July 17, 2018

The "trade war" favors a counter-cyclical trading approach

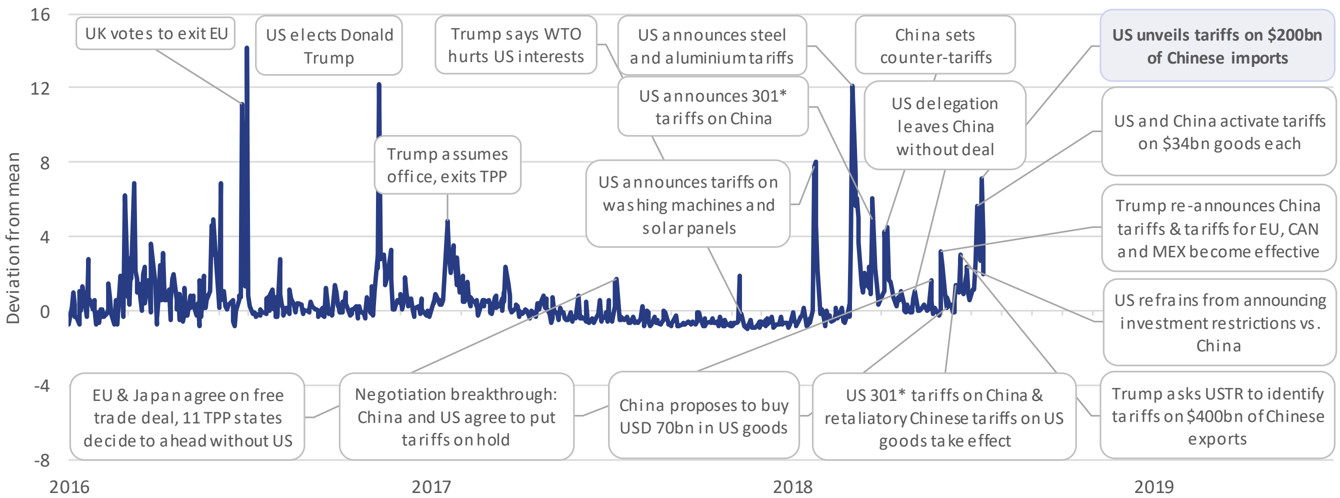
The escalating trade disputes could – eventually – result in more open global markets, at least among strategically allied nations with similar interests. In the meantime, however, the U.S. approach to strong-arm its trade partners into making big concessions is likely to keep disrupting markets. We thus remain inclined to trim equities during rallies.

Amid escalating international trade tensions, U.S. equity indices eked out a third monthly gain in June, while most other markets retreated. More recently, equities have started to regain upward momentum and rebound globally, as China has decided not to formally respond in kind against the latest set of U.S. tariff threats for now.

Against this background, we note the following:

- The so-called trade war is not over and liable to keep disrupting markets going forward
- The disputes between the U.S. and China are of a strategic nature and thus very difficult to be resolved quickly; the tensions are liable to spill over to other areas where long-term interest collide
- Most major democracies are long-standing treaty allies of the U.S. and largely share the latter's core concerns vis-à-vis China – that means they have a higher motivation to compromise and reach agreement
- However, U.S. President Donald Trump's methods and style complicate the negotiating process among allies and can lead to divisions and political backlashes within the camp
- The successive introduction of import tariffs by the U.S. and the retaliatory measures by other major economies will gradually creep into business supply chains, eat into profit margins and spill over to consumers, potentially hurting demand further down the road
- Lastly, the current equity market rebound is driven in large part by the anticipation of another strong corporate earnings season, as well as signs of an accelerating U.S. economy, driven by a generous fiscal stimulus

Graph 1
President Trump's trade war is back on
(One-year rolling deviation from the mean, standardized)



*Section 301 of a 1974 U.S. law that authorizes the president to take "all appropriate action" against policies that burden or restrict the U.S. commerce. TPP: renamed Comprehensive and Progressive Transpacific Partnership (CPTPP) following the US withdrawal includes Australia, Brunei, Canada, Chile, Japan, Malaysia, Mexico, New Zealand, Peru, Singapore, Vietnam, and has an annual economic output worth USD 13.5 trillion. USTR: U.S. Trade Representative. CAN: Canada, MEX: Mexico. Source: LGT Capital Partners, Bloomberg

Counter-cyclical trading approach

In short, the U.S. administration's aggressive posture has increased uncertainty over policy and the outlook, which is clearly weighing on stock markets. Equity markets should normally be trading significantly higher in an economic environment as good as the current one.

