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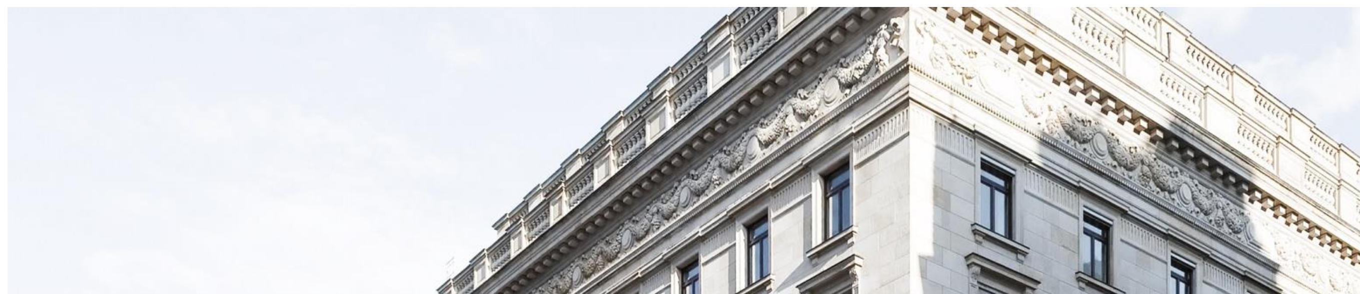


ECONOMIC SITUATION AND STRATEGY

April 27, 2018

Only a brief comeback of inflation

Inflation fears are back. That is at least the impression given by recent movements on the stock and bond markets. On Tuesday, the yield on 10-year US government bonds reached 3% for the first time since January 2014. After a buoyant start on the US stock market that day, prices came under heavy pressures as trading continued. This cannot be explained by corporate earnings. More than 200 of the S&P 500 companies in the United States have already released their financial statements, and the results are quite respectable, with 82% of companies beating earnings expectations and 75% surpassing sales forecasts. The results from companies on the Dow Jones and the Nasdaq 100 are even better. That is even more notable since this time analysts have not revised their estimates downward ahead of reports, as they usually do. Nevertheless, price reactions have been muted.

Two things are troubling the stock market. One is the fear that profit margins have peaked and will decline in the future in view of rising costs and higher interest rates. According to data service provider FactSet, the profit margin of S&P 500 companies increased in the first quarter of 2018 to 11.1%. That is the highest number measured since the beginning of the time series in the third quarter of 2008. However, analysts expect that margins will rise even somewhat further in the quarters ahead, an effect attributable to the US tax reform. Of course, it is possible that margins will actually decline in the future, but this worry has existed for many years and anyone who has allowed it to determine their investment decisions has had to pay a steep price of missed opportunity in stock performance.

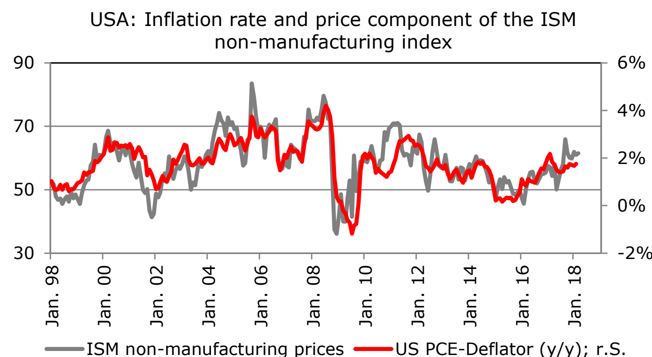
The other concern is the argument that 10-year US government bonds, with a yield of 3%, have become a serious investment alternative to stocks. However, it is wrong to consider this an all-or-nothing matter, with bond yields being simply unattractive below and attractive at or above 3%. Whether and when the bond market will become an alternative to the stock market depends on many factors. In our view, higher corporate earnings thanks to a prospering economy are currently the decisive factor, and that is why stocks are still more attractive than bonds. Moreover, prices of fixed-income securities will decline inversely if the rise of yields continues. Investors should therefore not simply follow some rule of thumb that says they must get out of stocks when yields reach 3%, or 3.5%, or 4%. The reality is much more complicated and unfortunately more dissatisfying as far as the alleged rules are concerned. As in so many things, we have to say *it all depends*. Investors may thus find the bond market attractive at yields of 2% or less if a recession is imminent and the central bank is lowering interest rates. Conversely, bonds will be unattractive even at a yield of 4% as long as the economy keeps growing, prices rise moderately, and monetary policy becomes more restrictive.

