M.M.WARBURG & CO
BANK

ECONOMIC SITUATION AND STRATEGY

May 24, 2019

Where is Europe headed?

Elections to the European Parliament are taking place now. People in the Netherlands and Great Britain were already voting yesterday, and Germans will go to the polls this Sunday. We will know early Monday morning how the 705 parliamentary seats available will be distributed among the various political groups. The elected representatives are allocated to the (still) 28 countries of the European Union (EU) according to the principle of degressive proportionality. This means that countries with greater populations get more representatives than countries with fewer inhabitants, but the latter have more representatives per inhabitant. As the largest EU country, Germany accounts for 96 seats, while the smallest EU countries, Luxemburg, Malta, and Cyprus, will each send six representatives to the parliament.

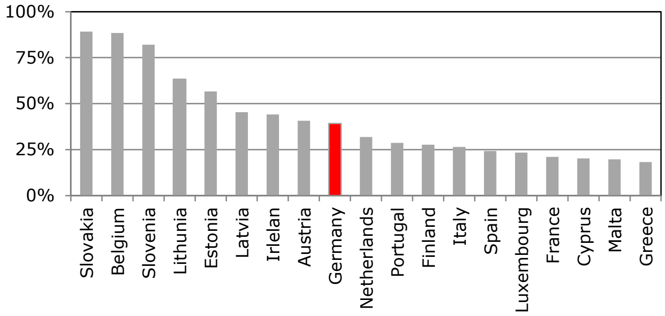
According to recent polls, the two strongest groups in the European Parliament, the European People's Party (EPP), which includes Germany's CDU/CSU, and the Progressive Alliance of Socialists and Democrats (S&D), which represents Germany's SPD, are likely to suffer significant losses. The EPP, with German Manfred Weber as lead candidate for EU Commission president, may drop from 216 seats to 170-180. The S&D, led by Belgian candidate Frans Timmermans, will probably only have 140-150 representatives instead of 185. On the other hand, the Alliance of Liberals and Democrats for Europe (ALDE), to which Germany's FDP party belongs, and the two euroskeptical groups, Europe of Nations and Freedom (ENF) and Europe of Freedom and Direct Democracy (EFDD), may all expect significant gains.

How large the share of votes the euroskeptics get is the crucial factor for the financial markets. According to the latest polls, they are likely to get a good 30% of the votes. If that is correct, the next European Parliament will have not just two, but three, groups from the "establishment" that will have to cooperate to secure needed majorities. Conservatives and Social Democrats will be dependent on support from Liberals and/or Greens. Recently, however, actual election results have diverged significantly from the polls in some cases. So, there is speculation about whether euroskeptical or right-wing populist parties, including the AFD in Germany, the Lega in Italy, the Rassemblement National (formerly Front National) in France, and the newly formed Brexit Party in Great Britain, might even receive 40% or more of the votes. If so, four groups would have to unite to form a majority. Making and implementing political decisions would become very complicated. Nevertheless, it is very unlikely that the euroskeptics will make such great gains in the new parliament that they could change the basic framework of the European Union. We therefore see no danger of the euro being discontinued.

In addition to the political difficulties that would attend an ambiguous outcome in the European election, there are currently huge economic problems. Although the EU and the euro zone have so far not been directly involved in a trade conflict with the United States, the significant slowing of global trade observed since spring 2018 is negatively affecting almost all European national economies. That is because exports make up a large part of total economic output in most European countries. In the euro zone, Slovakia and Belgium exhibit the greatest export dependence at almost 90%. Germany is about midway on the scale at 39%, while exports are less economically important to France, Cyprus, Malta, and Greece.