Furthermore, the upcoming earnings season may distract from the trade war and thus offer an opportunity to trim equity exposure, particularly in the markets that are likely to be most negatively impacted by policy uncertainty and potential changes in the global trade regime.

We therefore remain inclined to use periods of strong stock markets gains to trim our equity position and raise cash in order to be better prepared to rebuild positions when the opportunity arises. We are upholding this countercyclical approach while maintaining our constructive but defensively-biased broader asset allocation (see page 6).

The trade war is holding back markets

Below we examine the U.S. policy impact on markets. It should be noted that equity valuations collapsed right after the U.S. tax reform was passed and have not recovered since, despite a very strong economy. U.S. nominal gross domestic product (NGDP) is currently growing at an annual pace of about 4.5%, which is significantly above the 20-year average. Corporate profit growth is surging at 20% or more, and recent U.S. business surveys are pointing to an accelerating momentum again.

And yet, the stock market's year-to-date gains are equivalent to only about a quarter of current profit growth - a clear sign of investor caution. If history is any guide, the current state of the economy could easily justify a price-earnings ratio that is closer to 20 for the S&P 500, rather than the current level of 16 to 17 (graph 3).

Graph 3

U.S. valuation have collapsed and remain modest

(S&P 500 price divided by 12-month forward earnings)

Source: LGT Capital Partners, Bloomberg

A comparison of the relationship between the U.S. purchasing manager index (PMI) and the broad stock market returns points to the same fact: President Donald Trump policies are holding back the stock market despite near-boom conditions. In fact, the rather rare divergence between returns and the PMI began right after Trump's election (graph 2).

In other words, Trump's methods could end up squandering what could have turned into a long-lasting economic boom and roaring bull market, like the one we have seen in the second half of the 1990s. That is what markets are suggesting - and they might be proved right further down the road.

Global earnings expectations since Trump's biggest policy decisions

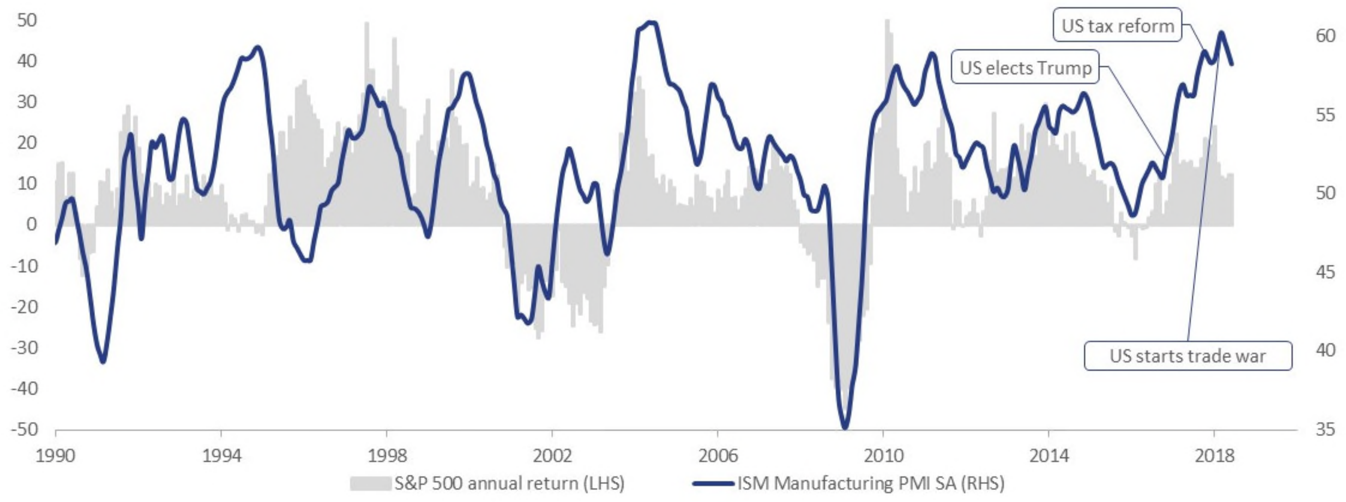
Generally, the following points stand out with respect to the earnings outlook for the year ahead:

