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Equity Strategy Insights

Investing in a Period of Heightened Trade Uncertainty

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Executive Summary

- In this report, we highlight some investing opportunities for the current environment of significant trade policy uncertainty, which we call phase one.
- We also identify some investments LPL Research believes may be well positioned after the tariff dust settles, or phase two.
- We believe consumer staples, real estate, and gold are well positioned for the current phase of uncertainty, phase one.
- For phase two, once trade policy is further clarified, communication services is well positioned for potential outperformance, in our view.
- Chances are good that consumer discretionary and technology, in the tariff crosshairs, may also outperform during this later phase, evidenced by the sectors' strong performance since the April 8 low after the 90-day pause on reciprocal tariffs was announced.

Looking Beyond the Tariff Horizon

It's difficult to make tactical asset allocation decisions right now because it's unclear where tariffs will end up, what trade deals will look like, how quickly global supply chains will shift, and what the eventual impact on margins might be. Given that uncertainty, we recommend investors maintain balance in portfolios, holding some relative tariff winners for the current period of uncertainty and some sectors hurt by tariffs that are well positioned to perform well after the trade dust settles. Here we highlight some sector opportunities for both environments.

Setting the Stage

Effective tactical asset allocation calls require either some visibility into the macroeconomic environment and earnings outlooks, or well-heeled technical analysis skills. We'll leave the technical analysis to our colleague and Chief Technical Strategist Adam Turnquist and focus more on the fundamentals here. On that score, we don't have much clarity at the moment.

Our base case is that the overall weighted average tariff rate will land between 10% and 15%, down from the proposed rate of over 20% currently that would kick in after the April 9 reprieve. After the 90-day reciprocal tariff pause, China's rate went up and the rest of the world's rate went down, leaving the overall rate at over 20% and still higher than the level prescribed by the Smoot-Hawley Tariff Act that exacerbated the Great Depression.

Lower tariff rates may take a number of months to achieve (90 trade deals in 90 days seems like a stretch), even though we do expect frameworks of deals to emerge within the next couple of weeks. That means earnings this year will likely be depressed. In last week's *Weekly Market Commentary*, we suggested a range of S&P 500 earnings per share (EPS) of $250 to $255 for this year, followed by $270 in 2026. Those numbers are down from prior estimates of $260 and $275, respectively, and well below the consensus currently sitting at $264 and $300.

Phase One Environment Reflects Significant Trade Uncertainty

To help us identify winners and losers in this environment, we break the rest of the year into two phases. The first phase is what we're in now. Call it peak uncertainty and peak tariffs. The second phase will start once several trade deals with large trading partners are announced and overall tariff rates begin to come down. In the first phase, the winners are the more defensive sectors relatively insulated from tariffs. In the second phase, the winners may be the sectors that benefit most from lower tariffs (and lower non-tariff trade barriers). One caveat is that some sectors that are hurt by tariffs, such as artificial intelligence (AI) semiconductors, present risks to national security and therefore may not get the boost from trade deals that they might otherwise get.

Phase One Winners: Real Estate and Utilities

During phase one, with elevated uncertainty and extremely high tariffs in the works after the 90-day reciprocal pause ends on July 9, it makes sense that the most defensive investments with the least amount of exposure to tariffs would perform well. Real estate and utilities fit that bill, given less discretionary and mostly domestic business models. Markets rewarded these sectors for their defensive characteristics this year through the April 8 market low with outperformance, but no equities have been completely immune to the selling pressure.

