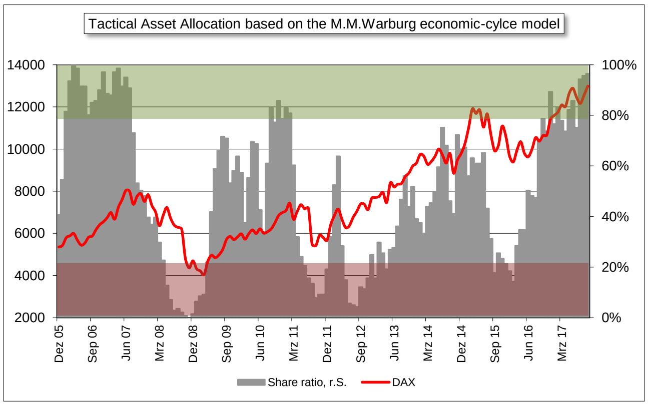
DAX 13,000: Still room for more?

Stock market development in 2017 has far surpassed the expectations of most market participants at the beginning of the year. After ending 2016 at 11,481 points, the DAX index of Germany's 30 largest stocks was only forecasted on average to advance to 11,629 points this year. It should be noted in the analysts' defense that most of the forecasts were made at the end of November and beginning of December and the DAX was still significantly below 11,000 points then. Given the turbulence of 2016, a year that brought two concrete surprises with the Brexit decision on June 23 and Donald Trump's election as US president on November 8, it was widely assumed that risk-exposed securities would not advance much in such an environment.

As we know now, that was a false assessment, based mainly on the assumption that political risks would overtake and impede the capital markets. Europe's "super election year" with votes in the Netherlands, France, and Germany, the beginning of the Brexit negotiations, and uncertainties regarding the concrete shape Donald Trump's economic policy would take kept many investors away from the stock market. However, it was (and is) important to remember that it is not politics, but rather economic development that determines the basic direction and hence prosperity or adversity of the stock market. The operative statement here is that risk-exposed assets like stocks perform more positively during an economic upswing than "safe" asset classes such as money market funds, time deposits, savings accounts, government bonds, or gold.

We believe the stock market's good performance this year is mainly due to the extremely positive and stable state of the world economy. The OECD leading indicators for the top 35 industrialized countries have been improving month after month since summer 2016. Moreover, the emerging countries are participating in this upswing. For the first time since the financial and economic crisis, the world economy thus finds itself in a synchronously moving upswing. All OECD countries and almost all emerging countries will show positive growth rates this year and next. Even though the growth rates expected for 2017 and 2018 will still be lower than before the 2008 crisis, the increasing breadth of the upswing is an especially positive factor. The more participating national economies there are, the greater the probability is of mutually beneficial interaction. It is therefore likely that the growth forecasts of the IMF, the OECD, or the World Bank for this year and next are still too cautious and further positive economic surprises may be expected.

Our business cycle model, which we developed in 2000 and have used in the past 15 years as a source of real-time signals for tactical asset allocation, also comes to this conclusion. This model evaluates about 30 time series, of which most are leading indicators and the rest depict information from the financial markets. The more positive the signals are, the higher the stock ratio or the ratio of risk-exposed asset classes in a portfolio should be. In the severe downswing phases of the stock market from 2000 to 2003 and in the years 2008 and 2009, the model warned very early and recommended a very low stock ratio both from summer 2000 to spring 2003 and from autumn 2007 to spring 2009. On the other hand, the model gave a strong overweight signal from summer 2003 to spring 2004, as it likewise did for the period from the beginning of 2006 to summer 2007. By proceeding this way, relatively large losses could be avoided for investors during the financial and economic crisis of 2008-2009, although the model could not foresee the Lehman Brother bankruptcy or the subsequent subprime crisis. On this approach, only the significant worsening of general economic conditions was recognized correctly and in time before the outbreak of the crisis.



Economic data have been so good overall since last December that our model again recommends a strong overweighting or full utilization of permissible stock ratios. This positioning has been maintained over the entire year. The interim weak spell, mainly on the European stock markets, from the beginning of June to the beginning of September was a technical consolidation phase that had nothing to do with fundamental conditions. Those remained positive even during the summer months. Anyone who followed the model and kept their stock ratio high has been rewarded for that lately with good performance.

