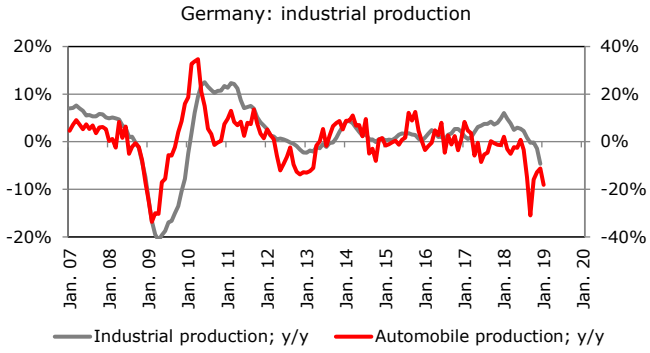
M.M.WARBURG & CO
BANK

ECONOMIC SITUATION AND STRATEGY January 11, 2019

Germany on the verge of recession

The German economy's descent continues. The data released this week signal that the negative third-quarter growth rate was not a mere outlier. Above all, the significant decline of industrial production in November by 1.9% – the third negative change in a row – could mean that real GDP fell again slightly in the fourth quarter. With two consecutive quarters of negative growth rates, what was recently still unthinkable would occur, i.e., the technical criterion for a recession would be fulfilled. Although it would be a very mild recession, that would be little consolation.



Especially in the manufacturing sector, which still plays a much more important role in the German economy than in other countries, companies are changing from the fast lane to the slow at breakneck speed. The automobile industry is a very clear example of this. The diesel emissions scandal, driving bans, and especially the problem of converting to the new Worldwide Harmonized Light Vehicle Test Procedure (WLTP) have had a substantial impact there. Hopes that third-quarter production losses could be made up quickly have not been realized. Although more vehicles came off the assembly line in the period from September to November than in the very weak summer months, automobile production dropped sharply in December and was consequently down at year's end by a significantly double-digit percentage.

The situation is not much better in the chemical industry, where production is almost 10% below its year-earlier level. One may point to some special factors contributing to this weak development. The critically low level of the Rhine River has played role, as has a lower number of production days due to the timing of holidays relative the weekend, which has negatively affected the chemical industry and all other sectors. The increase of uncertainty due to political chaos observed in 2018 might also prove to be temporary. Nevertheless, special factors alone cannot explain the economic slump of the past 12 months. Finally, we do not know if 2019 will bring further extreme weather events as in 2018 or if political developments will take a different, more reasonable path and soon dispel the uncertainties of businesses and consumers.

Next Tuesday morning at 10:00 (CET), the Federal Statistical Office will publish the figures for Germany's 2018 national accounts and gross domestic product. To meet our growth rate forecast of 1.5%, growth in the final quarter will have to have increased by at least 0.1% compared with the previous three months. Somewhat better consumer spending and higher government consumption could result in this number's being reached and thus narrowly avert a technical recession. But much more than that is probably not to be expected. Since we have so far expected stronger growth of 1.1% for 2019,

we would have to adjust our forecast further downward in that case to somewhere near 0.5%.

Forecasts of growth in 2019 will probably prove too optimistic not only for Germany (average expected growth rate according to Consensus Economics: 1.5%) but also for many other countries, if global leading indicators do not stabilize or recover very soon. But that is still not in sight. For that reason, the World Bank has just lowered its growth forecasts for 2019 and 2020 slightly, because all major engines of growth – the United States, China, and the euro zone – are starting to sputter at the same time. The United States has so far managed largely to avoid the economic slowdown, but in December the manufacturing purchasing manager index (PMI) registered the largest drop since the financial crisis of 2008, and that got attention.

What does this mean for the stock markets? Since most major indexes are now off their peaks by up to 25%, prices have already discounted a good deal of the growth slowdown. Analysts have lowered their earnings forecasts, and market valuations have become significantly cheaper. The price-earnings ratio based on current earnings expectations for the coming 12 months is about 11 for the DAX index of German blue chips, and 14.5 for the S&P 500. That is significantly cheaper than a year ago, when their respective valuations were just over 13 and 18. This makes US stocks about as expensive as on average of the past three decades, excluding the dot-com bubble, and the DAX is even about 10% cheaper. That is also the reason for the price recovery from the beginning of year onward, which happened despite poor economic data and some seriously negative noises from the corporate side (including Apple, FedEx, Samsung, and LG). For this upward tendency to prove sustainable, the world economy must regain its footing. Otherwise, the downward adjustment of earnings expectations so far will not be sufficient. Although analysts have already corrected their forecasts for 2019 and 2020, earnings growth rates of about 10% for the coming two years are still expected in the case of many indexes.

For example, after a roughly 5% decline last year, earnings growth of about 10% is expected for the DAX this year, and about 9% next year. As long as major leading indicators like the Ifo business climate index or the PMIs do not stop falling, that is probably too optimistic and the inevitable result will be further reduction of profit expectations. If the economic picture does not brighten, DAX earnings could decline again in 2019. However, it need not come to that.

