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# Investment Strategy

## Private Clients

3/4

July 2018 · 3rd quarter

**Macro insights**

Reflecting on trade tensions

p.03

### At a glance

- We continue to assume that trade tensions will remain contained but must recognise that the prospect of a trade war has become a risk warranting serious consideration.
- Leading indicators are not pointing to a US recession anytime soon – particularly since the Federal Reserve has no reason to speed-up its policy tightening.
- The Eurozone economy has taken a breather, but the softness recorded year-to-date does not herald a sustained downturn and the central bank has committed to remaining accommodative for longer.
- In Japan, the steady uptrend in wages and rebound in activity will ease concerns surrounding negative 1st quarter GDP growth; despite its dovish talk, the Bank of Japan is engaged in a "silent tapering".
- The global environment is not conducive for emerging markets to thrive, but the countries most affected to date have been those with the weakest fundamentals or highest political risk.
- With the soft patch experienced by non-US economies now likely over, fundamentals should run strong, underpinning our pro-growth stance. Rising political uncertainty nonetheless warrants adjustments in active portfolio risk and a continued search for asymmetric trade opportunities.

**Also featured**

OPEC committed
to stabilising oil prices

Quarterly publication of
Lombard Odier Investment Solutions – Strategy

**Important information**
Please read the important information
at the end of the document.
Data as of 2 July 2018

# Reflecting on trade tensions

Recent developments have turned the prospect of a trade war, which was but a mere hypothetical scenario in the early days of the Trump administration, into a risk worth considering more seriously.

The US has already imposed a series of measures against a number of trade partners. The list so far includes imports of solar panels and washing machines, steel and aluminium, and a broad set of Chinese exports to the US. The North American Free Trade Agreement (NAFTA) is under renegotiation, but the process has proven slow, inconclusive, and often acrimonious. The relationship between the US and most of the other G7 countries appears increasingly tense.

Given the size of the US current account deficit (see chart I, page 04) President Trump's focus on bilateral trade deficits is bound to lead to numerous targets, whether among security allies such as Japan or Germany, or rivals like China – which has been the primary target of the Trump administration so far. The US complaints have revolved around the size of China's trade surplus vis-à-vis the US (ca. USD 350 billion (bn) in 2017) but also its industrial policies, including the treatment of US technology and intellectual property.

The first trade blows between the US and China are due to take effect in early July. US tariffs of 25% will be imposed on approximately USD 50 bn worth of Chinese exports, with a similar in scale response to be implemented by China in retaliation. The threat of a second round of retaliatiory measures has also been raised, mostly on the part of the US, which – given the total size of imports from China (ca. USD 500 bn) – have more room for such action.

The impact of tariffs on an economy amount to a typical negative supply shock: output falls while prices rise. Given the current US inflation rate, they are also likely to result in tighter monetary policy.

The direct economic cost of the tariffs announced to date is modest, of an order of magnitude of 0.1-0.2% of GDP (Gross Domestic Product). Given the ongoing strength of global trade (see chart II, page 04), recent actions do not pose a severe risk for the world economy. The cost may, however, become more significant in the future, for instance if the tariffs that President Trump has threatened to impose on an additional USD 200 bn worth of Chinese imports or broad-based tariffs on auto imports come to materialise (see chart III, page 04).

Meanwhile, from the perspective of financial markets, pressure on corporate margins and broader business disruption – from the unravelling of global supply chains, for example – would be a significant concern. The impact could be amplified by other second-round effects of trade tensions, such as a dampening of business confidence and fixed investment intentions, or a possible wave of risk-aversion that would in turn impact financial conditions.

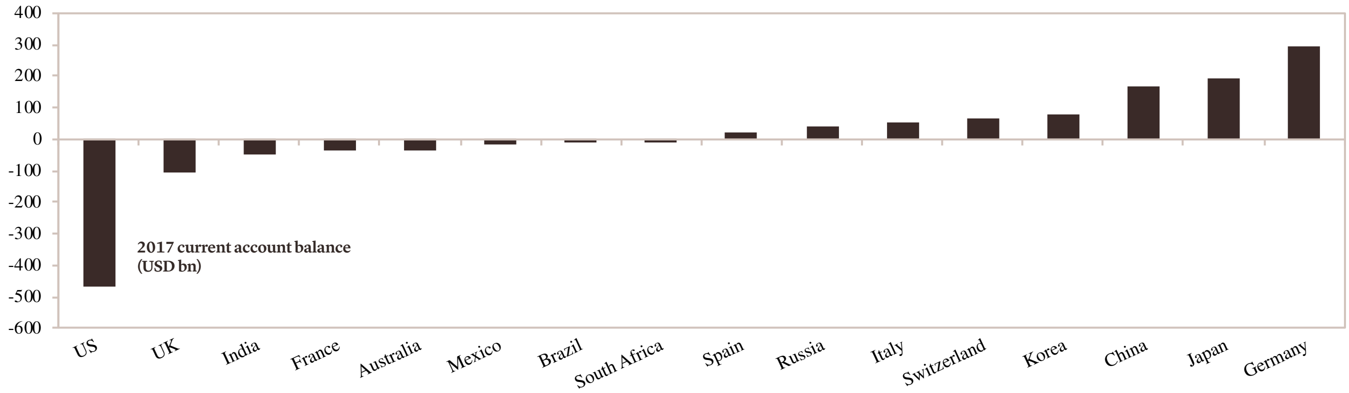
Market participants have taken comfort in mitigating factors, such as the pressure from the US business community (even within the Republican Party) against protectionist measures and the Trump administration's own sensitivity to negative market reaction. We think the most reasonable base case is that the trade tensions are likely to remain contained and, thanks to economic self-interest on all sides, a global trade war will be avoided. That said, given recent developments and the stakes involved, a trade war is a risk that investors will need to take into account in their scenario analysis for the foreseeable future.

