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Investment **News**

Trade war: plenty of barking and little action so far

Has Trump destroyed the “Goldilocks scenario”?

In recent years, an environment with moderate growth, low interest rates and subdued inflation has created an ideal basis for rising share prices and persistently low bond yields. It is quite possible that by lowering U.S. taxes, President Donald Trump has destroyed this perfect “Goldilocks scenario” by triggering an additional growth spurt at a time when the US economy is already in full swing.

Not too hot and not too cold

In the fairytale ‘Goldilocks and the Three Bears’, the eponymous heroine wants porridge that is neither too hot nor too cold. Similarly, investors in the international capital markets seem to prefer an economic environment that is neither running too hot nor cooling so much that the threat of recession looms. The last few years have been characterised by this kind of “Goldilocks scenario” with moderate growth, low inflation and low nominal and real interest rates – an ideal environment for bullish equity markets.

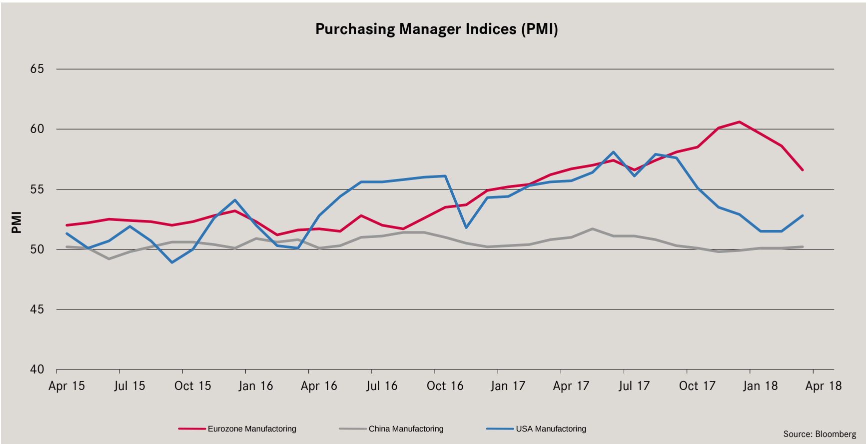
Tax boost at exactly the wrong time

US tax reforms are expected to provide additional growth stimulus even though increased profits are primarily being used for share repurchase programmes, at a time when capacities are being utilized and the labour market is at full employment. As government spending is also being massively increased, particularly in the military, the US budget deficit is soaring. Providing this additional economic stimulus at the wrong time carries the risk that increasing labour costs will reignite inflation and that higher interest rates will trigger a boom-and-bust cycle. Some observers believe there is a risk that the US economy will tend towards weakness just as the next election approaches in 2020 and that Trump could thereby end up digging his own grave.

The notorious twin deficits

In recent years, US government debt has risen sharply when measured against gross national product and could become significantly larger over the next few years. This means that Americans will live beyond their means in the coming years, with a larger part of their debt being financed from abroad. Consequently, the “wicked” Chinese, Japanese and Germans are not the only ones leading the Americans towards reduction with regards to their export surpluses. Instead, the fundamental causes of the trade deficit are the excessively low savings rate and rising public and private debt, a development that could be observed even before the financial crisis and one that is moving in the wrong direction once more after a period of consolidation.
As a result of the tax cuts and rising government spending, estimates suggest that the USA will have to refinance government bonds totalling more than USD 1,200 billion this year after around USD 400 billion last year – just at a time when the US Federal Reserve is preparing to significantly reduce the amount of treasuries it holds.