- Earnings growth is robust and valuations are rather low (below bull market norms)

Graph 2

U.S. stocks should be trading higher in this economy

(Annual returns and three-month moving average PMI level)



Start of trade war = U.S. announcement of steel and aluminum tariffs in March 2018. ISM = Institute for Supply Management. SA = seasonally adjusted. Readings above 50 indicate improving outlook and vice-versa. Source: LGT Capital Partners, Bloomberg

- Sales growth expectations are in line with general economic conditions for America and Europe, and rather subdued for Asia and the emerging markets (EM)
- Asia-Pacific excluding Japan (APXJ) and the EM are hit hardest by the trade war. The U.S. and Japan are least negatively impacted by the trade war

The trends make sense, as they reflect the respective markets' exposure to changes in the export outlook. European and Asian countries typically boost some of the most strongly export-driven economies (see graph 5).

Table 1 and graph 4

Earnings forecasts justified by current macro trends

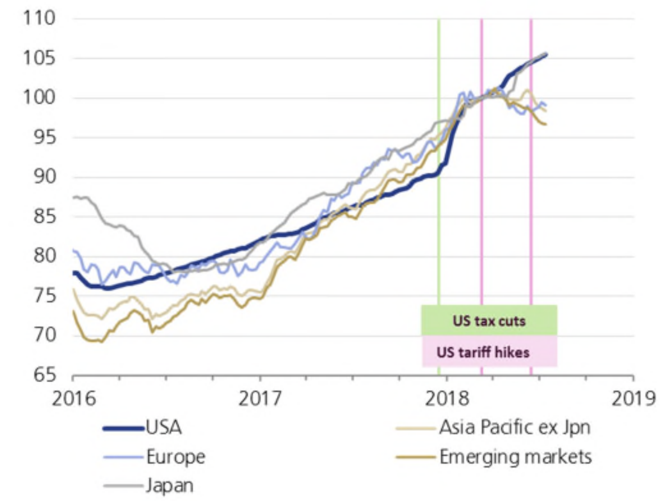
(12-month forward forecasts / trailing 12-month results)

	Earnings per share	Sales per share	NGDP growth*	Forward price-earnings ratio
USA	29.2%	5.2%	4.7%	16.8
Europe	9.2%	3.9%	3.4%	13.8
Eurozone	16.6%	3.6%	3.9%	13.6
Japan	9.1%	2.6%	1.6%	12.8
Asia-Pacific ex Japan	10.2%	4.7%	8.6%	12.5
Emerging markets	11.5%	4.7%	8.2%	11.3

*NGDP growth = year-on-year for most recently available quarter

Earnings revisions are diverging

(Rebased to day of March tariff announcement)



Tariff hikes = U.S. announcements or activation of import tariffs in March and July 2018. Source: LGT Capital Partners, Bloomberg

These earnings revision make sense, since these regions are most exposed to the risk of a more protectionist global economic system. The revisions reflect the broad sensitivities of the respective economies to pure exports.

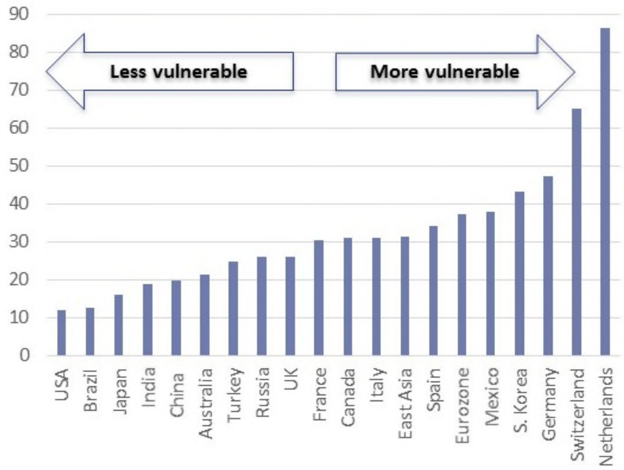
However, EU countries predominantly trade within the union, which clearly mitigates the problem – and may explain why European revisions have stabilized ahead of those in the EM and Asia. The recent European downward revisions were probably more related to the rally in the euro late last year, as well as the brief uptick in EU political risks following the Italian election in March, rather than the Trump administrations tariff threats.