*Bill Papadakis, Macro Strategist*

Note: Unless otherwise stated, all data mentioned in this publication is based on the following sources: Datastream, Bloomberg, Lombard Odier calculation.

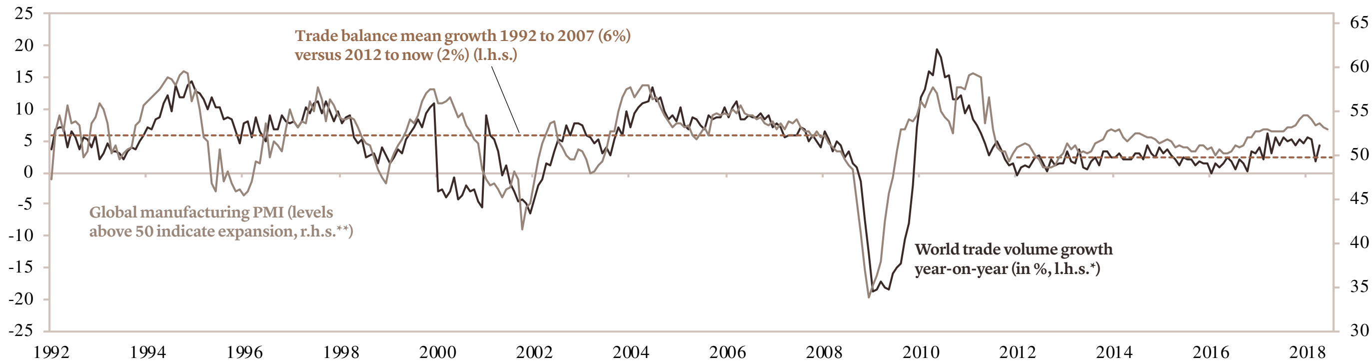
### I. The US is running by far the largest current account deficit, leading to political tensions

Current account balances for major economies in 2017




Sources: IMF, Lombard Odier calculation

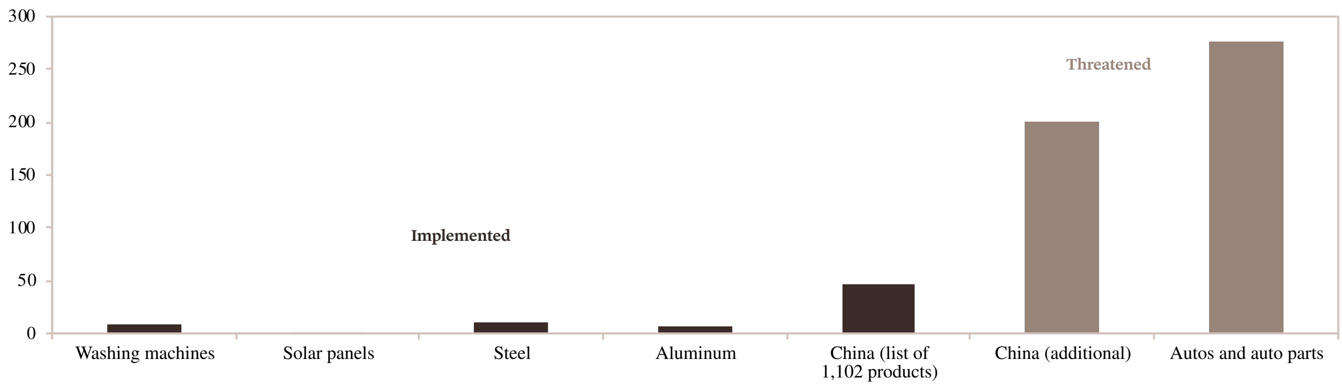
### II. World trade and industrial production running at healthy levels




* left hand scale, ** right hand scale
Sources: CPB, Datastream, Lombard Odier calculation

### III. The amount of trade affected by measures imposed so far is small, but could grow significantly if further threats are implemented

Volume of 2017 imports into US (in USD bn)




Sources: Department of Commerce, USTR, PIIE, Lombard Odier calculation

# United States
## As good as it gets

### In a nutshell

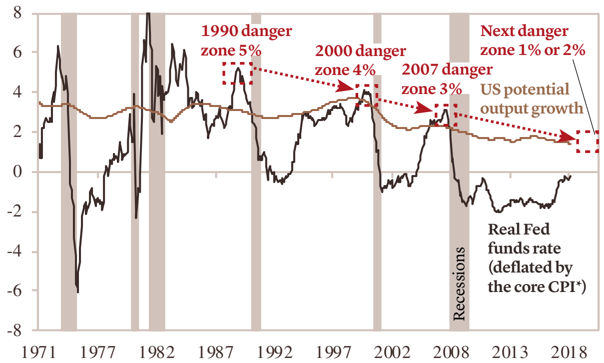
- The US economy is growing well above its potential, with further acceleration unlikely.
- Consumer spending, in particular, should be held back as job growth slows down and price pressures rise.
- Leading indicators are, however, not pointing to a downturn anytime soon – particularly since the Fed has no reason to accelerate its policy tightening.

