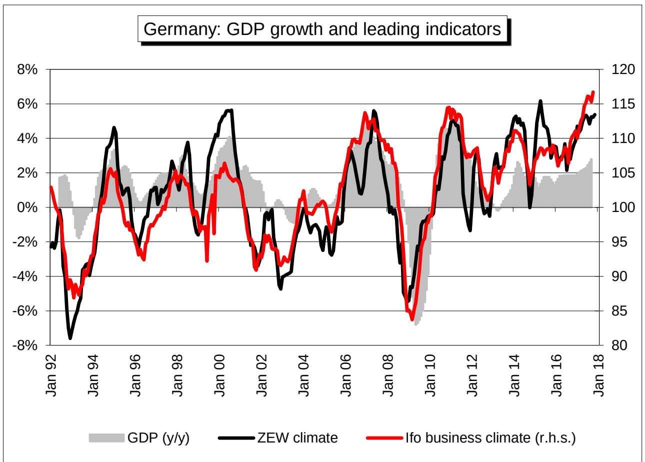
Outlook for 2018 (I): "Golden Age" for the German economy

In the weeks ahead, we will present our economic and capital market outlook for 2018 in a series of articles here. Beginning today, we consider the economic prospects for Germany. Our assessment there continues to be positive.

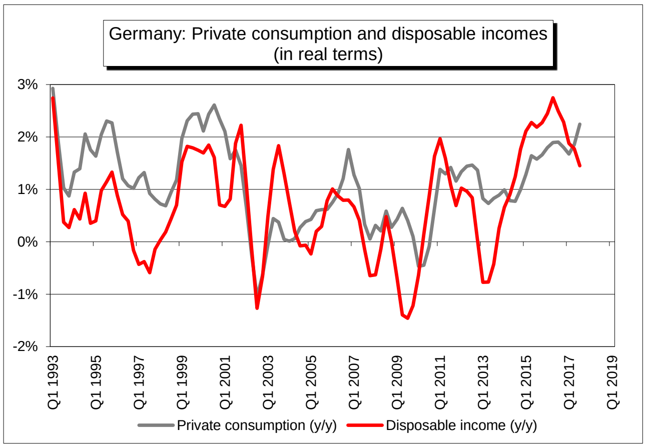
The German economy has grown at an impressive pace in 2017. Real GDP was up 0.8% in the third quarter compared with the preceding quarter. Moreover, since the growth rate for the first quarter of 2017 has been revised upward, economic growth will significantly surpass the 2% mark. We now expect an increase this year of 2.3%. In regard to the official growth rate, it must be taken into account that this year has had three fewer working days than 2016 had. This calendar effect means the growth rate after adjustment for calendar and seasonal influences (relevant measurement for international comparison) actually comes to 2.6%. Economic momentum has seldom been as underestimated as it has this year. The average of growth forecasts was at just 1.3% in January 2017, with the most optimistic at 1.7% and the most pessimistic at 1.1%.



Since the Ifo business climate index, the most important leading indicator for the German economy, has recently hit a new record, everything now points to continuing high growth. The economy might shift back to a somewhat slower pace in the second half of 2018 at the earliest. Business sentiment has seldom been higher not only in manufacturing but also in the services sector. We therefore expect real GDP growth of 2.7% for 2018, with there being no appreciable calendar effects next year. There are also political conditions that give reason for optimism. If the Christian Democrats (CDU/CSU), Free Democrats (FDP), and the Greens agree to form a governing coalition, tax cuts and more expansionary fiscal policy are likely to be adopted in the foreseeable future, which will lead to additional growth impetus in 2018 and 2019.

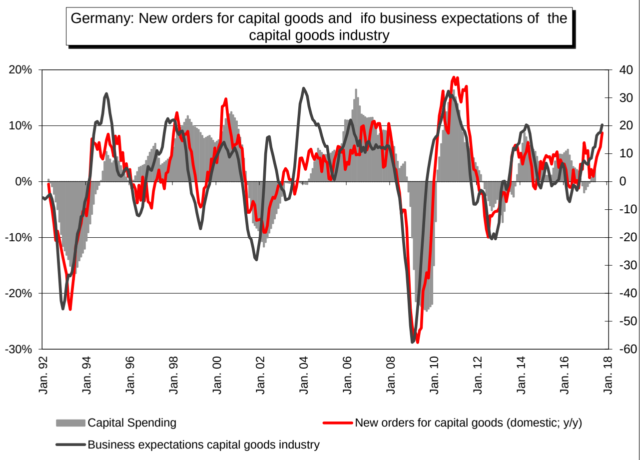
Higher real wages support consumer spending