By comparison, earnings forecast for the U.S. and Japan continued to rise smoothly during the recent escalation of trade tensions. These two economies have the smallest export sectors as a share of total economic output (Japan generates a current account surplus due to its large financial and industrial holdings overseas, rather than outright exports of goods that are manufactured at home).

Graph 5

General dependency on exports

(Exports of goods and services in percent of NGDP)



Source: LGT Capital Partners, International Monetary Fund, Bloomberg

Emerging markets and Asia are left holding short end of stick for now

In short, all that leaves the EM and many Asian countries holding the shorter of end of the stick in a global trade war, especially as their reliance on China is also larger in many cases. We are therefore most inclined to trim equity exposure in these markets when the opportunity arises.

Admittedly, we should also note that the negative revision trends for these regions will at some point create buying opportunities further down the road – i.e. once the trade war either subsides or businesses have sufficiently adapted to the new international rule-set, etc.

There will come a point when expectations for the emerging space have turned too negative, and too positive for the developed markets (DM). But that point has not come yet in our view.

In any case, the DM are weathering the trade war salvos relatively well thus far, while the selloff in the EM is not over yet. The latter markets may have to relinquish more of the gains they had accumulated during their phase of outperformance over past couple of years, before stabilizing (graph 6 on next page).

Graph 6

Emerging vs. developed equity markets indices

(MSCI net total return local-currency indices in USD, rebased to the start of 2016)

Tariffs threat vs. all = U.S. announcement of general steel and aluminum tariffs. Source: LGT Capital Partners, Bloomberg

Broader macroeconomic outlook remains constructive

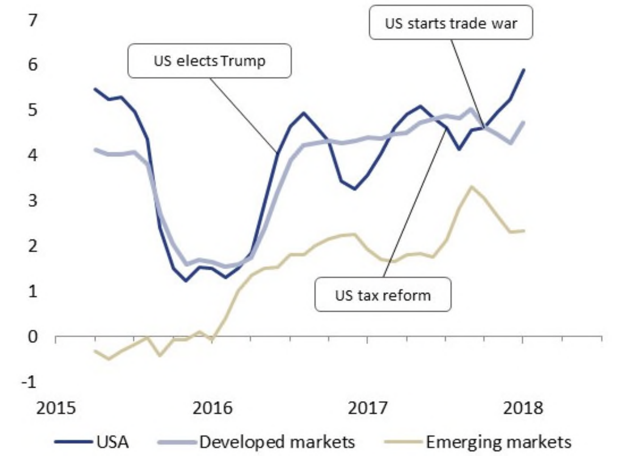
Finally, we should also remind readers why a (modest) overweight in equities remains appropriate: our caution with respect to the current rally is embedded in a broader macroeconomic outlook that remains sufficiently positive – and even improving again in the case of the U.S. (graph 7).

We therefore do not exclude the possibility of a relatively quick resumption of the underlying tailwinds for equities, which is why we maintain our overall constructive outlook on markets.

Graph 7

Global business surveys: U.S. outlook surges higher

(Composite PMI data by Markit)



Growth threshold reset at zero, with values above pointing to an improving outlook and vice versa. Source: LGT Capital Partners, IHS Markit Ltd., Bloomberg

Indeed, market participants may be overreacting to Donald Trump's rather fast and loose negotiating style. To be fair, the strategy could perhaps still lead to a relatively quick resolution of the disputes and ultimately lower trade barriers.

Some of the involved parties might prefer to compromise rather than to continue to deal with elevated uncertainties and a constant barrage of new demands.

Also, unlike in the case of the protectionist 1930s, today's trade tensions are still modest and the new tariffs are imposed from historically very low levels – we still have very open markets. In addition, they come at a time when growth in most developed economies is near of even above potential, which reduces the downside, at least for the foreseeable future. If there is a time for the U.S. to strong-arm more favorable terms by threatening to impose high costs on everyone, this might be the best possible moment.

Likewise, the EM are overall in a much better fundamental shape than during phases of economic or political turmoil in previous decades. Their growth rates are more robust, the reliance on foreign funding is lower, fiscal balances are stronger and (foreign currency) debt levels generally more moderate. Monetary policy and currency regimes have also improved over time, with much fewer countries pursuing fixed exchange rates, enabling the economies to respond more flexibly to external changes.

