Investment **News**

Trade war increasingly focused on technological leadership

Robust US economy – slumping share prices

Share prices worldwide have fallen sharply in the last few months. The main reason for this development is likely a growing fear among investors that an uncontrolled trade war could lead to an accelerated global slowdown. The hope is that the imminent shift from a dispute over tariffs to a battle to become the world's technology leader will inflict less collateral damage on the global economy.

The bear market has begun!

Until September this year, the leading US stock exchanges seemed immune to the effects of an escalating trade war, the risk of an uncontrolled Brexit and rising interest rates. Since then, the tide has suddenly turned in the equity markets, with the S&P500 leading index now in a bear market after falling more than 20% from its annual high.

With Europe and even China already showing signs of economic weakness for several months, fears of a slowdown in the US economy have also risen sharply in recent weeks. Although unemployment is consistently close to a record low of around 3.9% and American consumer spending remained undiminished over the Christmas period, investors in the US equity and bond markets are far more pessimistic, as clearly demonstrated by significant price declines and falling government bond yields.

Fears of a global recession

Looking back, we can identify the following reasons for a bear market in the equity markets: fears of recession, overvaluations and/or share price bubbles, extremely high commodity prices (crude oil) and aggressive interest rate hikes by central banks like the US Federal Reserve (Fed).

So far, commodity prices and the current US key interest rate of 2.5% can be ruled out as causes of the correction in the current environment. Even if we assume that analysts' profit forecasts are still too high for most companies, equities are appropriately valued based on historical valuations at the current level.

The main reason for the marked weakness in the global equity markets is the fear of a significant economic downturn or even a ***recession***. While sharp stock market declines are indeed an extremely useful early indicator of an imminent recession, the equity markets have overstated the threat of one or two recessions in the past. This also raises questions about what could bring about a drastic economic slowdown in the current market environment.

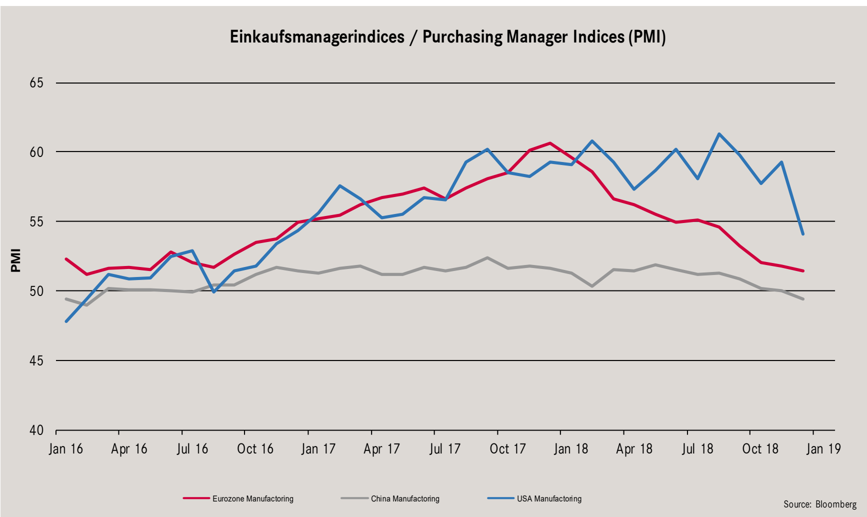
After the last recession was primarily triggered by a financial market crisis that originated in the USA and the subsequent sovereign debt crisis in Europe, one might ask ***whether the current trade war has the potential to place a similarly significant brake on global economic development***.

Costs of a global trade war

Recent analysis by the IMF, OECD and specialised analysis firms make it clear that it is extremely difficult to predict the effects of dislocations in trade policy. Nevertheless, it would seem that the maximum tariff increases threatened would 'cost' the USA and China around 1% and 2% of GNP respectively. The many different secondary effects are significantly harder to quantify. Based on the tariff increases imposed so far, it appears that the global value chain for international companies is being massively disrupted, with several sectors such as the US automotive industry confronted with sharply rising costs for components procured abroad. Numerous companies in Asia have also accelerated their plans to move production facilities away from China. The lack of visibility over the outcome of this trade dispute is leading to a high degree of investment uncertainty and causing significant friction in global trade. Inflation is also rising in the USA, which could prompt the Fed to raise interest rates more sharply than is necessary.

The more the data worsens, the higher the pressure to find a solution to the trade war becomes. It is therefore hoped that the 'architects' of the "Made in America" policy will focus their attention from the tariff dispute to the more important yet more difficult to solve problem of ***forced technology transfer*** and the ***protection of intellectual property rights***. It will no longer be possible to make too much progress on this front, however, as China has now become a leading innovator in many areas. In 2017, China was responsible for around 40% of all patent applications worldwide, with the USA representing "just" 20% by comparison. Nevertheless, a selective policy focused on technological leadership should have a much **lower drag on the economy** than an erratic tariff dispute.

