M.M.WARBURG & CO
BANK

ECONOMIC SITUATION AND STRATEGY January 18, 2019

Brexit, shutdown, yellow vests, and recession fear: Reasons to turn away from the capital market?

Imagine that Germany's center-right political party (CDU/CSU) held a referendum to see whether Germans want to leave the European Union, and the exit supporters narrowly won the referendum. The ensuing negotiations with Brussels are then conducted so amateurishly as to resemble a second-rate farce. Ultimately, the negotiations reach a result at the last minute that still appears acceptable enough to all parties under the circumstances. The draft agreement comes up for a vote in the German parliament. Only about two-thirds of the CDU/CSU members vote for the agreement, and almost all others (including those of all other parties) vote against it. And they do so not because they would rather remain in the European Union, but because they think the European Union's concessions regarding the modalities are not sufficient. In the wake of this rejection, anything is possible: A new referendum, a constitutional crisis, an extension of the deadline for negotiations with the European Union, staying in the European Union involuntarily due to unclear legal issues, or complete chaos (the most likely outcome). That sounds crazy, but it is exactly what has happened in Great Britain, and – to put it mildly – it does not cast a positive light on the quality of British politics.

However, the quality of politics in many other countries is not much better. In the United States, employment will decline in monthly comparison for the first time in 99 months. And that is not because the economy is flagging, but because a considerable number of federal employees can no longer go to work due to the government shutdown. Thanks to buoyant tax revenue, the shutdown would not be necessary at all, but it is rather part of Trump's attempt to extort money from the Democrats for the construction of a wall on the Mexican border. One should be able to expect more reasonable behavior from adults.

That also applies to the behavior of the yellow vests in France, who have raised an almost revolutionary fervor in the country. Moreover, their conduct demonstrates that they do not have much respect for democratic rules – but that is very typical of revolutionary movements. It almost makes you feel sorry for the French president, even though he has contributed substantially to harming the established French party system himself, without creating resilient new structures. After all, his “En Marche” movement also consisted largely of political neophytes, many of whom have reduced or ended their political involvement after initial euphoria. Moreover, President Macron's recent helpless flailing gives no indication that there is a tenable concept as to how he intends to deal with this situation.

On the other hand, the Italian government's budget problems seem almost "quaint" now that people are gradually getting used to the occasional impertinence and shortcomings of political leaders in Rome and no longer feel the need to take them seriously. And as if that were not enough, economic data are worsening daily.

The business cycle model that we developed in 2002 and have been using since then is near 20% – on a scale from zero to 100. The message to infer from that is relatively clear. Even though the significance of such models must always be put into proper perspective and interpreted, you cannot avoid the conclusion that the world is in an economic downswing. This assessment is additionally consequential inasmuch as the downswing is proceeding comparatively homogenously across countries and continents. Many indicators have worsened appreciably in Europe, but that also applies to China and more recently to the United States.

With now dimmed assessments of their business situations, many companies are confirming that our macroeconomic view cannot be far off the mark. But that also means that things are presumably going to get a little worse before they get better. For, just as countries and regions spurred each other positively in the past years, a mutually reinforcing downward spiral may be expected now. The beginning of this spiral is already finding expression in earnings estimates for 2019 and 2020, which analysts have been gradually lowering in the past few months. What initially looked like "data noise" is increasingly turning out to be a real turning point. And experience teaches that such turning points are definitely relevant. Once earnings are subject to negative revision momentum, it usually takes more than six months for the situation to turn for the better. Accordingly, and against the background of extreme political uncertainties, prices of stocks and corporate bonds may not be expected to advance substantially in the near future. On the other hand, a lot of negative news has already been factored into prices. The market has been very efficient in anticipating a gradually worsening newsflow in recent months. That is also reflected in the performance of the markets and asset classes usually found in highly diversified multi-asset portfolios. Nearly all these investments showed a negative performance last year. Rarely has there been such a bad market constellation in recent decades.