However, in view of the level prices have been reached, many investors are wondering whether there is any more potential in the stock market or it is time to slowly take one's foot off the gas. Especially those who are not invested point out that there are a number of risks that the stock exchanges are tuning out. They include political issues like the possible secession of Catalonia from Spain and the signal that would send for all of Europe, the smoldering conflict between North Korea (Kim Jong-un) and the United States (Donald Trump), and the election coming up next year in Italy. The skeptics also muster many arguments to question the solidity of the upswing. They claim that it is built primarily on cheap money. But if the Fed and the ECB should turn off the money faucet in the foreseeable future and raise interest rates perhaps even more strongly than generally expected, that would likely be anything but good for stock prices. Finally, they argue, monetary policy has favored the formation of a bubble that will deflate rapidly then. And if, in addition, the Chinese economy, whose upswing is allegedly also financed on credit, should lose its steam and Donald Trump cannot push through his promised tax reform, the world economy would face its next crisis sooner or later.

Now, all these arguments can be splendidly debated, but we do not consider them really cogent. We have already stated in detail our position on the influence of politics. In a nutshell, we believe that political stock markets have short legs. Regarding the economic trend and outlook, we refer to our business cycle model. The world economy is now robust enough to withstand small or even larger disruptions relatively unscathed. It is unlikely that monetary policy will become a greater risk, since both the Fed and the ECB are adjusting their interest rate policies gradually and carefully in view of very low inflation rates. In the United States, interest rates have been raised in four steps by just 100 basis points since the end of 2015, and there will be at most four more hikes by the end of 2018, probably fewer. The ECB will modify its bond purchase program and probably first taper and then discontinue it in the course of next year, but higher interest rates will not be on the agenda until 2019 at the earliest. Moreover, there are again more central banks that have lowered interest rates this year than have raised them. Of the 41 central banks that we watch, eight have raised rates and 12 have lowered them.

Finally, the question remains whether stocks might be overvalued. Often, valuation bubbles are only recognized for timing purposes only after they have burst. That is because there can be very long phases of overvaluation. But a concrete trigger is always needed to cause the bubble to burst and that often comes from the real economy. For, as long as economic conditions are good, most market participants will have enough reasons to justify a high valuation ("this time is different"). Neither the crash of October 19, 1987, when the DOW lost more than 22% in value on a single day (the DAX fared better with a loss of just under 10%) nor the horrendous price losses resulting from the 2008-2009 financial and economic crisis were foreseen by the majority of market participants. Compared with then, US stocks are more expensive today. The P/E ratio for the S&P 500 based on earnings expectations for the next 12 months is 18. In October 1987, it was about 15, as it also was in summer 2007. However, since the pace of US economic growth is accelerating, there are good reasons to bet on a continued rise of stock prices in the United States. On the other hand, the DAX is still only moderately valued at a P/E of just under 14. We therefore no not believe it is time (yet) to talk of a general overvaluation of stocks.

Corporate earnings are the most important driver for stock prices. That is why indexes like the S&P 500 and the DAX have performed significantly better than, for example, the Euro Stoxx or the all-Europe Stoxx index in the last few years. For, the earnings of the companies in the latter two indexes have still not reached their pre-crisis levels, while the earnings of companies in the S&P and the DAX have recently set new records. But one index has registered the most successful earnings development, the MDAX, which many investors do not really have on their radar. The companies in that index show unparalleled profitability.