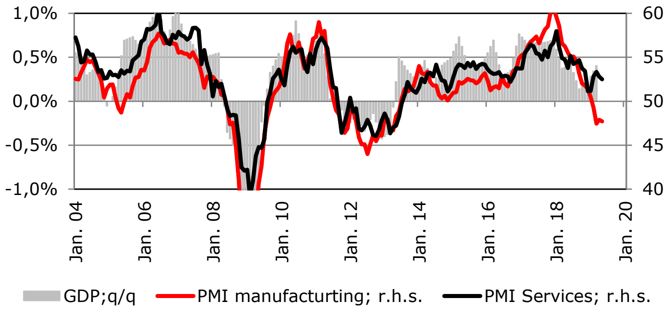
This development has greatly weakened growth momentum in the European industrial sector, which is reflected particularly by the purchasing manager indexes (PMIs) for manufacturing. While the global PMI, at 50.3 points, is still just over the growth threshold of 50 points, the number for the euro zone countries has fallen to 47.7. This weakness is primarily due to exports, since foreign new orders have been declining lately. In the euro zone, the PMIs for Germany, Italy, and Austria are especially weak at levels below 50 points, while the situation looks better in Greece, Ireland, and the Netherlands. Compared with manufacturing, sentiment in the services sector is still significantly more optimistic. The global PMI stands at 52.7 points, and the euro zone's level is comparably good at 52.5. In contrast to the industrial sector, where German companies bring up the rear in the global ranking, German service providers top the list at 55.0 points in international comparison.

Share of exports in gross domestic product



What does this mean for euro zone growth prospects? The good news is that we need not now expect a recession, defined as a decline in economic activity in two or more consecutive quarters. Even though the industrial sector has at least one foot in a sharp downswing, the strong services sector is seeing to it that the overall economy continues to grow. In the first quarter of this year, economic growth in the euro zone was surprisingly appreciable at 0.4% over the fourth quarter of 2018. But the bad news is that this good result will not continue in the subsequent quarters. A growth rate of only 0.2% appears likely for the second quarter, so the euro zone economy will only grow at a real rate of 1% in 2019 as a whole. By contrast, GDP growth of 1.8% was achieved in 2018, and 2.5% in 2017. Those good times are over for now.

Euro area: GDP growth and Purchasing Managers Indices



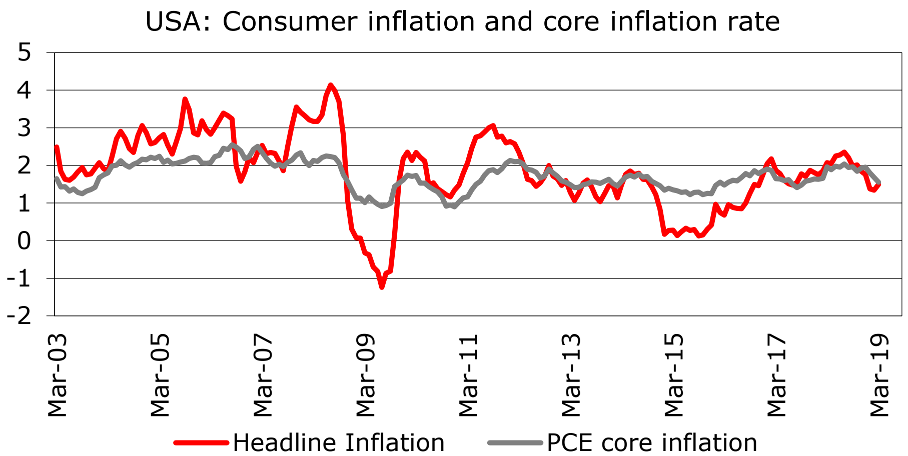
Besides Germany, where we expect 0.7% economic growth in 2019, the economic trend in Italy is especially negative. The Italian economy did grow at 0.2% in the beginning of the year, but as in the case of other national economies, some special factors probably positively influenced that result. Although it has developed even worse under the coalition government formed last year by the Five Star Movement and the Lega than it had under the previous governments, a significant gain in the current European election is forecast for the Lega, led by leader Matteo Salvini. Economists can at best only shake their heads in response to the economic policies advocated by Salvini and his party. Asked about the country's high and still rising debt ratio of over 130% of GDP, Salvini reached deep into his economic bag of tricks and proclaimed that only tax cuts would help reduce the debt. If it were that simple to lower debt by way of less taxation, all problems would disappear tomorrow. But the real world is different. Less taxation reduces incomes and increases budget gaps. The persistent notion that lower taxes lead to higher disposable incomes and that the money can then simply be spent with the result that government revenue will ultimately turn out higher than before the tax cut thanks to more consumption, more employment, and more growth is an economic fallacy fit for the delusional.

