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# Perspectives

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## Horizon special

With key economic and market shifts in prospect, PWM's return expectations for the next 10 years contain a stark message: annual returns for all major asset classes could be considerably lower than they have been over the past two decades.

## ECONOMIC INDICATORS & PICTET WEALTH MANAGEMENT ESTIMATES (E) (AT 15 MAY 2018)\*

EQUITIES INDEXES	CURRENT	DECEMBER 2017	DECEMBER 2018	
S&P 500	2730	2674	3050	
Stoxx 600	392	389	420	
Euro Stoxx	395	386	422	
CAC 40	5541	5313	5840	
DAX 30	12978	12918	14500	
MSCI Italy	67	60	66	
IBEX 35	10258	10044	10900	
MSCI EM	1169	1158	1300	
TOPIX	1806	1818	1970	
SMI	9001	9382	10125	
INTEREST RATES (IN %)	CURRENT	DECEMBER 2017	DECEMBER 2018	
Switzerland - short	-0.75	-0.75	-0.50	
Switzerland - 10 year	0.10	-0.15	0.30	
Euro area - Refi rate	0.00	0.00	0.00	
Euro area - Deposit rate	-0.40	-0.40	-0.40	
Germany - 10 year	0.61	0.43	0.90	
France - 10 year	0.84	0.79	1.40	
Italy - 10 year	1.93	2.02	2.50	
Spain - 10 year	1.33	1.57	1.80	
US - Fed rate (mid range)	1.63	1.38	2.38	
US - 10 year	3.00	2.41	3.00	
UK - Repo rate	0.50	0.50	0.75	
UK - 10 year	1.47	1.19	1.50	
Japan - Overnight	-0.10	-0.10	-0.10	
Japan - 10 year	0.05	0.05	0.10	
CREDIT SPREADS (IN BP)*	CURRENT	DECEMBER 2017	DECEMBER 2018	
European IG	93	87	110	
European HY	300	279	320	
US IG	114	99	120	
US HY	337	363	390	
EM Corporates (USD)	294	282	310	
EM Sovereign (USD)	320	286	320	
* Bank of America Merrill Lynch indices				
FOREIGN EXCHANGE	CURRENT	DECEMBER 2017	DECEMBER 2018	
EUR/USD	1.19	1.20	1.25	
EUR/CHF	1.19	1.17	1.18	
USD/CHF	1.00	0.97	0.94	
GBP/USD	1.36	1.35	1.38	
USD/JPY	110	113	110	
COMMODITIES	CURRENT	DECEMBER 2017	DECEMBER 2018	DECEMBER 2019
Gold	1314	1302	1325	
Oil (WTI)	71	63	70	62
GDP GROWTH RATES	CURRENT (YOY)	2017	2018E	2019E
US	2.5%	2.3%	3.0%	2.4%
Euro area	2.5%	2.5%	2.3%	1.8%
UK	1.2%	1.8%	1.3%	1.2%
Suisse	1.9%	1.0%	2.0%	1.8%
Japan	2.0%	1.7%	1.2%	1.0%
China	6.8%	6.8%	6.6%	6.3%
World	3.9%	3.7%	3.9%	3.8%
CONSUMER PRICE INFLATION	CURRENT (YOY)	2017	2018E	2019E
US (core PCE)	1.5%	1.5%	1.9%	2.3%
Euro area (headline HICP)	1.3%	1.5%	1.5%	1.7%
UK (headline CPI)	2.5%	2.7%	2.3%	2.1%
Switzerland (headline CPI)	0.8%	0.5%	1.0%	1.5%
Japan (core CPI)	0.9%	0.5%	1.0%	1.0%
China (headline CPI)	1.8%	1.6%	2.2%	2.5%
World (headline HICP)	4.0%	3.7%	3.8%	3.7%
As of 14.05.18 Source: Bloomberg, Factset, Eikon, AA&MR				

\*Past performances or forecasts are not per se a reliable indicator of future performance.

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# LIVING ON THE MARGIN



**CESAR PEREZ RUIZ**

Head of Investments and CIO  
Pictet Wealth Management

**“The level that margins have reached may in itself be a reason for market participants to worry”**

In spite of a solid earnings season, some market participants are circumspect about the prospects for risk assets. The solid first-quarter earnings season, during which US companies largely exceeded their sales and net income forecasts, failed to spark much enthusiasm and the markets are largely flat year-to-date, reflecting the uptick in volatility due to inflation fears at the start of the year and gathering trade tensions.

There may be some other well-founded reasons for circumspection beyond the often mind-boggling turns in world affairs. One prime reason is the outlook for corporate margins, the rise of which has been key to buoyant earnings in recent years. Some companies, including bellwether stock Caterpillar, have been intimating that Q1 will be as good as it gets.

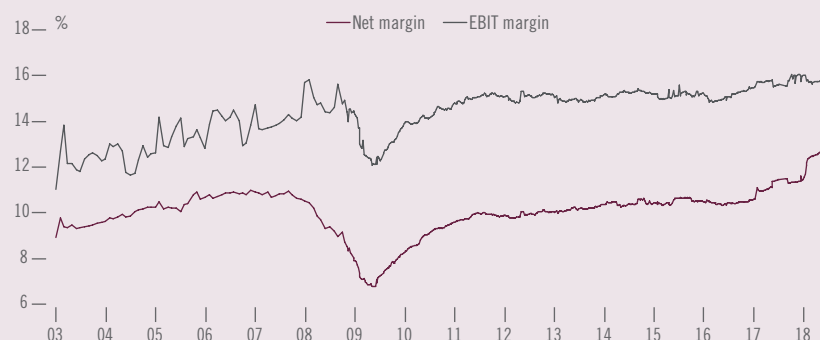
But how can this be? After all, markets remain supported by solid corporate and economic fundamentals, while US companies are still not facing much pressure on the wage front. Indeed, one of the great conundrums of the lengthy economic upswing is the weak momentum in US wage growth, which came in at 2.6% annualised in April. Compare this with expected earnings per share well above 20% for S&P 500 companies this year and after-tax adjusted profit margins that have been not far from 12%, well above the 8% average for the period 2000–07 (see chart).

The level that margins have reached may in itself be a reason for market participants to worry—until one remembers that the rise is largely concentrated in the tech industry. At the same time, the fat margins that large, increasingly oligopolistic tech disrupters are reporting are attracting the attentions of regulatory authorities. The recent rise in oil prices shows that companies could also face pressures from other sources. And one may doubt how long corporations can continue to book increasing profits without facing higher wage pressure, especially as labour markets grow increasingly tight.

This need not be bad news. A fairer distribution of corporate fortunes, whether in the form of productive investments or extra money in consumers’ pockets, could help sales growth and prolong the earnings growth cycle even longer. Put another way, if consumers’ earnings stagnate, how can corporate revenues grow?

One way or another, pressure on margins should increase in the normal order of things. But even if they are squeezed, companies’ revenues can continue to grow if the economic cycle still has legs—which we think it has, thanks in part to an upswing in global investment and household spending. Probably the greatest risk is a surge in inflation in the US and a rise in annualised wage growth towards 3.5%. But barring a trade war with China, the world’s largest economy remains in fine shape and there is no indication that the Fed is behind the curve when it comes to hiking rates. In short, we still expect benign economic conditions to last until 2019, helping cushion corporations against margin pressures.

## NET MARGINS AND EARNINGS BEFORE INTEREST AND TAXES (EBIT) MARGINS FOR S&P 500 COMPANIES, 2003-2018



Source: Pictet WM-AA&MR, Factset, May 2018

# Investment Strategy Highlights

An overview of Pictet Wealth Management's stance on asset classes.\*

## ASSET STANCE

- › Since the beginning of the year, many asset classes have risen marginally at best. In such conditions, asset allocators face two choices.
- › The first is whether one has faith in a global growth engine that is humming along thanks to a synchronised growth cycle and US tax cuts, or whether one decides to listen more to the noise this engine is producing (such as higher long-term interest rates, inflation and changes in the slope of the interest rate curve). We opt for the former and are not changing our basic view that resilient growth will continue to help drive risk asset returns.
- › The second choice involves the direction of economic policy, especially in the US. Do recent initiatives from President Trump (such as the threat of increased trade tariffs on imports) constitute a decisive turn in US economic policy, or are they simply a pre-mid-term election dose of rhetoric? We plump for the latter. Our baseline scenario therefore remains that equity markets will cast aside their current doubts, although we remain conscious that still-high valuations leave no room for disappointment.

