



ECONOMIC SITUATION AND STRATEGY

12. July 2019

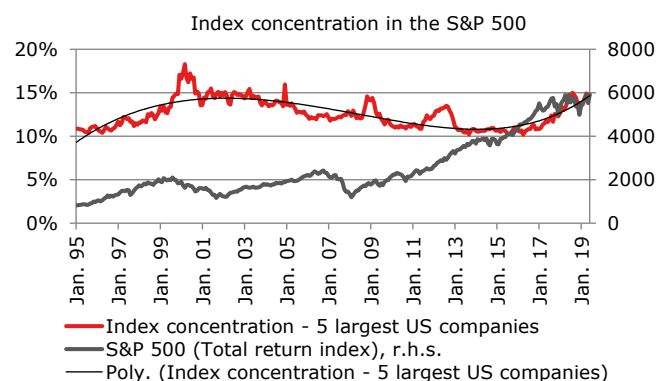
Who will beat the S&P 500?

The prospect of central banks going even more expansive in their monetary policies has prompted the equity markets to ignore all clouds on the economic and geopolitical horizon this year. The S&P 500 has already gained some 18.5 percent in the first six months of this year and even 19 percent in euro terms. At first glance this looks like a pretty successful first half of the stock market year. A more detailed analysis of this performance, however, reveals that the dark clouds are still looming.

Especially in the US, the index heavyweights rather than the broad base have been driving the performance. These are traditionally established, unexciting companies. European heavyweights like Nestlé, Roche, and Novartis certainly match the blue chip mold. This is not at all the case in the US, though. The so-called FAANGMs (i.e. Facebook, Apple, Amazon, Netflix, Google (Alphabet), and Microsoft) rank top five in the ten largest S&P 500 stocks (although Netflix is just a hair short) and are neither old nor unexciting. Adding Visa to this new world order and Berkshire, too, because it is heavily invested in the FAANGM leaves only ranks eight (Johnson & Johnson), nine (JP Morgan), and ten (Exxon Mobile) to classic blue chips.

The top five S&P 500 stocks account for more than 15 percent of the index as a whole. This currently extreme situation raises the question whether such concentration has occurred before and is therefore a normal constellation at the end of a long upswing. In order to get to the bottom of this question, we have looked on a monthly

basis at the pro rata market capitalization of the five largest companies in the S&P 500 since 1995. The chart shows that such an index concentration has indeed happened before and was even more pronounced than the current level.



The concentration occurred in the months immediately before the dot com bubble burst. At that time, the relative market capitalization of the five largest S&P 500 stocks reached 18 percent. The biggest players then were not primarily –as one would expect – the highly valued internet and technology companies of the time like Motorola, Intel, and IBM but also included rather defensive stocks such as Coca Cola and Walmart. In contrast to today, the concentration then was not problematic. The price plunge was broadly based and did not stem from a correction at the very top.

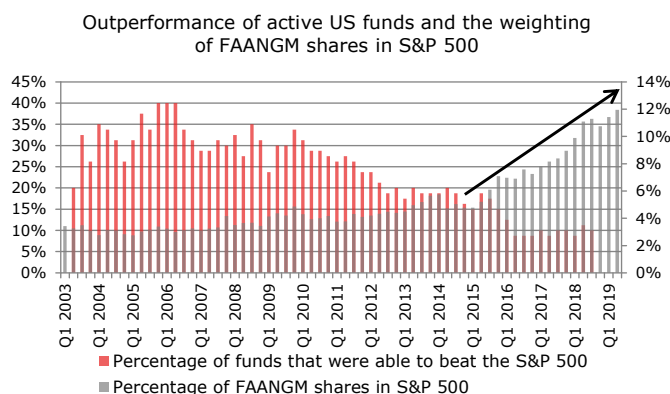
Thanks to globally very expansive monetary policies, such a correction is not yet on the horizon but the current market constellation is quite challenging for active asset managers and factor-based quantitative approach-

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es. It is at present virtually impossible to beat the S&P 500!

