Real Asset Winners and Losers in a Trade War

Recent tariff actions by the U.S. and threats of retaliations have put the world at greater risk of a global trade war than at any time since the 1930s. While we don’t expect it to get that far, tit-for-tat tariffs among the world’s largest economies could take a toll on global supply chains, consumers and risk appetite, driving further market volatility. We see the potential implications for real assets falling in two groups:

For real estate and infrastructure, we believe minimal direct impact on fundamentals, combined with a calmer interest-rate environment, should support better relative performance versus many other equity strategies.

For commodities and natural resource equities, the market may react poorly in the short term to the prospect of slower global growth—but with both asset classes experiencing a longer-term bull market in fundamentals, we believe this could ultimately create a buying opportunity.

What’s Happening?

On July 12, 2018, the U.S. announced tariffs on an additional $200bn worth of Chinese goods at a 10% rate—this after China responded in kind to previous U.S. tariffs on $50bn worth of goods, which went into effect at the beginning of July. At a time when President Trump has been ratcheting up trade pressure on U.S. allies, markets are starting to react to the rising prospect of global escalation. Here are the potential outcomes we see:

- Resolution: Trade negotiations are successful over the next 6 months, limiting the potential damage to the tariffs already implemented—**probability: low**
- Bilateral escalation: The U.S. goes through with its threat to impose additional tariffs in September/October; China responds with proportional tariffs and other trade measures—**probability: high**
- Global trade war: Trade discussions with Europe and other allies unsuccessful, prompting a breakdown in a range of global trade agreements—**probability: low but rising**

Key Tariff Actions in 2018

<table>
<thead>
<tr>
<th>US</th>
<th>China</th>
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<tr>
<td><strong>January 22</strong></td>
<td><strong>February 4</strong></td>
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<td>Tariffs on Chinese washing machines and solar cells</td>
<td>Investigates U.S. sorghum subsidies</td>
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<td><strong>March 9</strong></td>
<td><strong>March 23</strong></td>
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<td>Announces global tariffs on steel and aluminum</td>
<td>Responds with tariffs on $3bn of U.S. agricultural products and other goods</td>
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<td><strong>April 3</strong></td>
<td><strong>April 4</strong></td>
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<td>Targets $50bn in Chinese high-tech goods for tariffs to counter intellectual property theft</td>
<td>Says it will impose 25% tariff on 106 U.S. products, including soybeans, cars and planes</td>
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<td><strong>June 15</strong></td>
<td><strong>June 19</strong></td>
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<td>Moves forward with tariffs on $50bn in Chinese goods</td>
<td>Threatens tariffs on additional $200bn of Chinese goods</td>
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<td><strong>July 6</strong></td>
<td><strong>Late July</strong></td>
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<td>Tariffs on $34bn go into effect</td>
<td>Remaining $16bn goes into effect</td>
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<td><strong>Sept/Oct</strong></td>
<td><strong>Sept/Oct</strong></td>
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<td>Will decide whether to impose $200bn in China tariffs</td>
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Market Implications

- As long as the dispute remains mostly contained to the U.S. and China, we expect the economic impact on the two countries to be relatively small—though the market reaction could be large due to potential disruption in global supply chains, tighter margins resulting from higher input costs, and lower earnings multiples amid reduced investor confidence. Trade uncertainty could also interrupt corporate investment decisions, which has been integral in driving long-term earnings growth.

- The U.S. economy, which is largely domestic-focused, should remain a relative winner in a trade war. The worst would likely be felt by emerging markets, many of which are already facing stress due to China’s slower growth trajectory and tighter global financial conditions.

- A trade war would likely drive higher inflation globally, as trade today is dominated by intermediate goods used to create other products, so higher production costs could affect prices of a wide range of consumer and industrial goods. Historically, real assets have done well in periods of unexpected inflation, whereas broad stocks and bonds have generally lagged.

- We expect short-term U.S. interest rates to continue moving higher as the Federal Reserve responds to a strengthening U.S. economy and rising inflation risks. However, bond yields could remain capped in the near term as the market prices in the potential long-term consequences of higher trade barriers on growth.

Real Estate

Domestic focus could make REITs relative winners. Any slowdown in economic growth or employment could negatively affect demand for real estate. However, we believe REITs could fare better than other areas of the market if trade tensions intensify: 1) REITs get most of their revenues from properties within their home market, limiting the direct impact from tariffs. 2) Higher commodity prices would make construction more expensive, possibly slowing the pace of new supply. 3) Bond yields would likely come under pressure as investors shift to safe havens, potentially supporting REIT prices. This scenario would be occurring at a time when earnings multiples for REITs are already relatively compressed—not having benefited from the expansion in multiples seen in the broader market in recent years—and when there is a significant amount of private capital looking to buy real estate, which has led to an increase in REIT acquisitions this year as private investors have looked to acquire high-quality portfolios at a discount.

Retail and hotels most affected. Regional mall and shopping center REITs—which are already struggling due to retailer bankruptcies and lower sales productivity as more sales shift online—would likely be among the most affected by tariffs, as higher consumer prices could hurt retail spending, weakening retail tenants even more as they struggle to push through higher prices amid higher input costs. We would also expect hotels to underperform, as their rents, which reset daily, are generally the most sensitive to changes in the economy. Real estate in gateway cities (San Francisco, Seattle, New York, Boston) is generally more tied to global business and tourism, and could be more vulnerable.

Tech REITs likely less affected. Data centers and cell towers have little exposure to tariff effects, in our view, as they are driven primarily by the need for technology infrastructure to support the growing digital economy. Manufactured housing may also be relatively insulated, supported by a growing retirement population and a near total lack of new supply.

