

ECONOMIC SITUATION AND STRATEGY

April 26, 2019

Investment success with bonds despite low interest rates

The phenomenal performance of the stock markets has been the topic of much discussion in recent weeks. Germany's leading index, the DAX, has gained 16% in the first four months of 2019, causing last year's weak showing to be at least partly forgotten. This probably annoys many investors who have had little or no exposure in stocks. However, we should not forget that an investment strategy must fit the relevant risk profile. While people often feel their stock ratio is too low in times of advancing prices, the opposite is true when the markets are tumbling. This leads to procyclical adjustments of the investment ratio and less than optimal results. The right strategic asset allocation is the crucial factor for success. It must not only conform to the return needs of investors, but also take account of their risk tolerance.

Strategies with 100% exposure to stocks are therefore suitable for very few investors. So, how should we allocate the part not invested in stocks? In times when money is lying around not drawing much interest, if any, in an instant access account or savings passbook, such facilities do not even ensure preservation of capital when the inflation rate is greater than zero. Consequently, there is great demand for real estate investments, particularly in Germany. The "pro" arguments are nearly irresistible. Prices have been going up for the last ten years, and real estate is attractive because it is not subject to round-the-clock value determinations, in contrast to stocks. However, real estate is not liquid, and that can be a decisive disadvantage. For that reason, illiquid investments play no role in our asset management.

Instead, the part of the assets we manage that is not in stocks is invested in bonds. But when interest rates are as low as they are now, one might think investing in bonds is just as pointless as leaving money in a savings account. But that is certainly not the case. For, bond performance depends on two components: the coupon interest rate and the bond price. Normally, a bond is issued at a price of 100 and repaid at the same price at the end of its term. Investors who hold the bond until maturity ("buy and hold strategy") can only earn the interest afforded by the coupon rate. However, the bond price can rise or fall during the term of the bond, and an additional value driver thus arises if one practices skillful bond management. Price performance will then depend, among other things, on the general trend of market interest rates, the issuer's creditworthiness, and the investor's risk tolerance.

Not only stock prices, but also bond prices have performed very positively since the beginning of 2019. So, investors who have not put all their money into stocks need not fret. If they have not left it in savings accounts, but have invested it in bonds, they can generate respectable value gains that way. Despite very low coupon rates for European government bonds, a value increase of 2.4% (iBoxx Euro Sovereigns Index) could be achieved with them since the beginning of the year. That is remarkable inasmuch as the prices of government bonds and stocks often move in opposite directions. If investors are very skeptical, they normally sell risky securities (like stocks) and in their place buy safe bonds from issuers they trust to pay interest on time and repay the bond at maturity.

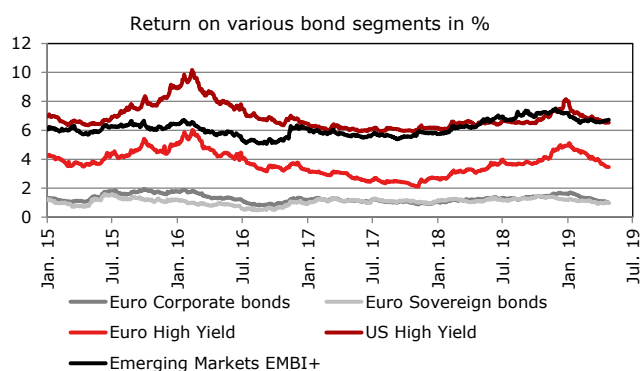
Economic Situation and Strategy

Corporate bonds have performed even better than government bonds. European corporates with an investment-grade rating are quoting 3.9% up since the beginning of the year. We may also observe on the bond market that the segments with the highest risk show the best performance in the same period. High-yield corporates (bonds that do not have an investment-grade rating of at least BBB-) have gained almost 7% since the beginning of the year in Europe, while their US counterparts are up almost 9% (in USD). It has even been possible to earn more than 5% with USD-denominated bonds from emerging markets. On our balanced asset management strategy, which may invest at most 50% in stocks and now has a stock ratio of about 35%, we have already managed to achieve a gain of 8.4% before costs this year thanks to a good mixture of different bonds.

At least at first glance, equally positive performance of stocks and (government) bonds appears inconsistent. Continuing high demand for safety (government bonds) shows that many investors remain skeptical in view of current economic data about whether the upswing will continue and, if so, at what pace. At the same time, the advance of stock prices signals that enough investors at least rule out the recession scenario. Central bank action is perhaps the most important factor benefiting both stock prices and bond prices. The US Federal Reserve, in particular, has greatly influenced price development on the capital markets with its abrupt monetary policy about-face at the beginning of the year. The Fed had raised its key interest rate again as recently as mid-December 2018 and presented the prospect of further rate hikes in 2019. Then, the surprising change of course happened in January. Because of weaker economic momentum and falling inflation rates, further increases would be superfluous.