Trade war primarily creating losers



The trade dispute President Trump has triggered with plenty of noisy rhetoric and the threat of massive tariff increases has created widespread uncertainty among investors and shareholders. However, it appears that talk of an actual trade war is still premature. The trade policy adjustments negotiated with individual countries at lightning speed also raise the question of whether they will have any impact at all. For example, increased export quotas for US automotive exports to South Korea serve as little more than a paper tiger as long as US cars remain non-sellers among South Koreans. It is becoming increasingly clear that the wrath of the US President is primarily directed at the Chinese, who generate an annual bilateral trade surplus of around USD 350 billion with the USA. The primary focus on trade flows associated with intellectual property and technology transfer and thus particularly involves chip producers. Now, however, the Chinese themselves hold several good cards with which to take effective countermeasures in a full-blown trade dispute. Companies such as Apple not only have some of their products and components manufactured in China but also sell a significant share of their smartphones in the Middle Kingdom. There are doubts about whether it is worth destroying the established value chains of international companies with a trade dispute for the sake of an uncertain outcome.
It very much appears as if the sorcerer’s apprentice in the US presidential office is preparing to seriously jeopardise the Goldilocks scenario on the global markets with a series of kneejerk measures motivated by economic policy. This increases the risk that inflation and interest rates will rise significantly and sow the seed of an imminent economic slowdown. After all, investors in the equity and bond markets do not seem to like things too hot or too cold.

Prof. Markus Ruffner

Global upturn continues

Leading economic indicators point to a continuation of the largely synchronised global growth in 2018. As a result, the global economy is expected to grow by almost 3.5% this year. However, some economic figures suggest that there is a limit to this expansion. This even applies to the **USA**, where tax reform was expected to provide an additional boost. While consumer spending dropped slightly here in January and remained constant in February, massive expansion in the US budget deficit at the end of a long phase of growth increased the risk that a boom-and-bust cycling would be triggered in the USA. In particular, increased inflation risk due to utilised capacity and depreciation of the dollar could prompt the US Federal Reserve to tighten the reins (too far?), resulting in a clear growth slowdown in the second half of 2019 or 2020. We expect the USA to record growth of 2.7% in 2018 with core inflation at around 2%.

After an extremely positive performance from the economy in **European countries** in 2017, the PMI Eurozone Index (which measures sentiment among purchasing managers) weakened significantly in the last few months compared to its previous highs. The latest figures show that the strong appreciation of the euro, particularly against the US dollar, caused an economic slowdown, even though signs are still pointing towards expansion. It is particularly pleasing that unemployment figures in the EU are continuing to fall, with a shortage of qualified labour even emerging in some sectors in Germany. Overall, we anticipate growth of 2.3% for the eurozone, with inflation below the 2% target.

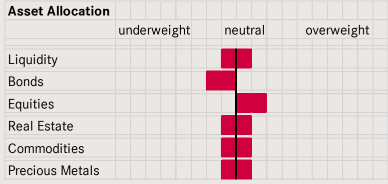
In Italy, eurosceptic parties clearly gained the upper hand in the recent parliamentary elections, albeit without any major effects on the markets so far. If these parties implement their extremely free-spending campaign pledges, this could have a destabilising effect on the euro.

A slight economic slowdown is also apparent in **Japan**, where the currency has appreciated even more strongly against the dollar than the euro.

The economy is expected to remain stable in almost all **emerging markets**. **China** continues to surprise with growth rates of almost 7%, particularly due to massive investments aimed at reducing pollution. Despite leading indicators surprising on the upside – the March Manufacturing PMI amounted to 51.5% and the Non-Manufacturing PMI 54.6% – the overheated real estate market and high indebtedness in this segment is likely to slightly weaken growth in the second half of the year. Strong consumption growth is being observed in most emerging markets thanks to rising wages. Strongly export-oriented emerging and developing countries are also benefiting from the weak dollar and higher commodity prices. This is particularly true of **Brazil** and **Russia**, which are showing clear signs of economic recovery after years of recession.

Prof. Markus Ruffner

Strategy



Investors should be significantly underweight in **bonds** in an environment of sustained economic momentum and the ending of ultra-expansive monetary policy. Given the appropriate diversification, preference should continue to be given to corporate bonds with short- to medium-term maturities.

After the latest share price declines, **equities** are around their historic averages thanks also to a further increase in profits. Although – or even because – US equities performed better in the recent past, we believe the shares of Japanese and European companies, as well as those from emerging markets, have higher potential. We see modest recovery potential towards the end of the year.

