M.M.WARBURG & CO
BANK

ECONOMIC SITUATION AND STRATEGY

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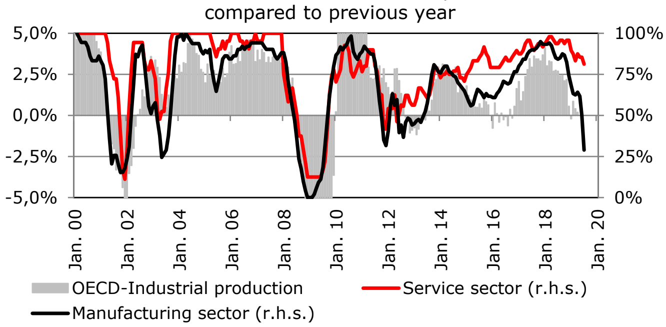
Let's get ready to rumble!

Considering development on the capital markets these days, practically all investors will be glad they put their money in stocks, bonds, or other securities. In contrast to passbook and instant access savings accounts, most of which pay zero interest, most stock indexes show double-digit percentage price gains, while value increases in the medium to high single-digit percentage range have been achieved in many cases with bonds. Even the price of gold has risen 10% since the beginning of the year. However, with all the cheer over the large gains, aren't we overlooking something?

That stocks, bonds, and gold are all performing positively, especially to such an extent, is unusual and has surprised us because the global economy is showing increasingly clear signs of a slowdown. While most economists are not willing yet to predict a recession, that does not mean much. In the past, recessions have almost always not been recognized as such until after they started. At the moment, the difficulty is that contradictory signals are coming from manufacturing and services. We are relatively certain that global industrial companies are already in a mild recession. At 49.4 points in June, the global purchasing manager index for the manufacturing sector allows that conclusion. The index design is such that values above 50 points indicate growth, and values below 50 points contraction. At the regional level, the weakness is most conspicuous in Europe and many emerging countries. Of the 40 indexes that we analyze monthly for the worldwide industrial sector, only 21% improved last month over the previous month – the lowest percentage since the end of 2008. At the same time, only 29% of the analyzed time series were above the 50-point growth threshold. A lower percentage was last recorded in summer 2009.

Purchasing managers indices: Share of countries with indices >=50 and OECD industrial production compared to previous year



On the other hand, things look significantly better for companies in the services sector. At 51.9 points, its global purchasing manager index continues to signal moderate growth, and a good 80% of the countries still report levels above 50 points. So, can we give an all-clear sign? No, because ahead of the last two large recessions (2001-2002 and 2008-2009), the services sector just managed to defy the downward cyclical pressure longer than industrial companies could. However, the services sector successfully and durably decoupled from small phases of economic weakness at the end of 2011 and beginning of 2016, with the result that they remained short global dips. How the race will turn out this time is still completely open, in our view.

Stock market participants assess the situation differently. Since recessions and bear markets normally go hand in hand, it is clear that they have so far been ruling out a recession. Despite weak economic data, they continue to bet entirely on the positive effects of monetary policy. Now that both the Fed and ECB have announced their intention to ease monetary policy in the foreseeable future, the stock markets have switched to turbo mode. The reason one may give for the price rally is that falling interest rates will prolong the economic upswing and drive out the specter of recession. So, let's get ready to rumble!

However, the crucial question is whether monetary policy actually can stop the economic downswing. In view of the low level of interest rates observed for years now, the worry is creeping over us that further expansionary measures will hardly have appreciable positive effects for the real economy. In economic theory, there is what they call the liquidity trap in which business and consumers do not use greater central bank money supply for investment or consumption purposes. Demand for credit does not increase, and the desired positive effect on economic growth does not materialize. This phenomenon has been observed in Japan for almost two decades now and is becoming more and more evident in the euro zone.