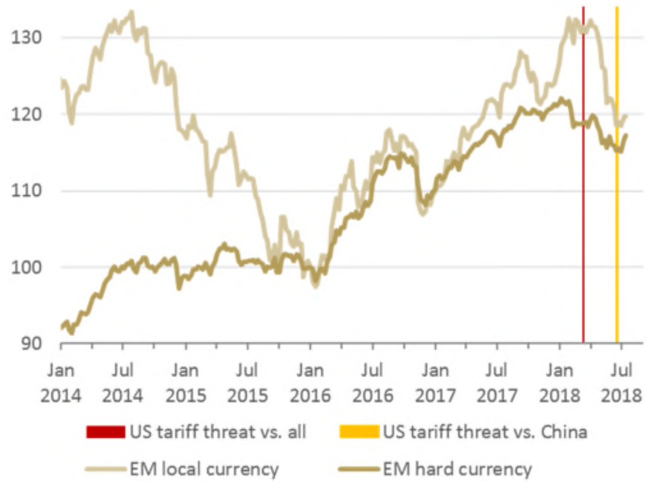
EM debt markets have started to stabilize

These reasons are why we are still comfortable with our overweight in EM bonds, for example. Indeed, unlike EM equities, this fixed income segment has started to stabilize since the imposition of U.S. tariffs against China (graph 8).

Graph 8

EM bonds: buying the significant dip in prices

(Total return vs. sovereign bonds, rebased at start of 2016)



J.P. Morgan EMBI Global Diversified Composite for hard-currency EM bonds, J.P. Morgan GBI-EM Global Diversified Unhedged USD for local currency EM bonds. Source: LGT Capital Partners, Bloomberg

Countries move on to sign trade agreements even without the U.S.

The last mitigating factor is that the U.S. is not the only trading nation. Reliance on the U.S. has decreased over the years, and several new major trade agreements have been concluded recently, including the Economic Partnership Agreement (EPA) between the EU and Japan and the Comprehensive and Progressive Transpacific Partnership (CPTPP). The latter represents 11 economies, including Japan, Canada, and Australia, and generates a combined GDP of 13.5 trillion USD, or roughly the size of the Eurozone. More regional economies likely to join over time.

The strong-arming from Washington has evidently increased pressure on European and Asian political leaders to seek economic engagement and cooperation, as the visit by Chinese Premier Li Keqiang to Germany earlier this month underlined.

Similarly, following a prolonged period of diplomatic chill and maritime border tensions, even Japan and China have recently decided to resume talks on regional initiatives, ranging from China's One-Belt-One-Road project to the Regional Comprehensive Economic Partnership (RCEP).

Table 2

The imposed and threatened U.S. tariffs so far

Product category	Tariff rates	Value of goods subject to tariffs
Already imposed:		Billion USD
Washing machines	16% - 50%	1.8
Solar panels	15% - 30%	8.5
Steel	25%	29.0
Aluminum	10%	17.4
Chinese goods	25%	34.0
Total imposed:		**90.7**
Officially on the way:		
Chinese goods	25%	16.0
Chinese goods	10%	200.0
Total on the way:		**306.7**
Threatened by president		
Still more Chinese imports	10%	200.0
Autos	up to 25%	208.0
Total threatened:		**408.0**
Grand total:	Billion USD:	**805.4**

Source: LGT Capital Partners, Bloomberg

Concluding, our overall asset allocation strategy therefore remains constructive in terms of the outlook, albeit with a defensive bias – i.e. we maintain only a modest overweight in equities, against a pronounced underweight in fixed income, with exceptions such as EM debt, and a very high allocation to cash.

