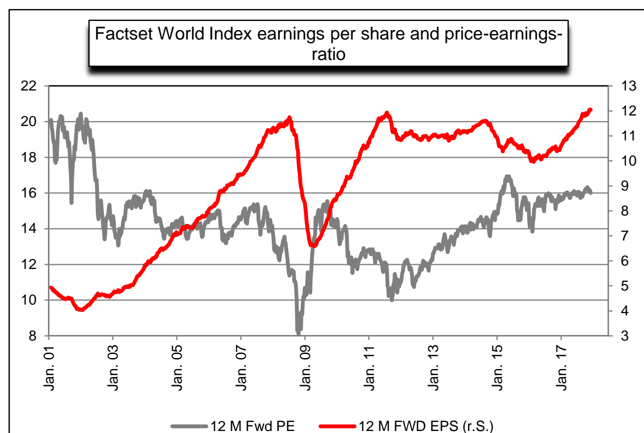
Outlook for 2018 (IV): Global economic recovery heralds further stock price advances

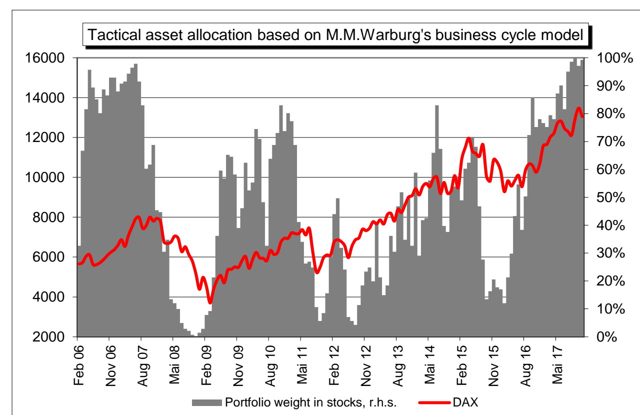
The world economy will grow more dynamically in 2018 than it has this year. Business conditions have been improving in both industrialized and emerging countries, resulting in the first synchronous world economic upswing in a long time. The tendency is self-reinforcing, so global growth should surprise positively in the coming year. That is the conclusion to draw from the first three parts of our "2018 Outlook" series. But how should investors position themselves for the new year? In Part IV, we now turn to prospects for the international stock markets. We expect stocks to remain the most attractive asset class for investors.

The gratifying price trend on international stock markets has caught many investors off balance this year. Most stock indexes have performed better than forecast at the beginning of the year. Worldwide corporate earnings have risen this year by almost 17% versus 2016, after nearly stagnating in the preceding six years. Earnings per share – as measured by the FactSet World Index, which includes more than 20,000 companies – have reached a new record level, with significant improvement of the earnings situation especially in many emerging countries. Anyone who wanted to invest successfully could not allow themselves to be influenced by the mostly negative political news, but instead had to keep their eye on the economic trend. The stabilizing and accelerating global upswing has stimulated corporate earnings around the world and led to a remarkable increase of earnings momentum in many regions. Investors positioned in stocks are advised to keep their weighting high as long as no economic downturn appears on the horizon. So far, this is not the case. Consequently, those who have missed the rally up to now can still jump on the bandwagon.



Stocks benefiting from strong business trend ...

Risk-bearing assets are benefiting from an economic upswing of above-average strength. That is the conclusion of the business cycle model that we developed in 2000 and that has supplied us with signals for tactical asset allocation for over 15 years. This model evaluates about 30 time series, of which most are leading indicators and the rest track information from the financial markets. The more positive the signals are, the better the environment is for stocks and other risk-bearing asset classes. In the sharp downswing phases of the stock market in 2000-2003 and 2008-2009, 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 signaled a strong overweighting from summer 2003 to spring 2004, as it also did for the period from the beginning of 2006 to summer 2007. This made it possible to avoid relatively large losses for investors during the 2008-2009 financial and economic crisis, although the model was unable to forecast the Lehman Brother bankruptcy or the subsequent subprime crisis. With this approach, the significant worsening of economic conditions before the outbreak of the crisis was recognized correctly and in good time. Since December 2016, on the other hand, economic data have been so good on the whole that our model has again been recommending a strong overweighting or full utilization of the allowable stock ratio.



