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OUTLOOK 2019

Poor policy harms the economy and the stock market

Content

Counting down to the New Year

Dear Reader,

The year 2018 has presented particular challenges to many of us. However, it has been primarily a year of disappointments for investors. Although it seemed to meet all the prerequisites for a flourishing capital market, with a global economy almost as prosperous as ever at the end of 2017, the German stock market has been on a downhill path since hitting its record high at 13,560 index points last January. While it looked halfway through the year as if the German stock market might make up lost ground, the downward trend even accelerated thereafter.

There are many causes behind this development, with politics in particular throwing the proverbial monkey wrench into the stock market. The smoldering trade conflict between the United States and China, the Brexit negotiations, which have been rather chaotic mostly on the British side due to unrealistic expectations, and the self-destructive course of Italy's policy in dealing with fellow EU members have all eaten away at stock exchanges and business in general.

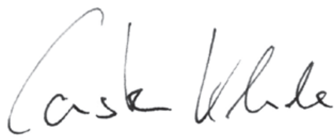
Consequently, the German economy has slowed down surprisingly strongly in the past year. It first seemed extraneous factors were to blame for taking the wind out of Germany's sails, but momentum did not resume even absent these influences. When automobile production slumped in the third quarter, GDP development even dipped into negative territory for the first time since the beginning of 2015.

We expect the German economy to grow by 1.4 % in 2019. That may sound worse than it is in econometric terms, since it is in line with the country's potential growth. A slower German economy will also spill over to export business and capital spending in the United States, China, and neighboring European states. German consumption, however, may actually pick up next year if the current oil price decline persists. That would lower inflation and raise purchasing power. Overall, there is much evidence that the current economic slump is just a normalization process and does not indicate a new recession.

Yet, investors do not share this view at present. Widespread sentiment that the current economic cycle has run its course, leaving no more potential for earnings growth, has led to a market funk in which investors are not recognizing and reacting to positive business news. As stock prices drop in the wake of their restraint, investors are interpreting the falling price level as evidence that the growth phase is ending. In a worst-case scenario, this would be a self-fulfilling prophecy of the vicious kind.

How do we get out of this downward spiral? Improving economic data and less chaotic politics would certainly help. There is also the possibility of central banks coming to the rescue. The US stock market's current weakness is at least partly due to investors' fearing that the Federal Reserve might automatically raise interest rates so much that an economic downturn or even recession would be inevitable. However, it need not come to that. We would not be surprised if the Fed were to shelve further rate hikes for the time being after the next one expected in December. After all, falling oil prices and a strong US dollar should soon take the edge off price pressure. Euroland may also be good for a surprise. We doubt that Mario Draghi and his ECB colleagues will actually raise interest rates next year. That means the generally expected change of interest rate policy may well be called off, which would be very good news for the stock markets. Having lost an unexpected amount of momentum this year, the economy and stock markets may as unexpectedly accelerate again in 2019, if political developments are conducive.

I wish you good luck, health, and success for 2019. And remember, always look on the bright side of life!



Carsten Klude, Chief Economist
Hamburg, December 2018

Tactical positioning is key to success

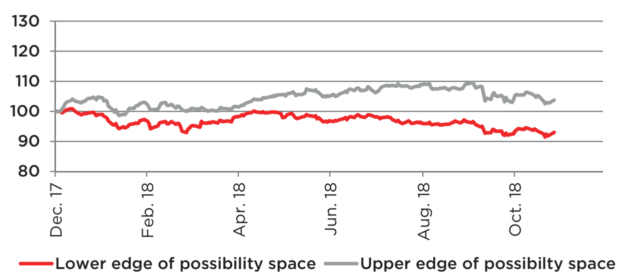
The year 2018 has been very challenging for multi-asset portfolios. It has seldom been so difficult to achieve a minimally positive return with a diversified portfolio. Even the best tactical allocation cannot perform magic in an environment as unfavorable as this year's. Still, we always try to select the best tactical allocation among available possibilities. Here, we explain how we will do that in 2019.

Asset allocation is the most important factor used to explain the historical performance of portfolios and design them to optimize future returns. Regrettably, investors have no crystal ball to give them sure signs of what asset classes or markets will exhibit the best performance in the coming month or year. If they did, they could dispense with diversification and simply invest wherever the highest gains are expected. But diversification makes sense because investment decisions are always made in the context of great uncertainty. The advantage resulting from the possibility of spreading risks is practically the only gift capital market investors get. They should therefore utilize this advantage – anything else would be like making a risky wager. One should not assume, however, that efficient diversification alone is adequate protection against temporary losses. Even the best distribution does not help when almost all investable markets are quoting in negative territory over a certain period. After all, the performance of a multi-asset portfolio – regardless of diversification effects – is not black magic, but rather simply the sum of its parts. If the individual components do not achieve positive returns, that will also be true of the overall portfolio. Thankfully, such a situation is the exception. As a rule, the performance of bonds is below average in good years for stocks, while bonds almost always rescue performance in bad years for stocks.

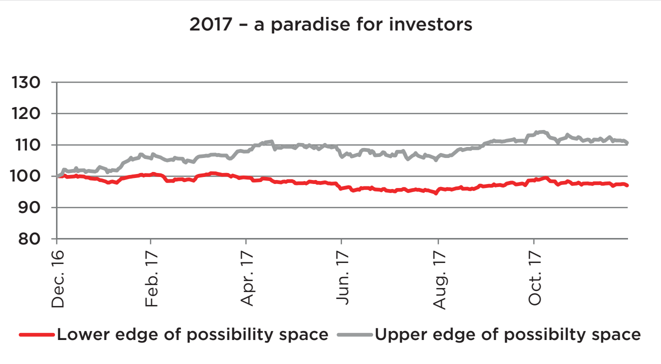
Regrettably, 2018 has been one of the few years in which almost all markets and asset classes have exhibited negative performance. It has been hard for investors, regardless of positioning, to achieve a positive return. But how difficult has 2018 actually been compared with previous years? To answer this question objectively, we randomly generated a thousand multi-asset portfolios, all of which could have existed as such in 2018. All were based on a diversified combination of 20 different stock, bond, and commodity markets investable by way of individual securities or ETFs. The stock ratios of the simulated portfolios ranged from 20 % to 80 %, with a foreign currency ratio averaging 40 %. We gave each simulated portfolio a weighting of the asset classes and markets at the beginning of the year and made no subsequent. We assumed the cash position was always exactly 0 %. The result of the simulation is striking. The best-diversified portfolio showed performance of just over 0 % in this simulation, while the worst lost nearly 10 %. Of the thousand possible portfolios, only a very few structures would have exceeded the zero line slightly. This shows how unrewarding and difficult this year has been for investors.

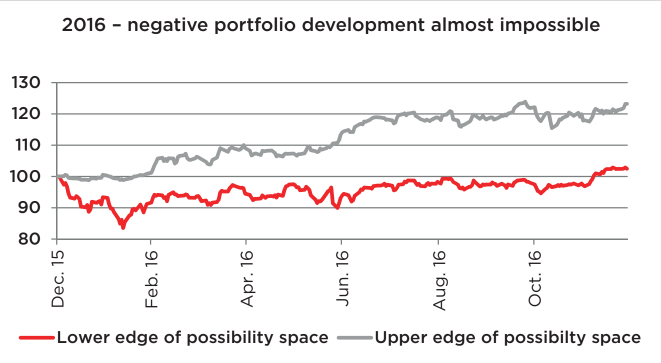
This becomes even clearer if we also determine the performance possibility space described by this simulation for other years. For example, 2017 was an investor's paradise. According to our calculations, it was not especially difficult to achieve performance above the zero line, and the vast majority of the possible portfolios were in significantly positive territory. That was also the case in 2016 to an even greater extent. In our simulation, it was not even possible to achieve negative performance in that year, while a plus of about 20 % was attainable in the best-case scenario.

2018 – a difficult year for multi-asset portfolios



We have done this type of calculation going back to 2005 and conclude that 2018 has also been an extremely difficult year for diversified multi-asset portfolios in this historical context. It is probably little consolation that having two consecutive years with such results is a rare exception. But even assuming 2019 will be generally less challenging, we still must determine what tactical allocation will achieve a positioning at the upper boundary of the possibility space. After all, this is ultimately what is demanded of tactical allocation: to put oneself at the upper end of the spectrum of possible





results. Sensibly meeting this challenge requires first developing a fundamental outlook for 2019, which we present in this annual publication.

In summary, we believe the US economy will lose a little momentum in the course of 2019, having been stimulated this year by a tax cut and debt-financed government spending. If the United States shows somewhat weaker GDP growth in 2019, earnings estimates are also likely to be lower. Experience shows that stock markets usually respond to such a development with lower prices. This scenario coincides in time with worsening economic data in Europe and China. Increased government spending is partly offsetting this development in China, but is not likely to be entirely successful. A synchronous global upswing is thus turning into a synchronous global downswing, but with there being no present indication of a recession. It is probably rather a gradual cyclical normalization after a phase of strongly above-average growth. This prepares the ground for increased volatility, and in this context, further price declines on risk-bearing assets are conceivable for the time being.

This may sound more dramatic, but since a serious recession is not imminent, the need for correction on the stock markets is likely to be limited. After all, the valuation level of stocks is not conspicuously high compared with alternative investments. Moreover, corporate earnings are very likely to be above their 2018 level by the end of next year, even if the growth rate turns out lower than many analysts now expect. So, ultimately, a recovery of stock prices is also likely in the course of 2019. At any rate, markets anticipate future development, and we believe it is plausible to assume now that the fundamental economic situation after 2019 will ease instead of becoming more critical. From that perspective, there is some reason to expect that the majority of stock markets will be quoting above current prices at the end of 2019. But which market has the greatest potential and should thus receive an especially heavy weighting?

Europe comes to mind first. European stocks have taken a significant price hit and are now quite attractive in valuation. Moreover, the region has already put some of the cooling process behind it, while the United States is just starting the process. We should also remember that the US dollar no longer has above-average revaluation potential, since the Fed is hardly going to surprise with unexpected interest rate hikes. Instead, the opposite is the case. It is quite possible that the Fed will omit an interest rate step that the markets now still expect. If that happens, the euro is more likely to revalue than devalue against the dollar. All this would speak clearly in favor of European stocks and against US stocks.

Regrettably, though, the matter is not that clear. Falling stock prices in the United States usually lead to falling stock prices in Europe, regardless of how large the correction in Europe has been beforehand. And worse, if US stocks decline by 10 %, European stocks decline more sharply, even if the cause of the correction is in the United States. They therefore offer no protection against price losses of US stocks and do not deliver the outperformance one would hope for in the subsequent upswing phases. That is clear enough from a look at the price trend of the last 10 or 20 years. Returns on European stocks are almost pitiful compared with those of US stocks. German stocks are somewhat of an exception, and German small and mid-caps have done comparatively well in the past years. However, the overall development of European stocks is disappointing. And there is an important fundamental reason for that. Earnings of publicly traded companies have developed much worse in Europe, owing to much weaker economic momentum, than in the United States. That is a structural situation unlikely to change in the coming months and quarters, especially since Europe already faces enough problems with Italy, Brexit, and a stricken auto industry. So, we continue to conclude that there is no way around US stocks and no reason to underweight them significantly. At most, one might consider slightly reducing a very heavy overweighting of US stocks. Much more than that would be like a wager lacking a fundamental basis.

However, the question of country allocation is only one of many when it comes to stocks. A more important aspect, for example, is whether one should prefer small or large caps. Investors must also be clear about whether they would rather buy stocks with higher or lower cyclical sensitivity. We start with the question of the preferred market capitalization and hence size of stocks. Those with low market capitalization have very often performed above average in recent decades. Substantively, that is even quite understandable in principle. Relatively small companies usually have leaner structure, are easier to manage, have focused business model, and are watched by fewer analysts, so that hype leading to a fundamental overvaluation may emerge less quickly. However, this trend has no longer been so clear in recent years. Our calculations show that the performance of portfolios with low caps has run parallel to that of large caps in recent years. Moreover, when their other properties are neutralized, low caps have even done comparatively poorly.

For example, every stock always has a large number of properties simultaneously. Of companies with low market capitalization, it may be said, for example, that they are often valued somewhat cheaper than large companies, though they be similarly profitable. In the past, small companies have therefore not infrequently performed comparatively well mainly because they possessed other positive properties at the same time. When one statistically eliminates these side effects, not much is left in the way of particularly attractive properties of low cap companies in recent years. We expect there will also be no great need in the coming quarters to focus more on small companies. Given that 2019 will be shaped initially by further decline of economic momentum, large caps will be the "safe haven." We have thus outlined what we consider the critical factors in the coming year. The United States may remain overweighted relative to Europe, but should be less so than in 2018. The overall ratio for stocks should be more defensive, at least in the first half of 2019, until a higher ratio is justified by emerging stabilization of the cyclical trend. Stock selection should aim at buying less cyclically sensitive stocks at first, with a focus on small companies presumably not delivering any added value.

