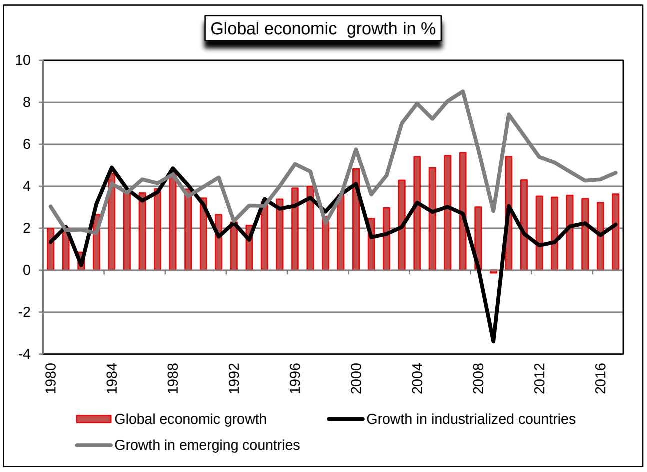
ECONOMIC SITUATION AND STRATEGY

Outlook for 2018 (II): Upswing entering next round in the US and euro zone

Having dealt with prospects for the German economy last week, we present part two of our 2018 outlook now, turning to economic conditions in the United States and the euro zone. Prospects for both regions are good.

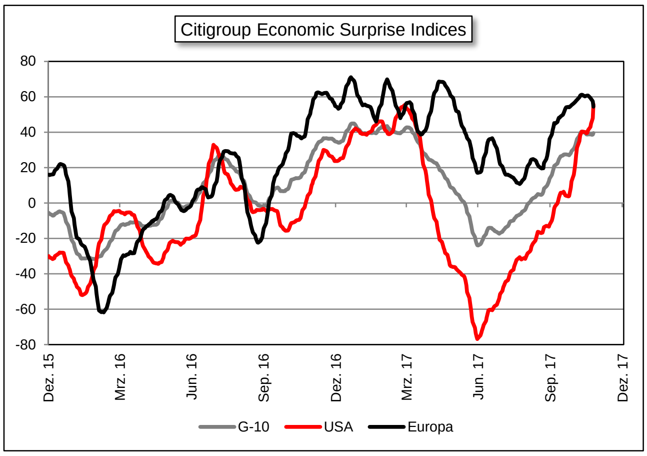
Cyclical recovery of the world economy…

Since the 2008-2009 financial and economic crisis, the world economy has grown very unevenly and weakly compared with previous cycles. Instead of growth rates of 4%-5%, the world economy has grown in the past years at a rate of just over 3%. The industrialized countries were mainly responsible for the slow growth at first, as they had to struggle with a sharp rise of government debt in the years following the crisis. Later, misguided political developments in some emerging countries added to that and noticeably dampened growth, and a collapse of commodity prices intensified their negative effects in 2015. Last year, it looked at times as if the upswing would finally run out of steam, after political events (Brexit decision in June and US presidential election in November) led to a strong increase of "felt" economic uncertainty. But things turned out different. Although the upswing has now lasted for more than 100 months and a new downswing is long overdue relative to the average length of an economic cycle in the last 70 years, economic momentum has surprised positively in both the industrialized and the emerging countries in the course of 2017. We expect this positive trend to continue in 2018.