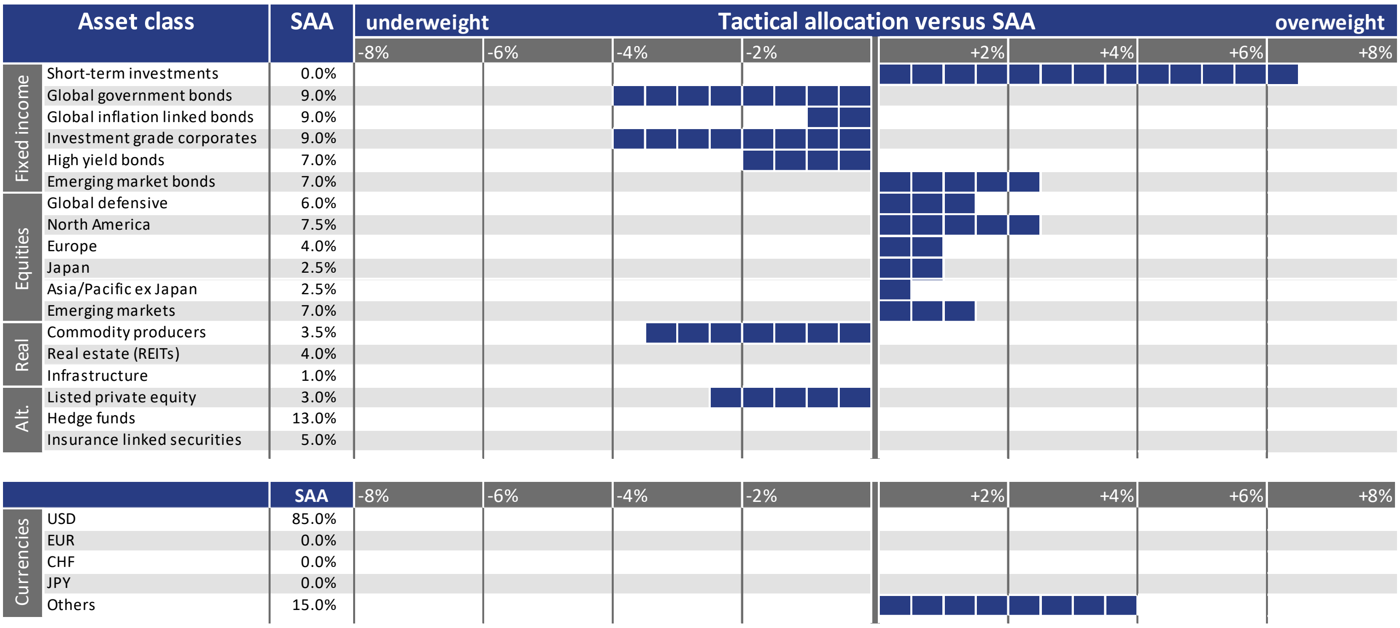
The next LGT Beacon will be published in mid-August.

END OF REPORT

LGT Capital Partners: tactical asset allocation for a balanced model portfolio in USD

Our tactical asset allocation (TAA, positions versus neutral strategic quotas) is set every quarter with a time horizon of three to six months and reviewed monthly, as well as ad-hoc, when needed. Further action may be implemented for purely technical reasons at any time. The current TAA was last revised on June 8, 2018.

- **Moderate overweight in equities, large underweight in fixed income (except for EM debt), very high cash reserves**
- **Real/alternative assets: generally underweight, with exception of real estate and infrastructure**
- **Currencies: no active positions, passive overweight in mainly EM and currencies relative to base currency**



The TAA positions shown are based on the LGT GIM Balanced (USD) strategy managed by LGT Capital Partners AG. The TAA can be transferred to similar portfolios as a general rule, but investment restrictions or liquidity considerations may lead to deviations in implementation. In currencies, "others" represents indirect exposures resulting from over-/underweights of unhedged positions in markets, against a portfolio's base currency; the effective position of the base currency may thus deviate from the direct tactical position shown above.