An allocation analysis would not complete, however, without also commenting on bonds. We have not said anything about them so far because they contribute little to performance due to low yields. We do not expect that to change very quickly because we are certain the ECB is going to continue its low interest rate policy for many more years and the Fed will again act more cautiously in the coming year. However, the possibility definitely exists of temporarily falling yields and hence advancing prices of high-rated government bonds in 2019. So, it does not seem off-target for the allocation to consider these rather boring and unattractive securities, even if a buy-and-hold strategy would be amiss. Bonds with poorer ratings appear more problematic at first glance, since we may see more defaults again in the context of worsening economic data. Even if there are no major defaults in the end (as we would assume), relatively large, temporary price fluctuations are likely. But that will also create opportunities. And it would therefore be a mistake to avoid such bonds altogether, whose yields are several times higher than those of government bonds. Anyone who takes all this to heart should have good chances next year of attaining performance in the upper half of the range made possible by the capital market.

Tactical positioning to start 2019

		Strongly under-weight	Slightly under-weight	Neutral	Slightly overweight	Strongly overweight
Stocks	European stocks			✓		
	US stocks				✓	
	Asia/Pacific stocks			✓		
	Emerging market stocks		✓			
	Discount certificates				✓	
Bonds	Government bonds		✓			
	Covered Bonds (Pfandbriefe)		✓			
	Corporate bonds				✓	
	High-Yield corporate bonds			✓		
	Emerging market government bonds		✓			
	Hard currency bonds		✓			
	Subordinated bonds			✓		
	Convertible bonds			✓		
Alternative asset classes	Absolute return stocks			✓		
	Absolute return bonds			✓		
	Open-end real estate mutual funds				✓	
	Private equity				✓	
	Private debt			✓		
	Other holdings			✓		
	Gold		✓			
	Crude oil			✓		
	Industrial metals		✓			

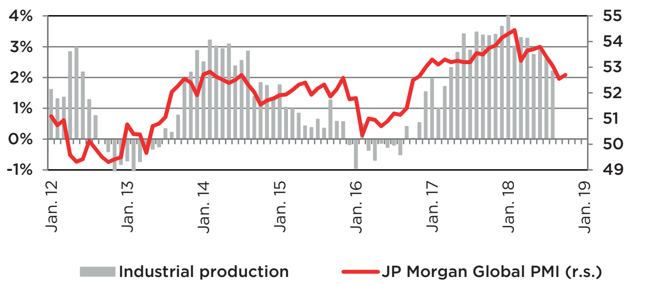
/ **Dr. Christian Jasperneite**
Chief Investment Officer

Trade dispute, other political imponderables are negative factors

After a promising start, economic momentum gradually weakened in 2018. In particular, political issues have substantially burdened sentiment. Most countries are now affected by this development, only the USA has so far been able to avoid it. The slowing may still be interpreted as cyclical normalization, but if the trade dispute escalates, there may be a greater economic setback in 2019.

After surprisingly strong world economic growth in 2017, we expected that this positive trend to continue in 2018, at least at the same pace. But we were far off. Having run smoothly until then, the economic engine began to sputter already at the beginning of the year. It first appeared that special factors were responsible for the weaker economic growth. But eventually it became clear that this was more than a temporary phenomenon, and a noticeable recovery did not ensue. Instead, tough talk from the White House on trade has made for increasing uncertainty among globally operating businesses. Consequently, important leading indicators, such as that of the OECD and global purchasing manager indexes from the manufacturing and services sectors, have been weakening since the beginning of the year.

Global purchasing managers index and OECD-industrial production weaken

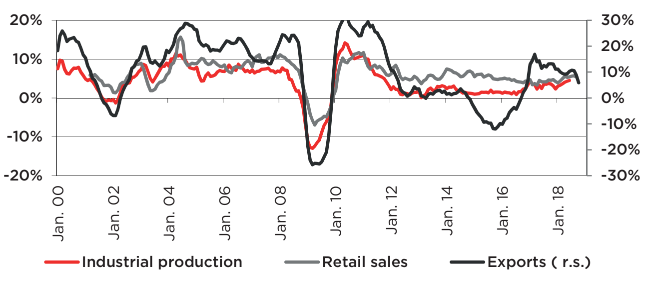


If the trade dispute were to escalate into a trade war, this would have unforeseeable consequences for the world economy The result might be a significantly stronger downswing or even a new global recession. However, that need not happen if political leaders allow reason to prevail. More than ever, political developments are thus the key factor influencing the world economic trend. This means greater forecasting uncertainty than usual regarding next year.

Emerging markets: Heterogeneous economic development continues

There have been many crises in various emerging markets in 2018. Negative headlines have come mainly from Argentina and Turkey, but also from South Africa, Venezuela, Brazil, and Iran. The International Monetary Fund (IMF) expects stable growth of 4.7 % in the emerging markets next year.. Chinese economic growth has slowed somewhat this year. Real GDP is forecast to increase by 6.6 % year-on-year (2017: 6.9 %). However, there have been mounting signs recently that the country might face a more severe economic slowdown. Above all, the impending trade war with the United States might cause growth to dip more sharply than expected next year. Declining foreign orders, as reflected in the Chinese purchasing manager index, already previews what could happen to the country's exports next year: stagnation or even contraction. Although the Chinese government would counter such a development with more expansionary fiscal policy and the central bank would loosen monetary policy, we expect that growth of the Chinese economy will slow to somewhat less than 6 % in 2019.

Emerging markets: Industrial production and retail sales robust, slowdown in export growth



For India, Brazil, Russia, and Mexico, the largest emerging markets after China, the International Monetary Fund assumes somewhat higher growth rates in 2019. Whether that is realistic will also crucially depend on how the trade conflict develops. We expect that also to burden the exports of other emerging markets as long as there is no agreement between the United States and China. Even though the data from most national economies, apart from the above-mentioned crisis countries, have been comparatively robust so far, growth of exports has slowed almost everywhere.

Among the large emerging countries, India has the best growth prospects for the coming year. That is because the country has implemented important economic reforms in recent years that have improved its economic stability. Moreover, with its young and growing population of 1.3 billion, India is less dependent on foreign trade than on domestic demand. Since per capita income has already risen in the past years and still has huge catch-up potential, consumption is likely to remain the most important engine of growth in the foreseeable future. In addition, the inflation rate will decline in the coming year if the oil price stays at roughly the current level, as we expect. The associated improvement of purchasing power suggests that the Indian economy will grow by 7.5 % next year and hence even somewhat more strongly than the 7.3 % forecast for 2018.

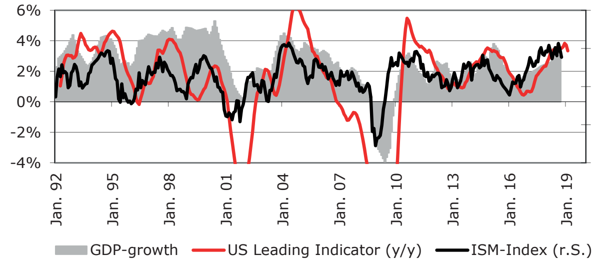
On the other hand, we see a more difficult environment for Brazil and Russia, two countries that depend heavily on commodity price development. Both the sharp oil price decline and slowing economic growth in China are burdens in that respect. The two countries have delayed implementing necessary economic reforms in the past, so no growth impetus may be expected from that angle. Even though business and consumer sentiment has improved since his victory, newly elected Brazilian President Jair Bolsonaro did not campaign on an express desire to distinguish himself as a great reformer.

However, it remains to be seen whether this improvement will last. After all, there is hardly room for more expansionary fiscal policy in view of the increased national debt. But support may come from the Brazilian central bank, which could still lower its key interest rate somewhat if the Brazilian currency continues to recover. In contrast to the IMF, which expects Brazilian growth to accelerate from 1.4 % to 2.4 %, our estimate of real GDP growth remains more cautious at 1.8 %. Unlike the IMF, we expect a slight decline in economic momentum for Russia in the coming year. The Russian economy will show 1.7 % growth in 2018, and we expect that to slow to 1.5 % for 2019 (IMF: 1.8 %). That is mainly due to the oil price decline and continuing economic sanctions..

USA: Upswing continues with less momentum

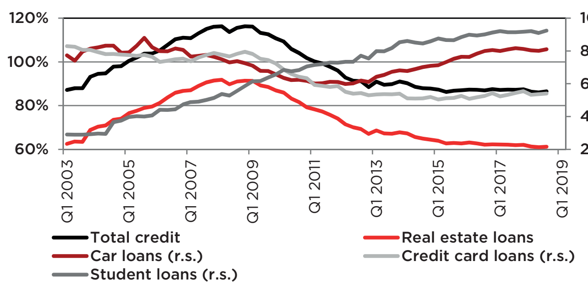
The US economy will show about 3 % growth for 2018, which is somewhat stronger than what we forecast last year. US President Trump thus appears to have kept his promise to lift the economy to a “sustainable” higher growth level with the help of tax cuts and deregulation. The strong growth impetus is coming from consumer spending, which is benefiting from the good labor market situation. The official unemployment rate is lower than at any time in the last 50 years, while wages are rising somewhat more strongly than in the past. Consequently, the national wage and salary total, which is the key figure for consumption, has increased by almost 5 % this year. Since no trend reversal on the labor market is in sight, the upswing should continue next year. It will set a new record of more than 120 months if it lasts until June 2019.

US economic momentum has reached its peak



However, we expect that US economic growth will slow next year to 2.4 %. The positive effects of the tax cut are fading, and increased US interest rates are dampening growth. The real estate market currently poses the biggest problem for the US economy. Prices have risen significantly faster than disposable incomes in recent years because the supply of homes and apartments is too low or unsuitable. Moreover, the Fed's tighter monetary policy has caused mortgage interest rates to rise sharply. Because of these two factors, properties have become increasingly unaffordable, and the real estate market has cooled. This trend will continue in 2019. However, we do not expect a real estate market crash with similarly devastating effects on the overall economy as occurred during the financial crisis of 2007-2008. That is because the total of currently outstanding mortgage loans is, at about USD 10.2 trillion, somewhat lower than it was ten years ago, and the ratio of debt to disposable income is significantly lower than it was then. In our opinion, US households do not have a general debt problem, even though automobile and student loans have risen to a record level. Their total is not comparable to that of real estate loans, so the risk they pose to the US economy should be manageable. The risk of recession in 2019 therefore remains low.

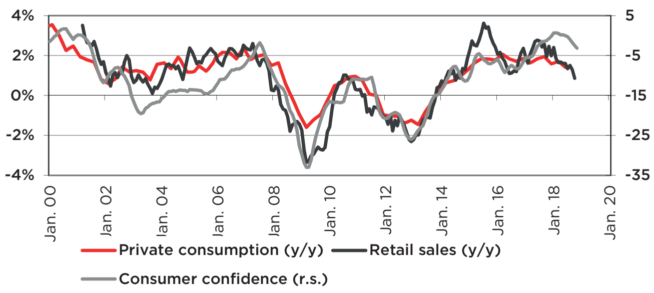
USA: Private household debt no reason for crisis



Euro zone: Political risks gaining the upper hand

Economic momentum in the 19 euro zone states has diminished significantly this year. Growth will still come to 1.9 % for 2018, but we expect it to slow to only 1.3 % next year. There are huge economic risks involved. Export business, on which the euro zone economy heavily depends, has already waned significantly. Besides heightened uncertainty related to trade disputes, revaluation of the euro is partly responsible for declining foreign demand. However, domestic demand has also provided less economic impetus than originally expected. Despite falling unemployment in most of the countries, wage growth has been limited. At the same time, purchasing power has declined due to rising inflation.