Performance in the multi-asset context (in local currency):

	10 Years	2018
Shanghai B Shares	146%	-21%
SDAX	268%	-20%
DAX 30	128%	-18%
MDAX	304%	-18%
STOXX 50	26%	-15%
Hang Seng	80%	-15%
MSCI Emerging Markets	130%	-15%
MSCI Europa Value	88%	-14%
S&P GSCI Commodity	-39%	-14%
Euro STOXX 50	70%	-12%
Nikkei 225	129%	-12%
STOXX EUROPE 600	133%	-11%
MSCI Europa Growth	148%	-11%
MSCI World	172%	-9%
Russia RTS	65%	-8%
EXANE TOP- ECI25	78%	-7%
JPM EMBI+	103%	-5%
S&P 500	252%	-5%
Nasdaq	330%	-5%
BOFA ML US HY	195%	-2%
IBOXX BBB	88%	-2%
Gold Bullion	52%	-2%
US Treasuries 10 Years	26%	-1%
Bunds 2 Years	8%	0%
US Treasuries 2 Years	10%	1%
Bunds 10 Years	64%	3%
Average	117%	-9%

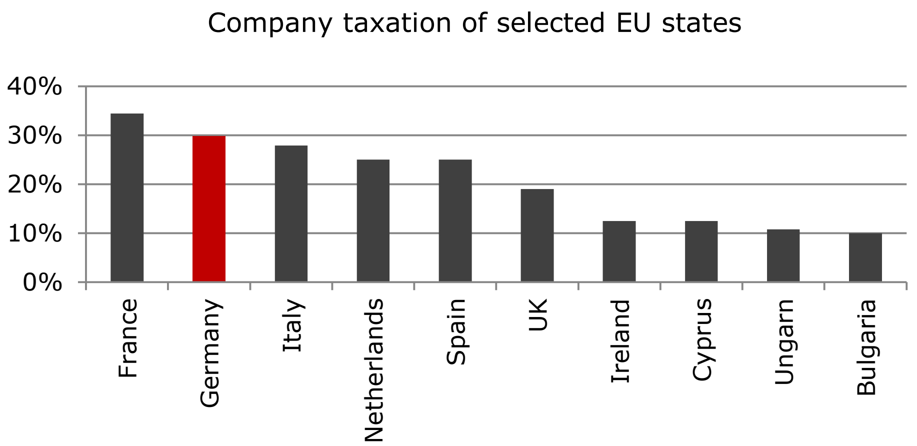
But what does this mean for current investment decisions? We actually see an opportunity in the situation described above. Even if political turbulence continues and economic and earnings data head south for a few months or quarters, the time has come for investors to position themselves for the coming years. As in the case of retailing, it is also true of the stock exchange that most of the profit lies in purchasing. And even after the Lehman Brothers bankruptcy and the ensuing severe global recession, it only took stock prices about six months to regain their footing. Those who think for the long term should not let short-term gyrations drive them crazy, as the performance of markets over relatively long periods impressively demonstrates. So, we continue to advise caution, but certainly not panic – regardless of political and economic uncertainties.

Weekly Outlook for January 21-25, 2019

	Aug.	Sept.	Oct.	Nov.	Dec.	Jan.	Release
DE: Producer prices, m/m	0.3%	0.5%	0.3%	0.1%	-0.2%		January 21
DE: Producer prices, y/y	3.1%	3.2%	3.3%	3.3%	2.9%		January 21
DE: ZEW economic expectations	-13.7	-10.6	-24.7	-24.1	-17.5	-18.5	January 22
DE: ZEW current conditions	72.6	76	70.1	58.2	45.3	43.5	January 22
DE: PMI, manufacturing – flash	55.9	53.7	52.2	51.8	51.5	51.0	January 24
DE: PMI, services – flash	55.0	55.9	54.7	53.3	51.8	51.5	January 24
DE: Ifo business climate index	103.9	103.8	102.9	102	101	100.4	January 25
DE: Ifo business expectations	101.1	101	99.7	98.7	97.3	97.0	January 25
DE: Ifo current conditions	106.7	106.6	106.1	105.5	104.7	104.1	January 25
EUR19: Consumer confidence – flash	-1.9	-2.9	-2.7	-3.9	-6.2	-6.0	January 23
EUR19: PMI, manufacturing – flash	54.6	53.2	52.0	51.8	51.4	51.0	January 24
EUR19: PMI, services – flash	54.4	54.7	53.7	53.4	51.2	51.0	January 24

MMWB estimates in red

Chart of the Week: Minimum tax rates – no thanks!



