NPB Neue Privat Bank

Investment **News**

'Lost' manufacturing plants are not returning to the United States

Trade war with China: few winners – many losers

After the United States increased tariffs on Chinese imports to the value of USD 34 billion, the Chinese immediately followed suit with tariff rises for 800 US products. The risk that the trade war will spread is high, because neither party can end this 'tit for tat' game without losing face. Even if China may have more to lose in the first round, Trump will hardly succeed in bringing 'lost' jobs in industry back to the United States.

Easy to win?

A look at the trade statistics seems to confirm Trump's propaganda slogan that a trade war with China ***is easy to win***. Last year's Chinese exports to the US of USD 505 billion compare with USD 130 billion in the other direction. China - according to the obvious conclusion - has therefore only about one-quarter of the American 'ammunition' to extend tariff increases to further imports, if the US for its part hits more goods exports from China with higher tariffs in a fully-fledged trade war.

The calculation by US trade strategists in a 'tit for tat' dispute should probably not be so simple: according to Deutsche Bank, US subsidiaries in China sell products and services to the value of about USD 280 billion. The ruling powers in Beijing can make life difficult for US branches through government-inspired boycotts, as they have already done in previous trade wars with Japan and Korea. A further defensive measure is a devaluation of the Chinese currency, making US imports more expensive and Chinese goods cheaper. China would have to ensure that such a depreciation did not get out of hand and lead to uncontrolled currency outflows. As a final measure, as it were, the Chinese as the largest holder of US government bonds could sell off US debt securities to a greater extent – just when the American government has a significantly widening deficit and the central bank is scaling back its purchases. Rapidly rising yields and a recession would result. China would not take such a measure lightly and would first try to counter Trump politically with targeted tariff increases on price-sensitive agricultural goods (particularly soya). These affect US farmers, who are among Trump's most loyal voter base.

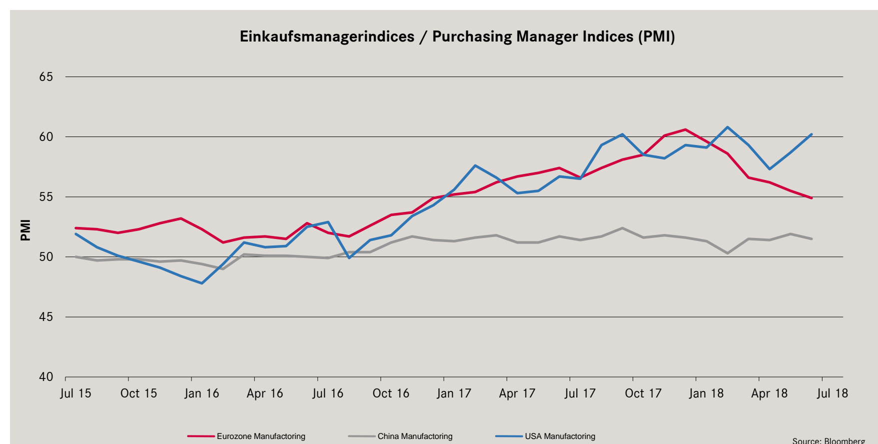
Hands of time cannot be turned back

America has actually lost millions of industrial jobs to Asia and above all China from the turn of the century. Chinese exports to the United States have therefore increased by an exorbitant 640% (!) over the last 20 years. American firms such as Apple, which mainly have components produced for their products in Asia, have also contributed significantly to this. As Trump himself always emphasises, with a sideswipe to his predecessor, he is very late with his disciplinarian strategy if he wants to bring back part of production and the associated jobs to the US. Whether or not it pleases the West, the Chinese have managed in recent decades to build modern industrial plants, which may like the cutting-edge aluminium plants, for example, be more efficient than the sometimes ageing production facilities in the old industrialised countries. With its targeted technology transfer policy, China has caught up with the West in many areas to become a serious competitor in know-how for some sectors today, as can be seen in spite of Tesla in electric car manufacturing. Higher tariffs alone cannot turn back the hands of time. Such a policy also risks 'destroying' highly complex and established global supply chains with unforeseeable cost impacts. Chinese companies can also get around the tariffs aimed solely at China by outsourcing production plants to other countries in Asia.

USA as second-round loser

If you go by the markets' reaction, America has clearly won the first round of the trade war, as equity prices on domestic Chinese markets have fallen much more than the US market. Thanks to the fiscal stimulus, the US economy looks stronger, whereas Beijing is fighting flattening economic growth. Although China must pay a not inconsiderable price in the form of a palpable growth slowdown in the short term, the country will try to strengthen its relations with other economic areas in the medium and long term. There seems a low probability that global firms will transfer their investments on a large scale to the US because of Trump's tenure of 4 or 8 years. It may be just as unlikely that the US succeeds in sustainably lowering its foreign trade deficit. The price for a bit of a tailwind for the Midterm elections of this autumn looks very high from this perspective.