Concerns have been mounting again lately that the Fed will raise interest rates not just two more times this year, but might take three further steps. The fed funds future contract for December 2018 now implies a probability of about 55% for two rate hikes and 45% for three. Three further interest rate increases this year would be likely, in particular, if inflation were to rise above the Fed's target of 2%. That may actually happen in the

coming months. However, it has nothing to do with an emerging general trend towards higher prices. Instead, base effects will cause the inflation rate to move upward until the summer. This relates, for example, to the sharp decline of prices for cell phone and internet services due to competition and a significant reduction of prices for new and used automobiles last year. Together, these effects make the inflation rate lower by about 0.6 percentage points. In addition, energy prices fell due to the declining oil price. All these factors are now gradually dropping out of the statistical calculation of the inflation rate, which measures the price changes of the past 12 months. Consequently, there will be an automatic "normalization" of the inflation rate in the months ahead.

On the other hand, we do not expect a sustained rise of prices. The oil price increase has recently led to somewhat higher inflation expectations, but we believe US oil production will continue to expand in the course of the year. That should close the currently observed output gap, which is attributable to consistent compliance with the OPEC production cuts. Moreover, the latest oil price increase is probably due to "bets" made by speculators on higher prices. The weekly Commitments of Traders report shows that speculative long positions in oil are at an almost record high. At the same time, the "bets" on falling prices for 10-year US Treasuries are likewise at an exceptionally high level. It thus looks almost as if hedge funds are now trying to set up a "perfect storm" towards rising US yields.

Prices of other commodities, such as steel, aluminum, and nickel, have also been rising recently. But that is primarily due to fears of a trade war and sanctions against Russia. These developments have caused the price indexes of the various national and international manufacturing PMIs to spike. However, inflation pressure has remained comparatively moderate in the services sector, which is especially important for the US economy. If one takes the price component of the services PMI as the explanatory variable for the US inflation rate (PCE deflator), the inflation rate forecast on that basis continues to amount to only 2%. Moreover, almost all major producers of consumer goods, such as Procter & Gamble, Unilever, and Nestle, have stated in the current reporting season that they are hardly able to push through higher prices to their customers. The ever-growing influence of online shopping is thus working as a price inhibitor.



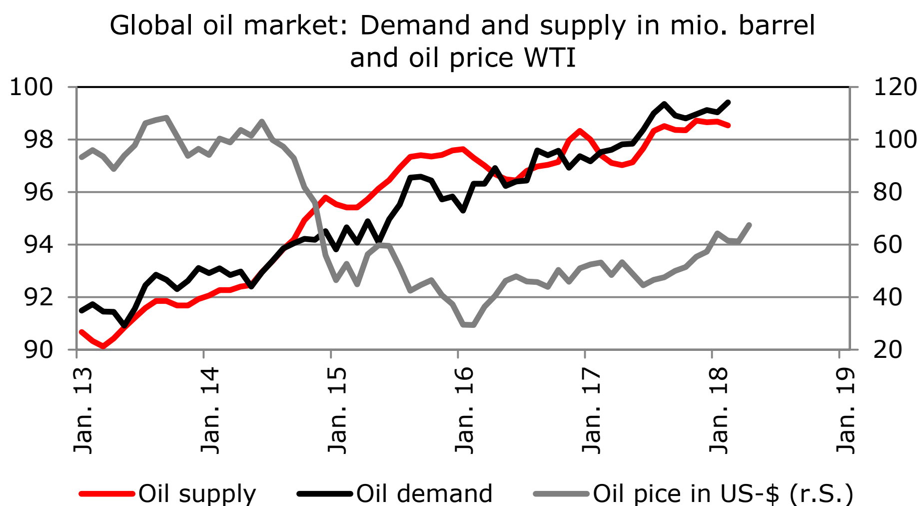
Overall, US inflation rates are therefore likely to be lower again in the second half of the year. Yields should then stop rising. The PCE price deflator, the decisive metric for Fed monetary policy, will probably increase to somewhat over 2% by July, but fall after that to about 1.7% by year's end. The core inflation rate is likely to get very close to the 2% mark, but not to exceed it. Interest rate and inflation fears should therefore subside in the second half of the year, so the stock markets may then take aim at their old record levels, if not sooner.

