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COMPANIES FEATURE

5 Cheap Stocks to Ride Out the Trade War

By Jack Hough Updated May 20, 2019 / Original May 17, 2019

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After stocks tumbled on trade tensions this past week, Wall Street quickly offered more repositioning advice than a yoga class, with none of the relaxation.

Get defensive. No, defensive stocks look expensive. Avoid companies that import from China. No, buy them, as long as they have enough pricing power to pass along higher costs to customers. Reduce large-caps. No, look to them as havens.

The good news is that stocks recovered for the most part by week's end. The bad news is that if things keep going well, we might all need more repositioning.

Forget news-based portfolio management. Investors shopping for stocks are better off simply favoring cheap ones with decent long-term growth prospects than reacting to each new development on tariffs and other

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One tariff question worth considering is whether a full-blown trade war would tank the U.S. stock market. Not necessarily. The first round of tariffs that the Trump administration placed on $50 billion worth of Chinese imports last summer, along with China's retaliatory tariffs, will sap only about $1.50 a share from S&P 500 index earnings, calculate strategists at J.P. Morgan. That is presumably baked into Wall Street's estimate of $167 a share in earnings for this year.

The latest round, expanding tariffs to another $200 billion of goods, could raise the cost to about $5 a share, assuming China retaliates. And an all-out trade war could cost $9 a share. That means an S&P 500 that traded recently at 17 times this year's earnings would go for about 18 times earnings if trade talks fall apart—still attractive relative to ultralow yields on Treasurys. J.P. Morgan predicts that the S&P 500 will hit 3000 by year end, up 4% from here, as investors increase their stock exposure from cautious levels and companies continue to buy back stock.

EDITOR'S CHOICE

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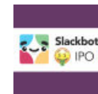
Slack Is Going Public as It Tries to Kill Email. The Stock Won't Be Cheap.

The United Technologies Merger With Raytheon Isn't Great for Shareholders. But Both Stocks Are Cheap.

For investors looking to put money to work, another question is whether cheapness is still a desirable attribute in stocks. Growth stocks have outperformed value stocks for so long that value investing appears broken. One reason is that the world has never seen companies so large growing so fast as now. Amazon.com (AMZN), whose $940 billion market value makes it the second-largest U.S. company behind Microsoft (MSFT), is expected to increase revenue 18% this year. Facebook (FB), No. 5, at $533 billion, is seen growing 24%.

Even so, the underperformance of value stocks has left them more attractive than usual, asset manager GMO noted in an analysis this week. By its math, value stocks in recent decades have traded at an average discount to the broad market of 24%, but now can be had at a discount of 31%.

MORE ABOUT THE TRADE WAR

We screened recently for sold-off stocks that, relative to earnings, are cheaper than both the market and their own five-year averages. Among these, we searched for companies whose growth opportunity appears brighter than gloomy valuations suggest.

Charles Schwab (SCHW) has sold off from a high of $60 a year ago to a recent $43 and change. That puts the stock at 15 times earnings, versus a five-year average of 22 times. Brian Yacktman, manager of the YCG Enhanced fund (YCGEX), which ranks near the top of its peer group for one-, three- and five-year performance, calls Schwab the Amazon of financial services. "They're a low-cost leader, which is great for gathering assets," he says.

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Rising interest rates last year had promised to expand profits for banks in general, but now the Federal Reserve has put rate increases on hold. The outlook is a bit more complicated for Schwab's bank, because it thrived when rates were near zero, and the company's brokerage and mutual fund customers were happy to leave balances at the bank for convenience. Rising rates had some customers shifting cash around to find higher yields, but that process appears to be winding down. Anyhow, the fine details of interest-rate sensitivity might miss the point. Schwab grew revenue 14% last quarter, to $2.7 billion, a 15th consecutive record. Wall Street expects years of healthy growth ahead. The stock had been prohibitively expensive until recently. No longer.

