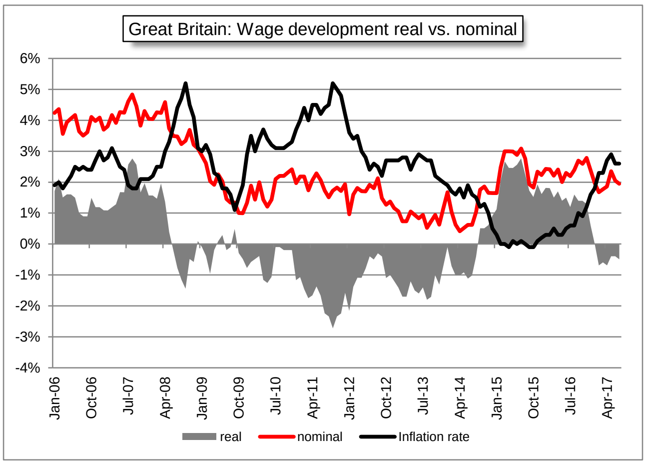
ECONOMIC SITUATION AND STRATEGY

Great Britain: Economic decline already beginning before Brexit

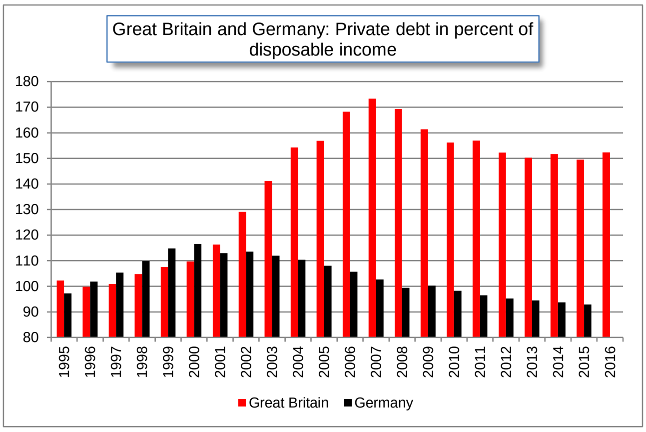
A few days ago, Boris Johnson, Great Britain's foreign minister, promised the country a "glorious" future after Brexit. Even if nobody can really predict the future, one needs to have a great imagination to share this opinion. For, what has been emerging in the past months is a slow decline of the British economy, not a heroic resurrection.

The economic downturn is not happening abruptly as some had expected shortly after the Brexit referendum, but is creeping in slowly due to the adjustment of capital spending in the business sector. The dimmed or at least uncertain prospects for the future are causing companies to exercise more restraint. They are postponing major investments, accommodating demand spikes by means of overtime rather than new hiring, and only reluctantly raising salaries.

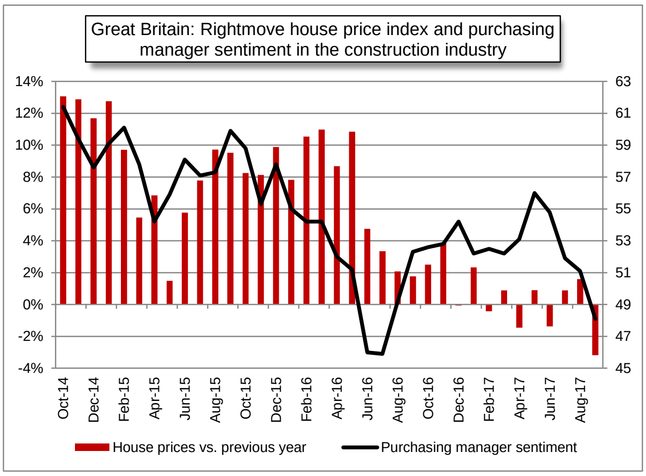
The restraint in wage policy directly affects household incomes. Real wages have fallen appreciably lately due to growing inflation, which in turn has been reinforced lately by the British pound's devaluation. Consumers are reacting by using more debt to finance their expenditures. That has caused the saving ratio to decline to 1.7% of disposable income, which is not much compared with Germany's almost 10% and represents an all-time low.



