

## Tariffs, Trade Wars, and Your Portfolio

July 2019

### Key Points:

1. So far in 2019, the threat of tariffs has given the Fed Chairman a run for his money
2. While ongoing trade disputes involve several developed and emerging economies across the globe, the focus remains on the two world largest economies: United States and China
3. Overall positioning can now be characterized as “balanced” between market participation and market protecting

### A brief history of tariffs

So far in 2019, the threat of tariffs has given the Fed Chairman a run for his money in terms of their day-to-day impact on the financial markets. President Trump’s use of tariffs represents a departure from the free trade approach the United States has mostly employed since the end of World War II. In order to better understand the tariffs’ utility as foreign policy tool, perhaps a brief history lesson is in order

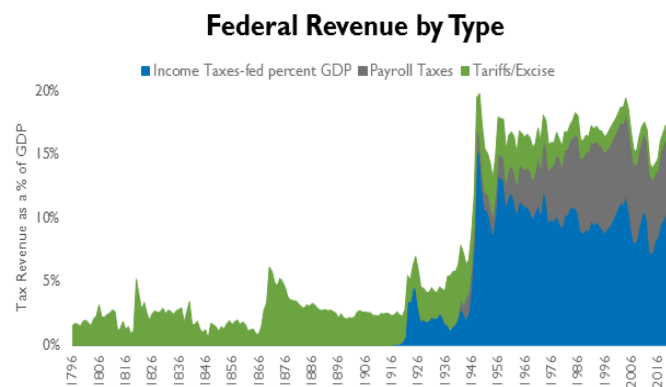
Secretary of the Treasury Alexander Hamilton was instrumental in the passing of The Tariff Act of 1789, which was designed to provide revenue for the federal government, protect U.S. manufacturing, and promote trade. At a time when there was no income tax, tariffs provided more than 90% of the nation’s revenue in most years. While an income tax was briefly instituted during the Civil War and during the 1890’s financial crisis that culminated in the Panic of 1893, it wasn’t until 1913 that the Sixteenth Amendment was passed, which permanently legalized a federal income tax. By that time, tariffs were deemed passé as the industrial revolution was in full swing.

However, in the wake of the stock market crash of 1929, President Hoover signed the Smoot-Hawley Tariff Act which raised import duties by 20% on average, with a primary objective of protecting farmers from European imports in the wake of the crash. Trade between Europe and the U.S. fell by two-thirds, and led to a severe economic downturn for the U.S. in the 1930’s.

Following World War II, the U.S. steered international discussions that led to the General Agreement on Tariffs and Trade, which provided the foundation upon which the World Trade Organization was built.

Fig 1: Federal revenue by type

Source: FY 2016 [https://www.usgovernmentrevenue.com/revenue\\_chart\\_1792\\_2016USp\\_18stli01lcn\\_10f3of4of](https://www.usgovernmentrevenue.com/revenue_chart_1792_2016USp_18stli01lcn_10f3of4of)