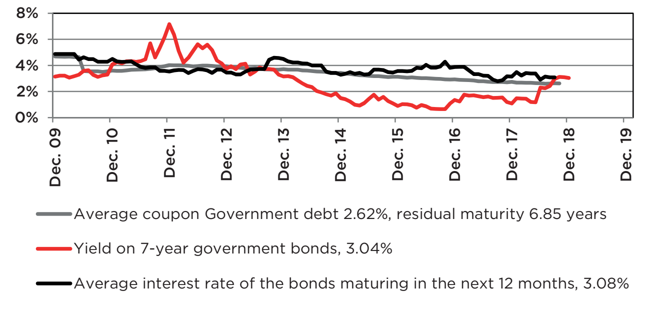
Eurozone: Consumption disappoints



Moreover, Brexit is proving to be especially burdensome, as negotiations for Great Britain's withdrawal from the European Union have been chaotic, to say the least. Whether the deal negotiated by British Prime Minister Theresa May will find a majority in the British parliament is still entirely open. It now appears that the British politicians who agitated for Brexit have totally underestimated the complexity of withdrawing. As feared, the expectations stoked in the United Kingdom ahead of the Brexit decision are proving unrealistic. A disorderly withdrawal by Great Britain could drive the country into a recession next year because it would no longer have any special trade relations with the European Union. The economic effects would likewise be negative for the EU countries as a whole, but probably not as much as for Great Britain. However, this does not apply to member states that have especially close economic ties to Great Britain like Ireland, Malta, and Cyprus. A recession in those countries would also be likely.

On the other hand, Italy is a very worrisome case. The confrontational dealings of the populist government in Rome with EU partners are fueling concerns about a new debt crisis. The announcement that next year's budget deficit is to be larger than originally agreed has led to higher risk premiums on Italian government bonds. The interest rate for taking on new debt or rolling existing debt forward is already higher than the interest rate on maturing bonds. However, we believe there will be a compromise that will lead to a budget deficit that is larger than the old government's planned amount, but is somewhat lower than what the League and the Five Star Movement have announced. As in Greece in 2015, reaching an agreement is also likely to be a painful process in Italy. On the other hand, we think it is very unlikely that Italy will leave the euro zone and return to a currency of its own. For, like the Greeks before them, the Italians have elected a government that is critical of the euro, but the majority of the population would nevertheless prefer to keep the euro as legal tender.

Italy: Making debt more expensive

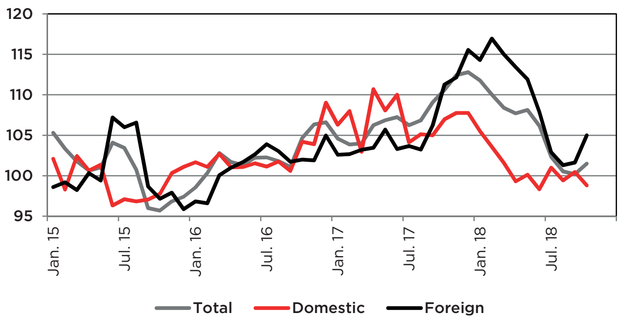


Germany: Going downhill

The German economy has slowed more than expected this year. At first, it looked as if special factors were responsible for that (a very cold winter followed by a hot, dry summer, labor strikes, and a flu epidemic at the beginning of the year), but the picture did not improve subsequently. In the third quarter, a slump in automobile production then drove the economy in reverse for the first time since the beginning of 2015. The problems of adjusting to comply with the new Worldwide Harmonized Light Vehicle Test Procedure (WLTP) meant that German automobile production in August and September was about one-fourth lower than in the year-earlier period. Moreover, delivery difficulties have led to a decline of exports and negatively affected private consumption. But production recovered in October, and that trend should continue for the time being. Existing unfilled orders in vehicle manufacturing are at a record level. Growth in the fourth quarter will therefore benefit from this catch-up process. Nevertheless, only a real GDP growth rate of 1.6 % may be achieved this year

On the other hand, the international trade dispute emanating from the United States has so far had little directly measurable impact. German exports to China and the United States have increased significantly this year. The development of exports in 2018 has nevertheless been disappointing, and that is primarily because exports to Great Britain and other countries outside the euro zone have declined considerably. We expect even lower economic growth in Germany of 1.4 % for 2019. This rate roughly matches potential growth, so the forecast does not imply that the upswing in Germany is over. This is both good and bad news. Good because it asserts only cyclical normalization, but bad because the danger exists that this estimate might be too optimistic if the various above-men-

Order development in the German automotive industry in decline



tioned risks are realized. The economic slowdown in the United States, China, and neighboring European countries will be a drag on exports and business investment. German exports to China and the United States have increased significantly in 2018, but new orders from abroad have been falling steadily in recent months. Export momentum will therefore weaken. The devaluation of the euro might be a ray of hope on the horizon. Usually, it takes about half a year before exchange rate movements are reflected in the real economy. However, since the global economy will slow in 2019, the more competitive exchange rate will only be of limited help. We therefore expect that exports will grow by 1.7 % next year (2018: 2.2 %). On the other hand, imports will increase more strongly, so the result will be another negative growth contribution from trade.

Moreover, the heightened business uncertainty reflected in major leading indicators like the Ifo index and the PMIs means that investments will be postponed or cancelled altogether despite high capacity utilization. Capital spending on equipment will therefore

Economic growth in Germany
Change in real gross domestic product compared with previous year

	2017	2018	2019
Private consumption	2.0 %	1.2 %	1.4 %
Government consumption	1.6 %	0.9 %	1.6 %
Capital expenditure	4.6 %	4.0 %	2.4 %
Building investments	3.8 %	3.2 %	2.3 %
Other facilities	1.3 %	0.3 %	0.8 %
Exports	5.3 %	2.2 %	1.7 %
Imports	5.3 %	3.5 %	2.8 %
Gross domestic product	**2.5 %**	**1.6 %**	**1.4 %**

increase by only 2.4 % in 2019 (2018: 4.0 %). That will contribute to a further decline of potential growth in the years ahead.

In contrast, consumption in Germany might grow somewhat more strongly in 2019, by 1.4 %, compared with this year (1.2 %), provided the current oil price decline is sustained. In that case, inflation would fall from 1.9 % to an average 1.6 % next year, giving households more spending leeway. While e-commerce continues to flourish, bricks-and-mortar retailers are struggling with a variety of problems. Moreover, the auto industry's problems and related unresolved issues (driving bans, retrofitting old diesel cars, and transition to e mobility) have made customers very uncertain. Their buying restraint is most evident in the fact that the saving ratio has risen sharply in the last few quarters. That is normally not what one would observe in such a phase of the economic cycle. At 10.7 %, Germans' fear-driven saving in the third quarter of 2018 was almost as pronounced as in the 2008-2009 crisis. Overall, the financial situation may be described as very comfortable, though. As long as the above-mentioned problems are not resolved, Germans will probably not change their role as reluctant consumers. However, the potential exists for stronger growth of consumer spending in the future.

While the IMF expects unchanged global growth of 3.7 % next year, we expect growth of only 3.4 %. This is mainly due to significantly cooling economic activity in industrialized countries. The Brexit and Trump's election are taking a late toll.

/ **Carsten Klude**
Chief Economist

Euro stays, so does debt

The continuing growth of debt in many states is increasingly jeopardizing the independence of central banks. Even relatively small interest rate steps are having dramatic effects on the sustainability of debt loads and hard-won growth successes of recent years. Pressure on central banks will increase in this environment and limit their ability to act.

The global inflation rate has increased significantly more in 2018 than expected at the beginning of the year. Various national economies have recently exceeded the inflation target for many central banks of 2 % mainly due to rising energy and commodity prices but also to a number of administrative price increases. In addition, rising food prices due to weather-related crop failures have contributed to advancing prices. This has not affected the core inflation rate much, since its measurement does not include volatile energy and food components. The stronger US dollar has added to a rise of imported inflation for the euro zone, since most imported commodities are quoted in dollars.

In this context, the question arises again for monetary policy whether regularities observed in past economic cycles still apply today. In view of reduced unemployment and corresponding labor shortages in many sectors, the puzzlingly slow change of wages is such a phenomenon. Understanding this would be helpful for future inflation forecasting and ultimately for expected central bank actions. Is this only a temporary situation with limited impact or a continuing paradigm shift? This crucial question concerns us repeatedly in the following. In addition to advancing globalization, continuing demographic trends, and technological innovations, disruptive processes influencing macroeconomic relations are likely to play a role that should not be underestimated.

Despite such global considerations, the monetary policy decisions of leading central banks will probably remain divergent in the coming year. The parallel development of the years before the financial crisis does not appear likely to return in the foreseeable future.

"Make America stable again" – new Fed Chair versus Donald Trump

As previously stated, the Federal Reserve (Fed) is already ahead of its counterparts in Europe and Japan on the way to normalizing monetary policy and has so far caused no collateral damage in the process. Jerome Powell, the new Fed Chair, has seamlessly continued his predecessor's policy, much to Donald Trump's chagrin. After all, he had already been one of Janet Yellen's closest associates for years and participated in all past monetary policy decisions.

Since the end of 2015, the Fed has raised its key interest rate seven times to the current target range of 2.0–2.25 %. The probability of another rate hike this year has fallen recently, as has that of further increases in 2019. The Fed now expects temporarily higher inflation due to base effects and sees less need for further or more severe interest rate steps. The "best president America has ever had" (Trump on himself) is likely to be glad, although he previously saw the matter quite differently out of self-interest. During the election campaign, he scolded the Fed because of its measured monetary policy. Not long after his election, however, it was not measured enough for him. He considers higher interest rates an impediment to the growth effects of his actions on the US domestic market, which are admittedly quite presentable.

The first few months of next year will tell us whether the switch to a more unhurried interest rate policy is correct or the Fed will have to tighten its reins further. If declining energy and commodity prices should be accompanied by an appreciable loss of growth momentum, as recently observed, it will not be possible to rule out the expectation of an imminent end to the upward interest rate trend in the United States. Perhaps, the upper turning point is already in sight, and the US interest rate trend will reverse direction sooner than expected. And perhaps that will happen before the Europeans even begin to normalize monetary policy to an extent actually worth mentioning.

Regardless of Trump's criticism, Jerome Powell and his colleagues see that the time has come to take stock and reconsider the central bank's modus operandi. An inflation target should not be engraved in stone. How monetary policy is determined, executed, and communicated should be critically questioned, and necessary changes openly discussed. A first change for 2019 has already been announced. In the future, the Fed Chair will appear before the press after every meeting, and no longer only once a quarter. In its effort to achieve more transparency, the Fed intends to include broad population groups without compromising its mandates, which are to ensure price stability and full employment. Besides changing its communication practices and discussing its policy toolbox, the Fed has also begun to ease regulations on American banks introduced during the financial crisis (Dodd-Frank Act). Now, banks with total assets of less than USD 700 billion will benefit in the future from lower liquidity requirements, among other things.

Besides the above-mentioned rate steps, the Fed already began to reduce its inflated balance sheet in October 2017. Initially, USD 10 billion in government bonds and mortgage-backed bonds were no longer replaced by new securities. The size of these tranches has risen by another USD 10 billion every three months since then. The targeted monthly maximum of USD 50 billion has almost been achieved, and the balance sheet total has already been reduced by USD 300 billion to USD 4.2 trillion now. Since the purchases made in the framework of the QE3 program started in 2010 had a monthly volume of USD 85 billion, the reduction will take significantly longer than the accumulation of these positions. Despite foreseeable adjustments, the Fed is likely to have a greater interest in a stable monetary policy corset than in buying an "America made great again" for the short term. Donald Trump has already identified the "gone crazy" Fed as a scapegoat in case his plans go awry.

Herculean tasks for ECB

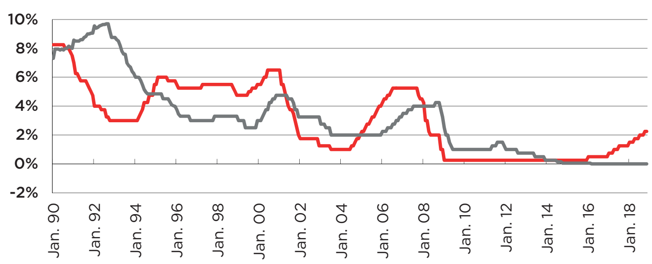
At the beginning of 2018, the European Central Bank (ECB) reduced its monthly bond purchases from EUR 60 billion to EUR 30 billion and finally to EUR 15 billion. The phase of extremely expansionary monetary policy is supposed to end at the turn of the year. The central bank will continue to reinvest the principal payments from maturing purchased securities for as long as necessary after the end of its net asset purchases. It thus expects to maintain favorable liquidity conditions and sufficient monetary policy accommodation. In the first half of 2019, about EUR 17 billion per month will be reinvested. The ECB Council so far expects that key interest rates in the euro zone will remain at their current level at least until sometime in the third quarter of 2019. In our opinion, the key interest rate and the interest rate for the deposit facility will remain as in the current year at 0.00 and 0.40, respectively, even beyond that period. Weaker economic data and declining inflation will probably force the ECB to maintain its monetary stance longer

"Nothing gives a fearful man more courage than another's fear."