Prof. Markus Ruffner



A cooling economy

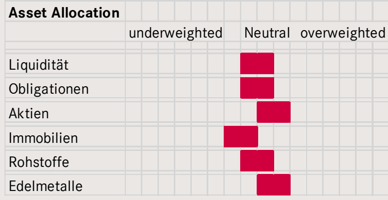
Most economies (Europe, Japan, China, United Kingdom) have slowed and global trade is losing considerable momentum. While the first signs of a decline in growth are also apparent in the USA, the latest figures do not suggest a dramatic slump. The US Purchasing Manager Index (PMI), for manufacturing goods, a reliable leading indicator, dropped to 54.1 points in December from 59.3 in the previous month. Any figure over 50 continues to suggest stable growth. Nevertheless, the number of market observers predicting a significant cooldown in the US economy is increasing. There are concerns that the expansionary impact of the country's tax reforms will come to an end in 2019 and that higher interest rates will curb construction activity and investments. The trade war triggered by the USA has now become apparent for individual goods, even for American consumers, as the prices of imported goods increase. This is causing higher inflation, which in turn could prompt the Fed to implement further rate hikes. There seems to be no doubt that the US economy cannot continue to grow at 2018 rates. However, as suggested at the start of this section, a sober analysis of the trade war's possible effects does not mean that its impact will be as far-reaching as the financial crisis or that an imminent recession is inevitable in the US. Nevertheless, a growth slowdown to well below 2% in 2020 seems entirely possible.

The economic “spring” in **Europe** did not last nearly as long as in the US. Although employment (as a lagging economic indicator) continues to grow in the EU, the region’s economic development has been showing signs of weakness since the second quarter of 2018. This is particularly true of European economic driver Germany, where negative growth was recorded in the third quarter, not least due to sluggish automobile production. Despite the risk of a hard Brexit and populist movements in Italy and France, both of which are stifling essential structural market reforms, we anticipate growth rates of around 1.5% in Europe in 2019 and 2020.

Is the Chinese colossus faltering?

Further development in China will be crucial for global growth and, in particular, the prosperity of Asian countries. As the country most severely affected by the consequences of the trade war, one might ask whether the time has come for a larger economic slump in China after its sensational growth rates over the past few decades. Unlike in the wake of the financial crisis, when China recovered astonishingly quickly thanks to a huge expenditure programme, the country now faces an economic policy dilemma: to curb credit growth in light of a rise in non-performing loans while at the same time preventing an overly restrictive credit policy from triggering a slump in real estate prices. All that remains is an expansive fiscal policy to keep the now fragile economy on track for growth within a range of 5% to 6% p.a.

Strategy



Bonds should be equally weighted in an environment of declining growth. Given the appropriate diversification, preference should continue to 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 moderately valued almost everywhere after severe setbacks, even though corporate profits are expected to rise more slowly. Although European equities are currently completely out of fashion, we continue to hold European stocks as well as attractively priced emerging market equities.

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 huge falls in crude oil prices, we see some recovery potential thanks to production cutbacks in OPEC countries.

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	2.9	2.5	2.1	2.4	1.8	-1.19	-4.3	82.3	24.35	0.14
Eurozone	2.6	2.0	1.6	1.5	1.7	1.2	-0.07	-1	n.e.	n.e.	n.e.
Germany	2.4	1.6	1.4	1.7	1.8	1.4	-0.17	1	64.1	16.67	-1.51
France	1.8	1.6	1.0	1.2	2.0	1.1	0.23	-2.7	97.0	41.67	-1.11
Italy	1.5	1.3	0.9	1.3	1.2	1.1	-4.10	-2.4	131.5	226.86	1.67
United Kingdom	1.5	1.5	1.5	2.7	2.5	2.0	-3.23	-1.8	87.0	42.01	-1.27
Switzerland	0.9	2.8	1.5	0.5	0.8	1.0	-2.58	0.441	42.8	12.72	-1.03
Japan	1.7	0.9	0.8	0.5	1.0	1.0	-1.51	-2.63	236.4	25.69	-1.12
China	6.8	6.6	6.0	1.6	2.1	1.9	n.e.	-3.72	47.8	66.8	0.85
India	6.5	7.7	7.4	3.3	4.5	4.3	n.e.	-4.01	70.2	115.8	2.67
Russia	1.5	1.5	2.3	3.7	2.8	4.0	n.e.	0.80	17.4	153.33	5.65
Brazil	1.0	1.2	2.0	3.5	3.3	4.1	n.e.	-7.1	84.0	196.07	1.50

