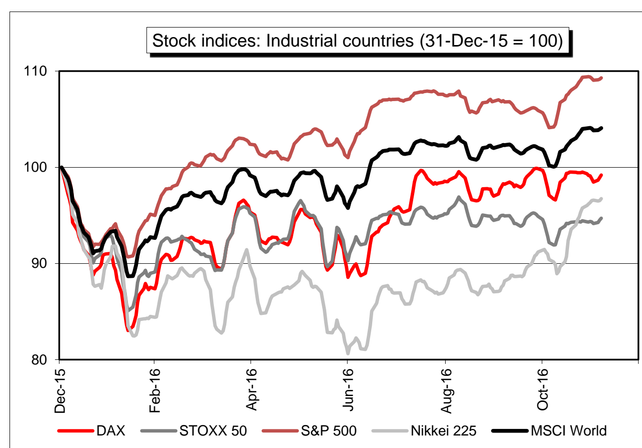
ECONOMIC SITUATION AND STRATEGY

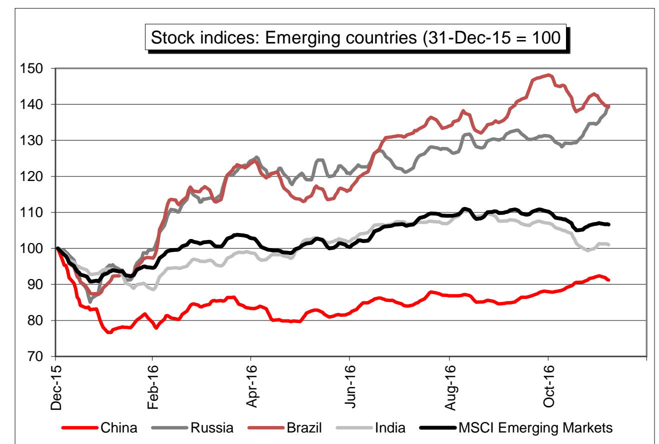
Capital market outlook for 2017: Politics or economics – which will dominate?

Most investors have not had an easy year again in 2016, especially those who focus on German and European stocks. The DAX index has moved sideways with much volatility and now shows a small advance of about 3%, while the Stoxx 50 has declined by about 6%. Things look better in the United States, where the S&P 500 is up about 10% calculated in US dollars. Most emerging country stock markets have also performed positively this year. Price gains have been especially strong in Brazil (Bovespa: +42%) and Russia (RTS: +43%). The Chinese stock market is still down (Shanghai Composite: -9%) due to a weak beginning of the year, but prices have also recovered significantly there in recent weeks.



Things already started going far differently than expected at the outset. The world's major stock markets made the weakest start of all time in 2016, with the DAX losing about 2,000 points in just the first six weeks of the year. There were some reasons for this almost 20% price decline, including poor economic data from the United States, worries about a significant slowdown in China, and persistently falling commodity prices, which was considered a negative signal for emerging economies. But as oil prices stabilized and started recovering in mid-February, stock prices moved slowly back upward. Just when it seemed in early summer as if better times might be dawning for stocks, political events took center stage. At the end of June, the surprising Brexit vote sent stock prices into another tailspin, and the DAX lost about 10% in a very short time, but prices then recovered just as quickly as they had previously fallen. On the other hand, the markets have shrugged off the election of Donald Trump as the new US president and the failure of the constitutional referendum in Italy. Nevertheless, European stock markets have been more or less treading water since mid-August, so prices on the DAX will clearly fall short of the year-end target of 12,000 points that we postulated 12 months ago.

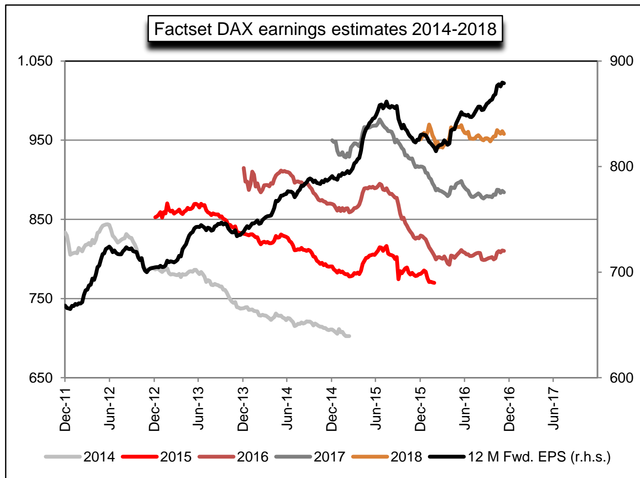
However, fundamental conditions for stocks have improved significantly in the past months. As we presented in our economic outlook for 2017 last week, the world economy is well on its way to achieving the strongest growth in five years, although the upswing has been underway for more than seven years. The safety margin relative to a possible recession was comparatively small in 2016, but it will become larger next year. That should help keep regularly resurging economic fears in check. The expected continuation of the upswing should have a generally positive effect on stock market performance in 2017.



