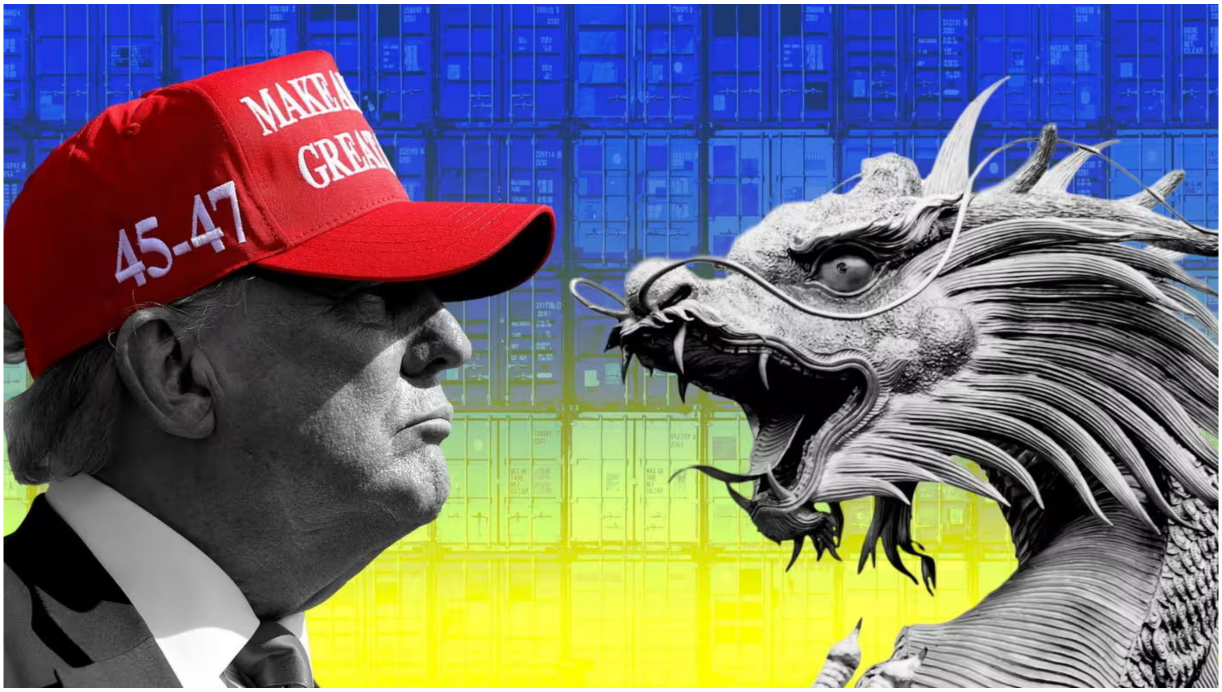
Opinion **Skin in the Game**

Stock investors needn't fear tariffs

Uncertainty around trade merely increases the equity risk premium

STUART KIRK



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Never read or post. That is my rule on social media. Always use primary sources. That is my rule when it comes to data and research for this column. When they clash — which frustratingly they have twice in as many months — the second rule trumps the first.

October saw me download TikTok to confirm whether indeed a song had gone viral about “looking for a man in finance”. What a cesspit of nonsense that app is. I pity the Chinese spies having to wade through it all day.

This week I’ve been forced to join Truth Social, as Donald Trump is using it to announce major policy initiatives. I wanted to see exactly what he wrote about tariffs on Monday that rattled markets so.

Have you ever read a full post by the president-elect? What I don’t understand is his random use of capital letters. For example, the words Crime, Drugs, Invasion and Caravan appear mid-sentence. As do Illegal Aliens and Open Border.

But "simmering problem" isn't capitalised, nor is "pay a very big price". Then I wondered if he was sending a secret message in caps. If you can decipher what MCCDCMOBEOMCTALLUSOBTDFAICMC means, do email our news desk.

What was clear, though, is tariffs were branded as threats rather than instruments of economic policy. In this case against Canada and Mexico for supposedly failing to stop humans and Fentanyl from "pouring" into "our Country!"