Source: German Federal Ministry of Finance

Shortly ahead of the next European Parliament elections, the EU Commission has proposed a move towards standardizing tax policy. Specifically, it wants to gradually change the requirement that tax decisions be unanimous to a system of qualified majority voting (QMV) by 2025. Since it considers unanimity neither feasible nor effective as a decision-making rule and because members states with low tax rates, like Luxembourg, Ireland, and the Baltic states, often exercise their veto right, the Commission proposes a four-step transition to QMV. This will prevent "systematic blocking" of future progress as well as all too frequent "horse trading". The steps include cooperation in combating tax fraud and evasion and making mutual recognition agreements, eliminating the unanimity requirement for the pursuit of non-fiscal objectives (e.g., climate protection), and introducing QMV for matters concerning value-added tax. We regard these three as sensible. However, the Commission's fourth step involves developing policy initiatives "for fair and competitive taxation" to be decided by QMV. This formulation seems to have been left open deliberately, but it will ultimately swing the door open for minimum tax rates. However, that would reduce competition among EU states to absurdity. That competition is an effective and urgently needed means of saving EU states from excessive tax levies and protecting businesses and citizens from that. Structurally weaker countries (especially in Eastern Europe) also need the opportunity of mitigating location disadvantages by means of lower taxes. However, there is no need to panic, since the move away from unanimous voting will ultimately require a unanimous vote.

