M.M. WARBURG & CO
BANK

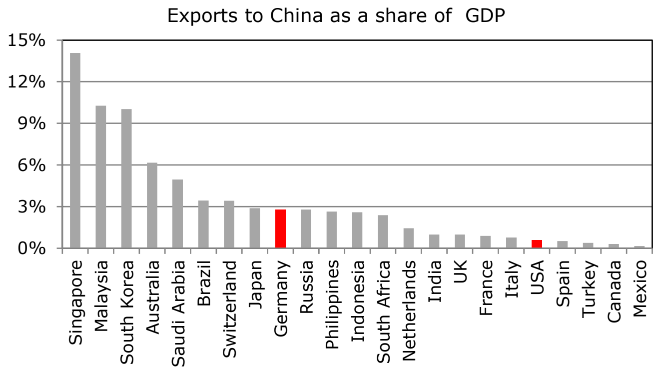
ECONOMIC SITUATION AND STRATEGY

May 10, 2019

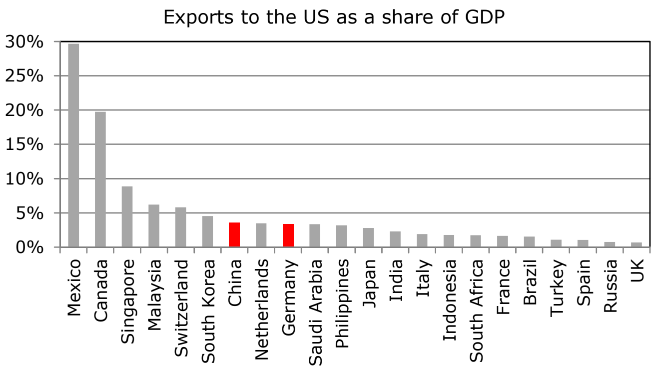
Fasten your seatbelts: Deal or no deal?

The topic of a possible trade war has concerned the markets since Donald Trump imposed import tariffs of 25% on steel and 10% on aluminum in March 2018. The US president is pursuing an aggressive trade strategy, especially in relation to China. By now, almost half of all Chinese goods coming into the United States are subject to punitive tariffs. One is 25% on USD 50 billion in imports (goods relevant to industrial technology), and another is 10% on USD 200 billion on other imports. However, the latter might increase to 25% as early as Friday, now that Trump has expressed his dissatisfaction with the progress of current trade talks in recent days and accused China of wanting to cancel or renegotiate commitments already made. Moreover, the United States might impose a 25% tariff "soon" on all other imports from China, which heretofore have come in duty-free. That would affect goods worth about USD 300 billion.

It is still anyone's guess whether Trump's threats are serious or just part of his negotiating tactics, which consist in putting his counterparts under maximum pressure to achieve the result he wants. China's reaction will now be crucial. Will the country allow itself to be intimidated by the United States and give in to Trump's demands, or will it ratchet up pressure of its own by threatening countermeasures? From the standpoint of game theory, this is a typical case of "chicken." Two potential opponents are on a collision course, but whoever turns away first will thus reveal their fear and lose the game. Which of the two countries will "chicken out"? Or will there actually be a huge crash this time?