Prof. Markus Ruffner



USA top – Europa flop?

The global purchasing managers' index (PMI) compiled by JP Morgan, at a value of 53.0 (where over 50 means an improvement in the business situation), points to continuing stable global growth. Looking at individual economic regions, there is a contrasting picture of a US economy going full steam ahead and growth slowdown in other regions such as Europe. The PMI for the USA rose from 58.7 to 60.2 in June, whereas in Europe it fell from 55.5 to 54.9. The growth upturn in the **USA** can be primarily explained by the extra stimulus that was triggered by massive tax cuts and an increase in government spending. Nonetheless, contrary to textbook theory, ***wage costs*** with record-low unemployment are only rising moderately and core inflation (excluding food and energy prices) is oscillating roughly around the US central bank's target corridor of 2%.

The slight weakening of economic growth in **European countries** should not be overanalysed. It may be at least partly explained by the soaring euro in the first quarter, which was only a temporary phenomenon. For example, ***industrial production*** in Germany in May was much stronger than expected, at 2.6%. The effect of the trade war masterminded by the United States has therefore not yet fully unfolded statistically in Europe.

Political developments in Italy have also hardly acted as a brake to date, although wide implementation of the electoral promises by the new coalition government would see government debt shoot up further. Such a development could lead to a major acid test for the European single currency in the medium term, particularly as moderately capitalised, narrow-chested Italian banks are among the government's largest creditors. In light of Italy's government debt of nearly EUR 2.3 trillion, Italy would be simply "to big to save" for the ECB, unlike Greece. In contrast to the United States, inflation is currently not an issue in Europe, as core inflation is at around 1% and the labour market in most European countries is far less tense than in the USA.

In spite of a strong currency, the slowdown in **Japan** has not continued, and the PMI rose slightly to 53 points in June.

As discussed in the first article, the trade war will affect **China** worst in the short term. If the trade war escalates further and America extends tariff increases to a trade volume of USD 200 billion, this may lead to an economic slowdown of around 0.5% of Chinese GDP, according to Bloomberg Economists. This may well accelerate the policy-driven structural shift in the Chinese economy from exports to domestic consumption. China will also use its not inconsiderable room for manoeuvre in trade terms to take monetary and fiscal policy measures to counteract the negative effects of a trade war with the United States.

The economic outlook has also deteriorated in some emerging markets, particularly strongly in **South Africa** and **Turkey** and slightly less in **Brazil** and **Russia.**

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Strategy

Asset Allocation

	Untergewichtet	Neutral	Übergewichtet
Liquidität			
Obligationen			
Aktien			
Immobilien			
Rohstoffe			
Edelmetalle			

Investors should be underweight in **bonds** in an environment of sustained economic momentum and the impending conclusion of ultra-expansive monetary policy. Preference should be given to corporate bonds with short- to medium-term maturities.

After the latest share price declines, **equities** are around their historic average thanks to a further increase in profits. In view of the widening global trade war, US equities should perform better than the rest of the world. We see modest recovery potential towards the end of the year.

Real estate entails a certain consolidation risk due to increasing yields, particularly in the USA. Commercial real estate prices in Switzerland could also come under pressure amid rising vacancy rates. In countries such as Germany, there is some pent-up demand in residential construction.

Commodities: Price-setting producers 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 in %			Inflation in %			Output gap in %	Deficit in% GDP	Debt in% GDP	CDS spread in bp	Real interest rates in %
	2017	2018E	2019E	2017	2018E	2019E		2018	2018		
United States	2.2	2.8	2.5	2.1	2.5	2.2	-1.10	-3.7	77.4	29.69	0.34
Eurozone	2.2	2.3	2	1.5	1.6	1.5	0.01	-0.9	n/a	n/a	n/a
Germany	2.4	2.2	2.1	1.7	1.7	1.7	-0.17	1.3	65.7	13.21	-1.38
France	1.8	2	1.9	1.1	1.8	1.4	0.29	-2.6	96.1	29.61	-1.09
Italy	1.5	1.4	1.3	1.4	1.2	1.2	-4.10	-2.3	131.2	236.25	1.60
United Kingdom	1.5	1.4	1.4	2.7	2.5	2.1	-3.23	-1.9	90.4	25.63	-1.25
Switzerland	0.9	2.2	1.9	0.5	0.8	0.9	-2.58	0,441	32.9	11.38	-0.87
Japan	1.5	1.3	1.2	0.5	1.1	1.3	-1.56	-2.51	223.8	24.91	-1.07
China	6.8	6.6	6.4	1.6	2.3	2.4	n/a	-3.72	18.6	67.57	1.25
India	6.5	7.3	7.5	3.4	4.7	4.8	n/a	-3.67	50.1	96.18	3.17
Russia	1.9	1.8	1.7	3.8	3	4	n/a	0.80	11.8	146.15	4.75
Brazil	0.7	2.2	2.8	3.4	3.4	4.1	n/a	-7.52	78.4	270.05	2.56