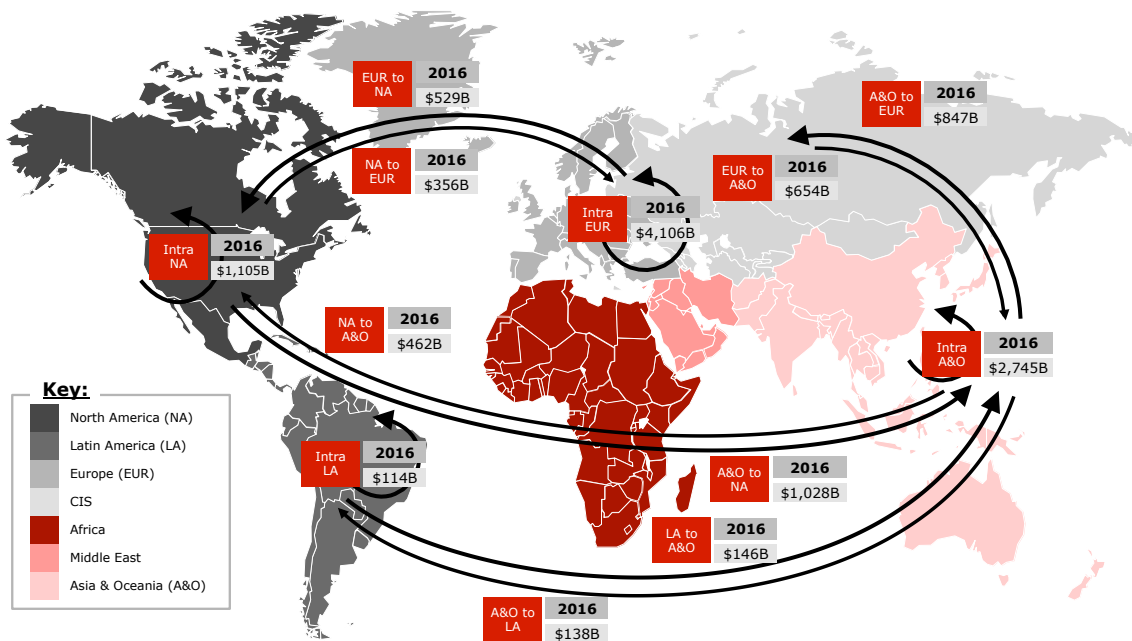


## Tariffs today

In 2018, over \$25 trillion of merchandise and services were traded across the globe. This growth in global trade and free markets over the past 75 years is often pointed to as the reason for a massive decline in global poverty, and enormous gains in economic growth in many regions. Global trade volumes are an important indicator of the health of the global economy, and a good gauge in the direction of global growth. U.S. and global recessions tend to be accompanied by a protracted contraction in global trade volumes.

Fig 2: World region export analysis

Source: World Trade Organization (WTO) world region export analysis. October 2017: Bain & Company analysis



The stated objectives of the President's current use of tariffs are to protect and rejuvenate American manufacturing employment, combat tariffs placed on U.S. goods by foreign countries, and put an end to intellectual property theft, mainly by China. In the spring of 2018, tariffs on aluminum and steel went into effect for about \$20 billion of product imported by the United States. Soon after, a number of countries across the globe had retaliated by imposing tariffs on U.S. steel, aluminum, consumer and agricultural goods. By the end of the summer, the focus had shifted to capital goods, technology and intellectual property. By the fall, the U.S. had imposed tariffs on about \$200 billion of Chinese exports. China had retaliated imposing tariffs on about \$60 billion of imports from the U.S. The combination of a slowdown in global economic activity and the ongoing trade disputes were partially blamed for the double digit losses in global equities in the fourth quarter of 2018.

## Will they work?

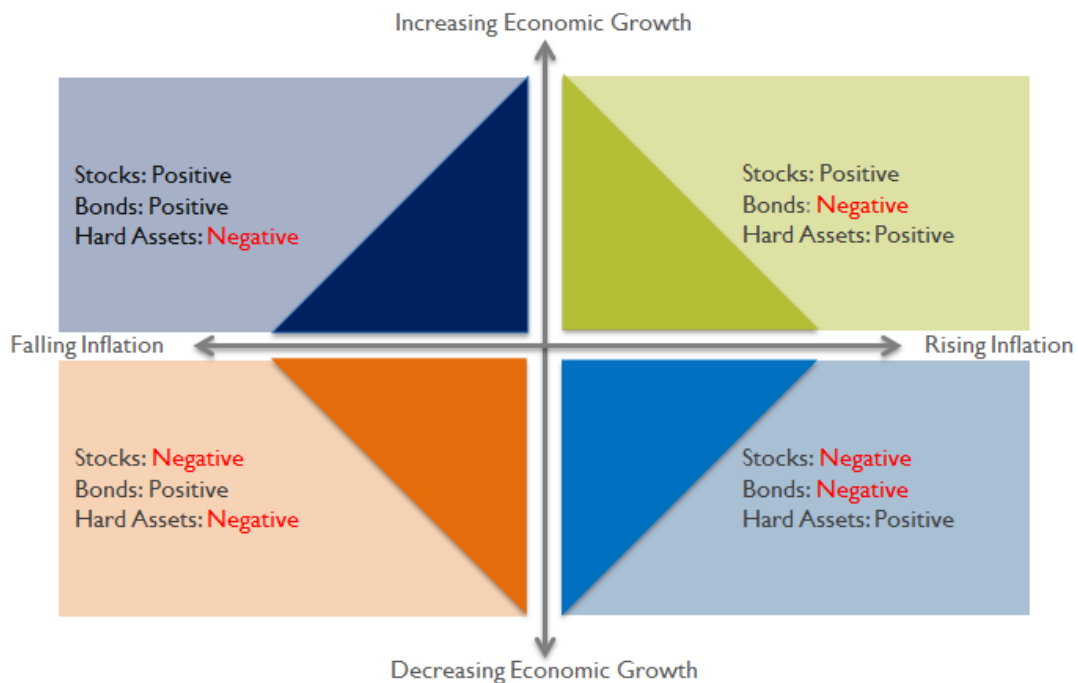
While ongoing trade disputes involve several developed and emerging economies across the globe, the focus remains on the two world largest economies: United States and China. At the heart of the ongoing disputes are the large trade gap between U.S. and China, as well as U.S. concerns regarding Chinese unfair trade practices for technology and intellectual property.