Lower taxes and strong financial assistance to families would affect consumer spending positively. Domestic demand will therefore be the engine of economic activity in the near future. Private consumption is benefiting from the good labor market situation. The number of employed persons recently reached a record level of more than 44 million, of which more than 32 million have jobs subject to social insurance obligations. In the past two years, total gross wages have risen by more than 4% per annum. At about 3%, the increase of disposable incomes was not quite as strong due to the tax progression, but was still impressive. Since the average unemployment rate will fall from 5.9% this year to 5.7% next year, total gross wage will also show a comparatively strong gain. We expect the inflation rate to drop from 1.6% this year to 1.3% in 2018. That is mainly due to the oil price and the stronger euro, which means that imports will not become appreciably more expensive. The inflation rate will therefore drop to about 1% at the beginning of 2018 and only rise slightly in the course of the year. Households will thus have more real money in their pocketbooks than in 2017, especially since contributions to pension and health insurance will decline slightly and pension benefits are likely to rise by about 3%. Consumer spending will increase by just over 2% in 2018 and thus somewhat more strongly than in 2017. If this forecast proves correct, this will be the largest increase of consumer spending since 2000.



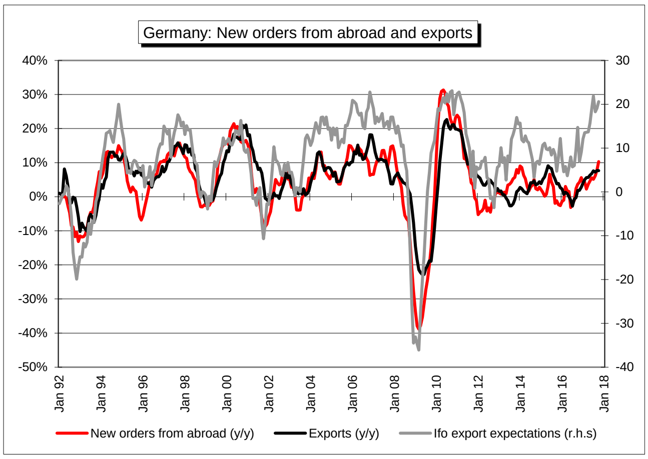
Construction spending with lower momentum, but growth surge from equipment spending

Construction spending has been expanded enormously in the last two years because of the German real estate boom. The favorable situation will not change much for the time being, especially since a "Jamaica" coalition (CDU/CSU, FDP, and Greens) would like to support private housing construction more strongly. However, order intake has weakened in the construction industry in the past months, and it remains to be seen whether this is just a breathing spell or a more lasting slowdown. In contrast to construction spending, growth of equipment spending has been very subdued in the past three years. This has been mainly due to great political uncertainties, which have put the brakes on capital investment propensity. But now the tide is turning. Recently, business expectations in the capital goods sector have brightened noticeably, and the German machinery industry is more optimistic about the coming quarters than it has been in a long time. We expect equipment spending to increase by a good 6% in 2018.



Exports: Euro revaluation not a spoilsport thanks to robust world economy

The positive overall situation for the German economy is topped off by exports. German companies will benefit more than average from the stronger expansion of the world economy in 2018. True, the revaluation of the euro is applying the brakes slightly to foreign trade, but the continuing optimistic export expectations of German companies indicate that sales prospects do not depend primarily on the currency trend. In addition to price competitiveness, the economic environment in the sales markets is playing a decisive role. As described above, that is more positive than it has been in a long time. Demand for German goods and services, both from the emerging markets and from euro zone countries, is growing more strongly than in previous years. In particular, China is playing an ever more important role for German companies. In the past months, China has almost overtaken France as the second most important export market, and only the United States still has a greater lead. But if imports and exports are considered together, China already took the place of France and the United States as Germany's most important trading partner last year. We expect German exports next year to be a good 5% above the level of 2017. Imports are likely to increase even more strongly due to strong domestic demand in Germany, which will primarily benefit neighboring countries in the euro zone. Because of the increase of imports by more than 6%, foreign trade may be expected to make only a small positive contribution to growth.