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	2.60	3.31	20.91	15.65	2.11	S&P 500
Germany	-4.38	1.67	13.75	11.59	3.53	DAX
France	0.67	1.63	16.85	13.29	3.57	CAC 40
Italy	-0.98	1.17	38.80	10.34	4.68	FTSE MIB
United Kingdom	-0.84	1.84	13.61	12.97	4.41	FTSE 100
Switzerland	-9.27	2.30	28.31	13.54	3.99	SMI
Japan	-2.17	1.80	17.07	14.12	2.11	NIKKEI
China	-5.22	1.26	11.34	10.16	3.93	Hang Seng
India	1.34	2.93	21.92	14.96	1.78	Nifty
Russia	9.72	0.76	6.81	5.54	n/a	RTS

Rising profits – falling prices

After rising yields on US government bonds led to a hard correction on equity markets in the first quarter of 2018, the trade policy uncertainties weighed down on dividend-bearing securities to begin with during the second quarter. The Chinese equity market was particularly shaken, and securities listed in China (measured by the Shanghai Shenzhen CSI 300) lost approx.. 15% of its value over the year. Emerging market equities came under pressure generally, because rising US interest rates and a strong dollar do not bode well for companies that are heavily indebted in foreign currency. The poor performance of Swiss blue chips was seen in the less attractive sectoral mix, while badly shaken German automotive shares were sucked into the maelstrom of the looming trade war. The fact that the US market performed best in a country comparison was thanks to the large-cap technology stocks (Amazon, Netflix, Microsoft, Google etc.), without which the S&P 500 would have posted negative annual performance. Conversely, cyclical stocks, which had strongly profited from the initial Trump rally, suffered. In general, a sectoral rotation from cyclical securities to defensive stocks stands out.

Because in 2018 corporate earnings in all key markets rose greatly while equity prices fell, dividend-bearing securities have become fundamentally cheaper and also no longer expensive in a historical comparison. However, this does not meant that equity prices have no further to fall. As described in our leading article, the signs currently suggest an escalating trade war mainly with China. Because the impact on the economic environment and corporate profit situation is difficult to assess, investors will seek to reduce equity risk (further). Against such a backdrop of high volatility, it can sometimes also be worth buying structured products, which have an additional risk buffer, instead of making direct equity investments.

Fundamentally, we consider it too early to invest in the Chinese and Asian equity markets that have bounced back strongly. Many analysts have also significantly revised the profit outlook for these markets.

We assume that the trade war will continue for some time, so investment should be primarily in stocks of (domestically oriented) companies that will be at most marginally affected by higher tariffs and changes to global supply chains. In the short term, it can generally be assumed that US companies will be least affected by higher tariffs. The United States is the only region for which financial analysts are pushing their profit forecasts upwards again. We therefore plan an overweighting for the USA. We only see a sustainable recovery for the equity markets and sectors most shaken by the trade dispute when there are signs that the global trade war is easing.

Extremely flat US interest rate curve

The second quarter of 2018 saw 10-year yields on US government bonds stabilise at just under 3%. An extremely flat interest rate curve – 2-year bonds are yielding only 30 basis points less than 10-year securities – is from a historical perspective almost always an indicator of significant economic weakening. In the current environment, the flat interest rate curve also reflects market players' expectations that a series of interest rate rises by the US central bank is a foregone conclusion. European interest rates have developed very differently. After populists promising higher spending took power in Italy, yields on Italian government debt rose by more than one percentage point. Conversely, yields on 10-year German government bonds fell below the level at the start of the year, to around 0.3%. The latent danger of Italy's rampant indebtedness and the subdued economic signals in Europe may have again limited the ECB's leeway for an imminent withdrawal from the low interest rate policy. Even if the bond-buying programme will finish at year-end, the ECB may have to wait until the fourth quarter of 2019 for an initial interest rate rise. Overall, government bonds have performed much better than corporate bonds. This is particularly true for high-yield emerging market bonds that have suffered several bitter price falls. The significantly higher yields make selective purchases of these bonds attractive again.