Umberto Eco

than it really would like. We therefore expect hardly any changes in capital market yields in the euro zone. Within the common currency area, however, antagonisms are likely to increase further, if Italy's example of brazen populism catches on.

No interest rate turnaround yet in the euro zone



As in the United States, the ECB finds itself exposed to attempts by political leaders to exert influence on it. For years, the principal debtor states have demanded communitization of debts, and the creditor states have rejected it. A "truly European banking sector," with cross-border mergers to create globally competitive financial institutions, is likewise a popular topic. The central bank itself considers cybercrime and vulnerable IT systems in the financial sector as the most striking challenges in addition to the stock of non-performing loans. The almost resigned attitude of banks in reaction to ever more complicated regulations continues to be viewed with concern.

Europe faces a number of critical political decisions in the coming months, each of which could influence exchange rates, inflation data, and ultimately the economic trend. As mentioned above, they include uncertainty regarding Great Britain's withdrawal from the European Union (Brexit) and separatist movements in other parts of Europe. Continuing chilly relations with Russia and increasing alienation in the partnership with the United States have explosive potential for political and economic disruption. The European population's growing dissatisfaction regarding the way governments are dealing with the many troubling side effects of mass immigration is causing political polarization and hence more often capricious election results.

This is nowhere more evident now than in Italy, where the new government is financing its populist campaign promises with new borrowing contrary to all European treaties and agreements and is thus subjecting the monetary union to another tough test. Political caprice is the normal state of affairs for Italy. The rest of Europe used to find this amusing. However, since the introduction of the common currency and ever-stronger mutual integration with the euro zone's third-largest economy, the ubiquitous cliffhanger is no longer amusing. We may still hope that Europe-friendly forces in Italy as well as entrepreneurs and intellectuals will be able to exert enough influence to find sustainable compromises.

However, regarding the concern that what is happening in Rome will continue, we should not overlook the fact that political stability is at risk even in the supposedly robust economies of Europe. In Germany, Austria, and the Netherlands, once dominant national parties are gradually losing their electoral base to the political fringes. Complicated coalitions and vulnerable minority governments are created out of necessity and may have only a limited shelf life. The young French president, Emmanuel Macron, who took office amid such hope and advance praise, is losing appeal at home and allies in Europe. In such an environment, the idea of European unity is becoming increasingly strained, and nationalistic slogans are gaining traction and influence. Generally, the ECB cannot resolve these developments.

In view of the almost insurmountable task of gradual monetary normalization, all these political trouble spots sites create additional ballast for the ECB. The basic question is whether monetary policy for the common currency area is already overtaxed or is pursuing too many goals at the same time. Policy instruments like the European Stability Mechanism (ESM) and the Outright Monetary Transactions (OMT) program are still available for a possible emergency bailout of the euro by monetary means, as in the wake of the 2011 crisis. But their use presupposes the good behavior of the beneficiary government. After years of problem management almost solely by the central bank, it is therefore high time for bold and sustainable political solutions.

Monetary policy in Japan, Great Britain and Switzerland

The monetary policy of the Bank of Japan (BoJ) has long remained expansionary. It has not reached its inflation target of 2 % for a long time and apparently considers just having overcome deflation a success story. Recently, the central bank introduced its yield curve control policy (YCC), a somewhat more flexible way of using its instruments. In this context, the BoJ will continue to keep the yield on 10 year Japanese government bonds near zero, but will permit greater fluctuations around this anchor value. However, the central bank's stock purchasing program is likely to shift focus in the future from the Nikkei index to the Topix and thus become more broadly based. Its balance sheet total has expanded to about EUR 4.4 trillion due to the continuing purchases and has thus recently exceeded the country's nominal economic output for the first time. The BoJ now holds over 40 % of Japan's government bonds. Among industrialized countries, Japan is probably the farthest away from an end of expansionary monetary policy.

Despite increased inflation, the Bank of England (BoE) has recently left its key interest rate unchanged at 0.75 % because of a reduced growth forecast and the ever-greater uncertainty of economic forecasting related to Brexit. If the country's withdrawal from the European Union is smooth and orderly, interest rates might rise somewhat more sharply in the coming quarters, according to BoE Governor Mark Carney. For, economic growth would probably accelerate significantly in that case. However, it is hard to foresee how negative the effects of a no-deal scenario would be. The British central bank is therefore keeping all options open.

On the other hand, the Swiss National Bank (SNB) intends to stick to its policy of maintaining an unattractive Swiss franc despite mounting criticism. The central bank will expand its balance sheet further, if necessary, and sees more downward latitude for in interest rate policy even though the key rate is already negative at 0.75 %. The SNB's foreign exchange portfolio now comprises over CHF 760 billion after years of interventions. In view of diverse instabilities, including Brexit and eroded confidence in the euro, the Swiss central bank fears revaluation pressure on a dwindling interest rate differential and losses of price competitiveness for the export-dependent Swiss economy.

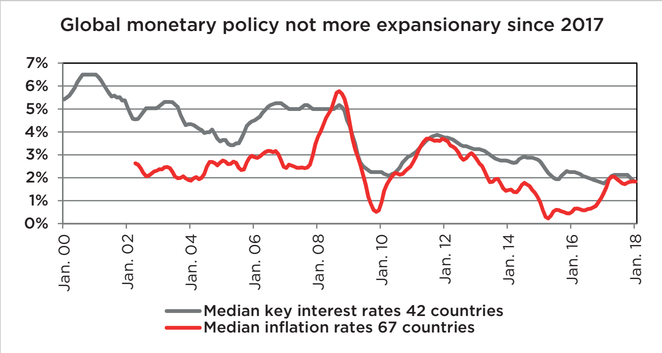
As in the United States and Great Britain, other countries have increased key interest rates, including Canada, India, Mexico, and several emerging markets. In many of these countries, the need to stabilize the local currency has been the most important argument for raising interest rates. In China, the party, government, and central bank have decided on further adjustments in the direction of a more domestically oriented economy and reduced dependence on export markets. The key themes are increasing productivity and promoting innovation in addition to measures taken to reduce the debt of state enterprises. They are willing to accept growth losses during the transformation process, but there has not been much of that so far. Whether things stay that way depends on reaching agreement in the trade dispute with the United States. In addition to levying tariffs on more and more goods and services between the two countries, international treaties and free trade agreements with other countries are now also coming into question. However, despite reduced foreign exchange reserves, the central bank still has impressive tools at its disposal in this environment, with possibilities of intervention to stimulate growth in case the conflicts escalate.

Central banks stay at the helm

Economic trends, currency relations, and changes in political direction are one side of the coin. Expectations regarding future

"No sooner does any 10-year bond yield rise than someone cries the sky is falling."

Jens Weidmann, President of the Deutsche Bundesbank



monetary policy are the other. Most post-war recessions have not been triggered by sudden demand slumps or extreme protectionism, but rather by excessively high or fast-rising interest rates. It is therefore not surprising that the behavior of central banks, in particular, is of key importance for the capital market trend going forward. Monetary policy in the industrialized countries has not become more expansionary since 2017. Some central banks have even already proclaimed a major reversal of interest rate trend for the long term.

We definitely do not share that view (yet), and for good reasons. Despite still comparatively good economic conditions and temporary base-induced outliers in monthly price data, pressure on central banks to act due to inflation is now lower than in past eras. Long-term trends show a tendency towards a lower global inflation rate already since the 1970s and in its wake a long-term decline of global interest rates. Of course, this is not happening in a linear manner without contrary movements. However, the more moving averages are used to smooth it, the more obvious this trend becomes. It is still not clear beyond doubt whether this is a temporary phenomenon or structural changes have led to permanently lower inflation.

Furthermore, the question arises whether the toolbox of the central banks, which almost universally includes an inflation target of about 2 %, is still right for the times under these conditions. Price-curbing effects of new technologies and distribution methods as well as consumers' ability to obtain information about inexpensive alternatives at any time suggest that companies actually have less latitude for passing on price increases. For example, rapidly growing e-commerce in the European Union has reduced the inflation rate for industrial goods by 0.1 percentage points annually since 2003. However, it is still too soon to consign the inflation target to the history books. A rebirth of good old inflation could occur in the future due to the long-term effects of digitalization on the market power and pricing latitude of important players at that time.

Independently of these general considerations, we expect the inflation rate in Germany to decline from 1,9 % this year to 1.6 % in 2019. That is primarily due to an expectation of lower commodity prices and stabilization of exchange rates. In the meantime, this could also lead to even lower inflation rates.

Euro interest rate increase? Only very slow, if at all

For the economic trend and the capital market, a great deal still depends on the fine-tuning skills of the central banks. We expect two key interest rate increases in the United States. However, a “real” interest rate reversal in Europe is receding in the distance. Japan is also still far from rate hikes in 2019.

This year's dominant political issues are certain to remain virulent in 2019. However, besides US trade disputes, Brexit, and Italy-EU tensions, entirely surprising events may arise and move the capital markets.

/ **Dr. Frank Geilfuß**
Investmentoffice

Political topics dominate

Many political uncertainties will shape the stock market in 2019. In our main scenario, we regard high single-digit percentage price gains as possible. However, the stock markets will suffer if there is a hard Brexit, further escalation of trade disputes, or another debt crisis flare-up in Southern Europe.

Volatility is back

After a comparatively continuous advance in 2017, marking the sixth consecutive winning year, international stock markets have seen a return of persistent, high volatility in the course of 2018. The leading German index, the DAX, reached a new all-time high of over 13,000 points in January 2018, but then corrected by over 13 % in the following two months to below 12,000 points. It then went back to a level of around 13,000 points by June. Anyone who then thought to celebrate the new highs was quickly disabused of that notion. A bear market took hold in autumn and has dragged the DAX down to about 11,000 points.

Heavy fluctuations again in 2019

After analyzing the reasons for this year's volatile performance, we find forecasting a similar pattern for 2019 inescapable. On the one hand, the current economic cycle will continue. We expect positive GDP growth rates for Germany, Europe, and the United States next year. Nevertheless, growth rates in many countries will be lower than they have been in the past few years.

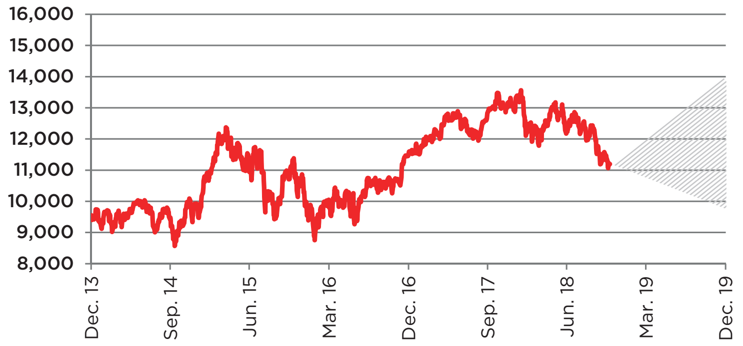
Germany is likely to be no exception, although several one-off factors have weighed on its economy in 2018, such as the Worldwide Harmonized Light Vehicle Test Procedure (WLTP), a new emissions standard, which led to temporary production losses in the automobile industry. But even with lower growth rates, companies have the potential to increase operating earnings if they keep their costs under control. This would be a good situation to foster positive stock market development. On the other hand, certain potentially destructive factors hang over these generally favorable macroeconomic conditions. They primarily include three political risks.

One is the continuing danger that US President Donald Trump will implement an active trade policy ahead of the presidential election in 2020. As in 2018, there may be further tensions or de-escalation. Both scenarios are conceivable, but their probability of occurring can scarcely be forecast.

Another adverse factor, which will not become clearer until March 2019, is the final outcome of the United Kingdom's withdrawal from the European Union. Here, too, a clear result (hard or soft Brexit) is conceivable, as is a middle path. But even though the deadline of March 29, 2019 is clear, the effects on the economy and businesses will only become discernible in course of 2019 and thereafter.

The third risk factor for the stock markets already known today is Italy. The government in Rome is planning to increase borrowing further to finance its election campaign promises. The European Union has lately already rejected the budget plan for next year. But even if Italy borrows less than initially planned, its huge debt load will continue to grow. We may therefore see another debt crisis. With Italy as the main actor, however, this situation is much more critical than when Greece was the protagonist. That is because of Italy's size and importance for the European Union compared with Greece and because of the absolute amount of its national debt. While Greece was running debt of about EUR 350 billion, Italy's debt load is now is six times as high at about EUR 2.3 trillion. Germany's debt amounts to about EUR 2.1 trillion, but its economic

Forecast uncertainty for the DAX is high



output is almost double that of Italy. This shows that even though a combined effort of member states can rescue a country like Greece, that would be much more difficult, if not impossible, in Italy's case.

