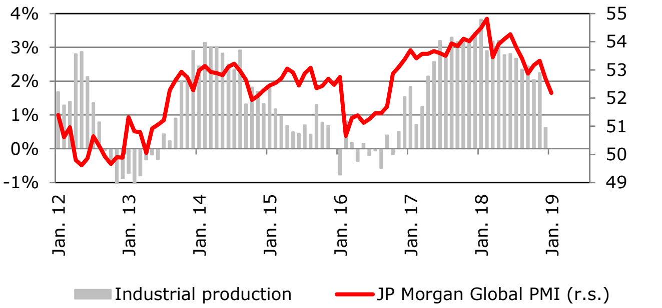
M.M. WARBURG & CO
BANK

ECONOMIC SITUATION AND STRATEGY February 8, 2019

Global economic slowdown, rising recession risk

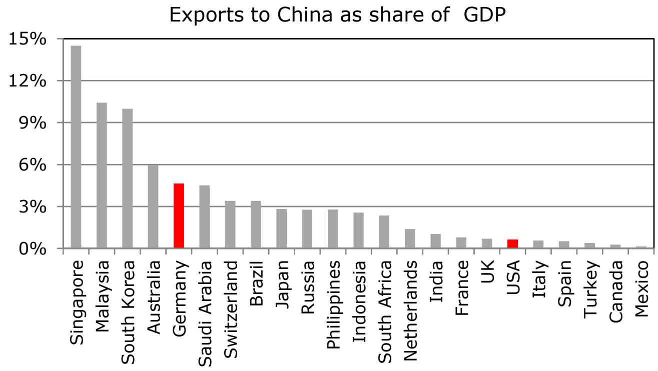
In a year's time, directional signs for the world economic trend have turned 180 degrees. Most leading indicators were at a very high level in the beginning of 2018, so almost all economists expected the strong momentum then to continue. But that has not happened. It soon appeared that growth in the manufacturing sector had peaked and would not accelerate further. Hopes still resided then in the services sector, which signaled solid growth rates until the middle of last year. However, prospects have also dimmed significantly there in the past months. A third of the purchasing manager indexes (PMIs) in manufacturing are now below the 50-point threshold signaling a business contraction, as are a quarter in the services sector.

Global purchasing managers index and OECD-industrial production y/y



Political developments in the past 12 months are the main reason for the abrupt course change. For example, Trump's announcement in March 2018 that he would impose tariffs on steel and aluminum imports and goods from China caused a substantial loss of business and consumer confidence. Continuing debates and related uncertainties about how Great Britain would withdraw from the European Union have added to that. The new Italian government's political Punch and Judy show, which gained voter support with big promises to make the country more competitive but has done nothing since to deserve it, has also left its mark. Hopes that the responsible politicians would come to their senses at least so far remain unfulfilled. Instead, there are growing fears that the world economy is moving unchecked towards a new crisis.

Because of their export orientation, China and the euro zone countries are the most strongly affected by a slowing of economic growth. Growth in China slowed to 6.4% in the fourth quarter of 2018. The country's industrial sector is particularly feeling the trade conflict with the United States. While foreign trade benefited for a long time from anticipatory effects, both exports and imports were lower year-on-year at the end of 2018. The downward trend will continue if there is no lasting solution to the dispute with the United States. As the PMIs show, this primarily affects small and medium-sized manufacturing firms. In contrast, the majority of large industrial businesses and firms in the services sector continue to report positive business numbers. Not least, the real estate market is likely to play an important role in this. After the central bank managed to stage a soft landing of an overheated housing market, restrictions have been eased since last spring with the result that prices have gone back up. This has compensated for the negative effect of slumping stock prices on consumer wealth. However, room for significantly more expansionary monetary and fiscal policy is probably limited in view of sharp increased household and business debt. Investors should therefore not rely too much on help from the central bank and government if the economic weak spell continues. If there is no deal with Trump in the next three weeks, the Chinese economy is likely to grow by at most 6% in 2019.



The economic slowdown in China is bad news for all of the country's close trading partners. Measured by their exports to China as a percentage of GDP, Singapore, Malaysia, South Korea, Australia, and Germany are especially vulnerable. For the United States, in contrast, the trade dispute that it instigated hardly plays a role. This is also evident from the great discrepancy in the economic data. While the data in Germany signal heightened risk of a recession, there is currently little probability of that in the United States.

For Germany, the economic data trend has remained negative. In particular, the industrial sector is on the verge of a recession. While the economy grew slightly in the fourth quarter of 2018 and thus narrowly avoided meeting the technical criterion for a recession, new orders and industrial production continue to develop very weakly. On the other hand, things look somewhat better in public and private consumption and in foreign trade. However, though still increasing so far, exports to China are likely to slow in the near future. Economic growth will therefore be restrained in the coming quarters. Depending on how growth for the fourth quarter of 2018 actually turns out, our GDP forecast of about 1% for 2019 might yet prove to be too optimistic.