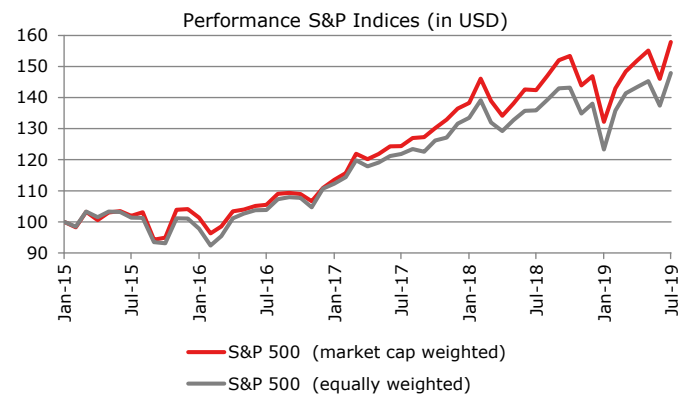
Stock pickers and quantitative factor approaches face similar problems in this regard. Both use qualitative and quantitative methods in selecting companies that offer some risk premium exposure or specific factor characteristics. The typically most desired characteristics are high quality, low volatility, low valuation, and high price momentum. If it were not for their high price momentum no active funds manager would think of FAANGM stocks as a standard buy and no quantitative filter would select them either. Active funds managers with strong diversification bias would also never consider putting almost 20 percent of their portfolios in only six stocks. Actually, in Europe it is not even allowed under UCITS guidelines to put more than ten percent of a stock fund into a single stock and the current S&P 500 heavyweights are also largely in the same sector.

Does this mean that ETFs are the only reasonable alternative to US stock market investments? In the first five years after the end of the financial crisis, the stock market rally was quite broadly based and thus a good environment for active funds managers. The significant decline in index concentration during a massive rally demonstrated this as well. A comparison of the average performance of the 250 largest and 250 smallest S&P 500 companies over the period from mid-2009 to mid-2015 reveals no major difference.

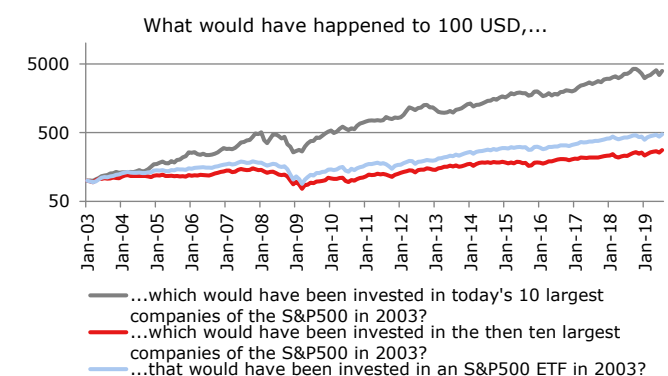


However, from 2015 to today we get a very different picture. Now we see big caps substantially outperforming small caps. The index concentration clearly reflected this by rising from 10 to 15 percent in this period. We also see that as the FAANGM stocks are increasingly dominating the S&P500 it is becoming ever harder to beat the index.

Moreover, comparing the regular, market-cap-weighted S&P 500 with an equal-weighted S&P 500 impressively illustrates the impact of the heavyweights. Since the beginning of 2015, the S&P 500 gained almost 60 percent on a market-cap-weighted basis but only 46 percent on an equally weighted basis (both in USD). For the past three years investing in an S&P 500 ETF would have actually been the better choice.



However, on a longer term horizon, active funds managers and factor approaches do much better. Large companies owe their current high weighting in a market-cap-weighted index to their past success and therefore a stronger price and market capitalization growth than other companies. The current Top Ten in the S&P 500 have since the beginning of 2003 or their IPO gained on cumulative average almost 25 percent per year while the index as a whole grew just under ten percent per year over the same period.

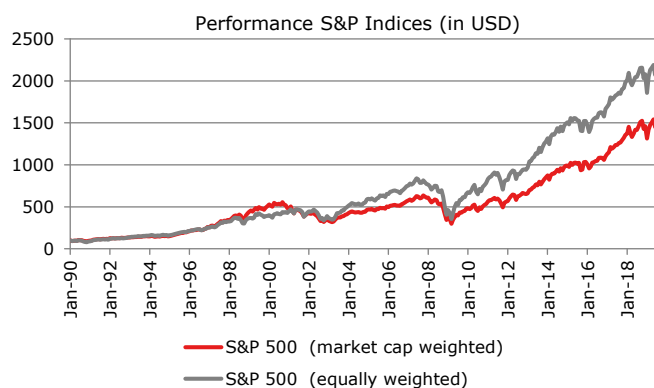


At first glance, this may suggest that it makes good sense to overweight blue chips. There is a catch, though. It was their past performance that made them blue chips to begin with. It may be far more intriguing to see how a portfolio would have performed if it consisted of the Top Ten largest stocks from 2003. Such a portfolio would have no survivor bias and the results show a bigger picture. Indeed, that portfolio would have gained

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just under six percent per year and thus substantially underperformed the S&P 500. It seems that betting on yesterday's winners hoping they will win again is not the best strategy. However, this is precisely the bet a market-cap-weighted index makes.

While betting on favorites is currently working, the big question remains how long this can continue. There have been many periods in the past – interestingly often leading up to recessions or economic downturns – when market-cap-weighted indices outperformed the overall market. On a long-term horizon, however, the alternative, in this example equal-weighted, index will perform significantly better.



