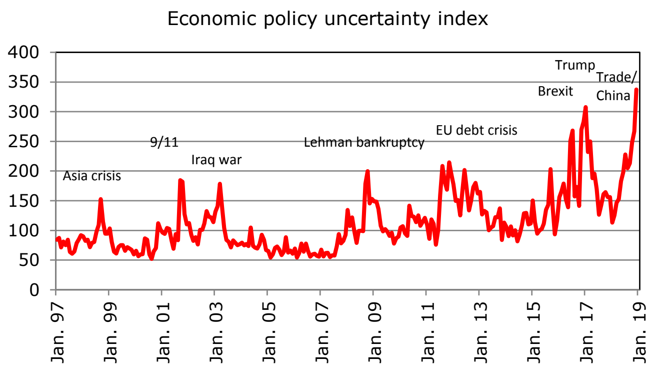
# ECONOMIC SITUATION AND STRATEGY February 1, 2019

## Reporting season weaker than usual – earnings recession in United States?

Stock markets have kicked off the new year with great impetus and positive energy. While December 2018 was a horrible month for investors, the situation looks significantly better four weeks later. January has almost entirely made up the huge loss in the preceding month, and almost all of last year's losers are now among the big winners. Deutsche Bank, Continental, HeidelbergCement, and Covestro are among the best-performing stocks this year in Germany's DAX index, after bringing up the rear in 2018 with losses between 40% and 56%. But will this development continue?

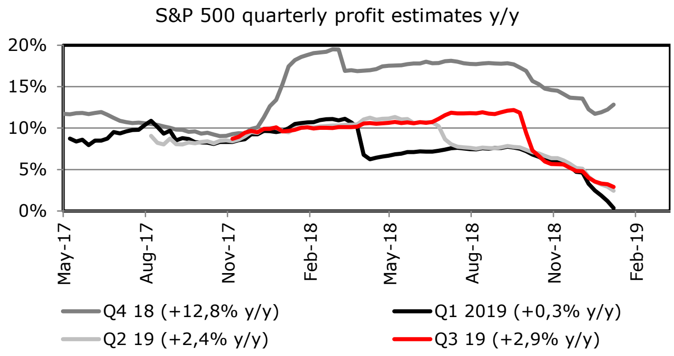
Last year's price losses seemed exaggerated not only to us. Such developments normally occur only when there are major economic problems. While investors must anticipate significant price declines in recessions, the world economy achieved solid growth in 2018 in spite of everything. However, the economic problems continuously worsened during the past year. The economies of China and Europe, in particular, are no longer running smoothly because the political uncertainties aroused by the US-China trade dispute and chaotic Brexit negotiations have made businesses and consumers very nervous. The German economy only barely escaped a recession in the second half of the year, while Italy was less fortunate. Its economy contracted in both the third and fourth quarters of 2018.

Unfortunately, it is not clear even at the beginning of 2019 that the economic cycle has hit bottom. Since almost all major economic data have continued to weaken, the stock market recovery rests on a fundamentally unstable foundation. At any rate, our business cycle models signal that forecasts for economic growth this year are still too optimistic in many cases. Stock prices may rise even when the economy is ailing. However, expectations for corporate earnings should be sufficiently skeptical and the leading indicators must point to an end of the economic downswing in the near future.




One can tell what kind of shape earnings are in from the reporting season for the fourth quarter of 2018. Just over 200 of the companies in the S&P 500 have now reported their numbers, and 74% have managed to beat earnings expectations. That is a somewhat better number than the long-term average (71%), but significantly lower than in the past quarters. Positive surprises have been reported by 60% of companies regarding sales development, compared with the long-term average of 62%. One should not forget that analysts significantly reduced their estimates ahead of the reporting season. In October 2018, they were still forecasting an earnings increase of almost 18% over the year-earlier quarter, but it now appears that the figure is likely to be about 12%.

However, forecasts for the coming quarters are being reduced further. Earnings growth of roughly 1% is expected for the first quarter of 2019, 2-3% for the second and third quarters, and 13% for the fourth quarter. But since earnings expectations are almost always too optimistic at the beginning of the year – especially in years with dwindling economic momentum – there is considerable risk of an "earnings recession." That means that earnings below their year-earlier level in at least two consecutive quarters.