For the United States, on the other hand, there have been few signs of significant economic slowing. The country's greatest advantage in this regard is its low dependence on the global business cycle thanks to strong domestic demand. The labor market's still very robust development suggests that consumer spending will continue to function as the engine of growth for the overall economy. There are nevertheless indications that economic momentum will also wane in the United States this year. The diminishing impact of expansionary fiscal policy (tax reform and higher government spending) will be felt as much as the after-effects of more restrictive monetary policy. And even though foreign trade does not play as great a role in economic growth for the United States as for other countries, the United States is no "island paradise." Large, internationally operating US companies are quite aware of that. The latest data show that US businesses are accumulating excessive inventories. These may positively influence growth for a while, but that will turn around at some point. Then, the impetus from the inventory investment cycle will be negative for growth.

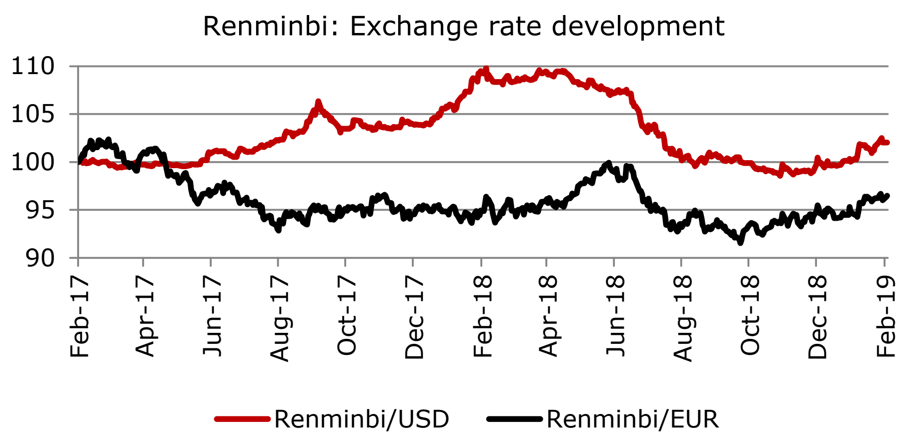
To break a downward economic spiral, policymakers normally resort to more expansionary monetary and fiscal policy. However, the room for higher government spending is limited given the increase of debt in recent years. Consequently, the task of "coming to the rescue" will probably again fall to monetary policy. India's central bank has already lowered interest rates, and the US Federal Reserve might follow this year. On the other hand, as usual, the European Central Bank will again only react quite late, partly because the end of Mario Draghi's tenure as ECB president this year is expected to have a certain "lame duck" effect. In such an environment, investors are reducing the risk of their positions and shifting more to safety, e.g., in the form of government bonds.

Weekly Outlook for February 11-15, 2019

	Sept.	Oct.	Nov.	Dec.	Jan.	Feb.	Release
DE: ZEW economic expectations	-10.6	-24.7	-24.1	-17.5	-15.0	-16.0	February 11
DE: ZEW current conditions	76.0	70.1	58.2	45.3	27.6	25.0	February 11
EUR19: ZEW economic expectations	-7.2	-19.4	-22.0	-21.0	-20.9	-22.0	February 11
EUR19: Industrial production, m/m	-0.6%	0.1%	-1.7%	-1.4%			February 13
EUR19: Industrial production, y/y	0.6%	1.2%	-3.3%	-2.0%			February 13
EUR19: Trade balance, in EUR bn	12.4	14.0	19.0	11.0			February 15
	Q2 2018		**Q3 2018**		**Q4 2018**		
DE: GDP, q/q – s.a.	0.5%		-0.2%		0.1%		February 14
DE: GDP, y/y – s.a.	2.0%		1.1%		0.9%		February 14
EUR19: GDP, q/q – s.a.	0.4%		0.2%		0.2%		February 14
EUR19: GDP, y/y – s.a.	2.2%		1.6%		1.2%		February 14

MMWB estimates in red

Chart of the Week: Renminbi trending up



The day June 15, 2018 marked a key point in the development of the renminbi against the US dollar and the euro. That was when the United States published a list of tariffs on Chinese imports worth USD 50 billion. The renminbi subsequently lost almost 4% in value against the dollar in just a few days. But the Chinese currency has made up lost ground recently and reached its highest level in over six months. For one thing, US President Donald Trump has lately spoken more positively about talks to solve the trade conflict with China. An until recently expected meeting with Chinese President Xi Jinping likewise added to the probability of reaching a deal satisfactory to both sides. For another thing, there is the Federal Reserve's very dovish statement lowering expectations of further Fed interest rate hikes and reduction of the central bank's balance sheet. Is the positive development for the renminbi likely to continue? Even if the parties make a deal, pressure on the Chinese currency is likely to increase again. For, growth of the Chinese economy should remain relatively weak, while the United States is developing robustly. The leading indicators for the two countries continue to favor the United States. And even though we do not expect a US interest rate step soon, the US-China interest rate gap is likely to widen. The Chinese central bank will probably ease monetary policy as the economy there weakens. In addition, demand for the US currency as a safe haven is high in times of turbulent markets.