First signs of progress are emerging in the attempt to settle the US-China trade dispute. Even though Donald Trump is not known for his ability to compromise, the US stock market's price slump and partly weaker economic data should also increase pressure on the United States to resolve the conflict. Moreover, a vote will be taken next week in Great Britain on the Brexit deal that Prime Minister Theresa May has negotiated with the European Union. If the British parliament should not approve, which is what we expect, the cards could be reshuffled. Besides a hard Brexit, which would harm both the economy and the stock market, there is the possibility of new elections and/or a new referendum. Though still very unlikely, a cancellation of Brexit would probably cause a spectacular rise of stock prices, since it would dispel a great deal of uncertainty.

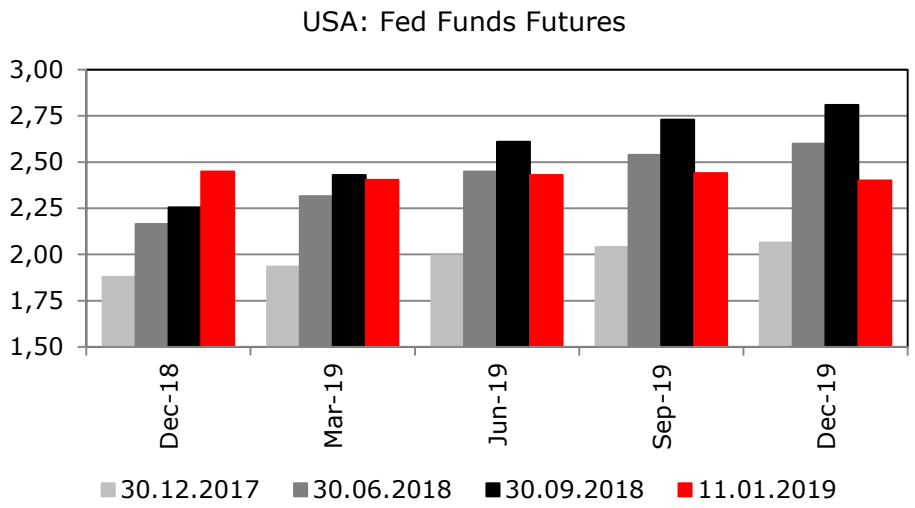
However, as long as the political issues are not resolved and macroeconomic indicators still seem to be worsening, we continue to urge caution regarding stocks. We think it will take some time for market buoyancy to return for the longer term.

Weekly Outlook for January 14-18, 2019

	July	Aug.	Sept.	Oct.	Nov.	Dec.	Release
DE: Consumer prices, m/m - final	0.3%	0.1%	0.4%	0.2%	0.1%	0.1%	January 16
DE: Consumer prices, y/y- final	2.0%	2.0%	2.3%	2.5%	2.3%	1.7%	January 16
DE: Core inflation rate, y/y - final	1.4%	1.3%	1.5%	1.7%	1.5%	1.0%	January 16
EUR19: Industrial production, m/m	-0.6%	1.2%	-0.6%	0.2%	-0.2%		January 14
EUR19: Industrial production, y/y	0.7%	1.0%	0.7%	1.0%	-1.0%		January 14
EUR19: Consumer prices, y/y - final	2.1%	2.0%	2.1%	2.2%	1.9%	1.6%	January 17
EUR19: Core inflation rate, y/y - final	1.1%	0.9%	0.9%	1.1%	1.0%	1.0%	January 17

MMWB estimates in red

Chart of the Week: Fed somewhat more dovish



The central bank of the United States raised its key interest rate by 0.25 percentage points to a target range of 2.25-2.5% in December despite criticism from President Donald Trump. This was the fourth increase in 2018 and the ninth since policy normalization began at the end of 2015. At the same time, it reduced the interest rate hikes planned for 2019 from four to two. While the market still rated the lower number hawkish given the weaker outlook for the US economy, the nervously awaited minutes of the Federal Open Market Committee's meeting now show that the FOMC is somewhat more dovish than initially assumed. The minutes make clear that there were also votes to put raising interest rates on hold. According to some FOMC members, the central bank could "afford to be more patient" and give greater attention to risk factors such as a possible trade war escalation or global economic downswing. Increased volatility on the financial markets and the effects of previous rate hikes on the US economy remained among the topics discussed in the minutes. Sectors sensitive to interest rates such as the US housing market are already sending negative signals. The minutes and current comments thus suggest that there will be neither further interest rate steps nor a final date for hikes toward the neutral corridor in the coming months. A look at fed funds futures reveals that on average the capital market actually expects a reduction of the key interest rate sometime this year. While the Fed is still in the process of finding its stance, the market view is unambiguous.