The last earnings recession in the S&P 500 was between the second quarter of 2015 and the second quarter of 2016, and the time before that was for eight quarters in a row between the fourth of 2007 and the third of 2009. In most cases, earnings recessions entail negative stock market development. Thus, the S&P 500 went into reverse gear between October 2007 and March 2009, and stock prices also declined between February 2015 and February 2016. In 2019, earnings could fall over three quarters (Q1-Q3). At the sector level, there are four in which analysts are already forecasting an earnings recession: energy (Q1-Q4 2019), technology (Q1-Q3 2019), materials (Q4 2018-Q2 2019), and utilities (Q4 2018-Q2 2019).

While an earnings increase of 6% is expected for the S&P 500 in 2019 (11% in 2020), forecasts for the DAX are actually even more optimistic at 9% this year (10% in 2020). The long-term growth rates expected for the S&P 500 and DAX are 16% and 10%, respectively. However, we find it hard to share this microeconomic optimism in view of current macroeconomic developments. We expect real GDP growth of about 1% for Germany this year, while the United States should grow at about twice that rate. A year ago, an increase of 9% was likewise forecast for the 2018 earnings of DAX companies compared with the previous year. We now know that earnings actually declined last year. Even if we assume no repetition of that in 2019, we would currently expect at most an earnings growth rate of 5% for this year and next.

To achieve our year-end target of 11,800 points on the DAX, the P/E ratio would have to increase in this scenario from just under 12 now to 12.5. A slight earnings increase plus a somewhat higher valuation multiple would presuppose the occurrence of our base scenario, i.e., no global recession, but rather "only" economic slowing in the industrialized world and most emerging countries. A crucial assumption here is that the United States and China reach a trade agreement, thus allowing the economic situation in China to stabilize. That would be good news especially for major exporting countries like Germany and Japan, for which China is now the most important trading partner. Moreover, a hard Brexit, which would severely hurt all European economies, must be avoided,

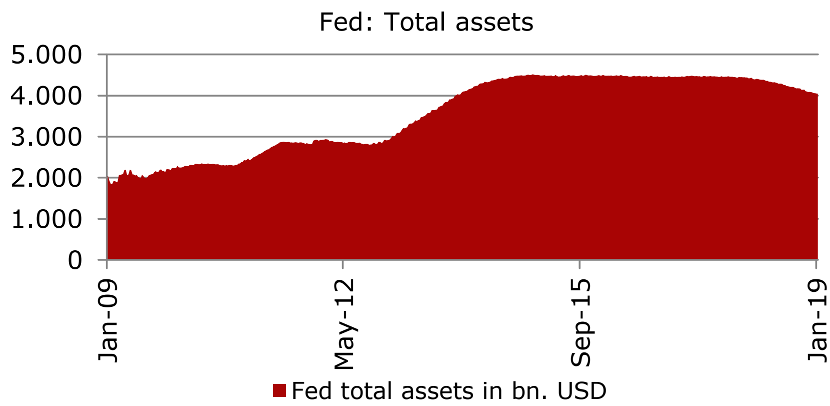
As long as these two political hurdles are not overcome, the economic slowdown is likely to continue, and earnings estimates will probably need further revision. We therefore view the current recovery on the stock markets mainly as a technical reaction to the severe price losses of 2018. Thus, we cannot give an all-clear signal from a fundamental perspective and investors should not get too excited yet.

