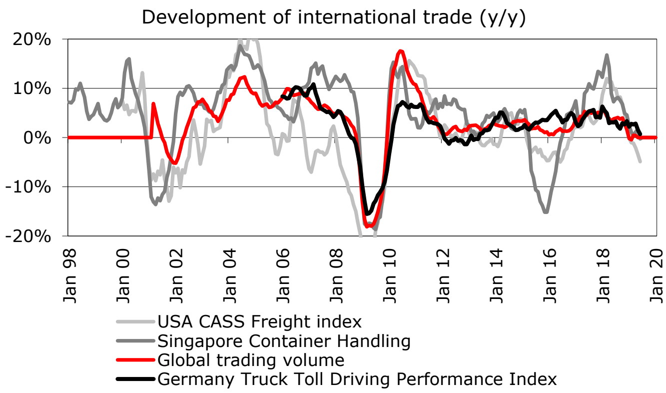
ECONOMIC SITUATION AND STRATEGY

19. July 2019

Economy and Capital Markets 2019: The Half-Time Show

Mid-July is a good time to review what has happened so far this year and check reality against forecasts and estimates from the beginning of the year. Which assumptions have been spot on and which were wrong? What was the first half like and what may be expected in the second half? We are starting our little reality check with the forecasts in our monthly publication, *Capital Market Perspectives*, from January 2019.

1. Economy: We took a rather skeptical view of the economic outlook at the beginning of the year. We were correct in our assumption that the International Monetary Fund's 3.7 percent growth forecast was unrealistic considering the continuing trade disputes and Brexit troubles. The IMF has meanwhile reduced its growth forecast to 3.3 percent but even that may be still too optimistic. While we still expect US economic growth to reach 2.4 percent this year, we have lowered our expectations for Euroland somewhat (from 1.1 percent to 1.0 percent) and for Germany substantially (from 1.1 to 0.7 percent). Since there is as yet no indication of an economic turnaround to the better, it is becoming evident that a further downward revision may be called for – especially for Germany as it is in an uncomfortable position between the main combatants USA and China. Germany is by now joining Italy at the bottom end of Euroland's growth ranks. France's economy is doing better since the yellow jacket protests have calmed down. Many emerging economies are also ailing. Not only China's economy has slowed down substantially but also many other countries are struggling. For instance, real gross domestic product has dropped in Mexico, Russia, South Africa, South Korea, and Brazil. All these countries are suffering from the global trade slowdown and the data of the international transport sector reflects this. Until these storm clouds dissipate, a further economic slowdown is more likely than a recovery.



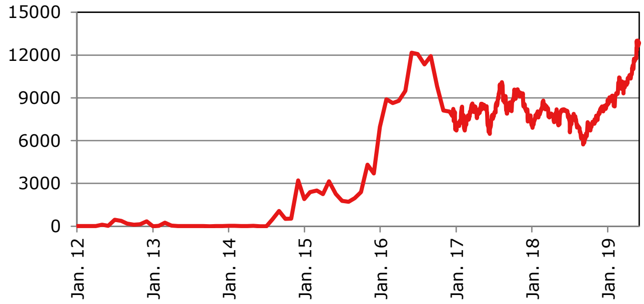
2. Inflation: In light of the sluggish economy it is not surprising that inflation is falling around the world. With only a few exceptions (e.g. iron ore) most commodity prices are currently below their prior-year values. Crude oil, for example, which makes up about a tenth in the basket of goods used for determining inflation rates, is down almost 20 percent. We still expect 1.2 percent inflation in Euroland and 1.6 percent in the US as we did at the beginning of the year.

3. Interest Rates/Bond Markets: The greatest surprise this year was the substantial yield decline on the bond markets. Although our forecasts at the beginning of the year were already among the lowest, we had actually underestimated the real decline. The yield on 10-year US Treasuries dropped 70 basis points this year to 2.10

percent and the yield on 10-year Bunds shed 60 basis points to -0.30 percent. The yield collapse was primarily due to weak economic data and the corresponding expectation that central banks will cut interest rates. The Fed in particular made an impressive about-face this year. In the beginning of the year the Fed announced that it intends to stay its rate hike course of the past few years. This was put on ice relatively quickly and has recently been changed to a clear rate cutting course. The question is now no longer whether but when and by how much the Fed will cut interest rates. The European Central Bank followed a similar path. At the end of 2018, the ECB ended its bond purchasing program and stated that it intends to start raising rates after this summer. We were already skeptical then and quite rightly so as we now know. It is not just that the ECB is not going to raise interest rates it will actually lower them soon. The ECB will probably also revive its bond purchasing program. The times they are a changing indeed! We therefore greatly reduced our interest rate forecast from the beginning of the year from 0.45 to -0.50 percent for 10-year Bunds and from 2.6 to 1.5 percent for 10-year US Treasuries.