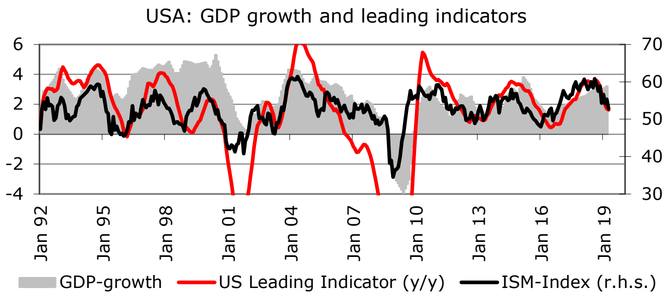


China undoubtedly has more to lose in a trade war than the United States does. That is because the goods it exports to the United States amounts to 3.5% of its GDP, which is significantly more than the other way around. The GDP share of US exports to China is only 0.5%. Simulations calculated by the International Monetary Fund conclude that 25% tariffs on the total exchange of goods between the United States and China would cause real GDP to decline by 0.3-0.6% in the United States and by 0.5-1.5% in China. In isolation, these two effects would make global economic growth 0.2-0.3 percentage points slower than it would otherwise be. Even if the US-China trade conflict becomes a real trade war, the probability is low that a global recession would result from weaker world trade (which would undoubtedly occur). Nevertheless, other countries could suffer in this case, especially those for which foreign trade, either in general or with China in particular, plays a key role. Germany and Switzerland are examples, but so are Singapore, Malaysia, South Korea, and Saudi Arabia.



However, when focusing on foreign trade in this way, we must not overlook the threat of further cyclical slowing by way of capital spending and personal consumption. Among other things, the uncertainties raised by the trade disputes have prompted businesses to postpone their original investment plans. Increasing inventories and falling prices are negative secondary effects, which will also affect the United States itself. Even if the surprisingly strong US economic growth in the first quarter of 2019 of 3.2% may perhaps have made Trump believe he had the economically stronger position versus China, the details of the economic story reveal some weaknesses. For, consumer spending or business investment were not the main economic drivers as they had been in the past. Instead, growth was mainly attributable to a buildup of inventories and declining imports.

The key leading indicators for the US economy, the purchasing manager indexes for the manufacturing and services sectors, and the Conference Board's leading indicator point to a slowing of economic growth to about 2% in the next few quarters. If China and the United States do not reach a trade deal, growth prospects might worsen even further. Investors should keep a close eye on consumer spending, which is responsible for about 70% of the US economy's total output. In view of a 3.6% unemployment rate, the lowest in 50 years, and moderately rising wages, one should assume that consumption would remain the engine of US economic growth. However, tariffs on all Chinese imports could negatively affect US consumers. While business have mainly borne the costs of the tariffs already introduced, that will probably no longer be true of the new tariffs. For, in all likelihood, they would make goods like textiles, shoes, furniture, and cell phones significantly more expensive for consumers.



So, what does this mean for investors? To a considerable extent, the stock market's very good performance this year is attributable to hopes for a quick and positive outcome of the US-China trade dispute. In that case, one could expect that the Chinese economy would recover, because no appreciable slowing of foreign trade would get in the way of the positive effects of expansionary monetary and fiscal policy. Just as some countries will be the main sufferers if there is no trade agreement, those very countries will be among the top beneficiaries if there is one. Consequently, the DAX is certainly one of the stock indexes reacting strongly these days to every new headline out of Washington or Beijing.

Investors need a great deal of nerve to get through this phase on the stock market. We recommend staying calm and awaiting the actual result of the negotiations. Reacting to short-term political news has almost always been the wrong thing to do in the past 12 months. A further sharp drop on the stock market may be expected if the two parties do not reach an agreement. Conversely, there will probably be a rally, if they do. Since it is hardly possible to predict political developments in the Age of Trump, this means investors need to fasten their seatbelts and keep their nerve.