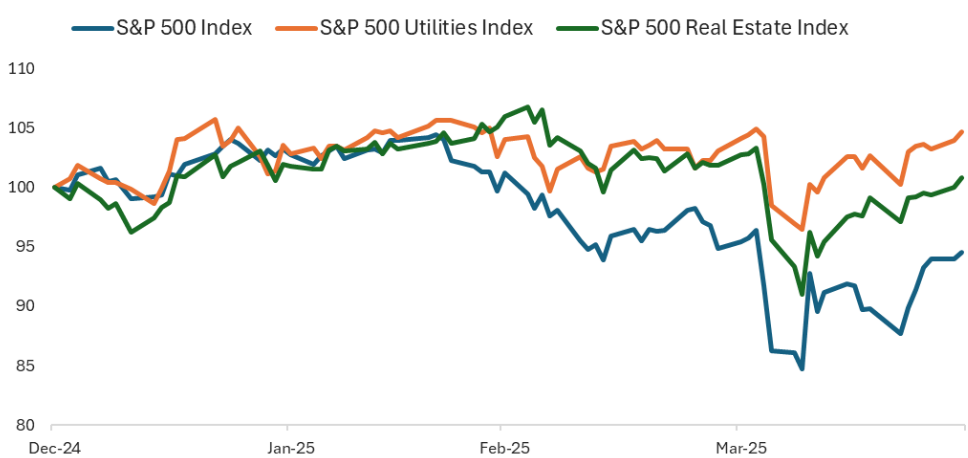
One challenge for these sectors is a potential increase in rates. They carry high debt levels and are used by investors for their dividends, which become relatively less attractive than fixed income at higher rates. Another challenge is a likely (continued) shift toward more cyclical sectors after trade deals start coming, which markets have been pricing in over the past couple of weeks. LPL Research's Strategic and Tactical Asset Allocation Committee (STAAC) reduced its suggested allocation to utilities this week to underweight for just this reason. Utilities are likely an underperformer on trade clarity.

Another risk for utilities during this uncertainty is regarding AI-related power demand. The AI power names, such as Vistra (VST), that were bid up in 2024 may struggle if analysts worry about reductions in AI power needs following China's AI advancements from DeepSeek and others. Strong AI investment guidance from big tech this earnings season was reassuring.

For real estate, challenges include: 1) pressure on retailers from tariffs, 2) work-from-home challenges for the office segment, 3) potential reductions in data center investment, and 4) sensitivity to a slowing U.S. economy.

Real Estate and Utilities Have Been Year-to-Date Winners

Buoyed by limited tariff exposure and relatively less economic sensitivity



Source: LPL Research, FactSet 04/29/25
All indexes are unmanaged and cannot be invested in directly. Past performance is no guarantee of future results.

Phase One Winner: Consumer Staples

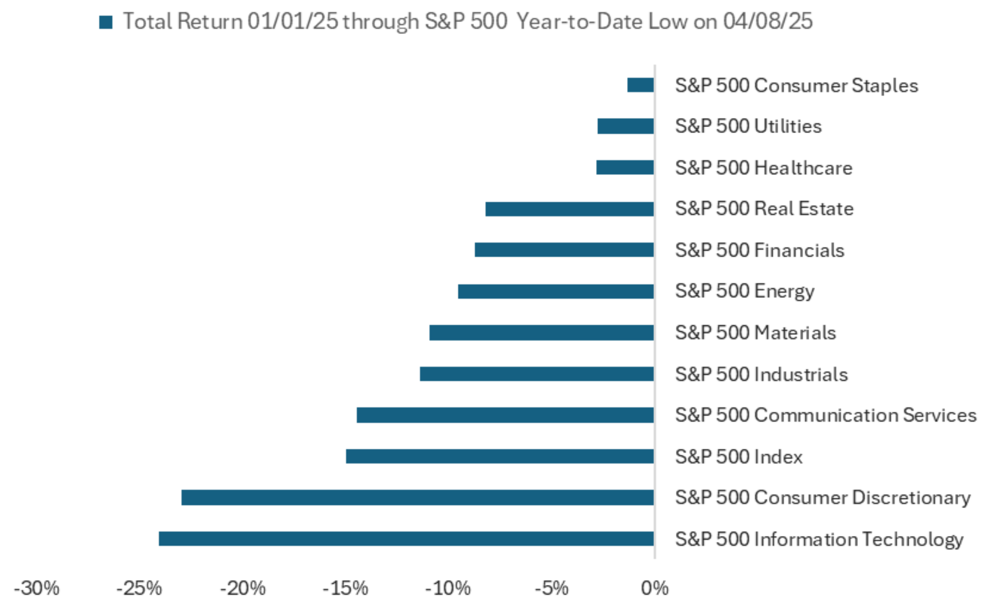
The tariff impact on consumer staples is mixed. On one hand, domestic packaged food companies are relatively insulated thanks to specialty crops (such as tomatoes, strawberries, avocados, and chocolate) falling within the United States-Mexico-Canada trade agreement (USMCA). This makes it less likely that grocers and other retailers with notable grocery operations will hike prices on perishable imports.

