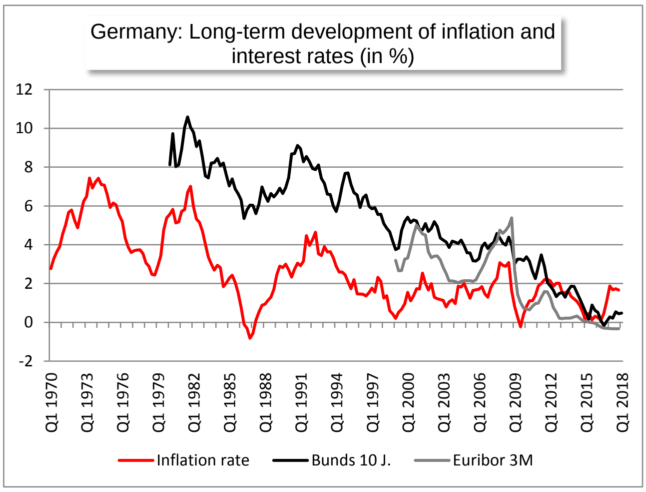
ECONOMIC SITUATION AND STRATEGY

Low interest rates: Calm before the storm or here to stay?

The German economy is booming. According to an initial estimate by the Federal Statistical Office (Statistisches Bundesamt), gross domestic product (GDP) grew in 2017 by a very respectable 2.2% and thus more strongly than at any time since the recovery phase in 2011. Given that an above-average number of holidays reduced working time last year, the growth rate was actually a stronger 2.5%. However, despite the buoyant mood in Europe's largest national economy, key interest rates in the region are still at a record low and are likely to stay there until well into 2019. Moreover, long-term market interest rates, as measured by 10-year German government bonds (Bunds), are only about 0.5%.

Is this surprising interest rate development only the calm before the storm? Theoretically, an economic upswing accompanied by ultra-expansionary monetary policy should eventually lead to increasing inflation and hence to higher interest rates. At some point, the glut of central bank money created by the huge bond purchase programs would finally make itself felt. Rising prices for real estate and other assets might herald a big wave of inflation that is subtly, but inexorably rolling towards us. Ultimately, the European Central Bank would have to counter on a massive scale with higher key interest rates. The dramatic consequence could be stagflation, i.e., simultaneous depreciation of money and economic crisis.

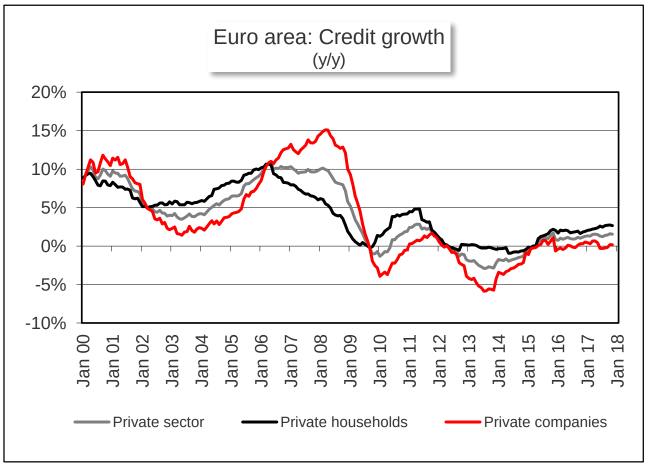
But contrary to initial intuition, there are good reasons to believe that inflation will remain low in the long term despite the economic boom and the glut of money. In other words, there is evidence that the long-term trend towards ever-lower inflation will continue and there will not be a "mean reversion," i.e., a return to the long-term average.



The principal reason is demographics. In many European states, the potential sales market is shrinking due to low birth rates and a dwindling population. Furthermore, the aging of society is contributing even more to a decline of demand in all the national economies. Experience shows that older people have significantly lower consumer needs than young members of society. The consequence is a continuously contracting domestic market. For business, this accordingly leads to lower production quantities and capacity downsizing instead of investments in expansion.

