NPB Neue Privat Bank

Investment **News**

Little chance of resolution as trade dispute escalates

The battle for global technological leadership

The trade war with China triggered by Trump is increasingly taking the form of a cold war for technological leadership in the 21st century's cutting-edge industries. Due to a fundamental clash of interests which are not least rooted in the contrasting economic systems of the two adversaries, a lasting agreement now appears to be a distant prospect. As a result, global growth continues to weaken and central banks are maintaining their low interest rate policy.

A new technology cold war.

Amid repeated expectations from “well-informed sources” of a swift resolution to the trade war, most major stock exchanges recorded welcome double-digit gains by the end of April. Even after President Trump’s surprising tweet announcing plans to raise tariffs from 10% to 25% on around USD 200 billion worth of imports from China, many investors initially believed it was primarily a tactically motivated manoeuvre aimed at increasing pressure even further on Chinese negotiators.

However, the reactions and statements from both sides in recent weeks now suggest that, for the USA, this conflict goes much further than bringing jobs that were lost to China and Asia back to the USA and thus reducing the US trade deficit. The drastic moves to deny telecoms giant Huawei access to Android software and essential components from American chip manufacturers point towards a drawn-out technological cold war. Although security concerns are used as a pretext, the USA’s ultimate aim is to secure its status as the leader in the most important state-of-the-art technology, including 5G networks, artificial intelligence, the Internet of Things, the cloud and quantum computing. Much is at stake, as these technologies are also tremendously significant for the military strength of both nations.

The crux of Beijing’s planned economy

Although the share of the private sector in China has increased sharply in recent years, key sectors continue to feature distinctive elements of a planned economy. An agreement might still be reached with the Chinese on the contentious issue of forced technology transfer and in the area of patent protection, especially as even Chinese companies are increasingly interested in the effective protection of intellectual property rights. American negotiators are likely to end up banging their heads against a brick wall in their attempts to limit Beijing via difficult-to-control subsidies that support strategically important industries or even by dismantling key pillars of China’s planned economy. In fact, given the experiences of model companies ZTE and Huawei, nothing will stop China from investing hundreds of billions in cutting-edge technology and its own chip industry in the coming years.

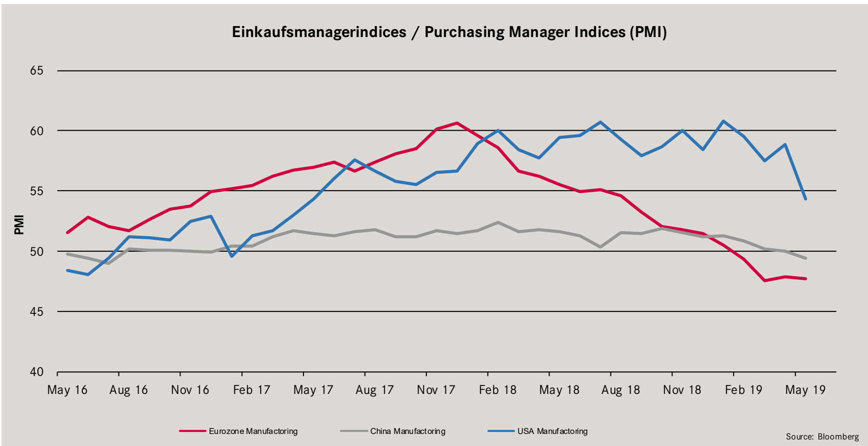
Consequences for the global economy

The braking effects on the gross domestic product (GDP) of both countries can be roughly calculated using global macro models such as NiGEM. If US tariffs are raised to 25% for all Chinese imports and Beijing introduces retaliatory measures, China could grow around 1% slower and the USA by 0.7% less in 2021. As both countries collectively represent around 40% of global gross national product (GNP), this would result in a 0.6% reduction in world economic growth. Japan, Singapore, Hong Kong and South Korea are among the Asian countries that would be most strongly affected. Higher tariffs act like a massive additional tax on consumption. In addition, according to calculations by the Information Technology and Innovation Foundation, restrictions on US technology exports would cause these exports to drop by more than USD 50 billion and lead to the loss of around 75,000 jobs within five years. Serious stock market setbacks would exacerbate the slowdown in growth and, in extreme cases, ramp up the pressure to reach some kind of agreement.