Weekly outlook for April 30-May 4, 2018

	Nov.	Dec.	Jan.	Feb.	Mar.	Apr.	Release
DE: Retail sales, m/m	1.7%	-1.0%	-0.3%	-0.7%	0.3%		April 30
DE: Inflation rate, flash, m/m	0.3%	0.6%	-0.7%	0.5%	0.4%	0.3%	April 30
DE: Inflation rate, flash, y/y	1.8%	1.7%	1.6%	1.4%	1.6%	1.8%	April 30
DE: PMI, manufacturing, final	62.5	63.3	61.1	60.6	58.2	58.1	May 2
DE: PMI, services, final	54.3	55.8	57.3	55.3	53.9	54.1	May 4
EUR19: M3 money supply, y/y	4.9%	4.6%	4.6%	4.2%	4.5%		April 30
EUR19: PMI, manufacturing, final	60.1	60.6	59.6	58.6	56.6	56.0	May 2
EUR19: Unemployment rate, s.a.	8.7%	8.6%	8.6%	8.5%	8.5%		May 2
EUR19: Inflation rate, flash, y/y	1.5%	1.4%	1.3%	1.1%	1.3%	1.5%	May 3
EUR19: Producer prices m/m	0.6%	0.1%	0.4%	0.1%	0.1%		May 3
EUR19: Producer prices y/y	2.8%	2.2%	1.6%	1.6%	2.1%		May 3
EUR19: PMI, services, final	56.2	56.6	58.0	56.2	54.9	55.0	May 4
EUR19: Retail sales, m/m	2.0%	-1.0%	-0.3%	0.1%	0.4%		May 4

MMWB estimates in red

Chart of the Week: High demand drives oil price



The price of oil reached a 3-year high on Tuesday this week. At USD 68.64 per barrel, the price of West Texas Intermediate (WTI) crude oil was thus significantly above the low of February 2016. At that time, a surplus from the United States, brought about by the fracking industry and lower demand from China, pushed the price down to USD 26. But much has changed since then. For one thing, decreased prices have made oil production in the fracking industry unprofitable, which has put pressure on supply over a long period. At the same time, OPEC has imposed production cuts and thus limited supply. Meanwhile, the good global economic trend has caused demand for oil to increase, and it will continue to do so. The oil supply can now hardly keep pace with demand. So, the price of oil has been recovering over the last two years. Does that mean that we should expect a continuing rise of oil prices? Some market participants are already talking about an oil price of USD 100 towards the end of the year. But we have a different view. The rising oil prices will ultimately make fracking in the United States significantly more attractive again. The rising number of oil rigs in the United States is still significantly below the 2016 level, but that may change soon. Moreover, fracking is becoming exponentially more productive, so total output is expanding even with a low number of rigs. Finally, with the dramatic increase of bets on rising oil prices, the probability of a typical trend reversal of those bets has gone up. Overall, we thus see limited room for a further increase of the oil price.