Although this trend has been going on for some time, it was partly offset in the 1990s by the new markets in Eastern Europe and in the 2000s by the integration of China, India, and other emerging countries in global trade. But this situation is abating for three reasons. First, growth rates in emerging countries are declining slowly but steadily. Second, the dismantling of trade barriers has slowed noticeably and in some cases has even given way to the opposite. Third, businesses are increasingly switching to local production directly in their sales markets.

Consequently, the propensity of companies to build new factories or expand existing capacities in Europe is diminishing. Instead, at most, the less capital-intensive services sector is still growing, with its share of value addition continuing to increase. The result is lower demand for credit. Despite the booming economy, the amount of credit extended to businesses in the euro zone is only rising at a meager rate of 0.2%. The lower credit demand coincides with restraint on the supply side. Tightened administrative regulation and increased capital requirements are causing financial institutions to price credit conditions and grant loans less aggressively than they have in similar cyclical phases in the past. Weaker credit growth is the price of more crisis-resistant banks.

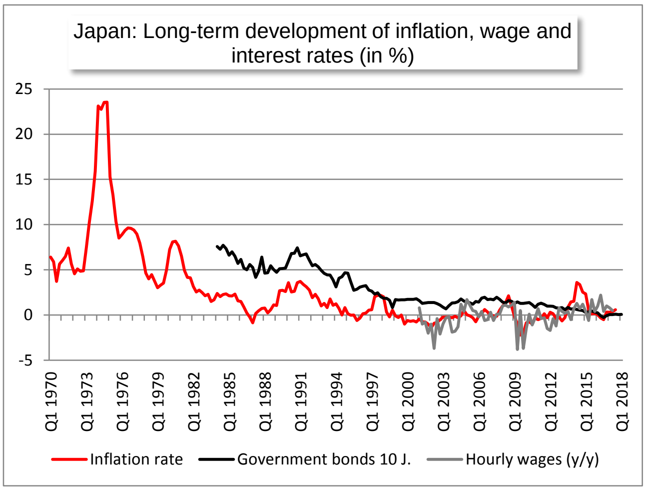


The low level of lending is increasingly impeding the flow of money. A loan leads to roughly an eight-fold increase of the money supply by way of the money creation mechanism. That is, in return for a loan, goods and services are purchased and the seller deposits the proceeds at the bank, which then grants a new loan on the basis of the additional deposits, so the flow continues. Like other central banks before it, the European Central Bank (ECB) is trying to offset the current impediment by directly injecting liquidity into the market through the purchase of bonds. Its action has proven correct inasmuch as deflation has been successfully prevented in the near term. But it is also intensifying the problem in the medium to long term. For, the additional liquidity eventually arrives at businesses and households in the form of sight deposits. However, anyone who has a great deal of cash has less need of credit and that further disrupts the money creation mechanism. Normally, the high cash positions of businesses should eventually be used for capital investments. But with consumer demand shrinking in the domestic market, the capital investment incentives are low. So, this essentially explains where all the money is that is being pumped into the market. It is not trickling through, but is displacing other money. Economist John Maynard Keynes already recognized this danger and described it as a liquidity trap.

The described mechanism explains why there has been no money glut. Nevertheless, rising wages in a booming economy with record employment could set an inflationary trend in motion. But there is also little evidence for that at present. What are the reasons for the inert development of wages? For one thing, labor unions apparently have less power than in the past. The declining number of workers and lower propensity to organize among young people have caused union membership to fall both in absolute terms and relative to total employment. Furthermore, it seems members are becoming more interested in more flexible working time and other non-financial workplace improvements. Finally, since the financial crisis experience, workers seem to give greater preference to job security compared with wage increases.

However, the greatest impact on wage development probably comes from globalization. Companies today are much more able to react to changes of labor costs in an economy by moving production to other countries. Organized only nationally, the unions stand against internationally operating corporate groups. This trend is visible worldwide and is not likely to be reversible.

