ECONOMIC SITUATION AND STRATEGY

Hopeful about May, doubtful about Trump

British Prime Minister Theresa May's latest speech has supplied clarity. She has set straight anyone still wondering if she is looking for a backdoor out of Brexit. The prime minister appears determined to pursue the goal of leading Great Britain out of the European Union. As the British people have voted against staying in the EU, the government is now considering how it can position the country in the global context.

In some ways, its approach to this is oriented to the British Empire tradition. The idea is quite logical. Thanks to its colonial past, military capabilities, and intact global military presence, Great Britain has a reliable international network. And if the country's "business model" has to be reinvented now anyway, it makes sense to build on this existing network. Instead of having duty-free access "only" to the single European market, Great Britain will now strive to conduct unimpeded trade with the whole world in the medium to long term.

Of course, May is aware that this path will become rough and the country does not have the capacities and abilities for the necessary negotiations yet. It is therefore also a clever move by May to bring in the British Parliament when negotiations with the EU are to be finalized. For, if the EU should remain tough in its position, including Parliament will at least lend greater legitimacy to the taken approach and the attendant (hard) consequences.

As the time provided for the upcoming negotiations with the EU might prove too short, Great Britain is relying on a transition solution until all the details are clarified. This means that even if a hard Brexit emerges at the end of the negotiations, it will not necessarily take effect already in spring 2019. That makes the process a little less explosive and gives Great Britain the time it needs to develop and modify new modes of trading with other countries and regions.

Since Great Britain can now plan largely independent of EU directives and master data, a sufficiently well-functioning business model might even eventually evolve. May's speech has set the parameters for this. She intends to pursue a selective immigration policy aimed at attracting highly skilled workers. Using tax policy, the country may give huge incentives to businesses and thus enter into stiff competition with the EU regarding taxation. Moreover, since the idea is to have autonomous monetary policy and no longer participate in an emerging European "transfer union," Great Britain could become an established safe haven, if another financial crisis should hit the Continent – provided the United Kingdom gets its budget and current account deficits under control. Ultimately, it is not completely out of the question that Great Britain may then position itself as a kind of "deregulated Singapore of the North Sea" – with a legal framework friendly to financial markets and a generally very positive attitude towards free trade. From this perspective, dismay and pity for Great Britain may be premature. We rather think that Great Britain might have the potential to emerge stronger from this situation after some difficult years. Against this background, the question also arises whether the huge devaluation of the British pound is actually justified or the markets' reaction has been overall a little too much of a knee-jerk.

EXPECTED SCHEDULE OF BREXIT	
January 2017	▪ Decision of Supreme Court to bring in the British Parliament
February 2017	▪ Brexit Minister David Davis presents his negotiation concept
March 2017	▪ Opening of negotiations between the EU and Great Britain
April / May 2017	▪ Presidential elections in France
Summer 2017	▪ „Great Repealing Law"
September 2017	▪ Bundestag general elections in Germany
Fall 2018	▪ Preliminary completion of negotiations ▪ Start of ratification of negotiation results
Spring 2019	▪ European election ▪ Enforcement of Brexit ▪ Probably: taking effect of an interim solution

So, while the overall outlook of many market participants for Great Britain seems a bit too negative, the markets' early approval of the new US president may be a little exaggerated and premature. Above all, the US stock market has advanced so strongly since the election because it expects an acceleration of GDP growth in the near term based on more debt and government spending. Although this assumption is plausible, we wonder whether a favorable long-term forecast can be derived from expected Trump policies. For, whereas Great Britain is very open to free trade in principle, the new US administration appears to be headed in precisely the opposite direction. Protectionism is fashionable again, cheerfully supported by none other than the United States. However, the US administration's criticism of some current trade practices is neither wrong nor beside the point. From a purely theoretical perspective, free trade always makes sense for all participants en toto (but not for every individual in every situation at every point in time). The theoretical groundwork for this statement lies in the Heckscher-Ohlin model and in principle is not controversial in academic circles. But such models assume (some not explicitly) that free trade occurs for all participants according to the same rules, rights, and obligations in the framework of a free market process and no participants can gain a systematic advantage at the expense of the other participants by engaging in self-serving behavior not conforming to the market.