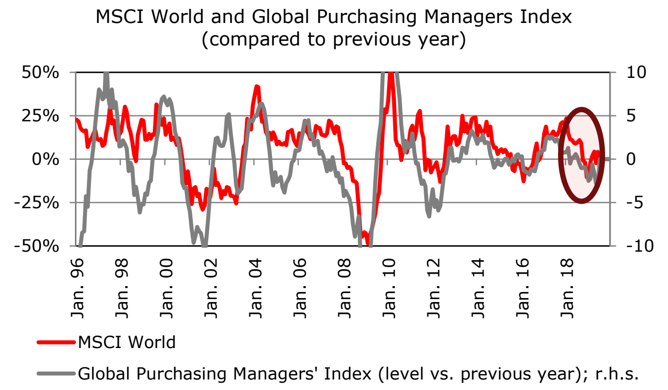
Dropping yields have inspired the entire bond market from government bonds to corporate bonds around the globe. High bond demand has driven prices up and yields down. Already 12.5 trillion US-dollars worth of bonds are yielding negative representing just over 20 percent of all bonds outstanding. Negative yielders are making up almost 50 percent of the European bond market where even some non-investment-grade, short-term corporate bonds have negative yields (e.g. Nokia). In the first six months of the year, it was possible to attain about a 6-percent performance overall on European government and investment-grade corporate bonds and about 8 percent on European high-yielding corporate bonds. The phenomenon was even more pronounced among US corporate bonds that gained nine to ten percent (in US dollars). Emerging economies' government bonds were the top performers at 11 percent value gain in the first half of the year.

Volume of outstanding bonds with negative yield
(Barclays Global Aggregate Index, USD billion)



4. Equity Markets: What bonds can do equities can do better - at least this year they could. After sliding downhill in 2018 with an outright nosedive particularly in the fourth quarter, the equity markets are racing for the next peak again to the great joy of investors. Many stock indices in industrialized countries have gained 15 to 20 percent since the beginning of the year. Emerging economies were taking a bit slower pace but still added just over ten percent. Most of this performance took place in the first three months of the year making up for the drastic losses in the previous quarter. After the disastrous price drops in December 2018, we had revised our DAX forecast for this year from 12,600 to 11,800 points and the S&P 500 forecast from 3,000 to 2,800 points. Now, we are raising our expectations seeing the DAX reaching the old estimate again and the S&P 500 making it to 3,100 points.

The equity market rally was for a long time born by hope for economic recovery in the second half of the year and an end to the trade dispute between the US and China. However, neither of the two has come about. There is even no prospect of it happening any time soon. The fronts in Trump's standoff with China seem hardened and the economy does not play along either. Recently, the equity markets thus started betting on a new scenario – central bank intervention. Falling interest rates - the market argues – will boost the economy and thus the equity markets can rally on new liquidity. Consequently, the market has adopted the strange new logic that bad economic news is good for the equity market. Economists worth their salt know better, though, bad news is bad news.



5. *Outlook*: What does all this mean for investors and how should they position themselves for the second half of the year? Global growth is slowing and the probability of recession in some countries has greatly increased. The negative trend is pervasive throughout almost all countries and regions although the US seems to be holding up better than most economies thanks to a lastingly booming labor market and robust consumer spending. Export-heavy countries including Germany, however, run the risk that a growth slump may develop in a lasting crisis.

As this scenario naturally comes with low inflation it only stands to reason that central banks will loosen their purse strings. This year, already 15 central banks have cut interest rates and the Fed and ECB will soon follow suit. The global low-interest phase is going into overtime and may last longer than an evenly-matched soccer game. Investors will be well advised to choose their bond maturities not too short. Even if it may look at first glance that low or outright negative yields are not a good idea, bond investments still make sense. Growth stocks are also not chosen for their dividend yield and bonds are nowadays worth more than their interest coupons as price levels rise. Investors should diversify their portfolios with government and corporate bonds including bonds from emerging markets.