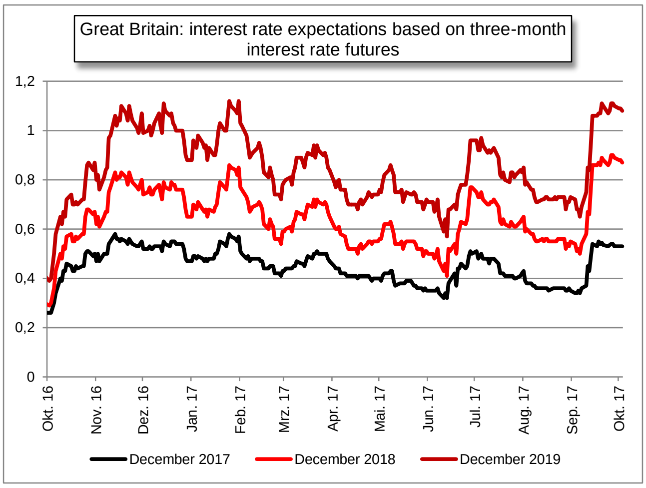
In other words, this means British consumers are living beyond their means. Altogether, household debt amounts to over 150% of disposable income, which is very high by international comparison. In Germany, household debt is only about 90% of disposable income. The British Financial Services Authority estimates that about 16% of the population has to struggle with debt problems. The young generation is especially burdened. For example, total student loans increased by 17% in 2016 alone.



Flat wage development and political uncertainty are also burdening the real estate markets, which are economically very important for the United Kingdom. According to Rightmove, the country's largest property website, house prices stagnated in the first nine months of this year. Offer prices were actually 3.2% lower in September 2017 compared with last year. The weakness is clearly reflected in purchasing manager sentiment in the construction sector. An index value of 48.1 points signals a decline of business expectations in the primary construction industry. It is still mainly the commercial building segment where the uncertainty is visible, but the housing construction segment usually follows at a short time lag.



The national economy can cope with temporarily higher borrowing as long as interest rates do not rise. However, since the inflation rate has jumped to 2.9% and inflation expectations for the long term (5-10 years) have climbed back above 3%, the Bank of England is under pressure to act. It is very likely to raise the key interest rate from 0.25% to 0.5%. Such a small interest rate hike will still not be a real threat. But if the central bank is forced to take further steps, consumer loans, which mostly carry variable interest rates, could lead to a rise of household insolvencies. That would in turn be a burden on banks and hence on the economy's financial stability. For, not only are households living on credit, but the national economy as a whole. The current account deficit has decreased somewhat recently, but it is still about 4.5% of GDP and hence relatively close to the critical 5% mark.



A crisis is not to be expected in the very near term, since international economic development is so strong and is helping to stabilize the British economy. However, the United Kingdom is at risk of being the first to suffer in a downswing phase. And the creeping process of economic weakening is likely to continue even before that.

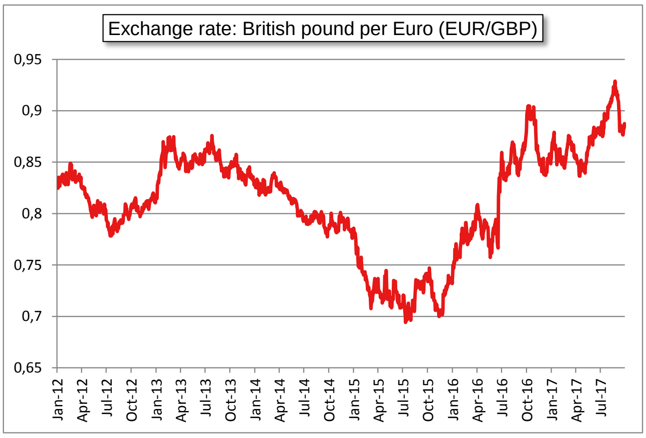
The Brexit negotiations are hardly moving forward because positions on both sides are still very far apart. However, it appears to make a difference whether two states or federations enter into a new trade agreement or they renegotiate or cancel an existing agreement. While both parties negotiate with equal rights regardless of economic size in the case of new agreements, their economic importance makes itself strongly felt when the trade community already exists or is dissolved. The reason is that the economic gain of a new trade agreement appears very vague and thus does not entail any felt disadvantages for the population if the agreement does not come about. On the other hand, the losses of an economic separation are more visible and can thus be used as a bargaining chip by the stronger party. For example, the United States can compel the other parties to renegotiate NAFTA because dissolving the agreement would pose more serious economic problems for Canada and Mexico than for the huge US economy.