German stocks benefiting from economic environment

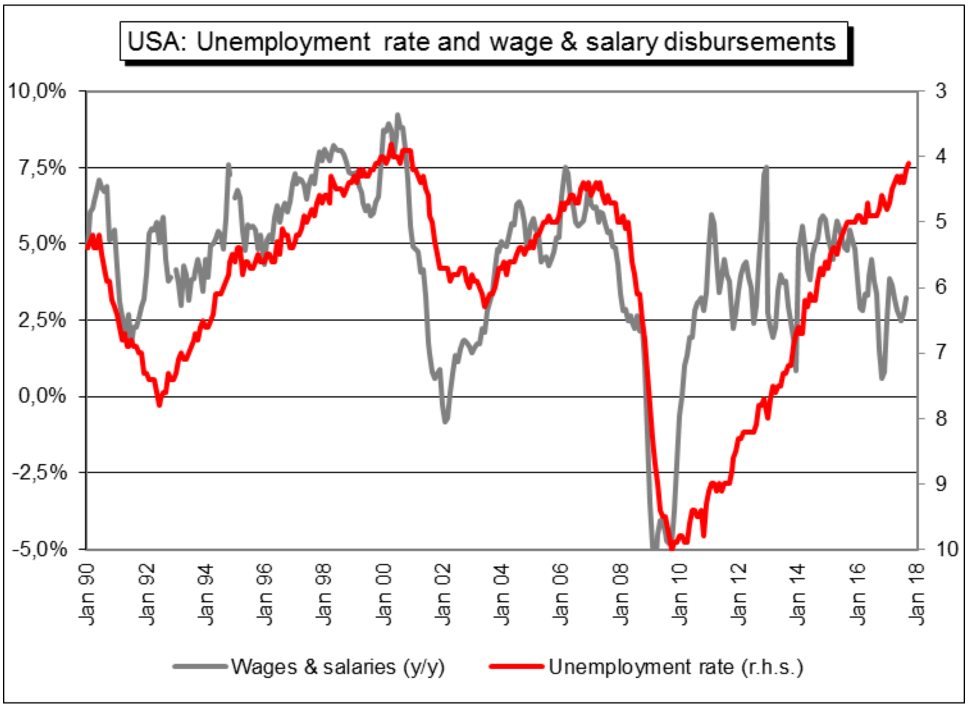
Germany's DAX stock index has achieved an average return since 2009 of 9%. The MDAX (14.9% p.a.), SDAX (14.1% p.a.), and TecDAX (13.0% p.a.) have done even better – and also outstanding by international comparison. Even those who invested in the DAX before the outbreak of the financial and economic crisis in November 2007 at about 8,000 points could now look back on a return of 5.4% p.a., and that although a loss of more than 50% had to be endured in the meantime. Since the German economy will grow strongly again in 2018, this success story should continue with the cooperation of the world economy. Despite the high price gains of the past years, the valuation of the DAX is not high relative to its own history or compared with other indexes. The price-earnings ratio based on earnings expected for the coming 12 months is 13.5, while the long-term average is 15. This is because the German stock market is dominated by cyclical stocks that react strongly to changes in economic conditions, e.g., stocks of automobile manufacturers as well as chemical and industrial companies. This is also why the DAX exhibits higher volatility than other indexes – the share prices fluctuate more strongly. According to corporate analysts, 12 of the 30 DAX companies will be able to increase their earnings by double-digit percentage rates in the coming 12 months. At the index level, another earnings plus of 10% is expected. That would mean an increase of aggregate earnings per share of DAX companies to 980 points in 2018 and to more than 1,060 points in 2019. Multiplied by the current P/E ratio, this yields a price target for the DAX of 14,500 points. If one assumes that German blue chips will become only somewhat more expensive next year, a price target of 15,000 points would even be attainable.

Weekly outlook for November 20-24, 2017

	June	July	Aug.	Sept.	Oct.	Nov.	Release
DE: Producer prices, m/m	0.0%	0.2%	0.2%	0.3%	0.1%		November 20
DE: Producer prices, y/y	2.4%	2.3%	2.6%	3.1%	2.5%		November 20
DE: PMI, manufacturing, flash	59.6	58.1	59.3	60.6	60.6	60.1	November 23
DE: PMI, services, flash	54.0	53.1	53.5	55.6	54.7	55.0	November 23
DE: Ifo business climate index	115.2	116.1	116	115.3	116.7	116.4	November 24
DE: Ifo business expectations	106.7	107.3	107.8	107.5	109.1	108.7	November 24
DE: Ifo current conditions	124.3	125.7	124.7	123.7	124.8	124.6	November 24
EUR19: Consumer confidence, flash	-1.3	-1.7	-1.5	-1.2	-1.0	-1.2	November 22
EUR19: PMI, manufacturing, flash	57.4	56.6	57.4	58.1	58.5	58.2	November 23
EUR19: PMI, services, flash	55.4	55.4	54.7	55.8	55.0	55.4	November 23

MMWB estimates in red

Chart of the Week: Labor market and wage trends have decoupled



In recent decades, capital markets have frequently kept a close eye on the US labor market partly because the unemployment rate correlates directly with the growth rate of wages and has thus exerted a comparatively direct influence on the price trend. For this reason, the concept of the non-accelerating inflation rate of unemployment (NAIRU) has functioned extremely well in the United States for decades. It describes the unemployment rate at which the inflation rate is in a state of equilibrium. The unemployment rate has fallen so sharply in recent years that the NAIRU would almost certainly have to be above the current unemployment rate. In the past, the inflation rate would increase in such a situation. But since the growth rate of wages now appears no longer to correlate with the unemployment rate, the NAIRU connection has also lost its importance. As a result, the rise of inflation is significantly more moderate than it would have been on similar data in the past. So, there is every indication that the Fed will raise interest rates a maximum of four times next year on more or less unchanging data, since there would be not the slightest reason to do so from the standpoint of inflation.