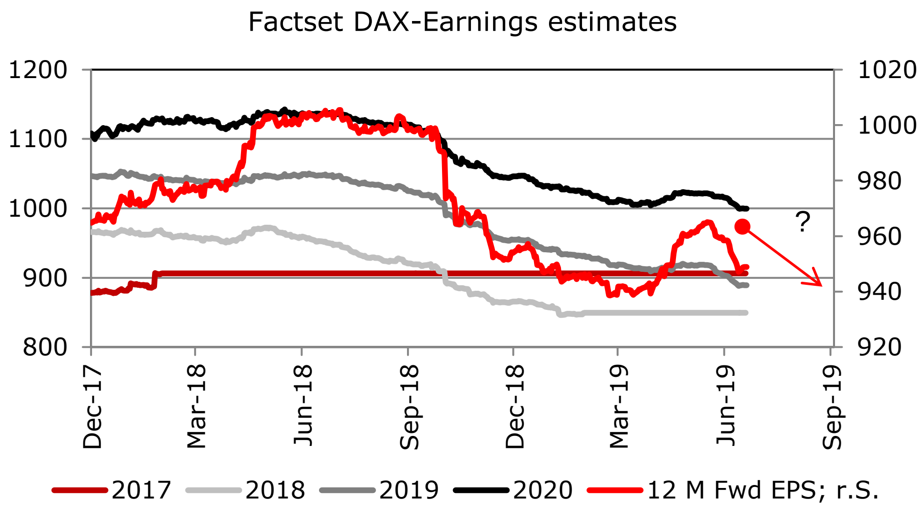
After a strong equity market rally in the first half of the year, investors should play the market more defensively in the second half. Equity markets have increasingly ignored the reality of economic fundamental data of late which has driven up valuations. US stocks should continue to fare better than European equities as earnings expectations in Europe are still far too optimistic and need to be revised downwards. However, one should have learned from the 1990s dot-com-bubble that phases or irrational exuberance can last a long time. There are always plausible, convincing arguments why stock prices should continue to rise. We recommend being prepared to reduce the equity ratio on short notice. Our year-end forecasts for the DAX and S&P 500 suggest that the upside potential in the stock markets is largely exhausted. The next few months will show whether we are right or not. If vague forecasts annoy you please remember this near-legendary quote of the then Borussia Dortmund mid-fielder Andreas Möller: “Milan or Madrid - who cares – as long as I get to play in Italy!” Even the most virtuosic soccer artists may be somewhat geography challenged when determining a destination. Time will tell whether we, too, may not know where we were headed. Now let us kick off a great second half.

Weekly Outlook for the period from July 22-26, 2019

	Feb	Mar	Apr	May	June	July	Release
DE: PMI Manufacturing – Flash	47.6	44.1	44.4	44.3	45.0	45.4	July, 24
DE: PMI Services. – Flash	55.3	55.4	55.7	55.4	55.8	55.6	July, 24
DE: PMI Total – Flash	52.8	51.4	52.2	52.6	52.6	52.7	July, 24
DE: Ifo Business Climate	98.8	99.7	99.3	97.9	97.4	97.8	July, 25
DE: Ifo Business Expectations	94.0	95.6	95.3	95.2	94.2	95.1	July, 25
DE: Ifo Economic Assessment	103.9	104.1	103.5	100.7	100.8	100.7	July, 25
EUR-19: Consumer Confidence – Flash	-7.4	-7.2	-7.9	-6.5	-7.2	-7.0	July, 23
EUR-19: PMI Manufacturing – Flash	49.3	47.5	47.9	47.7	47.6	47.7	July, 24
EUR-19: PMI Services – Flash	52.8	53.3	52.8	52.9	53.6	53.1	July, 24
EUR-19: PMI Total – Flash	51.9	51.6	51.5	51.8	52.2	52.2	July, 24
EUR-19: M3, y/y	4.2%	4.6%	4.7%	4.8%	4.7%		July, 24

MMWB estimates in red

Chart of the Week: 13% Earnings Growth in 2020?