This is where the criticism of Trump takes hold. Amongst other things Trump criticizes China for playing an "unfair" game in trade that ultimately tilts the mutual advantages of free trade in China's favor. This criticism cannot be entirely dismissed. The Chinese currency could be mentioned as an example. The exchange rate of the renminbi to the US dollar or the euro does not result from prices formed in a free market, but primarily from a political process. It is plausible to assume here that the exchange rate reflects the result of economic policy goals – with corresponding advantages for China and disadvantages for its trading partners.

Another example concerns access to the Chinese market. While Chinese businesses enjoy more or less unfettered access to the European and US markets, it is often only possible to sell foreign products in China if a certain part of the value-added originates there. In some cases, the Chinese government's demands have gone so far that, for example, a German manufacturer may not sell its automobiles to the desired extent there unless it relocates entire development departments to China. It is rumored that such relocated departments are subject to intensive industrial espionage by the Chinese, a consequence exporters must accept since sales of their own products would be jeopardized otherwise. Also, the fact that Chinese businesses are able to acquire Western companies largely unimpeded while Western businesses are not allowed to do that in China may be viewed as an example of a certain asymmetry in trade practices.

Of course, China has the right to develop its own ideas about what is good for China. But its trading partners also have the right to consider in their own interest whether China's somewhat idiosyncratic interpretation of free trade still leads to sufficiently large advantages for them. From this perspective, the time has presumably come to deal with this issue and talk to China about the extent to which mutual economic dealings can and should be adjusted. Consequently, we are generally encouraged by the prospect that the new US administration will take up this topic, especially since this debate will get people in Germany thinking critically about the extent of silently accepting "unfair" trade behavior and when to actively resist it.

When we nevertheless worry now that this could cause a great deal of damage (on all sides, including China), that is mainly because of the individuals involved. We do not wish to offend the new US president; it appears though that Trump could expand his capacity for self-reflection as well as improve his interest in factual details. That is not a good starting position for a president, since sometimes the world can simply be complex and difficult and not all issues can be conclusively resolved in the 140 characters of a Twitter Tweet. And so it is not always enough to approach a fundamentally important issue with the right angle of attack in principle, if lack of dedication to detail causes even greater harm.

