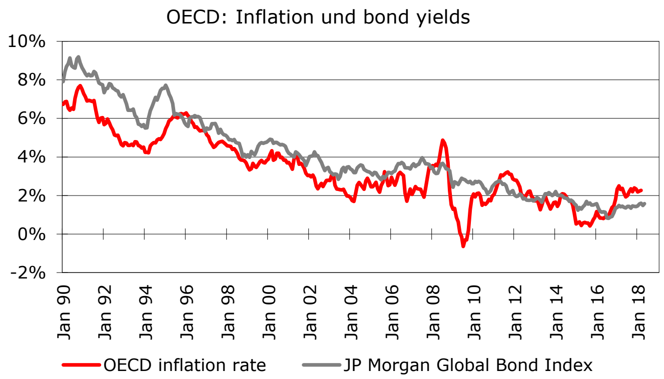
ECONOMIC SITUATION AND STRATEGY

May 11, 2018

Dividends, the better "interest"

Expectations about the future seldom rest on accurate calculations, but mostly derive from what one has observed in the recent past. "Adaptive expectations," which involve adjusting forecasts based on recent experience, is often also the logical and best approach in the absence of knowledge about circumstances. However, problems start to arise when the initial situation or state of affairs on which the relevant assumptions are made have changed so much that an erroneous forecast is almost inevitable.

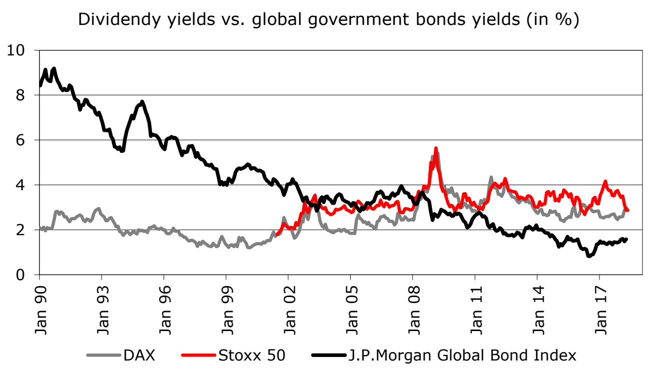
The past 20 years saw a real bonanza for those who invested in fixed-income securities. It required no great skill to achieve an annual return of 5% or more with comparatively low volatility. It was therefore virtually no problem to satisfy the return requirements of foundations, pension funds, and insurance companies. One could only obtain substantially worse results on the bond market by having chosen bonds of excessively short duration and hence residual maturity, which by definition would not have made sense for a very long investment horizon. With these results in mind and wishing to avoid risks in their portfolios, many investors have maintained their strategic bond ratios in the past years. On the other hand, they have increased stock ratios only sporadically and even then to a measured extent, although investing in fixed-income products has yielded less and less. One could only achieve a yield of 2% on high-rated European government and corporate bonds last year, while the result for US bonds actually turned out negative due to exchange rate development. In strategically favoring bonds, which they assumed offered high returns at low risk, many investors underestimated the danger of betting on the wrong horse. At the same time, the opportunity costs of missed returns on the stock market were and continue to be enormous.



However, fixed-income investors now sense a new day dawning due to the recently rising yield level. Many hope this will continue, since theory teaches that an economic upswing combined with very accommodative monetary policy should lead sooner or later to rising inflation and hence higher interest rates. But contrary to intuitive first impressions, there are good reasons why inflation will remain low in the long term despite the economic boom and abundance of liquidity. In other words, there is evidence that the long-term trend towards ever-lower inflation rates will continue without a mean reversion, or return to the long-term average.

This gives rise to two recommendations for investors. First, they should be less worried about climbing inflation rates and less hopeful about higher interest rates. The last 20 to 25 years in Japan provide a good example of how long inflation and interest rates can stay at an extremely low level. Second, investors should reconsider their strategic asset allocation. The yield to maturity of European government and corporate bonds of investment grade is only about 1%. The yield to maturity is the annual return one would achieve by buying a bond today and holding it until final maturity, assuming full redemption of nominal value. If asset allocation is not adjusted, the capital market environment will take its toll, forcing one to reduce return expectations to a realistic level. If one is unable or unwilling to take this step, there will be no other choice but to increase portfolio risk.

Can stocks make up for this poor outlook for bonds? In the case of stocks, it is more difficult to calculate exact return expectations for the near term due to possible fluctuations. However, a stock's dividend yield is a good point of reference for payout-oriented investors. The dividend yield comes to about 3% for both the DAX 30 and the Stoxx 50. The robust world economic trend, reflected in strong corporate financial statements, is largely responsible for this. The 30 largest German companies, which form the DAX index, made a cumulative net profit last year of over EUR 90 billion. That is the highest amount in the past ten years. This earnings situation has allowed companies to raise what they pay to shareholders in the form of dividends to a record level. Cumulative payouts will thus reach about EUR 35 billion in the current dividend season. The extent to which shareholders participate in earnings varies greatly among companies. For example, Commerzbank will not pay any dividend, while Daimler AG, the company that pays the largest dividend, will distribute about EUR 3.6 billion.



