March 12, 2018

Cohn Departure and Tariff Talk

News flow out of our nation's capital drove the bulk of the market action last week. After market close on Tuesday, the President's top economic advisor and former Goldman Sachs alum, Gary Cohn, announced his resignation. This departure had been speculated since mid-2017, but the President's initial decision to press for tariffs on all imported steel and aluminum was the straw that broke the proverbial camel's back, apparently. Cohn's involvement in the President's administration was viewed positively by market watchers and participants – evidenced by the S&P 500 futures selling off 1.5% in the immediate aftermath of his resignation. Cohn is credited in large part with spearheading the President's efforts to get tax reform across the finish line late last year. Who steps in to take Cohn's place will be heavily debated, with no shortage of names being batted around, and due to the President's proclivity to surprise, it's anyone's best guess at this point. Markets would prefer it be a Cohn-clone with more of a globalist bend to counterbalance what is at least perceived to be a more nationalistic/protectionist tone on economic policy/trade coming from the White House of late.

Leading up to Gary Cohn's resignation, markets had been fixated for the better part of the preceding week on the administration's initial proposal on steel and aluminum tariffs. The original proposal called for a blanket tariff of 25% on all imported steel and 10% on all imported aluminum, with no carve-outs or exemptions. It had been speculated that the initial proposal was largely an attempt to bring both Canada and Mexico to the bargaining table for NAFTA (North American Free Trade Agreement) renegotiations, and the President all but confirmed as much last week by ultimately exempting those two countries specifically from the tariff proposal, although the exemptions are not "open-ended". All told, Canada (16.7%) and Mexico (9.4%) account for approximately 26% of all U.S. steel imports - hardly a rounding error. Equities sold off initially on reports of an across-the-board tariff as opposed to a more focused or targeted effort on curbing China's dumping of steel onto the U.S. market, but when news broke that the President was even considering exempting Canada and Mexico, stocks rallied up toward their 50-day moving average before again encountering resistance.

A blanket tariff on steel and aluminum would be inflationary as price increases on any product using steel and/or aluminum as throughputs would likely follow. Price hikes on products we import from abroad would undoubtedly also be inflationary as well as trade partners retaliate or respond in-kind. To the surprise of few, the European Union (EU) had come out staunchly against the proposed tariffs, stating it would enact tariffs on everything from Kentucky bourbon to Harley Davidson motorcycles should the U.S. move forward as outlined. The President then fired a shot across the bow of the EU stating that he is considering tariffs on cars imported from Europe. Tough talk on tariffs between the President and the EU appears poised to drag on for a bit longer still, as the White House is affording other nations an opportunity to justify why they should also be exempt. Fascinating political theatre should follow in relatively short order.

While potential EU tariffs on exported bourbon and motorcycles are headline-grabbing, it's important to note the U.S. exported some $129.7B in agricultural products in 2016 according to the U.S. Department of Agriculture (USDA) – with $49.6B going to Canada, Mexico, and the EU. Soybeans and soybean product exports accounted for 19.5% of the $129.7B total, with China being the primary importer. China accounted for 14.8% of the $129.7B in total agricultural exports. Global trade is a spider web of interconnected relationships and a move on one front can have significant unforeseen ramifications all the way on the other side of the globe. Our primary concern from a markets perspective is that uncertainty surrounding trade breeds uncertainty in markets and can cause paralysis, or worse, overreaction, on the part of market participants waiting for definitive proof/evidence that something is/isn't going to occur. For now, it appears as though the status quo will be maintained, with perhaps a few relatively minor tweaks. The bark was worse than the bite, this time. Our positive outlook on stocks hasn't changed, nor has our preference for international equities over domestic stocks.