On the other hand, dollar stores and supercenters are not immune due to a reliance on goods from China and will be forced to raise prices or adjust supply chains after inventories are depleted. Empty shelves are a real risk. Imports of alcoholic beverages and spirits could also be a point of pain. Cumulative price increases, ongoing sticky inflation, and elevated consumer borrowing costs have already hurt volumes, and profits could face more downward pressure as consumers opt for cheaper, domestic alternatives to avoid higher priced items.

That said, given staples are more "needs" than "wants" and revenues typically hold up well in an economic slowdown, we'll put consumer staples in the phase one winner category. The sector also collectively sources fewer goods from outside the U.S. than most other sectors, including consumer discretionary, communication services, and technology (source: Bloomberg analysis). That favorable positioning for the current environment is supported by outperformance year-to-date through the April 8 market low.

Consumer Staples Held Up Well This Year Through the April Stock Market Low

Less economic sensitivity and relatively less tariff exposure helped boost the sector



Source: LPL Research, Bloomberg 04/29/25
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Phase One Winner: Gold

Gold is another winner during phase one. The commodity typically benefits from policy uncertainty. But, add a whiff of stagflation from tariffs and U.S. dollar weakness, alongside questioning of the U.S. exceptionalism theme and Federal Reserve (Fed) independence, and you had the ingredients for one of the biggest rallies ever in gold prices. Gold has reached extremely overbought levels, and markets did not demand hedges in late April, so it's not a high conviction overweight. But after a pullback, adding some gold exposure for those without it makes a lot of sense as a hedge against a potential central bank policy mistake and potential negative trade negotiations outcomes.

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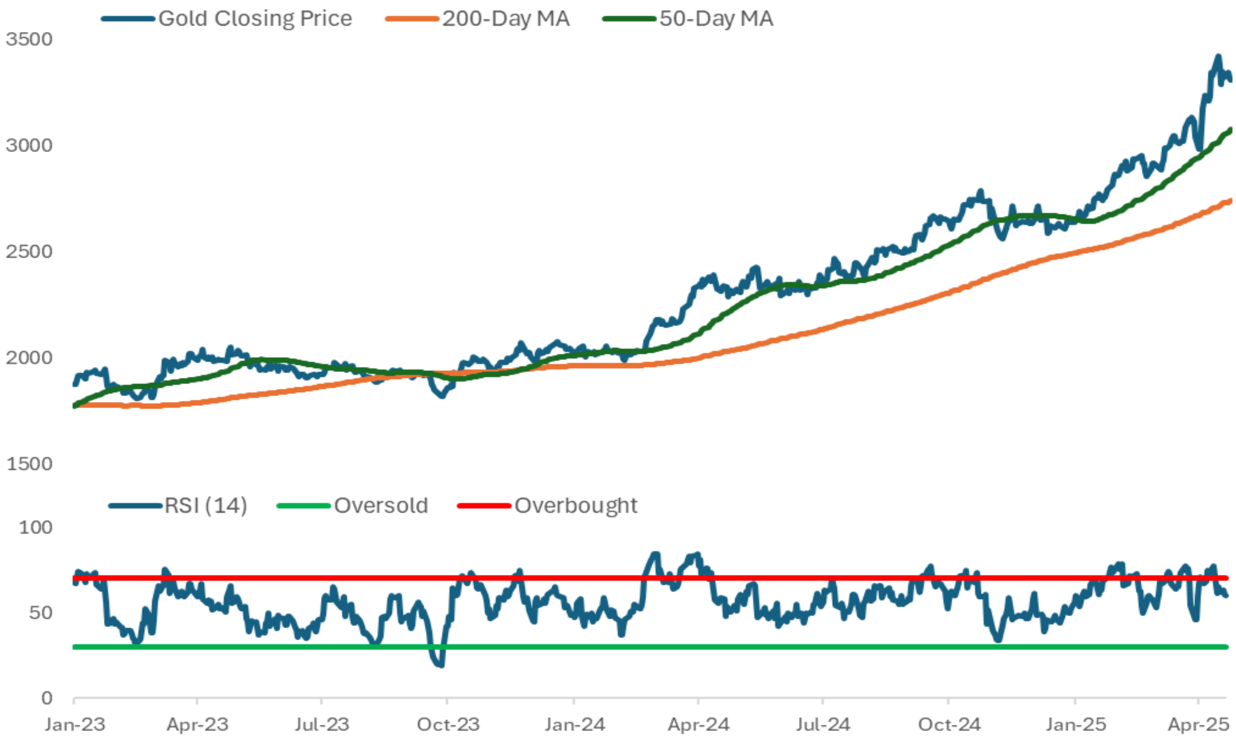
Gold Winning in the Current Environment but Working Off Overbought Conditions