Wide index fluctuation possible

If one looks at the stock markets in 2019 with these opportunities and risks in mind, it appears more difficult than ever to make a concrete forecast for the DAX, the Euro Stoxx 50, and S&P 500. This forecasting uncertainty is based not only on the above-mentioned risks, but also primarily on the considerable outcome variance of the relevant events. Against this background, we approach forecasting the stock market for 2019 with scenarios and fluctuation ranges for the indexes. Though about 15 on average since 1988, the price-earnings ratio (P/E) for the DAX in 2018 is only 12.4. Multiplied by earnings expected for 2020, that yields a DAX target of about 12,600 points.

However, a DAX of about 10,000 points is also possible in the course of 2019, if the negative variants of the above-mentioned risk factors occur. For that case, we assume a P/E of 10, which was also observed on average in 2011 and 2012. At that time, the financial markets were focused on the debt crisis, and economic growth was cooling off sharply after a boom phase. However, assuming positive outcomes for all the political risks, one can also derive DAX targets of up to 13,700 points. That would correspond to a P/E of 13.5 based on earnings forecasts for 2020. This value was last seen in the beginning of 2018, when the financial world was not yet under pressure from Trump, Brexit, and Italian debt.

Analogously to this procedure, one may derive price targets for the Euro Stoxx 50 between 2,700 and 4,100 points. This represents a range in the underlying P/E from 9.1 (average of 2011 and 2012) and 13.9 (peak in 2018). In contrast to our outlook for the leading German and European indexes, we are more optimistic regarding the US stock market. The political risks of Brexit and Italian debt are primarily European issues. However, an escalation of trade disputes would also negatively impact the United States.

Again in contrast to the DAX and Euro Stoxx 50, we do not assume a politically influenced negative scenario for the S&P 500 in 2019. Based on the current P/E of 15.6 and earnings estimates for 2020, we arrive at a price target of about 3,000 points for the S&P 500.

Use recovery phases in cyclical sectors to switch into defensive titles

After the sharp stock market correction at the end of 2018, we believe especially weak stocks may recover as we move into the new year. That will likely be the case for automobile stocks, which have suffered in the second half of 2018 from production losses due to the WLTP. Passenger vehicle production has already normalized in the last two months of 2018, and the first quarter of 2019 should benefit from catch-up effects and a high number of working days compared with 2018. Since the automobile industry is an important customer for other cyclical areas, such as chemicals and raw materials, a recovery is also likely in those sectors.

We also believe technology firms, especially in the United States, will be interesting again after the price corrections. Many of these companies will continue to benefit from the structural change brought by automation and digitalization. The megatrends include e commerce, cybersecurity, and cloud-based data processing. This is reflected in continuing high growth rates and strong margins.

As 2019 moves along, we recommend using good stock market phases for selling to make portfolios more “weather-resistant” and focusing on investments in high-quality companies. Those include companies with good financial ratios, high market entry barriers, good pricing power, and less cyclical sales and earnings. The background for this is the cooling economic trend and increased attractiveness of short-dated debt securities in the United States as well as decreasing liquidity on the capital markets due to the Fed's tighter monetary policy.

Political risks and global slowing of economic growth will likely lead to high stock market volatlity in 2019.

/ Daniel Hupfer

Head Portfolio Management

/ Björn Voss

Head Advisory Office

Technical analysis – near-record bull market ending or going into overtime?

It has seldom been harder to make capital market forecasts based on technical analysis. Not because this bull market is one of the longest in history, entering its tenth year in March, but because politics and instant communication ("tweets") have never influenced the markets as much as today. Or is this just our imagination, since the recent past has seen nearly volatility-free upward movement?

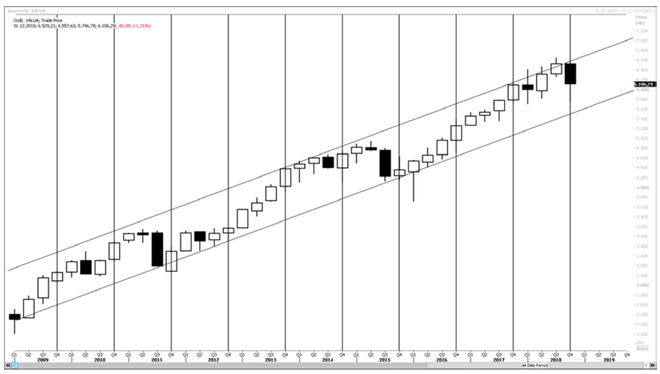
People say bull markets do not die of old age, so we would like to consider first whether the stock markets still have sufficient potential after almost 10 years (anniversary on March 9, 2019). Not to give too much away, we will tell you now the answer is affirmative.

First, we consider the statistics. There have been 18 mid-term elections in the United States since World War Two. Why is that significant? Statistics tell us that, regardless of outcome, US stocks have advanced on average by 17 % in the 12 months following a mid-term election (the most recent was held last month). As if that were not enough, there has not been a 12-month period following a mid-term election that turned out negative. Additional hope may be taken in the fact that a US president's third year in office has also been the most successful on the stock exchanges, following on the second year, the worst for the markets. Accordingly, the US presidency cycle argues in favor of a good year for the stock market in 2019.

The years ending in "9" since World War Two (1949, 1959, etc.) have gone very well on average. In these seven years, the S&P 500 has registered gains per year of 13 % on average, and investors only saw a negative number in 1969 (11 %). The statistics thus argue in favor of a positive year for the US stock market, because 2019 unites all the favorable characteristics described in a single year.

But does that provide sufficient market breadth? A looming end of a bull market is often characterized by the relevant index being carried by only a few large cap stocks. We want to raise this question with respect to the Value Line Arithmetic Index, which comprises over 1,600 North American companies in an equally weighted calculation. As may be gathered from the following chart, this broad index has been moving in an intact trend channel since the beginning of the bull market. Important marks hit during this year include the low of 2018 at about 5,700 points and the area around 5,500 points, where the lower end of the trend channel runs. On the upper end is the boundary at the beginning of the year at about 6,500 points, which has risen to about 7,000 points in the course of the year.

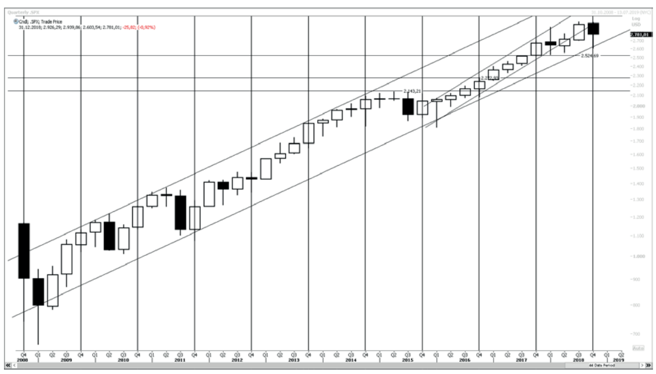
Value Line Arithmetic Index (quarterly)



Source: Reuters

The trend in the S&P 500 index may be described as completely intact. However, it is all the more important here to keep an eye on the bottoms of the year 2018. There is intersection support at just over 2,500 points from the lower line of the uptrend channel and the horizontal support line. Added to that is the 200-week exponential moving average, which is at about 2,380 points and thus makes for more support.

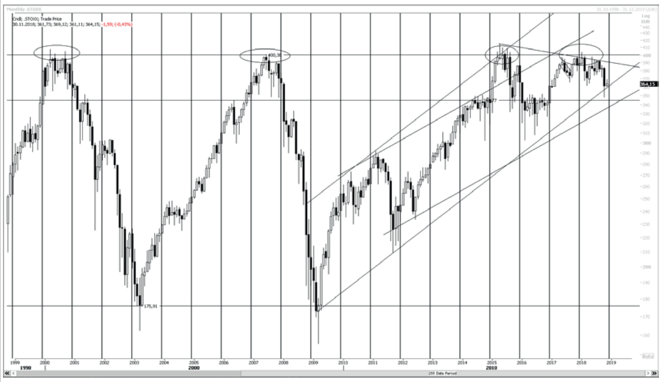
S&P 500 (quarterly)



Source: Reuters

On the upper side, the targets are in the area between 3,200 and 3,500 points. While US stocks have a "green light," we find it significantly harder to outline a similarly positive picture for European stocks.

Stoxx Europe 600 (monthly)



Source: Reuters

The technical situation of emerging market stocks is literally hanging by a thread. The MSCI Emerging Markets index has not managed to overcome its all-time high to date at 1,345 points. Shortly before reaching that, it ran out of steam, followed by a sharp correction to the overcome downtrend line starting from the all-time high and the horizontal support at about 900 points. If this intersection support, with which the uptrend has also associated since 2003, should fail to be defended, the downward momentum around 700 points would probably even increase. However, if the support should hold, this mark would be an ideal springboard for a strong recovery that would not encounter serious resistance until around 1,250 points.

MSCI Emerging Markets (monthly)

Source: Reuters

With a positive spin, one could say: "The Stoxx Europe 600 index is (still) in an uptrend." However, it has conspicuously tested the 400-point mark several times in the last 20 years and has always failed. In any case, the year 2019 will bring a decision about the direction of the broad European stock market. If the uptrend is successfully defended, this previously insurmountable resistance should also be overcome. Such a breakout would theoretically release at least 15 % follow-on potential up to about 460 points. However, if the strategic support at about 340 points should fall, the path downward would be open to 300 points, and the ten year uptrend would be history.

DAX (monthly)

Source: Reuters

Germany's DAX index has already gone a step farther on the southward path. The uptrend of the last ten years has been broken. Likewise, a major trend reversal pattern has formed in a head-and-shoulders movement. The "neckline" of this formation is at about 11,800 points and is thus the first important resistance on the way (back) to higher stock prices. Even worse, if this mark is not recaptured, the theoretical follow-on potential will amount to about 1,800 points, which would come near the mark at 10,000 points. On the other hand, the technical picture would not become significantly more positive until above 12,500 points.

If the american markets continue to trend upward, a rising tide should lift all boats and the world's stock markets will follow suit.

/ Nils Theilfarth
Portfoliomanagement

Yield level remains low – little potential for value gain

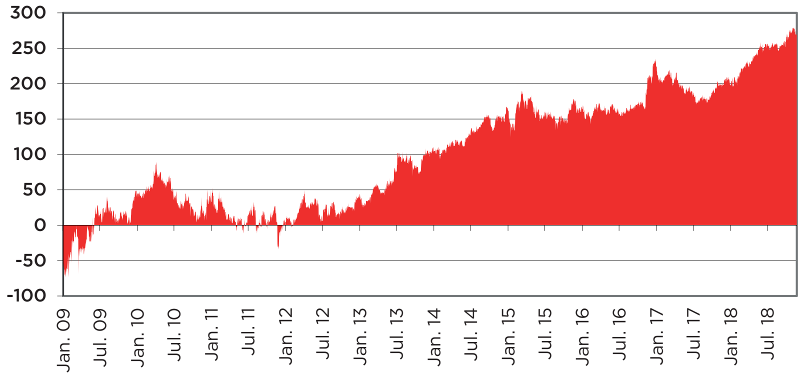
The bond markets will be shaped again in the coming year by central bank policy and political imponderables. Since the risk of interest rate change should remain manageable, our allocation focus is on credit risks.

Key interest rates in Europe unchanged in 2019

While the Federal Reserve (Fed) in the United States has raised its key interest rate significantly, in eight steps since last December, the European Central Bank (ECB) has not raised its main refinancing rate and has no plans to do so in 2019. Its monetary policy will remain expansionary, and the interest rate level will continue to be low. The ECB is set to end its bond-purchasing program at the end of the year, but will continue to reinvest proceeds from maturing securities from the bond holdings of euro zone central banks for the indefinite future. Moreover, ECB President Mario Draghi has stressed repeatedly that the current level of key interest rates will remain unchanged until beyond next summer. General economic and political conditions are playing into his hands in that regard. On the one hand, economic data in the euro zone have slowly but surely weakened this year.

On the other, trade disputes, Brexit, and the budget policy of Italy's populist government have hung like a sword of Damocles over the economic trend in the euro zone. It is therefore not surprising that the yield difference between German government bonds (Bunds) and US Treasuries, the "transatlantic spread," has climbed to ever-higher peaks, across all maturity bands.