## COMMODITIES

- › While geopolitics, shifts in sentiment and OPEC production quotas could maintain upwards pressure on oil prices, they could still drift down towards its long-term equilibrium prices in the months ahead.

## CURRENCIES

- › Driven by signs of moderating growth momentum elsewhere and expectations of US interest rate rises, the US dollar strengthened and emerging market currencies weakened in April. However, our baseline scenario is that the dollar's strength will fizzle out in the medium term.
- › After a further limited decline against the dollar in the short term, we believe the euro could rebound to USD1.25 by the end of the year.

## EQUITIES

- › April proved moderately positive for equities after a good earnings season. Cyclical, which we favour given strong business momentum, outperformed in the

## OUR CURRENT ASSET CLASS STANCE\*\*

	STANCE				
	Very bearish	Bearish	Neutral	Bullish	Very bullish
<b>CASH/CURRENCY</b>					
USD (vs EM and G10 currencies)					
EUR (vs USD)					
CHF (trade-weighted index)					
<b>DEVELOPED MARKET EQUITIES</b>					
US					
Euro area					
Europe					
Switzerland					
Japan					
<b>EMERGING MARKET EQUITIES</b>					
Asia					
Latam					
<b>SOVEREIGN BONDS</b>					
US					
Euro periphery					
Core Euro					
USD EM					
Local currency EM					
<b>CORPORATE BONDS</b>					
US high yield					
US investment grade					
EUR high yield					
EUR investment grade					
Hard currency EM					
<b>GOLD</b>					
<b>HEDGE FUNDS</b>					
<b>PRIVATE EQUITY</b>					
<b>REAL ESTATE</b>					

\*At 1 May 2018.

\*\* 12 month horizon.

US and Europe, while defensive sectors such as real estate and consumer staples lagged.

- › A possible reduction of trade tensions and an extra push from buoyant M&A activity should boost the stock markets.

## FIXED INCOME

- › Our baseline scenario remains that the ten-year yield will peak at 3.1% this year, although we are watching any signs that inflation pressure is proving sustained.
- › We remain neutral on investment-grade credit, with a relatively attractive coupon compensating for the slight widening in spreads we expect this year.

## ALTERNATIVES

- › Most hedge fund strategies rose in value in Q1, proving resilient in the face of market turbulence. We remain overweight tactical

trading and relative strategies that stand to benefit from arbitrage trades.

- › While private equity fundraising eased in Q1, competition and valuations remain high, with managers ever-more pressed to add value

NOTICE: This asset class stance is provided for illustrative purposes only. In general, asset allocations will differ among investors according, in particular, to their individual circumstances, risk tolerance, return objectives and time horizon. Therefore, the asset allocation in this publication may not be suitable for all investors and shall not be used as the basis of an investment decision.



**ALEXANDRE TAVAZZI**

Global Strategist  
Pictet Wealth Management

## INVESTMENT STRATEGY

# Should we 'sell in May and go away'?

While investors might be showing signs of doubt, economic and corporate fundamentals still permit a degree of confidence in risk assets.

The sell-off in risk assets that occurred in late January and early February could largely be ascribed to over-optimistic positioning by speculative investors than to any changes in market or economic fundamentals, which remain sound.

But the fact remains that the main developed-market equity indices continue to struggle and were still close or slightly below the zero mark for 2018 by end-April.

Beyond the technical factors, the changing rates environment would seem to be the culprit. After nine years of economic recovery and the best growth environment since 2010, interest rates have begun to normalise. Logically enough, US long rates have moved above 3% for the first time in this cycle. Moreover, the short end of the US yield curve is under pressure as the Fed has embarked on a normalising path, just as the Treasury has increased issuance of short-dated bonds to fund a rising budget deficit. Thus, two-year US rates had reached almost 2.6% by mid-May, a level well above the S&P 500 dividend yield. Investors thus have the option to stay out of equities and collect a return on their cash by simply investing in risk-free short-term government bonds. Rising rates mean that the dollar has also been strengthening recently and gold prices have declined.

At the macroeconomic level, recent Q1 GDP statistics point to a soft patch in US and Europe growth. In the former, private consumption looked particularly weak when one considers that US households' disposable income rose a sharp 3.4% last quarter (the result of lower taxes). In Europe, temporary factors explain most of the

disappointment, especially in recent soft data such as business sentiment. In both cases, inflation remains quite low. Although the tightness in labour markets may lead to higher wage growth in the coming quarters, we do not see any signs of inflation running out of control.

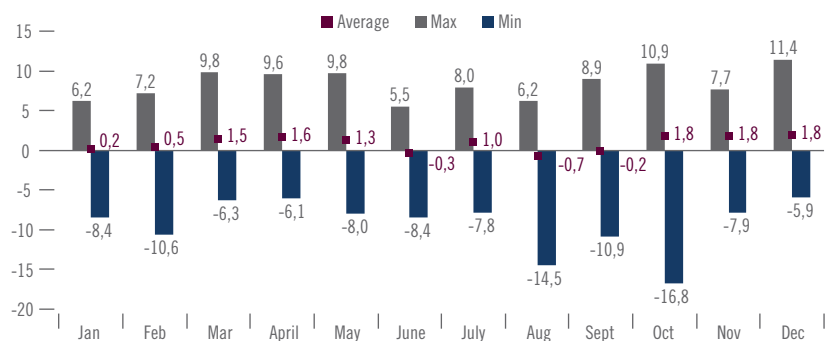
### Margins may have hit their top

Corporate earnings for Q1 largely beat expectations, but some issues are coming to the surface. Among these, the effect of rising costs and higher borrowing rates on corporate margins will be crucial. Some companies like Caterpillar have indicated that record first-quarter profits probably marked the "high watermark" for the year and that margins may have topped for this cycle. Markets will thus carefully look more closely at the potential for an escalation in international trade tensions to hurt US manufacturers' profitability through higher input costs. Despite these open questions, growth remains strong, with earnings growth of over 20% this year forecast for the

S&P 500 and over 9% for the Stoxx Europe 600. Growth of 20% in earnings should ensure equities are better remunerated than cash.

Despite the rise in interest rates and the question marks about corporate profitability, we remain reasonably optimistic for risk assets as we expect economic growth to rebound in the second quarter, while the early-year sell-off means that valuations have declined to summer 2016 levels. The current environment is clearly more uncertain than only a few months ago, which implies higher volatility, but current valuations have improved the trade-off between risk and reward on equity markets. There is a chance the old dictum, 'Sell in May and go away' does not hold this year. ■

### MAY IS NOT A PARTICULARLY BAD MONTH FOR EQUITIES—MONTHLY RETURNS SINCE 1990



Source: Pictet WM-AA&MR, Factset, May 2018

# Diminishing returns to become the norm

Pictet Wealth Management has published *Horizon\**, containing its analysis of expected returns for a wide variety of asset classes over a 10-year investment horizon. Simply put, the major asset classes can be expected to deliver lower average annual returns than in the past amid shifts in market and economic regimes and a wave of disruptive innovation. Cash and government bonds could offer poor returns and even equities could prove a less profitable investment than they have been. But alternatives such as private equity offer greater potential in exchange for a degree of illiquidity.

The latest issue of *Horizon*, in which Pictet Wealth Management sets out its expected returns for a range of asset classes over the coming decade, demonstrates the validity of a simple rule: higher expected returns require taking on more risk, with the most liquid (cash) and most risk-free assets (sovereign bonds) expected to deliver much lower returns than higher-risk assets (equities), while alternatives in general, and private equity in particular, have the potential to generate excellent returns. But private equity – the asset class with the highest expected return – commands an illiquidity premium (see chart).

**Cash.** Cash is no longer king! In the past, as long as real rates were negative and inflation low, it made sense to hold cash. But in the evolving market regime there are no returns without risk. As we progressively return to a regime characterised by positive real rates, cash will again be considered simply somewhere to park money temporarily before deployment to other assets offering higher returns. Expected average annual nominal returns for cash range from zero in Japan to 1.4% in Europe and 2.8% in the US.

**Government bonds.** As long as there is no spike in inflation, sovereign bonds still have their place in portfolios as a form of protection against recession, economic crisis and systemic risk. But one can no longer expect both protection and high returns. Investors will have to choose one or the other.