Market Data Overview

	As of	Change versus				
	18.01.2019	11.01.2019	17.12.2018	17.10.2018	17.01.2018	31.12.2018
Stock marktes	15:42	-1 week	-1 month	-3 months	-1 year	YTD
Dow Jones	24488	2,0%	3,8%	-4,7%	-6,2%	5,0%
S&P 500	2636	1,5%	3,5%	-6,2%	-5,9%	5,2%
Nasdaq	7084	1,6%	4,9%	-7,3%	-2,9%	6,8%
DAX	11144	2,4%	3,5%	-4,9%	-15,5%	5,5%
MDAX	23146	2,1%	5,6%	-5,2%	-14,4%	7,2%
TecDAX	2565	1,9%	2,7%	-4,5%	-3,1%	4,7%
EuroStoxx 50	3126	1,8%	2,0%	-3,6%	-13,5%	4,1%
Stoxx 50	2876	1,5%	2,1%	-2,2%	-11,0%	4,2%
SMI (Swiss Market Index)	8993	1,9%	4,5%	2,8%	-4,7%	6,7%
Nikkei 225	20666	1,5%	-3,9%	-9,5%	-13,4%	3,3%
Brasilien BOVESPA	96190	2,7%	11,3%	12,2%	18,5%	9,4%
Russland RTS	1171	1,9%	5,1%	0,7%	-7,4%	9,8%
Indien BSE 30	36387	1,0%	0,3%	4,6%	3,7%	0,9%
China Shanghai Composite	2596	1,7%	-0,1%	1,3%	-24,6%	4,1%
MSCI Welt (in €)	1976	2,2%	2,8%	-4,3%	-3,8%	5,5%
MSCI Emerging Markets (in €)	1009	2,1%	3,8%	3,9%	-11,6%	5,1%
Bond markets						
Bund-Future	164,59	18	145	543	377	105
Bobl-Future	132,72	-3	42	168	150	20
Schatz-Future	111,93	1	3	3	5	-2
3 Monats Euribor	-0,31	0	0	1	2	0
3M Euribor Future, Dec 2017	-0,25	-2	-4	-13	-38	0
3 Monats $ Libor	2,78	-1	-3	33	104	-3
Fed Funds Future, Dec 2017	2,46	4	-10	-42	21	0
10 year US Treasuries	2,76	6	-10	-42	18	7
10 year Bunds	0,25	7	0	-21	-24	1
10 year JGB	0,01	0	-2	-13	-7	1
10 year Swiss Government	-0,14	9	4	-18	-6	10
US Treas 10Y Performance	579,61	-0,5%	1,8%	4,8%	1,0%	-0,2%
Bund 10Y Performance	630,55	-0,1%	0,6%	2,7%	4,5%	0,5%
REX Performance Index	487,57	-0,4%	0,1%	1,0%	1,8%	0,0%
US mortgage rate	0,00	0	0	0	0	0
IBOXX AA, €	0,88	-3	0	6	19	1
IBOXX BBB, €	2,03	-6	-2	28	81	-3
ML US High Yield	7,23	-10	-27	52	115	-78
JPM EMBI+, Index	814	0,5%	3,0%	3,5%	-2,7%	2,8%
Convertible Bonds, Exane 25	6958	0,0%	0,3%	-3,8%	-6,9%	0,9%
Commodities						
CRB Spot Index	414,02	0,5%	-0,1%	-0,9%	-5,5%	1,2%
MG Base Metal Index	295,38	0,1%	-1,9%	-5,7%	-17,2%	0,2%
Crude oil Brent	61,87	1,9%	3,7%	-22,6%	-10,7%	16,5%
Gold	1282,41	-0,6%	3,2%	4,5%	-4,0%	0,1%
Silver	15,52	-0,8%	5,9%	5,6%	-9,1%	0,1%
Aluminium	1844,25	1,7%	-5,1%	-8,4%	-15,9%	-1,0%
Copper	5964,75	0,8%	-2,1%	-4,0%	-14,7%	0,3%
Iron ore	74,51	0,4%	9,4%	4,4%	-2,3%	7,7%
Freight rates Baltic Dry Index	1077	-7,9%	-23,4%	-30,7%	-7,5%	-15,3%
Currencies						
EUR/ USD	1,1386	-1,3%	0,4%	-1,2%	-6,7%	-0,6%
EUR/ GBP	0,8820	-1,5%	-1,9%	0,5%	-0,3%	-1,7%
EUR/ JPY	124,62	-0,2%	-3,0%	-3,7%	-7,8%	-1,0%
EUR/ CHF	1,1319	-0,1%	0,6%	-1,2%	-3,9%	0,4%
USD/ CNY	6,7733	0,2%	-1,8%	-2,2%	5,2%	-1,5%
USD/ JPY	109,24	0,6%	-3,2%	-3,0%	-1,8%	-0,3%
USD/ GBP	0,77	-0,6%	-2,3%	1,8%	7,2%	-1,3%

Carsten Klude
+49 40 3282-2572
cklude@mmwarburg.com

Dr. Rebekka Haller
+49 40 3282-2452
rhaller@mmwarburg.com

Martin Hasse
+49 40 3282-2411
mhasse@mmwarburg.com

Dr. Christian Jasperneite
+49 40 3282-2439
cjasperneite@mmwarburg.com

Bente Lorenzen
+49 40 3282-2409
blorenzen@mmwarburg.com

Julius Böttger
+49 40 3282-2229
jboettger@mmwarburg.com

This information does not constitute an offer or an invitation to submit an offer, but is solely intended to provide guidance and present possible business activities. This information does not purport to be complete and is therefore not binding. The information provided should not be considered a recommendation to purchase financial instruments individually, but serves only as a proposal for a possible asset allocation. The opinions expressed herein are subject to change without notice. Where statements were made with respect to prices, interest rates or other indications, these solely refer to the time when the information was prepared and do not imply any forecasts about future development, particularly regarding future gains or losses. In addition, this information does not constitute advice or a recommendation. Before completing any deal described in this information, a product-specific consultation tailored to the customer's individual needs is required. This information is confidential and exclusively intended for the addressee described herein. Any use by parties other than the addressee is not permissible without our approval. This particularly applies to reproductions, translations, microfilms, saving and processing in electronic media as well as publishing the entire contents or parts thereof.

This analysis is freely available on our website.