Weekly Update

C0 | EXTERNAL PUBLICATION

Trade war: walking the precipice

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CA189/JUL/2018

All data taken on 12/07/2018 from Bloomberg.

Market fears of a trade war with China are materializing. The US President is making good on his electoral pledges to address the trade deficit via protectionism. We have entered uncharted waters as the US stance has upended the post-WWII global economic order. Both superpowers are walking the precipice.

What has happened so far?

After tariffs were imposed on most US steel and aluminium imports, the administration is now taking China head on. On July 6, President Donald Trump imposed a 25% tariff on $34 billion worth of Chinese imports, to be expanded by $16bn on July 20. China responded with 25% tariffs on $34bn worth of US imports. Trump has since threatened to slap a 10% tariff on $200bn worth of goods, and potentially another $300bn, meaning additional tariffs on every single import from China. The US released the list of $200bn in imports on July 10, along with a timeline suggesting that these sanctions would take effect as early as September. Moreover, the renegotiation of NAFTA is set to resume after Obrador's election in Mexico and the US is also eyeing European car imports.

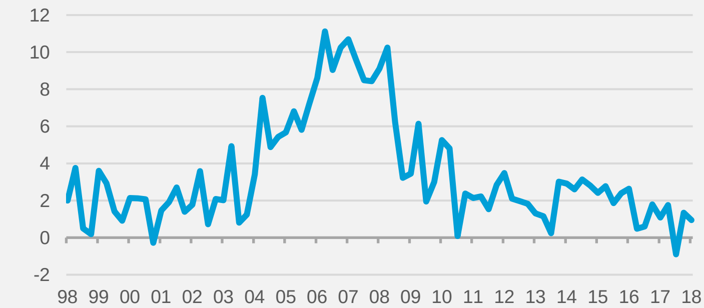
What are the next steps?

President Trump looks convinced that the US will win a trade war. The current conflict with China resembles the spat with Japan in the 1990s, which eventually led to the relocation of some Japanese plants to the US but did little to trim the bilateral trade deficit. Today, Washington's policy objectives are manifold: reducing the trade deficit, rejuvenating the US industrial base, challenging China's emerging dominance in technology. There is also a geopolitical dimension with ongoing discussions on denuclearization of North Korea. Although China has committed to retaliate – with a combination of tariffs and investment restrictions – its rhetoric has softened recently. Neither China nor the US can afford a full-blown trade war. Both countries have a clear interest in compromising.

Outcomes? Polar opposites:

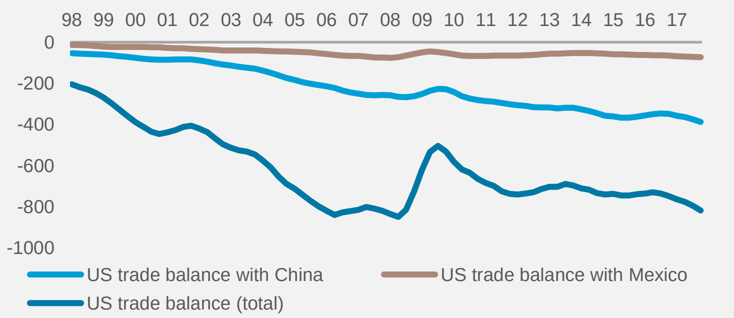
1. All-out trade war. Should tensions escalate further, there is obvious risk of economic downturn. Broadening tariffs would disrupt trade and weigh on global growth. Rising import costs would eat into corporate margins and dent consumer purchasing power across the board. That would lead to a severe downturn in advanced economies and to a possible recession in small open economies. We think there is only a one-in-ten chance that this scenario will play out.
2. A negotiated deal. A more benign outcome would be negotiations between US and China, leading to limited import restrictions on specific sectors and bilateral efforts to reduce trade imbalances. The economic consequences would be mild – a soft patch in business investment, marginal negative impact on Chinese growth and upside risk on US inflation. The US administration expects to cut a deal by November's mid-term elections. We attach a 90% probability to such an outcome, although we recognize that tensions are unlikely to disappear completely. The next phase is likely to focus on technology – China's strategy represents a clear challenge to US strategic dominance.

China's current account surplus has almost disappeared
China, Balance of Payments, Current Account, %GDP



Sources: SGPB, Datastream, 14/06/2018.

China remains a big part of the US trade deficit
US trade balance ($bn)



Sources: SGPB, Datastream, data as of Q1 2018.

This week and next

EUROZONE

- After a 11-month low in April, industrial production ex-construction rebounded above expectations from +1.7% to +2.4% YoY in May.
- The Sentix investor sentiment index rebounded to 12.1 in July after 9.3 in June, the low since October 2016.
- The German ZEW indicator of economic sentiment contracted by 8.6 points to -24.7 in July, against a consensus of -18. It has reached its lowest level since August 2012, below the 23.2 long-term average.

