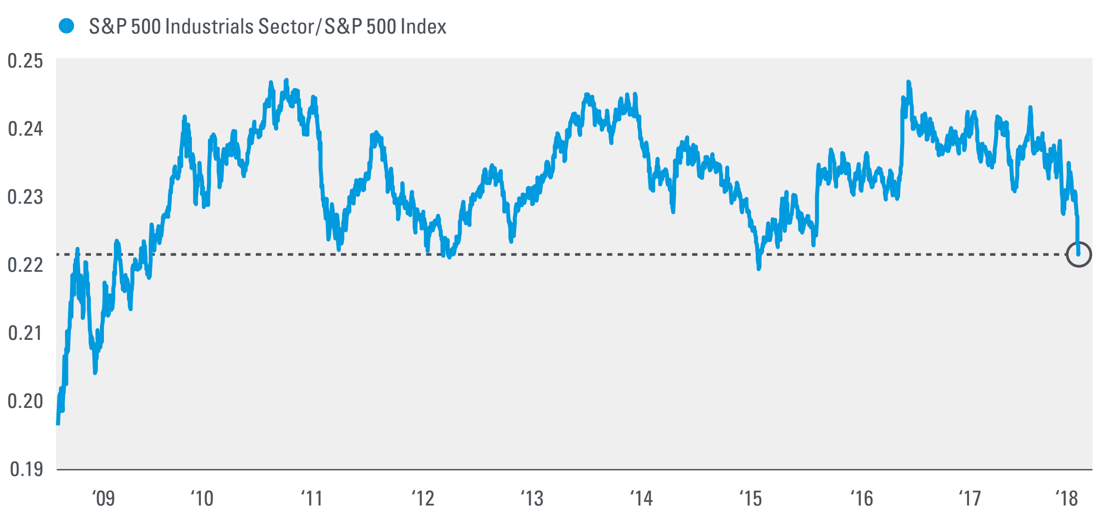
- **Art of the deal:** President Trump has a track record of starting a negotiation from an extreme position and then moving toward compromise. Keep in mind that the amount of time between announced tariffs and implementation—typically 60–90 days—provides time for negotiations and that announced tariffs may not be implemented.
- **Stock market vigilantes:** President Trump cares about the stock market. Bond vigilantes famously influence policy out of Washington, D.C., by moving interest rates. The same can be said about the stock market. In other words, there is a limit to how far the president may take the trade battle if stocks fall enough. We take the fact that stocks have generally hung in okay despite harsh words out of Washington as a positive sign.
- **It's the economy stupid:** The midterm elections are coming up and the Republicans do not want to do anything to damage their reelection chances, particularly in the battle for control of the House, which could be a close race. History tells us the president's party usually loses about 25 seats in the first midterm election, making economic conditions particularly important for Republicans (which is why China's retaliatory trade actions have targeted political pressure points such as agriculture).

OUR PLAYBOOK

We expect cooler heads to eventually prevail and the U.S. and China to reach an agreement. As a result, we have maintained our positive stock market view, as well as our economic growth and earnings forecasts for 2018. Here are the primary elements of our playbook for trade tensions:

- **Look for opportunities:** Volatility can create attractive investment opportunities. We think one such case is the industrials sector [Figure 1], which has suffered relative underperformance

1 IS TRADE RISK FULLY DISCOUNTED IN INDUSTRIALS?



Source: LPL Research, Bloomberg 06/22/18

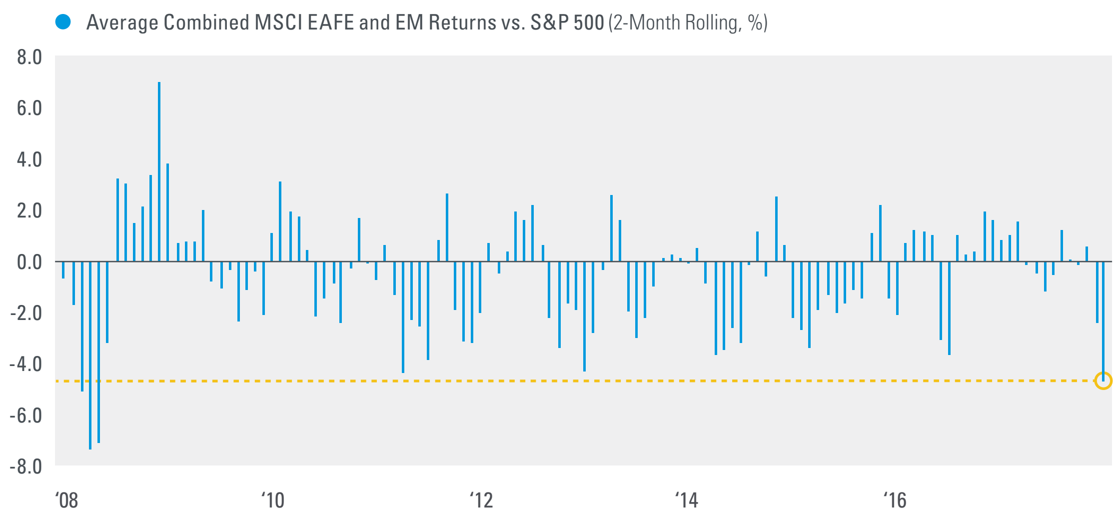
All indexes are unmanaged and cannot be invested into directly. Unmanaged index returns do not reflect fees, expenses, or sales charges. Index performance is not indicative of the performance of any investment. All performance referenced is historical and is no guarantee of future results.

recently that approaches the 2015 and 2016 lows during the Chinese currency and oil crises. We think emerging market (EM) equities also present an attractive opportunity should differences be resolved as we expect.