But even if monetary policy has the right effect, it might be too late to prevent a recession by lowering interest rates. However, stock market participants are betting that the scenario of 1995 and 1998 will repeat itself. In both those cases, the Fed recognized the impending downswing early enough to counteract it with more accommodative monetary policy. The economic upswing continued, as did the rally on the stock markets. Unlike in 2001 and 2008, when a recession could not be prevented despite interest rate cuts of about 500 basis points in each case.

Besides the economic uncertainties, politics also plays an important role in determining what will happen on the capital markets going forward. In this age of daily tweets from Donald Trump, we can forget the old adage "political markets have short legs." Analyzing political events reminds us more and more of riding on the national railway “Deutsche Bahn”. You wait and wait and are increasingly annoyed because nothing happens. The trade dispute between the United States and China is just as unresolved as the question whether and in what form Brexit will take place. Instead of moving at intercity express speed, decisions run on a slow train from one local stop to the next. So far, market participants are still very modest; at the train station, there would already have been a revolt long ago.

Politics are in the market spotlight not only in the United States and Great Britain. The latest decisions from Brussels are also creating movement in the euro zone. Whether Ursula von der Leyen will receive the votes from European Parliament members needed to become the new president of the EU Commission is an entirely open question. If she does not succeed, Germany would once again come away empty-handed from the deal making surrounding the most important offices. For, the office of ECB president, which is more important from an economic perspective, is again going to France. Christine Lagarde, who currently heads the International Monetary Fund, will be the crisis-tested successor to Mario Draghi, who ensured the euro's continued existence with decisions that were often unpopular in Germany.

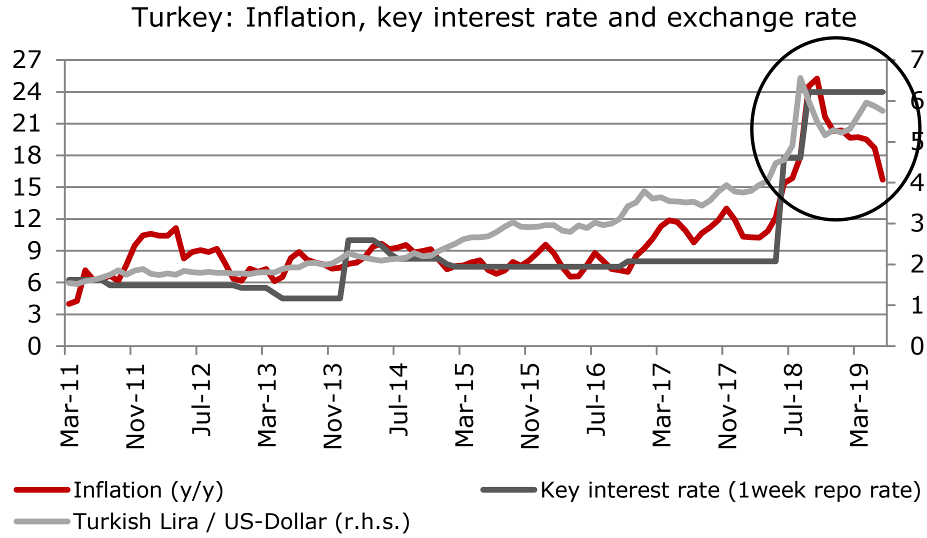
The ECB president is elected to a term of eight years by the European Council (consisting of the heads of state or government of EU member states), not by the EU Parliament. What consequences will the nomination of Ms. Lagarde have for investment policy? 1) In contrast to Ms. von der Leyen, Ms. Lagarde can be certain of being elected. 2) Ms. Lagarde has always commented positively on ECB monetary policy during her tenure at the IMF. Under her leadership, that relaxed monetary policy will continue. 3) With her in charge, interest rates will presumably stay low even longer. We have therefore reduced our interest rate forecast for 10-year German government bonds (Bunds) again by 10 basis points to -0.50% at year's end. 4) People who get upset that Donald Trump is trying increasingly to influence Fed monetary policy should realize that there are several members of the ECB Council who come directly from the political realm and have no experience as central bankers or economists, and Christine Lagarde, France's former finance minister, is no exception to that. 5) Investors who have increased their stock ratio on the motto "Let's get ready to rumble!" should also think back to the legendary "Rumble in the Jungle." On October 30, 1974, a boxing match for the world heavyweight championship between George Foreman, who held the title at that time, and Muhammad Ali, the challenger and former champion, was held in Kinshasa, Zaire. Ali won by knockout in the eighth round against his undefeated opponent. The lesson is that even if everything seems to be going well, one should never forget defense and always keep an eye on the risks.