The US economy continues to grow at a strong pace, but we do not believe that it can accelerate sustainably, despite the fiscal boost. In other words, the current US picture appears to be as good as it can get, with the expanding budget deficit and emerging signs of capacity constraints signalling that cyclical risks are beginning to build.
This is not to say that we anticipate a significant slowdown before real interest rates have moved up further and started to stress-test the current trends. But 5% nominal GDP growth (2.8% real growth) does seem somewhat excessive relative to the potential growth anchoring.
Typically, consumer spending should find itself constrained by slower job growth as full employment is reached, as well as by higher inflation biting into household income – not to mention the impact of rising gas prices.
Consumption could potentially be sustained by a fall in savings but, given the already low 3.2% savings rate, it is difficult to push this argument too far. Rather, we think that sub-3% real consumption growth is a reasonable assumption for the full year (see chart IV).
Meanwhile, though, investment spending has been picking up from low levels, thanks in part to the corporate tax cuts. And leading indicators that have served historically to anticipate downturns still suggest that recession is a distant prospect for the US (see chart V).
On the monetary policy front, we expect the Federal Reserve (Fed) to maintain its current pace of hiking interest rates once a quarter while continuing to gradually reduce the size of its balance sheet, at least until the end of this year. Inflation and wages are trending higher but only at a gradual pace, which is unlikely to force the Fed to reconsider its strategy.

*Samy Chaar, Chief Economist*

**IV. Short term real rates still low versus potential output growth**

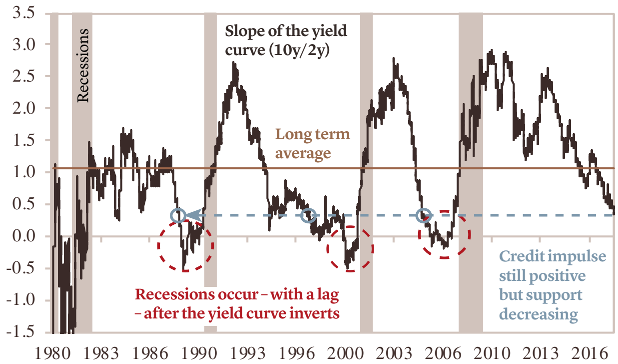
The real Fed funds rate can hardly be considered prohibitive for economic actors




* Consumer Price Index
Sources: Bloomberg, Datastream, Lombard Odier calculation

**V. Slope of the US yield curve (10 year – 2 year maturity, in %)**

The yield curve is steep enough to encourage bank credit, a pillar of economic activity




Sources: Datastream, Lombard Odier calculation

# Europe
## No sustained downturn

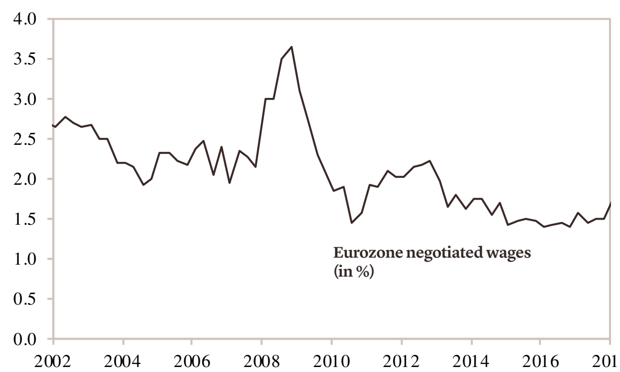
### In a nutshell

- The economic softness recorded year-to-date does not herald a sustained downturn.
- The ECB made a number of announcements at its June meeting, understandably perceived as dovish by market participants.
- Fiscal slippage, rather than insolvency, is the risk in Italy.