China will be much more severely affected economically than the USA in the first round of an escalation in the dispute, as Chinese equities have suffered greater losses in recent weeks than US stocks. Further declines on the stock markets are highly likely. However, the change to the US Federal Reserve (Fed)’s interest rate policy, which triggered the spring rally on the equity markets, should limit losses. Central banks have also signalled that they will not respond to the higher inflation caused by tariff increases by raising interest rates.

At company level, it is not too difficult to figure out who the main losers will be, with Chinese customers and US manufacturers (Qualcomm, Broadcom, Micron, Intel, Nvidia, etc.) set to be particularly affected by supply constraints. All companies forced to fundamentally rearrange their international value chain as a result of the tariff increases will also be among the biggest losers.

Prof. Markus Ruffner



Slowdown continues

The latest economic indicators, after the announcement of the failure to reach an agreement in the trade war, indicate that the USA is also showing signs of a significant economic slowdown. According to surveys conducted after the punitive tariffs were announced, the US Purchasing Manager Index (PMI), which includes production and services and is used as a reliable leading indicator, slipped from its previous mark of 53% to 50.6%. Surprisingly the service sector also faltered, with PMI Services dropping from 53% to 50.9%. Although individual monthly figures must be interpreted with due caution, these numbers point to annualised growth in the USA of just 1%. The economic cooldown was confirmed by a 2.1% decline in durable goods orders in April and a 0.9% fall in non-military capital goods orders. It is also worth noting that China's direct investment in the USA has collapsed completely. The sagging economy is being caused by waning stimulation from tax reform and growing uncertainty over rising costs associated with the trade war.

The latest economic data from the Eurozone is similarly sobering. While the PMI Services index only fell slightly from 52.8% to 52.5%, the PMI Manufacturing index dropped from 47.9% to 47.7%. This weakness in the manufacturing sector was confirmed by order intake, which declined for the eighth successive month. This means that the German economy's recovery in the first quarter of 2019 may prove to be little more than a flash in the pan. As a result, only 0.2% growth is expected for the second quarter of this year (after 0.4% in Q1). As a global export champion and industrial centre, Germany may be particularly hard hit by the adverse effects of the escalating trade and technology dispute.

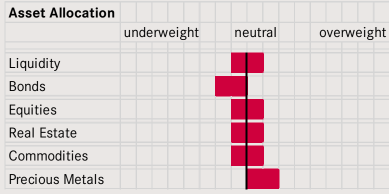
Winners and losers in Asia

Naturally, Asia is especially affected by the consequences of increasingly strained relations between the world's two economic superpowers. Extremely industry-heavy countries Japan and Korea are likely to feature among the losers in this region. Korea's political and military dependency on the USA, combined with its strong position in the telecommunications and electronics industry, appears particularly sensitive and may cause both companies and politicians to be placed under pressure from both sides.

Although the latest economic data from Japan was surprisingly positive, this should not obscure the fact that these figures were 'distorted' by a sharp decline in imports and a huge increase in inventory. With the most important leading indicators dropping below the growth threshold of 50, China is expected to record a significant deceleration in growth.

However, as the Beijing government will hardly let the US administration bring it to its knees, it will likely counteract this adverse impact on growth with massive investments in infrastructure. In addition, China is planning around USD 150 billion in spending to establish its own chip industry, which should end its dependency on foreign suppliers in the medium term..

Strategy



Bonds should be equally weighted in an environment of declining growth. Given the appropriate diversification, preference should be given to corporate bonds with an investment grade rating and short- to medium-term maturities. Selective investments can also be made in higher-yield emerging market bonds.