On the other hand, as in 2016, various political risks will have a burdening influence. Elections in the Netherlands, France, and probably in Italy as well as Germany's parliamentary election, the beginning of Brexit negotiations with Great Britain, and possible surprises regarding the details of Donald Trump's economic policies could frighten investors away from the stock market despite the good fundamental data. Above all, investors in English-speaking countries will wonder whether it is worthwhile to seek exposure in Europe at all given the political risks. However, skepticism about Europe and the euro zone is already very pronounced, and the valuation of European stocks is low compared with many other regions. That applies especially to the DAX index, which has a price-earnings ratio of about 12 and a price-book value ratio of 1.5, but also to the Euro Stoxx 50 (P/E: 13 and P/B: 1.4). Small positive impetus might therefore already be enough to bring investors back to Europe. The arm-wrestling match between politics and economics should be decided by the good fundamental data, which cannot be derailed so easily by political uncertainties.

German stocks especially have catch-up potential. The more positive economic conditions of the past months have so far not found adequate expression in stock prices. Leading indicators like the Ifo business climate index and the purchasing manager indexes show that the German economy will experience solid growth in 2017. While German service providers, construction companies, and retailers have been rating conditions in their own sectors positively for some time, sentiment in the manufacturing sector has only started to improve recently. In particular, cyclical industries like chemicals, mechanical engineering, automobiles, and electrical engineering are more optimistic, since they will benefit from improving export expectations. So,

there is some evidence that the 30 DAX companies will achieve respectable earnings growth in 2017 after only mediocre performance this year.

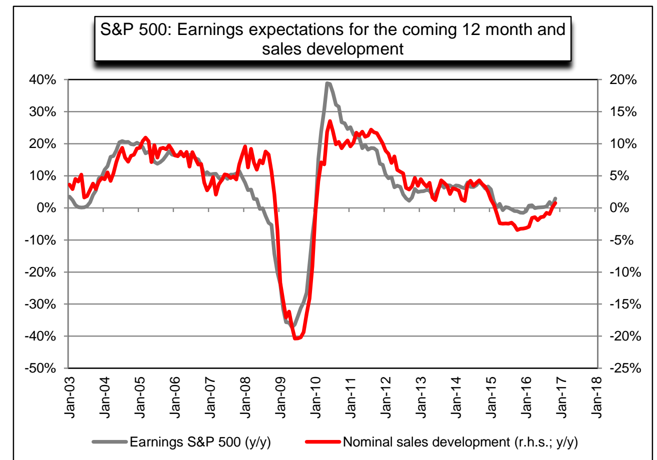


The double-digit percentage rates of increase expected by corporate analysts are probably a bit too high, as usual, but the good economic situation and relatively weak euro exchange rate should lead to impressive earnings growth. Expected DAX earnings (per share) have already reached new record levels now. Moreover, one should note that disappointing earnings in 2016 have had something to do with company-specific developments, and not with the macroeconomic situation. However, it is very likely that the sharp decline of earnings at Deutsche Bank, Commerzbank, E.ON, RWE, and Volkswagen will not continue. Even if one assumes that the valuation ratios will remain largely unchanged given the political uncertainties, the DAX could approach its old highs of spring 2015 at 12,400 points next year based on analysts' expectations. On somewhat more cautious earnings assumptions, we regard a DAX level of 11,850 at the end of 2017 as attainable. If the political uncertainties subside, that will be reflected in somewhat higher valuation multiples. A P/E ratio 1 point higher would lead to a DAX target almost 1,000 points higher. This shows clearly what potential the German stock market has. But things are not sorted out yet.