Real estate entails a certain consolidation risk due to increasing yields. For example, commercial real estate prices also appear to be vulnerable in Switzerland amid rising vacancy rates. In countries such as Germany, there is already some pent-up demand in residential construction.

Commodities: Price-setting producers both inside and outside OPEC have an interest in maintaining the present price level.

Precious metals: We regard gold and silver mainly as hedges against global political risks.

	Real GDP growth			Inflation			Output gap	Deficit	Debt	CDS spread	Real interest rates
			in %			in %	in %	in% GDP	in% GDP	in bp	in %
	2017	2018E	2019E	2017	2018E	2019E		2018	2018		
United States	2.2	2.8	2.4	2.1	2.3	2.2	-1.10	-3.4	77.4	27.51	0.56
Eurozone	2.2	2.5	2	1.5	1.5	1.5	0.01	-1.5	n/a	n/a	n/a
Germany	2.4	2.5	2.1	1.7	1.7	1.8	-0.10	0.8	65.7	11.62	-1.14
France	1.8	2.2	1.9	1.1	1.5	1.4	0.27	-3.4	96.1	19.08	-0.70
Italy	1.5	1.5	1.3	1.4	1.1	1.4	-4.13	-2.5	131.2	104.22	0.80
United Kingdom	1.5	1.5	1.5	2.7	2.6	2.2	-3.32	-2.9	90.4	19.31	-1.11
Switzerland	0.9	2	1.9	0.5	0.6	0.9	-2.71	0,441	32.9	13.32	-0.55
Japan	1.5	1.4	1.1	0.5	1	1.3	-1.59	-4.98	223.8	19.98	-0.97
China	6.8	6.6	6.4	1.6	2.3	2.4	n/a	-3.72	18.6	64.49	1.47
India	6.5	7.2	7.6	3.4	4.8	4.7	n/a	-3.67	50.1	75.13	2.76
Russia	1.9	1.8	1.8	3.8	3.3	3.9	n/a	0.80	11.8	118.38	3.70
Brazil	0.7	2.6	2.8	3.4	3.5	4.1	n/a	-7.49	78.4	163.51	1.45

Sources: Capital Economics, Roubini Global Economics, UBS, Bloomberg, Goldman Sachs, IMF, Economist, NPB Neue Privat Bank

Equity markets – fundamental valuations (performance in local currencies)

	Performance Equities (in %) YTD	Price/ book value	P/E ratio Current	P/E ratio 2018E	Dividend yield 2018E	Index
United States	-1.82	3.21	21.17	15.22	2.20	S&P 500
Germany	-5.25	1.71	13.91	11.68	3.51	DAX
France	-1.06	1.50	16.33	13.30	3.62	CAC 40
Italy	5.39	1.23	38.80	11.31	4.26	FTSE MIB
United Kingdom	-6.83	1.75	13.27	12.78	4.59	FTSE 100
Switzerland	-7.51	2.32	28.91	13.79	3.95	SMI
Japan	-4.77	1.74	15.91	13.89	2.14	NIKKEI
China	1.04	1.40	12.69	10.55	3.78	Hang Seng
India	-1.44	3.13	22.43	14.71	1.83	Nifty
Russia	1.17	0.75	6.94	5.66	n/a	RTS
Brazil	10.25	1.92	21.21	11.44	4.03	BOVESPA

Source: Bloomberg 09/04/2018

Turbulence despite rising profits

After a good start to the new year, investors in the equity markets were suddenly confronted with steep price declines and strong increases in volatility. By the end of the first quarter, only a few markets were still performing positively, with Brazilian and Russian equities helping to ensure that the emerging market equities outperformed those of developed markets. Together with British equities, the biggest losers so far this year include German and Swiss stocks in particular, which are also suffering as a result of the devaluation of the dollar. This price turbulence was initially caused by the sharp rise in yields on US government bonds, followed by fears of a trade war between the USA and China. The careless use of personal data gathered by Facebook and the US President's feud with Amazon founder Jeff Bezos (including the allegation that US Post makes a loss on every package it delivers for Amazon) have also impacted US technology stocks that have performed strongly to date. Generally speaking, the various economic and political uncertainties have caused investors to become more risk-averse, take profits and move into less risky investments.

