M.M.WARBURG & CO
BANK

ECONOMIC SITUATION AND STRATEGY

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The Empire Strikes Back

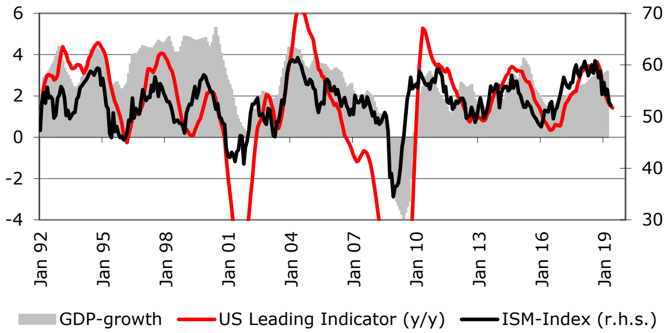
Do you remember Star Wars? The first movie in the Star Wars Saga came out in 1977 and was a total blockbuster. Part two “The Empire Strikes Back” followed in 1980 with similar economic success and later ranked highest in “Best Movie of All Time” list. The story is about an alliance centering on the two heroes *Captain Han Solo* and *Commander Luke Skywalker* fighting the evil imperial forces under the command of the dark overlord *Darth Vader*. So, what does this movie have to do with the current capital market situation? Quite a lot it seems.

We find Donald Trump’s antics and his treatment of Fed President Jerome Powell somewhat reminiscent of the epic battle between good and evil in Star Wars. *Darth Vader* (aka Donald Trump) is yet again trying to bring *Luke Skywalker* (aka Jerome Powell) over to the dark side of the force. Now they are fencing with words rather than light sabers but POTUS Trump is raising the pressure on the Fed Chief nearly on a daily basis to make him lower interest rates quickly and decisively. The US President has made thinly veiled threats that he might fire Powell for reasons of incompetence if he does not do Trump’s bidding. Trump argues that other central banks use monetary policy for weakening their currencies and thus getting an unfair advantage over the US, while the Fed is idling on the sidelines.

Yet, in his 2016 campaign Trump complained that the Fed was keeping interest rates artificially low purportedly to help President Obama. Then Fed Chief Janet Yellen was supposed to be ashamed for her monetary policy that was harming US citizens who were getting no interest on their savings.

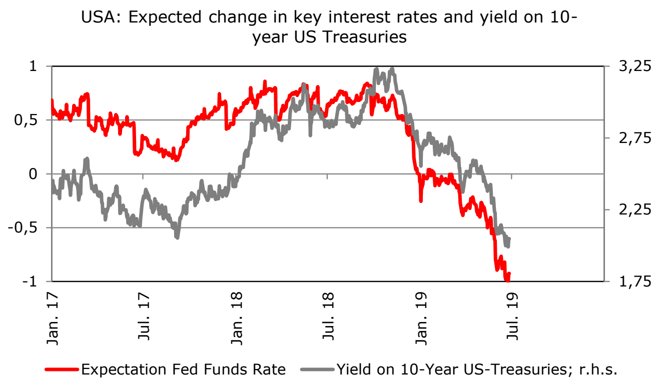
In this light, Donald Trump should have been elated over the Fed interest hikes during his office; especially because his own policies of tax cuts and increased spending last year were at the heart of the interest rate hikes. While the rest of the world suffered from Trump’s various trade wars, US economic growth was still fine until the end of last year. That made it all the more reasonable for the Fed to keep raising rates as one of its traditional objectives has always been to keep interest rates high in times of plenty to build leeway for lowering them when the economic tide turns. This appears to be the case now.

USA: GDP growth and leading indicators



Many leading economic indicators are losing ground in the US. Purchasing manager indices, order intake, and industrial production have been heading south since the end of last year. While economic growth was still above three percent in the first quarter of 2019, this was merely thanks to a few extraordinary factors. Second quarter growth should only come to about two percent and growth will probably slow down further in the remainder of this year. There are currently no indications of imminent recession but if the trade conflict with China remains unresolved this would put further pressure on the US economy. After all, the US is not immune to global economic woes.