Similar considerations also apply to the European stock market. Investor sentiment in Europe is mostly cautious at best despite the stable economic conditions, and euphoria is not discernible. On the contrary, the worries about political and economic imponderables that have dominated the whole year have kept the cash ratios of many investors very high and valuation multiples rather low. But both the recent good economic data and the improved earnings expectations are not yet reflected in stock price performance. We expect the Euro Stoxx 50 to reach 3,350 points next year, and the Stoxx 50 a level of 3,150 points. But one should keep in mind that European stocks will probably continue to exhibit strong volatility. Investors will therefore need steady nerves again next year.

That things are going quite differently this year is shown by the United States. Our price target for the S&P 500 of 2,150 points has already been surpassed. Market participants have quickly shrugged off the surprising election of Donald Trump as the next US president. Although it is not clearly discernible what the economic policies of the new administration will look like in detail, attention has initially focused on the positive aspects: more government spending and lower taxes. The US economy should therefore get additional tailwind due to Trump in 2017. Since it is moving past this year's weak phase in any case, a positive growth surprise in 2017 is possible.

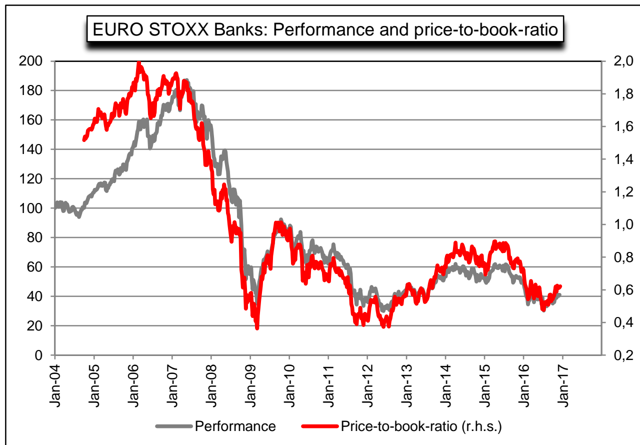
Even though already at record levels, US stocks should therefore have further price potential despite their relatively high valuation. We are optimistic for next year because earnings will make a strong recovery. The earnings recession (year-on-year earnings decline) that burdened price performance from mid-2015 onward is now history. The earnings of companies in the S&P 500 could increase by a good 10% in 2017, if one believes the analysts. This expectation may well sound overconfident at first, but there is one industry whose earnings development is likely by far to outpace that of all others: the energy sector.



Thanks to the recovery of the oil price, earnings in the energy sector are also rising again. The current earnings forecasts for 2017 are roughly comparable to the earnings achieved in this sector in 2003 and 2015. The average oil price was about USD 31 per barrel in 2003 and just over USD 48 in 2015. If one assumes that the oil price will range between USD 50 and USD 60 in 2017, the earnings forecasts might be too low, especially since the companies are meanwhile operating more cost-efficiently. Instead of the expected tripling of earnings, they might ultimately increase even somewhat more strongly – and thus positively influence the entire S&P 500. Moreover, the US stock market is also benefiting from the resumed rise of (macroeconomic) sales, which were disappointing from the beginning of 2015 to the middle of 2016. The US stock markets are therefore likely to continue setting new records in the coming year, without valuations becoming even higher. An attainable order of magnitude for the S&P 500 by the end of 2017 seems to be 2,400 points. If that happens, this global leader is likely to pull other stock markets along with it.

Considering the positive economic conditions, we favor cyclical sectors whose earnings development is supported by this environment. We currently regard the energy and materials sectors as especially interesting, as they should