Japan is a good example of how difficult it can be to come back out of a low interest rate environment. Despite huge bond and stock purchases, very expansionary fiscal policy, and growing pressure on unions and companies to make collective bargaining agreements with higher wages, reflation efforts have only succeeded to a limited extent. It is rather very probable that Japan will slide back into deflation in the next recession, if not sooner. There, too, an aging and shrinking population is the main cause of this development. Although Japanese companies are doing very well on the whole, they are investing less and less at home. Over many years, the unions have made agreements with companies that provide no increase in nominal wages.



Now, the aspects of demographics and mentality are still somewhat more pronounced in Japan than in Europe. However, the parallels in the trends, which come to Europe at a time lag, should also not be underestimated.

These considerations give rise to several long-term recommendations for investors. First, they should be less concerned about rising inflation rates and interest rates than the widespread worry about this in the German public. Second, they should consider what investments have been successful in Japan in the past 10-15 years. Third, they must use phases in which this long-term trend is eclipsed by short-term countermovements for bold investment decisions.

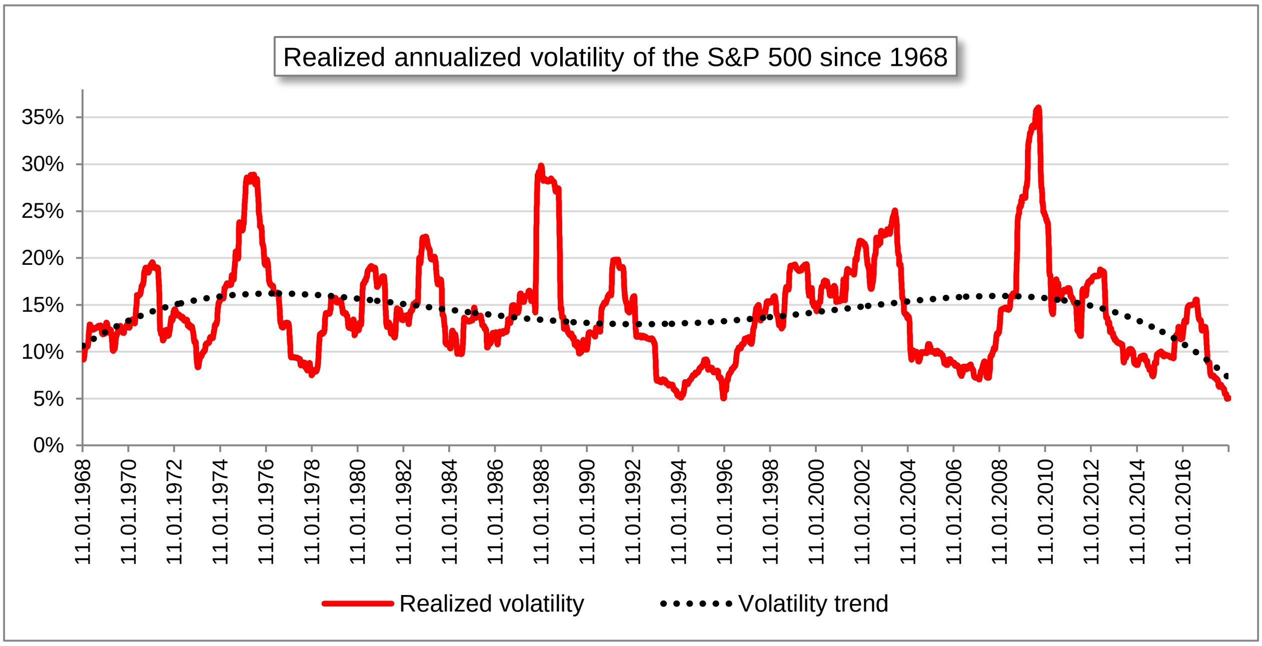
Concretely, this means boldly investing in long bonds at the moment long-term interest rates surprisingly advance. Even a return of over 0.5% on 10-year Bunds can ultimately pay off. In high phases of the business cycle, duration should be expanded boldly and successively to an above-average length. Stock ratios should be strategically increased. A consistent tactical allocation can yield considerable additional benefits, but stock ratios persistently kept too low will cause the most damage. Long-term real estate investments should aim for top locations in the most popular major cities. Residential properties are better than commercial in an aging population with a smaller workforce. Logistics are still more heavily affected by lower capital investment activity, and the retail trade is additionally under pressure from the trend towards online shopping. Investments should focus on growth fields, since total revenue is likely to stagnate. Among the sectors, those that suffer from low interest rates, like banks and insurance companies, should generally be underweighted, while technology and some parts of the industrial sector should be overweighted. Preference should be given to companies oriented to emerging markets.