Source: LPL Research, Bloomberg 04/29/25
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Other Ideas For Trade Uncertainty

It would be logical to put the defensive healthcare sector among the phase one winners, but pharmaceuticals are in the crosshairs of the Trump administration's trade policy. Sectoral tariffs could rattle the sector, pending successful country-level negotiations. Pharmaceuticals make up the bulk of the sector and are one of the most imported products for the U.S., though just 25% of U.S. drug imports come from top trading partners Canada, Mexico, and China (source: FDA).

On the manufacturing side, India has steadily gained share in the generic drug market. With annual operating expenses at roughly 37.5% of that in the U.S., India is poised to become a prime location for supply chain relocation from China and a trade deal framework is reportedly imminent.

On the medical equipment side, tariff exposure is relatively limited, with the most exposed companies generating 12% or less of their revenue in China and most manufacturing housed in the U.S., so that group may be a phase one winner.

Financials are another phase one winner because of the sector's limited exposure to goods imports, although cyclicality also makes it a potential winner in phase two. Higher replacement values may pressure insurers, and rates will likely have to keep rising in what would otherwise be a more defensive investment. LPL Research's STAAC upgraded financials to overweight in late April.

Phase One Winners: Real Estate, Utilities, Consumer Staples, and Gold

Honorable Mention: Medical Equipment Industry, Financials

Phase Two: After the Dust Settles

To identify potential winners in phase two — after trade deals are signed and tariff rates settle in — we start with the most global sectors that have been hit hardest during the tariff-driven sell-off and have the most to gain from lower tariffs. That leads us to the three biggest growth sectors: communication services, consumer discretionary, and technology.

Phase Two Winner: Communication Services

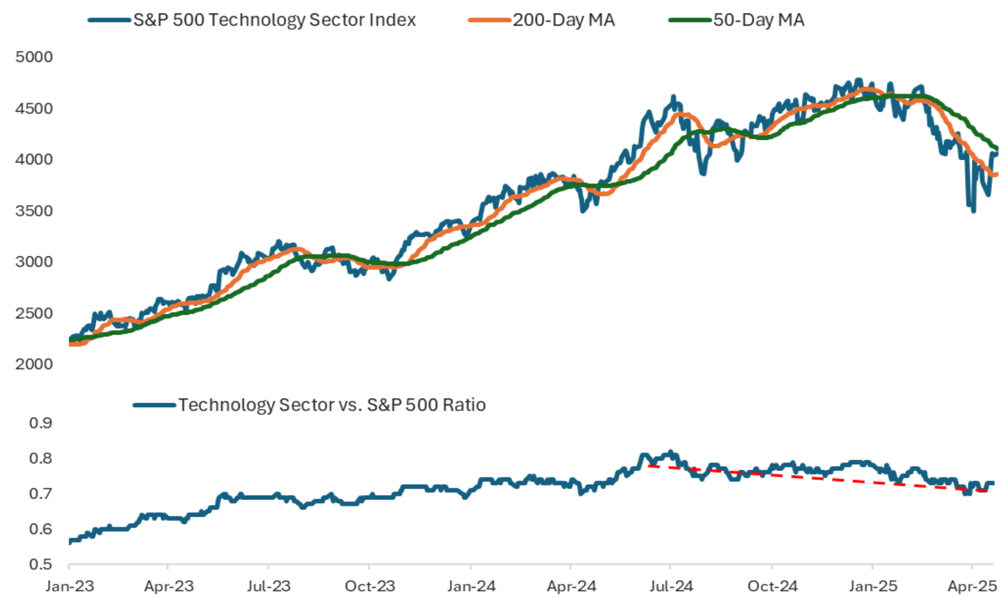
According to Bloomberg analysis, the communication services sector has the highest percentage of cost of goods sold sourced outside the U.S. among all S&P 500 sectors. Given the sector is still favored in our quantitative fundamental and technical work, we put it at the top of the list of sectors well positioned for phase two, and LPL Research maintains its overweight allocation to the sector. Solid first quarter results from Alphabet (GOOG/L), Meta (META), and Netflix (NFLX) supported this stance. The key risk, beyond regulatory pressures on the big internet companies, is that tariff rates don't come down as much as we anticipate, weighing on margins in this space, although the effects on the digital media segment of the sector are quite manageable.