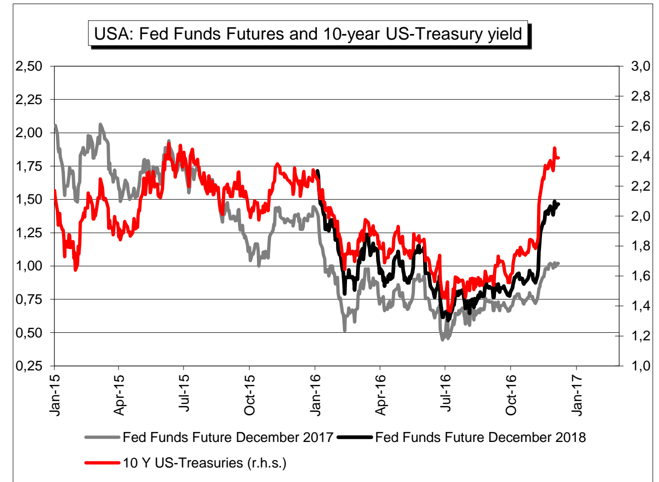
benefit from the continuing recovery of commodity prices and rekindled demand from the emerging countries. Furthermore, the long-observed poor performance of financial stocks (banking and insurance sectors) is unlikely to continue. In our opinion, monetary policy has now reached its maximum degree of expansion and interest rates will not fall further (or return to previous lows). Consequently, the earnings situation of both sectors should improve in 2017. Technology stocks will probably also continue to post gains. On the other hand, defensive sectors, which many investors have viewed as an alternative to the bond market in recent years, should become less appealing. Pharmaceutical and healthcare might be an exception to that, as their positive earnings development should support stock prices.



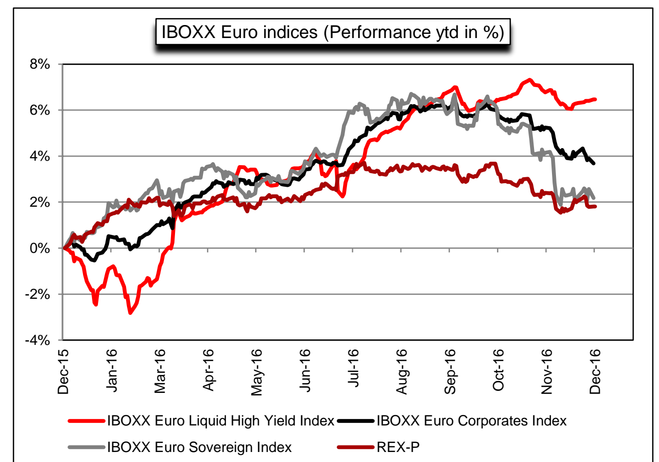
In contrast to the positive stock market scenario, we expect only a subdued year for the bond markets in 2017. Above all, it may become difficult next year to achieve positive performance with government bonds. That is because international monetary policy will not become even more expansionary for the first time in a long while. The ECB will adhere to its relaxed monetary policy, so interest rates in the euro zone will remain comparatively low in 2017, but yields may rise anyway, at least temporarily. Since coupons are so low that there is practically no buffer to cushion price losses, one must be prepared for high volatility in the near term, which could lead to severe losses at times.

Inflation rates will increase into the spring due to base effects, since the oil price rise will be felt more strongly until then. But as long as the prices of the other components in the basket of goods remain more or less stable, as we generally expect, inflation in the euro zone will not increase to more than 1.5%. On the other hand, price pressure might intensify somewhat more in the United States. Besides the higher oil price, somewhat greater wage increases are also possible and would affect the inflation rate. However, the PCE deflator, the price index that the Federal Reserve considers relevant for monetary policy decisions, will not climb above the 2% mark. The Fed is therefore likely to raise interest rates only moderately, probably in two steps taking the fed funds rate to a level of 1.0% to 1.25%.

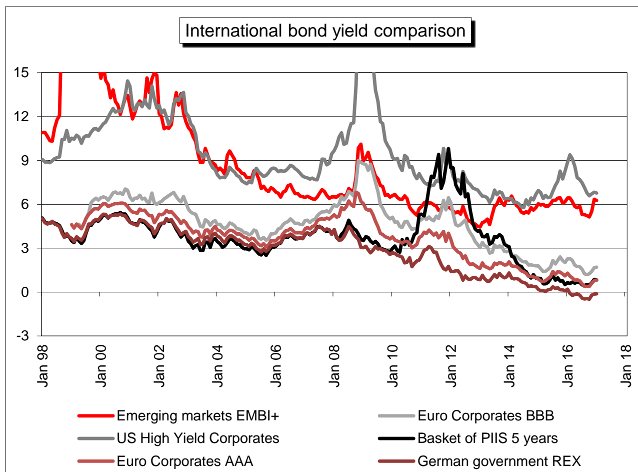
If this assumption proves correct, there will be little threat of trouble on the long end of the US yield curve – the 10-year Treasury yield will probably only rise slightly to 2.6% by the end of 2017. We originally expected that level already at the end of this year. Things could become more uncomfortable if the Fed has to raise interest rates more significantly due to higher inflation and stronger economic growth. Such a scenario has become somewhat more likely since Trump's election, but the US bond market has already reacted to that. The sharp rise of yields in the past weeks is attributable to heightened fears of more restrictive monetary policy from the Fed. An increase of 10-year Treasury yields to 3% or more could also put the brakes on the stock markets, but we would not expect that until the fed funds rate were raised to 2% or more.