Performance of relevant markets

		1 month	3 months	Year to date	3 years, p.a.[1]	5 years, p.a.[1]
Fixed Income						
Global government bonds	USD	0.6%	0.6%	0.8%	2.8%	3.3%
Global inflation linked bonds	USD	0.5%	1.4%	1.2%	2.4%	1.7%
Investment grade corporate bonds	USD	0.5%	0.2%	-1.2%	2.3%	2.6%
High yield bonds	USD	0.1%	-1.8%	-0.8%	5.8%	4.8%
Emerging market bonds	USD	1.8%	-3.4%	-3.7%	4.5%	3.5%
Equities						
Global defensive	USD	1.0%	1.4%	1.6%	8.6%	9.3%
North America	USD	0.8%	3.8%	5.3%	10.8%	11.8%
Europe	EUR	-0.7%	2.5%	0.7%	4.1%	8.0%
Japan	JPY	-2.6%	0.8%	-3.2%	2.2%	8.4%
Asia/Pacific ex. Japan	USD	-3.8%	-3.8%	-4.1%	8.0%	6.9%
Emerging markets	USD	-3.3%	-7.1%	-6.2%	6.8%	4.6%
Real assets						
Commodities (commodity producers' equities)	USD	0.3%	2.3%	4.0%	7.9%	1.7%
Real estate (real estate investment trusts, or REITs)	USD	1.2%	4.5%	1.2%	5.6%	6.1%
Infrastructure (master limited partnerships, or MLPs)	USD	1.1%	3.4%	0.2%	-5.1%	-4.1%
Alternatives						
Insurance linked securities (ILS)	USD	0.1%	1.4%	3.5%	4.8%	5.5%
HF CTA	USD	1.7%	-1.5%	-3.6%	-0.8%	2.1%
HF equity long/short	USD	-0.8%	0.8%	1.2%	4.9%	5.8%
HF event driven	USD	0.7%	2.1%	2.3%	4.6%	4.8%
HF relative value	USD	-0.2%	1.1%	1.5%	3.7%	4.4%
Listed private equity	USD	2.8%	4.7%	5.2%	8.8%	10.5%
Currencies [2]						
US dollar	USD	0.0%	5.1%	2.9%	0.1%	3.6%
Euro	EUR	1.2%	-0.8%	0.4%	3.1%	1.1%
Swiss franc	CHF	0.3%	1.8%	0.6%	-1.2%	2.4%
Norwegian krona	NOK	0.8%	0.5%	4.6%	0.5%	-3.0%
Australian dollar	AUD	-0.3%	0.0%	-2.7%	0.4%	-1.3%
Japanese yen	JPY	-1.7%	-0.4%	3.2%	3.8%	0.9%

[1] Annualized returns [2] Currencies are represented by Bloomberg's correlation-weighted indices (BCWI), which measure a currency against the remaining ten other major freely convertible currencies, to show the broader strength / weakness of a currency.

Economic and corporate fundamentals

Macro fundamentals		USA	Eurozone	China	Japan	Germany	Britain	Brazil	Russia	Switzerl.
Gross domestic product (GDP)										
- nominal	bn USD	19,391	12,607	12,015	4,872	3,685	2,625	2,055	1,527	679
- nominal, per capita 2017[1]	USD, PPP	59,501	38,322	16,660	42,832	50,425	44,118	15,603	27,834	61,422
- expected real growth for 2017	Consensus	2.3%	2.5%	6.9%	1.6%	2.5%	1.7%	1.0%	1.5%	1.0%
- expected real growth for 2018	Consensus	2.9%	2.2%	6.5%	1.1%	2.1%	1.3%	1.8%	1.8%	2.1%
- real growth in most recent quarter[2]	q/q annualized	2.0%	1.6%	7.4%	-0.6%	1.2%	0.8%	1.6%	-2.3%	2.4%
Unemployment rate[3]		4.0%	8.4%	3.9%	2.2%	5.2%	4.2%	8.2%	4.7%	2.6%
Inflation, core rate (CPI)	y/y	2.0%	1.0%	1.9%	0.1%	1.4%	2.1%	4.4%	2.3%	0.5%
Purchasing manager indices (comp.)	Neutral = 50	56.2	54.9	53.0	52.1	54.8	55.2	47.0	52.0	61.6
Structural budget balance/GDP 2017	IMF	-4.6%	-0.6%	-4.0%	-4.0%	0.9%	-2.3%	-6.4%	-1.4%	0.2%
Gross government debt/GDP 2017	IMF	108%	87%	48%	236%	64%	87%	84%	17%	43%
Current account balance/GDP 2017	IMF	-2.4%	3.5%	1.4%	4.0%	8.0%	-4.1%	-0.5%	2.6%	9.3%
International currency reserves	bn USD	43	284	3,112	1,197	37	125	185	379	800
Govt bond yield 2yr[4]	p.a.	2.60%	-0.50%	2.96%	-0.13%	-0.62%	0.75%	8.76%	7.94%	-0.72%
Govt bond yield 10yr[4]	p.a.	2.87%	0.61%	3.33%	0.04%	0.36%	1.28%	9.34%	8.54%	-0.03%
Main policy interest rate[5]	p.a.	2.00%	0.00%	4.35%	-0.10%	0.00%	0.50%	6.50%	7.25%	-0.75%