In a separate post Trump also tied an additional 10 per cent tariff on China specifically to drugs (small "d" this time). Hence it was surprising to me that currencies and stock prices took the news so seriously.

There was an immediate drop of 1 per cent in the Canadian dollar and Mexican peso versus the greenback. Asian equity markets were also weaker as were European bourses. Carmakers in particular needed their airbags.

By the end of the week, however, investors had moved on. Indeed, as I write the S&P 500 has racked up seven consecutive days of gains. Even the Nasdaq Golden Dragon China Index — heavy in tariff-vulnerable US companies with big China operations — is higher than it was last Friday.

Stuart Kirk's holdings, November 29 2024

	Assets under management (£)	Weighting	Total returns YTD
Vanguard FTSE 100 ETF	153,288	30%	11.3%
iShares MSCI EM Asia ETF	98,112	19.0%	13.6%
Vanguard FTSE Japan ETF	93,869	18.0%	9.6%
iShares $ Treasury 1-3 Years ETF	138,226	27.0%	4.1%
SPDR World Energy ETF	31,790	6.0%	9.2%
Cash	293	0.1%	-
Total	515,578		9.3%

S&P 500 (GBP)	28.0%
Morningstar GBP Allocation 60-80% Equity	10.0%
Any trades by Stuart Kirk will not take place within 30 days of being	

But the reason shares don't care about Trump waving his tariff club around like my two-year-old son has nothing to do with whether or not he is serious. Nor Christine Lagarde's advice on Thursday for Europe "not to retaliate but negotiate" on trade with the US.

It is because of the fundamental nature of equities and how the buyers of them are compensated for uncertainty. This so-called risk premium is why stocks outperform most other asset classes. The riskier the bet, the higher the return.

They are two sides of the same coin so cannot be separated. Trying to do so is silly. Proponents of environmental, social and governance-based investing, for example, keep failing to understand this.

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They argue on the one hand that picking stocks based on superior ESG scores makes sense because well-run companies are less risky. But they also claim these same companies should outperform over time.

Er, no. If they are less volatile their returns will be lower. The premium investors will demand to own them falls. I have written about the flip side to this before in relation to high-emitting stocks. They beat the index precisely because of transition risk.

The same is true with tariffs. If Trump and his latest nominees — Jamieson Greer for trade representative and Kevin Hassett for head of the National Economic Council — do ignite a trade war, equity risk premia rise and so too returns.

You don't need to be an academic to see that tariffs don't bother equity markets. Pull up any long-run chart you like. Likewise, China's stock market woes over the past few years have nothing to do with trade.

But if, like me, research papers make you tingle in a nice way, you could do worse than reading one from three years ago in the Journal of International Money and Finance by Marcelo Bianconi, Federico Esposito, and Marco Sammon.

In it they show that as well as affecting economic variables such as employment, trade and investment, uncertainty around tariffs also influences asset prices. Positively. Looking at the years between 1991 and 2001, as the US congress to and froed on revoking China's preferential tariff treatment, they found investors demanded an extra 3.6 to 6.2 per cent return as compensation when uncertainty increased.

Controlling for other factors, firms more exposed to possible tariffs experienced significantly higher stock returns than those less exposed, as defined by how global their businesses were as well as reliance on inputs from China specifically.

Any risk premium hypothesis also requires other explanations for outperformance to be discounted. The paper looked at the three most obvious ones: that changes in expected profitability and cashflows drove the differences in returns; that investors over- or -underestimated the effect of tariff uncertainty on stock prices; that trade worries were considered positive for some US firms as they discouraged Chinese imports.

None of these alternative explanations were supported by the data. Likewise, no premium was found when exactly the same analysis was run during years when trade regimes were stable.

Therefore the result is genuine. And it would have made good money by trading a portfolio made up of long positions in companies exposed to trade uncertainty, while shorting those which aren't. A similar approach based on ESG scores would probably work too — but try pitching that to Birkenstock-wearing Dutch trustees.

The point for newbie equity investors is that risk — from tariffs, wars, technology or otherwise — is not to be feared. If you can hack the volatility, you will be paid for taking it.

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