The level of yields on 10-year German government bonds (Bunds) should be somewhat higher at the end of 2017 than it is now. We mistakenly expected such a development already in 2016. We had not quite foreseen the decline of yields on European government bonds to significantly below zero at times following the expansion of the ECB's quantitative easing program. However, since economic data have improved lately despite all the political uncertainties and the inflation rate in the euro zone will run 1.5% in 2017 and thus somewhat higher than it is today, we expect increased volatility but ultimately a trend leading to only a slight yield rise to 0.7% at year's end. Investors would thus suffer a small loss of value in the next 12 months, since the price losses would be higher than the interest coupon. On the other hand, the 3-month Euribor will be set more or less in concrete by the ECB's monetary policy, so it should still be at -0.3% a year from now.



Despite a rather unpromising outlook, bonds will continue to have an important function in portfolios as a stability anchor. However, the focus will shift in contrast to 2016. To date, it has been mainly on government bonds with long residual maturities and corporate bonds, but those asset classes will probably provide hardly any return in 2017. Instead, the topic of spreads (yield premium versus safe government bonds) should be the focus on the bond side. This strategy has already proven successful in 2016. For its execution, the primary instruments are mutual funds and ETFs that invest in emerging country bonds, high yield and subordinated corporate bonds, or even catastrophe bonds ("cat bonds"). While the risk of interest rate change for government and corporate bonds is great because of low or even negative yields, the yield pick-up on the other mentioned bond classes is so attractive that even a moderate interest rate hike would not entirely consume the coupon. US high-yield bonds, for example, are now at 6.7%.



Bonds (as well as stocks) from the emerging markets have come under pressure since the US presidential election, but we continue to regard them as a sensible portfolio additive. The potential default risks should decline further due to the looming economic recovery in those countries. The susceptibility to balance payments risks that have occasionally made trouble for emerging country bonds is declining. That is because currency reserves have risen in the past months in almost all major emerging countries and are consequently at very high levels relative to respective economic output. The worry that a possible interest rate hike in the United States and a strong US dollar could lead to significant capital outflows appears exaggerated. Admittedly, the return on JPMorgan's EMBI+ is so attractive (6.3%) because the index contains bonds from countries like Venezuela, Ukraine, and Argentina, but bond investors should not be put off by that. After all, by purchasing an ETF or mutual fund based on this index, one obtains a broadly diversified portfolio with a good opportunity-risk mix. Moreover, we believe the same arguments also speak in favor of stocks from emerging countries.