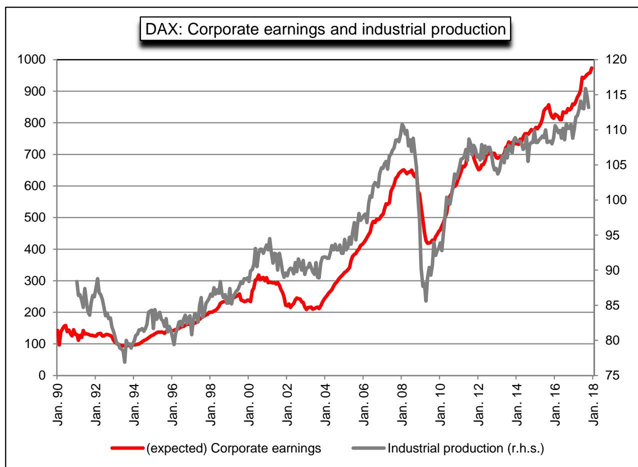
... and associated higher corporate earnings

Stocks perform positively during a business upswing because the profitability of most companies increases in a favorable business environment while negative news possibly threatening continued operation (such as failure to receive major orders or imminent insolvency) is less likely. Earnings per share are the most crucial factor influencing stock prices. After the significant increase of earnings worldwide in 2017, we consider the conditions present for a continuation of this positive trend in the coming year in view of the positive global economic outlook. Corporate analysts expect earnings growth at high single-digit or low double-digit percentage rates for almost all markets. If these estimates prove accurate, 2019 is likely to be another good year for stocks. That should apply to both industrialized and emerging countries. We see opportunities equally in all regions and would not give special preference to any regional investment, but would argue for maximum diversification. Among the emerging countries, the stock markets in Russia, Turkey, and Brazil are cheap, for example. The Chinese stock market is somewhat more expensive on av-

erage, but should be included in a portfolio due to the strong growth momentum of many Chinese companies.

DAX index: Further rise to near 15,000 points possible in the coming year

The prices of German stocks have advanced greatly in the past years. An investment in the DAX index would have yielded an average return of 9% per annum. Among the top performers by international comparison, the MDAX, SDAX, and TecDAX indexes have fared even better. Since the German economy will grow strongly again in 2018 and the world economy is cooperating, this success story should continue. A close analysis of the various stock indexes shows that indexes from countries with very good business and earnings development perform most successfully. Companies from the United States and Germany have therefore set one new earnings record after another in recent years. On the other hand, companies from other European countries have suffered from the poorer economic conditions there.



This is also reflected in the better performance of the S&P 500 and DAX compared with the European Stoxx indexes. German companies from the "second and third tiers" (MDAX, SDAX, and TecDAX) have done even better in respect to earnings growth and price performance. In particular, the valuation of the DAX is not high yet despite the large price advances of the past few years versus its own history and compared with other indexes. The price-earnings ratio is 13.5 based on earnings expected for the coming 12 months, while the long-term average is 15. Multiplying the current value by earnings expected for 2019 yields a price target of 14,500 points. Analogously, one may calculate price targets of about 4,000 points for the Euro Stoxx 50 and 2,850 points for the S&P 500. A change in the price-earnings ratio by only one point would result in a change of about 1,000 points in the DAX price target. If German blue chips were to become only somewhat more expensive next year, a price target of 15,000 would even be attainable.