Technology Faces Several Stiff Headwinds and a Mixed Technical Analysis Picture

Technology has been the best-performing sector since the April 8 low, suggesting it deserves consideration as a phase two winner. The sector could easily grow earnings 20% this year as AI investment continues, but our technical analysis work reveals a mixed picture. The sector has underperformed since July of 2024. We also worry about semiconductor industry disruptions from U.S.-China trade tensions, which have challenged NVIDIA (NVDA) performance lately. Software appears better positioned for this environment than semiconductors.

Meanwhile, Apple (AAPL) has significant China operations that will not be cheap or quick to move away from. We would not be surprised by technology outperformance during phase two, but our conviction level is low, and LPL Research maintains its neutral stance on the sector.

Mixed Technical Picture for Technology Despite Improving Tone on Trade



Source: LPL Research, Bloomberg 04/29/25

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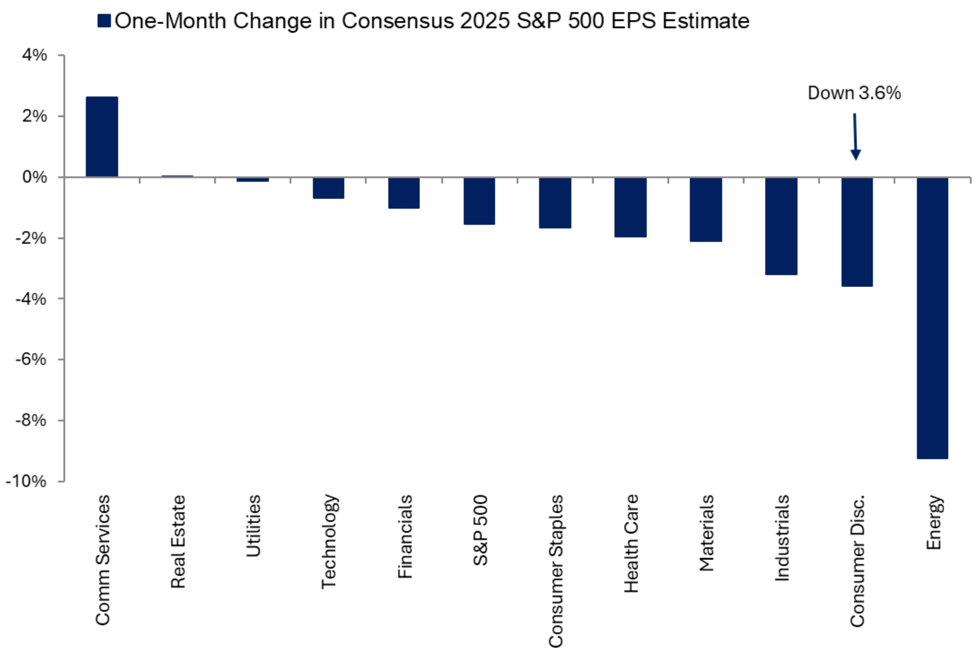
Consumer Discretionary One of Hardest Hit by Tariffs

Consumer discretionary (CD), home to apparel names, automakers, and homebuilders, is heavily impacted by tariffs, as evident from the sector's underperformance during this year's pre-April 9 market slide. Tariffs on apparel makers, autos, and home construction materials (primarily lumber) are particularly biting, while policy uncertainty has hurt consumer confidence and contributed to a slowdown in consumer spending. About half the sector's costs of goods sold are sourced from outside the U.S., which is high but less than technology. Earnings revisions reflect the challenges, as consensus earnings per share (EPS) estimates for the sector have been revised down more over the past month than any besides energy. Minimal earnings growth is anticipated for CD in 2025.

Consumer Discretionary Estimate Cuts Reflect Stiff Tariff Headwinds



Source: LPL Research, FactSet 04/29/25
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To sidestep the tariff hit, companies have halted Chinese shipments. Plus, some retailers have already expressed interest in rerouting Chinese supply to dodge direct exposure. The jury is still out on if or how much tariff relief China will receive, but duties will surely stay heavier than the rest of the world, which could force retailers to hike prices or shift production elsewhere once pre-tariff inventories are depleted.