Stock marktes	As of 17.11.2017 13:39	Change versus 09.11.2017 -1 week	13.10.2017 -1 month	15.08.2017 -3 months	30.12.2016 YTD
Dow Jones	23458	0,0%	2,6%	6,6%	18,7%
S&P 500	2586	0,0%	1,3%	4,9%	15,5%
Nasdaq	6706	-0,6%	1,5%	5,9%	24,6%
DAX	13074	-0,8%	0,6%	7,4%	13,9%
MDAX	26501	-0,3%	1,6%	6,9%	19,4%
TecDAX	2514	2,3%	-0,5%	11,4%	38,8%
EuroStoxx 50	3571	-1,2%	-0,9%	3,1%	8,5%
Stoxx 50	3146	-1,4%	-1,7%	2,7%	4,5%
SMI (Swiss Market Index)	9161	-0,2%	-1,6%	1,6%	11,5%
Nikkei 225	22397	-2,1%	5,9%	13,4%	17,2%
Brasilien BOVESPA	72789	-0,2%	-5,5%	6,5%	20,9%
Russland RTS	1132	-2,5%	-2,1%	10,2%	-1,7%
Indien BSE 30	33343	0,3%	2,8%	6,0%	25,2%
China Shanghai Composite	3382	-1,3%	-0,2%	4,0%	9,0%
MSCI Welt (in €)	2036	-1,7%	0,5%	4,0%	3,9%
MSCI Emerging Markets (in €)	1125	-2,1%	0,1%	6,5%	16,6%
Bond markets					
Bund-Future	163,14	56	112	-71	-101
Bobl-Future	131,75	-5	22	-88	-188
Schatz-Future	112,26	-2	5	9	-4
3 Monats Euribor	-0,33	0	0	0	-1
3M Euribor Future, Dec 2017	-0,33	0	-1	0	0
3 Monats $ Libor	1,42	1	7	11	42
Fed Funds Future, Dec 2017	1,29	0	2	6	0
10 year US Treasuries	2,36	2	9	9	-8
10 year Bunds	0,37	-1	-3	2	17
10 year JGB	0,03	0	-3	-1	-1
10 year Swiss Government	-0,12	-2	-8	-2	8
US Treas 10Y Performance	583,46	0,1%	-0,5%	0,0%	2,5%
Bund 10Y Performance	612,80	0,0%	0,3%	0,6%	0,6%
REX Performance Index	483,62	-0,3%	0,1%	0,2%	-0,3%
US mortgage rate	0,00	0	0	0	0
IBOXX AA, €	0,68	3	-3	-4	1
IBOXX BBB, €	1,19	7	-4	-9	-31
ML US High Yield	6,34	13	33	22	-12
JPM EMBI+, Index	825	0,4%	-1,9%	-0,3%	6,9%
Convertible Bonds, Exane 25	7350	0,2%	0,9%	2,7%	6,3%
Commodities					
CRB Spot Index	429,39	-0,4%	-0,2%	-1,9%	1,5%
MG Base Metal Index	338,37	-1,0%	-2,7%	4,4%	20,9%
Crude oil Brent	62,09	-3,3%	8,6%	22,8%	9,5%
Gold	1282,46	-0,1%	-1,3%	0,9%	10,8%
Silver	17,01	0,2%	-1,8%	2,0%	6,0%
Aluminium	2086,50	0,5%	-1,1%	1,6%	22,4%
Copper	6736,25	-0,6%	-1,8%	6,2%	22,0%
Iron ore	61,60	0,3%	1,6%	-16,0%	-22,8%
Freight rates Baltic Dry Index	1361	-8,1%	-8,4%	16,4%	41,6%
Currencies					
EUR/ USD	1,1795	1,4%	-0,1%	0,4%	11,9%
EUR/ GBP	0,8932	0,8%	0,4%	-2,0%	4,6%
EUR/ JPY	132,82	0,8%	0,2%	2,4%	7,6%
EUR/ CHF	1,1697	0,9%	1,4%	2,5%	8,9%
USD/ CNY	6,6323	-0,2%	0,8%	-0,8%	-4,6%
USD/ JPY	112,88	-0,5%	0,9%	2,0%	-3,4%
USD/ GBP	0,76	-0,6%	0,8%	-2,6%	-6,4%

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