## Weekly Outlook for February 4-8, 2019

| | Sept. | Oct. | Nov. | Dec. | Jan. | Feb. | Release |
|---|---|---|---|---|---|---|---|
| DE: PMI, services – final | 55.9 | 54.7 | 53.3 | 51.8 | 53.1 | | February 5 |
| DE: New orders, m/m | 0.0% | 0.2% | -1.0% | 0.3% | | | February 6 |
| DE: New orders, y/y | -2.5% | -3.1% | -4.3% | -6.6% | | | February 6 |
| DE: Industrial production, m/m | -0.1% | -0.8% | -1.9% | 0.5% | | | February 7 |
| DE: Industrial production, y/y | -0.2% | 0.5% | -4.6% | -3.8% | | | February 7 |
| DE: Exports, m/m | -0.3% | 0.9% | -0.3% | 0.1% | | | February 8 |
| DE: Exports, y/y | 2.0% | 3.3% | -0.1% | 0.0% | | | February 8 |
| DE: Imports, m/m | 0.6% | 0.8% | -1.3% | 0.2% | | | February 8 |
| DE: Imports, y/y | 7.8% | 7.0% | 3.8% | 3.0% | | | February 8 |
| EUR19: Sentix | 12.0 | 11.4 | 8.8 | -0.3 | -1.5 | -1.1% | February 4 |
| EUR19: Producer prices, m/m | 0.6% | 0.8% | -0.3% | -0.4% | | | February 4 |
| EUR19: Producer prices, y/y | 4.6% | 4.9% | 4.0% | 3.4% | | | February 4 |
| EUR19: PMI, services – final | 54.7 | 53.7 | 53.4 | 51.2 | 50.8 | | February 5 |
| EUR19: Retail sales, m/m | -0.5% | 0.6% | 0.6% | 0.4% | | | February 5 |

*MMWB estimates in red*

## **Chart of the Week:** Fed unexpectedly dovish




As expected, the Fed left its key interest rate unchanged in a range of 2.25%-2.50% at yesterday's FOMC meeting. Weaker macroeconomic data and easing inflation pressure had led almost all market participants to anticipate this decision. It was nevertheless surprising how clearly the tone of the official statements and subsequent press conference has changed compared with the previous meeting. For example, economic activity is now described only as rising at a "solid" instead of a "strong" rate. Moreover, more economic risks are perceived, which is also why arguments for further interest rate hikes have receded. Furthermore, the Fed has often emphasized that it would be "patient" in its approach, a point that comes up anew in the official statement. But it is even more surprising that the reference to "further gradual increases" in the key interest rate was omitted and replaced by the phrase "what future adjustments to the target range for the federal funds rate may be appropriate." This very neutral formulation indicates the Fed might have already arrived at the end of its interest rate cycle. However, the Fed has talked in unexpectedly dovish terms not only about the key interest rate, but also about reducing the size of its balance sheet. The statement and Chair Jerome Powell's comments clearly show that the Fed will no longer pursue reduction on autopilot, but will rather adapt the normalization program to market conditions. Finally, the Fed intends to continue post-crisis monetary policy with "an ample supply of reserves." That suggests balance sheet reduction is already at an advanced stage. In view of these comments, yields on US Treasuries should continue to fall.