Spread development US Treasuries vs. Bunds
(maturity 10 years; in basis points)



Bund yields trending sideways

Since we expect euro zone inflation to miss the ECB's target of "below but near 2 %" in both the headline and core rates next year, Bund yields will rise only moderately in 2019. Our forecast for German 10 year government bonds at year's end is 0.6 %, with the increase from the current level of just under 0.3 % not likely to materialize until the third and fourth quarters, when the ECB presents its outlook for monetary policy in 2020.

Credit risk the focus of allocation

In the United States, the Fed will stay on its monetary policy course for the time being and increase its policy rate once again in December 2018. However, we do not expect that it will, as if on autopilot, raise interest rates in three or four steps to a level of 3.00–3.25 % in 2019 as previously announced. Weaker economic data and exceeding the inflation peak will soon move the Fed to reconsider.

Lower money supply growth and simultaneous shortening of the Fed's balance sheet will have a braking effect. Consequently, the yield curve will stop flattening and an inverse curve, which would provoke fears of recession, will be avoided. The rise of yields on 10 year Treasuries, which enjoy steady demand at yields above 3 %, will therefore subside and reverse direction next year.

Given only moderate risk of interest rate change, we intend to focus primarily on credit risk in making portfolio allocations on the bond side. In the government bond segment, we are therefore sticking to our favorites from 2018. Fundamentals such as rating trends, growth and indebtedness, and attractive risk and return profiles on maturities up to ten years clearly argue in favor of Spanish and Portuguese government bonds. We expect that their credit premiums relative to Bunds will tighten, so negative performance can be avoided. We are not yet ready to consider investing in Italian government bonds despite the already significant rise of yields. Uncertainty is still too great whether the populist government in Rome will back down in the budget dispute with the EU Commission or can remain in power after doing so.

Timely additions of government bonds from Eastern Europe should mitigate the vulnerability of portfolio allocation in respect to the termination of the ECB's bond-purchasing program. For investors who focus on the investment-grade segment, these include issues from Poland, Hungary, and Rumania. However, we also consider issuers from the high-yield segment such as Croatia, Macedonia, and Montenegro attractive, but their volatility should not be overlooked.

However, the emphasis of our portfolio allocation remains on European corporate bonds, although the trend towards widening credit premiums should continue due to the termination of the ECB's bond-purchasing program at the beginning of 2019. For, corporate bonds benefit, on the one hand, from still attractive fundamentals such as continuing positive growth and a low interest rate level, which ensure that default rates stay significantly below historical averages. On the other hand, the risk and return profile of corporate bonds has improved considerably thanks to rise of yields under the influence of monetary policy and political developments. Yields are clearly above the lows of 2007 in both the investment-grade and high-yield segments, and above the figures of 2017. In particular, we believe exposure in the segment of high-yield issuers is worth the risk.

High yield bonds with positive bottom line in 2019

What speaks in favor of this segment? The first thing is the clearly improved quality of companies. That finds expression in much lower indebtedness and much improved interest service cover ratios, among other things. The rating agencies have taken account of this and given companies higher ratings in the last few years. While only 41 % of companies in Europe got the best high-yield rating in 2007, the number now stands at 72 %. Secondly, average duration in this segment is shorter than that of their counterparts in the investment-grade and government bond segments. And even though we do not expect a significant rise of interest rates, high-yield bonds perform the best thanks to their higher coupons and low duration in upward interest rate cycles. We expect a total return in 2019 of 2–3 % for European high-yield bonds and 0–0.5 % for corporate bonds with investment-grade ratings.

In conclusion, we would like to comment on bonds from emerging markets. We would treat this asset class with caution in the coming year, at least for the time being. Although fundamentals in these countries, such as stable growth and low debt compared with many industrialized countries, argue in their favor for allocation purposes, political risks, negative sentiment, and initially still rising US interest rates give us pause. We therefore recommend staying on the sidelines in this segment at the beginning of 2019. However, if sentiment should improve, e. g., due to a slowing US economy accompanied by a discontinuation of interest rate hikes and a weaker US dollar, hard-currency bonds from emerging markets will become interesting again.

Considering the low default rates and good fundamental data, we recommend overweighting european corporate bonds. In particular, the high-yield bonds in this segment exhibit a very attractive risk and return profile.

/ **Martin Hasse**
Macro-Research

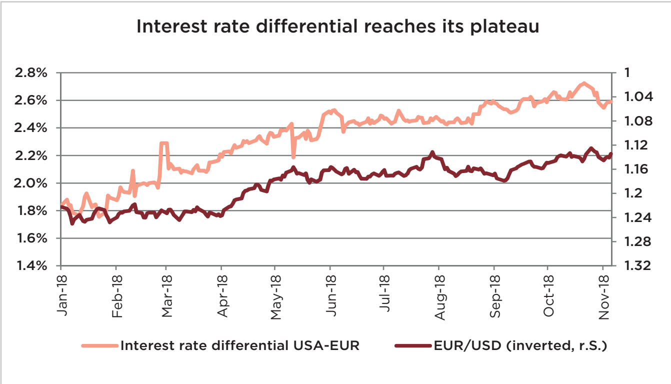
Foreign exchange markets: Political football

The risk of a no-deal Brexit, the budget dispute in Italy, and a slowing euro zone economy have dominated the exchange rate trend in recent months. These developments will continue to occupy the foreign exchange market for the time being.

The US dollar has revalued against the euro by over 6 % since the beginning of the year and is almost at the level of EUR/USD 1.13 that we forecast at that time. After the dollar devalued to over EUR/USD 1.25 in the beginning of 2018, the interest rate difference between the two reserve currencies and relative strength of the US economy became the dominant factors for a stronger dollar as the year went on. While better US economic data were published almost every month, it gradually became clear that the US and euro zone growth rates were drifting apart more than expected and the Fed was tightening interest rates faster. That was then reflected in a further widening of the difference in expected interest rates, which consequently contributed to the dollar's revaluation. Lately, however, the interest rate trend has played less a role than political uncertainty in and about the euro zone. Demand for the dollar as a safe haven has increased especially because of uncertainty regarding Italy and Brexit. If these uncertainties continue to exist and the Fed raises key interest rates further, as most market participants expect, the dollar is likely remain strong next year. Or perhaps not?

Focus on monetary policy

Experience has shown it is extremely hard to predict political developments, which significantly increases forecasting uncertainty. We nevertheless believe the budget dispute in Italy will eventually come to a positive conclusion. The dispute between the European Union and Italy is difficult and cannot be solved quickly. We even expect it will escalate further and might continue to pressure the euro for some time because of the size of the Italian economy in the euro zone. Ultimately, however, the cost of new Italian borrowing, already at the highest level since 2013, should improve the judgment of Italy's leaders and get them to concede on the budget plan (even if not to the desired extent). After all, the European Union has already gathered abundant experience in making compromises. In other words, things will get worse before they can get better. We also expect a Brexit solution in our base scenario. The critical juncture is the eventual vote in the British Parliament. Because of these great uncertainties, we expect increased exchange rate volatility in the coming weeks.



On the other hand, there is less uncertainty regarding the shape of future central bank policy. For, with conventional and unconventional monetary policy instruments having largely failed to achieve the desired effect, the European Central Bank (ECB), like the US Federal Reserve (Fed) before it, has added forward guidance to its toolbox. So, we know that the ECB is planning to end its bond purchasing at the end of this year. A possible first interest rate hike will not be decided before autumn 2019. However, with a core inflation rate of about 1 % and economic momentum waning in the euro zone, there is hardly room for interest rate increases. So, there is good reason to suppose that the ECB will not raise its key interest rate in the coming year. In contrast to the ECB, which is still waiting for the upward interest rate cycle to begin, the Fed has already almost reached the end of it. Besides the expected interest rate step in December, the Fed has announced three more for 2019. That would put the fed funds rate in a range of 3.00 3.25 %. However, the Fed is trying to find its way to the "neutral" interest rate, which does not additionally speed or slow the economy. While the majority of FOMC members have assumed this rate was about 3 %, the weakness of some US data suggests a lower level. The potential for further interest rate steps is therefore clearly limited. Given the advanced stage of the economic cycle in the United States, growth setbacks have become more likely, which would imply a more cautious approach to raising interest rates. Given the modest growth of unit labor costs and the recent decline of oil prices, which are now below their year-earlier level, inflation and hence pressure from that angle for interest rate hikes should turn out lower. We therefore expect at most one more interest rate increase by the Fed at the beginning of next year, followed by a relatively long pause. We believe this monetary policy shift will cause capital to flow into the euro zone and the euro will consequently revalue. While the dollar might continue to revalue for a while, less restrictive US monetary policy will make an exchange rate of USD 1.20 per euro possible. However, the higher key interest rate in the United States should prevent a more significant rise, for example, to near purchasing power parity at USD 1.28 per euro.

British pound

How the British pound's exchange rate will develop going forward is closely tied to the outcome of the Brexit drama. As we said above, we ultimately expect a soft Brexit. Nevertheless, the probability of a no-deal Brexit is about 50 % according to current data from oddsmakers, so we also have to consider this case. If there should be a no-deal Brexit, Great Britain would suddenly become an ordinary non-member of the EU and would lose access to the European Single Market. Great Britain is highly integrated into the international division of labor and value creation process, so its economic growth would become significantly lower in that case. The International Monetary Fund expects a no-deal Brexit would cost Great Britain 4 percentage points in growth by 2030. A slowing of growth in the coming year from an expected 1.3 % in 2018 to near zero would be huge, but would not necessarily mean a recession. However, that will depend heavily on what the no-deal Brexit looks like (orderly or disorderly) and on the fiscal and monetary response. The weaker growth trend and adjusted monetary policy would also adversely affect the exchange rate. While the pound fell by over 12 % against the euro in a one-year period because of the Brexit referendum, the decline on a no-deal Brexit is likely to be smaller, since a higher probability for this case is already discounted in the exchange rate.

We predict exchange rate development in the opposite direction if there is an orderly Brexit. The main reason we see for a rise of the pound is monetary policy that would be tighter than anticipated by the market. Both economic growth and inflation development could yield surprises and lead to further interest rate steps by the Bank of England (BoE). Important leading indicators, such as the purchasing manager indexes, have lately pointed to slower economic growth. Other less watched factors suggest, however, that this picture might be exaggerated. For example, a current BoE report shows that only a small number of companies have begun to implement their emergency plans. And the purchasing manager indexes have exaggerated the actual picture in Great Britain in many cases. Moreover, capital spending now postponed because of Brexit uncertainty is likely to be caught up in case there is an orderly Brexit. Besides these effects, increases in real wages should stimulate consumer spending. And the recently passed 2019 budget, which calls for higher government spending, should give economic growth additional impetus of about 0.3 percentage points. So, realizing a growth rate of almost 2 % appears possible. Given such growth, the inflation rate (now +2.4 %) would probably also turn out higher and motivate the BoE to take further interest rate steps. The BoE already took a somewhat stricter tone following its last interest rate decision. For one thing, an inflation rate above the 2 % target is projected on a horizon of two years. Since the interest rate path underlying this number is above market expectations, it is a sign that more rate steps than expected might occur. For another, these inflation rate projections are based on a growth rate of 1.7 % for 2019, with the additional fiscal stimulus from the passed budget not yet included in the GDP forecast.

While the market expects only two interest rate steps next year, we believe the central bank may take up to four. In that case, the pound would probably revalue gradually and reach its level before the Brexit referendum of EUR/GBP 0.76.

Political developments in Italy and the outcome of the Brexit vote will continue to dominate the exchange rate trend. In expectation of a positive outcome, the euro should revalue moderately against the US dollar, and tighter BoE monetary policy should strengthen the British pound against the Euro and USD.

/ **Julius Böttger**
Investmentoffice

Geopolitics, environmental protection, and innovation ever more important

Positive and negative factors for commodity price development are currently balanced. Supply has increased in the past few quarters despite political sanctions and now faces a global economy losing growth momentum at a high level.

With Donald Trump at the helm of the United States, politics have taken on a completely new level of influence on global commodity price development. A simple tweet or tightening or easing sanctions against Iran or Venezuela on a whim will make crude oil prices immediately react one way or the other. For instance, the United States put an embargo on Iran's oil exports after withdrawing from the nuclear power treaty with the country this autumn. Countries and companies now need special US permission to deal with Teheran. Any violations will incur hefty penalties that only serve to make other nations kowtow to the mighty POTUS. What this has to do with free trade eludes us. It also further complicates any attempt at a fundamental assessment and forecast of commodity price development. For example, the announcement of new sanctions against Iran last May first triggered fears of a supply shortage and made the Brent price gain 15 % by October. However, as the sanctions took effect, the oil shortage failed to materialize, and oil prices dropped back to their springtime level within a few weeks. This was further evidence of the now very pronounced supply resilience, with reserve capacities as key pricing factor. Saudi Arabia upping its production already sufficed to make up for the Iran shortfall. Since Iraq, Russia, and the United States also stepped up their oil production, this compensated for the Venezuela embargo, resulting in a total oil production increase within the Organization of Petrol Exporting Countries (OPEC) over the summer months that exceeded demand.