For the stock and bond markets, such a scenario is like a land of milk and honey. There is enough growth to keep

business and corporate earnings going, but without too much cyclical momentum leading to higher inflation rates and hence tighter monetary policy. As long as new economic data confirms these expectations, we are likely to see further price gains. Some reservations remain about the economic data, about whether there is more wishful thinking than reality involved. On the other hand, inflation is under control until further notice. If oil prices do not rise significantly in the near future, the annual average inflation rate will be just over 1.5% in the United States and just over 1% in the euro area. So, higher central bank interest rates on either side of the Atlantic should not be expected to spoil the party. The Fed might even lower interest rates during the year, if weaker economic data were to emerge in addition to the lower inflation rates.



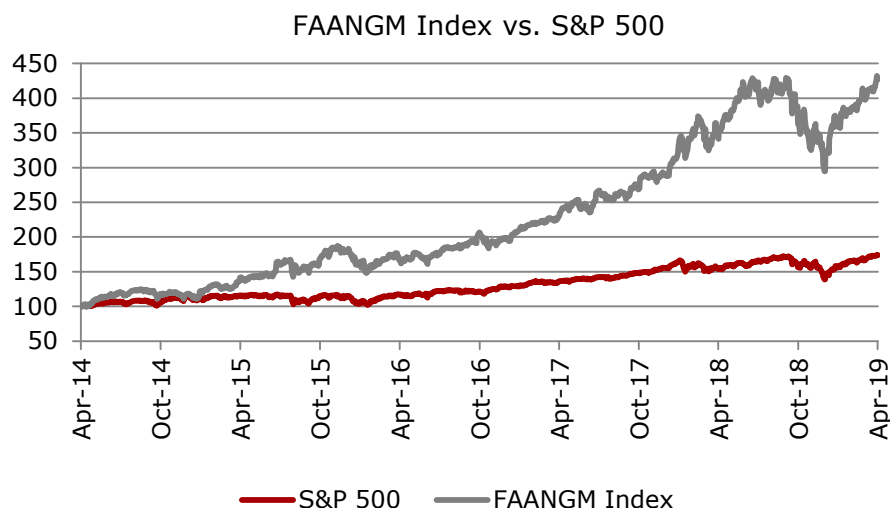
That is good news for the bond market, since there are prospects of further price gains. Investors should prefer bonds with relatively long maturities, which benefit above average from declining yields. Moreover, as long as a recession remains unlikely, corporate and emerging market bonds with relatively weak creditworthiness promise better performance than high-rated bonds, especially since yields on the riskier bonds are still higher now than on average of the last past two years.

Weekly Outlook for April 29-May 3, 2019

	Dec.	Jan.	Feb.	Mar.	Apr.	May	Release
DE: GfK consumer climate	10.4	10.5	10.8	10,7	10,4	10,2	April 30
DE: Import prices, m/m	-1.3%	-0.2%	0.3%	0,3%			April 30
DE: Unemployed, change in 000s	-14	-4	-20	-7	-12		April 30
DE: Unemployment rate	5.0%	5.0%	5.0%	4,9%	4,9%		April 30
DE: Inflation rate, m/m – flash	0.0%	-0.8%	0.4%	0,4%	0,3%		April 30
DE: Inflation rate, y/y – flash	1.6%	1.4%	1.5%	1,3%	1,4%		April 30
DE: PMI, manufacturing – final	51.5	49.7	47.6	44,1	44,5		May 2
EUR19: M3 money supply, y/y	4.1%	3.8%	4.3%	4,0%			April 29
EUR19: Business climate	0.86	0.69	0.69	0,53	0,50		April 29
EUR19: Economic confidence	107.4	106.3	106.2	105,5	105,1		April 29
EUR19: Consumer confidence – final	-8.3	-7.9	-7.4	-7,2	-7,9%		April 29
EUR19: Industrial confidence	2.3	0.6	-0.4	-1,7	-1,5		April 29
EUR19: Unemployment rate, s.a.	7.9%	7.8%	7.8%	7,8%			April 30
EUR19: PMI, services – final	51.4	50.5	49.3	47,5	47,8		May 2
EUR19: Inflation rate, y/y – final	1.5%	1.4%	1.5%	1,4%	1,4%		May 3
EUR19: Producer prices, m/m	-0.8%	0.3%	0.1%	0,2%			May 3
	Q3 2018		Q4 2018		Q1 2019		
EUR19: GDP, q/q – s.a.	0.2%		0.2%		0.2%		April 30
EUR19: GDP, y/y – s.a.	1.6%		1.1%		0.6%		April 30

MMWB estimates in red

Chart of the Week: FAANGM index dominates



The S&P 500 index has already risen an impressive 17.5% since the beginning of the year. But the performance of the FAANGM stocks (Facebook, Apple, Amazon, Netflix, Google (Alphabet), and Microsoft) is even more impressive. On average, prices of those stocks have advanced by over 30% in the same period and have thus strongly boosted the market cap-weighted indexes in the United States. After all, the six FAANGM stocks now make up almost 16% of the free

float market cap of the 500 stocks in the S&P. Now that Microsoft has managed to surprise analysts positively in the current earnings season, its market cap has even exceeded the trillion-dollar mark at times. That makes Microsoft now even worth more than Apple, which last year became the first listed company to break that barrier. With a market cap of just under USD 800 billion, Amazon is probably the next potential candidate for this illustrious club.