After experiencing some of its strongest growth rates in at least a decade, the Eurozone economy took a breather during the past few months. Fortunately, the latest set of macro data provides reassurance that the softness recorded in early 2018 does not mark the start of a sustained downturn.
Instead, European economies continue to benefit from their return to above-trend growth, with a number of fundamental drivers still in place. Rising employment, strong confidence, accommodative financial conditions, recovering trade and investment, and solid corporate profitability all suggest that the ongoing recovery has further to run. Some inflation is also finally materialising, with the core Harmonised Index of Consumer Prices (HICP) surpassing 1% recently, and wage growth also starting to show encouraging signs (see chart VI).
The European Central Bank (ECB) continues to provide support to the economy, even if its monetary policy stance is clearly shifting towards less accommodation. The monthly amount of asset purchases will be reduced once again in September, continuing at a lower pace of EUR 15 bn until quantitative easing in all likelihood comes to an end in December (see chart VII). The ECB has also extended its forward guidance on interest rates, effectively committing to keeping them unchanged at their current low levels through September 2019. While this development came as a dovish surprise to market participants, who were expecting a somewhat earlier "lift-off", the process of interest rate normalization remains our base case and we expect to see an end to Negative Interest Rate Policy in the Eurozone by December 2019.
As regards political developments, we should stress that Italy of 2018 is not Greece of 2011. Current accounts of countries in the Eurozone periphery, including Italy, have since moved into surplus, eliminating concerns about solvency – and hence a repeat of the sovereign debt crisis. Notwithstanding a new government formed of non-mainstream parties, polls do not signal a voter bias towards leaving the Eurozone or European Union (EU), nor is there any intention for such a question to be submitted to the public. Rather than an exit from the euro, the risks that we would focus on in Italy have to do with fiscal slippage and the country's relationship with other EU members.

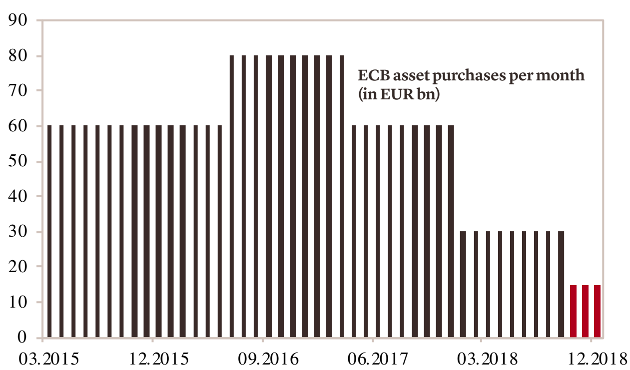
*Samy Chaar, Chief Economist*

**VI. Eurozone wage growth finally starting to show signs of life**
Annualized rate of growth in negotiated wages, in %




Sources: ECB, Bloomberg, Lombard Odier calculation

**VII. Monthly pace of ECB asset purchases will halve in September, and then most likely end in December**
Monthly pace of asset purchase programme




Sources: ECB, Lombard Odier calculation

# Japan
## Silent tapering

### In a nutshell

- The steady uptrend in wages and rebound in activity data will ease concerns surrounding Japan's negative 1st quarter GDP growth.
- Spring wage negotiations led to what should prove the best "base-pay" growth since 1998.
- The apparent dovishness of the Bank of Japan (BoJ) is contradicted by its quiet reduction in asset purchases and the debate regarding financial stability.

Recent economic reports confirm that the Japanese economy is bouncing back from its 1st quarter weakness. Industrial production and retail sales improved in April, while trade data suggests that exports will be a major contributor to GDP growth in the 2nd quarter, buoyed by the slightly weaker yen. Core machine orders (a rough proxy for corporate capital expenditure) also indicate that Japanese businesses' appetite for investment remains decent.

Wage momentum finally seems to be firming, with the unemployment rate (at 2.5% in April) hovering above multi-decade lows. Although bonus volatility caused a dip in headline cash earnings growth, April saw the scheduled component of cash earnings maintain its fastest pace in two decades (+1.2%). In addition, spring wage negotiations appear to have settled the annual increment of entire pay schedules (unique to Japan's age-based system) at 0.53%, probably the second-best outcome since 1998 (see chart VIII). Construction ahead of the 2020 Olympics should keep labour in tight demand, even if the government does go ahead with its second consumption tax hike in 2019.

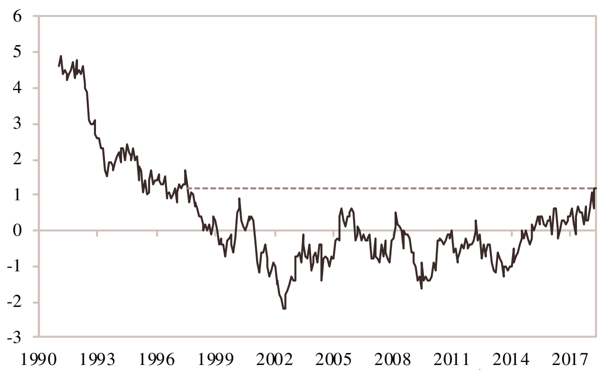
Admittedly, headline and core inflation data have been more mixed. Aware of the risk that a "dip" may become more entrenched, the BoJ has signalled greater caution with respect to its inflation outlook, to be updated in July. We stress, however, that removal of BoJ guidance as to when its 2% inflation target could be reached should not be taken as a dovish sign. Had Japanese policymakers really been serious about achieving that target, they would have taken action in the meantime to raise inflation expectations and hasten the price recovery.

Also, recent BoJ policy meeting minutes suggest that some board members are actively voicing concerns about financial stability, a coded reference to persistently low rates and bond market illiquidity. The BoJ's asset purchase history shows that banking sector complaints about these issues are having the intended impact: despite its supposed dovishness, the BoJ has been reducing its bond market presence markedly since 2016, occasionally tolerating an outright fall in its Japanese government bond (JGB) holdings (see chart IX). In effect, the BoJ has been using its 10-year yield target to mask a more neutral policy stance, helped in that by rising rates outside of Japan.