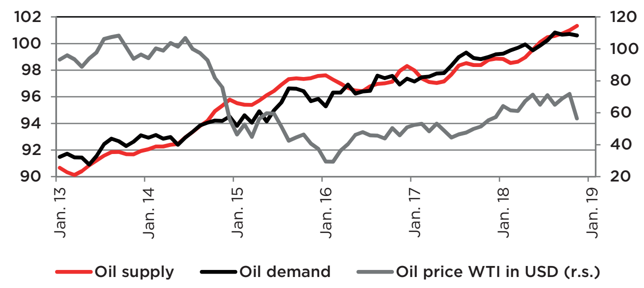
Waiting for Peak Oil

Notwithstanding the progress in alternative energy, fossil fuels, led by petroleum, remain by far the world's main energy source. Black gold accounts for about 36 % of global energy needs. The International Energy Agency (IEA) projects daily oil needs for 2030 at 110 million barrels crude (now about 95 million), with about 159

"Optimists buy gold and silver – pessimists buy canned food"

Investor proverb

Global oil market: Current supply overhang may be reversed in 2019



liters per barrel. This means that even including substitution effects, new technologies, and more efficient energy use, there is so far no discernible demand decline, although demand growth has been slowing. We are still far from the oil shock of the 1980s, when people panicked over the impending end of the Oil Age (peak oil), as deposits allegedly dried up. In the 1970s, the Club of Rome published a paper entitled "The Limits to Growth," which claimed the oil age would end before 2000. Current projections based on present consumption and considering modern exploration and processing technology see a reserve reach of another 50 years. Actually, the oil age may end before we run out of oil.

Commodity prices have dropped considerably, not least due to many geopolitical issues and resulting slower global economic growth. Especially trade disputes between the United States and China, but also the unresolved schedule for Great Britain's exit from the EU (Brexit) and Italy's newest reckless spending sprees have made many market observers cautious in their global economic forecasts. The above issues may impede growth and the historically strong correlation between economy and raw material demand suggests a resulting negative impact on commodity price development.

Despite these serious problems, we do not consider the above scenario a foregone conclusion. The political conflicts are resolvable, or at least there are options for making compromises and the supply-demand correlation has its elasticity limits. The oil production increases mentioned earlier are already straining capacity limits. Raising production any further to deal with new embargos would probably require major capital spending and some time for construction. It is thus not surprising that the US Energy Information Administration (EIA) projects oil production growth for 2019 at only 1 % while demand is expected to increase by 3 %. If this holds true, the current supply surplus should turn into a demand surplus sometime next year, and prices should first stabilize and eventually start rising again.

In this scenario, we expect high oil price volatility (Brent) around the US$ 60 per barrel mark, depending on many short-term factors.

World's workbench is changing – China losing appetite for raw materials

Considering the billions of US dollars that oil and ore groups are spending on dividends and stock buybacks, one might think that the primary industry is doing splendidly. A closer look reveals the real reasons for this surprising generosity. The primary industry currently seems to have hardly any lucrative capital spending projects pending, and major acquisitions made in the boom years following the financial crisis are being secretly revalued or even sold. China appears to be forcefully turning away from its decades-long role as the world's workbench. The country is going high-tech and turning away from its old raw material-based industries. A substantial part of the dividends paid to shareholders thus comes from divestment income and spinoffs rather than earnings growth. China's recently cooling economic engine and diminished demand for raw materials has sent industrial metal prices south since last summer. Particularly aluminum and copper prices show that demand is waning, especially in Asia. The outlook is also dim, with US tax reform effects ending and the trade conflict between the United States and China continuing. Coal and steel prices, however, are up on low supply after production shutdowns, as coal has been marginalized in power generation and the steel industry went through a phase of sector consolidation. Moreover, US steel import taxes have raised steel prices by 35 % year-on-year.

Precious metal prices are increasingly reflecting their role as value stores. Central banks and consumers have been buying more and more physical gold in 2018. According to the World Gold Council (WGC), demand for precious metals in industrial applications has dropped, though, as has certificate and ETF demand. The Russian central bank purchased 92 tons of gold in the third quarter of 2018, which represents the largest amount of gold the country has bought in any three-month period. The idea behind this purchase is Vladimir Putin's plan to make the Russian economy less dependent on the US dollar. Turkey and Kazakhstan have also been buying more gold. Private investors have stepped up their gold coin and bar purchases by 28 % as a safe haven investment. Demand has virtually skyrocketed in China and Iran. At the same time, investors have fled the precious metal ETF market, while industrial demand has stagnated at a low level.

In light of a still robust global economy, prospects of slightly rising real interest rates, and a stable US dollar, there should be no pressing need to invest in precious metals in the near future. We therefore reiterate our recommendation to consider holding physical precious metals as a minor investment to insure against disruptions of the global financial system. Investing in precious metals beyond this limited application seems unwarranted, as we forecast a year-end spot price of USD 1,150 per troy ounce.

Fundamental conditions for commodity price development are now characterized by stability-oriented supply policy and simultaneously slightly underestimated demand in the context of a somewhat cooling world economy, continuing political confrontations, and negative sentiment.

/ **Dr. Frank Geilfuß**
Investmentoffice

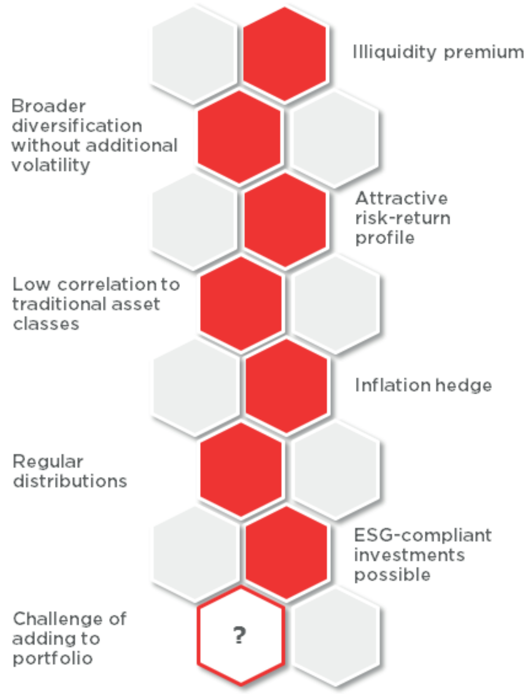
Alternative investments in strategic asset allocation

Widest possible diversification cross assets is the only protection against a multitude of economic and political imponderables. Thus, inclusion of alternative investments especially in turbulent times is trump.

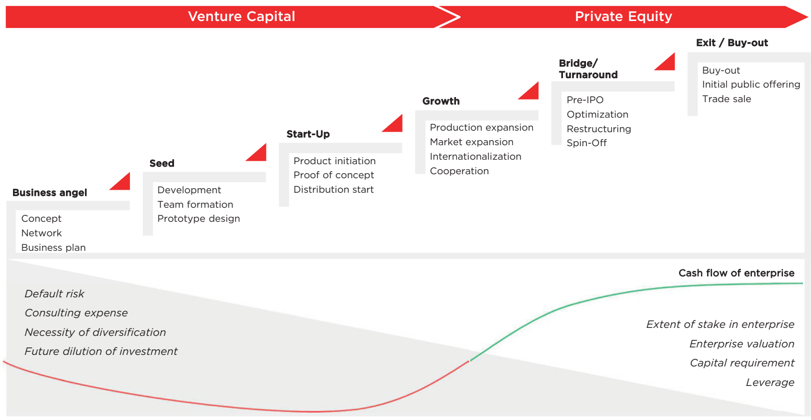
Given the high volatility in stocks and bonds coupled with drawdown risks and continuing low interest rates, portfolios of wealthy investors are now under stress. Performance in conventional asset classes this year has been correspondingly meager. A look at the typical stock and bond indexes reveals negative full-year performance. The Stoxx Europe 50 index shows a decline of more than 4 % at the end of November, and European bonds (iBoxx Euro Sovereign index) have lost more than 1.5 %. Conventional asset classes are not fulfilling their role as return drivers in the current environment. We need to add alternative asset classes to form an optimal portfolio that achieves a sufficient return and lower overall portfolio risk.

Alternative investments lead to more stabel portfolios

Various concepts and explanations are associated with alternative investments, including tangible assets, private markets, and illiquid assets. A universal definition does not exist. Our understanding includes the asset classes of real estate, private equity, infrastructure, private debt, and other opportunities (e.g., aircraft or ships). But what are the reasons for including such alternative investments in a portfolio structure? The high potential for return is one critical advantage over conventional asset classes. Their historical outperformance is based on a premium received for illiquidity and on generally difficult access to investments. The illiquidity premium describes the additional return that investors get for taking certain risks – in this case, that the underlying assets are not very marketable, if at all. Furthermore, alternative assets do not correlate much with conventional asset classes. This leads to a positive diversification effect and results in reduced total risk and/or less volatile portfolio development. Regular dividends are another important advantage. Many tangible asset investments, such as real estate, infrastructure, and private debt, are characterized by constant cash flows that ensure high distributions. This circumstance reduces future risks analogously to dividend strategies on the stock market. Finally, tangible assets are also considered a hedge against inflation for the investor.



But how to efficiently integrate this asset class into the strategic asset allocation? There are standardized, market-tested methods for implementing decisions involving stocks or bonds. Alternative investments still need to catch up in this respect. In particular, investors' different preferences and requirements regarding return expectations and risk tolerance must be considered. Investors should deal with certain questions themselves beforehand. Are they adding alternative investments with the aim of increasing returns or for diversification purpose? How long is their personal investment horizon? What value do they place on liquidity? Furthermore, we must consider that alternative investments are not a homogenous asset class, but rather their risk-return profiles are very heterogeneous. The limited liquidity and in some cases intransparency of the markets pose a special challenge to adding these assets. The step from strategic asset allocation to actual allocation involves an ramp-up phase of several years. This is due to the closed fund structures and strategies of the funds. Fund raising, drawdowns, buy-and-hold phases, and distribution yield are aspects that must be included in the implementation.



Private equity vs. public equity

After real estate, private equity ranks second worldwide among alternative asset classes in private and institutional portfolios. Such holdings are naturally related to investments in public equity, i. e., the purchase of shares in companies listed on the stock exchange. However, the differences are also the source of the attractiveness of adding them to portfolios.

Buy, change, sell – private equity's recipe for success

Stockholdings that constitute a passive minority stake allow investors to participate in the general market trend and development of specific companies. A private equity holding supplements these two return factors with a third, active element of value creation – the "alpha." Depending on the strategy, the investor generates additional value by means of operational management, targeted growth financing, corporate acquisitions, or restructuring. Forming the basis are optimization strategies developed in advance with which investors take a majority stake.

99 % – the investment universe

Hidden champions, innovation drivers, the German Mittelstand (midsized companies) – there are many notions associated with the universe of private investments, ranging from venture capital to private equity. Altogether, 99 % of all businesses in Germany belong to this asset class. Less than 1 % are listed on the stock exchange. This fact highlights the economic importance of private investments and offers investors diversification opportunities over different enterprise phases, participation strategies, and regions.

Entry barriers – opportunity for wealthy individuals

A private investment requires a multiple of the amount of capital as a stock investment. Because the business shares are not fungible, the duration of an investment may extend to five or ten years, as in the case of real estate. Investors must also manage without regular price determinations. These features are entry barriers for investors and explain why this asset class has been reserved historically for institutional investors. Like so many things in life, the disadvantages are accompanied by a positive duality. The entry barriers limit demand and open the high-return market to a select group of participants. The lack of fungibility and pricing takes volatility out of the portfolio and reduces the background noise of the investment. The closer ties and cooperation between investor and company makes for a more clear-sighted financing structure. Additional risk premiums can be received because of the long investment horizon and lower transparency. At portfolio level, the alpha component in particular results in performance that is less correlated with and superior to the conventional capital market.