Next week's key events		Per.	Prev.	Cons.
18 Jul	Headline inflation YoY	Jun F	1.9%	2%
18 Jul	Core inflation YoY	Jun F	1.%	1%
20 Jul	Current account balance (€bn)	May	28.4	--

UNITED KINGDOM

- The first monthly GDP figures showed expansion at +0.2% in the three months to May, mainly thanks to services at +0.4%.
- Industrial production (ex. construction) rose less than expected in May at +0.8% YoY, well down from October's +4.4%. Manufacturing output rebounded slightly from +0.9% to +1.1% YoY in May, disappointing expectations.
- The RICS house price survey edged up from -2 to +2 in June after a 5-year low in April at -7.

Next week's key events		Per.	Prev.	Cons.
17 Jul	ILO unemployment rate	May	4.2%	--
19 Jul	Retail sales YoY	Jun	3.9%	--

UNITED STATES

- As expected, headline inflation crept up from 2.8% to 2.9% YoY in June (highest level since 2012), while ex food & energy prices rose from +2.2% to +2.3% YoY, an 18-month high.
- The trade deficit narrowed to $-43.1bn in May, continuing the improvement after this decade's low in February ($-55.5bn).
- The unemployment rate rose from May's 3.8% multi-decade low to 4% in June. Meanwhile, average earnings growth remained at +2.7% YoY in June.

Next week's key events		Per.	Prev.	Cons.
16 Jul	Retail sales (ex. autos) MoM	Jun	0.9%	0.4%
17 Jul	Capacity utilization MoM	Jun	77.9%	78.3%

ASIA & EMERGING COUNTRIES

- Japanese machinery orders rose 16.5% YoY in May against expectations for a 10.2% increase.
- In China, consumer prices rose 1.9% YoY in June from 1.8% in May.
- Brazilian inflation rose 4.4% YoY in June, up from 2.9% a month before. Retail sales beat expectations at +2.7% YoY in May, up from 0.6%.
- In India, inflation printed at 5% YoY in June after 4.9% in May, whereas it was at +1.5% in June 2017.

Next week's key events		Per.	Prev.	Cons.
19 Jul	Japan: trade balance (¥bn)	Jun	-580.5	--
16 Jul	China: GDP YoY	Q2	6.8%	6.7%

Sources: Datastream, Bloomberg, 13 July 2018, Note: YoY = year-on-year; QoQ = quarter-on-quarter; MoM = month-on-month, P = preliminary figure, A = advanced figure, F = final figure, seasonally adjusted, ECB = European Central Bank

Our 6-month targets for currencies and commodities

	Thursday close	6mth target
EUR/USD	1.17	1.20
GBP/USD	1.32	1.35
EUR/CHF	1.17	1.18
USD/JPY	113	110
Brent	$73.4	$75
Gold	$1247	$1250

No change to our 6-month targets this week.

Forecast figures are not a reliable indicator of future performance

Question time

Past performance should not been seen as a guarantee of future returns.

FIXED INCOME

What was the reason to close our Corporate Hybrid bond investment theme?

In September 2016, we initiated a tactical theme on Corporate Hybrids. At that time, 44% of European sovereign bonds were trading at negative yields and Corporate Hybrid bonds offered some diversification benefits and higher yields than Corporate Investment Grade bonds. Corporate High Yield bonds offered even higher yields, but with higher risk.

Since the implementation of the strategy, Corporate Hybrids have recorded a total return of 8%. Performance was even better at the start of the year, but has suffered as spreads have widened. In our recent third quarter House Views, we decided to take profits and close the strategy, which had lasted longer than the typical horizon for tactical themes (3 to 12 months).

Structurally and in the context of low interest rates (the 10-year Bund rate is stuck around 0.30% and the 2-year is still in negative territory close to -0.60%), Corporate Hybrids and Corporate IG remain attractive in terms of yield pick-up. We recommend holding on to these bonds in portfolios. In relative terms, Corporate IG has outperformed Hybrids in the recent environment of uncertainty, political crisis in Italy and global trade tensions. Please note that we have also upgraded our position on Corporate IG from underweight to neutral.

Spread widening, corporate hybrids have underperformed IG corporates since the beginning of the year

Hybrid Bonds OAS - Corporate Bonds OAS, bps

Sources: SGPB, Bloomberg, 30/06/2018

Market performance

Past performance should not been seen as a guarantee of future returns.