Weekly Outlook for July 8-12, 2019

	Feb.	Mar.	Apr.	May	June	July	Release
DE: Industrial production, m/m	0.4%	0.5%	-1.9%	0.3%			July 8
DE: Industrial production, y/y	0.1%	-0.8%	-1.9%	-3.3%			July 8
DE: Exports, m/m	-1.2%	1.6%	-3.7%	-0.5%			July 8
DE: Exports, y/y	2.8%	3.1%	-0.5%	-1.5%			July 8
DE: Imports, m/m	-1.6%	0.7%	-1.3%	-0.3%			July 8
DE: Imports, y/y	4.4%	5.7%	2.1%	1.1%			July 8
DE: Consumer prices, m/m – final	0.4%	0.4%	1.0%	0.2%	0.3%		July 11
DE: Consumer prices, y/y – final	1.5%	1.3%	2.0%	1.4%	1.6%		July 11
DE: Core inflation rate, y/y – final	1.5%	1.3%	2.0%	1.4%	1.4%		July 11
EUR19: Sentix	-3.8	-2.2	-0.3	5.3	-3.3	-3.9	July 8
EUR19: Industrial production, m/m	0.0%	-0.4%	-0.5%	0.2%			July 12
EUR19: Industrial production, y/y	0.3%	-0.6%	-0.4%	-1.6%			July 12

MMWB estimates in red

Chart of the Week: Soon even the Turkish central bank?



The markets expect key interest rate cuts this year both in the United States and in the euro zone. This conclusion appears logical in view of a weaker global economic outlook, numerous political risks, and inflation rates significantly below the 2% target. But now there is speculation about a key interest rate cut even in Turkey despite an inflation rate of 15.7% at last count. How does that figure? The main reason is that inflation there, though high, has declined significantly in recent months. It has been moving downward from a peak above 25% in October 2018, especially in the last three months. Besides a smaller increase of energy prices and base effects, weak demand across the economy is responsible for this. Gross domestic product declined in the last two quarters, and consumption dropped sharply.

The high key interest rate, which was raised 625 basis points in September 2018 to 24%, is thus having a significant impact. With the key interest rate remaining high and inflation falling significantly, the real interest rate has thus risen enormously and is now over 8%. That is one of the highest levels in the world (by contrast, the real interest rate in Germany is about -2%). Besides declining inflation and weak demand, the recent revaluation of the Turkish lira despite speculation about an interest rate cut argues in favor of such a step, possibly even this quarter. With the election cycle also ending, there is thus cautious hope that the Turkish economy can stabilize somewhat.

