Bruderman Perspectives
A Bruderman Asset Management Publication

Trade War? What is it Good For? Absolutely Nothing.

Michael Murphy, CFA
August 2019

Stocks plunged on Friday, August 23 as the intensity of the Trump Administration's trade war ratcheted up. First, China announced pre-emptive tariffs on agricultural and automotive products and then the President responded by appearing to order US companies to leave China.

Imports account for less than 20% of US GDP and exports only about 13%. So why are equities falling so much on trade news? There are three main reasons, we believe: first, exports are falling faster than imports and declining exports are typically seen only in recessions; second, the chaotic nature of the trade war may be eroding sentiment, causing companies to postpone spending; and finally, since tariffs are effectively a tax on trade, investors are concerned about US multinational margins and earnings as they internalize higher import costs.

Exports from the US have been hit far harder in this trade war than imports. Over the past year, exports have declined by 1.5% while imports have increased by 2.6%. The trade war has increased the trade deficit by nearly $100 billion which is unsurprising consider the US' massive budget deficit which must be financed with imported capital. Declines or slowdowns in imports and exports are closely associated with recessions (Exhibit 1) and the trade war appears to have taken a toll on US economic performance. Exports are additions to GDP while imports are subtracted so GDP growth has slowed dramatically since the beginning of the trade war.

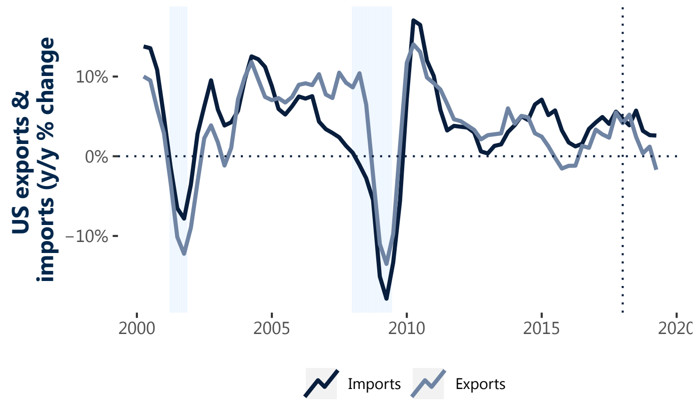

Exhibit 1. US Imports & Exports year-on-year change

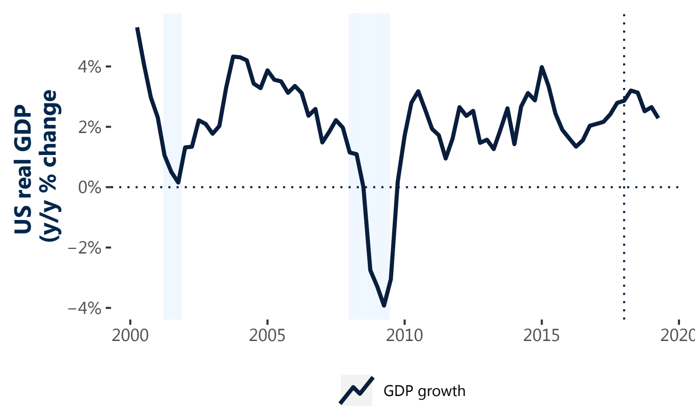

Exhibit 2. US GDP growth

Developments in the trade war have been impossible to predict and the sparring between China and the US have repeatedly caught investors and business managers off guard. This has begun to weight on confidence as evidenced by the sharp decline in PMI survey data which assesses purchasing manager's real-time view on their respective market conditions. The PMI has plunged from a healthy reading of near 60 to just over 52 in the July survey. A reading over 50 indicates expansion and the latest reading shows the economy's pulse is weak (Exhibit 3). Uncertainty seems to be slowing investment spending also. We calculated the year-over-year growth in capital expenditures for S&P 500 companies to assess investment spending. Growth has slowed by eight percentage points since the start of the year (Exhibit 4).