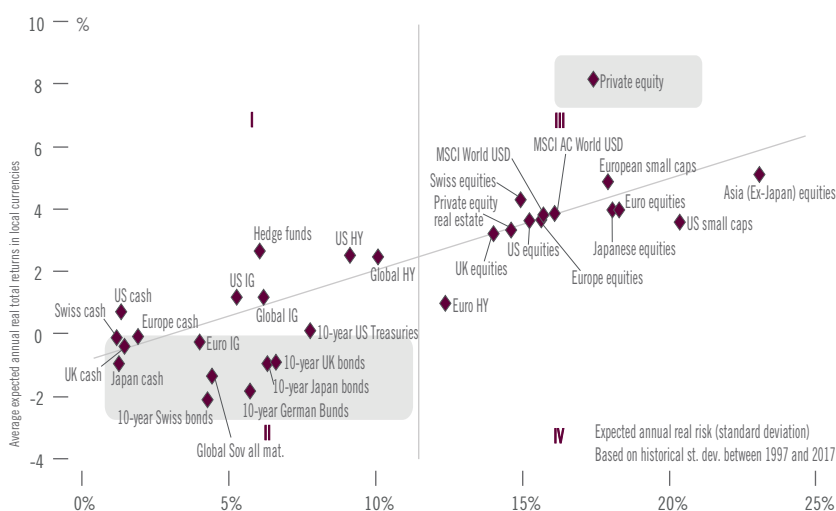
As part of the regime shift that is underway, average annual nominal

returns from core US Treasury bonds over the next 10 years could be less than 2.5%, according to our analysis—considerably less than the 9% they have delivered on average over the past four decades. But that would be more attractive than other 10-year government bonds, including the German Bund, which we expect to deliver an average return of -0.3%, and the Japanese 10-year bond, which we expect to return an annual average of -0.4%.

**Credit.** Returns are expected to be higher on average for US-dollar than for euro corporate bonds. Our analysis suggests euro investment-grade bonds should produce an average annual nominal return of 1.3% over the next 10 years, compared with 3.3% for (continued on page 8)

**“Alternatives, particularly private equity, have the potential to generate excellent returns”**

## MAJOR ASSET CLASSES' EXPECTED ANNUAL REAL TOTAL RETURNS AND RISK (IN LOCAL CURRENCY)

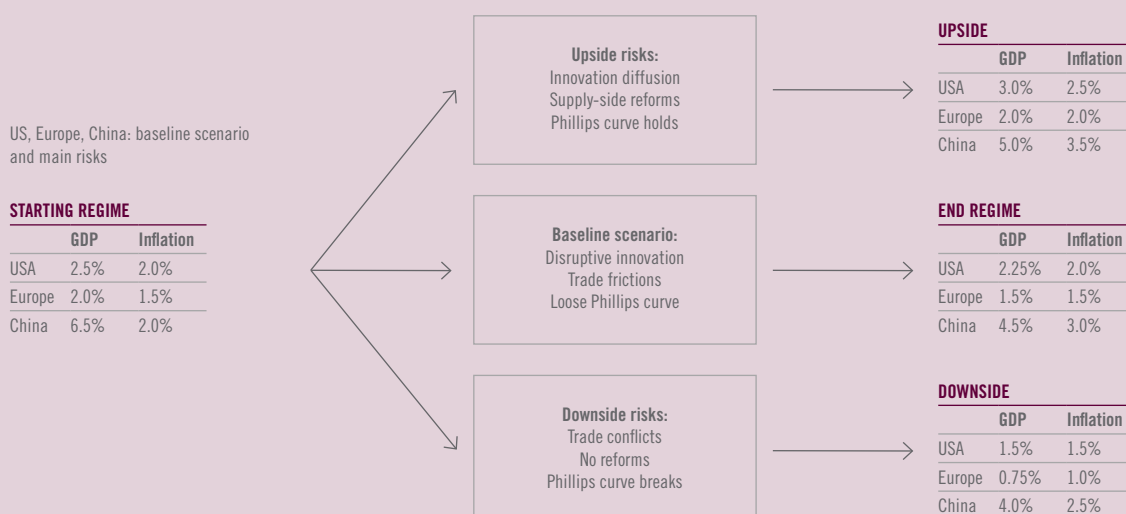


Source: Pictet WM-AA&MR, Factset, Global Financial Data, March 2018

\* For a copy of *Horizon*, please contact your Pictet relationship manager



## SECULAR OUTLOOK: ECONOMIC REGIMES AND THE BALANCE OF RISKS



Source: Pictet WM - AA&MR, Datastream

### SHIFTING ECONOMIC AND ASSET-CLASS REGIMES

Our 10-year expected returns incorporate top-down macroeconomic analysis that is built around the identification of economic regimes and shifts in those regimes. Such shifts can be provoked by a variety of factors, such as changes in monetary or fiscal policy, financial crises, political conditions or geopolitical crises.

Factors such as the lingering legacy of the financial crisis and a new wave of geopolitical risk are shaping the global economy and long-term investment outlook. Horizon's expected returns are also predicated on a regime shift prompted by innovation. The current innovation shock is still at a relatively early stage, but is steadily gathering pace. However, we believe this shock should have a limited impact on overall economic growth unless more ambitious pro-business, supply-side reforms are introduced in the coming years.

Yet, independently of the news cycle, our baseline case is still that we remain in the midst of a slow normalisation of growth and inflation—albeit with regional and national differences. Sustained governmental and central bank support and, more recently, fiscal cuts and spending increases (particularly in the US) are consolidating this view.

Taking into account disruptive innovation, some trade frictions and the re-emergence of a re-defined Phillips curve, our baseline scenario is that annual growth will end up in 10 years' time at 2.3% in the US, 1.5% in the euro area and 4.5% in China, compared with recent growth rates of around 2.5%, 2.0% and 6.5%, respectively. The accompanying chart presents some alternative upside and downside scenarios for growth and inflation.

The relationship between inflation and unemployment/wage growth as expressed by the Phillips curve has been highly irregular in recent years. But we believe it still holds (especially if broader definitions of unemployment are used)—albeit in a weaker, non-linear form. We remain of the view that emerging countries, especially China, will eventually export inflationary pressures to their trading partners. That said, we expect central banks to proceed toward normalisation very cautiously for the foreseeable future—in part because of the still-elevated overhang of public and private debt. Indeed, global debt has continued to increase since the sub-prime crisis and remains a risk to our baseline scenario.

An escalation of trade disputes is another risk to this baseline scenario: a genuine turn towards US trade isolationism would be likely to lead to a much lower growth trajectory than we currently forecast. But we still rule out a full-blown trade war. ■

US-dollar investment-grade. We expect average annual returns in the order of 2.5% for euro high-yield bonds, compared with 4.6% for US dollar high yield. The latter provides a much better risk-return profile than either global high yield or euro high yield.

**Equities.** The returns of developed-market equities over the next 10 years should, according to our analysis, be roughly a third lower than they have been over the past four decades. Their annual nominal returns over the coming decade in local-currency terms could range from an average of

5.0% for UK equities to 7.2% for Asia (ex Japan) equities. European small caps could deliver an average annual 6.4%.

**Alternatives.** Over the next 10 years, our analysis indicates that the average annual nominal return of private equity could be 10.2% in local-currency terms, the highest of any of the asset classes we analyse. But private equity's standard deviation of returns (the expected annual nominal risk) is also among the highest, at 17.4%.

Our expectation that the returns of traditional highly liquid assets (such

as bonds and equities) over the next 10 years will be about half what they were in the past calls for a change in the style of how we approach strategic asset allocation. A shift to more of an endowment-kind approach could help optimise returns by taking greater exposure to more illiquid asset classes such as private equity and private equity real estate. The play-off between risk and return in these areas should remain attractive in light of the evolving market and economic regime (see page 7). ■



**CHRISTOPHE DONAY**

Head of Asset Allocation &  
Macroeconomic Research  
*Pictet Wealth Management*

## HORIZON SPECIAL

# Subdued prospects for growth, inflation and expected returns

In an interview to mark the publication of *Horizon*, Christophe Donay suggests what investors could do about the fall in expected returns for most asset classes over the next 10 years.

### What is so particular about *Horizon* and the 'expected returns' it contains?

*Horizon* contains Pictet Wealth Management's (PWM) estimates of average annual returns relative to risk for a range of asset classes over the coming 10 years, a period that corresponds to the timescale of PWM's strategic asset allocation. Our large private clients also typically adopt an investment horizon of 10 years (or more). Building a robust idea of return prospects is essential for calibrating portfolios according to these clients' risk-return requirements.