Investors should realize that alternative index weightings (whether in the form of active management, equal-weighted index, or factor approach) will not always outperform traditional indices. It takes time to reap risk premiums on the stock market. The term risk premium is self-explanatory. If one wants to get a premium in the long term, one must accept the risk of underperforming the index in the short-term. With this calculated risk the savvy investor can benefit in the long run from alternative index setups that do not bet on yesterday's winners but rather on stocks with currently attractive fundamentals and ratios.

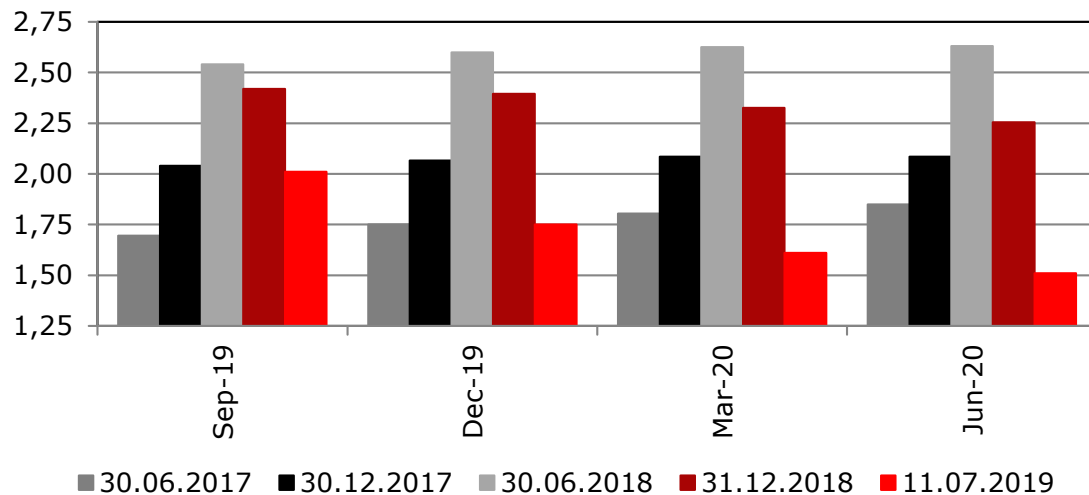
Weekly Outlook for July 15-19 2019

	Feb	Mar	Apr	May	June	July	Release
DE: ZEW Economic expectations	-13.4	-3.6	3.1	-2.1	-21.1	-15.8	July, 16
DE: ZEW Economic assessment	15	11.1	5.5	8.2	7.8	8.0	July, 16
DE: Producer prices, m/m	-0.1%	-0.1%	0.5%	-0.1%	0.2%		July, 19
DE: Producer prices, y/y	2.6%	2.4%	2.5%	1.9%	1.7%		July, 19
EUR-19: Consumer prices, y/y - final	1.5%	1.4%	1.7%	1.2%	1.2%		July, 17
EUR-19: Core inflation, y/y - final	1.0%	0.8%	1.3%	0.8%	1.1%		July, 17

MMWB estimates in red

Chart of the Week: Groundhog Day

USA: Fed Funds Futures



The past few trading days were certainly not unique in impressively demonstrating the impact monetary policy expectations have on the stock market. A strong US labor market report with more than 224,000 new jobs triggered three consecutive days of falling US stock prices. The reasoning behind this is that an unexpectedly good labor market may tempt the Fed to lower interest rates less or later. Yesterday's release of the minutes from the Fed's last interest rate session in June and the Fed president's semiannual testimony before congress came just in time to boost the S&P 500 to new heights. At their last meeting, the Fed still staid its course and kept interest rates unchanged but with a clear bias toward a rate cut in July as the market was hoping for. The Fed minutes confirmed the dovish stance of the central bankers. Economic risks have risen and many Fed members consider an imminent rate cut a desirable

risk management tool for buffering against setbacks. Low inflation (recently around 1.5 percent) and lower inflation expectations were further arguments in favor of cutting interest rates for many (but not all) Fed members. Moreover, Jerome Powell had already dispelled any remaining doubt about the rate cut at his testimony before congress. Powell highlighted again the various economic risks and explained that newly released data confirm the prospect of an economic downturn. He answered the question whether the unexpectedly positive labor market report may have changed the Fed's view with an uncharacteristic and unequivocal "...No!" However, he evaded the question whether the rate cut would be by 50 basis points. While the bets in favor a 50-basis-point cut are going up, the market still treats a 25-basis-point drop as the default scenario.