Regulatory agreements can and should address unfair practices and intellectual property. Realistically the structure of the two economies (service/consumer oriented in the U.S. and manufacturing/producer oriented in China) will not allow for much of a reduction in the trade deficit over a short period of time. If tariffs were to be imposed on all the goods that the U.S. imports from China (about \$540 billion) those tariffs would touch at least 2.5% of the U.S. economy. That said, it is unlikely that much, if any, manufacturing would return to the United States from China. Most manufacturing facilities are capital intensive, and even relatively low-tech products such as shoes involve sophisticated, expensive machinery that cannot be moved or built quickly. 72% of all footwear and 41% of apparel sold in the U.S. is manufactured in China (American Apparel & Footwear Association), and are sitting ducks with no viable option to move in order to avoid tariffs. It is much more likely that other low-cost countries, such as Thailand and Vietnam would be the likely beneficiaries of any new or moved manufacturing jobs, not the U.S. Moreover, when analyzing the net effect of a trade war, one would have to consider the negative effects of retaliation, such as tariff inflation that is passed to the U.S. consumer, animosity with a large trading partner, and the provocation of a military super power that is free to build trading relationships with the rest of the world. Tariffs are perhaps the weapon of choice of this trade war, though not necessarily ideal for producing an easy solution. While it is reasonable to think that both parties involved have an incentive to come to a resolution to avoid an economic slowdown and bring home a win for the electoral base, neither is willing to concede on their asks. In the case of China it could even be rational to “roll the dice” and hang in there hoping for a shift in policy after the next U.S. presidential election while in the meantime, extending fiscal and monetary stimulus to its own economy.

## Windhaven’s approach

The premise of the three Windhaven Strategies is to start with a diversified set of core holdings comprised of U.S. and international stocks and bonds, and then tactically allocate to a handful of the most attractive asset classes identified by our research process. In short, we seek to participate in the growth of markets when the environment is conducive, but when the wind shifts and risks outweigh the reward, we focus on protecting against large losses. Perhaps more than ever, the last twelve months have reinforced the importance of cutting through the noise while relying on a solid investment process grounded in research, and focusing on factors that have proven to be effective over time in providing guidance of the current and future market environment.

Given the context above, it should be clear that attempting to model the outcome of trade wars and their effects on economic activity and markets is a fool’s errand. Our research indicates that, over time, markets tend to revert to fundamental drivers and behavioral factors. Growth and inflation are two powerful forces that tend to drive asset returns over time, and both are critical to the Windhaven investment process.



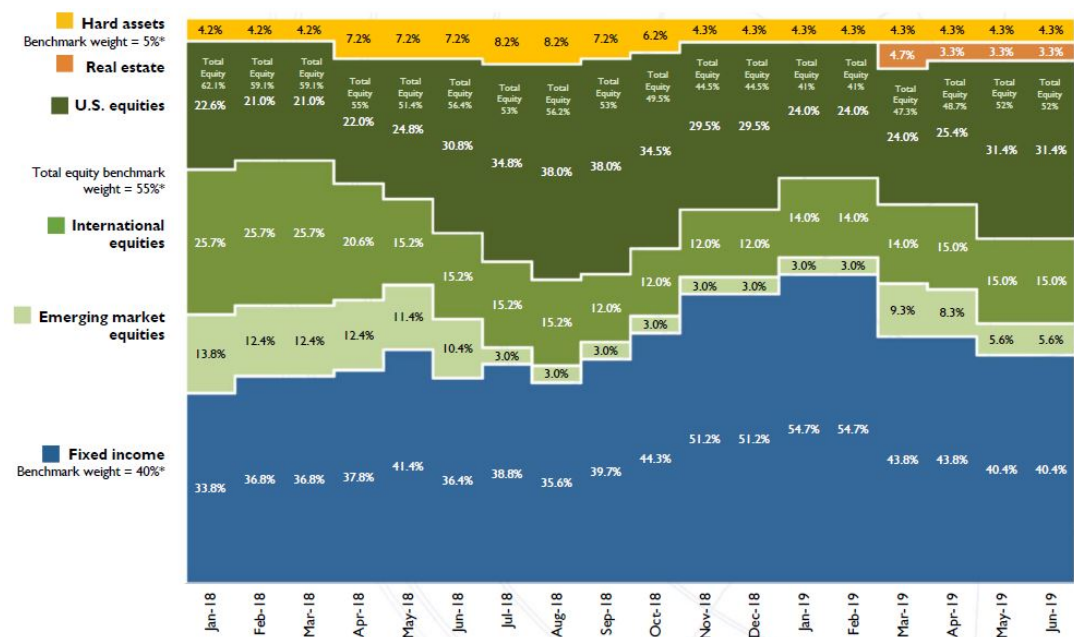
These relationships do not always hold true and there are periods of time when all asset classes might decline simultaneously. Hard Assets are physical assets.