In simple terms, the expected returns we calculate are fed into our goals-based strategic asset allocation. Clients obviously want to see the value of their holdings increase. But seek high returns even at the risk

of volatility, while others are more interested in protecting their principle and earning a steady income instead. Depending on the different emphasis investors place on high returns and portfolio protection over time, we can propose suitable investment solutions that take into account our expected returns for different asset classes.

To calculate expected returns, we use a dynamic model that is constantly being updated with the latest available data inputs. The number of asset classes we cover has been constantly expanding: when we first undertook this exercise in 2013, we covered 12 asset classes in local-currency terms. In this latest edition of *Horizon*, we provide the expected returns for 35 asset classes (including emerging-market assets) in US



dollars, euros, Swiss francs and sterling, as well as in local-currency terms. And we have also changed the way we treat currencies. Previously, we were agnostic on currencies, deriving their expected returns by looking at market exchange rates and forward contracts. We now take a more dynamic view of currencies' impact on returns, basing our calculations on the notion of equilibrium exchange rates.

The methodology we use to calculate expected returns integrates the most advanced academic research on asset pricing and investment and we apply it consistently across all asset classes. One of the originalities of our approach is the combination of this research with our own views on economic fundamentals and market developments to help us spot 'regime shifts'.

### Have there been any economic or market 'regime shifts' of note since last year's edition of Horizon?

Disruptive technological innovation and globalisation continue to shape the global economy, but the only economic regime shift of note since last year involves China. In our baseline scenario, we now see annual economic growth in China of 4.7% in 10 years' time, considerably lower than our forecast for its growth this year (6.6%), and inflation to be 3%, about 1 percentage point higher than today. Otherwise, there are no great changes: we remain in a relatively low-growth, low-inflation regime, throughout the

developed world at least, with projected economic growth of 2.3% in the US in 10 years' time and 1.5% in the euro area.

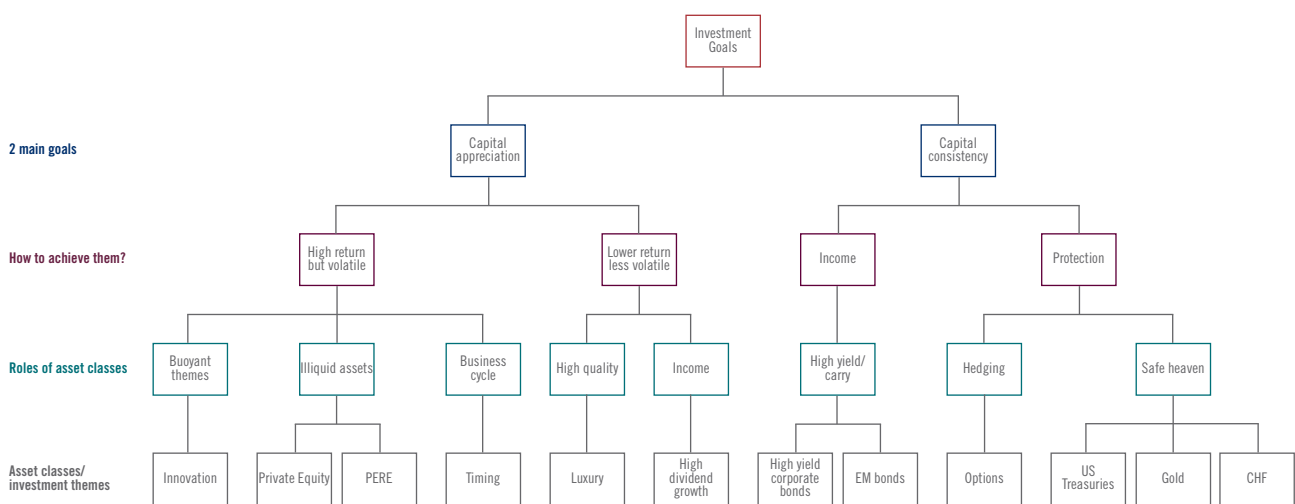
In terms of market regimes, we reiterate our view that returns will be considerably lower than they have been across all traditional asset classes, with the most dramatic declines coming in cash and core government bonds. The highest cash returns will come from the US dollar, the lowest from the yen, while Swiss, Japanese and German government bonds could all lose value in the coming 10 years. We also expect that average annual returns from equities will be about a third lower over the next decade than they have been in the past. Against this backdrop, we continue to believe that diversified portfolios need to include alternative assets to boost returns. Our analysis suggests that private equity and private equity real estate look particularly attractive, with the former seen as providing the highest average annual return of any asset class (10.2% in local-currency terms). Basically, to optimise returns in the years ahead investors will have to be open to investing in more illiquid asset classes. Our expectation that a traditional, historically effective 60% equities / 40% bonds portfolio will produce much lower returns over the next 10 years also means that wealth managers will need to adapt their style of strategic asset allocation (*see diagram for one possible model*).

### Overall, do you believe the glass is half full or half empty when it comes to the prospects for the global economy and financial markets?

There are two closely connected debates going on in economic circles at the moment. One pits those who think that the threat of deflation continues to hang over advanced economies against others who think that inflation is about to take off. For our part, our analysis suggests there should be neither deflation nor any great spurt in inflation over a 10-year horizon—although this does not exclude the possibility of some occasional spikes in inflation within this period. In fact, in our baseline scenario we believe annual inflation will be the same in 10 years' time as today in the European Union and the US. Only in China do we see a decisive rise in inflation, from 2.0% to 3.0% annually. Indeed, we expect China (and other emerging markets) to be a source of inflation rather than disinflation over the next 10 years.

The other debate revolves around the idea that developed economies are set for a long period of secular stagnation. Without being wildly optimistic, we do not agree. Our belief is that we are in the midst of a radical innovation cycle. Radical innovation initially causes a lot of disruption, but it should eventually lead to a rise in overall prosperity. This has historically been the case. Indeed, Horizon maps out an alternative scenario to our baseline view to capture the possibility that the spread of innovation

## INVESTMENT GOALS-BASED STRATEGIC ASSET ALLOCATION



Source: PWM - AA & MR

(together with supply-side reforms and a restoration of the traditional correlation between low employment and rising prices (the so-called Phillips curve)) leads to both higher growth and higher inflation.

**Coming back to innovation, a major theme in your long-term economic and market outlook, are you ‘techno-optimists’ or ‘techno-pessimists’ at PWM?**

Neither. We are ‘techno-realists’. Our view of innovation is that it is disruptive, deflationary (at least initially), global in impact and exponential. Innovation continues to play a big role in our expectations for economic growth and asset class returns. We

believe we are still near the beginning of a radical technological innovation wave. This innovation has done little to lift productivity so far because it has simply been displacing existing traditional industries and has not necessarily added to aggregate demand as yet. But we believe we are moving closer to more generalised propagation that looks set to fundamentally alter economies at large. In the end, stronger wage growth could be one of the drivers needed for an innovation-related investment boom, serving as a catalyst for global productivity. Yet one could equally argue that the innovation wave will change the role of humans in the production process—and in so doing increase

inequality, pushing out workers ill-equipped to deal with the latest technological changes, or at least forcing down their wages.

**Another theme that Horizon dwells on extensively is the growth in private debt...**

Private debt (the debt of households and non-financial corporations) continues to rise as a proportion of GDP. Although still manageable, this is something that will have to be monitored. We are paying particular attention to China, where private-sector debt was 194% of GDP in late 2017. Having increased almost four-fold since 2008, Chinese debt is an area of fragility for the world economy. ■

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## HORIZON SPECIAL

# The leverage issue: rising global debt

The build-up of Chinese debt remains a cause for concern, and the situation in some European countries and the US also needs to be watched closely.

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**“Without immediate action, China could face a Minsky moment”**

In the run-up to the financial crisis, several euro area countries built up large sums of domestic debt as a result of favourable financing conditions and buoyant demand growth. In the euro area as a whole, private sector debt had risen from 115% of GDP in 1999 to 164% of GDP by the middle of 2009, and was still at 160% of GDP in Q3 2017.

Germany is the only one of the four largest EU economies that has seen its debt ratio decrease throughout the 2000s, falling from 125% in 1999 to 108% by Q3 2017. France has moved in the opposite direction, with its private-sector debt-to-GDP ratio hitting 192% in Q3 2017. In Spain, private-sector debt peaked at 218% of GDP in mid-2010, but had declined to 160% by Q3 2017.