Interest rates

Interest rates	Last	1wk		3mth	YTD	12mth
EONIA (EUR)	-36 bp	0 bp	➡	0 bp	-2 bp	0 bp
3mth Euribor (EUR)	-32 bp	0 bp	➡	1 bp	1 bp	1 bp
3mth Libor (USD)	234 bp	0 bp	➡	-1 bp	64 bp	104 bp
3mth Libor (GBP)	73 bp	2 bp	⬆	-4 bp	21 bp	44 bp
10-year US Treasury bond	285 bp	1 bp	⬆	2 bp	44 bp	53 bp
10-year German bond	29 bp	0 bp	➡	-22 bp	-13 bp	-22 bp
10-year French bond	58 bp	-2 bp	⬇	-17 bp	-9 bp	-29 bp
10-year UK bond	133 bp	2 bp	⬆	-16 bp	10 bp	-1 bp

Credit

Credit	1wk		3mth	YTD	12mth
BAML EURO Corp. IG	0,2%	⬆	0,0 %	-0,2 %	1,3 %
BAML EURO Corp HY	0,6%	⬆	-0,7 %	-0,6 %	1,9 %
BAML GBP Corp IG	0,2%	⬆	0,4 %	-1,4 %	0,8 %
BAML US IG	0,4%	⬆	-0,2 %	-2,5 %	-0,2 %
BAML US HY	0,5%	⬆	0,5 %	0,5 %	2,9 %
JPM Global EM Sov. Plus	0,8%	⬆	-3,3 %	-4,4 %	-0,1 %

Exchange rates

Exchange rates	Last	1wk		3mth	YTD	12mth
EUR/USD	1,17	-0,2 %	⬇	-5,3 %	-2,8 %	2,3%
EUR/CHF	1,17	0,8 %	⬆	-1,4 %	0,0 %	6,2%
GBP/USD	1,32	-0,2 %	⬇	-7,2 %	-2,2 %	2,5%
USD/JPY	113	1,8 %	⬆	4,9 %	-0,1 %	-0,5%
USD/BRL	3,88	-1,3 %	⬇	13,7 %	17,2 %	21,0%
USD/CNY	6,67	0,5 %	⬆	6,0 %	2,5 %	-1,8%
USD/RUB	62,3	-1,4 %	⬇	0,4 %	8,0 %	3,8%

Government bonds*

Government bonds*	1wk		3mth	YTD	12mth
United States (3-7yr)	0,0 %	➡	0,3 %	-1,0 %	-1,2 %
United Kingdom (3-7yr)	-0,1 %	➡	1,0 %	-0,3 %	-0,3 %
Germany (3-7yr)	0,0 %	➡	0,9 %	0,7 %	0,9 %
Japan (3-7yr)	0,0 %	➡	0,0 %	0,0 %	0,3 %

Equities*

Equities*	Last	1wk		3mth	YTD	12mth
MSCI AC World	514	1,7 %	⬆	1,4 %	1,7 %	12,2 %
Eurostoxx 50	3 445	0,2 %	⬆	2,4 %	1,3 %	1,5 %
DAX	12 493	0,2 %	⬆	0,6 %	-3,3 %	-1,1 %
CAC 40	5 406	0,7 %	⬆	4,4 %	4,6 %	6,9 %
S&P 500	2 798	2,3 %	⬆	5,6 %	5,8 %	16,8 %
FTSE 100	7 651	0,6 %	⬆	6,6 %	1,9 %	7,4 %
SMI	8 818	1,7 %	⬆	1,9 %	-2,9 %	1,2 %
Topix	1 710	2,0 %	⬆	-0,3 %	-4,9 %	7,8 %
IBOV Brazil	75 856	1,8 %	⬆	-11,2 %	-0,7 %	17,0 %
MICEX Russia *	2 322	-1,1 %	⬇	5,1 %	10,1 %	18,8 %
MSCI EM	1 070	1,7 %	⬆	-7,9 %	-6,0 %	6,8 %
SENSEX 30 India	36 548	2,8 %	⬆	7,8 %	8,9 %	16,4 %
Hang Seng (H-K)	28 481	1,4 %	⬆	-5,7 %	-2,4 %	13,5 %
Shanghaï Composite	2 838	3,8 %	⬆	-10,8 %	-14,2 %	-11,3 %

Commodities

Commodities	Last	1wk		3mth	YTD	12mth
Brent	$73	-6,3 %	⬇	2,4 %	10,1 %	53,6 %
Gold	$1 247	-0,9 %	⬇	-6,8 %	-4,3 %	2,1 %
Silver	$16,0	-0,4 %	⬇	-3,2 %	-6,0 %	0,6 %

Source: Datastream, on 12 July 2018. 1wk = 1-week change, 3mth = 3-month change, 12mth = 12-month change, YTD = year-to-date change, YoY = year-on-year change, BAML = Bank of America Merrill Lynch, JPM = JP Morgan, IG = Investment Grade, EM = emerging markets. * Price return for MICEX equity index. Equities; total return in local currency. Government bonds = 3-7 year returns. Figures are rounded.

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