Market data overview

Stock marktes	As of 27.04.2018 13:12	Change versus 20.04.2018 -1 week	26.03.2018 -1 month	26.01.2018 -3 months	29.12.2017 YTD
Dow Jones	24322	-0,6%	0,5%	-8,6%	-1,6%
S&P 500	2667	-0,1%	0,3%	-7,2%	-0,2%
Nasdaq	7119	-0,4%	-1,4%	-5,2%	3,1%
DAX	12588	0,4%	6,8%	-5,6%	-2,6%
MDAX	25873	-0,4%	2,9%	-4,3%	-1,3%
TecDAX	2629	0,2%	4,6%	-1,4%	4,0%
EuroStoxx 50	3516	0,6%	7,2%	-3,6%	0,3%
Stoxx 50	3068	0,9%	6,0%	-5,9%	-3,4%
SMI (Swiss Market Index)	8822	0,2%	3,7%	-7,3%	-6,0%
Nikkei 225	22468	1,4%	8,2%	-4,9%	-1,3%
Brasilien BOVESPA	86383	1,0%	1,5%	1,0%	13,1%
Russland RTS	1156	0,9%	-6,1%	-10,2%	0,1%
Indien BSE 30	34970	1,6%	5,8%	-3,0%	2,7%
China Shanghai Composite	3082	0,3%	-1,6%	-13,4%	-6,8%
MSCI Welt (in €)	2092	1,5%	3,9%	-4,2%	-1,3%
MSCI Emerging Markets (in €)	1144	-0,2%	-0,6%	-7,5%	-1,9%
Bond markets					
Bund-Future	163,14	501	421	335	146
Bobl-Future	130,90	10	-9	23	-71
Schatz-Future	111,90	3	-5	6	-7
3 Monats Euribor	-0,33	0	0	0	0
3M Euribor Future, Dec 2017	-0,31	0	0	-5	0
3 Monats $ Libor	2,36	0	6	59	66
Fed Funds Future, Dec 2017	2,19	2	9	16	0
10 year US Treasuries	2,97	2	13	31	56
10 year Bunds	0,58	-1	6	1	15
10 year JGB	0,05	0	4	-2	1
10 year Swiss Government	0,10	-2	10	10	23
US Treas 10Y Performance	557,49	-0,3%	-0,8%	-2,1%	-4,1%
Bund 10Y Performance	601,86	-0,1%	-0,6%	0,4%	-0,9%
REX Performance Index	479,61	0,1%	-0,1%	0,4%	-0,2%
US mortgage rate	0,00	0	0	0	0
IBOXX AA, €	0,84	-1	5	11	16
IBOXX BBB, €	1,45	1	3	21	22
ML US High Yield	6,50	11	-13	43	34
JPM EMBI+, Index	808	-0,8%	-0,6%	-3,1%	-3,4%
Convertible Bonds, Exane 25	7398	0,0%	2,2%	-0,8%	0,0%
Commodities					
CRB Spot Index	446,29	0,1%	2,0%	1,4%	3,2%
MG Base Metal Index	349,55	-4,1%	4,2%	-3,9%	-2,6%
Crude oil Brent	74,54	1,3%	6,3%	5,8%	11,9%
Gold	1319,55	-1,4%	-2,6%	-2,4%	1,2%
Silver	16,49	-4,1%	-1,6%	-5,2%	-3,1%
Aluminium	2277,50	-8,3%	12,4%	1,1%	1,0%
Copper	6928,50	-0,3%	5,7%	-1,6%	-3,9%
Iron ore	65,29	0,4%	-7,4%	-14,3%	-8,4%
Freight rates Baltic Dry Index	1375	7,3%	22,1%	12,8%	0,7%
Currencies					
EUR/ USD	1,2082	-1,8%	-2,7%	-2,8%	0,7%
EUR/ GBP	0,8780	0,3%	0,4%	0,2%	-1,1%
EUR/ JPY	132,06	-0,3%	1,2%	-2,9%	-2,2%
EUR/ CHF	1,1967	0,0%	1,9%	2,9%	2,3%
USD/ CNY	6,3363	0,6%	1,0%	0,2%	-2,6%
USD/ JPY	109,31	1,5%	3,7%	0,5%	-3,0%
USD/ GBP	0,73	1,9%	3,4%	3,1%	-1,7%

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