Although the private sector has made progress in repairing balance sheets since the financial crisis and the euro area sovereign crisis, private debt levels in some countries are still very high, exceeding 120% of GDP. Given buoyant economic activity and

favourable financial conditions, corporate leverage has risen again, increasing sensitivity to higher rates. Indeed, almost two-thirds of private-sector debt in the euro area relies on the banking sector. Given this dependence, the current economic upswing could be an occasion to complete capital market union and help firms diversify their funding between debt and equity. And European companies need to be encouraged to use these favourable economic conditions to build up their capital buffers. Future development of the euro area’s debt situation will also depend crucially on governments’ policy choices. With interest rates expected to increase in the coming years, the need for macro prudential measures to avoid repeating history will be critical.

## CHINA’S DEBT IS OF GLOBAL CONCERN

According to our estimates, by Q3 2017, China’s total private-sector debt amounted to RMB156 trillion,

equivalent to 194% of its GDP (see chart 1). Since the end of 2008, total private debt in China has increased by 371%, and its ratio to GDP by 91 percentage points.

Non-financial corporates are the largest debtors, accounting for 74% of China's total private debt, equivalent to 143% of GDP (see chart 2). They are followed by the household sector, whose debts amount to 51% of Chinese GDP, and the government sector (central and local governments combined), which owes debts equivalent to 45%.

China's debt has attracted a lot of attention for a number of reasons. First, the potential bursting of a credit bubble in China would have huge consequences. Even though the Chinese household sector's debt-to-GDP ratio is actually among the lowest of the major economies at 51% of GDP, China's aggregate private debt is among the highest. Any financial disruption in China could cause enormous turmoil in the markets. Second, debt has been growing at a blistering pace. Third, the indebtedness of China's non-financial corporate sector is especially worrisome. At 143% of GDP, Chinese non-financial corporates owe more than twice as much as their counterparts in the US. Last but not least, the rapid growth of the poorly regulated, nebulous shadow-banking industry in credit creation in China is raising concerns.

On the other hand, Chinese debt exhibits some distinct features that make the system less prone to a crash and sustainable for far longer than many might suppose.

First, most Chinese debt is borrowed domestically. External debt accounted for less than 5% of total debt, or 12.7% of China's GDP, at the end of 2016, the lowest level of any major economy and

significantly below the levels in Mexico before the debt crisis of 1982 or in other Asian countries before the 1997 Asian financial crisis.

Second, about two-thirds of non-financial corporate debt is owed by state-owned enterprises, whose main creditors are state-owned banks. Since the entities on both sides of the transactions tend to be controlled by the Chinese government, outright defaults are rare, especially when the stakes are high.

Nonetheless, leverage cannot continue to rise without consequences. At the very least, there is the risk of capital being misallocated, with zombie companies being kept alive at the expense of more viable parts of the economy. Were the problem to grow, even an all-controlling government would eventually find the situation impossible to deal with. In our view, without immediate action to contain a further increase in China's debt, a 'Minsky Moment' (with a sudden collapse of asset values after a long period of speculation using borrowed money) looks inevitable down the road.

Fortunately, the authorities are taking the problem seriously. Since the second half of 2016, a series of policy measures to contain rising leverage have been introduced.

In the household sector, efforts are being concentrated on controlling mortgage loans, which constitute the bulk of household debt, by restricting speculative home purchases. The government has also been aggressively cutting excess capacity in some industries as part of supply-side reforms. The steelmaking and coal mining industries are on track to reduce their production capacities by nearly 10% from

their peak in 2015. These measures have substantially improved remaining companies' profitability and their ability to service debts.

These policies, combined with a rise in nominal GDP, have resulted in the growth in Chinese private debt slowing quite significantly since H2 2016. In addition, the central government is starting to tackle the debt issues in the financial and public sectors, cracking down on shadow banking and scrutinising local governments' infrastructure plans more closely.

We think it is too early to claim that the Chinese debt problem is close to being solved, but it appears to be moving in the right direction. In the meantime, vigilance is advised.

## US – A SHARP RISE IN GOVERNMENT AND CORPORATE DEBT

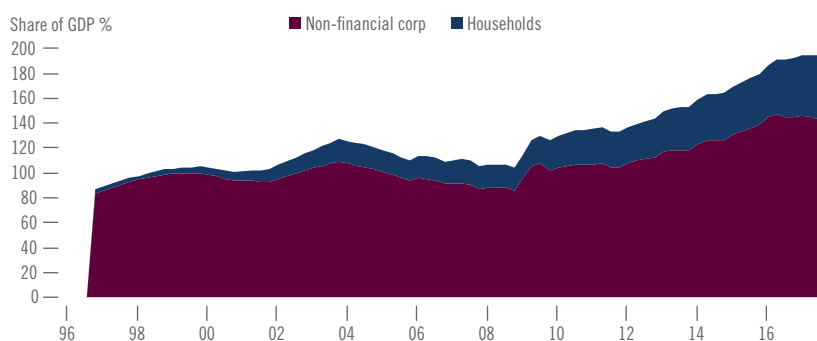
Household debt has fallen sharply in the US since the subprime crisis, dropping from 98% of GDP in Q1 2008 to 79% by Q3 2017, according to Bank for International Settlements data.

But the fall in household debt has been mostly due to a sharp reduction in mortgage debt, whereas several other categories of household debt have been rising steadily, led by auto loans and student debt. Non-mortgage debt rose from 20% of GDP in Q2 2013 to 21.6% in Q3 2017.

A rather puzzling development in recent months has been the deterioration in credit quality and rise in delinquencies, despite the sharp improvements in the labour market and the economy in general. This echoes the view that the recovery has been uneven among US households. Some have only seen meagre gains in incomes and are already facing difficulty in repaying their credit card loans. The situation could worsen as the prime rate (the lowest rate of interest at which money can be borrowed) rises in the wake of higher Fed interest rates. Hopefully, the rise in interest rates will be offset by an acceleration and broadening of wage growth.

The rise in Fed interest rates is also shining the spotlight on the sharp increase in government debt, which rose from 57.7% of GDP in Q4 2007 to 97.0% in Q3 2017. The situation is not yet alarming given the very low interest rates paid on this debt. Debt servicing

**CHART 1: CHINESE PRIVATE DEBT-TO-GDP RATIOS**

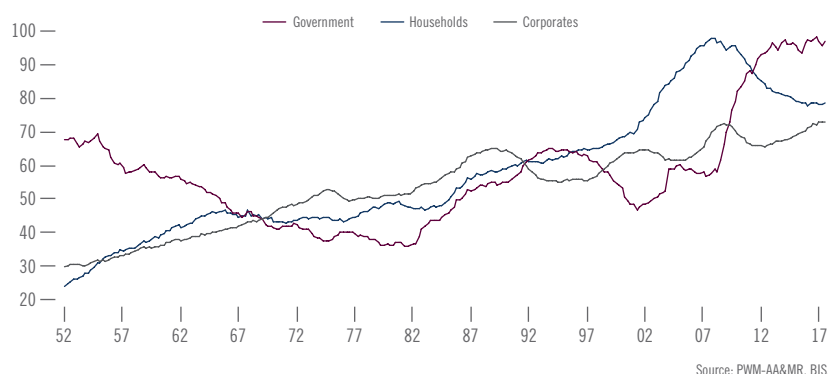


Source: Pictet WM - AA&MR, PBoC, NBS, SAFE, Ministry of Finance, CASS, Wind

should represent only 1.6% of US GDP in 2018, according to the Congressional Budget Office (CBO). But without a stricter deficit reduction strategy the CBO calculates that debt servicing will exceed 5% of GDP by 2022.

The key to US debt sustainability, both private and government, is whether GDP growth and productivity pick up. Hopefully the recent increases in investment will deliver higher potential growth. Otherwise, the Federal Reserve could come under pressure to ‘amortise’ all that debt one way or the other — with highly uncertain consequences. ■

**CHART 2: DEBT AS A % OF US GDP**



**DONG CHEN,**

Senior Asia Economist,  
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## HORIZON SPECIAL

# Asia as a source of inflation

Over the past two decades, China and other Asian countries have been a deflationary force in the global economy. But this could be about to change.

With greater integration of trade, finance and production, inflation has become increasingly influenced by global factors in recent years. Through its large pools of low-cost labour, emerging markets in Asia (and China in particular) have been a deflationary force in the global economy. But the fall in the workforce could result in Asia beginning to export inflation.

China's working-age population has peaked and the supply of urban labour has fallen below the level of demand since 2011. According to the Ministry of Human Resources and Social Security, urban China has been experiencing a labour shortage since 2001, aggravated by the rapid growth of service industries. A tight labour market drives up wage growth. In 2012, the growth in China's urban disposable income started to surpass nominal GDP growth, reversing the

relative positions that had mostly prevailed since at least 2003. As a result, labour compensation's share of GDP started to rebound in the same year after two decades of decline.