*Homin Lee, Macro Strategist - Asia*

VIII. Best "base-pay" growth in Japan since 1998

Growth in scheduled cash earnings (%, yoy*)

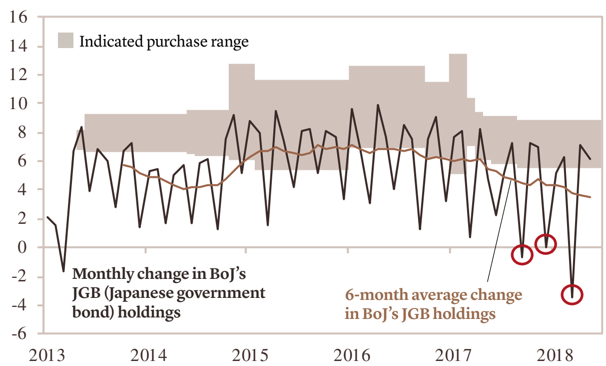



* year on year

Sources: Bloomberg, Lombard Odier calculation

IX. BoJ occasionally selling JGBs amid "silent tapering"

Monthly change in BoJ JGB holdings and indicated purchase range, JPY trillion




Sources: Bank of Japan, CEIC, Bloomberg, Lombard Odier calculation

# Emerging Markets
## The battle between risks and fundamentals

### In a nutshell

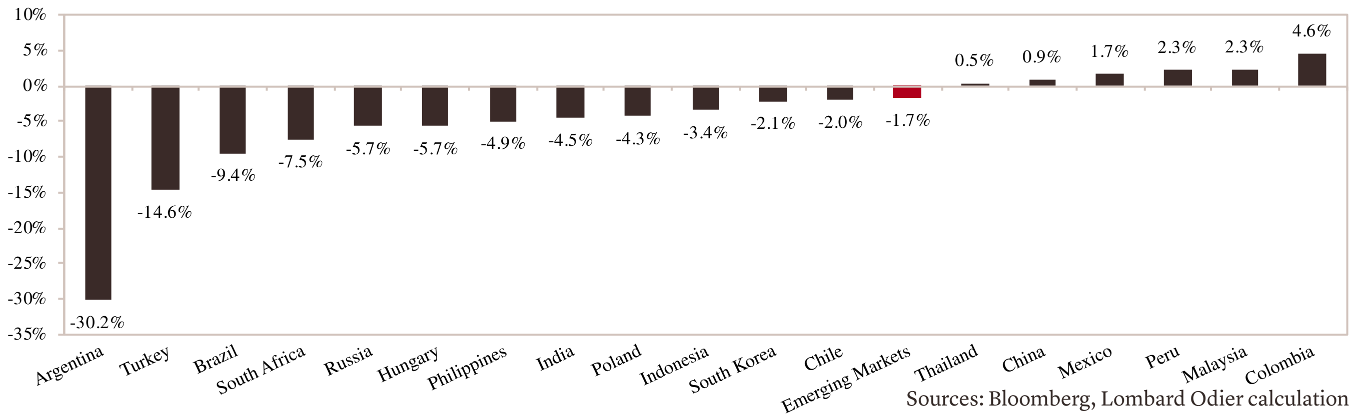
- The global environment is not conducive for emerging markets to thrive, but the countries most affected to date have been those with the weakest fundamentals or highest political risk.
- Absent a scenario of continued strong dollar appreciation or material trade war, the emerging complex does not pose systemic risk.
- A cautious and selective approach thus remains warranted.

Emerging economies are facing a growing number of headwinds, including rising US yields, a stronger dollar, trade war threats, and domestic political risks. While the overall trade-weighted exchange rate is down only 1.7% since the beginning of the year, some emerging currencies have undergone substantial pressure. Unsurprisingly, they belong to the countries with the weakest fundamentals or highest political risks: Argentina (-30%), Turkey (-15%), Brazil (-9%), South Africa (-8%), Russia (-6%) and Hungary (-6%). The sell-off has been lesser for other emerging countries, with countries like Thailand, China, Peru, Malaysia, Colombia, and even Mexico, posting appreciation over the 1st half of 2018 (see chart X).
As such, emerging markets do not appear to pose systemic risk. Rather, the issues seem idiosyncratic and are starting to be tackled: Argentina got a stand-by agreement from the International Monetary Fund (IMF) and Turkey has raised rates quite markedly.