…will accelerate in 2018

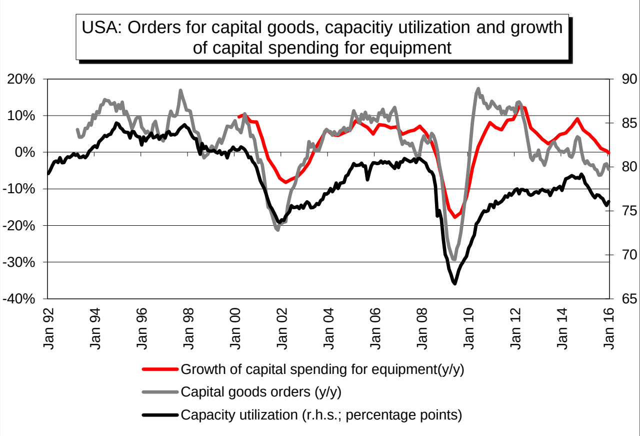
So far, there have been no signs of a nearing end to the good economic trend. On the contrary, almost all important leading economic indicators worldwide have improved in the past months. The IMF sees global growth accelerating next year from 3.6% to 3.7% in its latest forecast, and the OECD and World Bank likewise expect a slight increase of economic momentum in 2018. However, it is notable that all three organizations are still very cautious in their outlooks and point out the many risks that remain. But in our opinion, based on the now strong economic momentum worldwide, it is very likely that actual economic development in 2018 will turn out better than initially forecast, as it already has this year. Many forecasters are exercising caution mainly because their growth expectations were almost always too optimistic in the years after the financial crisis. By now, they have recognized the forecasting errors of the past and "learned" from them to make more cautious assessments (theory of adaptive expectations: previous forecasts are compared with actual results and new expectations take into account past mistakes). But this caution for 2018 is misguided. We expect global economic growth of 4%.



USA: Upswing enters tenth round…

The US economy's growth rate has risen this year as expected. After an increase of 1.5% in 2016, real economic output will grow by 2.3% this year. Because of continuing good financing terms and significantly improved business and household sentiment, we expected a somewhat stronger plus of 2.6% for 2018. The upswing in the United States, which began in June 2009 according to the National Bureau of Economic Research, will enter its tenth year in summer 2018. Donald Trump's campaign slogan, "Make America Great Again," thus appears to be coming true. However, digging deeper into the causes of the upswing, one must conclude that the United States is not on the right path *because* of Trump but rather *despite* him. After all, signs have been pointing upward already since spring 2016. This year, the US president has so far hardly managed to realize any of his economic policy ideas. But that could change soon.

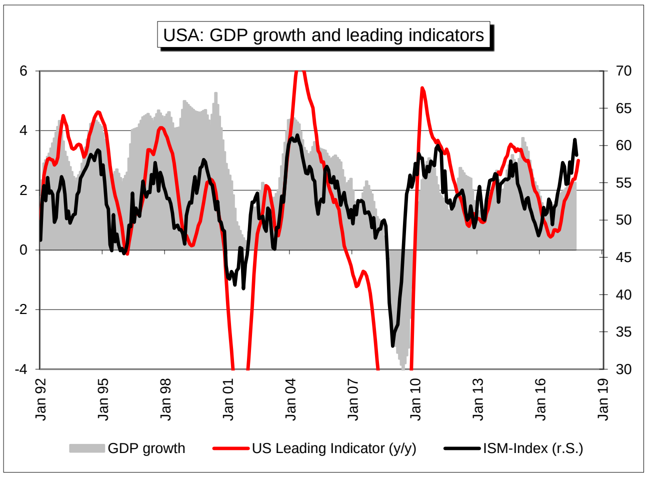
After both houses of US Congress passed a budget for 2018, a comprehensive tax reform bill has been proposed. Among other things, it calls for lowering the corporate income tax rate from 35% to 20%, limiting tax on accumulated offshore earnings to 12% to induce repatriation, reducing the number of income tax brackets to four, and roughly doubling personal exemptions. Businesses will be the main beneficiaries of the tax reform, so capital spending is likely to be expanded in the coming year by more than 5% on the preceding year. That will probably not change much even if the corporate tax reform is not implemented until a year later. The continuing weakness of capital spending, which has been a principal cause of low productivity growth in the past years, should thus be overcome. The other side of the coin is that government debt might increase by USD 1.5 trillion in the next 10 years due to tax revenue shortfalls.



In addition, the United States is benefiting from strong and steady growth of consumer spending. Thanks to a very low unemployment rate, which will fall significantly below 4% next year, and record-high employment, consumer spending will grow in the next few quarters at an annualized rate of about 3%. An even greater increase would be possible if wages were to rise more than they have so far. Average hourly wages in the private sector are only 2.3% higher than they were a year ago, and their growth has even slowed somewhat in the past months. However, it appears that wages in lower-income groups have recently been rising more strongly. Since low-wage earners usually consume more and save less as a percentage of income, this should tend to affect consumer spending positively.