## Market Data Overview

| Stock marktes | As of 01.02.2019 13:43 | Change versus 25.01.2019 -1 week | 31.12.2018 -1 month | 31.10.2018 -3 months | 31.01.2018 -1 year | 31.12.2018 YTD |
|---|---|---|---|---|---|---|
| Dow Jones | 25000 | 1,1% | 7,2% | -0,5% | -4,4% | 7,2% |
| S&P 500 | 2704 | 1,5% | 7,9% | -0,3% | -4,2% | 7,9% |
| Nasdaq | 7282 | 1,6% | 9,7% | -0,3% | -1,8% | 9,7% |
| DAX | 11141 | -1,2% | 5,5% | -2,7% | -15,5% | 5,5% |
| MDAX | 23726 | -0,4% | 9,9% | -1,9% | -11,6% | 9,9% |
| TecDAX | 2592 | -2,2% | 5,8% | -1,7% | -2,2% | 5,8% |
| EuroStoxx 50 | 3149 | -0,4% | 4,9% | -1,5% | -12,7% | 4,9% |
| Stoxx 50 | 2888 | 0,6% | 4,6% | -2,0% | -10,1% | 4,6% |
| SMI (Swiss Market Index) | 8943 | 0,2% | 6,1% | -0,9% | -4,2% | 6,1% |
| Nikkei 225 | 20788 | 0,1% | 3,9% | -5,2% | -10,0% | 3,9% |
| Brasilien BOVESPA | 97733 | 0,1% | 11,2% | 11,8% | 15,1% | 11,2% |
| Russland RTS | 1214 | 1,9% | 13,9% | 7,8% | -5,3% | 13,9% |
| Indien BSE 30 | 36469 | 1,2% | 1,1% | 5,9% | 1,4% | 1,1% |
| China Shanghai Composite | 2618 | 0,6% | 5,0% | 0,6% | -24,8% | 5,0% |
| MSCI Welt (in €) | 2028 | 0,3% | 7,5% | -1,0% | -0,4% | 7,5% |
| MSCI Emerging Markets (in €) | 1050 | 0,6% | 8,6% | 8,4% | -9,1% | 8,6% |
| **Bond markets** | | | | | | |
| Bund-Future | 165,67 | 60 | 213 | 541 | 685 | 213 |
| Bobl-Future | 132,98 | 15 | 46 | 154 | 253 | 46 |
| Schatz-Future | 111,90 | -1 | -5 | -8 | 8 | -5 |
| 3 Monats Euribor | -0,31 | 0 | 0 | 1 | 2 | 0 |
| 3M Euribor Future, Dec 2017 | -0,25 | -1 | 0 | -11 | -44 | 0 |
| 3 Monats $ Libor | 2,74 | -1 | -7 | 18 | 96 | -7 |
| Fed Funds Future, Dec 2017 | 2,35 | -12 | -5 | -50 | -3 | 0 |
| 10 year US Treasuries | 2,63 | -12 | -6 | -53 | -8 | -6 |
| 10 year Bunds | 0,15 | 1 | -9 | -23 | -48 | -9 |
| 10 year JGB | -0,02 | -2 | -2 | -14 | -10 | -2 |
| 10 year Swiss Government | -0,26 | -1 | -2 | -25 | -31 | -2 |
| US Treas 10Y Performance | 585,78 | 1,0% | 0,9% | 5,7% | 3,3% | 0,9% |
| Bund 10Y Performance | 635,97 | 0,4% | 1,4% | 2,8% | 6,8% | 1,4% |
| REX Performance Index | 489,18 | 0,0% | 0,3% | 0,9% | 2,7% | 0,3% |
| US mortgage rate | 0,00 | 0 | 0 | 0 | 0 | 0 |
| IBOXX AA, € | 0,75 | -7 | -13 | -8 | -2 | -13 |
| IBOXX BBB, € | 1,85 | -10 | -21 | 3 | 57 | -21 |
| ML US High Yield | 7,13 | -7 | -89 | 11 | 96 | -89 |
| JPM EMBI+, Index | 832 | 0,9% | 5,1% | 6,6% | 0,0% | 5,1% |
| Convertible Bonds, Exane 25 | 7037 | 0,0% | 2,1% | -2,5% | -5,0% | 2,1% |
| **Commodities** | | | | | | |
| CRB Spot Index | 412,83 | 0,4% | 0,9% | -0,7% | -6,9% | 0,9% |
| MG Base Metal Index | 309,45 | 2,8% | 5,0% | 2,8% | -15,1% | 5,0% |
| Crude oil Brent | 60,91 | -0,9% | 14,6% | -19,5% | -11,2% | 14,6% |
| Gold | 1321,34 | 1,8% | 3,1% | 8,7% | -1,5% | 3,1% |
| Silver | 16,08 | 2,4% | 3,7% | 12,1% | -6,7% | 3,7% |
| Aluminium | 1892,00 | -0,6% | 1,6% | -2,2% | -14,7% | 1,6% |
| Copper | 6151,25 | 1,9% | 3,4% | 1,9% | -13,1% | 3,4% |
| Iron ore | 84,45 | 13,1% | 22,0% | 16,0% | 11,3% | 22,0% |
| Freight rates Baltic Dry Index | 668 | -26,2% | -47,4% | -55,2% | -42,0% | -47,4% |
| **Currencies** | | | | | | |
| EUR/ USD | 1,1467 | 1,1% | 0,1% | 1,3% | -7,9% | 0,1% |
| EUR/ GBP | 0,8784 | 1,5% | -2,1% | -0,9% | 0,3% | -2,1% |
| EUR/ JPY | 124,89 | 0,1% | -0,8% | -2,5% | -7,9% | -0,8% |
| EUR/ CHF | 1,1388 | 0,7% | 1,1% | -0,1% | -2,1% | 1,1% |
| USD/ CNY | 6,7300 | -0,4% | -2,1% | -3,5% | 7,1% | -2,1% |
| USD/ JPY | 108,88 | -0,6% | -0,6% | -3,6% | -0,3% | -0,6% |
| USD/ GBP | 0,77 | 0,9% | -2,4% | -2,1% | 8,9% | -2,4% |

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