M.M.WARBURG & CO
BANK

ECONOMIC SITUATION AND STRATEGY

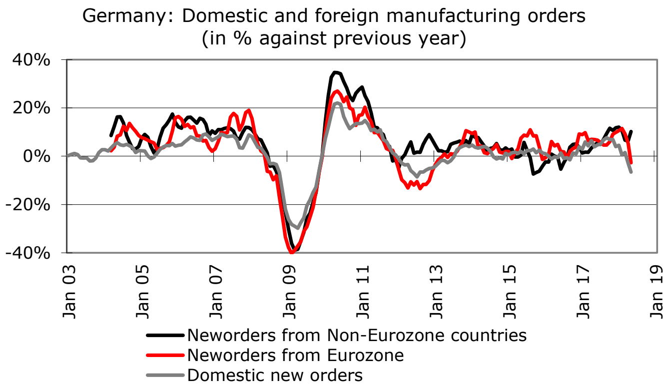
June 8, 2018

US economy humming, lean times in the euro zone continue

Expectations regarding economic activity this year were high. After the world economy developed significantly better than expected in 2017 and various political uncertainties did not have negative effects, almost all observers assumed momentum would increase again slightly this year in all regions. But now that more than five months have passed, a different picture has emerged.

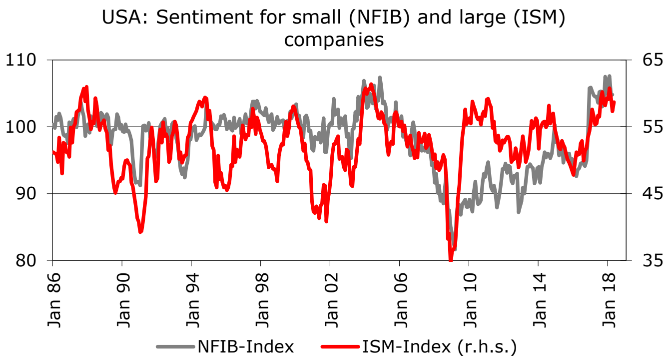
In 2017, the euro zone registered the strongest growth since 2007. Real economic output increased in all member states for the first time since the financial and economic crisis, with the Netherlands, Austria, Spain, and Germany registering especially high growth rates. Growing by more than 5% last year, exports were one reason for this positive development. Another was capital spending, which expanded by more than 3%. But the economic engine started to sputter at the beginning of this year. Although it initially seemed as if this was only a temporary slowdown due to special factors like strikes, weather, and illness-related production losses, there have been no signs of improvement recently. Almost all major leading indicators continue to point downward.

This has prompted us to revise our growth forecast for the euro zone downward from 2.4% to 2.1%. The revision for Germany is even greater. We now expect real GDP there to increase in 2018 by only 2.2% instead of 2.7%. This weaker development is due partly to external factors and partly to "homemade" problems. The danger of a trade war with the United States, Germany's most important trading partner, is likely to have dampened optimism and the business sector's propensity to invest lately. This finds expression in the recent decline of orders received by domestic producers of capital goods. Added to that is the euro's revaluation, which is creating headwind for exports. However, it appears that orders from the euro zone have dropped significantly recently, while new orders from countries outside the euro zone have remained comparatively stable.



The pressure that Donald Trump is exerting on the trading partners of the United States is likely to continue as long as they are willing to make concessions. Although we still consider it likely that the parties will come to an agreement, it will take a great deal of accommodation and time to achieve a solution. Moreover, increased political uncertainties in Italy might also negatively affect business confidence in the euro zone. A rapid economic recovery in Germany and the euro zone is therefore becoming less likely. Germany's principal homemade problem is the handling of the diesel crisis. Unit sales of diesel passenger and sport utility vehicles there have collapsed in recent months. Since from September 1 onward new vehicles may only be sold if they have passed a new emissions test, the automobile manufacturers will experience production losses in the months ahead. The new measurements are much more complex and costly, so it will take more time until the necessary registrations are issued.

The US economy has none of these problems. After a comparatively weak start into 2018, almost all important economic data have recently improved. Leading indicators like consumer confidence, purchasing manager indexes from the manufacturing and services sectors, and small business optimism are at or near historical highs. Not least of all, the US tax reform is making for good sentiment and fuller cash registers, in addition to further expansionary fiscal policy measures.



We therefore expect that companies will invest more going forward, especially since capacity utilization is relatively high. At the same time, there is nearly full employment, and businesses are for the first time creating more new jobs than there are job-seekers. Consumer spending, which only increased slightly in the first quarter of 2018, will make another significantly stronger contribution to economic growth in the quarter ahead. Furthermore, even foreign trade is developing splendidly by American standards. That has nothing to do with the threatened or already imposed tariffs, but rather with the improvement of US price competitiveness due the weak US dollar. Moreover, the United States is producing and exporting more oil than ever before. We expect that these favorable conditions will continue for quite a while. So, we are raising our 2018 growth forecast for the United States from 2.6% to 3.0%.