Market Data Overview

Stock marktes	As of 08.02.2019 13:05	Change versus 01.02.2019 -1 week	07.01.2019 -1 month	07.11.2018 -3 months	07.02.2018 -1 year	31.12.2018 YTD
Dow Jones	25170	0,4%	7,0%	-3,9%	1,1%	7,9%
S&P 500	2706	0,0%	6,1%	-3,8%	0,9%	7,9%
Nasdaq	7288	0,3%	6,8%	-3,7%	3,4%	9,8%
DAX	10945	-2,1%	1,8%	-5,5%	-13,1%	3,7%
MDAX	23339	-1,7%	5,3%	-4,4%	-9,8%	8,1%
TecDAX	2497	-0,8%	-0,6%	-7,1%	-2,4%	1,9%
EuroStoxx 50	3142	-0,9%	3,6%	-3,2%	-9,0%	4,7%
Stoxx 50	2919	0,4%	4,6%	-1,9%	-4,9%	5,8%
SMI (Swiss Market Index)	9019	0,3%	5,7%	-0,3%	0,5%	7,0%
Nikkei 225	20333	-2,2%	1,5%	-7,9%	-6,1%	1,6%
Brasilien BOVESPA	94406	-3,5%	3,0%	7,6%	14,1%	7,4%
Russland RTS	1196	-1,3%	6,9%	2,7%	-3,8%	12,1%
Indien BSE 30	36546	0,2%	1,9%	3,7%	7,2%	1,3%
China Shanghai Composite	2618	0,0%	3,4%	-0,9%	-20,9%	5,0%
MSCI Welt (in €)	2027	1,0%	6,6%	-1,5%	5,0%	8,6%
MSCI Emerging Markets (in €)	1042	0,4%	7,5%	5,8%	-3,4%	8,9%
Bond markets						
Bund-Future	166,36	86	240	686	813	282
Bobl-Future	133,18	20	54	199	268	66
Schatz-Future	111,89	-3	-2	-2	4	-5
3 Monats Euribor	-0,31	0	0	1	2	0
3M Euribor Future, Dec 2017	-0,24	0	-1	-10	-42	0
3 Monats $ Libor	2,70	-4	-10	10	90	-11
Fed Funds Future, Dec 2017	2,36	-2	-2	-56	0	0
10 year US Treasuries	2,64	-5	-4	-57	-20	-4
10 year Bunds	0,11	-6	-11	-34	-58	-14
10 year JGB	-0,03	-1	-1	-15	-10	-3
10 year Swiss Government	-0,29	2	-3	-31	-38	-5
US Treas 10Y Performance	585,25	0,4%	0,7%	6,1%	4,2%	0,8%
Bund 10Y Performance	638,56	0,5%	1,5%	3,8%	7,6%	1,8%
REX Performance Index	490,28	0,2%	0,5%	1,3%	2,9%	0,5%
US mortgage rate	0,00	0	0	0	0	0
IBOXX AA, €	0,65	-9	-26	-21	-12	-22
IBOXX BBB, €	1,74	-10	-40	-8	42	-32
ML US High Yield	7,06	-5	-51	15	72	-95
JPM EMBI+, Index	831	-0,2%	2,9%	5,7%	1,0%	5,0%
Convertible Bonds, Exane 25	7042	0,0%	2,0%	-2,6%	-4,0%	2,1%
Commodities						
CRB Spot Index	413,47	0,1%	0,0%	-0,8%	-6,5%	1,1%
MG Base Metal Index	311,62	1,0%	5,9%	2,2%	-13,3%	5,7%
Crude oil Brent	61,67	-0,8%	5,4%	-13,9%	-6,5%	16,1%
Gold	1312,20	-0,4%	1,9%	6,9%	-0,8%	2,4%
Silver	15,70	-1,6%	0,0%	7,5%	-4,2%	1,2%
Aluminium	1871,50	0,7%	0,3%	-5,1%	-13,4%	0,5%
Copper	6228,00	1,8%	5,5%	0,9%	-8,9%	4,7%
Iron ore	92,29	6,2%	24,5%	24,4%	22,7%	33,4%
Freight rates Baltic Dry Index	610	-5,4%	-51,1%	-53,2%	-44,4%	-52,0%
Currencies						
EUR/ USD	1,1339	-1,2%	-0,9%	-1,3%	-8,1%	-1,0%
EUR/ GBP	0,8748	-0,1%	-2,5%	0,2%	-1,2%	-2,5%
EUR/ JPY	124,51	-0,3%	0,5%	-4,2%	-7,7%	-1,1%
EUR/ CHF	1,1354	-0,4%	1,1%	-0,8%	-2,2%	0,8%
USD/ CNY	6,7426	0,0%	-1,6%	-2,6%	7,5%	-1,9%
USD/ JPY	109,82	0,3%	1,0%	-3,3%	0,4%	0,2%
USD/ GBP	0,77	1,0%	-1,5%	1,3%	7,1%	-1,7%

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