Since the global economy remains in good shape, worldwide GDP will continue to grow this year by about 4%. Current economic indicators are registering a moderate decline, but the consolidation is taking place at a high level. From today's perspective, it is too early to tell whether the current debate about tariffs and other trade barriers will have a lasting negative effect on the economic trend. That will critically depend on whether the parties involved come closer together as recently hinted and find new, pragmatic solutions.

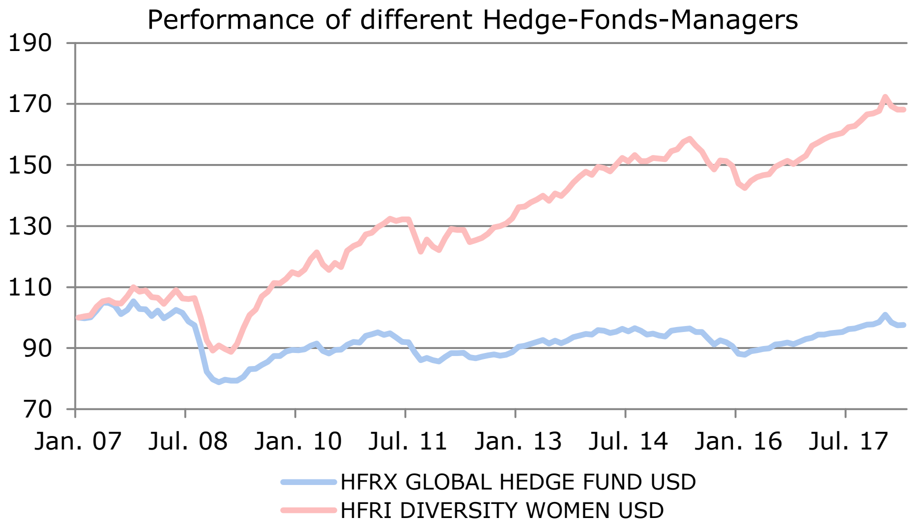
If a trade war is avoided, European stocks will again offer a dividend yield next year that is above the yield to maturity on most bonds. So, dividends are the better "interest" because they are more constant and provide higher payouts than may be expected from government and corporate bonds. In the Stoxx 600, for example, 11 out of 19 sectors have a dividend yield of more than 3%. Insurers (5.0%), utilities and telecoms (each 4.9%), and banks (4.7%) exhibit the most attractive payouts.

Weekly outlook for May 14-18, 2018

	Dec.	Jan.	Feb.	Mar.	Apr.	May	Release
DE: ZEW economic expectations	17.4	20.4	17.8	5,1	-8,2	-1,0	May 15
DE: ZEW current conditions	89.3	95.2	92.3	90,7	87,9	89,5	May 15
DE: Consumer prices, m/m - final	0.6%	-0.7%	0.5%	0,4%	0,0%		May 16
DE: Consumer prices, y/y - final	1.7%	1.6%	1.4%	1,6%	1,6%		May 16
DE: Producer prices, m/m	0.2%	0.5%	-0.1%	0,1%	0,3%		May 18
DE: Producer prices, y/y	2.3%	2.1%	1.8%	1,9%	1,8%		May 18
EUR19: Industrial production, m/m	-0.1%	-0.6%	-0.8%	0,6%			May 15
EUR19: Industrial production, y/y	5.0%	4.1%	2.9%	3,7%			May 15
EUR19: Consumer prices, y/y - final	1.4%	1.3%	1.1%	1,3%	1,2%		May 16
EUR19: Core inflation rate, y/y - final	0.9%	1.0%	1.0%	1,0%	0,7%		May 16
	Q3 17		Q4 17		Q1 18		
DE: GDP, q/q – s.a.	0.8%		0.6%		0.4%		May 15
DE: GDP, y/y – s.a.	2.8%		2.9%		2.4%		May 15
EUR19: GDP, q/q – s.a.	0.7%		0.6%		0.4%		May 15
EUR19: GDP, y/y – s.a.	2.8%		2.7%		2.5%		May 15

MMWB estimates in red

Chart of the Week: Team Diversity is winning



Anyone who follows the TV reality show "Germany's Next Top Model" has presumably noted that "Team Diversity" is now significantly ahead of "Team Michael." Interestingly, this pole position applies not only to the world of pretty fashion models, but also to that of hedge funds. At least, that is what an index calculated by well-known data service Hedge Fund Research (HFR) suggests. It shows that while investable hedge funds have only moved sideways overall since 2007, those managed by women have cumulatively gained about 70%. Now, women might simply have happened to manage strategies in recent years that have proven successful in retrospect. However, the outperformance is so systematic that it is unlikely to have occurred by chance. Instead, a University of Central Florida study cites comparatively strong evidence that the male hormone testosterone is an obstacle to good performance. So, the next time you select a new fund manager, you should not only consider historical performance, but also inquire about the manager's hormone level.