Market Data Overview

Stock marketes	As of	Change versus				
	26.04.2019 10:13	19.04.2019 -1 week	25.03.2019 -1 month	25.01.2019 -3 months	25.04.2018 -1 year	31.12.2018 YTD
Dow Jones	26462	-0,4%	3,7%	7,0%	9,9%	13,4%
S&P 500	2926	0,7%	4,6%	9,8%	10,9%	16,7%
Nasdaq	8119	1,5%	6,3%	13,3%	15,9%	22,4%
DAX	12280	0,5%	8,2%	8,9%	-1,1%	16,3%
MDAX	25865	0,0%	5,1%	8,6%	1,3%	19,8%
TecDAX	2897	3,4%	10,3%	9,3%	12,9%	18,2%
EuroStoxx 50	3492	-0,2%	5,8%	10,4%	0,2%	16,3%
Stoxx 50	3184	0,4%	3,7%	10,8%	4,7%	15,3%
SMI (Swiss Market Index)	9704	1,4%	4,3%	8,8%	11,0%	15,1%
Nikkei 225	22259	0,3%	6,1%	7,1%	0,2%	11,2%
Brasilien BOVESPA	96552	2,1%	3,1%	-1,2%	13,5%	9,9%
Russland RTS	1247	-1,1%	1,5%	4,6%	9,6%	17,0%
Indien BSE 30	38829	-0,8%	2,7%	7,8%	12,5%	7,7%
China Shanghai Composite	3086	-5,6%	1,4%	18,6%	-1,0%	23,8%
MSCI Welt (in €)	2165	1,3%	5,6%	10,2%	14,1%	18,2%
MSCI Emerging Markets (in €)	1077	-0,4%	4,5%	6,3%	3,4%	14,7%
Bond markets						
Bund-Future	165,69	47	3	62	797	215
Bobl-Future	133,08	24	29	25	243	56
Schatz-Future	111,96	5	7	5	9	2
3 Monats Euribor	-0,31	0	0	-1	2	0
3M Euribor Future, Dec 2017	-0,31	0	-2	-7	-36	0
3 Monats \$ Libor	2,59	1	-2	-17	22	-22
Fed Funds Future, Dec 2017	2,22	-8	8	-25	-40	0
10 year US Treasuries	2,52	-4	10	-23	-50	-17
10 year Bunds	-0,02	-5	0	-16	-66	-27
10 year JGB	-0,05	-2	4	-5	-11	-5
10 year Swiss Government	-0,33	5	18	-8	-48	-9
US Treas 10Y Performance	593,30	0,2%	-1,0%	2,3%	6,7%	2,2%
Bund 10Y Performance	646,37	0,3%	-0,1%	2,0%	7,9%	3,1%
REX Performance Index	491,69	0,2%	0,1%	0,5%	2,8%	0,8%
US mortgage rate	0,00	0	0	0	0	0
IBOXX AA, €	0,44	-5	-7	-38	-43	-44
IBOXX BBB, €	1,29	-6	-22	-65	-18	-77
ML US High Yield	6,55	0	-23	-64	1	-146
JPM EMBI+, Index	831	-0,5%	-0,7%	0,7%	2,9%	4,9%
Convertible Bonds, Exane 25	7303	0,0%	2,1%	4,1%	-1,0%	5,9%
Commodities						
CRB Spot Index	421,53	-0,8%	-0,9%	2,5%	-5,6%	3,0%
MG Base Metal Index	310,24	-0,9%	-1,2%	3,1%	-12,3%	5,3%
Crude oil Brent	74,23	3,2%	10,4%	20,7%	0,6%	39,7%
Gold	1281,68	0,5%	-3,0%	-1,3%	-2,9%	0,0%
Silver	14,96	-0,3%	-3,9%	-4,7%	-9,7%	-3,5%
Aluminium	1843,00	-0,6%	-0,6%	-3,1%	-18,0%	-1,1%
Copper	6358,50	-1,6%	0,3%	5,3%	-8,8%	6,9%
Iron ore	93,14	0,2%	8,5%	24,8%	42,8%	34,6%
Freight rates Baltic Dry Index	869	10,0%	26,1%	-4,0%	-36,8%	-31,6%
Currencies						
EUR/ USD	1,1132	-1,0%	-1,7%	-1,9%	-8,6%	-2,8%
EUR/ GBP	0,8627	-0,2%	0,6%	-0,3%	-1,2%	-3,9%
EUR/ JPY	124,32	-1,2%	-0,3%	-0,3%	-6,5%	-1,2%
EUR/ CHF	1,1367	-0,1%	1,2%	0,5%	-5,2%	0,9%
USD/ CNY	6,7380	0,5%	0,4%	-0,2%	6,5%	-2,0%
USD/ JPY	111,64	-0,3%	1,5%	1,9%	2,0%	1,9%
USD/ GBP	0,78	0,8%	2,3%	2,1%	8,0%	-1,3%

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