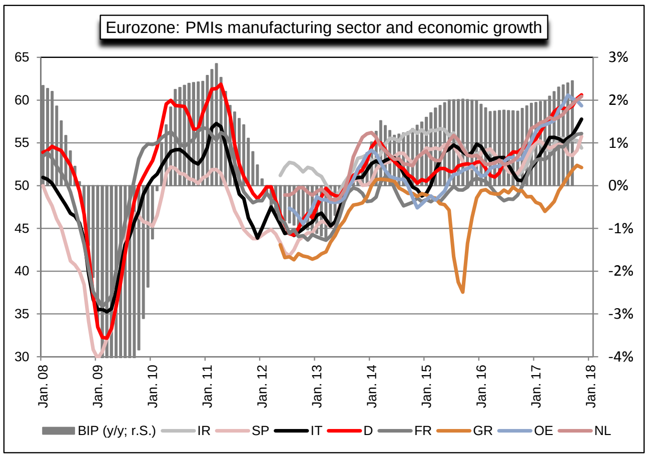
… and still no signs of a new recession

We regard as false the thesis that the length of the economic recovery alone is already a signal that it will end soon. The longest upswing in US history (since 1950) lasted 120 months, from March 1991 to February 2001. Among the four recession indicators that we follow – yield curve steepness, the annual rate of change in the Conference Board Leading Economic Index, the difference between the order and inventory components of the ISM purchasing manager survey, and change in the unemployment rate – we find no warning signs of an imminent downswing. In the past, a recession has always been accurately indicated when at least three of the four alarm components have gone off. So, at the moment, the lights are green for a continuing upswing. In most cases, an overly restrictive monetary policy by the Fed has led to a recession. In the 1970s and 1980s, it was furthermore the sharp rise of oil prices that caused the economic trend to stall. Today, neither of those factors is playing a great role. Consequently, it may well be that the current upswing will set a new record by continuing for more than 120 months. That would be the case if the upswing lasts at least until summer 2019. So far, the Fed has been very cautious about raising interest rates. If it continues on this course, we think a recession may not come until the second half of 2019 at the earliest.



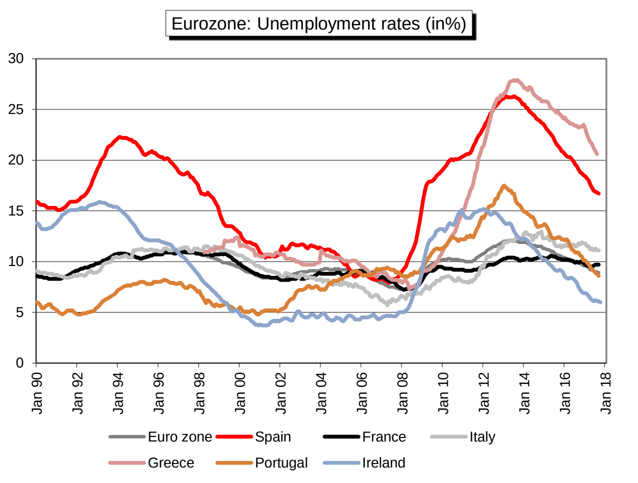
Euro zone: Political uncertainties are receding…

Contrary to what some feared, the "super election year" of 2017 has not led to a further drifting apart of euro zone countries. Instead, Brexit and Trump's election have caused the majority of European citizens to shy away from voting for parties seeking to win their favor with populist slogans. Moreover, the improvement of economic conditions in almost all the countries has resulted in a decline of skepticism about the euro and EU institutions. Economic data have worsened in the past months only in Great Britain, which actually wanted to lay the foundation for economic prosperity by deciding to withdraw from the European Union. Instead of remaining one of the countries with the greatest growth momentum in Europe, Great Britain has fallen to the bottom of the standings in the past few quarters.