Consequently, Jerome Powell and colleagues will probably start lowering key lending rates on July, 31, now that inflation has dropped to 1.5 percent and may fall further in the months ahead. We thus see good reason for a 50-basis-points rate cut because a swift and strong move makes sense given the relatively small leeway for the Fed. The US central bank also started its last two interest cutting cycles in 2001 and 2007 with bold 50-basis-point strides. Such a decision might raise some questions about the Fed's independence assuming that this really is a concession to presidential pressure. However, we do not think that there is much substance to that argument considering that US monetary policy already seems behind the curve. Trump may style this as a triumph even though his grandstanding may actually have held back an earlier Fed reaction.



Rate cuts are not only a hot topic in the US but also in Euroland. ECB Chief Mario Draghi, or in Star Wars terms - *Han Solo* – left no doubt in his speech at the ECB Forum in Sintra, Portugal, where the interest rate journey is headed. Just as distinct as in 2012 with his legendary "Whatever it takes" speech, he has set a clear direction for the ECB's further action: Without an improvement in economic data and simultaneously higher inflation rates, the European Central Bank will further relax its monetary policy. Already at its next meeting on July, 25, or on September, 12, at the latest, the ECB may decide to lower deposit and key lending rates by 10 basis points. We also consider it highly likely that the ECB will resume its bond purchase program.

Getting back into quantitative easing mode will probably be not that easy. So far, the ECB has bought some EUR 2.5 trillion worth of bonds as part of its Asset Purchase Program. Sovereigns account for the lion's share with EUR 2.1 trillion, covered bonds make up for EUR 260 billion, and corporate bonds add another almost EUR 180 billion. Buying more sovereigns is no simple task. On the one hand, the ECB buys Euroland sovereigns based on the capital key (measuring the percentage share of national central banks in the ECB capital). On the other hand, the ECB has set itself a 33-percent ceiling of any given country's bonded debt. Correspondingly, the ECB cannot buy much more German debt. If it were to raise that ceiling, the ECB would soon be accused of direct government financing, which is prohibited under the EU Treaties. Buying corporate bonds would be less complicated by far. However, this market segment is far less liquid.

What does all this mean for investors? 1. The ECB has announced that it will not raise key lending rates at least until summer of next year. We even assume that interest rates will not go up for quite a bit longer than that. That means capital market yields will not increase either but rather fall for the time being. 2. We are lowering our year-end yield target for 10-year Bunds to -0.40 percent and for US treasuries to 1.75 percent. 3. In the present set of circumstances investors are well advised to extend the duration of their bond portfolios. The claim that low interest rate levels mean that there is no money to be made on the bond market and thus the stock market must reign supreme (TINA – short for "There Is No Alternative") is plain wrong. If the yield on a 10-year bond drops from -0.3 to -0.5 (-1.0) percent this results in 1.8 (7.1) percent value gain over the course of a year. 4. A traditional buy-and-hold investment strategy makes no sense in a negative-yield scenario as this would actively destroy value. Active portfolio management, however, can definitely yield profits in such an environment. 5. Capital-market-savvy Star Wars fans need not worry, though. In contrast to the movie where *Darth Vader* reveals in the end that he is *Luke Skywalker's* father, Trump cannot really do that to Powell considering that they are only seven years apart.