Weekly Outlook for May 27-31, 2019

	Jan.	Feb.	Mar.	Apr.	May	Jun.	Release
DE: GfK consumer climate	10.5	10.8	10.7	10.4	10.4	10.6	May 28
DE: Import prices, m/m	-0.2%	0.3%	0.0%	0.5%			May 29
DE: Unemployed, change in 000s	-3	-20	-7	-12	-14		May 29
DE: Unemployment rate	5.0%	5.0%	4.9%	4.9%	4.8%		May 29
DE: Inflation rate, m/m – flash	-0.8%	0.4%	0.4%	1.0%	0.3%		May 31
DE: Inflation rate, y/y – flash	1.4%	1.5%	1.3%	2.0%	1.5%		May 31
EUR19: M3 money supply, y/y	3.8%	4.3%	4.5%	4.3%			May 28
EUR19: Business climate	0.69	0.69	0.54	0.42	0.40		May 28
EUR19: Economic confidence	106.3	106.2	105.6	104.0	103.6		May 28
EUR19: Consumer confidence – final	-7.9	-7.4	-7.2	-7.9	-6.5		May 28
EUR19: Industrial confidence	0.6	-0.4	-1.6	-4.1	-3.8		May 28

MMWB estimates in red

Chart of the Week: All quiet on the Western front



The last Fed meeting three weeks ago ended unsurprisingly. As expected, the US central bank left its key interest rate unchanged in a range of 2.25-2.50%. It sees no reason now to change interest rates in one direction or the other. The question remained whether the FOMC minutes released on Wednesday would hold further information. But that has yielded little news overall. The Fed does not intend to change its current patient approach to setting monetary policy "for some time." Some members have warned that inflation might weaken further, but most believe its decline is only transitory. In assessing the latter view, however, we should note that the minutes probably no longer reflect the Fed's current outlook. After all, the last FOMC meeting took place before the latest escalation of the US-China trade conflict. The Fed will consider the risks arising from that at its next meeting on June 18-19 and include them in the update of its economic projections. Besides the key interest rate decision, the members also discussed the future structure of the Fed's balance sheet. Some argued in favor of shortening the maturities of its holdings in preparation for exchanging short bonds for long ones in a possible downswing with the aim of lowering the long-term interest rates that importantly affect lending. That would give the Fed additional maneuvering room. However, the dilemma of this approach is that it would worsen current financing conditions, which would in turn necessitate a lower key interest rate. However, the desired maneuvering room in a downswing would be lost in that case. The problem has not been solved yet, and no decision has been made.