- **This volatility is normal:** Though the S&P 500 fell about 1% last week, the year still looks normal—the S&P 500 has returned 4% so far, halfway to its long-term average as the first half draws to a close. Stocks on average experience a mid-teens drawdown each year, and a little bit more in a midterm election year; so far this year we have seen only about two-thirds of that. Keep in mind the average return one year after the midterm election year trough for the S&P 500 is over 30%.

- **Stay diversified:** The impact of international underperformance on globally diversified stock portfolios has been substantial. In fact, international equities have underperformed the S&P 500 by as much in May and June as in any two-month period since 2008 [Figure 2]. But that doesn't mean you should not invest overseas (monitoring global benchmarks in addition to domestic provides useful perspective). While our tactical view of international developed equities remains less favorable, we remain believers in international diversification, especially for more strategic investors, and we continue to view EM as an attractive tactical opportunity where appropriate.

2 SIGNIFICANT INTERNATIONAL EQUITY DRAG IN GLOBALLY DIVERSIFIED PORTFOLIOS



Source: LPL Research, FactSet 06/22/18

EM—Emerging Markets, as measured by the MSCI Emerging Markets index.

Most recent data point includes the full month of May plus June as of 06/21/18.

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- **Stick to your plan:** It is always best to have a plan before you need it, so that market volatility doesn't knock you off track. For those uncomfortable with prospects of a trade war who may decide to reduce risk in portfolios, we encourage you to set some conditions under which you would get back to your target allocations in a positive scenario.

CONCLUSION

We expect eventual compromise with China to preserve the upward economic and earnings growth trajectory in the U.S. We believe that fiscal tailwinds will be sufficient to offset any tariff-related slowdowns. We expect tax policy changes, reduced regulation, and increased government spending to sustain the economic expansion with mild inflationary pressures. We do not expect the Fed to be as aggressive over the next 12–18 months as some market participants' fear.

Consequently, we look for double-digit gains in S&P 500 profits over the rest of 2018 to drive stocks higher in the second half, offsetting periodic bouts of volatility.

We acknowledge that trade tensions may escalate further, leading to additional market volatility. When volatility occurs, we plan to reinforce our tactical and strategic positioning in portfolios, consistent with our playbook, favoring stocks over bonds, small caps over large, value over growth, cyclicals over defensives, and U.S. and emerging markets over developed international. ■

IMPORTANT DISCLOSURES

The opinions voiced in this material are for general information only and are not intended to provide specific advice or recommendations for any individual. To determine which investment(s) may be appropriate for you, consult your financial advisor prior to investing. All performance referenced is historical and is no guarantee of future results.

The economic forecasts set forth in the presentation may not develop as predicted and there can be no guarantee that strategies promoted will be successful.

There is no guarantee that a diversified portfolio will enhance overall returns or outperform a non-diversified portfolio. Diversification does not protect against market risk.

Investing in stock includes numerous specific risks including: the fluctuation of dividend, loss of principal, and potential liquidity of the investment in a falling market.

Because of its narrow focus, specialty sector investing, such as healthcare, financials, or energy, will be subject to greater volatility than investing more broadly across many sectors and companies.

Investing in foreign and emerging markets securities involves special additional risks. These risks include, but are not limited to, currency risk, geopolitical risk, and risk associated with varying accounting standards. Investing in emerging markets may accentuate these risks.

Tactical allocation may involve more frequent buying and selling of assets and will tend to generate higher transaction cost. Investors should consider the tax consequences of moving positions more frequently.

Value investments can perform differently from the market as a whole. They can remain undervalued by the market for long periods of time.

The prices of small cap stocks are generally more volatile than large cap stocks.

All investing involves risk including loss of principal.

INDEX DESCRIPTIONS

The Standard & Poor's 500 Index is a capitalization-weighted index of 500 stocks designed to measure performance of the broad domestic economy through changes in the aggregate market value of 500 stocks representing all major industries.

S&P Industrials Index is market capitalization weighted index that tracks the performance of industrial companies.

The MSCI EAFE Index is a free float-adjusted market capitalization index that is designed to measure the equity market performance of developed markets, excluding the US & Canada. The MSCI EAFE Index consists of the following developed country indices: Australia, Austria, Belgium, Denmark, Finland, France, Germany, Hong Kong, Ireland, Israel, Italy, Japan, the Netherlands, New Zealand, Norway, Portugal, Singapore, Spain, Sweden, Switzerland and the UK.

The MSCI Emerging Markets Index is a free float-adjusted market capitalization index that is designed to measure equity market performance of emerging markets. The MSCI Emerging Markets Index consists of the following 21 emerging market country indices: Brazil, Chile, China, Colombia, Czech Republic, Egypt, Hungary, India, Indonesia, Korea, Malaysia, Mexico, Morocco, Peru, Philippines, Poland, Russia, South Africa, Taiwan, Thailand, and Turkey.

DEFINITIONS

The Industrials Sector consists of companies whose businesses manufacture and distribute capital goods, including aerospace and defense, construction, engineering and building products, electrical equipment and industrial machinery. Provide commercial services and supplies, including printing, employment, environmental and office services. Provide transportation services, including airlines, couriers, marine, road and rail, and transportation infrastructure.

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