Country implications. We believe tariffs would likely have the most impact on real estate in open, trade-oriented economies such as Singapore and Hong Kong—both of which include companies with significant property holdings in China. Emerging markets could also be challenged, particularly in Asia, whereas Brazil is generally more affected by domestic politics and local economic conditions. We will be closely watching NAFTA(1) negotiations as they pertain to property markets in Canada and Mexico, although we believe the risk to Canada is relatively low.

Infrastructure & Midstream Energy

Defensive infrastructure characteristics could be beneficial. If trade tensions continue to drive heightened concerns about global growth, we believe infrastructure could perform well relative to broad equities amid greater investor risk aversion. Our analysis has shown that in down periods for global equities, infrastructure has historically experienced just 65% of the downside of the broader equity market, consistent with the asset class’s more defensive characteristics. Also, many infrastructure assets and businesses benefit from the ability to pass higher input costs along to customers, albeit typically with a lag.

Transport subsectors most vulnerable to tariffs. Slower global trade would likely have the biggest impact on transport sectors, particularly marine ports, where cash flows are directly influenced by trade volumes. Railways, airports and

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(1) North American Free Trade Agreement (2) At June 30, 2018. Source: Cohen & Steers. Data quoted represents past performance, which is no guarantee of future results. Analysis covers the period since inception of the Dow Jones Brookfield Global Infrastructure Index on July 14, 2008, relative to the MSCI World Index. See back page for index definitions and additional disclosures.
toll roads may also be affected, to a somewhat lesser degree. By contrast, utility and communications infrastructure would likely see minimal impact, given the local nature of their assets. Utilities, via regulatory processes, tend to have the most straightforward mechanisms for passing through higher input costs to customers over time, while the more commercial infrastructure businesses such as railways and tolls tend to have less formal pricing constructs.

**Midstream impact mixed, but likely minimal.** Trade tensions could negatively affect sentiment for midstream energy along with other equities, and there are some areas where tariffs could hurt on the margin, such as crude oil and natural gas liquids exports. However, we believe the direct impact on fundamentals would be minimal, even with the potential for increased volatility in oil prices (see Commodities, below). Importantly, we expect that liquefied natural gas (LNG) exported from the U.S. to China will likely remain tariff-free. LNG has been notably excluded from China’s tariff threats, as the country is working to shift power generation from coal to cleaner natural gas. We are also watching to see if higher steel prices begin to drive the cost of pipeline projects modestly higher—though historically, midstream companies have been able to pass higher input costs through to customers.

**Commodities**

**Short-term negative within a broader bull market trend.** Since mid-June, strengthening commodity fundamentals have largely taken a backseat to trade fears and related global growth concerns. However, our analysis indicates that outside of a few specific cases where tariffs have impacted (or will begin to impact) trade flow, commodity fundamentals haven’t changed. Barring a significant escalation into a global trade war, we expect the synchronized rebalancing of commodity supply and demand to continue, potentially driving prices generally higher for the broader commodity market over the next year.

**Oil prices could see volatility.** Though China has threatened tariffs on U.S. crude oil, no action has been taken to date. China represents 17% of U.S. crude exports, so we see this as an important area to monitor given the potential impact on the U.S. crude oil balance sheet. Globally, a broader trade war could cause oil demand to slow significantly and loosen the global crude balance sheet, which may put downward pressure on oil prices and potentially prompt OPEC(3) to reconsider its recent decision to increase production.

**Soybeans and pork among the biggest losers.** Agriculture commodities, which are produced largely in Republican-dominated states, have been the primary targets for retaliatory tariffs in an effort to exert political pressure on the Trump administration. Soybeans have been the hardest hit, as China is the world’s largest importer of soybeans (used in making animal feed and cooking oil), accounting for 54% of U.S. exports year to date. However, we believe China cannot fully eliminate the U.S. as a supplier, considering that alternative sources such as Brazil do not have the production capacity to meet China’s entire demand. Multiple rounds of tariffs on pork have also started to affect demand, with U.S. exports to China falling precipitously in May. Pork tariffs were also recently imposed by Mexico, the largest U.S. pork customer, which threatens to weaken demand for U.S. pork further.

**Natural Resource Equities**

**Negative trade implications amid positive backdrop.** We believe a trade war would be a headwind across resource equity sectors. However, even with recent tariffs, we continue to see a generally attractive fundamental environment, including a favorable supply-demand balance, disciplined capital spending and much improved company balance sheets.

**Mining and energy stocks stand to lose the most.** We would expect mining companies to underperform if escalating trade tensions led to slower growth in China and other emerging economies. Energy stocks would likely come under pressure amid softer demand for oil, driven by emerging market weakness, although a re-initiation of OPEC supply cuts and a continuation of production issues could soften the blow.

**Agribusiness should fare better.** Though lower crop prices could negatively affect farm equipment industries, they would likely benefit packaged foods companies, as lower production costs could help support margins. In addition, due to its more stable revenue characteristics, agribusiness has historically been less volatile than metals or energy, which could be a benefit in case of a worsening trade war.

For more insights on the investment strategies discussed here, visit cohenandsteers.com.
The Cohen & Steers Real Assets Strategies

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Futures Trading Is Volatile, Highly Leveraged and May Be Illiquid. Investments in commodity futures contracts and options on commodity futures contracts have a high degree of price variability and are subject to rapid and substantial price changes. Such investments could incur significant losses. There can be no assurance that the options strategy will be successful. The use of options on commodity futures contracts is to enhance risk-adjusted total returns. The use of options, however, may not provide any, or only partial, protection from market declines. The return performance of the commodity futures contracts may not parallel the performance of the commodities or indexes that serve as the basis for the options it buys or sells; this basis risk may reduce overall returns.

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