Stocks from cyclical sector still favored

Given the good business conditions, we continue to favor stocks from cyclical industries, where earnings development is supported by the positive economic situation. In the *S&P 500*, analysts expect the highest earnings growth rates next year in the energy and raw materials sectors in view of the continuing recovery of commodity prices due to rising demand from the emerging countries. Moreover, US oil companies have significantly reduced costs in the past, so they will earn more even if oil prices are stable as we expect. Technology companies also remain interesting. Many US firms are world market leaders in their fields and are therefore able to obtain high margins. Despite above-average performance in the past 12 months, the sector is valued only slightly higher than the overall market. A bubble like the one that occurred in the tech sector at the end of the 1990s, with price-earnings ratios of 30 or more, is not in sight yet. The financials sector is also among the three mentioned and will benefit not only from the good economy but also from deregulation and somewhat higher interest rates.

USA: Price-earnings-ratio

Sector/ Index	current	average (since 2000)	difference
Cons Discr	21,4	18,3	17%
Cons Staples	20,0	17,5	15%
Energy	25,8	17,2	50%
Financials	14,8	12,5	19%
HealthCare	16,6	16,5	0%
Industrials	19,2	16	20%
Info Tech	18,7	19	-1%
Materials	18,0	15,6	15%
Telecom	12,6	13,5	-7%
Utilities	18,3	13,7	33%
Real Estate	17,8	15,6	14%
S&P 500	18,2	15,7	16%
Dow Jones 30	18,0	14,1	27%
NASDAQ 100	20,6	21,2	-3%
NASDAQ Composite	22,5	18,5	22%
PHLX Semiconductor	15,7	23,3	-33%

In the *Stoxx 600*, there are three sectors whose price-earnings ratios are especially attractive: automobiles, banks, and insurance. In regard to earnings growth forecasts for 2018, the insurance companies are at the very top of the rankings. This has to do with the many natural disasters and related claims this year, which have led to a sharp earnings decline. However, the earnings growth rates are only realistic if there is not another accumulation of major claims in 2018. The cheap valuation of the insurance sector offers at least a certain buffer in case of bad news. As in the United States, European technology companies are thought to have great potential for earnings growth in the coming year. But it remains to be seen whether they will really manage in 2018 to double their earnings momentum compared with this year. In contrast to US tech stocks, which have done the best of all sectors in respect to both earnings and sales surprises in the past quarters, European tech companies have shown only average numbers. The industrials and construction sectors should be able to increase their profitability to the expected extent thanks to the excellent economic situation. On the other hand, we remain skeptical about the retail trade. We regard the earnings turnaround that corporate analysts expect there in 2018 as unlikely.

Where are the risks?

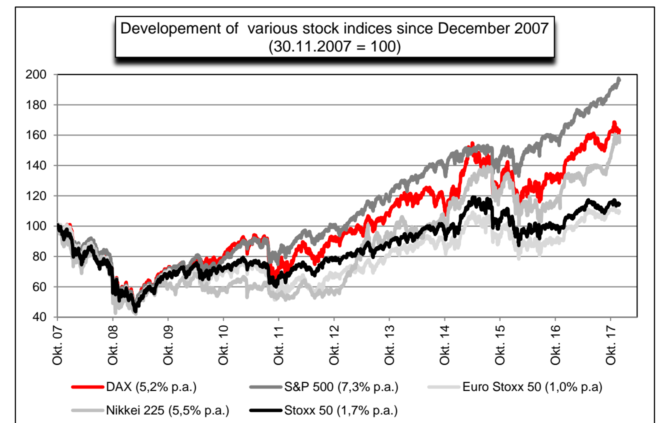
Despite the optimistic scenario presented here, there are, as always, a number of risks that could cause things to turn out different than expected. Investors must keep a close eye on the business trend. If, contrary to expectations, leading indicators should signal slowing growth in the months ahead, danger could be imminent. But if at all, that should not become an issue until the second half of 2018 at the earliest (and then with a view to 2019). Furthermore, though appearing quite diffuse, risks associated with geopolitical uncertainties could also spoil the party. One is, for example, the topic of North Korea, which has receded again in recent weeks. Perhaps the greatest risk consists in the fact that almost all investors are now betting on a Goldilocks scenario, i.e., a continuing combination of high economic growth and low inflation rates. For, that argues that central banks will not change their accommodative monetary policy. On the other hand, if inflation should make an unexpected comeback, interest rates could rise faster than expected and thus become a problem for the stock markets. A possible correction might turn out that much deeper, the more people invest in stocks and the higher stocks are valued.

