The tariff two-step

Blog

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Industrial stocks have been dancing back and forth from every tweet/ announcement between President Trump and China regarding the over year-old trade war between the two countries. Sector sentiment as a result has swung widely all year between high expectations for a trade deal and then despair that increasing trade tariffs will cause a recession. For example, the industrials sector was one of the best performing in the market during the first quarter on hopes for some trade resolution given encouraging tweets from the White House. This came to an abrupt end in May when the White House announced not an expected roll back in tariffs, but a hike to 25% on USD 200 billion in exports from China, effective 10 May. Since then the sector has struggled to keep up with the overall market with significant volatility.

The sector will likely continue this dance until a trade resolution is reached. The current environment has remained stuck in this same two-step dance. First, industrial stocks had again been rebounding over the summer until tariffs on an additional USD 300 billion were announced by the White House on 1 August. Then, President Trump's tweets of a week ago of intending to hiking tariffs further to 30% also caught the market by surprise and caused increased concern about another industrial recession. The President has also threatened to invoke the US International Emergency Economic Powers Act to curtail US firms' business with China. We have doubts that this rarely used 1977 law could or would be used given the potential damage to the US economy and that it was meant to isolate criminal regimes, not to settle trade disputes.

Most recently, the industrial sector has since rebounded again this week on signs from China that it wouldn't immediate retaliate and wanted to focus on removing new tariffs. This raises the possibility of further talks and possible trade deescalation. We continue to believe the industrials stocks will be caught in this dance until an ultimate resolution on trade is reached. Unfortunately any visibility on this is very low. and we expect trade will continue to depress valuation multiples as well as earnings growth. The bigger concern now is that the trade uncertainty will likely cause companies to postpone new projects and capital spending that will further depress the industrial sector's earnings prospects.

Sector earnings estimates likely have further downside in the near term. Trade uncertainty is feeding into a vicious cycle that is bringing the sector closer and closer to recession given weaker economic numbers.

We believe it is becoming more likely that continued escalation on trade will force the sector into its second recession in the last five years and result in continued stock underperformance. Our sector strategy group has maintained a moderate underweight in the sector primarily for these reasons. We would also expect to see the US ISM Manufacturing Index to fall below 50 in the months ahead. We may already be on this path given the recent slowdown and that we haven't fully felt the impacts from higher tariffs instituted earlier this year. Economic indicators in China and Germany have also slowed materially, which weighs on the global economic outlook.

Economic stimulus that we are seeing in US, Eurozone and China should help, but will likely take time to have an impact. UBS CIO expects the Fed to cut interest rates three more times, with rate cuts also likely by China and the European Central Bank. Given the negative trajectory of demand coming out of the second quarter, we would expect further downbeat forecasts from industrial companies as we enter the September conference season. We also believe that fourth quarter and 2020 earnings estimates will need to come down. This should set up a difficult environment for industrial stocks in the near term unless the trade music finally stops playing and we can return to old fashioned fundamentals.

Appendix

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