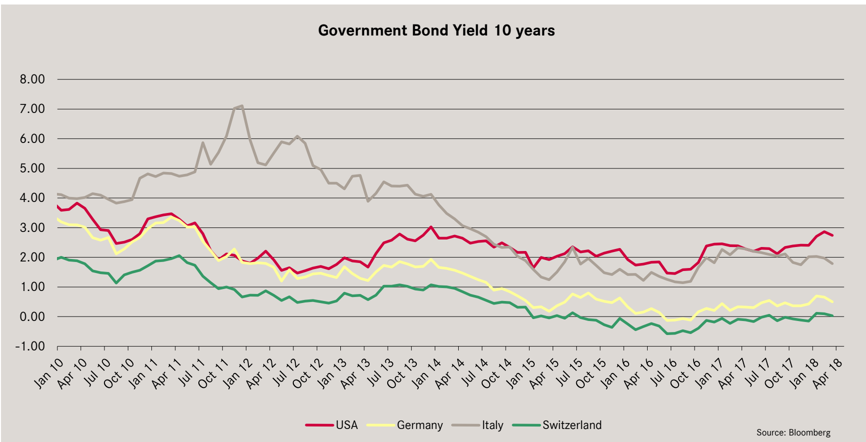
In one sense, the significant price losses contrast with encouraging profit expectations for both the American and Japanese equity markets, where profit rises of 18% and 10% respectively are anticipated over the next 12 months. This positive fundamental performance is countered by the aforementioned risk that the ideal Goldilocks environment will be replaced by one with rising inflation and higher (real) interest rates and that there may only be a few winners in the event that tensions in trade relations expand.

Nevertheless, it is apparent from the perspective of conventional valuation criteria (price-to-earnings ratio, price/book value, price/cash flow, dividend yield) that most equity markets will not be fundamentally overvalued after these corrections and will instead be close to their long-term averages. Among the outliers are the US market, which is still highly valued by historical standards with a PE ratio of 16x, while Russian equities, for example, are clearly undervalued on a historical basis with a PE ratio of around 6x.

In light of this, we expect markets to remain volatile in the coming months, with further declines not ruled out. Looking towards the end of 2018, we assume that the equity markets could live with further marginal increases in bond yields. Even amid tensions in international trade relations, there are legitimate expectations that, despite the sensational rhetoric, solutions can be found behind the scenes that will allow all parties to save face without fundamentally destroying the complex value chains of international companies. As a result, there are justified hopes that we will see another recovery in share prices in the course of the year.

End of ultra-expansive monetary policy

The first quarter of 2018 was characterised by a significant rise in bond yields. The dollar experienced the strongest yield increase as a result of the strong expansion of the budget deficit and the simultaneous reduction in demand for US government bonds by the Federal Reserve. Due to recent turbulence in the equity markets and looming tensions in foreign trade relations, demand for secure investments such as government bonds has risen once again, with the yield on 10-year treasuries levelling out at around 2.75% after a high of almost 3%. At the same time, the yield curve on dollar bonds with 2 to 30-year rates has flattened considerably. In light of three further interest rate hikes anticipated from the Fed in 2018, we expect yields on dollar bonds to continue rising slightly. While real yields on the dollar have now moved back into positive territory, euro yields remain extremely negative (-0.9% for ten-year bonds and -0.4% for five-year bonds). This kind of level cannot be sustained and will normalise by the time the European Central Bank attempts its first interest rate hike in 2019.



Although the strong economy has given the ECB increased scope, the appreciation of the euro against the dollar sounds a note of caution, as higher interest rates will further enhance the appeal of the euro. While government bonds continue to offer a certain amount of downside potential, it seems reasonable to focus on short-dated government bonds to come through this phase of rising yields reasonably unscathed.