Handbag maker Tapestry (TPR), formerly Coach, has lost 30% in a year. It trades at 11 times earnings, versus an average of 17 times over the past five years. Yet UBS analyst Jay Sole predicts a rebound to 17 times. How's that? Investors view the company's Coach and Kate Spade brands as fading, but Sole sees signs that Coach is stabilizing and predicts that Kate Spade can become a $2 billion brand over time, up from $1.2 billion now. His outlook calls for 9% compounded earnings-per-share growth over the next five years.

If that seems too bullish, note that the consensus outlook implies a compounded growth rate of 8%. Handbags aren't the runaway hit they were a decade ago, but they're still growing. Tapestry stock comes accessorized with a 4.4% divided yield.

Tense Over Trade? Take Five.

Company/ Ticker	Recent Price	52-Wk Change	NTM P/E	5-Yr Avg P/E	Market Val (bil)
Applied Materials / AMAT	$42.70	-21%	12.3	13.6	$40.5
BorgWarner / BWA	36.26	-31	8.4	12.1	7.5
Charles Schwab / SCHW	43.21	-27	15.2	22.1	58.1
Regeneron Pharmaceuticals / REGN	304.94	-1	13.6	27.5	33.4
Tapestry / TPR	30.78	-31	11.0	17.0	8.9

NTM=Next 12 months

Source: FactSet

Investors who have forgotten what it looks like when hot growth stocks turn into value stocks can look at Regeneron Pharmaceuticals (REGN) for a

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and Novartis (NVS) aims to introduce a rival as soon as later this year. If it succeeds, Regeneron could be forced to discount.

Regeneron is playing offense by working to expand uses and delivery methods for Eylea, while growing another drug, Dupixent, beyond inflammatory diseases such as eczema to new ones like asthma. Longer term, Regeneron hopes to make a push with cancer drugs now in trials. The consensus view is that, net of pluses and minuses, earnings per share will grow by 5% a year compounded over the next five years. Some analysts see much faster growth, and others, declines. The stock, which briefly topped $600 in 2015, recently sold for $305, even though earnings per share nearly doubled over that stretch. That means shares can be had for 11 times earnings—about the cheapest they have ever been.

Global auto production fell 7% during the first quarter, which is hardly a reason to get excited about BorgWarner (BWA)—especially because it has sales exposure to China. But if you're looking for reasons, here are three. First, the company has a favorable product mix of things like turbochargers, which can add power to small combustion engines, allowing car makers to boost efficiency, and systems used in hybrid and electric cars, which are expected to gain market share over time. So notwithstanding the current downturn, earnings per share could grow at a high-single digit yearly rate, on average, over the next five years. Second, the shares go for a scant eight times forward earnings estimates.

The third reason is that the recent auto downturn looks a lot like what happens during a typical recession. Why is that a positive? "Underlying results from auto suppliers fared better than what we believe many investors have come to expect for this group when the next 'true' recession arrives," Baird Equity Research analyst David Leiker wrote in a note to investors this past week. Indeed, Borg's earnings per share are expected to dip just 6% this year. If that's what hard times look like, the shares could deserve a higher valuation.

Chip chiefs like to say the industry is no longer as cyclical as it once was, and they have a point. The industry would thrive and crash with personal-computer demand. Now, silicon proliferation everywhere means that a lull in, say, cars, can be offset by a surge in smartphones. But the past year shows that less-cyclical isn't the same as not cyclical. A glut of memory, for example, has cratered prices, forcing manufacturers to slash output. That is hurting equipment makers like Applied Materials (AMAT), but also creating an

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The stock sells for 12 times forward earnings projections, down from a five-year average of close to 14. Applied is expected to take a 31% hit to earnings per share in its fiscal year ending in October, but to begin recovering thereafter. Expectations are low enough that the stock rose 2.5% during a market decline on Friday after Applied reported second-quarter financial results on Thursday evening. The company isn't calling a bottom in end markets like chips or displays, but B. Riley analyst Craig Ellis wrote on Friday that he sees signs of stabilization in both. He upgraded the stock to Buy from Neutral, with a price target of $54, implying more than 25% upside.

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