AN OVERVIEW OF TRADE WARS AND THE IMPLICATIONS FOR INVESTORS

Investors have invariably read and heard much about trade and tariff wars. What exactly is a trade war and what are the implications for investors' portfolios?

Trade Wars

A trade war occurs when countries retaliate against one another by raising import tariffs (taxes) or by restricting imports to each other. It is a tool formed under a protectionist policy and it can be controversial as critics say it is harmful to the economy, consumers, business owners and investors, while supporters say that it protects national interests and businesses.

Intellectual Property (IP) At the Centre of the Trade War with China

A key issue at the centre of the trade war surrounds "intellectual property" (IP). President Trump states that "we have a tremendous intellectual property theft situation going on."

According to the World Intellectual Property Organization, "intellectual property refers to creations of the mind: inventions; literary and artistic works; and symbols, names and images used in commerce." The US is convinced that China is stealing its IP and is demanding that they implement substantial laws to prevent this theft. China created regulations to address

IP protection and market access, including 38 penalties against IP violations. In addition, a new Foreign Investment Law has been approved that will ban the practice of forcing foreign companies to hand over their IP in exchange for access to the Chinese market.

The dispute of IP is so serious that the US recently increased the tariffs on $250 billion worth of Chinese products from 10% to 25%. China responded with tariffs on $110 billion worth of American products.

"Don't Say We Didn't Warn You"

This expression is used by official Chinese media to warn rivals over major areas of disagreement. "We advise the U.S. side not to underestimate the Chinese side's ability to safeguard its development rights and interests. Don't say we didn't warn you!" the People's Daily said in a commentary titled "United States, don't underestimate China's ability to strike back." The publication is the official newspaper of the Communist Party of China. The phrase "Don't say we didn't warn you" has been used before by the People's Daily in 1962 before China's border war with India and ahead of the 1979 China-Vietnam War.

The U.S. and China are playing a high-stakes poker game, and neither are willing to fold their cards, indicating that the impact is likely going to be greater than most imagine. The next card that China is threatening to play is the rare earth metal card. China's grip on the global market for rare earth metals gives it the ability to target American weaponry in its trade war with the U.S. "China has been signaling that it may restrict the export of rare earth minerals to the United States as the trade conflict between the two countries escalates. It is by far the largest producer of these raw materials, vital for many American industries including high-growth sectors such as electric car and wind turbine production. Last year, the US Geological Survey designated these minerals critical to the economy and national defense."

Trade War with India

The Generalized System of Preferences is a program that helps developing countries sell their products to U.S. consumers, duty free. India is the biggest beneficiary as it exported $5.7 billion to the U.S.

The latest strike in President Trump's trade war was on June 5, when he withdrew India's preferential trade status thereby terminating India's position as a developing country. India retaliated by increasing tariffs on 28 U.S. products totally $235 million but trade talks had delayed their implementation.

Trade War with Mexico

President Trump has Mexico in his trade war crosshairs and illegal migrants are the reason. He threatened 5% tariffs with monthly increases until the dispute was settled.

On June 7, the U.S. signed a migration deal that commits the Mexican government to protect the border from illegal Central Americans. Mexico has 45 days to make a meaningful effort and President Trump can table the tariff threat if he believes that the migration deal is not working.

A trade war with Mexico would be economically devastating. In the first quarter of 2019, Mexico overtook both China and Canada to become the U.S.'s top trading partner in goods, according to U.S. Census Bureau data.

Roughly 6 million jobs in the United States depend on trade with Mexico. This may have something to do with the fact that Mexico buys more American goods than all of the BRIC countries — Brazil, Russia, India, and China — combined.

Overall Effect on the Economy

Trade wars are more complex in a globalized economy and it is very difficult at this point to know what the long-term impact will be. In the short term, International Monetary Fund Chief Economist Gita Gopinath stated that the trade wars were one factor that had contributed to a "significantly weakened global expansion, especially in the second half of 2018." The IMF cut its growth forecast for this year by 0.2 percentage points to 3.3%. The Organization for Economic Cooperation and Development (OECD) said "tariffs imposed by the US and China last year had slowed economic growth in the world's two largest economies."

For consumers, trade wars are inflationary as producers faced with tariff-induced margin compression are forced to pass along increased prices, thereby impacting the consumer's quality of life. The consumer is then faced with the decision to either pay the higher price, which reduces disposable income, find a substitute or replacement, or in extreme cases, go without.

What sectors are insulated from trade wars?

Domestically oriented companies in sectors that are "tariff-free" will be least affected. Utilities and real estate are isolated from trade wars and they will be favoured. Additionally, health care, regional banking and hospitality are insulated. For long-term investors, investing in these sectors for the sole purpose of capitalizing on trade wars is not practical unless the company fundamentals support an investment. A short-term trade in these sectors without attractive underlying fundamentals amounts to speculation.

What are the implications for investors?

The implications for investors are volatility and uncertainty. Geopolitical events such as trade wars and yet-to-be-identified events will invariably continue, and investors resolve will be tested. A basic-but-powerful strategy to adopt is diversification; however, diversification beyond stocks and bonds is required due to increasing correlations between these asset classes. Increasingly interconnected markets mean that traditional asset classes and geographic diversification no longer provide the downside protection that investors expect.

Alternative investments have low correlation to traditional stocks and bonds, which can mitigate market volatility and lead to fewer losses and better returns in the long run. With increased market volatility, pension funds, family offices and institutional investors continue to steadily increase weightings in alternative investments with the goal of more stable growth. In 2018, the allocation to alternatives in sovereign wealth fund portfolios was 23%.

Alternatives are an area that accredited investors should have in their portfolios, however, great care should be taken in selecting the best-of-the-best alternative managers for their investment goals. Not all alternative investments are created equal as managers and their funds dramatically differ in their competence, experience, mandate, sector, liquidity and risk profile.

Sightline Wealth Management offers access to handpicked, best-in-class alternative investment managers as part of an accredited investor's portfolio and as part of the Smart Money model portfolios. With uncertainty and volatility expected to continue, we encourage investors to seek independent investment advice, hire best-in-breed managers, manage their emotions, and allow time to compound their wealth. We would be pleased to answer your questions at invest@sightlinewealthmgt.com.

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