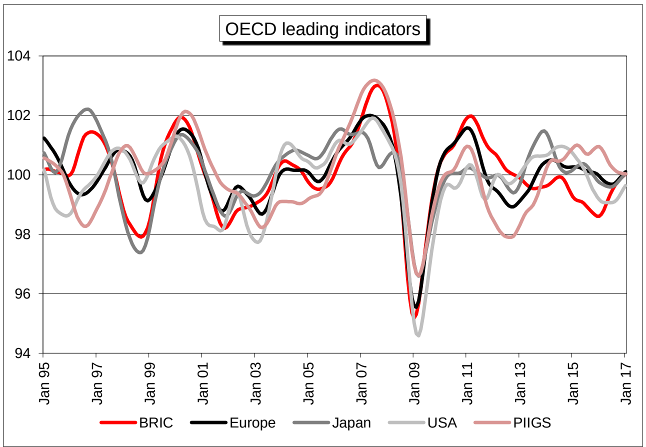


…and the labor market recovering, allowing economic activity to gain firm footing

The economic upswing in the euro zone has now spread to all the countries. Even once crisis-afflicted countries like Greece and Portugal are making positive headlines. The same applies to long-standing "problem cases" France and Italy. The leading indicators point to a continuing economic recovery for all the countries in the near future. After a plus of 2.3% this year, real gross domestic product in the euro zone is expected to increase again on the same order of magnitude in 2018. The upswing has been borne mainly by exports so far, but capital investment activity has also improved in view of low interest rates and good business expectations. In contrast to the United States, the economic recovery in the euro zone is still not very far along. This is reflected particularly in reduced but still high unemployment. Currently, about 14.5 million persons are registered as seeking employment in the euro zone (compared with 6.8 million in the United States). Before the crisis, the number was 11.5 million.



The unemployment rate has fallen significantly from its peak in Spain (by almost 10 percentage points), in Ireland and Portugal (by 9 percentage points each), and in Greece (by almost 7 percentage points). Despite the progress, unemployment in Spain and especially in Greece is still significantly higher than it was before 2008. In contrast, the labor markets in Portugal and Ireland have completely recovered. In Germany, unemployment today is even significantly lower than before the crisis. Since this positive trend is likely to continue, consumer spending in the euro zone will increase in 2018 by a good 2% compared with the preceding year and thus provide somewhat greater growth impetus than it has in the past years.



Conclusion

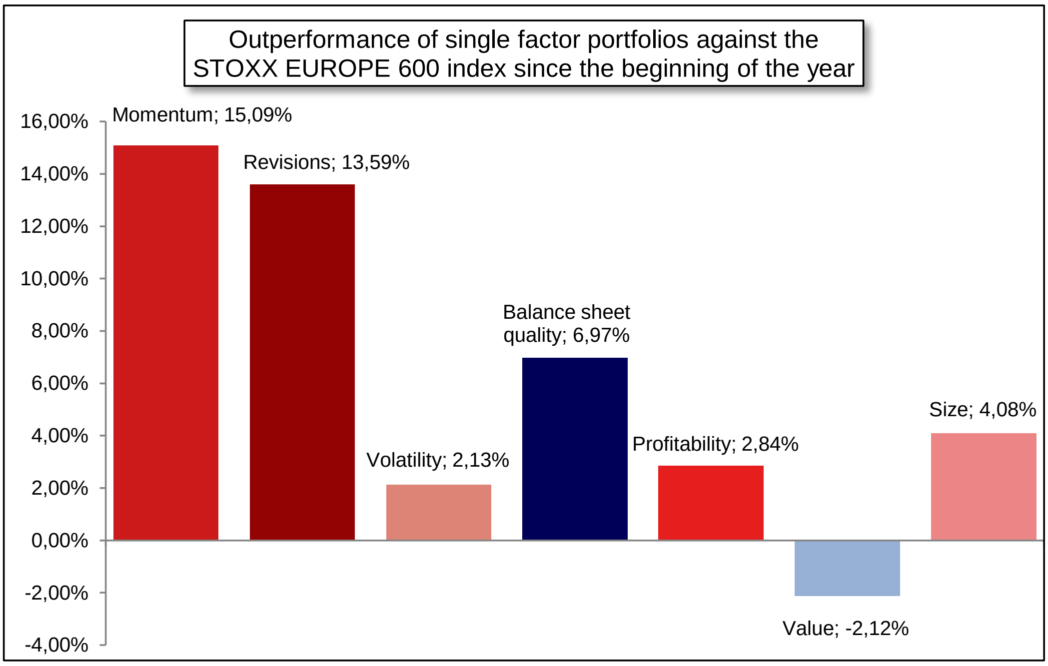
The world economy will grow even more dynamically in 2018 than it has this year. This is the conclusion suggested by a look at the most important global leading indicators, whether those of the OECD, global purchasing manager indexes from the manufacturing and services sectors, or consumer surveys. General economic conditions have improved recently in both industrialized and emerging countries, so the world economy finds itself in its first globally synchronous upswing in a long time. The tendency here is self-reinforcing, so global growth is likely to surprise positively again in the coming year.

