REUTERS

U.S. small-cap stocks find favor as trade-war fears spike

By Lewis Krauskopf, Sinéad Carew, April Joyner
MARCH 7, 2018

NEW YORK (Reuters) - Investors are scooping up U.S. small cap stocks as the specter of steel and aluminum tariffs escalating into a global trade war makes them more edgy about larger companies exposed to international markets.

The resignation of Gary Cohn, a top economic adviser to President Donald Trump who was seen a key voice pushing against protectionism measures, set off the latest bout of market volatility on Wednesday tied to fears of the tariffs.

Since Feb. 28, the day before Trump said he would impose import tariffs of 25 percent on steel and 10 percent on aluminum, the small-cap Russell 2000 has climbed 4.1 percent while the S&P 500 .SPX, the benchmark for large-cap stocks, has risen 0.5 percent.

On Wednesday, while the S&P 500 edged lower in a rocky session following Cohn's departure, the Russell gained 0.8 percent.

Small cap stocks are "domestic by nature; they're not selling internationally," said Ryan Detrick, senior market strategist at LPL Financial in Charlotte, North Carolina. "That they're insulated makes them potentially one group that will benefit on a relative basis."

The small-cap trade echoed the months after Trump's November 2016 election, when the Russell soundly beat the S&P 500 as investors bet on policies, such as corporate tax cuts, that would particularly benefit domestically-focused companies.

In 2017 overall, however, the Russell's 13 percent gain lagged the 19.4 percent climb for the S&P 500, and the small-cap barometer had underperformed this year, until Trump's tariff announcement last week.

"Somebody that's buying a U.S. small cap company that makes all its products in the U.S. is probably comfortable," said **Joe Saluzzi**, co-manager of trading at **Themis Trading** in Chatham, New Jersey. "You don't have a global situation there."

The S&P 500 derives about half its profits from outside the United States, according to Mark Luschini, chief investment strategist at Janney Montgomery Scott in Philadelphia.

Even so, he said, "there's merits in why you'd want to be diversified across small and large cap."

The Russell's outperformance "could easily dissipate if the bluntness of this trade policy is taken out," Luschini said. "You could get reversion pretty quickly."

While small caps appear to have benefited from the tariff talk, shares of companies that stand to see their costs rise have suffered.

The S&P 1500 machinery index .SPCOMMAC has fallen more than 1 percent since last week while the S&P 1500 automobiles and components index .SPCOMAU has shed over 2 percent.

By contrast, the S&P 1500 steel index .SPCOMSTEEL has climbed 5 percent in the past few days. (For a graphic of how stock indexes have reacted since Trump started talking about tariffs on aluminum and steel, see: reut.rs/2FkGUST)

Some investors stayed away from recommending any significant shifts in portfolio strategies based on the tariffs, as uncertainty remained about their extent and timing with a formal announcement still to come.

“We are not spending a lot of time trying to handicap industries or sectors just because we think there are too many moving parts,” said David Katz, chief investment officer at Matrix Asset Advisors in New York.

The risk from the tariffs themselves may be limited if there are no repercussions.

“Unless you have a 1950s portfolio of automakers, steelmakers and producers, you will probably not see much impact if you see the tariffs applied as they are being discussed,” said Jason Ware, chief investment officer with Albion Financial Group in Salt Lake City, Utah. “However, the big question is where does it go?”

Despite Cohn’s exit, some investors may be holding out hope the tariffs will fail to come to pass amid resistance from Republican lawmakers and other countries.

Trump looked set to authorize the tariffs this week as he stepped up pressure against China to develop a plan to reduce its trade imbalance with the United States by a billion dollars. However, stocks pared losses after the White House said late Wednesday that Canada and Mexico, and possibly other countries, may be exempted from the tariffs.

Indeed, an escalation into a trade war could reduce future growth expectations and equity valuations, according to UBS equity strategists, with investors saying the full risks of the tariffs had yet to be priced into the market.

The potential for tariffs also fed into concerns about rising inflation, one of the factors that set off the market’s recent 10 percent correction.

Even as stocks bounced back from that slide, they have found renewed volatility after months of relative calm, with the tariff developments and Cohn’s departure the latest news to spark swings and lead investors to question whether the decline is over.

The stock market tested major support levels “a few days ago and it was a good test: Half of the gains were wiped out and it bounced from there,” said Alan Lancz, president of investment advisory firm Alan B. Lancz & Associates in Toledo, Ohio. “We’re going to experience that again today and tomorrow. We’ll see what happens.”

Additional reporting by Megan Davies; editing by Tom Brown and Jonathan Oatis