For investors, this situation does not mean they should basically turn their backs on European stocks. Even though political and economic news from the euro zone has worsened, the economic upswing remains intact. Less growth momentum does not mean one should expect a sharp downswing or even a new recession. Only in that case we would recommend significantly reducing the ratio of stocks. While the economic data make euro zone stocks seem less attractive, valuations and especially still upward-pointing earnings expectations argue in their favor. Nevertheless, we believe one should take account of the current situation by seeking greater exposure in the United States and reducing the investment ratio in the euro zone somewhat. If the ECB should announce the end of their bond purchase program at their next meeting, stocks from the euro zone could come under additional pressure.

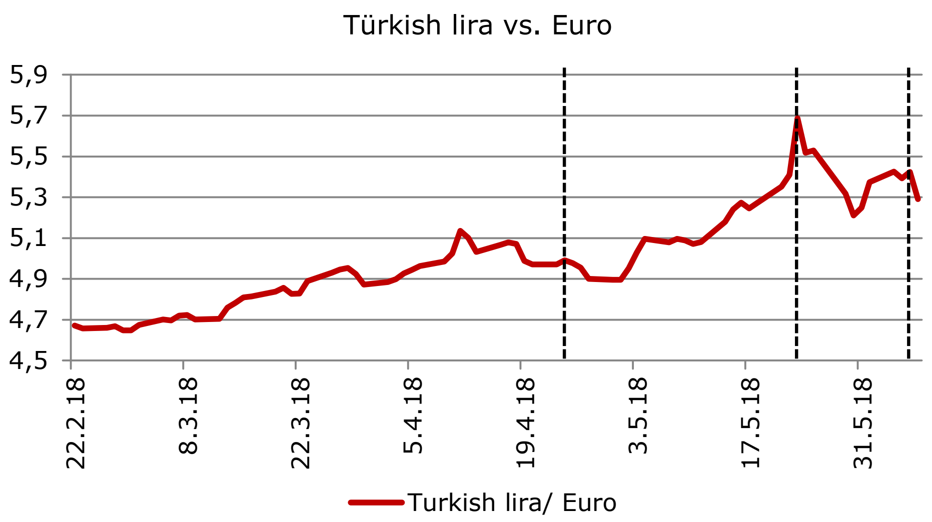
Corporate earnings are the single most important determinant of stock price performance. They normally increase as long as there is no recession. Predicting the next US recession has recently become a kind of sport among economists. We expect that it will not happen this year or next, and 2020 is still too far off to be able to make serious statements now. This year, S&P 500 companies will register earnings growth by about 20%, and another increase of 10% is expected for next year. In contrast, the growth rates expected for DAX and Euro Stoxx 50 companies come to about 8% for each of the next two years. If economic data in the euro zone do not improve soon, the risk will exist that these forecasts will prove too optimistic. On the other hand, the estimates for US earnings could still turn out to be too conservative, if economic growth improves as significantly as we expect.

Weekly outlook for June 11-15, 2018

	Jan.	Feb.	Mar.	Apr.	May	June	Release
DE: ZEW economic expectations	20.4	17.8	5.1	-8.2	-8.2	-9.0	June 12
DE: ZEW current conditions	95.2	92.3	90.7	87.9	87.4	85.5	June 12
DE: Consumer prices, m/m - final	-0.7%	0.5%	0.4%	0.0%	0.5%		June 14
DE: Consumer prices, y/y - final	1.6%	1.4%	1.6%	1.6%	2.2%		June 14
EUR19: Industrial production, m/m	-0.6%	-0.9%	0.5%	0.3%			June 13
EUR19: Industrial production, y/y	4.1%	2.7%	3.0%	3.2%			June 13
EUR19: Consumer prices, y/y - final	1.3%	1.1%	1.3%	1.2%	1.9%		June 15
EUR19: Core inflation rate, y/y - final	1.0%	1.0%	1.0%	0.7%	1.1%		June 15

MMWB estimates in red

Chart of the Week: Central bank supports Turkish lira



Most economists clearly recognize that low interest rates lead to higher inflation, and high interest rates to lower inflation. No member of the European Central Bank or the US Federal Reserve doubts this relationship. But Turkey's current president, Recep Erdogan, probably does. His résumé says he studied economics at the university in Istanbul, but various indications and his grasp of central bank policy call that into question. Contrary to all empirical evidence, Erdogan believes that lower interest rates will reduce inflation. This misconception is also the source of his demand for key interest rate cuts in Turkey, as the Turkish central bank is still clearly far from achieving its inflation rate target of 5%. Released on Monday, the latest data show inflation in May at an annualized rate above 12% and rising, which is the highest level in over 15 years. The markets have previously also reacted with corresponding annoyance to Erdogan's statements that he intends to interfere more in central bank policy. One may gather that from the weak currency, whose exchange rate the current account deficit and inflation have driven down sharply. Fortunately for Turkey, however, the central bank does not seem to have lost its independence (yet). The key interest rate hikes that the central bank governor has been able to push through support that conclusion. While the key interest rate was timidly raised at the end of April from 12.75% to 13.50%, a much more significant increase by 3 percentage points occurred on May 23. Now, another hike by 1.25 percentage points has happened today. That has also been accompanied by the desired revaluation of the Turkish lira. However, it is uncertain how long this will continue in view of the parliamentary elections coming up on June 24. After all, possibly with newly attained powers, Erdogan might also expand his influence on the central bank.