Weekly outlook for November 27-December 1, 2017

	July	Aug.	Sept.	Oct.	Nov.	Dec.	Release
DE: GfK consumer climate	10.6	10.8	10.9	10.8	10.7	10.9	November 28
DE: Inflation rate, flash, y/y	1.7%	1.8%	1.8%	1.6%	1.7%		November 29
DE: Core inflation rate, flash, y/y	1.7%	1.6%	1.5%	1.2%	1.4%		November 29
DE: Import prices, m/m	-0.4%	0.0%	0.9%	0.3%			November 30
DE: Import prices, y/y	1.9%	2.1%	3.0%	2.3%			November 30
DE: Retail sales, m/m	-0.5%	-0.2%	0.5%	0.4%			November 30
DE: Unemployed, change in k	-10	-6	-23	-11	-12		November 30
DE: Unemployment rate	5.7%	5.7%	5.6%	5.6%	5.5%		November 30
DE: PMI, manufacturing, final	58.1	59.3	60.6	60.6	62.5		December 1
EUR19: M3 money supply, y/y	4.5%	5.0%	5.1%	5.0%			November 28
EUR19: Business climate	1.04	1.07	1.34	1.44	1.46		November 29
EUR19: Economic confidence	111.3	111.9	113.1	114	114.1		November 29
EUR19: Consumer confidence, final	-1.7	-1.5	-1.2	-1.0	0.1		November 29
EUR19: Industrial confidence	4.5	5	6.7	7.9	8.0		November 29
EUR19: Inflation rate, flash, y/y	1.3%	1.5%	1.5%	1.4%	1.6%		November 30
EUR19: Core inflation rate, flash, y/y	1.2%	1.2%	1.1%	0.9%	1.2%		November 30
EUR19: Unemployment rate, s.a.	9.0%	9.0%	8.9%	8.9%			November 30
EUR19: PMI, manufacturing, final	56.6	57.4	58.1	58.5	60.0		December 1

MMWB estimates in red

Chart of the Week: "May the momentum be with you"



Month after month, we have been watching the factors relevant to our Multi Smart Beta fund perform compared with their benchmark, the STOXX Europe 600. While all the factor portfolios except the valuation factor have outperformed the benchmark this year, which is up no less than 9% since the beginning of the year, two factor portfolios stand out: momentum and revisions. To construct the portfolios, we select 100 stocks once a quarter that exhibit the best properties in respect to the factors that we watch and weight them equally in the portfolio. In the case of the momentum and revision factors, the stocks are ones with high price momentum and positive earnings revisions. Anyone who bet on these stocks at the beginning of the year can now enjoy a return of over 20%. It is questionable, though, how long this outperformance will continue, since momentum and revisions, being bound to a certain mean reversion, are very unstable factors. But since it is not possible to forecast which factor will beat the others in the future, it is important to be aware that single-factor investments always represent a bet on the future (out)performance of one factor. We therefore rely on an approach that seeks to capture all factor premiums simultaneously. This leads to performance that is steady, though not immense.