In our view, a shrinking workforce and rising labour costs will continue to exert inflationary pressures on the Chinese economy. On the demand side, rising household income is providing solid support to consumption, which is likely to put upwards pressure on prices. On the supply side, the growth in wages has been faster than the increase in productivity. As a result, businesses will eventually have to hike prices to compensate for rising labour costs. This is especially true for services, which are typically more labour intensive than manufacturing and where productivity growth is harder to achieve. Since 2002, when data on China's services CPI were first made available, services inflation

has more often than not been higher than that of other non-food items. As China's middle class's consumption increasingly turns from goods to services, this pattern should persist.

Based on a recent Bank for International Settlements study that identifies a positive relationship between inflation and a country's dependency ratio, China's headline rate of consumer price inflation could rise to about 3% by 2025 and stay around that level until the end of the decade. This would be about 1 percentage point higher than the average between 1998 and 2016 (see chart 1).

As the largest manufacturing hub in the world, when China sees inflation rise, mainly as a result of higher labour costs, the impact is likely to be felt globally. Of course, part of the price pressure can be offset by businesses sourcing from countries with lower costs. Indeed, many labour-intensive



manufacturers have already moved their production facilities from China to countries like Vietnam and Indonesia, where labour costs are roughly half those in China. This process started after the global financial crisis and is still going on.

In our view, however, industrial migration cannot fully offset the inflationary pressure from China. First, the largest part of the demographic dividend in Asia is already behind us. The growth in the labour force in the three most populous emerging coun-

tries (China, India and Indonesia) will be much slower than in the past over the coming decade. The three countries combined will see a net increase of their working-age population of about 121 million over this time, which is less than half of the increase in 2004-2014 (248 million) and 1994-2004 (303 million).

Second, while businesses can reduce their labour costs by moving out of China, they typically find themselves facing lower productivity and higher costs in other aspects (such as logistics) in the new destinations. In some cases, the overall costs could be even higher. In many areas of manufacturing, no other country has as complete a supply chain as China, and the scale of production that can be achieved in China is generally difficult to replicate in other countries, at least in the short term. As a result, the inflationary pressure brought about by Chinese manufacturers is highly unlikely to be absorbed fully by industrial relocation.

In addition to rising labour costs, some policies that the Chinese

government is pursuing to rebalance the economy will also add to global inflation, at least in the next few years.

First, as part of its supply-side reforms, the Chinese government has started to push aggressively to reduce excess capacity in some heavy industries. In steelmaking, for example, the government set a target of reducing total production capacity by nearly 9% (roughly 103 million tonnes) by 2020 from its peak in 2015. A similar target was set for coal mining. By Q3 2017, the total reduction in steel capac-

ity had reached 100 million tonnes (see chart 2), while the reduction in capacity for coal mining has been over 400 million tonnes.

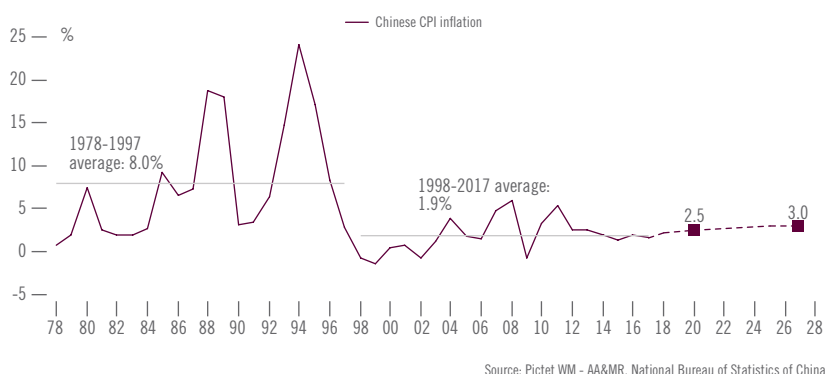
As China is the largest steel producer in the world, this aggressive capacity cut has led to a surge in global steel prices. A similar price rally has been observed for coal. Aluminium, another material that suffers from considerable excess capacity in China, could be the next candidate for capacity reduction. Such measures are likely to continue to create upward pressure

on the prices of some key industrial materials in the next few years, and this will eventually feed into consumer prices around the world.

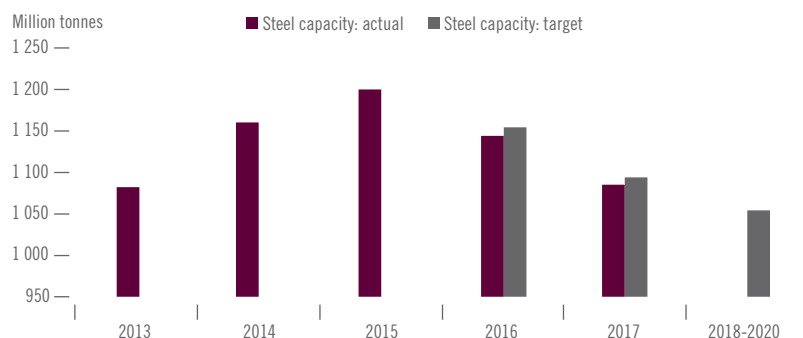
Second, the Chinese government is likely to take an increasingly tough stance on pollution control going forward as the country pursues quality growth. According to the Ministry of Environmental Protection, in the first half of 2017 the number of factories that were closed or suspended due to violation of environmental standards more than tripled compared with the same period in 2016. A recent survey conducted by investment bank CLSA suggests that production costs for some polluting industries could increase by 7% if current environmental standards are strictly enforced. These additional costs, just like in the case of rising labour costs, are unlikely to be fully offset by turning to alternative suppliers outside China. Over time, they will probably gradually translate into higher consumer prices in other parts of the world.

To summarise, after being a deflationary force for over two decades, we believe Asia is likely to gradually turn into an exporter of inflation. This process may be slow and non-linear due to unforeseen technological shocks. But at the very least, Asia, and emerging markets more broadly, should cease to be a source of deflation for the global economy over the coming decade. ■

**CHART 1: CHINA INFLATION TRENDS HIGHER BUT REMAINS STABLE**



**CHART 2: CHINESE STEEL CAPACITY**



**JACQUES HENRY**

Senior Cross-Asset Strategist  
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## Upside surprises underpin a strong earnings season

Earnings expectations have increased overall, especially for financials and energy-related stocks, but the picture has been more downbeat for more defensive sectors.

**GREGORY KUNZ**

Head of Equity Research  
Pictet Wealth Management

Earnings momentum remained strong during the first four months of 2018, with global earnings growth expected to reach 14.6% this year – almost four percentage points higher than what investors were expecting back at the end of December. The S&P 500 continues to lead the way (*see chart*), partly thanks to tax cuts and a weaker dollar. In the euro area, earnings growth for the year is expected to be solid, although a strengthening euro has triggered some negative revisions of late.

Almost 460 S&P 500 companies had reported their first-quarter earnings by mid-May, with two-thirds beating their sales and net income expectations. The average surprise in terms of sales (+1.6%) and net income (+3.3%) had also improved relative to the previous quarter. Overall, top-line figures have proved as robust as the tax-boosted bottom line. European figures have not been quite as strong, but over half of Stoxx Europe 600 stocks that had reported by mid-May were showing revenues and net income significantly above expectations.

Supported by these strong Q1 results, 2018 US earnings growth expectations had risen above 21% by early May. This is close to the initial rough estimate we made when the US tax cuts were announced last December. Interestingly, all sectors in the US have benefited from this rise in growth expectations. Sector investment returns have taken their cue from earnings trends, but there are some interesting facts to highlight.

The strongest positive surprises in terms of earnings per share have come from industrials, consumer discretionary, energy and IT, while defensive

sectors have either missed expectations, as has been the case for consumer staples, or have reported only marginally positive earnings surprises.

The already positive trend in expectations extended further for financials (supported by higher yields) and for oil & gas (supported by higher oil prices) in Q1. Meanwhile, the earnings outlook for technology remains as solid as ever (2018 earnings growth for the sector has been revised up from 18.9% to 21.2%), which is reassuring after all the concerns surrounding privacy and the regulatory issues facing Facebook.