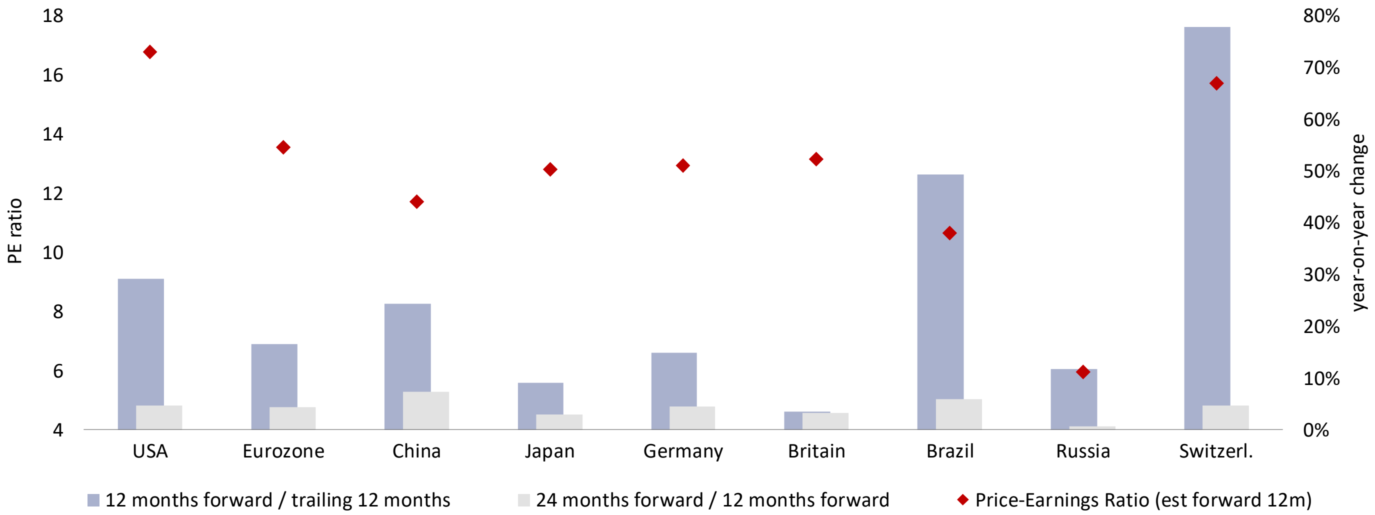
[1]IMF estimates. [2]annualized, most recent qtr. [3]PRC ex. migrant workers. [4]Currency swap rates for China and Brazil, closest ESM or EFSF bonds for Eurozone. [5]Max target rate for Fed, middle of the target range for SNB

Corporate fundamentals		USA	Eurozone	China	Japan	Germany	Britain	Brazil	Russia	Switzerl.
Exchange capitalization*	bn USD	31,134	8,202	11,754	6,065	2,330	3,711	769	613	1,578
Growth in earnings per share, estimated (MSCI)										
12 months forward / trailing 12 months	Consensus	29.2%	16.6%	24.4%	9.1%	14.8%	3.5%	49.3%	11.8%	77.8%
24 months forward / 12 months forward	Consensus	4.7%	4.4%	7.3%	3.0%	4.5%	3.2%	5.9%	0.7%	4.7%
Growth in revenue per share, estimated (MSCI)										
12 months forward / trailing 12 months	Consensus	5.2%	3.6%	13.2%	2.6%	3.9%	1.6%	6.1%	1.9%	4.4%
24 months forward / 12 months forward	Consensus	5.0%	2.8%	11.5%	2.6%	2.7%	0.7%	5.2%	4.2%	1.9%
Valuation metrics (MSCI)										
Price-Earnings Ratio (est forward 12m)	Consensus	16.8	13.6	11.7	12.8	12.9	13.2	10.6	6.0	15.7
Price-Sales Ratio (est forward 12m)	Consensus	2.1	1.1	1.3	0.9	0.9	1.2	1.3	0.8	1.9
Dividend yield	Consensus	1.0%	3.4%	2.3%	2.3%	3.1%	4.4%	3.8%	6.3%	3.4%

*Includes Hong Kong. Source: Bloomberg

Current equity market valuations and earnings growth expectations

(Implied growth based on Bloomberg BEst Estimates for the next 12 to 24 months)



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