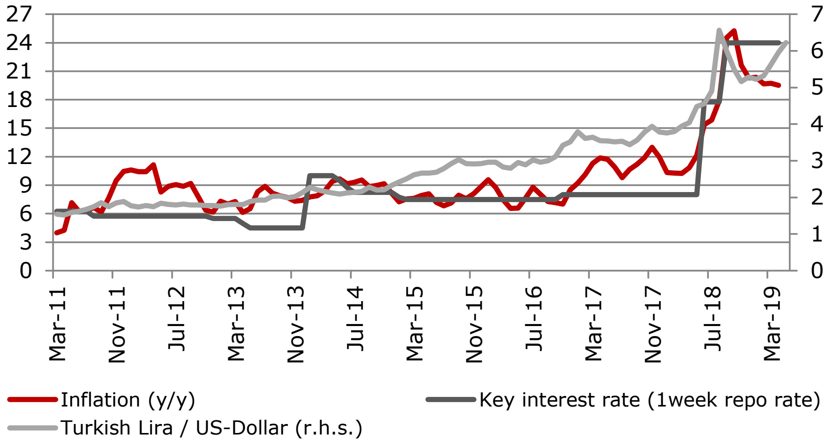
Weekly Outlook for May 13-17, 2019

	Dec.	Jan.	Feb.	Mar	Apr.	May	Release
DE: Consumer prices, m/m – final	0.0%	-0.8%	0.4%	0,4%	0,9%		May 14
DE: Consumer prices, y/y – final	1.6%	1.4%	1.5%	1,3%	1,9%		May 14
DE: ZEW economic expectations	-17.5	-15	-13.4	-3,6	3,1	3,3	May 14
DE: ZEW current conditions	45.3	27.6	15	11,1	5,5	5,9	May 14
EUR19: Industrial production, m/m	-0.9%	1.9%	-0.2%	0,5%			May 14
EUR19: Industrial production, y/y	-4.2%	-0.7%	-0.3%	-0,1%			May 14
EUR19: Consumer prices, y/y – final	1.5%	1.4%	1.5%	1,4%	1,7%		May 17
EUR19: Core inflation rate, y/y – final	0.9%	1.1%	1.0%	0,8%	1,2%		May 17
	Q3 2018		**Q4 2018**		**Q1 2019**		
DE: GDP, q/q – s.a.	-0.2%		0.0%		0.4%		May 15
DE: GDP, y/y – s.a.	1.1%		0.6%		0.7%		May 15
EUR19: GDP, q/q – s.a.	0.2%		0.2%		0.4%		May 15
EUR19: GDP, y/y – s.a.	1.6%		1.1%		1.2%		May 15

MMWB estimates in red

Chart of the Week: Turkish lira marked by uncertainty

Turkey: Inflation, key interest rate and exchange rate



The already high political and economic uncertainty in Turkey continues to grow. For one thing, Turkey remains under pressure due to foreign policy conflicts, especially with the United States. However, "home-made" domestic problems, having recently become more and more pronounced after a hiatus at the end of 2018, appear more serious. The inflation rate, for example, remains extremely high, which has forced the central bank already to make two huge, but still insufficient interest rate increases despite political pressure. The key interest rate now stands at 24%, but currency swaps imply a likely rise to 30% within a year. The weak currency, which is likewise exerting pressure on inflation, is also a reason for this. President Erdoğan's latest effort to thwart democracy – the forced repetition of mayoral elections in Istanbul, which his party, the AKP, had lost – has further eroded confidence in Turkish institutions. This is reflected in another devaluation of the lira, which has lost almost 18% in value against the US dollar since the beginning of the year. Businesses that have to service debt denominated in foreign currency are also feeling that. The consequences are debt restructuring and an increase of non-performing loans, which in turn weigh on the balance sheets of ailing Turkish banks. Although the central bank can stop the currency's devaluation by raising key interest rates, that would simultaneously further dampen the contracting economy. Given this dilemma, an economic recovery is therefore not likely anytime soon.