**Energy** has benefitted from renewed investor interest since early March and now ranks amongst the best-performing sectors year-to-date, fuelled by rising oil prices. We expect fundamentals to remain strong in the near term, as evidenced by the rapid decline in global oil inventories, even though the ending of US infrastructure bottlenecks could cloud the outlook for the sector by boosting oil supply.

The **US technology** sector, which was hit by negative news flow and high valuations in March, recorded a strong earnings season. After a lot of market noise, solid reports from big companies like Facebook and Google confirmed that the earnings outlook for the sector as a whole remains positive.

Among **industrials**, strong earning beats did not produce much by the way of higher share prices, whereas disappointments were severely punished; margin pressure from higher raw material costs has become a common theme, while sales comparisons with previous quarters have become tougher. The spectre of trade war has not been helping the sector either (*see separate article*). We may have entered a phase of valuation contraction

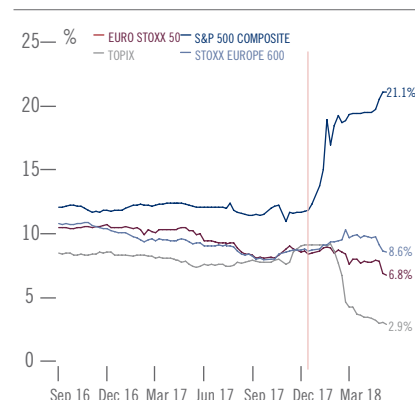


that requires patience. This may be a good time to look opportunistically at quality cyclical companies.

The dichotomy between the earnings performance of consumer **discretionary** companies on the one hand and consumer staples firms on the other is striking. The former has been benefitting from a boom in Chinese spending across almost all categories, prompting luxury conglomerates to report accelerating growth in the first quarter. Conversely, defensive **consumer staples** companies reported uninspiring results, still dominated by weak market share trends and distribution channel disruption.

The **utilities** sector is intriguing. Against a sound macroeconomic backdrop and at a time of rising bond yields, utilities are usually expected to underperform as their high dividend yields and regulated structure should be relatively unappealing to investors. And yet utilities shares have been outperforming since the beginning of the year in all regions, without any significant upward earnings revisions. Could this be a result of concerns in some quarters about economic prospects? This is unclear as yet and we remain positive on the US and European economies for the remainder of the year, but this type of market action has to be followed closely. ■

## 2018 EXPECTED EARNINGS GROWTH (AT END-APRIL)



Source: Pictet WM-AA&MR, Factset, May 2018

## M&A REMAINS BUOYANT... BUT FEW 'CHEAP DEALS'

So far this year equity returns have been fairly disappointing and market volatility has been significantly higher than in 2017. However, this has been driven neither by poor economic conditions nor by a worsening of company fundamentals, while mergers and acquisitions (M&A) have been supportive of the markets. Indeed, the acceleration of M&A in most regions illustrates that investor sentiment is not too pessimistic, which should help equity markets in the coming months.

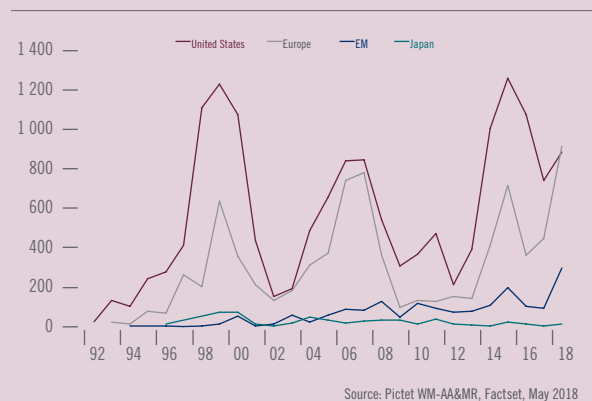
In the first four months of this year, 41 deals above USD 1bn were announced in the US, 30 in Europe and 20 in emerging markets. Annualising these figures shows an increase relative to 2017 in all of these regions, with the strongest acceleration in Europe and emerging markets. These annualised M&A figures represent 4% of current market capitalisation in the US and 9% in Europe. The aggregate value of deals in the first four months of 2018 was also impressive—USD 284bn in the US, USD 293bn in Europe and USD 96bn in emerging markets.

The premium paid by acquirers this year has been generous, at around 30% of market value in the US and over 40% in Europe—significantly higher than the 2017 average. Valuation multiples (in terms of EV/EBITDA) have been close to 13x in the US. The biggest deals have been in healthcare, both in the US and Europe, followed by tech in the US and consumer discretionary in Europe.

Long-term interest rates have been increasing this year, both for sovereigns and for corporates, impacting the kind of M&A deals being undertaken. Cash-only deals have increased in number over the past year, suggesting companies are turning to debt financing before further rises in rates.

Since 1992, an average of 19% of deals announced have eventually failed or were never finalised. Historically, big deals have been more likely to fail in Europe (20.6% of deals have failed in Europe, according to our analysis, compared with in the US (17.5%). The way mega deals are treated by the authorities may go some way to explaining this difference, with European anti-trust rules often seen to be more stringent than those in the US.

## VALUE OF M&A DEALS (USD BN) AT MID-MAY 2018



Source: Pictet WM-AA&MR, Factset, May 2018

In Japan, domestic M&A activity has always been tepid, with deal volume representing less than 1% of market cap since 2012. Promoting M&A has not been one of the targets of Abenomics, even though mergers could help improve efficiency and deal with excess cash on corporate balance sheets. Nonetheless, Japanese companies remain highly active in M&A outside Japan, having acquired companies worth USD 97bn since the beginning of the year. ■

## HOW THREATS OF TARIFFS COULD HURT

**The consequences of further escalation in trade tensions could be considerable. Certain sectors, like industrials, look particularly exposed.**

Recent months have seen trade tensions come to the fore across the world, with the US threatening to increase import tariffs across a range of sectors. Should these tensions escalate further, countries such as Germany know their bilateral surpluses with the US make them vulnerable to US threats to impose new raise tariffs on, say, European auto imports. Global value chains and the reliance of economies such as Germany's on external demand mean that Europe has a lot to lose. About a quarter of euro area GDP growth in 2017 was driven by net trade. And a sustained downturn in business

confidence resulting from trade tensions could eventually hit investment.

Meanwhile, efforts to overcome trade differences between the US and China continue. Both sides have begun to show a degree of flexibility, but trade is only one part of a much broader competition between the two countries for global strategic advantage. This means that differences over tariffs between both sides could prove difficult to resolve. The Chinese government has strong incentives to avoid a trade war, but it is unlikely, in our view, to buckle in the face of explicit threats from the Americans. We believe the path to a final agreement on trade could be long and bumpy. In the meantime, we remain conscious that any escalation of recent rhetoric could hurt business sentiment in both countries and contribute to jittery financial markets. ■



**FERNAND PACICCA,**  
Senior Investment Manager  
Pictet Wealth Management

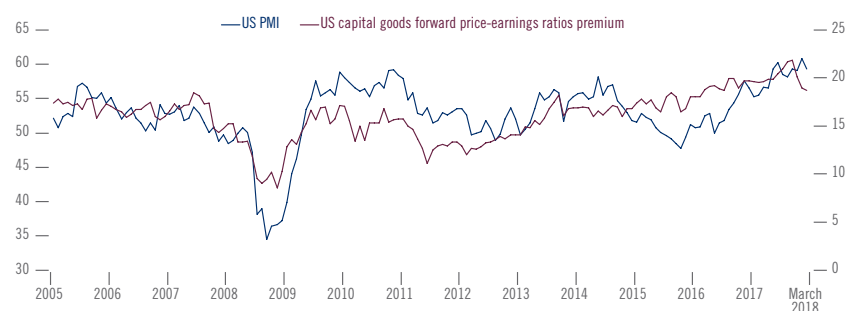
## Tensions are not good for industrial companies

A potential trade war between the US and China would have major implications for certain areas of the global industrial sector. Here we examine a few examples.

**I**mported metals. Sanctions imposed on Russian companies have been behind the rise in metal (aluminium, nickel and copper) prices so far this year, and pressure on other metal prices could intensify further. Russia is an important supplier of titanium, for example – a metal that is vital in the aerospace industry. But

aerospace should be broadly unaffected by tariffs on metals for three reasons: 1) the very high value they add reduces the impact of raw material prices; 2) its products have increasingly low steel and aluminium content (new aircraft like the A350 or 787 are over 50% composite); and 3) aircraft manufacturers use escalation

**CHART 1: THE CORRELATION BETWEEN THE US PURCHASING MANAGERS INDEX (PMI) AND FORWARD PRICE-EARNINGS RATIOS FOR US CAPITAL GOODS COMPANIES**



Source: Pictet WM, Equity Research, Bloomberg, Markit, April 2018

clauses in contracts that enable them to pass on raw material cost increases. On the other hand, the sector could be affected by shortages of metals (mainly titanium) and by the financial health of the airlines.