Small-Cap Resurgence

With tariff talk making the rounds, small-cap stocks have experienced an awakening. From market close on February 23 through last Friday, the small-cap Russell 2000 Index's 3.1% price return more than doubled the 1.4% price return of the S&P 500. A relatively small magnitude of outperformance to be sure, and over a very short time frame to boot, but notable nonetheless as the Russell 2000 had underperformed the S&P 500 by 9.7% on a total return basis from the start of 2017 through February 23. Interestingly, since the closing low of the recent correction in stocks on February 8, the Russell 2000 outperformed the S&P 500 by 1.2% (9.1% vs. 7.9%). Russell 2000 companies, broadly speaking, garner far less revenue from abroad than do their large and mega-cap brethren, thus, they are less affected by saber rattling on trade, and would likely be relative beneficiaries if a trade war erupts as fewer goods would be imported from abroad, leaving a demand vacuum to be filled with domestic supply.

At last check, approximately 1/3 of the companies in the Russell 2000 Index were not yet profitable, and with many of these companies relying heavily on debt to fund operations, rising short-term interest rates could wreak havoc on a large swath of this index over the coming quarters. Companies carrying a heavy debt load are going to find it costlier to refinance existing debt, making more exits via mergers and acquisitions increasingly likely in our view – but at what premium/discount to current market value is the question. A prolonged and messy battle on the trade front with China and/or the EU could pull additional capital out of the large and mega-cap names most associated with global growth, with a reallocation of those proceeds into domestically-focused names insulated to varying degrees from the fray. Concerns over a "trade war" appear overblown at the present time, but the longer tariffs remain in the news, the better the odds that small-caps continue to play catch-up vs. large-caps.

Source: Bloomberg, Factset, USDA, Wood Mackenzie

	Price/Yield	Total Return (%)					
	3/9/2018	1 Week Ago	1 Month Ago	Year to Date	1 Year	3 Years	5 Years
Dow Jones Industrial Average	25335.74	3.34	5.02	3.02	24.33	14.94	14.75
S&P 500	2786.57	3.59	6.59	4.63	20.18	12.58	14.79
NASDAQ	7560.81	4.20	10.11	9.76	30.89	16.57	19.85
Russell 2000 Index	1597.14	4.20	8.20	4.21	18.98	10.83	12.65
MSCI World ex US	2026.43	2.03	2.70	-0.60	19.36	6.59	6.81
MSCI EM	1207.23	1.82	5.80	4.46	34.21	10.90	5.38
Bloomberg Barclays US Aggregate	3.18	-0.12	-0.31	-2.22	1.69	1.36	1.80
Bloomberg Barclays Global Aggregate	1.89	-0.19	0.54	0.55	8.22	3.19	1.53
Bloomberg Barclays US Corporate Index	3.78	-0.15	-0.69	-2.96	3.50	2.56	3.05
Bloomberg Barclays 10-Year Muni Index	2.66	-0.04	-0.04	-1.93	3.32	2.40	2.76
Bloomberg Barclays High Yield Index	6.14	0.35	0.88	-0.40	5.20	5.34	5.21

	Price/Yield						
	3/9/2018	1 Week Ago	1 Month Ago	12/31/2017	1 Year Ago	3 Years Ago	5 Years Ago
1 Month LIBOR (rate)	1.75	1.69	1.58	1.56	0.88	0.18	0.20
30 Year Mortgage (average rate)	4.34	4.30	4.31	3.86	4.17	3.92	3.57
2 Year Treasury (yield)	2.27	2.23	2.05	1.88	1.38	0.69	0.26
10 Year Treasury (yield)	2.89	2.85	2.82	2.41	2.61	2.19	2.05
30 Year Treasury (yield)	3.16	3.13	3.13	2.74	3.19	2.80	3.24
WTI Crude (closing price)	62.05	61.19	59.20	60.46	48.75	49.95	91.95
Brent Crude (closing price)	65.51	64.26	63.04	66.73	50.65	60.67	111.04
Gold (NYM $/oz)	1322.40	1321.10	1313.10	1306.30	1202.40	1166.40	1576.60

Source: FactSet

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