Stocks are expensive, but not generally overvalued

Many investors are skeptical because of allegedly high valuations, and not only in the case of tech stocks. Often, one cannot tell whether a valuation bubble exists until it bursts. There have been phases of overvaluation in the past, some of which lasted a very long time. But a concrete trigger has always been needed to cause the bubble to burst, and that often comes from the real economy. For, as long as economic conditions are good, there will be good reasons that will justify a higher valuation. By international comparison, US stocks are particularly expensive. The price-earnings ratio for the S&P 500 based on earnings expected for the next 12 months is 18, while the average since 1985 is 15. But since the pace of US economic growth is accelerating, there are good reasons to bet on rising stock prices in the United States again next year. In contrast to the United States, almost all other international stock markets are valued cheaper. That applies to Europe, Japan, and most of the emerging countries. So, this cannot yet be described as a general overvaluation.

Investors with a long enough horizon can "sit out" interim price losses

However, one should not succumb to the illusion that stock prices can only move in one direction and will eternally advance. The next correction will come eventually, and as in the past, it will entail significant price losses. Investors with a long-term horizon should nevertheless not lose sleep over it. For example, even those who got into stocks at their historical highs just before the last big crisis began in October 2007 have long since made up the ensuing prices losses, which were horrific in some cases, by simply holding their positions. That is especially true of those who invested in the S&P 500 or in the DAX, but less so of those who invested their money consistently in the Euro Stoxx 50 or Stoxx 50. The debt crisis in the eurozone and the economic problems of the European Union have found expression in the past years in weaker earnings performance by the companies in the respective indexes. That alone demonstrates one of the greatest pitfalls of passive investing to which mainly (but not only) institutional investors are exposed, which is that whoever simply invests in markets without carefully analyzing their real economic trends runs the risk of making wrong decisions. Consequently, a reasonable macroeconomic analysis is the essential key to success ahead of investment decisions. Otherwise, though perhaps in the right asset class, one may not be invested in the right indexes.