Exhibit 3. ISM Purchasing Manager's Index

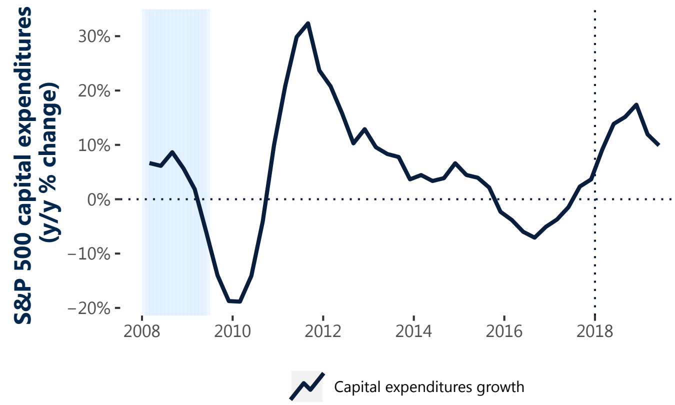

Exhibit 4. S&P 500 capital expenditures

The slowing economy is beginning to take toll on earnings growth. Exhibit 5 shows the trailing twelve month EBITDA value for S&P 500 companies. After enjoying growth of over 14% last year, EBITDA growth has slowed to only 1.2% after Q2 earnings, the slowest since the earnings recession in 2015-2016 (Exhibit 5). A large portion of stock price appreciation has resulted from valuation expansion over the past few years and earnings multiples are currently elevated for the market as a whole (Exhibit 6). Valuation multiples are based on a number of factors but expected earnings growth and investor confidence are surely among the important ones. At current valuations, even a one-point decline in the multiple can have a large impact on stock prices. In Q4 2018, for example, the market valuation multiple fell by 1.5 points and markets experienced a drawdown of nearly 20%.

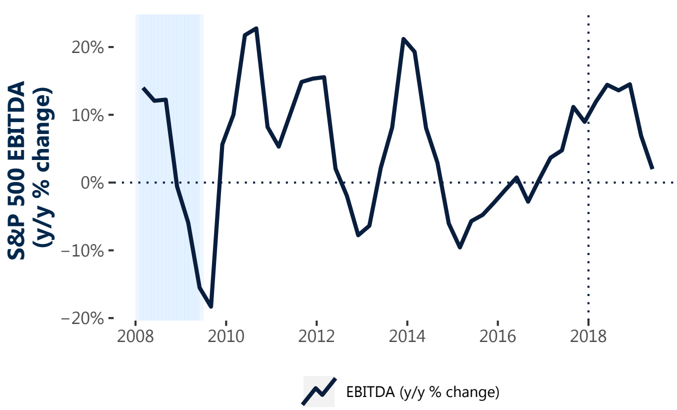

Exhibit 5. S&P 500 EBITDA growth

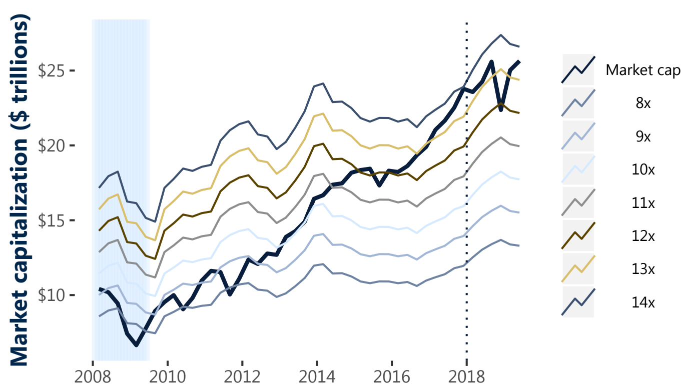

Exhibit 6. S&P 500 valuation multiple trends

Our view is that a large trade deficit is not a problem for the US and, in fact, reflects its strength in the world economy. There have been abuses in the trading system, particularly in the manner in which China manages its currency. However, the US approach to trade negotiation has resulted in very little, so far, other than antagonizing trading partners and confusing investors. Our base-case view is that an economy weakening into an election year will cause the Administration to reassess its approach to trade.

Sources & References: Bruderman Asset Management LLC calculations, Bloomberg Finance LP
"Key Statistics and Trends in International Trade 2018"; United Nations Conference on Trade and Development, April 2019
U.S. Bureau of Economic Analysis, Real imports of goods and services [IMPGSC1], retrieved from FRED, Federal Reserve Bank of St. Louis; https://fred.stlouisfed.org/series/IMPGSC1, August 24, 2019.
U.S. Bureau of Economic Analysis, Real Exports of Goods and Services [EXPGSC1], retrieved from FRED, Federal Reserve Bank of St. Louis; https://fred.stlouisfed.org/series/EXPGSC1, August 26, 2019.
U.S. Bureau of Economic Analysis, Real Gross Domestic Product [GDPC1], retrieved from FRED, Federal Reserve Bank of St. Louis; https://fred.stlouisfed.org/series/GDPC1, August 26, 2019.
Yanushevsky, Camilla; "Credit Analysis Companies and Sectors Most Impacted by US-Chinese Tariffs", S&P Global Market Intelligence, May 7, 2018
"World Trade Statistical Review 2019"; World Trade Organization, 2019
"World Trade Statistical Review 2018"; World Trade Organization, 2018

For More Information, Please Contact Your Financial Advisor.

Lower Hudson Valley
75 Montebello Road
Suffern, NY 10901

Long Island
64 Birch Hill Road
Locust Valley, NY 11560

New York City
10 East 53rd Street,
Penthouse Floor
New York, NY 10022

California
2029 Century Park East
Suite 400
Los Angeles, CA 90067

Bruderman