Market Data Overview

	As of 12.07.2019 11:24	04.07.2019 -1 week	10.06.2019 -1 month	Change versus 10.04.2019 -3 months	10.07.2018 -1 year	31.12.2018 YTD
Stock markets						
Dow Jones	27088	0,5%	3,9%	3,6%	8,7%	16,1%
S&P 500	3000	0,1%	3,9%	3,9%	7,4%	19,7%
Nasdaq	8196	0,3%	4,8%	2,9%	5,6%	23,5%
DAX	12332	-2,4%	2,4%	3,6%	-2,2%	16,8%
MDAX	25838	-0,9%	3,0%	2,7%	-2,0%	19,7%
TecDAX	2867	-2,6%	2,9%	4,6%	2,0%	17,0%
EuroStoxx 50	3500	-1,2%	3,4%	2,2%	0,8%	16,6%
Stoxx 50	3191	-1,5%	2,0%	0,9%	2,9%	15,6%
SMI (Swiss Market Index)	9849	-2,2%	1,0%	3,1%	12,3%	16,8%
Nikkei 225	21686	-0,1%	2,6%	0,0%	-2,3%	8,3%
Brasilien BOVESPA	105146	1,5%	7,9%	9,6%	40,5%	19,6%
Russland RTS	1385	-1,9%	3,7%	9,7%	15,2%	29,9%
Indien BSE 30	38895	-2,5%	-2,2%	0,8%	7,3%	7,8%
China Shanghai Composite	2931	-2,5%	2,7%	-9,6%	3,6%	17,5%
MSCI Welt (in €)	2205	-0,2%	3,7%	2,9%	3,2%	19,1%
MSCI Emerging Markets (in €)	1055	-0,6%	3,6%	-3,5%	-2,0%	11,1%
Bond markets						
Bund-Future	171,82	-203	71	593	944	828
Bobl-Future	134,07	-59	6	95	203	155
Schatz-Future	112,22	-9	11	28	19	28
3 Monats Euribor	-0,36	-1	-5	-5	-4	-6
3M Euribor Future, Dec 2017	-0,48	2	-9	-16	-35	0
3 Monats \$ Libor	2,34	4	-10	-26	0	-47
Fed Funds Future, Dec 2017	1,80	7	-1	-45	-86	-1
10 year US Treasuries	2,15	19	1	-33	-72	-54
10 year Bunds	-0,23	17	-2	-20	-56	-48
10 year JGB	-0,12	5	1	-5	-15	-12
10 year Swiss Government	-0,49	18	2	-17	-41	-32
US Treas 10Y Performance	620,65	-1,1%	0,7%	4,2%	10,1%	6,9%
Bund 10Y Performance	664,76	-0,9%	0,8%	2,6%	7,6%	6,0%
REX Performance Index	497,79	-0,3%	0,3%	1,3%	2,6%	2,1%
US mortgage rate	0,00	0	0	0	0	0
IBOXX AA, €	0,23	5	-17	-24	-53	-65
IBOXX BBB, €	0,97	5	-31	-43	-62	-109
ML US High Yield	6,44	3	-23	-18	-19	-157
JPM EMBI+, Index	876	-1,1%	1,9%	4,4%	9,7%	10,6%
Convertible Bonds, Exane 25	7423	-0,1%	1,8%	2,4%	0,7%	7,7%
Commodities						
CRB Spot Index	403,74	-0,5%	-1,7%	-5,1%	-8,0%	-1,3%
MG Base Metal Index	289,60	-0,7%	0,8%	-8,7%	-10,7%	-1,7%
Crude oil Brent	67,21	5,8%	6,4%	-6,0%	-14,8%	26,5%
Gold	1405,70	-0,7%	5,8%	7,5%	12,1%	9,7%
Silver	15,21	-0,7%	3,3%	-0,3%	-5,5%	-1,9%
Aluminium	1833,00	2,7%	5,1%	-0,3%	-13,4%	-1,6%
Copper	5928,50	0,3%	1,2%	-8,1%	-6,2%	-0,3%
Iron ore	120,32	-2,3%	21,2%	29,9%	90,4%	73,9%
Freight rates Baltic Dry Index	1816	6,8%	61,4%	147,4%	16,8%	42,9%
Currencies						
EUR/ USD	1,1257	-0,3%	-0,4%	-0,2%	0,0%	-1,7%
EUR/ GBP	0,8984	0,1%	0,8%	4,5%	1,7%	0,1%
EUR/ JPY	122,06	0,3%	-0,6%	-2,6%	-6,3%	-3,0%
EUR/ CHF	1,1111	-0,1%	-0,8%	-1,5%	-4,6%	-1,4%
USD/ CNY	6,8788	0,1%	-0,8%	2,4%	3,7%	0,0%
USD/ JPY	108,47	0,6%	0,0%	-2,3%	-2,3%	-1,0%
USD/ GBP	0,80	0,4%	1,3%	4,5%	5,9%	1,7%

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