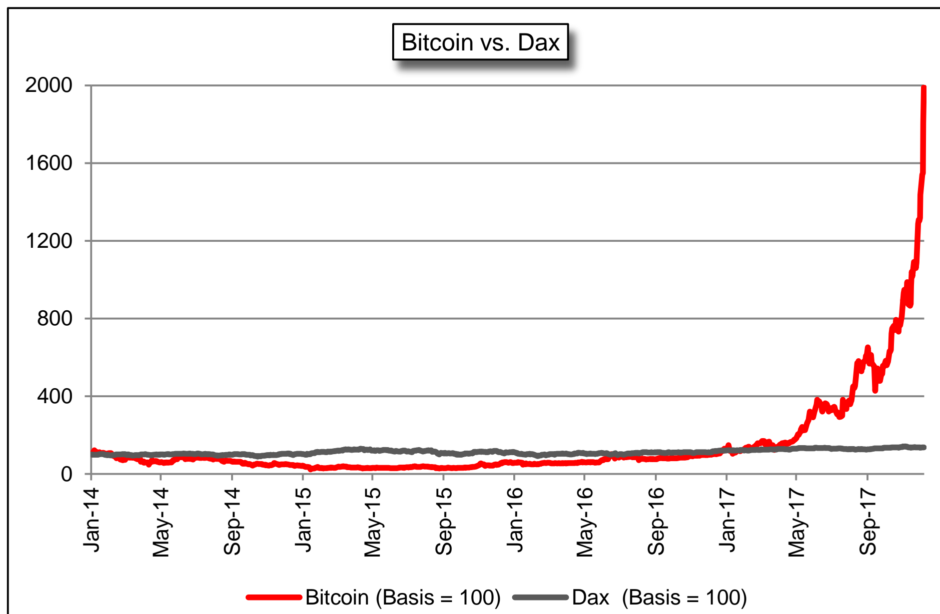


Weekly outlook for December 11-15, 2017

	July	Aug.	Sept.	Oct.	Nov.	Dec.	Release
DE: ZEW economic expectations	17.5	10.0	17.0	17.6	18.7	18.1	December 12
DE: ZEW current conditions	86.4	86.7	87.9	87.0	88.8	88.4	December 12
DE: Consumer prices, m/m - final	0.4%	0.1%	0.1%	0.0%	0.3%		December 13
DE: Consumer prices, y/y - final	1.7%	1.8%	1.8%	1.6%	1.8%		December 13
DE: Core inflation, m/m - final	0.5%	0.1%	-0.1%	-0.2%	0.0%		December 13
DE: Core inflation, y/y - final	1.7%	1.6%	1.5%	1.2%	1.2%		December 13
DE: PMI, manufacturing, flash	58.1	59.3	60.6	60.6	62.5	62.1	December 14
DE: PMI, services, flash	53.1	53.5	55.6	54.7	54.9	54.6	December 14
EUR19: Industrial production, m/m	0.4%	1.4%	-0.6%	-0.4%			December 13
EUR19: Industrial production, y/y	3.8%	3.6%	3.2%	2.9%			December 13
EUR19: PMI, manufacturing, flash	56.6	57.4	58.1	58.5	60.1	59.7	December 14
EUR19: PMI, services, flash	55.4	54.7	55.8	55.0	56.2	55.9	December 14

MMWB estimates in red

Chart of the Week: New Market 2.0?



Can you still remember the New Market? In those days, innumerable companies with new and untested business models ascended to unprecedented heights on the stock exchange. Investors who held "only" traditional blue chips in their portfolios were ridiculed by their neighbors, who were getting performance from stocks listed on the New Market of not 10% per year, but 10% per week. The absurdity of this development could also be gathered from plans at that time to merge the Frankfurt and London stock exchanges. In 2000, the idea was to move "boring" German blue chips to London in order to allow Frankfurt to focus on trading in the future-oriented stocks of the New Market. A few years later, many of those companies had disappeared from the exchanges, with a large part of their market capitalization more or less vanished. The bursting of this dot-com bubble shaped a whole generation of investors and continues to urge caution to the present day. Unfortunately, however, many market participants are becoming increasingly forgetful of that experience. It would otherwise be inexplicable that the exchange rate of cryptocurrencies could have shot up so quickly in just a few years. The most prominent example is the bitcoin, which has yesterday broken the USD 15,000 mark. Anyone who invested USD 100 in bitcoins at the beginning of 2014 now has an asset worth USD 2,000. That is a lot for a virtual currency that has no intrinsic value and is impossible to valuate by traditional standards. The value gain in the DAX, Germany's leading stock index, from EUR 100 to EUR 136 in the same period seems almost insignificant by comparison. But that does not mean our position regarding cryptocurrencies is fundamentally negative. The underlying technology has the potential to revolutionize transactions in business and finance. Moreover, cryptocurrencies will overcome existing technical deficiencies in the coming years and become easier for companies and individuals to use. They could thus actually become serious competition for "normal" currencies. However, the New Market already proved 17 years ago that not every good idea justifies a stock price explosion. A little caution appears appropriate.