Equities are no longer attractively valued after significant share price recoveries. Despite subdued profit forecasts, we do not expect reversals to be too large amid the ongoing struggle for technology leadership. The prospect of persistently low interest rates may provide the equity markets with pillar of support.

Commercial **real estate** poses a consolidation risk in countries such as Switzerland. There continues to be scope for higher real estate prices in a few European countries (e.g. Germany), in residential construction initially.

Commodities: After considerable declines in crude oil prices, we believe these prices will stabilise due to the production cuts implemented by OPEC countries and growing investment discipline of US shale oil producers.

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	2018	2019E	2017	2018	2019E		2018	2018		
United States	2.2	2.9	2.4	2.1	2.4	1.8	-1.19	-4.4	82.3	18.89	-0.42
Eurozone	2.2	1.8	1.2	1.5	1.8	1.3	-0.07	-0.5	n.e.	n.e.	n.e.
Germany	2.4	1.4	0.9	1.7	1.9	1.5	-0.17	1.7	64.1	13.67	-1.91
France	1.8	1.5	1.3	1.1	2.1	1.3	0.23	-2.5	97.0	32	-1.60
Italy	1.5	0.9	0.3	1.4	1.3	1.0	-4.10	-2.1	131.5	235.73	1.44
United Kingdom	1.5	1.4	1.3	2.7	2.5	1.9	-3.43	-1.5	87.0	33	-1.63
Switzerland	0.9	2.6	1.1	0.5	1.0	0.7	-2.66	0.441	42.8	11.09	-1.31
Japan	1.5	1.4	1.1	0.5	0.8	0.5	-1.46	-2.04	236.4	25.37	-1.20
China	6.8	6.6	6.2	1.6	2.1	2.4	n.e.	-3.69	47.8	61.3	0.96
India	6.5	7.4	6.9	3.4	4.8	3.7	n.e.	-3.94	70.2	88.96	2.26
Russia	1.9	2.3	1.5	3.8	2.9	4.5	n.e.	0.80	17.4	132.4	4.91
Brazil	0.7	1.1	1.8	3.4	3.5	4.1	n.e.	-6.98	84.0	183.4	1.54

Sources: 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 2019E	Dividend yield 2019E	Index
United States	9.78	3.19	18.02	14.89	2.26	S&P 500
Germany	10.29	1.49	15.49	11.34	3.81	DAX
France	8.94	1.47	17.26	12.17	3.92	CAC 40
Italy	7.08	1.02	10.80	9.02	5.36	FTSE MIB
United Kingdom	5.27	1.66	16.73	11.39	5.03	FTSE 100
Switzerland	12.20	2.49	19.33	14.44	3.67	SMI
Japan	1.98	1.54	15.20	13.79	2.41	NIKKEI
China	3.92	1.19	10.26	9.80	4.15	Hang Seng
India	10.62	3.06	26.20	16.29	1.70	Nifty
Russia	19.62	0.85	5.08	5.34	n/a	RTS
Brazil	10.40	2.09	17.74	10.52	4.30	BOVESPA

Source: Bloomberg

Brief pause or turning point for equities?

After a spectacular start to 2019, the equity market rally was brought to an abrupt end by President Trump's tweet on 2 May. After investors spent a long time feeling reassured that the trade dispute could be resolved, it became increasingly apparent that too many plates had been smashed and a lengthy cold war for leadership in key technologies was looming. Investors in Chinese equities suffered particularly serious setbacks, with the telecommunications and technology stocks affected by the US policy thunderbolt faring especially badly. However, the sharp price declines experienced by US chip manufacturers and companies such as Apple and Tesla with a strong focus on China as a sales market show that US companies are not escaping unscathed from the conflict between Washington and Beijing. As the hardliners in the US administration have gained the upper hand and the sanctions against China have received widespread approval from both Democrats and Republicans, further export bans affecting technology companies operating in sensitive areas cannot be ruled out. In light of this, we recommend refraining from investing in shares of manufacturers and buyers of sensitive technology products for the time being.