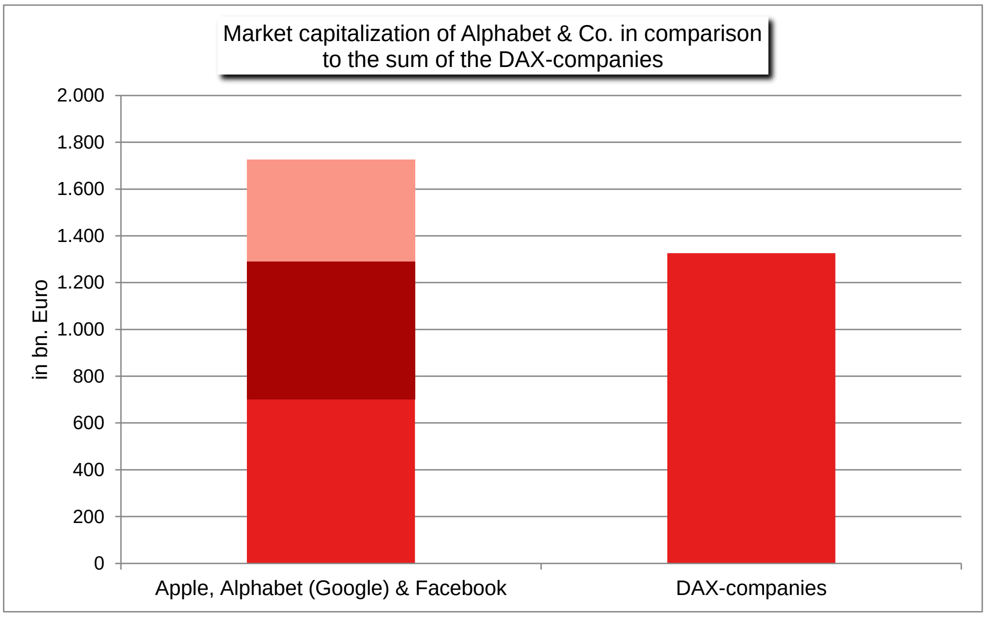
Calculated on the basis of earnings expectations for 2018 and an unchanged P/E ratio, the price target for year's end comes to 13,400 points. We proclaimed this target in May for the DAX, and we continue to consider it likely that it will be reached by the end of the year. Will that be the top of the flagpole? It will not be if one believes in a continuation of the upswing, as our business cycle model signals. If the economy keeps growing in 2018 and 2019, corporate earnings will also improve further. At the moment, analysts expect DAX earnings of about 1,050 index points for 2019. Multiplying that by the current P/E yields a potential price target of about 14,500 points. Stocks are thus still attractive, so investors should remain loyal to this asset class. And anyone who is not yet sufficiently invested should consider increasing their exposure. However, one should not surrender to the illusion that stock prices will continue advancing forever. The next collapse will come at some point, and as in the past, it will entail significant price losses. Investors with a long-term horizon should nevertheless not lose sleep over that. Anyone who bought stocks directly before the outbreak of the crisis in October 2007 (at then historical lows) and maintained their exposure has long since made up those price losses, which were horrendous in some cases. That is true especially for those who had invested in the S&P 500 or the DAX (per annum returns for the past ten years of 7.1% and 5.2%), but less so for those who were invested throughout in the Euro Stoxx 50 or the Stoxx 50 (per annum returns of 1.1% and 1.7% since October 2007). And anyone who invested in the MDAX during this period can celebrate a per annum return of 9.7%.

Weekly outlook for October 23-27, 2017

	June	July	Aug.	Sept.	Oct.	Nov.	Release
DE: PMI, manufacturing, flash	59.6	58.1	59.3	60.6	60.2		October 24
DE: PMI, services, flash	54.0	53.1	53.5	55.6	55.1		October 24
DE: Ifo business climate index	115.2	116.1	115.9	115.2	115.0		October 25
DE: Ifo expectations	106.8	107.3	107.8	107.4	107.2		October 25
DE: Ifo current conditions	124.2	125.6	124.7	123.6	123.4		October 25
DE: GfK consumer climate	10.4	10.6	10.8	10.9	10.8	10.6	October 26
EUR19: Consumer confidence, flash	-1.3	-1.7	-1.5	-1.2	-1.4		October 23
EUR19: PMI, manufacturing, flash	57.4	56.6	57.4	58.1	57.7		October 24
EUR19: PMI, services, flash	55.4	55.4	54.7	55.8	55.3		October 24
EUR19: M3, y/y	4.9%	4.5%	5.0%	5.0%			October 26

MMWB estimates in red

Chart of the Week: Lost in translation



Wednesday last week, Google launched its new smart phone, the Pixel 2, in San Francisco. It features a new screen and a new processor, and the new camera is supposed to be the best on the market. That is all well and good. But the really exciting part did not come until near the end of the presentation. Standing face to face, two Google executives held a conversation, one with an earphone in her ear and the other with a cellphone in his hand, one in Swedish and the other in English. It was all translated by Google Translate and in real time. The software will supposedly enable people of different countries to converse in their native languages, whose number now stands at 40. It is not surprising that this software to facilitate communication to such an extent comes from Google. The tech giants Google, Apple, and Facebook have long had an almost insurmountable lead in regard to technological innovations. The reason for this is not necessarily technical expertise, but rather the huge databases that these companies own and strategically deploy. In the case of Google Translate, this database consists of references from real language usage gathered by way of other Google applications like cellphone voice commands and then used to "train" an application like Google Translate with the help of statistical probability calculations. Companies without such databases hardly have a chance to meet the Silicon Valley firms on a level playing field in this area.

To ensure that Europe is not left behind in the IT field, it is urgent that demands such as those raised by Germany's National Association for Blockchain (Bundesverband für Blockchain) be met. The Association published its position paper a few days ago, calling for increased support of the relatively new blockchain technology in Germany. In particular, it demands educational programs, capital investment in pilot projects, and legal certainty through government regulation. Blockchain technology, which is the basis for the well-known cryptocurrency bitcoin, is already being used intensively primarily by banks and has great potential to revolutionize other industries.[1] The technology may offer Germany and Europe a great opportunity to assume a pioneering role this time.