Sources: Capital 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 2019E	Dividend yield 2019E	Index
United States	-7.03	3.02	17.29	13.38	2.43	S&P 500
Germany	-18.26	1.45	11.90	10.42	4.08	DAX
France	-11.93	1.45	14.66	10.83	4.35	CAC 40
Italy	-16.15	1.02	38.80	8.39	5.73	FTSE MIB
United Kingdom	-12.48	1.62	15.76	10.89	5.29	FTSE 100
Switzerland	-10.16	2.25	22.12	12.78	4.16	SMI
Japan	-12.08	1.54	13.88	12.83	2.34	NIKKEI
China	-13.61	1.20	9.82	8.99	4.46	Hang Seng
India	3.15	2.90	22.02	15.98	1.78	Nifty
Russia	15.09	0.80	5.50	5.03	n/a	RTS
Brazil	15.03	1.95	20.38	10.32	4.30	BOVESPA

Source: Bloomberg

Serious setbacks

After a record 12 months in 2017, 2018 was a year to forget for the stock markets. Most equity markets recorded high double-digit losses over the past year. Chinese equities listed on domestic stock exchanges fared particularly badly, plummeting approximately 30% during the course of 2018. Yet even American share indexes, which still perform best among the developed markets, recorded serious double-digit losses compared to their annual highs, with small and mid-cap companies hit hardest. Even large technology stocks, which had a very good run until October, fell sharply in the last two months of the year.

While European stocks - including German shares - performed even worse, with special factors such as the diesel emissions scandal dragging German auto stocks down particularly strongly, other DAX heavyweights such as Bayer also suffered huge losses caused by the detrimental effects of the Monsanto acquisition.

Earnings growth disappoints

The varying high levels of losses on individual stock markets can largely be explained by differences in earnings growth. While US stocks recorded average profit rises of more than 20% thanks to pro-business tax reforms in 2018, corporate earnings stagnated in Germany due to the aforementioned special factors and the disappointing performance of industrial goods exports. After a generally positive start to the year that initially focused on cyclical stocks, a succession of company profit forecasts were revised downwards, first in the rest of the world and now in the USA too.

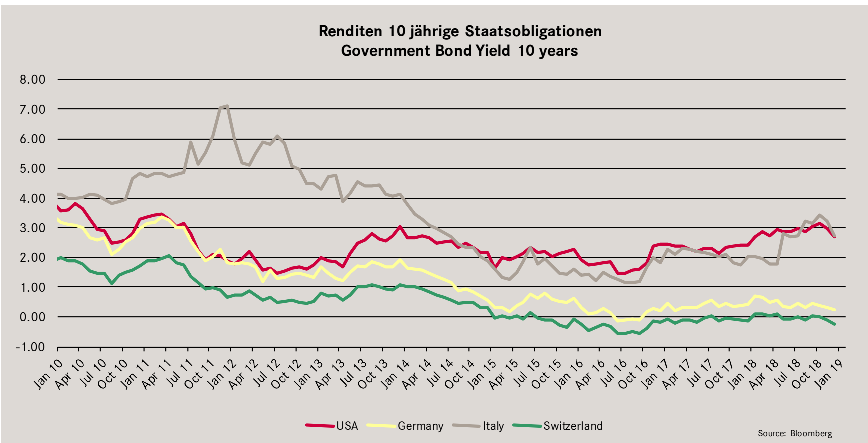
After a disastrous fourth quarter on the world's key stock exchanges, equities have now become fundamentally cheaper once again (see table opposite). Price-earnings (P/E) ratios now largely sit under long-term historical averages, even if we assume that the analysts' profit forecasts shown in the table still prove to be too high. Although it is difficult to find the ideal moment for selective acquisitions, current prices offer recovery potential in the medium term. The less that the exaggerated recession fears come to pass, the greater this potential will be.

Defensive stocks back in fashion

After cyclical and momentum stocks remained among the favourites in the first two quarters of 2018, investors have since become more cautious when it comes to economies with a tendency towards weakness. Investing primarily in defensive, less economically sensitive stocks may be worthwhile at present. In this environment, so-called 'dividend aristocrats' - i.e. stocks of companies that have increased their dividend every year without exception over a long period of time - are also top picks. A solution to the trade dispute would make emerging market equities more attractive once again.