The British government has not accepted its worse negotiating position yet. It is grasping at straws, hoping a new German government will be more pro-business and accordingly more willing to compromise. For this reason, negotiations will only proceed very reluctantly until the beginning of 2018. But these hopes are likely to be dashed, since there is agreement throughout Europe that it is better to cope with the economic damage than to strengthen the centrifugal forces of the European Union by being too accommodative. However, a hard Brexit should not be expected in March 2019. A transitional phase is already emerging in which Great Britain will formally withdraw but will largely observe the obligations of the European Union in order to avoid losing access to the single market.

In our view, a transitional phase with a relatively soft Brexit will begin in March 2019 and continue at least until the conclusion of the 7-year EU budget period at the end of 2020. Because of the shortage of time, the country is not prepared for an abrupt break. In this phase, Great Britain will continue to pay its full share to the EU budget, since those funds have already been firmly promised in any case. This solution is also attractive for the European Union, because it need not close any budget gaps by means of additional payments from national budgets.

It is largely unclear what will happen after this transitional phase. A retreat from Brexit is nearly out of the question, however. The desire for national self-determination, particularly in respect to immigration policy, is too great. But that will entail appreciable economic sacrifices for Great Britain. A crisis in the United Kingdom cannot be ruled out. However, because its share of global GDP is limited at about 3%, that will not result in a collapse of the world economy.

We recommend making investments in the United Kingdom only very selectively. The earnings of British companies could come under pressure because of business investment restraint, and the financial stability of the national economy could someday be in danger. We expect a further weakening of the British pound despite the impending interest rate increase. Even parity with the euro, which would represent a pound devaluation by 12%, cannot be ruled out. Together with limited additional private borrowing, this will burden EU exports to the United Kingdom. In particular, makers of consumer goods including automobile manufacturers are likely to register sales volume losses. But they might be offset by stronger demand from other parts of the world such as the United States, China, or southern Europe, so one should not generally dismiss investing in companies that export to Great Britain. Moreover, the planned transitional phase of two to three years will prevent an economic shock.

