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Americas CIO View

Post G20: Existing tariffs stay in effect, lower S&P 500 EPS outlook

No agreement or timeline to cut 25% tariffs on half the imports from China

The post G20 summit between President Xi and President Trump produced many pictures and handshakes, but no framework or timetable to reduce existing tariffs. The recently hiked tariff rate from 10% to 25% on $200 billion of imports from China (effective essentially in June given the seaborne provision) and also China's retaliatory tariffs stay in effect indefinitely. Neither leader is in a rush to drop these tariffs. While they agreed to delay further tariffs for several months, postponement is not cancellation and U.S. Trade Representative Lighthizer continues with preparations to provide President Trump additional tariff options on China and others. We still think another round of China tariffs is unlikely, but no more unlikely than before the G20 given the Fed's more accommodative stance and strong financial markets.

We cut our 2019E and 2020E S&P 500 EPS to $165 and $175 from $169 and $179

Because of the direct cost of tariffs and the related potential hits to demand and possible supplier disruptions, we reduce our S&P 500 earnings-per-share (EPS) estimates for this year and next. This assumes that the existing two-way tariffs continue through most if not all of 2020, but that companies find ways to mitigate some of the costs and disruptions in 2020. We continue to monitor the side effects of slower trade, slower investment, slower manufacturing and slower global growth from this trade conflict; which includes risk of stronger dollar and lower oil prices. We think it likely that the U.S. Federal Reserve (Fed) cuts by 25 basis points (bps) on July 31, but we do not expect a series of Fed rate cuts over the coming year. We do think that Powell's dovish pivot curbs dollar upside risk and oil price downside risk to S&P 500 EPS. We expect a stable dollar, despite the Fed's dovish stance, because very few central banks would welcome their currency appreciating vs. the dollar. However, lower U.S. interest rates have lowered our Financials EPS outlook.

S&P 500 EPS cuts at Financials, Tech, Industrials, Energy and Consumer

We have repeatedly argued that continued tariffs could negatively affect Industrials, Technology hardware, Energy and certain Consumer industries and that lower interest rates weaken the profit outlook for Financials. We previously published that if existing tariffs continue through this year, we would cut our S&P EPS estimate by $3 to 5. Today, we cut both our 2019 and 2020 S&P 500 EPS estimates by $4: About $1.50 from Financials, $1.00 from Tech, $0.75 from the Consumer sectors, $0.50 from Industrials and Energy each. The recent rally in oil prices prevented a larger cut to

In a nutshell

- No agreement or timeline to cut 25% tariffs on half the imports from China
- We cut our 2019E and 2020E S&P 500 EPS to $165 and $175 from $169 and $179
- S&P 500 EPS cuts at Financials, Tech, Industrials, Energy and Consumer
- There might be shelter at bond substitute domestic equities and IG corporate credit

Energy. Our new 2019 quarterly S&P 500 EPS estimates are: $39, $41, $42, $43 = $165.

S&P 500 sector strategy adjustments: Energy raised to equal-weight

Given the recent rally in oil prices and our reduced earnings outlook for Financials, we close out our long standing preference for the Financials sector over Energy. We now put both equal-weight. We still find the valuations and dividend-growth potential more attractive at Financials, but Energy could outperform, especially short-term, if oil rallies further. We remain constructive on big Banks given undemanding valuations, benign credit costs and dividend-payout ratio upside, but pressure on net-interest margins from collapsed interest rates is a risk we must carefully monitor. We also raised Utilities to overweight from neutral to broaden our overweight of domestic bond substitutes. We lowered Industrials and Consumer Staples to underweight on weak EPS growth outlooks and demanding valuations. Our earnings estimates by sector and sector valuation and sector/industry allocations are inside.

There might be shelter at bond substitute domestic equities and IG corporate credit

We continue to expect the S&P 500 to fall to or below 2800 this summer as the continuation of existing tariffs causes companies to guide earnings estimates lower and a U.S. fiscal fight begins to brew for the autumn to posture for the 2020 elections.

We see greater risk from the continued trade conflict to the global cyclical sectors of the S&P 500 than to broad Emerging-Market (EM) Asia or China equities. Tariffs on China imports will mostly be paid by the importing companies. China's listed companies are more exposed to domestic consumption and less exposed to export activity than China's economy. Because of fiscal and monetary stimulus in progress and also because exports are a much smaller driver of China's growth than a decade ago (only a quarter of China's exports are to the United States) we expect China's economy and its currency to prove resilient. We also think the best short-term reward vs. the risk for any de-escalation of the trade conflict is EM Asia equities. Yields on investment-grade (IG) credit are low vs. normal, but the credit spread is attractive. Observed spreads should narrow if the 10-year Treasury yield settles at 2%.

Glossary

Accommodative

The aim of an **accommodative** monetary policy is to support the economy by means of monetary expansion.

Appreciation

In relation to currencies, **appreciation** refers to a gain of value against another currency over time.

Basis point

One **basis point** equals 1/100 of a percentage point.

Central bank

A **central bank** manages a state's currency, money supply and interest rates.

Earnings per share (EPS)

Earnings per share (EPS) is calculated as a company's net income minus dividends of preferred stock, all divided by the total number of shares outstanding.

Emerging markets (EM)

Emerging markets (EM) are economies not yet fully developed in terms of, amongst others, market efficiency and liquidity.

G20

The **Group of 20** are the largest industrialized and emerging economies in the world.

Investment grade (IG)

Investment grade (IG) refers to a credit rating from a rating agency that indicates that a bond has a relatively low risk of default.

Margin

Margin describes borrowed money that is used to purchase securities.

Pro-cyclical sectors

Pro-cyclical sectors are those likely to particularly benefit from an upturn in the economic cycle (i.e. stronger growth).

S&P 500

The **S&P 500** is an index that includes 500 leading U.S. companies capturing approximately 80% coverage of available U.S. market capitalization.

Spread

The **spread** is the difference between the quoted rates of return on two different investments, usually of different credit quality.

Treasuries

Treasuries are fixed-interest U.S. government debt securities with different maturities: Treasury bills (1 year maximum), Treasury notes (2 to 10 years), Treasury bonds (20 to 30 years) and Treasury Inflation Protected Securities (TIPS) (5, 10 and 30 years).

U.S. dollar (USD)

The **U.S. dollar (USD)** is the official currency of the United States and its overseas territories.

U.S. Federal Reserve (Fed)

The **U.S. Federal Reserve**, often referred to as "**the Fed**", is the central bank of the United States.

Valuation

Valuation attempts to quantify the attractiveness of an asset, for example through looking at a firm’s stock price in relation to its earnings.

Yield

Yield is the income return on an investment referring to the interest or dividends received from a security and is usually expressed annually as a percentage based on the investment's cost, its current market value or its face value.

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