Weekly outlook for January 15-19, 2018

	July	Aug.	Sept.	Oct.	Nov.	Dec.	Release
DE: Consumer prices, m/m - final	0.4%	0.1%	0.1%	0.0%	0.3%	0.6%	January 16
DE: Consumer prices, y/y - final	1.7%	1.8%	1.8%	1.6%	1.8%	1.7%	January 16
DE: Producer prices, m/m	0.2%	0.2%	0.3%	0.3%	0.1%	0.3%	January 19
DE: Producer prices, y/y	2.3%	2.6%	3.1%	2.7%	2.5%	2.4%	January 19
EUR19: Consumer prices, y/y - final	1.3%	1.5%	1.5%	1.4%	1.5%	1.4%	January 17
EUR19: Core inflation rate, y/y - final	1.2%	1.2%	1.1%	0.9%	0.9%	1.1%	January 17

MMWB estimates in red

Chart of the Week: Volatility well below trend



The US stock market is an extremely mature market with a long history. It therefore makes sense to base one's analyses always on US data when attempting a historical classification of current data. For precisely this reason, we have considered the last 50 years of the S&P 500 in our Chart of the Week to determine the extent to which the low volatility of stocks now "felt" is a historical outlier. After all, it is not only that stocks in the United States have been moving almost vertically for a year and no significant correction has been observed in that time. There is also an unerring measurement used to determine the range of stock price fluctuation. It is called volatility and results mathematically from the standard deviation of price fluctuations. The average volatility and hence range of price fluctuation for the S&P 500 in the last 50 years has been 14.2%, and the median of all data points has been 13.3%. However, the volatility in the S&P 500 as we calculate it (annualized standard deviation of daily moving monthly rates over a year) fell below 5% some days ago and thus marked the lowest level of realized volatility in the last 50 years. The number now stands at 5.1%. In the past, there have been only two other very short periods of a few days in which volatility was similarly low. Undoubtedly, the current level may be classified statistically as a complete outlier. However, there are some good ways of explaining this economically. Fundamental data have not only been remarkably good for some time now, but exhibit a very stable positive trend. They are also more homogenous than usual worldwide such that no big crisis is looming in any major national economy. But even if one takes that into account, such a low level of volatility is not likely to be sustainable. If it were, some textbooks would actually have to be rewritten, and that is unlikely. On the other hand, rising volatility is not necessarily bad. More volatility gives stock prices greater latitude to have "a life of their own" and thus increases the potential of outperformance for active investors. However, since higher volatility is also accompanied by more significant corrections, strategists may be called on this year to look for a good time to reduce the stock ratio. That time has not come yet, since the fundamental data do not indicate that the cyclical high point has been reached.