Stock marktes	As of 08.12.2017 15:49	Change versus 30.11.2017 -1 week	06.11.2017 -1 month	06.09.2017 -3 months	30.12.2016 YTD
Dow Jones	24249	-0,1%	3,0%	11,2%	22,7%
S&P 500	2648	0,0%	2,2%	7,4%	18,3%
Nasdaq	6776	-1,4%	-0,1%	6,0%	25,9%
DAX	13161	1,1%	-2,3%	7,8%	14,6%
MDAX	26175	-3,2%	-2,8%	6,0%	18,0%
TecDAX	2510	-0,2%	-3,2%	8,5%	38,5%
EuroStoxx 50	3601	0,9%	-2,2%	4,9%	9,4%
Stoxx 50	3181	0,7%	-1,9%	4,5%	5,6%
SMI (Swiss Market Index)	9313	-0,1%	0,3%	5,1%	13,3%
Nikkei 225	22811	0,4%	1,2%	17,8%	19,3%
Brasilien BOVESPA	73255	1,8%	-1,4%	-0,2%	21,6%
Russland RTS	1120	-1,1%	0,9%	1,2%	-2,8%
Indien BSE 30	33250	0,3%	-1,4%	5,0%	24,9%
China Shanghai Composite	3290	-0,8%	-2,9%	-2,8%	6,0%
MSCI Welt (in €)	2064	0,1%	-0,6%	6,9%	5,6%
MSCI Emerging Markets (in €)	1101	-1,0%	-4,1%	3,1%	14,4%
Bond markets					
Bund-Future	163,14	42	0	-234	-101
Bobl-Future	132,65	114	73	-66	-98
Schatz-Future	112,21	2	-9	-11	-8
3 Monats Euribor	-0,33	0	0	0	-1
3M Euribor Future, Dec 2017	-0,32	0	1	1	0
3 Monats $ Libor	1,52	4	13	21	52
Fed Funds Future, Dec 2017	1,29	0	1	10	0
10 year US Treasuries	2,37	-5	5	26	-8
10 year Bunds	0,31	-6	-4	-4	10
10 year JGB	0,05	2	2	6	0
10 year Swiss Government	-0,17	-6	-7	-2	4
US Treas 10Y Performance	584,41	0,7%	0,0%	-1,6%	2,6%
Bund 10Y Performance	617,56	0,7%	0,4%	0,5%	1,3%
REX Performance Index	484,51	0,3%	0,0%	-0,1%	-0,2%
US mortgage rate	0,00	0	0	0	0
IBOXX AA, €	0,53	-16	-7	-15	-14
IBOXX BBB, €	1,10	-6	3	-17	-40
ML US High Yield	6,18	0	13	10	-28
JPM EMBI+, Index	834	0,4%	0,7%	-0,9%	8,1%
Convertible Bonds, Exane 25	7376	0,0%	-0,4%	3,3%	6,7%
Commodities					
CRB Spot Index	427,97	-0,4%	-0,5%	-1,9%	1,2%
MG Base Metal Index	331,24	-2,1%	-5,4%	-2,8%	18,4%
Crude oil Brent	63,25	-0,9%	-0,8%	16,5%	11,5%
Gold	1250,32	-2,3%	-1,8%	-6,7%	8,0%
Silver	15,93	-2,4%	-7,3%	-11,5%	-0,7%
Aluminium	2002,00	-1,6%	-6,9%	-3,8%	17,5%
Copper	6517,50	-3,2%	-6,0%	-5,2%	18,0%
Iron ore	67,41	6,4%	7,4%	-11,6%	-15,5%
Freight rates Baltic Dry Index	1679	6,4%	14,0%	34,3%	74,7%
Currencies					
EUR/ USD	1,1758	-0,8%	1,4%	-1,5%	11,5%
EUR/ GBP	0,8768	-0,5%	-0,7%	-4,0%	2,7%
EUR/ JPY	133,15	0,1%	0,7%	2,5%	7,9%
EUR/ CHF	1,1693	-0,1%	0,9%	2,6%	8,9%
USD/ CNY	6,6180	0,1%	-0,3%	1,4%	-4,8%
USD/ JPY	112,30	-0,2%	-1,2%	2,8%	-3,9%
USD/ GBP	0,75	1,0%	-2,1%	-2,5%	-7,8%

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