Within the machinery segment, agricultural, mining and oil & gas equipment manufacturers are the best placed to pass on increases in imported metal prices due to industry consolidation. Conversely, trucks, cranes and earth-moving equipment manufacturers face higher margin risk as they compete in more fragmented, less rational markets.

**Chinese imports from the US.** Half of Chinese proposed tariffs on US goods target agricultural/farming products and aircraft. Tariffs would probably alter trade flows, with the new tariffs persuading China to source soya from countries such as Brazil. This could have a negative impact on US agricultural machine makers as reduced revenues for US soya producers would translate into less investments.

The levy on US aircraft imports is more complex and focuses on planes weighing between 15 and 45 tonnes. That could include planes as big as the Boeing 737. Interestingly, the new 737-Max has an operating empty weight of 45.07 tonnes. Currently, Boeing has 236 of these planes on order from China, representing 5% of its order book.

We are somewhat sceptical about China's capacity to maintain such tariffs on aircraft imports. With the growth of the Chinese middle class, the country will need 7240 new planes (according to Boeing) over the next two decades, valued at USD 1.1trn. Assuming that Boeing holds half of the market, the

proposed tariffs would raise the price paid by Chinese airlines by USD 137.5bn.

Chinese airlines could switch orders to Airbus, but would have to wait many years for delivery. Moreover, commercial aerospace is a strategic industry for China. Chinese capabilities are in their infancy and the sector's development cannot be achieved without the help of Airbus or Boeing. It is therefore understandable that the Chinese are proving less aggressive in their approach to aerospace than to imports in other sectors..

**Chinese equipment suppliers.** If implemented, US tariffs on imported goods would directly raise the price of eligible Chinese equipment. This could also encourage non-Chinese producers to raise prices, especially for products of which China is an important supplier. Aircraft, electrical equipment, appliances and machinery manufacturing industries in the US could face steep rises in the cost of inputs as they are highly dependent on tariff-affected products.

What would happen to Chinese spare production capacity in this scenario? The answer is simple. It would go to other markets, especially Europe, increasing competition and deflationary pressures there. This could potentially lead to protectionist measures being taken by Europe that would surely lead to countermeasures by the Chinese.

Tariffs could also result in investment in the regions imposing them. But this could happen only if tariffs were implemented over a long period and assuming that economies continue to grow. This is a big assumption, as we all know that protectionism always leads to a decline in wealth growth. Conversely, tariffs could also lead to a halt in investments as companies switch

to wait-and-see mode as global trade recedes. This will ultimately lead to a recession.

## IMPACT ON VALUATIONS

The initial reaction of US companies to the escalation of trade tensions since March has been negative. The shares of Boeing, one of the companies most sensitive to global growth and to China, fell by 3.5% the day the US announced tariffs on imported metals, by 5.2% when the US proposed to tax other Chinese goods, and by 1.7% when China retaliated.

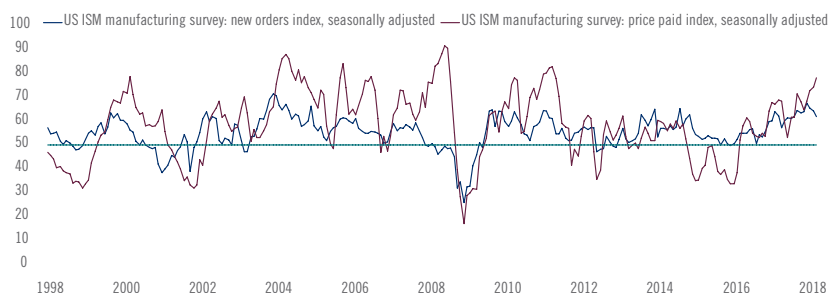
By contrast, the broader industrial sector hardly reacted at all to tariff news. Yet any escalation of the trade war is bound to have an effect on business sentiment, inflation and valuations. The industrial sector is highly sensitive to the global growth outlook, so a worsening of the situation will have negative repercussions on sentiment, purchasing manager indices will fall – and so will the sector's valuation. The correlation between sentiment and the industrial sector's valuation premium is high at 77%.

Higher input prices for US and Chinese companies could have a broad impact and raise the spectre of economic stagflation. New orders and prices paid by manufacturers have recently begun to diverge (*see chart 2*). At this stage, this should not be considered alarming, but further, persistent divergence could signal the risk of stagnation or even recession.

## CONCLUSION

All in all, an escalation of tensions between the US and China only raises the probability of a slowdown in an economic cycle that is already well advanced. Investors' nervousness is already palpable in the way that share prices have been reacting to any downward revisions of companies' earnings outlooks. Any intensification of trade tensions will be negative for the US capital goods sector and also, potentially, for its European counterpart. Industrial companies tend to have a global presence, so what weakens global trade weakens the sector. ■

**CHART 2: RECENT DIVERGENCE BETWEEN PRICES PAID AND NEW ORDERS IN INSTITUTE FOR SUPPLY MANAGEMENT (ISM) MANUFACTURING SURVEYS**



Source: Pictet WM, Equity Research, Institute for Supply Management, April 2018

**RODOLPHE RANOUIL**

Head of Fixed Income Research  
Pictet Wealth Management

## Prodding a wobbly credit market

Already having to deal with rising rates, parts of the corporate credit universe have been rattled by talk of trade tariffs and sanctions.

Talk of trade wars has clearly introduced a negative undertone into credit markets already digesting a changing interest rate and central bank policy environment that has led to the return of rates and spread volatility. Negotiations to overcome trade differences between China and the US are still at an early stage, and their final outcome could potentially lead to a rise in global inflation or move us closer to recession. In addition, the string of decisions taken by the White House over the past few months has been chaotic and highly disruptive for certain commodity markets such as aluminium, and also for supply chains.

When it comes to the effects of trade tensions on credit markets, the first case that comes to mind is that of Huawei, a large Chinese information technology supplier, which was about to price its inaugural five-year bond in euros when news broke of a US Department of Justice probe into the company on whether it violated sanctions on Iran. Coming shortly after the US Commerce Department announced a ban on American companies selling components to Chinese telecoms giant ZTE (which is now about to be lifted, thanks to a Trump tweet), Huawei had to postpone its planned deal. In our view, the ZTE/Huawei sagas mean that Chinese technology companies looking to tap the US or European credit markets from now on will have to pay more and/or provide stronger covenant packages.

The package of recent US decisions affecting the base metal markets (25% tariffs on steel imports and sanctions on Russian aluminium producer Rusal) is likely to result in rising input prices for industrial companies

and their clients, depending on how escalation clauses are worked out and pricing strategies are devised by management teams. US car parts and car manufacturers look particularly exposed, but we believe they will probably be able to pass on part of any increase in the cost of steel and aluminium imports to their final clients. In addition, the initial negative effect on corporate bonds following President Trump's announcement of tariffs and sanctions has faded—in part because of the watering down of sanctions on Rusal. The credit spreads of mainstream Russian issuers have retraced 60–75% of their initial widening following the April sanctions announcement, for example.

To conclude, in spite of the granting of temporary exemptions and other efforts to reduce tensions, US trade tariffs and sanction announcements have meant uncertainty for spreads in general, particularly for the industries and regions most directly affected by them. They come at a time when credit valuations have already been hit by a rise in underlying rates and wider

spreads, particularly in the US market. Twice this year, tariffs and/or sanction announcements have put a halt to the credit market's attempts to rally, and even caused significant retracements. In addition, the moves to dial back on some of the initially announced measures (such as temporary exemptions from tariffs and moves to lift the ban on ZTE) have not created much in the way of risk-on relief.

As much as market participants would like to set President Trump's tariff announcements aside, on the whole, trade tensions are adding a layer of uncertainty and leading to repricing of a credit market that was already becoming more difficult to navigate. In a market environment in which intermediaries' risk absorption capabilities are being quickly saturated, the overall price impact of trade uncertainty on credit issues can be significant—sometimes unjustifiably. ■

### RUSSIAN CORPORATE CREDITS HAVE RECOVERED, BUT NOT FULLY. EMERGING MARKET CORPORATE BOND SPREADS



Source: ICE BofAML



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