Profit forecasts stabilise

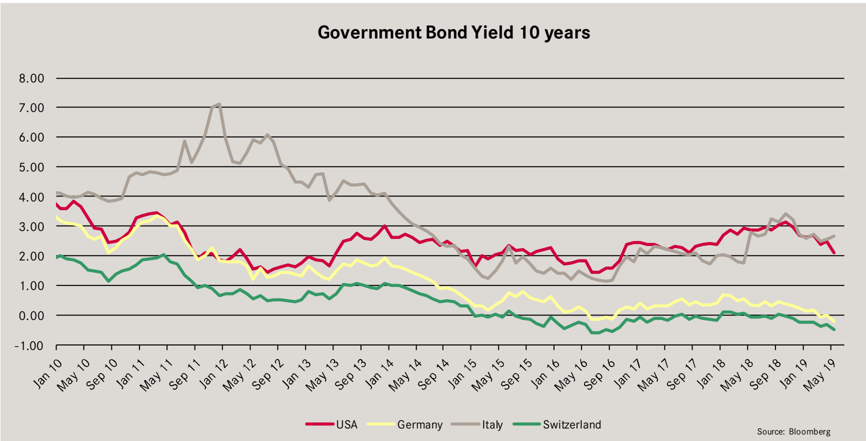
It is evident that the equity rally witnessed in the first four months of the year was not driven by companies' earnings performance, since analysts have significantly lowered their profit forecasts in recent months. Instead, the main driver of this encouraging price trend was the US Federal Reserve's complete about-turn, which signalled clearly that it will refrain from further interest rate hikes given the impending slowdown in growth in 2019. In light of the latest economic figures and the strain placed on consumers by increased tariffs, the Fed may instead be inclined to reduce rates this year. If we compare potential bond yields with the dividend yields on most equity markets, investments in equities still look attractive. Conversely, the number of positive profit adjustments is now higher than negative corrections for the first time in many months. In any case, it is reasonable to wonder to what extent analysts have already included the braking effect of the escalating tariff and technology dispute in their forecasts. As already mentioned, it is therefore important to avoid companies whose profits are most vulnerable to this global upheaval.

Quality stocks still preferred

Although Chinese equities have been attractively valued for a long time due to their price/earnings ratio of around 10x, we believe it is too early to invest at this stage. We are also wary of industrial stocks given the economic slowdown. Although they are by no means cheap, we still prefer less cyclical quality stocks such as the major blue chips in the Swiss Market Index. .

Interest rate hikes postponed indefinitely

The impending global economic slow-down, accompanied by a decline in global trade volume, is also reflected in bond prices. Yields on 10-year US government bonds are now at an annual low of 2.26% after 2.71% at the beginning of the year. Yields on 10-year German government bonds have also slipped well into negative territory (-0.17%). In the current environment, interest rate hikes by the Fed, ECB or even the Swiss National Bank have become a distant prospect. Instead, central banks are considering scenarios to see what countermeasures can be taken if the economic downturn intensifies. A temporary rise in inflation caused by the sharp tariff increase in the USA will change very little in this scenario. This would only change if the pressure on company valuation ranges were to ease as a result of global competition and new online distribution channels – which is not foreseeable at the moment. Given the negative interest rates in CHF and EUR, we recommend keeping the weighting of government bonds low, especially as profit and loss risks have become asymmetrical due to the low level of interest rates. Investing in a well diversified portfolio of corporate bonds with sufficiently good credit ratings and medium-term maturities continues to provide an alternative. In doing so, special attention must be paid to company-specific risks, particularly as a deterioration in the economy could quickly turn debt repayments into a major burden for some individual companies..