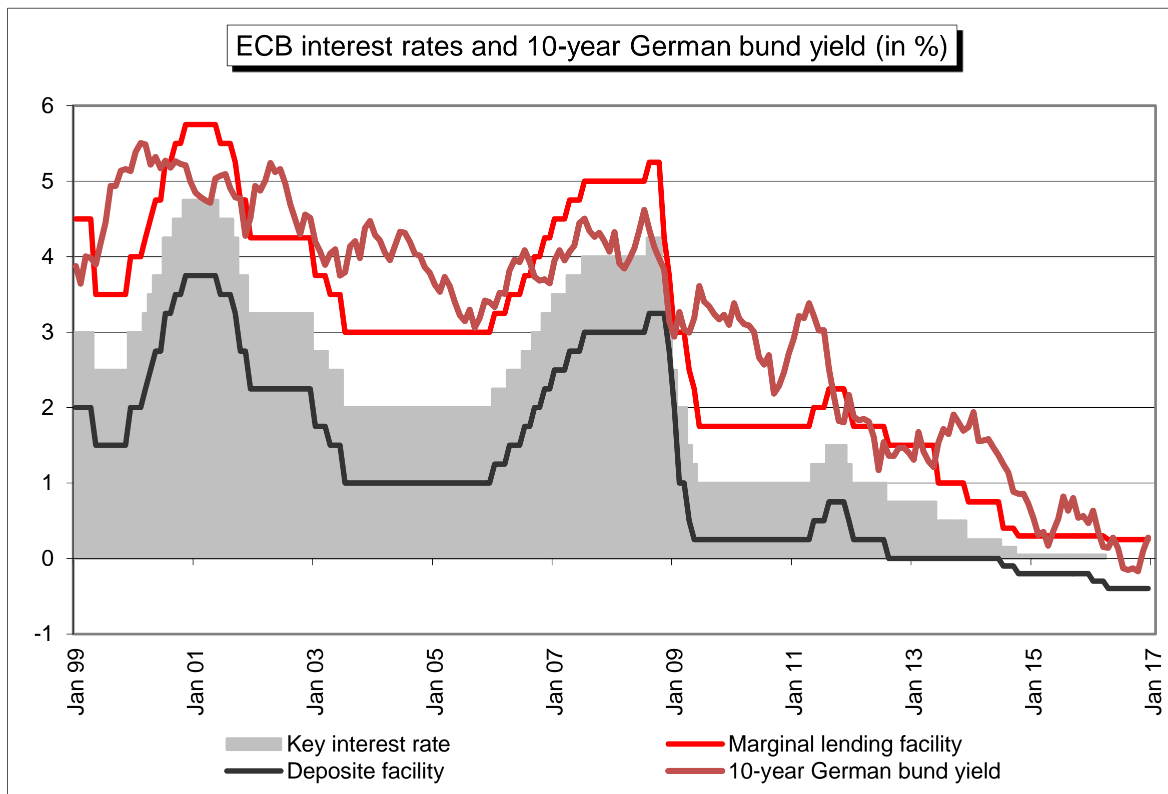
The US dollar has revalued somewhat after the US presidential election and will probably be only slightly off the exchange rate forecast of USD 1.10 per euro that we made 12 months ago for the end of 2016. We expect that investors will continue to favor the US dollar in the months ahead, since worries about further escalation of the political crisis within the euro zone still dominate. The US dollar is therefore likely to reach almost parity with the euro in the first half of 2017. Only later in the year, when it emerges that the euro will survive 2017 more or less undamaged, the exchange rate will probably starting moving back upward to near USD 1.10.

Weekly outlook for December 12-16, 2016

	July	Aug.	Sept.	Oct.	Nov.	Dec.	Release
DE: Consumer prices, m/m - final	0.3%	0.0%	0.1%	0.2%	0.1%		December 13
DE: Consumer prices, y/y - final	0.4%	0.4%	0.7%	0.8%	0.8%		December 13
DE: ZEW economic expectations	-6.8	0.5	0.5	6.2	13.8	14.5	December 13
DE: ZEW current assessment	49.8	57.6	55.1	59.5	58.8	59.2	December 13
DE: PMI, manufacturing, flash	53.8	53.6	54.3	55.0	54.3	54.8	December 15
DE: PMI, services, flash	54.4	51.7	50.9	54.2	55.1	55.4	December 15
EUR19: Industrial production, m/m	-0.7%	1.8%	-0.8%	0.3%			December 14
EUR19: Industrial production, y/y	-0.4%	2.3%	1.3%	1.0%			December 14
EUR19: Consumer prices, y/y - final	0.2%	0.2%	0.4%	0.5%	0.6%		December 16
EUR19: Core inflation rate, y/y - final	0.9%	0.8%	0.8%	0.8%	0.7%		December 16

MMWB estimates in red

Chart of the Week: ECB extends bond purchase program



As many market participants expected, the ECB has left its key interest rate at 0.0% and the deposit interest rate at -0.4%. There was much more suspense concerning its statement about what would happen when its quantitative easing program expires at the end of March. Rumors of tapering already led in the beginning of October to significant pressure on long-dated German government bonds. The ECB has clearly denied the rumors and extended the bond purchase program to at least the end of 2017. Starting in April, however, it intends to buy only EUR 60 billion per month instead of the previous EUR 80 billion. But at the same time, it has announced that it will increase its monthly money purchases if inflation development lags behind expectations. In November, the euro zone's inflation rate was 0.6% and hence far below the desired 2.0%. The forecast presented by the ECB does not see inflation near its price stability target until the end of 2019, at 1.7%. The program's modalities will also change somewhat as of January. The minimum maturity for purchases will drop from two years to one year, and the purchase of bonds with a yield below the deposit interest rate will be allowed. The goal is to increase the range of purchasable securities, since yields have fallen below the deposit interest rate in recent months, especially in relatively short maturities.