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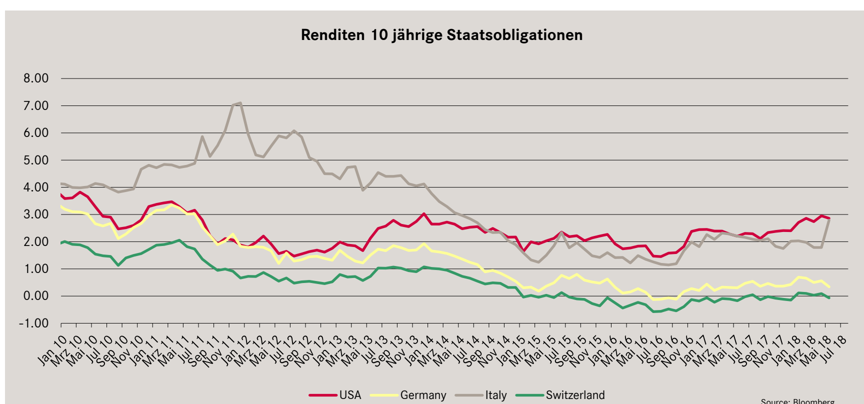


Trends & Forecasts

July 2018

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

We anticipate two 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	-0.7312	-2.01%	-0.5
EUR	-0.3847	-0.3671	-4.57%	0.00
USD	1.6943	2.3356	37.85%	2.75
JPY	-0.0242	-0.0392	-62.06%	0.20

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

Although we are not expecting inflation to accelerate, we assume slightly higher yields on US bonds (3.2% for 10-year bonds) because of higher government debt.

	End of 2017	Latest	YTD %	12 months
CHF	-0.07	-0.10	-30%	0.2
EUR/GER	0.43	0.29	-32.5%	0.7
USD	2.42	2.82	16.5%	3.20
JPY	0.04	0.03	-25%	0.10

Equity markets

We believe that in the next 12 months, the upside potential is also higher in the United States than in Europe because of better earnings. In general, the downside risk has increased because of uncertainty relating to the global trade war. Despite much lower prices, we think it too early to enter positions in Chinese securities.

	End of 2017	Latest	YTD %	12 months
United States	2,673.61	2,743.05	2.60%	2,850
Germany	12,917.64	12,398.34	-4.02%	13,000
France	5,312.56	5,353.24	0.77%	5,400
Italy	21,853.34	21,650.17	-0.93%	20,000
United Kingdom	7,687.77	7,623.11	-0.84%	7,700
Switzerland	9,381.87	8,531.11	-9.07%	9,200
Japan	22,764.94	22,271.77	-2.17%	23,000
China	29,919.15	28,356.26	-5.22%	27,000
India	10,530.70	10,671.40	1.34%	108,000
Russia	13,672.33	15,013.36	9.81%	17,000
Brazil	76,402.08	71,871.52	-5.93%	74,000

Oil and gold

Given the much higher oil price, we believe there is limited potential for further increases. Pressure from the United States will ensure that Saudi Arabia will expand its gas and oil 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)	59.42	72.47	21.96%	74
Gold	1,302.80	1,255.42	-3.64%	1,350

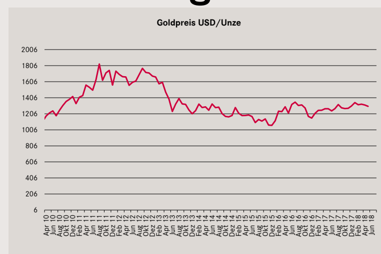
Exchange rates

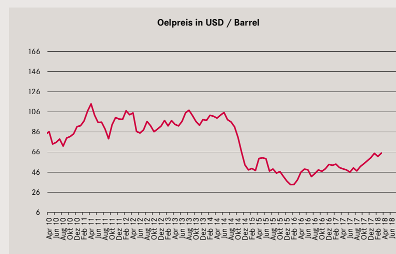
Despite the widening interest rate spread between the USD and euro, we do not expect the structurally weak dollar to appreciate further.

	End of 2017	Latest	YTD %	12 months
EUR/CHF	1.1703	1.1536	-1.43%	1.18
USD/CHF	0.9743	0.9948	2.10%	0.99
EUR/USD	1.2005	1.1596	-3.41%	1.19
EUR/JPY	135.2800	128.1100	-5.30%	126

Source: **Bloomberg 04/07/2018**

Interesting Charts





Source: Bloomberg

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