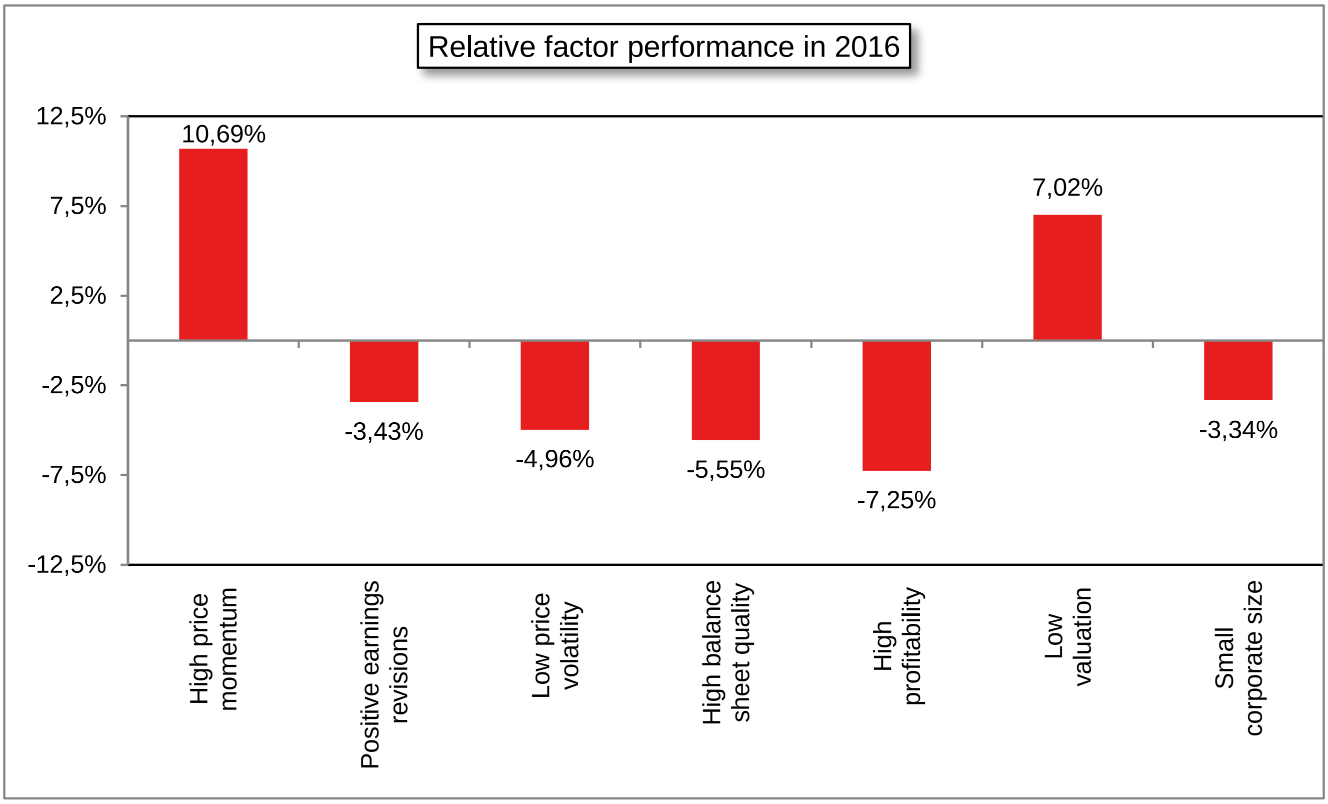
And while we are on the subject of damage; the fact that Trump does not limit himself to criticizing unfair trade practices but obviously has doubts about free trade in general causes us some concern. The point of specialization advantages is apparently lost on Trump, who instead relies on conceptually outdated mercantile approaches. The great "fun" in interventionism and dirigisme coupled with selective promotion of commerce is probably also connected with Trump's own career. As a real estate tycoon, he has learned that good deals are the most important thing in his business. Only a series of singular good deals (buy low, sell high) leads to success in the real estate business. But in other business areas, a large number of small and even micro decisions and events is what determines success or failure. Trump now seems to be making the mistake of transferring his experience to the business of politics. We regard this as extremely problematic. An economy the size of the United States cannot be steered by means of singular decisions. The country needs economic policy that relies on sensible incentives and good framework conditions from which all will then benefit. Selective interventions and associated "deals" will only work in isolated cases, often with undesired side effects. Moreover, this approach will lead to nepotism and "good old boys" – which also explains why Trump apparently finds a kindred spirit in Putin. Accordingly, we are a little worried that the United States could enter troubled waters in the years ahead (not necessarily in the next 18 months, though), while Great Britain seems actually to have the potential to surprise positively.

Weekly outlook for January 23-27, 2017

	Sept.	Oct.	Nov.	Dec.	Jan.	Feb.	Release
DE: PMI, manufacturing, flash	54.3	55.0	54.3	55.6	55.4		January 24
DE: PMI, services, flash	50.9	54.2	55.1	54.3	54.5		January 24
DE: Ifo business climate index	109.5	110.5	110.4	111.0	110.8		January 25
DE: Ifo current conditions	114.8	115.1	115.6	116.6	116.9		January 25
DE: GfK consumer climate	10.2	10	9.7	9.8	9.9	10.2	January 26
EUR19: PMI, manufacturing, flash	52.6	53.5	53.7	54.9	54.6		January 24
EUR19: PMI, services, flash	52.2	52.8	53.8	53.7	54.0		January 24
EUR19: M3, y/y	5.1%	4.4%	4.7%	4.8%			January 27

MMWB estimates in red

Chart of the Week: "And the winner is…" – factor performance in 2016



Anyone picking stocks who relied on the factors of positive price momentum and low valuation in 2016 was a big winner (at least relative to the broad European STOXX 600 index). While the STOXX 600 ended last year with only slightly positive price performance of +2.37%, investors who had bet on the factors of momentum and valuation at the beginning of the year finished 10.69% and 7.02% above the index, respectively. For our study, we formed factor portfolios at the beginning of each quarter with 100 stocks from the STOXX 600 that exhibited the greatest exposure to the referenced factor at that time. We weighted their performance equally over the following three months and then rebalanced at the end of each quarter. Factor portfolios geared to positive earnings revisions (-3.43%), low price volatility (-4.96%), high balance sheet quality (-5.55%), high profitability (-7.25%), and small corporate size (-3.34%) closed significantly worse than the STOXX 600. However, last year's winning factors certainly may not be those of tomorrow. Since it is impossible to predict which factors will beat the others in the future, it is important to realize that single-factor investments are always a bet on one factor's future performance (being better). We therefore recommend as far as possible selecting stocks that exhibit equally high exposure to all factors.