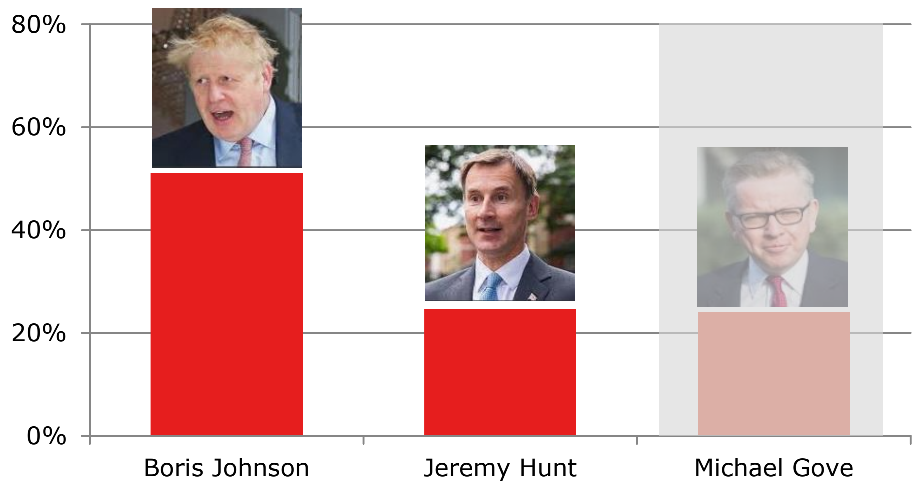
Weekly Outlook for July 1-5, 2019

	Jan	Feb	Mar	Apr	May	June	Release
DE: PMI manufacturing, final	49.7	47.6	44.1	44.4	44.3	45.3	July, 1
DE:Unemployment rate	5.0%	5.0%	4.9%	4.9%	5.0%	5.0%	July, 1
DE:Change in unemploynent in 1000	-3	-20	-8	-12	60	-10	July, 1
DE: Retail sales, m/m	2.7%	0.7%	0.0%	-2.0%	0.5%		July, 2
DE: Retail sales, y/y	3.2%	4.3%	-2.0%	4.0%	2.8%		July, 2
DE: PMI services, final	53.0	55.3	55.4	55.7	55.4	55.6	July, 3
DE: PMI total, final	52.1	52.8	51.4	52.2	52.6	52.6	July, 3
DE: Order intake, m/m	-2.1%	-4.0%	0.8%	0.3%	0.2%		July, 5
EU-19: M3, y/y	3.7%	4.2%	4.5%	4.7%	4.5%		July, 1
EU-19: PMI manufacturing, final	50.5	49.3	47.5	47.9	47.7	47.8	July, 1
EU-19: Unemployment rate	7.8%	7.8%	7.7%	7.6%	7.6%		July, 1
EU-19: Producer prices, m/m	0.3%	0.1%	-0.1%	-0.3%	0.1%		July, 2
EU-19: Producer prices, y/y	2.9%	3.0%	2.9%	2.6%	2.6%		July, 2
EU-19: PMI services, final	52.1	52.8	53.3	52.8	52.9	53.4	July, 3
EU-19: PMI total, final	51.0	51.9	51.6	51.5	51.8	52.1	July, 3
EU-19: Retail sales, m/m	0.9%	0.6%	0.0%	-0.4%	0.6%		July, 3
EU-19: Retail sales, y/y	2.2%	3.0%	2.0%	1.5%	1.8%		July, 3

MMWB estimates are shown in red

Chart of the Week The New Prime Minister

Voting result of the last ballot for the Tory chairman



As soon as Theresa May announced her resignation as party leader and Prime Minister, succession hopefuls lined up for her positions in the upcoming elections. The conservative caucus whittled down the number of candidates from ten to two. After five election rounds only Boris Johnson and Jeremy Hunt remained as candidates for the May succession and will be up for election by 160,000 party members at the end of July. Boris Johnson is the current favorite for becoming the next occupant of 10 Downing Street and resuming Brexit negotiations with the EU. Considering that Johnson is a Brexit hardliner he will probably treat a no-deal Brexit as a viable option in the negotiations. However, that does not mean the EU will make any such concession. The EU has no intention of changing the treaty, at least officially. While Johnson is allegedly quite charming, that may not be all that helpful considering what he has so far said about the EU and its politicians. Should Johnson prevail in the elections, we think that a no-deal Brexit becomes slightly more likely in contrast to Johnson who reckons the odds at a million to one in favor.