Stock marktes	As of 12.01.2018 13:35	Change versus 04.01.2018 -1 week	08.12.2017 -1 month	10.10.2017 -3 months	29.12.2017 YTD
Dow Jones	25575	2,0%	5,1%	12,0%	3,5%
S&P 500	2768	1,6%	4,4%	8,5%	3,5%
Nasdaq	7154	1,1%	4,6%	8,6%	3,6%
DAX	13213	0,3%	0,4%	2,0%	2,3%
MDAX	26900	0,6%	2,8%	4,2%	2,7%
TecDAX	2650	1,1%	5,4%	6,1%	4,8%
EuroStoxx 50	3605	1,0%	0,4%	0,2%	2,9%
Stoxx 50	3236	1,0%	1,9%	1,3%	1,8%
SMI (Swiss Market Index)	9532	0,2%	2,3%	2,9%	1,6%
Nikkei 225	23654	0,6%	3,7%	13,6%	3,9%
Brasilien BOVESPA	78861	0,3%	8,4%	2,6%	3,2%
Russland RTS	1252	3,2%	11,9%	10,4%	8,5%
Indien BSE 30	34592	1,8%	4,0%	8,4%	1,6%
China Shanghai Composite	3429	1,3%	4,2%	1,4%	3,7%
MSCI Welt (in €)	2172	0,9%	1,4%	4,5%	2,1%
MSCI Emerging Markets (in €)	1197	-0,1%	4,4%	4,7%	2,2%
Bond markets					
Bund-Future	163,14	155	-34	166	146
Bobl-Future	131,06	-56	-153	-22	-55
Schatz-Future	111,85	-10	-34	-30	-12
3 Monats Euribor	-0,33	0	0	0	0
3M Euribor Future, Dec 2017	-0,23	2	5	-2	0
3 Monats $ Libor	1,70	0	16	35	1
Fed Funds Future, Dec 2017	1,29	-63	-52	-34	-1
10 year US Treasuries	2,55	10	17	21	14
10 year Bunds	0,52	8	21	7	9
10 year JGB	0,07	2	4	2	3
10 year Swiss Government	0,00	16	16	5	13
US Treas 10Y Performance	574,93	-0,8%	-1,2%	-1,2%	-1,1%
Bund 10Y Performance	607,52	-0,4%	-1,6%	-0,2%	-0,5%
REX Performance Index	478,50	-0,4%	-1,2%	-0,8%	-0,5%
US mortgage rate	0,00	0	0	0	0
IBOXX AA, €	0,68	0	14	-7	0
IBOXX BBB, €	1,20	0	10	-8	-3
ML US High Yield	6,12	5	-7	14	-3
JPM EMBI+, Index	832	-0,6%	-0,1%	-0,7%	-0,5%
Convertible Bonds, Exane 25	7479	-0,1%	1,2%	3,0%	1,1%
Commodities					
CRB Spot Index	441,15	1,0%	2,3%	3,1%	2,0%
MG Base Metal Index	358,69	-1,0%	8,9%	5,0%	0,0%
Crude oil Brent	68,92	1,3%	8,8%	21,3%	3,5%
Gold	1331,79	1,1%	6,7%	3,0%	2,2%
Silver	16,97	-1,3%	7,7%	-1,2%	-0,2%
Aluminium	2167,25	-3,0%	8,8%	1,4%	-3,9%
Copper	7112,75	-0,5%	8,8%	6,1%	-1,3%
Iron ore	76,15	2,1%	11,2%	26,5%	6,8%
Freight rates Baltic Dry Index	1303	-2,8%	-23,4%	-8,1%	-4,6%
Currencies					
EUR/ USD	1,2124	0,5%	3,3%	2,8%	1,1%
EUR/ GBP	0,8894	-0,2%	1,2%	-0,5%	0,2%
EUR/ JPY	134,77	-0,8%	1,1%	1,7%	-0,2%
EUR/ CHF	1,1775	0,1%	0,6%	2,2%	0,6%
USD/ CNY	6,4591	-0,6%	-2,4%	-1,8%	-0,7%
USD/ JPY	111,44	-1,2%	-1,8%	-0,9%	-1,1%
USD/ GBP	0,73	-0,6%	-1,8%	-3,0%	-0,7%

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