While retailers dependent on China face the biggest headwinds, Trump's willingness to negotiate and some workaround options may ease the pain. Reports of progress in negotiations with other big trading partners (e.g., India, Japan, South Korea, and Thailand) are encouraging, as is Trump's recent softer tone on China. One silver lining is that some brands have reduced reliance on China since the 2018 tariffs under Trump 1.0, mitigating the impact today. Another potential positive is the hit to food import costs from Canada and Mexico for restaurants may be manageable under the coverage of the USMCA — for you Chipotle (CMG) fans, watch those guac prices.

For autos, additional costs are estimated to drive auto prices up between $6,000 and $10,000 per vehicle if all costs are passed on to consumers, according to Bloomberg analysis. The cost increase would hit demand and profits, and manufacturers may delay capital expenditure plans while contemplating expensive reshoring projects in a challenging economy with frequent policy shifts.

The Big Three have made some production changes following early-April implementation of auto tariffs, increasing output at some stateside plants and temporarily halting production at facilities in Mexico and Canada to mitigate tariff effects. But, parts are sourced around the globe and still face the 10% universal tariff (for now, a possible reprieve could be coming) and a max 25% levy on non-USMCA vehicles from Mexico and Canada. Steel and aluminum tariffs are not expected to be stacked on top of other auto tariffs. However, homebuilders — which also call the consumer discretionary sector home — will likely face headwinds as well given their reliance on imported lumber, steel, and other building materials.

Bottom line, as one of the sectors hit hardest by tariffs, it makes sense that consumer discretionary would benefit if those levies come down. But the uncertainty is still too high right now and a neutral stance seems prudent.

Industrials Crosscurrents

Industrials are a potential phase two winner given the significant international exposure, including to China, and the potential for clarity on trade policy to spark more capital investment. Like consumer discretionary, about half of the sector's cost of goods sold is sourced outside the U.S., leaving industrial companies with a lot to gain if tariffs come down. The sector is also a potentially appealing option due to near-shoring opportunities and investment in artificial intelligence infrastructure. Industrial companies can help move supply chains and establish manufacturing hubs in the U.S., though this takes a significant amount of time and isn't always economical due to labor supply constraints.

On the flip side, industrials face headwinds from the reconciliation bill that could claw back Inflation Reduction Act (IRA) spending to fund additional tax cuts. Industrial companies bring substantial exposure to the energy sector, and we know the Trump administration is directly targeting lower oil prices. Opportunities for industrial machinery makers to sell equipment to China are impaired by China's retaliatory tariffs. And transportation and logistics providers like FedEx (FDX) and UPS (UPS) are hurt by reductions in global trade.

These factors have been reflected in estimate reductions. Industrials' 2025 earnings estimates have been revised down by almost as much as consumer discretionary (-3.2%), making the sector less attractive from a valuation perspective.

Bottom line, we'll make industrials an honorable mention for phase two because of the opportunity in near-shoring and the potential benefit from easing trade barriers, but LPL Research has moved to a neutral stance on the sector to reflect these crosscurrents.

Phase Two Winner: Communication Services

Honorable Mention: Technology, Consumer Discretionary, Industrials

Conclusion

Trade policy uncertainty remains high, suggesting that, for now, it may make sense for investors to maintain ample exposure to some of the relative tariff winners such as consumer staples, real estate, and possibly gold, as well as to beneficiaries of eventual lower tariffs, such as communication services, and to a lesser extent, consumer discretionary, industrials, and technology. For now, while markets are still in this period of significant tariff uncertainty, maintaining a balanced exposure of relative tariff winners and losers while limiting dispersion from benchmarks seems prudent. LPL Research recommends tactical overweight allocations to the communication services and financials sectors, underweights to materials and utilities, and continues to favor precious metals within the commodities complex.

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The Standard & Poor's 500 Index (S&P500) is a capitalization-weighted index of 500 stocks designed to measure performance of the broad domestic economy through changes in the aggregate market value of 500 stocks representing all major industries.

The PE ratio (price-to-earnings ratio) is a measure of the price paid for a share relative to the annual net income or profit earned by the firm per share. It is a financial ratio used for valuation: a higher PE ratio means that investors are paying more for each unit of net income, so the stock is more expensive compared to one with lower PE ratio.

Earnings per share (EPS) is the portion of a company's profit allocated to each outstanding share of common stock. EPS serves as an indicator of a company's profitability. Earnings per share is generally considered to be the single most important variable in determining a share's price. It is also a major component used to calculate the price-to-earnings valuation ratio.

All index data from FactSet.

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