Clearly, in a scenario of continued and substantial greenback appreciation, emerging economies would find it difficult to escape the vicious circle of capital outflows, currency weakness, tighter policies and slower growth. Similarly, a material trade war between China and the US would have very tangible negative consequences for the emerging complex.
But assuming the dollar stabilises, perhaps even weakens slightly, and trade tensions de-escalate, emerging markets fundamentals are by no means as worrisome as recent market action and sentiment would suggest.
Non-financial corporate debt build-up peaked in 2016 and has stabilised since. External debt and budget deficits could admittedly afford some improvement but are at manageable levels for two thirds of the 18 largest emerging countries. Current account deficits have subsided, greatly reducing vulnerability to external financing. And the emerging recovery is still young, dating back only 3-4 years versus nearly 10 in the US. Few inflationary pressures are thus apparent, and interest rates remain at very low levels – leaving central banks room to defend their currencies.
So, while there is no denying the difficult global backdrop, which will keep volatility high, emerging markets also offer economic and financial value to cautious and selective investors.

*Stéphanie de Torquat, Macro Strategist*

X. **Broad nominal effective exchange rates (J.P. Morgan indices)**
Year-to-date return, as of 30 June 2018




Sources: Bloomberg, Lombard Odier calculation

# Asset Allocation
## Back to positive fundamentals? How to cope with rising uncertainty

### In a nutshell

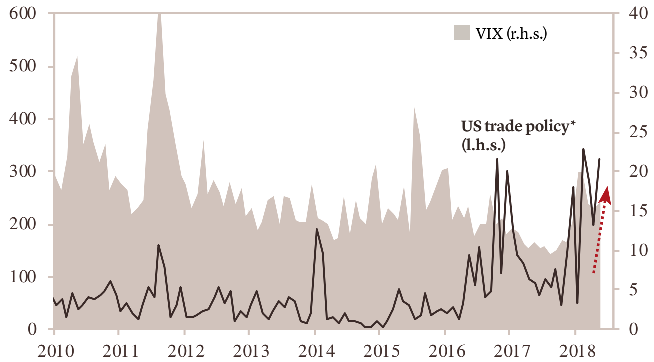
- With the soft patch experienced by non-US economies now likely over, fundamentals should run strong, underpinning our pro-risk stance.
- More synchronized growth means lesser US dollar pressure on financial markets, removing one of the main headwinds affecting our current portfolio positioning.
- That said, we acknowledge that the business cycle is advancing, making growth assets increasingly sensitive to potential macroeconomic and political challenges – as uncertainty rises, we continue to seek exposure to asymmetric trades.
- Economic overheating in the US, fuelling disruptive Fed action, and/or an intensification of protectionism remain the two main risks to our baseline scenario. We will continue to closely monitor the US yield curve, the US dollar and upcoming global trade data releases, and be prepared to adapt our asset allocation accordingly.

Mid-year is an opportune time to take a step back and review our key calls for 2018. While our expectations of a shift towards lower financial asset returns and higher market volatility, fuelled by inflation and monetary policy, proved correct, geopolitics appear to have had a greater impact than initially anticipated. Since last quarter's publication, political developments have definitely taken centre stage, both in developed (Italy, US trade tariffs) and emerging (elections in Turkey, Brazil and Mexico) countries. And it would be unfair to say that financial markets remained immune to this unstable backdrop (see chart XI). Political newsflow intensified just as the global business cycle was proving somewhat disappointing, with the notable exception of the US economy – whose unilateral upturn is at least partly attributable to the fiscal impulse. Hence the strengthening of the US dollar, and its traditional victims: emerging markets. We will closely monitor developments on this front, as the Fed's monetary path could prove disruptive in an environment where other major central banks (ECB and BoJ) are still somewhat more accommodative. At this point, however, we believe that markets have largely priced in Fed and ECB action during the next quarters (see chart XII), warranting our recently updated neutral stance on the EUR/USD (from 1.23 to 1.20 on a 12-month horizon).

For trade disputes to turn into full-blown war is not our base case, meaning that we expect no significant dent to global growth. The latest Purchasing Managers' Index (PMI) releases signalled an upturn in most cyclical economies – usually a good leading indicator (see chart II, page 04). We will be watching out for an indirect impact on capital expenditures (capex) via business confidence, should the negative newsflow persist for too long. Company guidance during the 1st quarter earnings season was still well-oriented, with no concern expressed about potential tariffs in the US and capex expected to pick up in coming quarters, but the pending 2nd quarter earnings reports will certainly provide more information on this topic. Indeed, with Chinese authorities turning more vocal on qualitative retaliation options, the outlook could worsen for US companies

**XI. Trade policy newsflow starting to weigh on financial markets**

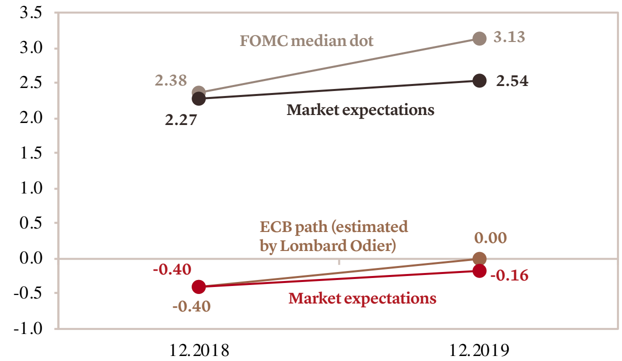
* Index based on newspaper coverage frequency, considering articles that contain trade-related terms




Sources: Bloomberg, Baker, Scott R.