The chart above (Fig 3) captures the influence these two factors can have on the major asset categories. After a decade of economic growth and muted inflation that has been very kind to most investment portfolios, the prospect of tariff-induced slower growth and rising prices rightly concerns market participants. Windhaven's approach is to identify and shift our strategies toward the handful of asset classes that we believe are likely to perform in the current environment, while always maintaining a minimum amount of diversification.

### How Windhaven's positioning has shifted

After participating in the upside of the strong global stocks markets in 2017 and the first quarter of 2018, risk exposure in all three Windhaven Strategies during much of the last three quarters of the year was reduced. Ongoing trade disputes began to cause a deterioration of behavioral factors and fundamentals that caused a fairly sizable plunge in markets during the fourth quarter, causing 2018 to finish as the first negative year for U.S. stocks since 2008. Beginning with the March 2019 trading period, our research suggested it was prudent to add back a bit of the equity exposure, and subsequent trades in the second quarter continued that theme. Overall positioning can now be characterized as "balanced" between market participation and market protecting, reflecting the delicate balance between potential risks emanating from politics and geopolitics, with the opportunities that could come from a potential trade resolution in an environment of ongoing non-inflationary growth.

The chart below (Fig 4) illustrates how our Diversified Growth strategy has navigated current markets. Fig 4: Diversified Growth Strategy 18-month changes Model allocations as of the end of each month



Model allocations shown as of the end of each month with the exception of June 2019, which is as of 6/4/2019.

We appreciate your investment in the Windhaven Strategies. Please contact your Investment Professional if your investment objectives or circumstances have changed such that a review of your Windhaven Strategy account(s) might be necessary, or if you have any specific questions about how your account is managed. We value the trust our clients have placed in us, and we are passionate about the Windhaven Strategies and the role they play in helping each of you reach your investment goals.

*-The Windhaven Portfolio Management Team*

**Important Notes and Disclosures:**

Portfolio Management for the Windhaven Strategies is provided by Windhaven Investment Management (“Windhaven”), a division of Charles Schwab Investment Advisory, Inc. (“CSIA”). CSIA is a registered investment adviser and an affiliate of Charles Schwab & Co, Inc. (“Schwab”). Both CSIA and Schwab are separate entities and subsidiaries of The Charles Schwab Corporation.

The information provided herein is for general informational purposes only and should not be considered an individualized recommendation or personalized investment advice. The investment strategies mentioned here may not be suitable for everyone. Each investor needs to review an investment strategy for his or her own particular situation before making any investment decisions.

All expressions of opinion are subject to change without notice in reaction to shifting market conditions. Data contained herein from third party providers is obtained from what are considered reliable sources. However, its accuracy, completeness or reliability cannot be guaranteed and CSIA expressly disclaims any liability, including incidental or consequential damages, arising from errors or omissions in this publication.

Asset classes and the proportional weightings in the strategies may change at any time without notice subject to the discretion of the Windhaven Portfolio Management Team.

Indexes shown in the charts throughout are unmanaged, do not incur fees or expenses, and cannot be invested in directly.

**Past performance is no guarantee of future results.**

Diversified Growth Strategy 18 Month Changes: Model allocations shown as of the end of each month. Allocations do not necessarily reflect our current investment views and should not be used as the basis for investment decisions. Holdings of individual client portfolios may differ, sometimes significantly, from those shown in the model allocation chart. Cash positions whether in US dollars or other currency are included in the relevant fixed income section. Hard Assets are physical assets and may include exposure to gold, commodities and energy.

The following Global benchmarks for each Windhaven strategy are:

Global Conservative is composed of 20% MSCI All-Country World Index (ACWI), 75% Bloomberg Barclays US Aggregate Bond Index, and 5% S&P GSCI Total Return Index (GSCI), rebalanced monthly.

Global Growth is composed of 55% MSCI ACWI, 40% Bloomberg Barclays US Aggregate Bond Index, and 5% S&P GSCI, rebalanced monthly.

Global Aggressive is composed of 70% MSCI ACWI, 20% Citigroup FTSE World Government Bond Index (CWGBIWGBI), and 10% S&P GSCI, rebalanced monthly.

International investments may involve additional risks, which could include differences in financial accounting standards, currency fluctuations, political instability, foreign taxes and regulations, and the potential for illiquid markets. Investing in emerging markets may accentuate these risks.

Fixed income securities are subject to increased loss of principal during periods of rising interest rates. Fixed income investments are subject to various other risks including changes in credit quality, market valuations, liquidity, prepayments, early redemption, corporate events, tax ramifications and other factors.

Hard assets can be significantly affected by commodity prices, world events, import controls, worldwide competition, government regulations, and economic conditions.

Windhaven’s risk management process includes an effort to monitor and manage risk, but should not be confused with and does not imply low risk or the ability to control risk.

Please refer to the Windhaven Strategies Disclosure Brochure for additional information.