Stock marktes	As of 24.11.2017 10:01	Change versus 17.11.2017 -1 week	23.10.2017 -1 month	23.08.2017 -3 months	30.12.2016 YTD
Dow Jones	23526	0,7%	1,1%	7,9%	19,0%
S&P 500	2597	0,7%	1,3%	6,3%	16,0%
Nasdaq	6867	1,2%	4,3%	9,4%	27,6%
DAX	13025	0,2%	0,2%	7,0%	13,4%
MDAX	26681	0,9%	2,4%	7,1%	20,2%
TecDAX	2577	2,6%	3,1%	13,6%	42,2%
EuroStoxx 50	3572	0,7%	-1,0%	3,9%	8,6%
Stoxx 50	3170	1,0%	-0,6%	4,3%	5,3%
SMI (Swiss Market Index)	9303	1,3%	0,6%	3,8%	13,2%
Nikkei 225	22551	0,7%	3,9%	16,0%	18,0%
Brasilien BOVESPA	74487	1,4%	-1,2%	5,7%	23,7%
Russland RTS	1165	2,8%	3,0%	11,5%	1,1%
Indien BSE 30	33693	1,1%	3,7%	6,7%	26,5%
China Shanghai Composite	3354	-0,9%	-0,8%	2,0%	8,1%
MSCI Welt (in €)	2053	0,4%	0,1%	5,2%	4,2%
MSCI Emerging Markets (in €)	1152	0,8%	2,2%	6,6%	18,8%
Bond markets					
Bund-Future	163,14	28	146	-171	-101
Bobl-Future	131,59	-19	17	-141	-204
Schatz-Future	112,19	-8	-2	-4	-10
3 Monats Euribor	-0,33	0	0	0	-1
3M Euribor Future, Dec 2017	-0,33	0	0	0	0
3 Monats $ Libor	1,46	2	9	15	46
Fed Funds Future, Dec 2017	1,29	0	2	9	0
10 year US Treasuries	2,35	-3	-3	18	-10
10 year Bunds	0,37	0	-7	6	16
10 year JGB	0,03	-1	-4	-1	-2
10 year Swiss Government	-0,14	-1	-11	1	7
US Treas 10Y Performance	584,30	0,3%	0,5%	-0,7%	2,6%
Bund 10Y Performance	614,68	0,2%	0,9%	0,4%	0,9%
REX Performance Index	483,63	0,0%	0,1%	0,1%	-0,3%
US mortgage rate	0,00	0	0	0	0
IBOXX AA, €	0,68	1	-3	0	1
IBOXX BBB, €	1,16	-1	-6	-10	-34
ML US High Yield	6,15	-6	25	0	-31
JPM EMBI+, Index	831	0,2%	-0,8%	-0,1%	7,6%
Convertible Bonds, Exane 25	7380	0,0%	1,3%	3,0%	6,7%
Commodities					
CRB Spot Index	431,15	0,6%	0,4%	-1,2%	1,9%
MG Base Metal Index	344,33	1,6%	-0,6%	3,2%	23,1%
Crude oil Brent	63,66	1,9%	10,4%	21,4%	12,3%
Gold	1290,59	0,2%	1,2%	0,1%	11,5%
Silver	17,14	-0,1%	0,9%	0,7%	6,8%
Aluminium	2097,00	0,5%	-1,3%	-0,2%	23,1%
Copper	6937,25	2,9%	-0,5%	6,1%	25,6%
Iron ore	62,99	2,4%	3,8%	-15,8%	-21,0%
Freight rates Baltic Dry Index	1445	5,4%	-8,9%	18,2%	50,4%
Currencies					
EUR/ USD	1,1860	0,6%	1,0%	0,5%	12,5%
EUR/ GBP	0,8898	-0,3%	-0,1%	-3,6%	4,2%
EUR/ JPY	132,14	-0,5%	-1,1%	2,7%	7,1%
EUR/ CHF	1,1634	-0,5%	0,5%	2,1%	8,3%
USD/ CNY	6,6031	-0,4%	-0,6%	-0,9%	-5,0%
USD/ JPY	111,22	-0,8%	-2,0%	2,0%	-4,9%
USD/ GBP	0,75	-0,9%	-1,0%	-4,0%	-7,3%

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