Low interest rates persist

Monetary policy in individual economic regions could not have been more different during the past year. While the US Fed increased its key interest rates in four steps to 2.5%, the European and Japanese central banks continued to hold fire on rate hikes. In light of burgeoning fears of a recession, the Fed seems to have become more cautious recently and has reduced its predicted number of interest rate rises from four to two for 2019. The European Central Bank is lagging significantly behind the Fed in terms of time. Although the bond purchasing programme was not extended any further at the end of the year, maturing bonds will continue to be offset by the acquisition of new bonds. Given disappointing growth momentum in the euro zone and Italy's habitual problem when it comes to achieving reasonably satisfactory economic growth, it is by no means certain that the ECB will attempt its first interest rate hike in autumn this year. The sharp decline in crude oil prices is having a clear dampening effect on inflation. Waning economic momentum and moderate wage increases as measured by productivity gains are moving in the same direction. As a result, it seems likely that core inflation adjusted for food and energy will not consistently exceed the 2% barrier in the USA and will remain significantly below the ECB's target range in Europe. As central banks cut back or no longer extend their bond purchases, we anticipate a moderate rise in bond yields in the major currencies.



Trends & Forecasts

December 2018

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

We anticipate one more rate hike by the Federal Reserve by December 2019. The ECB will cautiously cut back its expansionary monetary policy so as not to impose additional burdens on the southern countries.

	End of 2017	End of 2018	YTD %	12 months
CHF	-0.7462	-0.7134	7.13%	-0.70
EUR	-0.3847	-0.3557	7.53%	-0.10
USD	1.6943	2.8076	65.70%	2.75
JPY	-0.0242	-0.0277	-14.46%	0.10

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

The Fed's more restrictive balance sheet policy and expansion of US debt triggered by tax reforms mean moderately higher bond yields (2.9% for the USA). We expect slightly steeper yield curves in Germany and Switzerland.

	End of 2017	End of 2018	YTD %	12 months
CHF	-0.18	-0.24	-33.30%	0.10
EUR/GER	0.42	0.24	-42.85%	0.50
USD	2.41	2.74	13.69%	2.90
JPY	0.04	-0.01	-125.00%	0.20

Equity markets

We anticipate a moderate recovery in persistently volatile markets. 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. Small and mid-cap companies in Asia have become fundamentally even cheaper. The risk of setbacks has diminished in light of these more attractive valuations.

	End of 2017	End of 2018	YTD %	12 months
United States	2,673.61	2,506.85	1.43%	2'500
Germany	12,917.64	12,169.25	-5.79%	11'500
France	5,312.56	5,181.28	-2.47%	4'900
Italy	21,853.34	22,567.40	3.27%	18'500
United Kingdom	7,687.77	6,970.87	-9.33%	6'800
Switzerland	9,381.87	8429.30	-10.16%	9'200
Japan	22,764.94	21,591.99	-5.15%	21'000
China	29,919.15	31,071.05	3.85%	26'000
India	10,530.70	10,114.75	-3.95%	11'000
Russia	13,672.33	15,055.50	10.12%	17'000
Brazil	76,402.08	84,976.59	11.22%	95'000

Oil and gold

Crude oil prices fell sharply in 2018, in particularly due to growing economic fears. Thanks to effective production cutbacks among OPEC nations, we expect a moderate recovery in crude oil prices. As in the previous year, we consider an investment in gold to be a sensible hedge against different types of global (political) risks.

	End of 2017	02/01/2018	YTD %	12 months
Crude oil (WTI)	60.27	46.62	-22.6%	55
Gold	1302.80	1279	-1.2%	1350

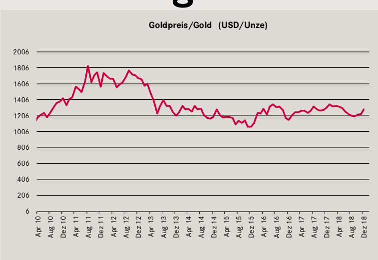
Exchange rates

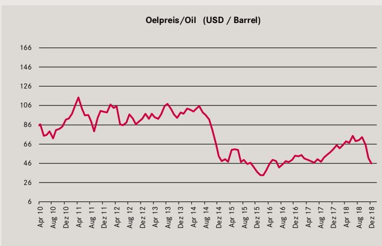
As the interest rate spread between the USD and Euro is unlikely to widen much further, we expect the structurally weak dollar to weaken slightly.

	End of 2017	31/12/2018	YTD %	12 months
EUR/CHF	1.1703	1.1267	-0.23%	1.11
USD/CHF	0.9743	0.9827	0.86%	0.96
EUR/USD	1.2005	1.1466	-4.49%	1.07
EUR/JPY	135.2800	127.09	-4.37%	128

Source: **Bloomberg 31/12/2018**

Interesting Charts





Source: Bloomberg

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