Market Data Overview

Stock marktes	As of 28.06.2019 10:34	Change versus 21.06.2019 -1 week	27.05.2019 -1 month	27.03.2019 -3 months	27.06.2018 -1 year	31.12.2018 YTD
Dow Jones	26527	-0,7%	3,7%	3,5%	10,0%	13,7%
S&P 500	2925	-0,9%	3,5%	4,3%	8,3%	16,7%
Nasdaq	7968	-0,8%	4,3%	4,2%	7,0%	20,1%
DAX	12341	0,0%	2,2%	8,1%	-0,1%	16,9%
MDAX	25521	0,1%	1,1%	3,3%	-1,7%	18,2%
TecDAX	2871	0,9%	0,3%	6,9%	5,5%	17,2%
EuroStoxx 50	3450	-0,5%	2,6%	3,9%	1,6%	15,0%
Stoxx 50	3160	-0,6%	1,5%	2,0%	4,1%	14,5%
SMI (Swiss Market Index)	9838	-0,9%	1,3%	4,8%	15,7%	16,7%
Nikkei 225	21276	0,1%	0,4%	-0,5%	-4,5%	6,3%
Brasilien BOVESPA	100724	-1,3%	6,2%	9,6%	42,7%	14,6%
Russland RTS	1390	1,1%	7,9%	15,1%	23,6%	30,4%
Indien BSE 30	39517	0,8%	-0,4%	3,6%	12,2%	9,6%
China Shanghai Composite	2979	-0,8%	3,0%	-1,5%	5,9%	19,4%
MSCI Welt (in €)	2166	-1,2%	1,6%	2,3%	6,4%	15,6%
MSCI Emerging Markets (in €)	1055	-0,5%	4,9%	-0,1%	2,3%	9,8%
Bond markets						
Bund-Future	172,62	55	498	603	1032	908
Bobl-Future	134,34	10	65	108	219	182
Schatz-Future	112,26	2	19	27	16	31
3 Monats Euribor	-0,34	0	-3	-3	-2	-3
3M Euribor Future, Dec 2017	-0,47	-2	-12	-16	-34	0
3 Monats $ Libor	2,33	-2	-20	-27	0	-48
Fed Funds Future, Dec 2017	1,70	2	-42	-43	-89	-1
10 year US Treasuries	2,02	-5	-31	-35	-81	-67
10 year Bunds	-0,31	-3	-17	-23	-64	-56
10 year JGB	-0,16	1	-10	-10	-20	-16
10 year Swiss Government	-0,53	4	-1	-2	-50	-29
US Treas 10Y Performance	624,29	0,6%	3,1%	4,0%	10,3%	7,5%
Bund 10Y Performance	665,58	0,3%	1,7%	2,3%	7,7%	6,1%
REX Performance Index	497,25	-0,1%	0,6%	1,0%	2,4%	2,0%
US mortgage rate	0,00	0	0	0	0	0
IBOXX AA, €	0,27	-2	-18	-17	-50	-61
IBOXX BBB, €	1,04	-2	-33	-41	-58	-102
ML US High Yield	6,46	5	-27	-27	-5	-155
JPM EMBI+, Index	878	-0,1%	4,5%	4,8%	11,9%	10,9%
Convertible Bonds, Exane 25	7360	0,0%	1,5%	2,8%	-0,1%	6,8%
Commodities						
CRB Spot Index	408,67	-0,6%	-1,5%	-4,1%	-6,8%	-0,1%
MG Base Metal Index	295,02	1,2%	0,5%	-6,6%	-13,9%	0,1%
Crude oil Brent	66,25	1,4%	-2,3%	-2,7%	-14,9%	24,7%
Gold	1413,53	1,4%	10,0%	7,9%	12,6%	10,3%
Silver	15,19	-0,8%	4,2%	-0,9%	-6,2%	-2,1%
Aluminium	1770,50	1,6%	0,0%	-6,4%	-19,0%	-5,0%
Copper	5976,50	0,3%	0,8%	-5,7%	-10,7%	0,5%
Iron ore	108,72	1,1%	10,8%	26,8%	67,6%	57,1%
Freight rates Baltic Dry Index	1340	8,2%	25,7%	94,2%	2,4%	5,4%
Currencies						
EUR/ USD	1,1389	0,6%	1,7%	1,1%	-2,0%	-0,5%
EUR/ GBP	0,8978	0,7%	1,7%	5,3%	1,8%	0,0%
EUR/ JPY	122,60	0,8%	0,0%	-1,5%	-4,3%	-2,6%
EUR/ CHF	1,1096	-0,1%	-1,4%	-0,9%	-3,8%	-1,5%
USD/ CNY	6,8635	-0,1%	-0,5%	2,0%	3,8%	-0,2%
USD/ JPY	107,80	0,4%	-1,6%	-2,5%	-2,2%	-1,6%
USD/ GBP	0,79	0,1%	0,0%	4,0%	3,7%	0,4%

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