Market Data Overview

Stock marktes	As of 11.01.2019 13:15	Change versus 04.01.2019 -1 week	10.12.2018 -1 month	10.10.2018 -3 months	10.01.2018 -1 year	31.12.2018 YTD
Dow Jones	24002	2,4%	-1,7%	-6,2%	-5,4%	2,9%
S&P 500	2597	2,6%	-1,6%	-6,8%	-5,5%	3,6%
Nasdaq	6986	3,7%	-0,5%	-5,9%	-2,3%	5,3%
DAX	10859	0,9%	2,2%	-7,3%	-18,2%	2,8%
MDAX	22620	2,6%	2,5%	-6,3%	-16,1%	4,8%
TecDAX	2519	2,0%	1,5%	-1,4%	-4,9%	2,8%
EuroStoxx 50	3070	0,9%	1,8%	-6,0%	-15,0%	2,3%
Stoxx 50	2830	0,6%	1,7%	-5,1%	-12,8%	2,5%
SMI (Swiss Market Index)	8840	2,7%	3,4%	-0,6%	-7,2%	4,9%
Nikkei 225	20360	4,1%	-4,1%	-13,4%	-14,4%	1,7%
Brasilien BOVESPA	93806	2,1%	9,2%	12,1%	20,0%	6,7%
Russland RTS	1149	2,8%	1,1%	0,5%	-6,9%	7,8%
Indien BSE 30	36010	0,9%	3,0%	3,6%	4,6%	-0,2%
China Shanghai Composite	2554	1,5%	-1,2%	-6,3%	-25,4%	2,4%
MSCI Welt (in €)	1958	1,7%	-0,7%	-6,5%	-5,8%	3,2%
MSCI Emerging Markets (in €)	999	2,3%	2,8%	1,0%	-13,3%	2,7%
Bond markets						
Bund-Future	164,21	24	81	633	314	67
Bobl-Future	132,74	4	48	225	118	22
Schatz-Future	111,92	-2	7	14	-5	-2
3 Monats Euribor	-0,31	0	1	1	2	0
3M Euribor Future, Dec 2017	-0,23	1	-3	-17	-31	0
3 Monats $ Libor	2,80	0	2	37	109	-1
Fed Funds Future, Dec 2017	2,41	6	-16	-50	25	0
10 year US Treasuries	2,72	6	-14	-46	16	3
10 year Bunds	0,19	-2	-5	-36	-29	-5
10 year JGB	0,02	5	-2	-14	-7	2
10 year Swiss Government	-0,17	10	-2	-28	-6	7
US Treas 10Y Performance	580,58	-0,3%	2,0%	5,5%	1,0%	0,0%
Bund 10Y Performance	630,14	0,1%	0,4%	3,5%	4,3%	0,5%
REX Performance Index	489,49	0,2%	0,4%	1,8%	2,0%	0,4%
US mortgage rate	0,00	0	0	0	0	0
IBOXX AA, €	0,92	2	1	2	24	4
IBOXX BBB, €	2,11	0	-2	32	91	5
ML US High Yield	7,34	-38	-16	55	122	-67
JPM EMBI+, Index	809	0,6%	3,1%	3,6%	-2,8%	2,1%
Convertible Bonds, Exane 25	6944	0,0%	0,3%	-3,7%	-7,2%	0,7%
Commodities						
CRB Spot Index	411,00	-0,5%	-1,6%	-1,4%	-6,8%	0,4%
MG Base Metal Index	294,77	1,0%	-2,8%	-6,3%	-17,8%	0,0%
Crude oil Brent	61,80	8,6%	1,4%	-26,1%	-10,7%	16,3%
Gold	1292,94	0,8%	3,7%	8,9%	-2,0%	0,9%
Silver	15,66	-0,6%	7,3%	9,4%	-7,7%	1,0%
Aluminium	1841,00	-1,5%	-4,5%	-9,8%	-15,1%	-1,2%
Copper	5907,75	0,2%	-3,0%	-5,5%	-16,9%	-0,7%
Iron ore	73,98	1,2%	11,2%	5,1%	-4,4%	6,9%
Freight rates Baltic Dry Index	1189	-5,6%	-14,2%	-20,4%	-13,0%	-6,5%
Currencies						
EUR/ USD	1,1531	1,1%	0,9%	0,3%	-3,8%	0,7%
EUR/ GBP	0,8996	0,3%	-0,9%	3,0%	1,6%	0,2%
EUR/ JPY	124,82	1,3%	-3,1%	-4,2%	-6,6%	-0,8%
EUR/ CHF	1,1329	0,6%	0,3%	-0,7%	-3,4%	0,5%
USD/ CNY	6,7422	-1,9%	-2,5%	-2,6%	3,6%	-1,9%
USD/ JPY	108,43	-0,1%	-4,3%	-3,4%	-2,7%	-1,0%
USD/ GBP	0,78	-0,7%	-2,2%	3,0%	5,6%	-0,6%

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