**XII. ECB and Fed "dots" vs. market expectations**

Central banks policy close to fully priced in




Sources: Bloomberg, Lombard Odier calculation that generate significant revenues in China or intend to invest in new production capacities there. Specifically regarding the US economy, as already mentioned, tariffs amount to a typical negative supply shock (falling output, rising prices), a situation which could eventually lead to a tighter monetary policy. With the long-end of the curve capped by policy uncertainties (the 10 year term premium remains anchored in negative territory), a more rapid flattening of the yield curve cannot be excluded, should the situation worsen.

Against this backdrop, we have begun a gradual process to lower our active risk. First, we neutralized our exposure to local currency-denominated emerging debt in USD portfolios. With cash starting to become attractive in the US and likely to trend higher based on Fed guidance, the relative value between the two asset classes was becoming less obvious (see chart XIII). On the other hand, we maintain exposure to emerging debt in EUR, GBP and CHF portfolios, given the still attractive carry. Going forward, our neutral stance on the greenback should prevent further losses on the forex side, while historically low inflation levels preclude a surge in interest rates. Emerging debt labelled in hard currency will of course remain sensitive to US interest rates. But even if there is some risk of overshooting, it should prove temporary, leading us to maintain our exposure.

We then lowered the active risk inherent in our regional equity allocation, reducing the US equities underweight relative to European and emerging equities. Indeed, with the US 12-month price/earnings ratio approaching its long-term average of 16x, the valuation argument is no longer pertinent (see chart XIV). Also, US earnings momentum is favourable, driven primarily by second-round effects now that the fiscal plan is in full swing. We maintain a (smaller) overweight in European equities, believing that the recent period of soft economic data should prove temporary and that prospects for positive growth surprises are compelling. But our exposure to emerging equities has been cut to neutral, meaning that our Tactical Asset Allocation is now aligned with our Strategic Asset Allocation – bearing in mind that the latter is well-loaded in emerging risk following the changes operated last September (see Investment Strategy 4th quarter 2017). In effect, we have taken profits on the emerging equities trade initiated two years ago, considering that earnings momentum and valuation offer less relative appeal in the short term, and volatility could persist at least for the next quarter. We do, however, maintain a positive stance on the Pacific region, including Japan, where market reforms are deploying their effects and the fundamental backdrop remains solid. From a sector perspective, we have upgraded US banks and telecom to overweight (from neutral and underweight respectively), and industrials to neutral. Finally, our positive view on the small-cap segment still holds, given its greater exposure to reflation and tax policy, and lower sensitivity to trade risk.

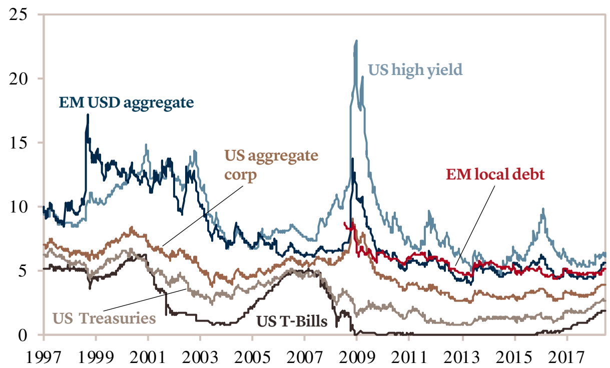
In the fixed income space, while we continue to prefer credit to sovereign bonds, the attractiveness of the asset class has deteriorated further in EUR and CHF markets, leading us to cut exposure for the second time this year. With indices' duration at historical highs, credit is increasingly vulnerable to interest rate volatility. Given the current depressed level of coupons, we see no plausible scenario that could yield positive returns, or even exceed cash returns. Under our base case (10-year Bund yield at 0.80% and slightly wider credit spreads), expected returns are negative. Should the economic activity accelerate, the rise in rates and moderate spread tightening would also lead to negative returns. And in an adverse scenario, the drop in interest rates would be insufficient to offset spread widening.

However, because we believe that the current economic backdrop continues to support value creation in the corporate space – and given the still low yield on cash in EUR and CHF – we reinvested the proceeds into hedge funds. While posting a low beta, equity long/short managers are well-positioned to benefit from rising sector and stock dispersion. Dispersion across instruments has also been high, and macro managers are expressing more diverse opinions today than in recent years, which should both limit crowded trades and enable the best managers to prosper.