Stock marktes	As of 20.01.2017 14:48	Change versus 06.01.2017 -1 Woche	12.12.2016 -1 Monat	12.10.2016 -3 Monate	30.12.2016 YTD
Dow Jones	19732	-1,2%	-0,3%	8,8%	-0,2%
S&P 500	2264	-0,6%	0,3%	5,8%	1,1%
Nasdaq	5547	0,5%	2,5%	5,9%	3,1%
DAX	11607	0,1%	3,7%	10,3%	1,1%
MDAX	22610	1,6%	4,7%	6,4%	1,9%
TecDAX	1833	-0,3%	4,9%	2,9%	1,2%
EuroStoxx 50	3301	-0,6%	3,2%	9,7%	0,3%
Stoxx 50	3012	-1,3%	2,5%	6,7%	0,1%
SMI (Swiss Market Index)	8268	-1,8%	2,8%	2,5%	0,6%
Nikkei 225	19135	-1,6%	-0,1%	13,6%	0,1%
Brasilien BOVESPA	64334	4,3%	8,7%	5,4%	6,8%
Russland RTS	1137	-3,0%	-1,0%	14,2%	-1,3%
Indien BSE 30	27035	1,0%	2,0%	-3,7%	1,5%
China Shanghai Composite	3123	-1,0%	-1,0%	2,1%	0,6%
MSCI Welt (in €)	1776	-0,9%	0,4%	8,4%	0,4%
MSCI Emerging Markets (in €)	895	1,0%	2,1%	2,6%	2,7%
Bond markets					
Bund-Future	162,69	-15	164	-61	-146
Bobl-Future	133,18	-14	44	169	-45
Schatz-Future	112,19	-7	-3	11	-10
3 Monats Euribor	-0,33	-1	-1	-2	-1
3M Euribor Future, Dec 2017	-0,31	-4	-5	2	0
3 Monats $ Libor	1,02	1	6	14	2
Fed Funds Future, Dec 2017	1,10	-4	5	30	0
10 year US Treasuries	2,49	7	1	72	4
10 year Bunds	0,40	19	9	41	30
10 year JGB	0,07	1	1	12	2
10 year Swiss Government	-0,08	10	-4	40	12
US Treas 10Y Performance	573,14	0,5%	1,1%	-4,1%	0,6%
Bund 10Y Performance	610,90	0,6%	1,5%	-1,4%	-0,3%
REX Performance Index	483,28	-0,1%	0,3%	-0,9%	-0,4%
US mortgage rate	0,00	0	0	0	0
IBOXX AA, €	0,72	-3	-10	21	4
IBOXX BBB, €	1,53	-2	-13	19	3
ML US High Yield	6,30	1	-22	-20	-16
JPM EMBI+, Index	783	0,0%	2,5%	-3,0%	1,4%
Convertible Bonds, Exane 25	6937	0,1%	1,9%	3,2%	0,3%
Commodities					
CRB Index	432,70	1,2%	1,8%	4,0%	2,9%
MG Base Metal Index	293,59	3,9%	-0,6%	12,9%	4,9%
Crude oil Brent	55,03	-3,5%	-1,7%	6,1%	-3,0%
Gold	1202,77	2,4%	3,7%	-3,9%	3,9%
Silver	16,81	2,0%	-2,2%	-3,7%	4,7%
Aluminium	1791,00	4,1%	3,2%	6,6%	5,1%
Copper	5813,75	4,4%	1,1%	21,3%	5,3%
Iron ore	81,50	4,5%	-1,8%	41,7%	1,9%
Freight rates Baltic Dry Index	942	-2,2%	-11,9%	4,0%	-2,0%
Currencies					
EUR/ USD	1,0648	0,6%	0,5%	-3,4%	1,0%
EUR/ GBP	0,8665	0,9%	3,5%	-4,1%	1,5%
EUR/ JPY	122,47	-0,3%	-0,2%	7,0%	-0,8%
EUR/ CHF	1,0724	0,0%	-0,4%	-1,7%	-0,1%
USD/ CNY	6,8725	-1,0%	-0,7%	2,3%	-1,2%
USD/ JPY	114,72	-1,9%	-0,3%	10,1%	-1,9%
USD/ GBP	0,81	0,3%	3,1%	-0,8%	0,6%

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