[1] Blockchain stands for a decentralized database system. At the World Economic Forum in Davos, Blockchain was identified as one of six mega-trends in the IT sector that will substantially shape society in the next ten years.

Stock marktes	As of 20.10.2017 14:28	Change versus 13.10.2017 -1 week	19.09.2017 -1 month	19.07.2017 -3 months	30.12.2016 YTD
Dow Jones	23163	1,3%	3,5%	7,0%	17,2%
S&P 500	2562	0,3%	2,2%	3,6%	14,4%
Nasdaq	6605	0,0%	2,2%	3,4%	22,7%
DAX	13011	0,1%	3,6%	4,5%	13,3%
MDAX	26082	0,0%	2,6%	4,3%	17,5%
TecDAX	2505	-0,8%	4,4%	9,3%	38,3%
EuroStoxx 50	3610	0,1%	2,2%	3,1%	9,7%
Stoxx 50	3189	-0,3%	2,4%	1,0%	5,9%
SMI (Swiss Market Index)	9242	-0,7%	1,6%	2,4%	12,4%
Nikkei 225	21458	1,4%	5,7%	7,2%	12,3%
Brasilien BOVESPA	76682	-0,4%	0,9%	17,6%	27,3%
Russland RTS	1137	-1,7%	2,5%	9,0%	-1,3%
Indien BSE 30	32390	-0,1%	0,0%	1,4%	21,6%
China Shanghai Composite	3379	-0,3%	0,7%	4,6%	8,9%
MSCI Welt (in €)	2033	0,2%	3,2%	1,3%	3,6%
MSCI Emerging Markets (in €)	1117	-0,8%	2,0%	2,8%	15,6%
Bond markets					
Bund-Future	163,14	112	205	122	-101
Bobl-Future	131,32	-21	15	-46	-231
Schatz-Future	112,20	0	8	22	-9
3 Monats Euribor	-0,33	0	0	0	-1
3M Euribor Future, Dec 2017	-0,33	-1	-1	-2	0
3 Monats $ Libor	1,36	1	4	6	36
Fed Funds Future, Dec 2017	1,27	0	3	3	0
10 year US Treasuries	2,37	9	13	10	-8
10 year Bunds	0,45	4	-1	-3	24
10 year JGB	0,08	1	5	0	3
10 year Swiss Government	-0,03	1	1	-1	17
US Treas 10Y Performance	583,96	-0,4%	-0,5%	0,4%	2,5%
Bund 10Y Performance	611,40	0,0%	0,5%	1,5%	0,3%
REX Performance Index	482,86	-0,1%	0,1%	0,6%	-0,5%
US mortgage rate	0,00	0	0	0	0
IBOXX AA, €	0,69	-2	-8	-14	2
IBOXX BBB, €	1,21	-3	-10	-16	-29
ML US High Yield	5,95	-6	-4	-2	-50
JPM EMBI+, Index	842	0,1%	0,1%	1,9%	9,1%
Convertible Bonds, Exane 25	7274	0,0%	0,3%	0,8%	5,2%
Commodities					
CRB Spot Index	428,61	-0,4%	-0,1%	-3,6%	1,3%
MG Base Metal Index	345,68	-0,5%	3,6%	13,5%	23,6%
Crude oil Brent	56,89	-0,5%	2,6%	14,8%	0,3%
Gold	1283,32	-1,3%	-1,9%	3,3%	10,9%
Silver	17,23	-0,6%	-0,3%	5,9%	7,4%
Aluminium	2145,00	1,7%	2,3%	13,3%	25,9%
Copper	6934,00	1,1%	6,9%	16,9%	25,5%
Iron ore	60,39	-0,4%	-15,9%	-8,5%	-24,3%
Freight rates Baltic Dry Index	1582	6,5%	11,8%	66,9%	64,6%
Currencies					
EUR/ USD	1,1815	0,0%	-1,3%	2,4%	12,1%
EUR/ GBP	0,8960	0,7%	1,1%	1,4%	5,0%
EUR/ JPY	133,76	1,0%	0,2%	3,7%	8,4%
EUR/ CHF	1,1598	0,6%	0,5%	5,5%	8,0%
USD/ CNY	6,6170	0,5%	0,5%	-2,0%	-4,8%
USD/ JPY	112,55	0,6%	0,9%	0,5%	-3,7%
USD/ GBP	0,76	0,9%	2,6%	-1,1%	-6,3%

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