Market data overview

Stock marktes	As of 08.06.2018 15:45	Change versus 01.06.2018 -1 week	07.05.2018 -1 month	07.03.2018 -3 months	29.12.2017 YTD
Dow Jones	25184	2,2%	3,4%	1,5%	1,9%
S&P 500	2770	1,3%	3,7%	1,6%	3,6%
Nasdaq	7635	1,1%	5,1%	3,2%	10,6%
DAX	12756	0,2%	-1,5%	4,2%	-1,3%
MDAX	26672	0,5%	0,0%	3,2%	1,8%
TecDAX	2803	0,3%	1,8%	8,0%	10,8%
EuroStoxx 50	3450	-0,1%	-3,2%	2,2%	-1,5%
Stoxx 50	3060	-0,8%	-1,7%	2,9%	-3,7%
SMI (Swiss Market Index)	8529	-1,0%	-5,0%	-2,9%	-9,1%
Nikkei 225	22695	2,4%	1,0%	6,8%	-0,3%
Brasilien BOVESPA	73874	-4,4%	-10,7%	-13,6%	-3,3%
Russland RTS	1151	-1,2%	-0,3%	-9,4%	-0,3%
Indien BSE 30	35444	0,6%	0,7%	7,3%	4,1%
China Shanghai Composite	3067	-0,3%	-2,2%	-6,3%	-7,3%
MSCI Welt (in €)	2138	0,8%	3,2%	6,7%	3,6%
MSCI Emerging Markets (in €)	1150	1,2%	2,1%	2,1%	1,2%
Bond markets					
Bund-Future	163,14	168	383	371	146
Bobl-Future	131,41	-71	23	44	-20
Schatz-Future	112,04	-5	13	6	6
3 Monats Euribor	-0,32	0	1	1	1
3M Euribor Future, Dec 2017	-0,27	1	4	0	0
3 Monats $ Libor	2,33	1	-4	27	63
Fed Funds Future, Dec 2017	2,16	0	-4	6	0
10 year US Treasuries	2,93	4	-2	5	52
10 year Bunds	0,44	7	-9	-22	2
10 year JGB	0,05	0	0	1	0
10 year Swiss Government	0,03	10	0	-1	16
US Treas 10Y Performance	560,05	-0,3%	0,2%	0,1%	-3,7%
Bund 10Y Performance	608,02	-1,1%	0,4%	1,8%	0,1%
REX Performance Index	483,23	-0,1%	0,6%	1,3%	0,5%
US mortgage rate	0,00	0	0	0	0
IBOXX AA, €	0,91	8	11	14	23
IBOXX BBB, €	1,66	7	22	28	43
ML US High Yield	6,49	-6	-2	-1	34
JPM EMBI+, Index	790	-0,1%	-0,4%	-2,7%	-5,5%
Convertible Bonds, Exane 25	7442	0,0%	-0,2%	2,4%	0,6%
Commodities					
CRB Spot Index	447,02	0,3%	0,4%	0,2%	3,4%
MG Base Metal Index	369,27	4,7%	6,0%	5,7%	2,9%
Crude oil Brent	76,73	0,2%	3,2%	17,5%	15,2%
Gold	1299,11	-0,2%	-1,2%	-2,1%	-0,3%
Silver	16,87	2,4%	2,2%	2,5%	-0,8%
Aluminium	2302,50	-0,3%	-2,8%	10,9%	2,1%
Copper	7330,50	6,5%	8,0%	6,1%	1,7%
Iron ore	65,17	1,0%	-2,3%	-12,5%	-8,6%
Freight rates Baltic Dry Index	1395	20,7%	0,8%	17,1%	2,1%
Currencies					
EUR/ USD	1,1760	0,5%	-1,2%	-5,3%	-1,9%
EUR/ GBP	0,8793	0,5%	0,1%	-1,5%	-0,9%
EUR/ JPY	128,75	1,6%	-1,1%	-2,0%	-4,6%
EUR/ CHF	1,1605	0,8%	-3,0%	-0,6%	-0,8%
USD/ CNY	6,4041	-0,3%	0,6%	1,3%	-1,6%
USD/ JPY	109,71	0,1%	0,6%	3,4%	-2,6%
USD/ GBP	0,75	-0,3%	1,5%	3,9%	1,2%

Carsten Klude
+49 40 3282-2572
cklude@mmwarburg.com

Dr. Rebekka Haller
+49 40 3282-2452
rhaller@mmwarburg.com

Martin Hasse
+49 40 3282-2411
mhasse@mmwarburg.com

Dr. Christian Jasperneite
+49 40 3282-2439
cjasperneite@mmwarburg.com

Bente Lorenzen
+49 40 3282-2409
blorenzen@mmwarburg.com

Julius Böttger
+49 40 3282-2229
jboettger@mmwarburg.com