Market data overview

Stock marktes	As of 11.05.2018 14:18	Change versus 04.05.2018 -1 week	10.04.2018 -1 month	09.02.2018 -3 months	29.12.2017 YTD
Dow Jones	24740	2,0%	1,4%	2,3%	0,1%
S&P 500	2723	2,2%	2,5%	4,0%	1,8%
Nasdaq	7405	2,7%	4,4%	7,7%	7,3%
DAX	12981	1,3%	4,7%	7,2%	0,5%
MDAX	26702	1,2%	3,4%	6,7%	1,9%
TecDAX	2786	3,3%	8,5%	14,1%	10,2%
EuroStoxx 50	3562	0,3%	3,6%	7,1%	1,7%
Stoxx 50	3129	1,0%	2,9%	5,2%	-1,5%
SMI (Swiss Market Index)	8982	0,9%	2,6%	3,5%	-4,3%
Nikkei 225	22758	1,3%	4,4%	6,4%	0,0%
Brasilien BOVESPA	85861	3,3%	1,6%	6,1%	12,4%
Russland RTS	1197	4,4%	9,7%	0,9%	3,7%
Indien BSE 30	35536	1,8%	4,9%	4,5%	4,3%
China Shanghai Composite	3163	2,3%	-0,9%	1,1%	-4,4%
MSCI Welt (in €)	2124	1,9%	5,2%	6,5%	1,4%
MSCI Emerging Markets (in €)	1157	2,1%	1,9%	4,0%	0,3%
Bond markets					
Bund-Future	163,14	406	409	510	146
Bobl-Future	131,11	-1	15	62	-50
Schatz-Future	111,92	1	6	5	-5
3 Monats Euribor	-0,33	0	0	0	0
3M Euribor Future, Dec 2017	-0,30	1	-1	-5	0
3 Monats $ Libor	2,36	-1	2	54	66
Fed Funds Future, Dec 2017	2,21	2	12	26	0
10 year US Treasuries	2,96	1	16	12	55
10 year Bunds	0,55	1	4	-14	13
10 year JGB	0,05	0	1	-3	0
10 year Swiss Government	0,05	4	4	-5	18
US Treas 10Y Performance	557,82	-0,3%	-1,3%	-0,8%	-4,1%
Bund 10Y Performance	604,30	-0,1%	-0,3%	1,9%	-0,5%
REX Performance Index	480,10	0,0%	-0,1%	1,1%	-0,1%
US mortgage rate	0,00	0	0	0	0
IBOXX AA, €	0,80	0	-3	1	13
IBOXX BBB, €	1,46	1	3	9	23
ML US High Yield	6,50	-3	6	-10	35
JPM EMBI+, Index	797	0,3%	-2,5%	-1,3%	-4,7%
Convertible Bonds, Exane 25	7497	0,0%	2,1%	3,9%	1,3%
Commodities					
CRB Spot Index	444,07	-0,4%	0,9%	1,3%	2,7%
MG Base Metal Index	352,44	1,1%	0,4%	0,9%	-1,8%
Crude oil Brent	77,18	3,8%	8,5%	21,7%	15,9%
Gold	1325,13	1,1%	-1,1%	0,9%	1,7%
Silver	16,73	1,6%	0,7%	3,0%	-1,6%
Aluminium	2330,25	-1,7%	5,6%	9,9%	3,3%
Copper	6884,00	1,4%	-0,4%	2,6%	-4,5%
Iron ore	66,49	-0,7%	1,8%	-11,2%	-6,7%
Freight rates Baltic Dry Index	1453	5,0%	49,2%	29,2%	6,4%
Currencies					
EUR/ USD	1,1937	-0,3%	-3,4%	-2,7%	-0,5%
EUR/ GBP	0,8801	-0,3%	1,0%	-0,8%	-0,9%
EUR/ JPY	130,44	0,1%	-1,4%	-2,4%	-3,4%
EUR/ CHF	1,1933	-0,1%	1,2%	3,8%	2,0%
USD/ CNY	6,3312	-0,5%	0,8%	0,5%	-2,7%
USD/ JPY	109,40	0,2%	2,0%	0,6%	-2,9%
USD/ GBP	0,74	-0,3%	4,5%	1,8%	-0,2%

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