Trends & Forecasts

June 2018

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

We anticipate that the Federal Reserve will make its first rate cut by December 2020. The ECB will maintain its expansionary monetary policy so as not to impose additional burdens on southern member states.

	End of 2018	actual	YTD %	12 months
CHF	-0.7134	-0.7130	-0.06%	-0.70
EUR	-0.3557	-0.3433	-3.49%	-0.40
USD	2.8076	2.5025	-10.87%	2.25
JPY	-0.0727	-0.0607	-16.51%	0.10

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

Amid declining economic activity, we expect bond yields to move sideways (2.3% for the USA). We anticipate a slightly steeper interest rate curve for the Swiss franc and the euro.

	End of 2018	actual	YTD %	12 months
CHF	-0.28	-0.51	81.49%	-0.20
EUR/GER	0.24	-0.21	-187.69%	0.10
USD	2.69	2.08	-22.39%	2.30
JPY	-0.01	-0.10	1860.05%	0.10

Equity markets

With markets remaining extremely volatile, we expect share prices to be slightly higher at the end of the year. Although dividend-paying European stocks are out of fashion among internationally oriented investors, we recommend an equal weighting of equities from American and European companies, particularly as the difference in valuations has reached a historic high. We remain underweight in most emerging market equity markets.

	End of 2018	actual	YTD %	12 months
United States	2'506.85	2'752.06	9.78%	2'800
Germany	10'558.96	11'726.84	11.06%	12'500
France	4'730.69	5'207.63	10.08%	5'400
Italy	18'324.03	19'621.39	7.08%	20'500
United Kingdom	6'728.13	7'161.71	6.44%	7'300
Switzerland	8'429.30	9'523.98	12.99%	9'800
Japan	20'014.77	20'410.88	1.98%	21'000
China	25'845.70	26'859.70	3.92%	29'000
India	10'862.55	12'016.55	10.62%	13'000
Russia	1'068.72	1'282.23	19.98%	1'400
Brazil	87'887.26	97'030.32	10.40%	95'000

Oil and gold

After a significant recovery in crude oil prices in the first few months of this year, prices have corrected, particularly due to growing fears about the economy. As a result of the implemented OPEC production cuts, we expect prices to stabilise at their current level. Gold remains a sensible hedge against different types of global (political) risks.

	End of 2018	actual	YTD %	12 months
Crude oil (WTI)	47.30	52.94	11.92%	55
Gold	1281.58	1315.41	2.64%	1350

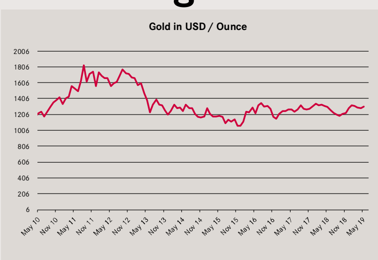
Exchange rates

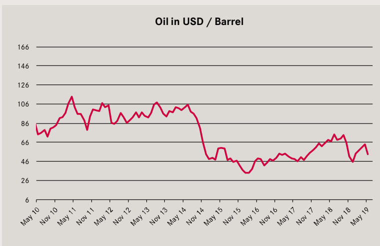
As the interest rate spread between the USD and euro is unlikely to widen much further, we expect a sideways movement in the exchange rate

	End of 2018	actual	YTD %	12 months
EUR/CHF	1.1256	1.1132	-1.10%	1.11
USD/CHF	0.9828	0.9963	1.37%	0.98
EUR/USD	1.1452	1.1173	-2.44%	1.13
EUR/JPY	125.6200	120.9600	-3.71%	123

Source: **Bloomberg 03/06/2019**

Interesting Charts





Source: Bloomberg

Imprint

NPB Neue Privat Bank AG
Limmatquai 1 | am Bellevue
PO Box
CH-8024 Zurich
Tel: +41 44 265 11 88
Fax: +41 44 265 11 89
info@npb-bank.ch
www.npb-bank.ch