Market Data Overview

Stock marktes	As of 24.05.2019 11:46	Change versus 17.05.2019 -1 week	23.04.2019 -1 month	22.02.2019 -3 months	23.05.2018 -1 year	31.12.2018 YTD
Dow Jones	25490	-1,1%	-4,4%	-2,1%	2,4%	9,3%
S&P 500	2822	-1,3%	-3,8%	1,1%	3,3%	12,6%
Nasdaq	7628	-2,4%	-6,1%	1,3%	2,7%	15,0%
DAX	12037	-1,6%	-1,6%	5,1%	-7,2%	14,0%
MDAX	25263	-2,1%	-3,0%	3,7%	-5,4%	17,0%
TecDAX	2857	-0,3%	0,8%	9,2%	2,2%	16,6%
EuroStoxx 50	3359	-2,0%	-4,1%	2,7%	-5,2%	11,9%
Stoxx 50	3108	-1,0%	-2,5%	2,9%	-0,9%	12,6%
SMI (Swiss Market Index)	9673	0,1%	0,4%	3,5%	10,0%	14,8%
Nikkei 225	21117	-0,6%	-5,1%	-1,4%	-6,9%	5,5%
Brasilien BOVESPA	93910	4,4%	-2,1%	-4,1%	16,1%	6,9%
Russland RTS	1285	2,5%	0,6%	7,3%	9,4%	20,6%
Indien BSE 30	39364	3,8%	2,1%	9,7%	14,6%	9,1%
China Shanghai Composite	2853	-1,0%	-10,8%	1,7%	-10,0%	14,4%
MSCI Welt (in €)	2087	-1,5%	-3,5%	1,3%	2,9%	13,4%
MSCI Emerging Markets (in €)	985	-1,3%	-9,1%	-5,8%	-9,0%	4,4%
Bond markets						
Bund-Future	167,22	16	228	60	746	368
Bobl-Future	133,58	4	82	43	202	106
Schatz-Future	112,03	-2	13	14	0	9
3 Monats Euribor	-0,31	0	0	0	1	0
3M Euribor Future, Dec 2017	-0,35	0	-4	-9	-31	0
3 Monats $ Libor	2,52	0	-6	-12	19	-28
Fed Funds Future, Dec 2017	2,11	-2	-15	-26	-52	0
10 year US Treasuries	2,33	-7	-24	-33	-69	-36
10 year Bunds	-0,12	-1	-16	-22	-62	-36
10 year JGB	-0,07	-1	-4	-3	-11	-7
10 year Swiss Government	-0,43	5	-7	-8	-49	-19
US Treas 10Y Performance	606,84	0,8%	2,6%	3,6%	8,9%	4,5%
Bund 10Y Performance	653,31	0,2%	1,6%	2,2%	7,6%	4,2%
REX Performance Index	493,75	-0,1%	0,7%	0,8%	2,6%	1,2%
US mortgage rate	0,00	0	0	0	0	0
IBOXX AA, €	0,47	3	-2	-16	-36	-41
IBOXX BBB, €	1,39	6	4	-33	-18	-67
ML US High Yield	6,74	5	20	-12	20	-127
JPM EMBI+, Index	839	0,2%	0,5%	1,3%	5,7%	6,0%
Convertible Bonds, Exane 25	7252	0,0%	-0,6%	2,6%	-2,5%	5,2%
Commodities						
CRB Spot Index	413,02	0,1%	-2,3%	-0,5%	-7,2%	0,9%
MG Base Metal Index	292,82	-1,7%	-6,6%	-7,7%	-16,3%	-0,6%
Crude oil Brent	68,55	-5,6%	-4,9%	1,9%	-13,3%	29,0%
Gold	1281,86	0,4%	1,0%	-3,6%	-0,9%	0,0%
Silver	14,65	1,5%	-1,1%	-8,2%	-10,7%	-5,5%
Aluminium	1765,75	-2,3%	-4,6%	-6,6%	-21,9%	-5,2%
Copper	5901,00	-2,2%	-7,7%	-9,5%	-13,7%	-0,8%
Iron ore	97,31	1,0%	4,3%	10,4%	46,7%	40,6%
Freight rates Baltic Dry Index	1068	2,7%	30,1%	68,5%	-8,1%	-16,0%
Currencies						
EUR/ USD	1,1184	0,1%	-0,5%	-1,2%	-4,5%	-2,3%
EUR/ GBP	0,8817	0,6%	1,8%	1,5%	0,5%	-1,8%
EUR/ JPY	122,57	0,2%	-2,6%	-2,4%	-4,7%	-2,6%
EUR/ CHF	1,1216	-0,6%	-2,2%	-1,1%	-3,3%	-0,5%
USD/ CNY	6,9043	-0,2%	2,6%	2,8%	8,0%	0,4%
USD/ JPY	109,61	-0,4%	-2,0%	-1,0%	-0,4%	0,0%
USD/ GBP	0,79	0,4%	2,0%	3,0%	5,2%	0,4%

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