Stock marktes	As of 12.12.2016 11:49	Change versus 22.11.2016 -1 Woche	28.10.2016 -1 Monat	26.08.2016 -3 Monate	31.12.2015 YTD
Dow Jones	19757	3,9%	8,8%	7,4%	13,4%
S&P 500	2260	2,6%	6,3%	4,2%	10,5%
Nasdaq	5369	-0,3%	3,4%	2,9%	7,2%
DAX	11184	4,4%	4,6%	5,6%	4,1%
MDAX	21588	4,2%	2,0%	0,1%	3,9%
TecDAX	1749	0,5%	1,1%	1,5%	-4,4%
EuroStoxx 50	3195	5,0%	3,8%	6,1%	-2,2%
Stoxx 50	2944	4,2%	3,9%	2,9%	-5,0%
SMI (Swiss Market Index)	8082	4,4%	2,2%	-1,1%	-8,3%
Nikkei 225	19155	5,5%	9,8%	17,1%	0,6%
Brasilien BOVESPA	0	-100,0%	-100,0%	-100,0%	-100,0%
Russland RTS	1144	12,5%	15,3%	17,5%	51,1%
Indien BSE 30	26515	2,1%	-5,1%	-4,6%	1,5%
China Shanghai Composite	3152	-3,0%	1,6%	2,7%	-10,9%
MSCI Welt (in €)	1760	3,0%	7,3%	8,7%	8,8%
MSCI Emerging Markets (in €)	878	2,6%	0,2%	3,8%	13,6%
Bond markets					
Bund-Future	161,01	-39	-107	-669	309
Bobl-Future	132,74	145	167	-88	207
Schatz-Future	112,21	-3	22	20	69
3 Monats Euribor	-0,32	0	0	-2	-19
3M Euribor Future, Dec 2016	-0,31	0	0	0	0
3 Monats $ Libor	0,94	1	5	10	32
Fed Funds Future, Dec 2016	0,53	0	3	-2	0
10 year US Treasuries	2,51	19	67	88	24
10 year Bunds	0,41	26	32	56	-23
10 year JGB	0,08	5	12	14	-18
10 year Swiss Government	-0,05	14	35	46	2
US Treas 10Y Performance	574,09	0,0%	-3,5%	-4,8%	1,7%
Bund 10Y Performance	612,87	0,4%	-0,2%	-2,4%	5,9%
REX Performance Index	482,31	-0,3%	-0,6%	-1,7%	1,7%
US mortgage rate	0,00	0	0	0	0
IBOXX AA, €	0,67	-3	10	30	-61
IBOXX BBB, €	1,63	-2	24	44	-64
ML US High Yield	6,75	-3	26	0	-214
JPM EMBI+, Index	763	-0,1%	-4,6%	-6,1%	8,4%
Convertible Bonds, Exane 25	6803	1,9%	0,7%	-0,1%	-2,3%
Commodities					
CRB Index	421,14	0,1%	-1,0%	0,8%	11,0%
MG Base Metal Index	305,63	5,8%	16,9%	21,8%	31,6%
Crude oil Brent	56,57	16,3%	12,7%	12,8%	58,5%
Gold	1153,72	-4,6%	-9,2%	-13,5%	8,6%
Silver	16,59	-0,4%	-6,1%	-11,4%	19,8%
Aluminium	1745,00	-1,2%	1,5%	7,2%	16,3%
Copper	5865,75	4,8%	21,4%	27,4%	24,7%
Iron ore	81,00	6,6%	27,6%	33,9%	84,9%
Freight rates Baltic Dry Index	1090	-11,5%	30,7%	51,4%	128,0%
Currencies					
EUR/ USD	1,0595	-0,2%	-3,0%	-6,2%	-2,7%
EUR/ GBP	0,8419	-1,2%	-6,4%	-1,5%	14,2%
EUR/ JPY	122,77	4,3%	6,7%	8,3%	-6,3%
EUR/ CHF	1,0766	0,3%	-0,8%	-1,5%	-0,6%
USD/ CNY	6,9130	0,3%	1,9%	3,7%	6,5%
USD/ JPY	111,94	0,7%	6,9%	9,9%	-7,0%
USD/ GBP	0,79	-1,2%	-3,4%	4,9%	17,1%

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