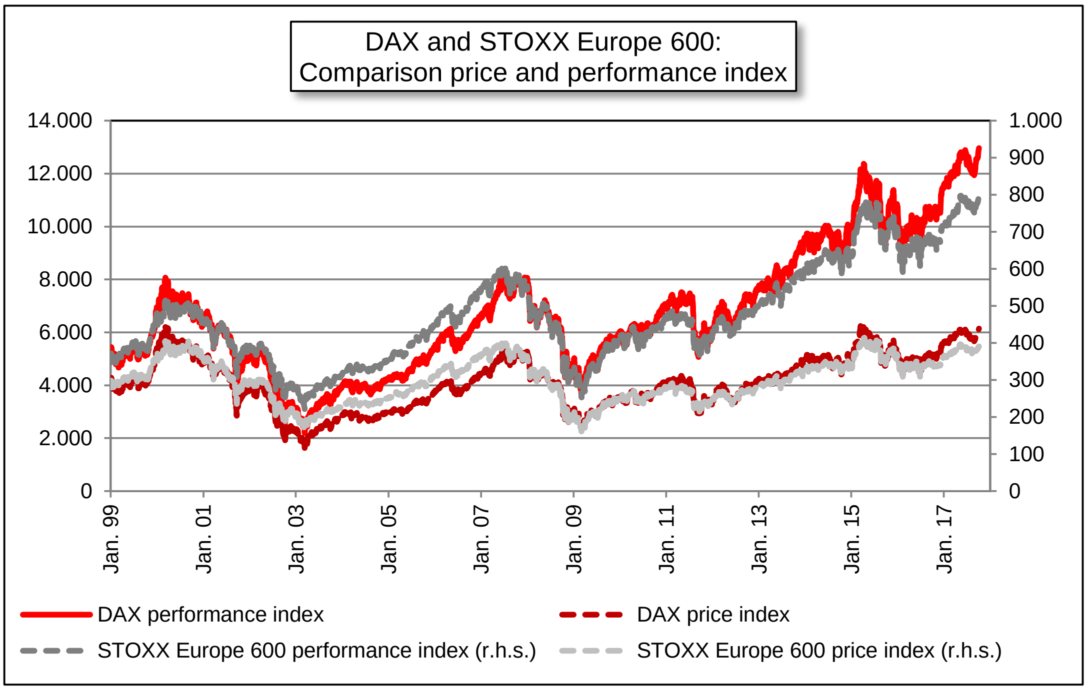


Weekly outlook for October 9-13, 2017

	May	June	July	Aug.	Sept.	Oct.	Release
DE: Industrial production, m/m	1.2%	-1.1%	0.0%	0.9%			October 9
DE: Industrial production, y/y	4.9%	2.5%	4.0%	2.7%			October 9
DE: Exports, m/m	1.5%	-2.7%	0.2%	0.3%			October 10
DE: Exports, y/y	8.7%	5.8%	7.8%	4.4%			October 10
DE: Imports, m/m	1.1%	-4.4%	2.3%	0.5%			October 10
DE: Imports, y/y	12.8%	7.1%	9.6%	8.0%			October 10
DE: Consumer prices, m/m - final	-0.2%	0.2%	0.4%	0.1%	0.1%		October 12
DE: Consumer prices, y/y - final	1.5%	1.6%	1.7%	1.8%	1.8%		October 12
DE: Core inflation, m/m - final	0.1%	0.3%	0.5%	0.1%	0.0%		October 12
DE: Core inflation, y/y - final	1.3%	1.6%	1.7%	1.6%	1.6%		October 12
EUR19: Sentix	27.4	28.4	28.3	27.7	28.2	28.0	October 12
EUR19: Industrial production, m/m	1.4%	-0.6%	0.1%	0.6%			October 9
EUR19: Industrial production, y/y	4.0%	2.7%	3.4%	2.3%			October 9

MMWB estimates in red

Chart of the Week: DAX hits record highs – where to from here?



The close on Wednesday marked a new high in the DAX index of leading German stocks at 12,970 points, never before seen in its almost 30-year history. The index thus surpassed its previous record high of 12,951 points reached last June. While the S&P 500, the broad US index, has swung from one high to the next since mid-2013 in both the price and performance indexes, the situation in Europe is somewhat different. As performance indexes, the broad STOXX Europe 600 and the DAX present a similar picture, but as prices indexes (the "classic" version of stock indexes that does not take account of paid dividends), both the STOXX and the DAX are respectively still about 4% and 3% below their highs of 2000 and 2015. But this is only one reason why we believe the stock market rally in Europe and especially in Germany is not over yet. The euro, which has weakened somewhat against the US dollar in the past weeks, is playing into the hands of the positive momentum of the European stock markets. Above all, however, global economic data are better than they have been in a long time. In particular, the German economy is in outstanding shape. This trend is also affecting the stock markets positively, because corporate earnings are increasing sharply. If earnings maintain their momentum, the DAX will continue to set records. At a P/E ratio of just over 13, the DAX is still valued rather low compared with the American stock market.