The size of the private equity market has steadily increased since the financial crisis of 2008 and reached a new record level at the end of last year. This was driven by mega buy-out funds, each more than USD 4.5 billion in size. Low-interest-rate policy has created a flood of liquidity, as in other markets, which is also taking "dry powder," now in excess of USD 1 trillion, from one record level to the next. This consists of capital that has been raised but not yet allocated to future holdings. However, elevated business valuations are lowering future return expectations. The attractiveness of niche segments, including small and midsized business segments, is therefore increasing. Historically, half of all private equity funds worldwide have achieved an annual return of at least 13.5 % across all strategy specifications.

Astorius Capital Private Equity IV	
Fund	Fund of funds Private Equity
Investment focus	European small- & mid-cap target funds in growth, buy-out, and restructuring strategies
Minimum investment	EUR 200,000
Maturity outlook	About 10 years
Target yield after cost	8.00 % p.a.

* according to the product documentation of the initiator

Real estate as portfolio addition – many paths to allocation

Real estate is another important element in both institutional and private portfolios. A solid risk-return profile, diversifying characteristics, and hedge against inflation underscore the need to add this asset class. Rare agreement on this exists among investment experts. But consensus ends when it comes to the type of investment. The reason lies in the individual requirements made on capital providers. Here, investors must decide what requirement profile fits to them and what concessions they are willing to make.

Owning real estate as an investment is the most direct and costly kind of real estate allocation. The list of potential troubles is long: high planning costs, non-paying tenants, contrary co-owners, expensive property managers, etc. Furthermore, diversification across properties, types of use, regions, and tenants is hardly possible. There is no fungibility, and real estate is even tax disadvantaged as a protection against speculation.

Open real estate funds enable access even with small investment amounts to a broad real estate portfolio that is diversified over locations and tenants. This fund category is unlimited in its term. Although fund shares are regularly priced, investors can only sell them after a minimum holding time and notice period. Some providers furthermore work with cash-call and cash-stop phases to manage the raising of new money and associated purchase of properties. This mechanism protects the fund from excessive cash holdings and from the resulting reduction of returns.

KanAm Leading Cities Invest	
Fund	Open-end real estate fund
Investment focus	Individual properties in large European cities with focus on offices
Minimum investment	No minimum
Maturity outlook	Indefinite; minimum holding period of 2 years
Target yield after cost	3.00 % p.a.

* according to the product documentation of the initiator

Industria Fokus Wohnen Deutschland	
Fund	Open-end real estate fund
Investment focus	German residential real estate with low near-property addition of commercial space
Minimum investment	No minimum
Maturity outlook	Indefinite; minimum holding period of 2 years
Target yield after cost	3.00 % p.a.

* according to the product documentation of the initiator

Closed-end real estate funds are a possible type of participation for less ambitious investors. Analogous to direct real estate ownership, these funds often have to do with individual properties that offer little or no risk spreading. The investment horizon is about ten years, and the minimum amount is EUR 10,000. Property management and rental operation are outsourced, thus reducing current expense for investors. This type of investment offers performance that is largely independent of the stock market.

Patrizia GrundInvest Berlin Landsberger Allee	
Fund	Closed-end real estate fund
Investment focus	A building ensemble with diverse types of use in Prenzlauer Berg, Berlin
Minimum investment	EUR 10,000
Term forecast	About 10 years
Return forecast after costs	4.00 % p.a.

* according to the product documentation of the initiator

Investors with a shorter investment horizon who value daily liquidity and are willing to make concessions in the form of a high correlation with the stock market resort to **real estate investment trusts (REITs)**. These publicly traded real estate companies are obligated to distribute their income to investors regularly. Unlike any other form of real estate investment, they are listed stock companies and hence subject to the ups and downs of the capital market. So, here, market dependence is accepted for the sake of fungibility.

Conclusion: Real estate is per se not fungible and has a long investment horizon. The structuring forms described above cannot entirely mask these inherent features. Every compromise, particularly regarding tradability and investment duration, poses risks.

Private debt

Since the financial crisis of 2008, banks have increasingly withdrawn from the business of commercial lending and have left a financing gap. The solution to this problem is called private debt and is another interesting asset class for investors. But what exactly is private debt? It is defined as the provision of privately placed external financing instruments primarily by institutional investors outside the capital market. Private debt comprises five different credit strategies: direct lending, mezzanine, distressed debt, venture debt, and special situations. The focus is on direct lending, which involves directly providing external capital to an enterprise. The main financing providers are funds. Typically, there is no central underwriting by a syndicating bank, but rather the credit is extended directly by the fund manager to the enterprise. These are mostly owner-operated, midsized companies with sales between EUR 100 million and EUR 2 billion. The financing terms are negotiated directly between the fund manager and the company, resulting in flexible structuring arrangements.

Financing in this sector largely takes place in the framework of private equity transactions. The companies are often owned by a private equity fund, which again decreases the risk of default. In practice, the direct lending asset class is thus characterized by low default risk and a high recovery ratio. However, it should be noted that the private debt asset class has fallen victim to its own success. Since more and more capital is flowing into this sector and unused liquidity needs to be invested, there is competition for the attractive investments, which weakens the negotiating position of the lender. Conversely, the risks for investors increase.

Infrastructure – a heterogeneous asset class

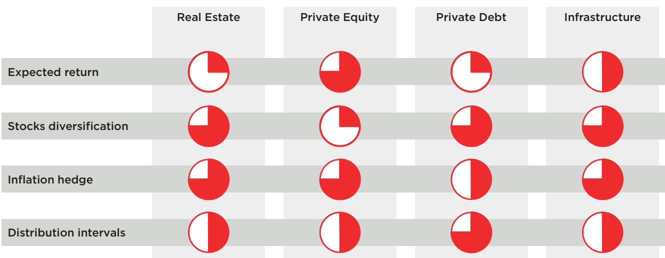
Infrastructure is an important and often essential basis for our modern life, yet this asset class is a comparatively new investment possibility. Until a few years ago, most infrastructure investments were financed by government institutions, particularly in Europe.

Now, the market has changed both on the supply side, e.g., due to declining government spending, and on the demand side, promoted by pressure to invest. The long-term need to invest thus meets the long-term need of financing for infrastructure projects.

How is infrastructure defined in this context? Investors participate in projects or their financing that serve to build, operate, and maintain infrastructure. A distinction is made here between the greenfield and brownfield segments. Greenfield projects are infrastructure investments in development including the phases of initial project planning to project realization to commissioning. Investments are possible by way of equity investments in the form of project development companies or by way of external financing instruments. However, greenfield investments are characterized by increased risks including, for example, construction and completion risks. Brownfield infrastructure investments are already completed. Investor capital is used for administration, operation, and maintenance.

Infrastrukture sectors	
Energy generation	Renewable energy and conventional electricity generation
Utilities	Water supply, power grids
Transportation	Airports, roads, harbours, railway
Social infrastructure	Hospitals, care facilities, schools

The concept of infrastructure is difficult to define because it subsumes different sectors, but investors find broad diversification even within the asset class for the same reason. The other special aspects and properties of infrastructure include current, stable cash flows, which often lead to a constant current return. Other features are high market entry barriers and limited competitive intensity in many infrastructure markets, whether due to the nature of the investment itself (e.g., in the form of natural monopolies) or due to government regulatory measures or concession agreements.



Because of the relatively low volatility of infrastructure investments and their below-average correlation with conventional asset classes, an investment in this class can be an important component in optimizing investor portfolios. However, there are also substantial hurdles and risks here, such as access to the investments or high planning, construction, or operator risks. Investors whose strategy is compatible with these features may broaden their portfolios by adding infrastructure investments, another attractive asset class.

Adding alternative investments to an existing portfolio is a demanding undertaking. A resource-intensive selection of investments on the market is necessary to separate the wheat from the chaff. We recommend diversification over different assets classes and different investment strategies in each.

/ Dustin Reichelt

Alternative investments

/ Charlotte Höntschke

Alternative investments

M.M.Warburg & CO is expanding internationally!

While the Warburg family has always maintained a very strong international network, the activities of the Bank have, for some time, mainly concentrated on German domestic business. Nevertheless, Jörn Voderberg has been in charge of the business with high net worth international clients for quite some time. In mid-2016 Jens Dose and Christian Speer joined M.M.Warburg & CO with a team of experienced shipping bankers in order to expand the international business.

Jens and Christian: Why did you join M.M. Warburg & CO in mid-2016?

Jens Dose: Combined, Christian and I have about 40 years of experience in serving international shipping clients . We all see more and more banks withdrawing from the field of ship banking in the wider sense either by reducing their finance activities or simply putting an increasing number of restraints on running normal operational accounts for shipping companies. There is no continuation of traditional business models. As Christian and I increasingly realized this some four or five years ago, we thought it was the right time to continue doing what we do best: Servicing the shipping industry with a strong dedication and commitment to long-standing clients.

Christian Speer: In our initial discussions with the management of Warburg there was a common understanding that we wanted to combine our strengths: Warburg's knowledge in shipping and an excellent brand built up over 220 years in combination with our network in the international shipping markets. Hiring a whole team during the deepest crisis in shipping is proof of the long-term commitment of the owners and, within Warburg, we have a platform which allows us to do what we like most: Shipping!

Jörn – what was your initial thought when you learned that a team with an international approach was joining Warburg?

Jörn Voderberg: Immediately I was enthusiastic about this idea. I do agree that Warburg is indeed a name with an excellent reputation, so why not give this name a more international approach. And from the perspective of private wealth management the international shipping industry is a most interesting area. We love the idea of supporting entrepreneurs from one source, both for corporate as well as private matters. So we have travelled together quite a lot over the last 2½ years. Christian and Jens delivered on their promise: within 2 to 3 years the shipping world outside Germany would be familiar with the Warburg Bank again as an important player in the market. Our profile has definitely become more international and more recognizable beyond German borders.

From left to right: Christian Speer (Joint Head Global Shipping), Jörn Voderberg (Head of International Private Wealth Management), Jens Dose (Joint Head Global Shipping)

What has been achieved, from your perspective, over this period?

Jens Dose: Considering that we were a start-up less than three years ago, we are more than happy that all our plans and expectations have not only been met but even exceeded by far. Among other achievements, we have been able to set up a completely new, state-of-the-art online banking system. However, technology is just one aspect. Most important is the personal service provided by our highly motivated team. As a result, we have been able to build up a substantial client portfolio, mainly serving cash management needs. We are one of only a few banks left offering these services to the shipping industry with a knowledgeable team and we see a growing demand.

Christian Speer: We have also started to build up a very conservative ship finance book which is slowly growing. Asset-based lending with low loan-to-value ratios, positive cash flows and excellent counterparties: We can prove that lending to the shipping industry can be a very healthy business. Nevertheless we have to say, that these days Warburg's DNA is more towards services. Any lending should be able to generate some side business where we can offer additional value. Recently, we also extended our FX team with an experienced FX expert who has dealt with many shipping clients in the past.

Jörn Voderberg: I believe that all three of us enjoy very much what we do. Clients do see and appreciate this. Still, banking is a people business and we have been able to introduce our networks to one another for mutual benefit. Warburg is, in our view, the ideal bank to provide banking services: located in one of the most stable economies in the eurozone and equipped with a conservative, family-run business model. This combination provides an ideal basis for excellent service as well as a stable outlook. Especially for the shipping industry, stability is one of the cornerstones of the industry.

But what comes next after initiating these major changes within Warburg?

Christian Speer: We have ambitious goals to become the prime contact for the demands of our valued maritime friends. Next to the traditional balance sheet lending we are also benefiting from our network within the institutional world of financiers. This means that we have set up a debt fund to allow close friends of the Warburg Group to co-invest in our conservative loans. The return/risk aspect is quite interesting for semi- and institutional investors to increase returns through alternative investments in a formerly overleveraged asset class.

Jens Dose: Indeed, but alongside this model we also combined our internal forces on the servicing and loan administration levels, comparable to gear-wheels which lock into each other. This enables us, besides having all decision-makers under one roof, to be fast and efficient in getting "deals" done.

Jörn Voderberg: And this, again, is recognizable in the positive response, either directly from the clients or their active introduction to new contacts who were used to this kind of service which somehow became unattractive in the last number of years.

You seem to be enjoying what may be just work for others!

Jens Dose: We most certainly do! As stated before, Warburg is our platform which allows us to do what we do best: Shipping!

Christian Speer: I can't agree more, and our clients, hopefully, feel the positive attitude towards the industry.

Jörn Voderberg: The addition of Jens, Christian and their skilled colleagues has added a great amount of value to the visibility of M.M.Warburg in the international scope of service.

I trust there will be many good and interesting years ahead.

Thank you for the refreshing and positive Interview.

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