Market Data Overview

Stock marktes	As of 05.07.2019 12:02	Change versus 28.06.2019 -1 week	04.06.2019 -1 month	04.04.2019 -3 months	04.07.2018 -1 year	31.12.2018 YTD
Dow Jones	26966	1,4%	6,4%	2,2%	11,5%	15,6%
S&P 500	2996	1,8%	6,9%	4,0%	10,4%	19,5%
Nasdaq	8170	2,0%	8,5%	3,5%	8,9%	23,1%
DAX	12597	1,6%	5,2%	5,1%	2,3%	19,3%
MDAX	25979	1,4%	3,7%	2,0%	1,2%	20,3%
TecDAX	2943	2,3%	7,3%	6,4%	9,1%	20,1%
EuroStoxx 50	3538	1,8%	6,1%	2,8%	3,7%	17,9%
Stoxx 50	3235	1,8%	5,1%	2,0%	5,8%	17,2%
SMI (Swiss Market Index)	10029	1,3%	4,5%	4,9%	15,8%	19,0%
Nikkei 225	21746	2,2%	6,6%	0,1%	0,1%	8,7%
Brasilien BOVESPA	103636	2,6%	6,4%	7,6%	38,7%	17,9%
Russland RTS	1407	1,9%	7,6%	15,4%	22,6%	32,0%
Indien BSE 30	39508	0,3%	-1,4%	2,1%	10,8%	9,5%
China Shanghai Composite	3011	1,1%	5,2%	-7,3%	9,1%	20,7%
MSCI Welt (in €)	2215	2,8%	6,4%	3,0%	6,4%	19,5%
MSCI Emerging Markets (in €)	1065	2,0%	5,7%	-1,9%	0,8%	12,1%
Bond markets						
Bund-Future	173,85	111	539	833	1130	1031
Bobl-Future	134,63	19	77	170	248	211
Schatz-Future	112,31	2	26	38	25	37
3 Monats Euribor	-0,35	-1	-3	-4	-3	-5
3M Euribor Future, Dec 2017	-0,50	-3	-13	-19	-36	0
3 Monats $ Libor	2,29	-3	-19	-30	-5	-52
Fed Funds Future, Dec 2017	1,74	3	-6	-50	-86	-1
10 year US Treasuries	1,96	-4	-16	-55	-87	-72
10 year Bunds	-0,39	-7	-18	-38	-70	-64
10 year JGB	-0,16	0	-6	-11	-19	-17
10 year Swiss Government	-0,65	-12	-18	-35	-55	-49
US Treas 10Y Performance	627,29	0,4%	1,8%	5,7%	11,0%	8,0%
Bund 10Y Performance	670,77	0,7%	1,8%	3,8%	8,4%	6,9%
REX Performance Index	499,50	0,3%	0,7%	1,6%	2,8%	2,4%
US mortgage rate	0,00	0	0	0	0	0
IBOXX AA, €	0,19	-7	-26	-31	-58	-69
IBOXX BBB, €	0,92	-11	-45	-52	-74	-114
ML US High Yield	6,41	-3	-45	-26	-32	-160
JPM EMBI+, Index	885	0,9%	4,2%	5,3%	12,2%	11,8%
Convertible Bonds, Exane 25	7454	0,0%	2,9%	2,7%	1,8%	8,1%
Commodities						
CRB Spot Index	405,61	-0,6%	-2,3%	-5,1%	-7,3%	-0,9%
MG Base Metal Index	291,70	-1,2%	1,1%	-8,6%	-11,6%	-1,0%
Crude oil Brent	63,36	-5,2%	2,4%	-9,1%	-19,0%	19,3%
Gold	1413,96	0,1%	7,0%	9,8%	12,6%	10,4%
Silver	15,32	0,0%	3,7%	1,5%	-4,5%	-1,2%
Aluminium	1784,25	0,3%	1,3%	-4,7%	-15,6%	-4,2%
Copper	5909,00	-1,2%	0,9%	-8,2%	-7,5%	-0,7%
Iron ore	123,16	12,8%	25,2%	33,1%	92,2%	78,0%
Freight rates Baltic Dry Index	1700	25,6%	51,5%	143,2%	8,5%	33,8%
Currencies						
EUR/ USD	1,1262	-1,0%	0,2%	0,4%	0,0%	-1,6%
EUR/ GBP	0,8973	0,3%	1,2%	4,6%	1,8%	0,0%
EUR/ JPY	121,63	-0,8%	0,0%	-2,7%	-5,4%	-3,4%
EUR/ CHF	1,1119	0,1%	-0,5%	-0,8%	-3,8%	-1,3%
USD/ CNY	6,8761	0,1%	-0,5%	2,3%	3,6%	0,0%
USD/ JPY	107,81	-0,1%	-0,3%	-3,5%	-2,4%	-1,6%
USD/ GBP	0,80	1,4%	1,0%	4,2%	5,3%	1,5%

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