Market Data Overview

Stock marktes	As of 10.05.2019 14:05	Change versus 03.05.2019 -1 week	09.04.2019 -1 month	08.02.2019 -3 months	09.05.2018 -1 year	31.12.2018 YTD
Dow Jones	25828	-2,6%	-1,2%	2,9%	5,2%	10,7%
S&P 500	2871	-2,5%	-0,3%	6,0%	6,4%	14,5%
Nasdaq	7911	-3,1%	0,0%	8,4%	7,8%	19,2%
DAX	12059	-2,8%	1,8%	10,6%	-6,8%	14,2%
MDAX	25467	-1,9%	1,2%	9,7%	-4,6%	18,0%
TecDAX	2815	-2,6%	2,7%	13,4%	1,5%	14,9%
EuroStoxx 50	3367	-3,9%	-1,5%	7,4%	-5,7%	12,2%
Stoxx 50	3087	-3,3%	-2,4%	5,9%	-1,7%	11,8%
SMI (Swiss Market Index)	9509	-2,4%	-0,8%	5,6%	5,8%	12,8%
Nikkei 225	21345	-4,1%	-2,1%	5,0%	-4,7%	6,6%
Brasilien BOVESPA	94808	-1,2%	-1,5%	-0,6%	12,5%	7,9%
Russland RTS	1219	-2,3%	-2,3%	1,6%	6,8%	14,4%
Indien BSE 30	37463	-3,9%	-3,8%	2,5%	6,1%	3,9%
China Shanghai Composite	2939	-4,5%	-9,3%	12,3%	-7,0%	17,9%
MSCI Welt (in €)	2119	-3,3%	-0,7%	6,0%	6,2%	14,7%
MSCI Emerging Markets (in €)	1028	-5,7%	-5,6%	0,3%	-4,9%	8,6%
Bond markets						
Bund-Future	166,26	100	78	-49	741	272
Bobl-Future	133,26	32	34	-4	217	74
Schatz-Future	112,00	6	9	8	8	6
3 Monats Euribor	-0,31	0	0	0	2	0
3M Euribor Future, Dec 2017	-0,32	-1	-1	-8	-32	0
3 Monats $ Libor	2,54	-2	-5	-16	18	-27
Fed Funds Future, Dec 2017	2,19	-7	-7	-16	-45	0
10 year US Treasuries	2,45	-9	-5	-19	-56	-24
10 year Bunds	-0,04	-7	-4	-13	-60	-29
10 year JGB	-0,04	0	2	-2	-9	-5
10 year Swiss Government	-0,35	3	2	2	-40	-11
US Treas 10Y Performance	598,10	0,7%	0,6%	2,0%	7,4%	3,0%
Bund 10Y Performance	648,89	0,7%	0,4%	1,3%	7,5%	3,5%
REX Performance Index	492,37	0,3%	0,2%	0,4%	2,7%	1,0%
US mortgage rate	0,00	0	0	0	0	0
IBOXX AA, €	0,44	-1	-6	-21	-38	-44
IBOXX BBB, €	1,33	6	-10	-41	-14	-73
ML US High Yield	6,67	14	4	-41	16	-134
JPM EMBI+, Index	834	-0,2%	-0,5%	0,5%	5,9%	5,4%
Convertible Bonds, Exane 25	7277	0,0%	0,4%	3,7%	-2,9%	5,6%
Commodities						
CRB Spot Index	412,54	-1,4%	-2,9%	-0,1%	-7,2%	0,8%
MG Base Metal Index	298,40	-1,6%	-6,4%	-3,9%	-14,5%	1,3%
Crude oil Brent	70,94	-0,7%	0,2%	14,7%	-8,2%	33,5%
Gold	1285,55	0,4%	-1,5%	-2,2%	-2,2%	0,3%
Silver	14,78	-1,1%	-3,5%	-6,4%	-10,7%	-4,7%
Aluminium	1767,75	-0,1%	-4,5%	-4,8%	-25,6%	-5,1%
Copper	6089,00	-2,3%	-6,0%	-1,6%	-10,1%	2,4%
Iron ore	94,24	0,5%	1,6%	2,3%	42,4%	36,2%
Freight rates Baltic Dry Index	974	-1,1%	34,3%	62,1%	-33,5%	-23,4%
Currencies						
EUR/ USD	1,1231	0,7%	-0,4%	-1,0%	-5,5%	-1,9%
EUR/ GBP	0,8629	1,2%	-0,1%	-1,4%	-1,2%	-3,9%
EUR/ JPY	123,23	-0,9%	-1,8%	-1,1%	-5,4%	-2,1%
EUR/ CHF	1,1375	-0,1%	0,9%	0,2%	-4,4%	0,9%
USD/ CNY	6,8217	1,3%	1,6%	1,2%	7,2%	-0,8%
USD/ JPY	109,76	-1,2%	-1,2%	0,0%	0,0%	0,2%
USD/ GBP	0,77	0,8%	0,3%	-0,5%	4,3%	-2,1%

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