Prof. Markus Ruffner

Trends & Forecasts

April 2018

Short-term interest rates (money market 3-month Libor)

We anticipate three more rate hikes by the Federal Reserve by December 2018. The ECB will cautiously cut back its expansionary monetary policy so as not to impose additional burdens on the southern countries.

	End of 2017	Latest	YTD %	12 months
CHF	-0.7462	-0.7374	-1.18%	-0.70
EUR	-0.3847	-0.3893	1.19%	-0.10
USD	1.6943	2.2481	32.69%	2.30
JPY	-0.0242	-0.0498	106.16%	0.20

Long-term interest rates (10-year government bonds)

The more restrictive monetary policy and expansion of US debt triggered by tax reforms mean the USA in particular is expected to generate higher yields (3.2% for ten-year bonds).

	End of 2017	Latest	YTD %	12 months
CHF	-0.18	-0.01	-95.19%	0.20
EUR/GER	0.42	0.52	23.21%	0.70
USD	2.41	2.83	17.50%	3.20
JPY	0.04	0.04	-8.15%	0.20

Equity markets

We expect the upside potential to be greater in Europe than in the United States over the next 12 months. Japanese equities should also continue to benefit from expansionary monetary policy and moderate valuations. Small and mid-cap companies in Asia are still fundamentally cheap. Given the various economic and political risks, the potential for (temporary) setbacks has become greater.

	End of 2017	Latest	YTD %	12 months
United States	2,673.61	2,669.46	-0.16%	2700
Germany	12,917.64	12,305.19	-4.74%	12,700
France	5,312.56	5,276.67	-0.68%	5500
Italy	21,853.34	22,969.50	5.11%	25,000
United Kingdom	7,687.77	7,199.50	-6.35%	7300
Switzerland	9,381.87	8,742.60	-6.81%	9100
Japan	22,764.94	21,645.42	-4.92%	23,000
China	29,919.15	29,518.69	-1.34%	32000
India	10,530.70	10,325.15	-1.95%	10900
Russia	13,672.33	15,089.43	10.36%	17000
Brazil	76,402.08	85,722.37	12.20%	90000

Oil and gold

Given the strong expansion in gas and oil production in the United States, we see little or no room for rising oil prices despite OPEC's cuts in production. We consider an investment in gold to be a sensible hedge against different types of global (political) risks.

	End of 2017	Latest	YTD %	12 months
Crude oil (WTI)	60.27	63.78	5.82%	60
Gold	1302.80	1325.77	1.76%	1370

Exchange rates

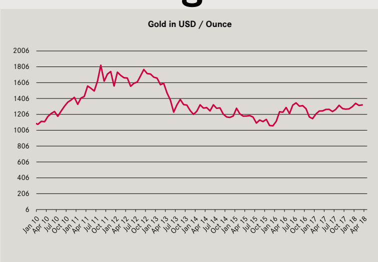
Despite the widening interest rate spread between the USD and euro, we do not expect the structurally weak dollar to appreciate.

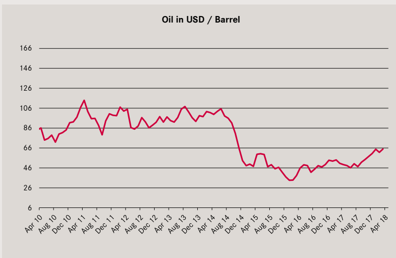
	End of 2017	Latest	YTD %	12 months
EUR/CHF	1.1703	1.1781	0.67%	1.19
USD/CHF	0.9743	0.9626	-1.20%	0.97
EUR/USD	1.2005	1.2239	1.95%	1.23
EUR/JPY	135.2800	131.4600	-2.82%	130

Source: **Bloomberg 06/04/2018**

Prof. Markus Ruffner

Interesting Charts





Source: Bloomberg

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