Stock marktes	As of 06.10.2017 12:49	Change versus 29.09.2017 -1 week	05.09.2017 -1 month	05.07.2017 -3 months	30.12.2016 YTD
Dow Jones	22775	1,7%	4,7%	6,0%	15,2%
S&P 500	2552	1,3%	3,8%	4,9%	14,0%
Nasdaq	6585	1,4%	3,3%	7,1%	22,3%
DAX	12980	1,2%	7,1%	4,2%	13,1%
MDAX	26102	0,4%	5,7%	5,5%	17,6%
TecDAX	2488	2,2%	7,8%	11,9%	37,3%
EuroStoxx 50	3604	0,3%	5,4%	3,6%	9,5%
Stoxx 50	3194	0,7%	5,2%	1,6%	6,1%
SMI (Swiss Market Index)	9270	1,2%	4,5%	3,5%	12,8%
Nikkei 225	20691	1,6%	6,7%	3,0%	8,2%
Brasilien BOVESPA	76618	3,1%	6,2%	21,3%	27,2%
Russland RTS	1146	0,8%	4,1%	13,7%	-0,6%
Indien BSE 30	31814	1,7%	0,0%	1,8%	19,5%
China Shanghai Composite	3349	0,0%	-1,0%	4,4%	7,9%
MSCI Welt (in €)	2016	1,6%	4,7%	1,6%	3,6%
MSCI Emerging Markets (in €)	1103	2,8%	3,2%	5,6%	15,1%
Bond markets					
Bund-Future	163,14	213	-238	121	-101
Bobl-Future	131,10	-8	-226	-73	-253
Schatz-Future	112,14	1	-19	23	-16
3 Monats Euribor	-0,33	0	0	0	-1
3M Euribor Future, Dec 2017	-0,32	0	1	-3	0
3 Monats $ Libor	1,35	1	3	4	35
Fed Funds Future, Dec 2017	1,26	1	7	-2	0
10 year US Treasuries	2,36	4	30	3	-8
10 year Bunds	0,48	2	14	1	37
10 year JGB	0,06	-1	6	-3	1
10 year Swiss Government	-0,02	-1	13	3	19
US Treas 10Y Performance	581,72	-0,2%	-2,3%	0,7%	2,2%
Bund 10Y Performance	608,62	0,2%	-1,0%	1,0%	-0,7%
REX Performance Index	482,33	0,0%	-0,4%	0,5%	-0,6%
US mortgage rate	0,00	0	0	0	0
IBOXX AA, €	0,76	-1	9	-11	9
IBOXX BBB, €	1,31	0	5	-12	-19
ML US High Yield	5,98	3	-12	-13	-48
JPM EMBI+, Index	840	0,2%	-0,3%	2,9%	8,8%
Convertible Bonds, Exane 25	7273	0,0%	1,8%	1,4%	5,2%
Commodities					
CRB Spot Index	430,41	0,6%	-1,4%	-3,9%	1,7%
MG Base Metal Index	338,58	1,1%	-1,8%	13,0%	21,0%
Crude oil Brent	56,71	-1,5%	5,7%	17,9%	0,0%
Gold	1269,96	-1,1%	-5,0%	4,0%	9,7%
Silver	16,67	-0,5%	-7,0%	4,4%	3,9%
Aluminium	2148,25	3,3%	3,7%	11,9%	26,1%
Copper	6658,25	3,5%	-3,1%	14,5%	20,6%
Iron ore	62,84	-9,9%	-19,1%	-0,3%	-21,2%
Freight rates Baltic Dry Index	1382	1,9%	13,7%	63,2%	43,8%
Currencies					
EUR/ USD	1,1711	-0,8%	-1,5%	3,4%	11,1%
EUR/ GBP	0,8959	1,7%	-2,1%	2,2%	5,0%
EUR/ JPY	132,19	-0,5%	1,7%	2,8%	7,1%
EUR/ CHF	1,1467	0,1%	0,5%	4,7%	6,8%
USD/ CNY	6,6533	0,0%	1,7%	-2,2%	-4,3%
USD/ JPY	112,82	0,3%	3,7%	-0,4%	-3,5%
USD/ GBP	0,77	2,7%	-0,3%	-1,1%	-5,4%

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