Turning to currency markets, we have revised our target for the EUR/CHF from 1.20 to 1.18, to account for short-term political

**XIII. Relative value within the US fixed income space: cash is back as an asset class**

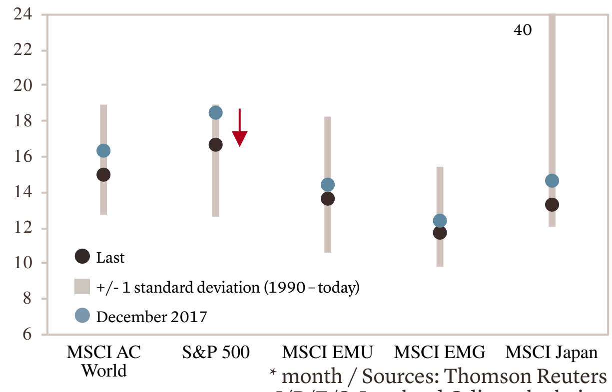
Yield to worst, %




Sources: Bloomberg

**XIV. US equity valuations are less stretched**

12m* forward price-to-earnings ratio




* month / Sources: Thomson Reuters I/B/E/S, Lombard Odier calculation

uncertainty in Italy. We maintain a positive view on the yen, pending an official change in the BoJ's policy stance. As for the GBP, it should continue to suffer from volatility as the most fundamental issues around Brexit (Northern Ireland, custom arrangements) are still unresolved.
In conclusion, with the soft patch experienced by non-US economies during the first months of the year expected to prove temporary, we maintain our long growth assets positioning, favouring corporate over sovereign risk and seeking exposure to more asymmetric trades. As such, following prior forays into the yen (on which we took profits in May) and convertible bonds (which we still hold), we used part of our cash holdings to increase exposure to commodities in April. This asset class can bring asymmetry to a multi-asset portfolio: its returns should be decent in our baseline scenario (mainly thanks to base metals), while the downside should be limited by the capacity constraints on the supply side, with even significant upside for oil and/or gold, should any of the risk scenarios materialise. That said, the level of uncertainty surrounding the political and, in turn, financial landscape makes us particularly vigilant and prepared to take action should the indicators we monitor worsen significantly.

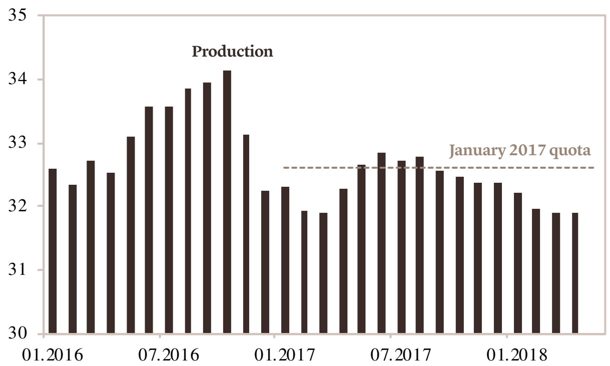
*Sophie Chardon, Cross-Asset Strategist*

## OPEC committed to stabilising oil prices

At their late June meeting, OPEC (Organization of Petroleum Exporting Countries) and Russia secured an agreement to increase oil supply by as much as 1 million barrels per day, starting 1 July. They also discussed how to bring compliance to 100% – versus the near 150% level experienced since January 2017, due notably to the plummeting of Venezuelan output (see chart XV).
Only a handful of OPEC members (Saudi Arabia, Kuwait, UAE), alongside Russia, have the capacity to increase production at short notice. Saudi Arabia confirmed that it has already ramped up exports, while the Russian Minister of Energy indicated that the rise in Russian exports will be more gradual, depending on additional drilling.
As a result, despite this agreement, the oil market should at best be balanced this year and perhaps even suffer from undersupply, if demand rises faster than the International Energy Agency is forecasting. For 2019, we expect a rather balanced supply-demand situation. Inventories may grow modestly in absolute terms, while remaining lower than their five-year average (see chart XVI).
Given more limited spare capacity and the lack of investment during recent years, oil could, however, become more sensitive to disruptions and geopolitics.
What does this mean for our investment case? We continue to favour commodities as an asset class, providing a hedge against geopolitical and inflation risks. Our view on oil remains neutral, with a target price of USD 70. OPEC is clearly still committed to defending this price level, comfortable for both producers and consumers.
Short-term, with additional Saudi exports not to be delivered before August, the oil price will remain underpinned by the recent pick-up in outages (Libya, Nigeria, Canada). Strong backwardation (i.e. price of futures below spot price) will persist, offering carry opportunities for investors.

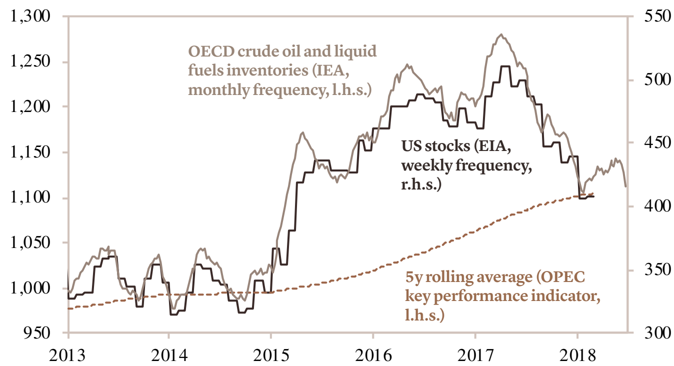
*For more: www.lombardodier.com/contents/corporate-news/investment-insights/2018/june/oil-on-settled-waters-opec-antic.html*

**XV. OPEC oil production**
OPEC members have agreed to bring compliance back to 100%




Source: Bloomberg

**XVI. Mission accomplished: the supply glut has been reduced**
In million barrels (mb)




Sources: Bloomberg

## Important information

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