In the run-up to reporting season, profit warnings for German companies are coming in. Not only second-tier players like Aumann, Krones, and Deutsche Beteiligungs AG have taken down their earnings estimates for 2019 but also blue chips like Lufthansa, Daimler, and BASF have put lower numbers on their targets for this year. More profit warnings are likely to follow. Analysts have followed suit and revised their earnings expectations downward over the past few weeks. At the beginning of the year, analysts still expected DAX companies' profits to rise more than 12 percent, which has meanwhile been taken down to just under 5 percent. This did not come as a surprise considering that the economy is seriously ailing in Germany with the industrial sector in outright recession and the global market place is not faring much better. Indeed, it was rather remarkable that it took analysts this long to substantially revise their earnings estimates especially because the consensus estimate was still 8 percent earnings growth just a month ago. Even more astonishing are the 2020 earnings estimates. True, the comparative base has come down considerably by the downward revisions for 2019 but the going estimates are still at 13 percent earnings growth for 2020. This can only be due to pathological economic optimism or belief in the profit margin fairy that brings about higher prices over night. Inflation and producer prices do not indicate anything of that sort and neither currently weak economic data nor leading indicators suggest an imminent economic upswing while current trade disputes do not appear to resolve soon either.

Market Data Overview

Stock marktes	As of 19.07.2019 11:27	Change versus 12.07.2019 -1 week	18.06.2019 -1 month	18.04.2019 -3 months	18.07.2018 -1 year	31.12.2018 YTD
Dow Jones	27223	-0,4%	2,9%	2,5%	8,0%	16,7%
S&P 500	2995	-0,6%	2,7%	3,1%	6,4%	19,5%
Nasdaq	8207	-0,4%	3,2%	2,6%	4,5%	23,7%
DAX	12279	-0,4%	-0,4%	0,5%	-3,8%	16,3%
MDAX	25862	0,2%	1,0%	0,0%	-3,8%	19,8%
TecDAX	2863	0,0%	0,7%	2,2%	-0,5%	16,9%
EuroStoxx 50	3499	0,1%	1,3%	0,0%	0,4%	16,6%
Stoxx 50	3200	0,6%	0,6%	1,0%	3,2%	15,9%
SMI (Swiss Market Index)	9989	2,3%	0,0%	4,4%	11,8%	18,5%
Nikkei 225	21467	-1,0%	2,4%	-2,8%	-5,8%	7,3%
Brasilien BOVESPA	104717	0,8%	5,3%	10,7%	35,4%	19,1%
Russland RTS	1362	-1,8%	0,2%	7,9%	19,0%	27,8%
Indien BSE 30	38388	-0,9%	-1,7%	-1,9%	5,5%	6,4%
China Shanghai Composite	2924	-0,2%	1,2%	-10,0%	4,9%	17,3%
MSCI Welt (in €)	2198	-0,5%	1,7%	1,8%	6,0%	18,9%
MSCI Emerging Markets (in €)	1052	0,2%	2,2%	-3,7%	1,6%	10,9%
Bond markets						
Bund-Future	173,25	157	39	803	1030	971
Bobl-Future	134,70	55	7	186	253	218
Schatz-Future	112,31	7	1	40	28	37
3 Monats Euribor	-0,37	-1	-5	-6	-5	-6
3M Euribor Future, Dec 2017	-0,51	-3	-4	-19	-39	0
3 Monats $ Libor	2,30	-2	-8	-28	-4	-51
Fed Funds Future, Dec 2017	1,68	-8	-12	-63	-99	-1
10 year US Treasuries	2,04	-7	-2	-52	-83	-65
10 year Bunds	-0,32	-8	0	-35	-61	-57
10 year JGB	-0,13	-1	-1	-11	-18	-14
10 year Swiss Government	-0,62	-13	-8	-33	-56	-45
US Treas 10Y Performance	623,13	0,8%	0,3%	5,3%	10,5%	7,3%
Bund 10Y Performance	667,82	1,0%	0,3%	3,7%	7,7%	6,5%
REX Performance Index	498,49	0,4%	0,1%	1,6%	2,6%	2,2%
US mortgage rate	0,00	0	0	0	0	0
IBOXX AA, €	0,18	-8	-12	-30	-55	-70
IBOXX BBB, €	0,90	-7	-23	-45	-65	-116
ML US High Yield	6,48	2	-10	-7	-10	-153
JPM EMBI+, Index	878	0,5%	0,9%	5,2%	9,8%	11,0%
Convertible Bonds, Exane 25	7448	0,0%	1,3%	2,5%	0,2%	8,0%
Commodities						
CRB Spot Index	403,92	-0,4%	-2,0%	-5,0%	-6,5%	-1,3%
MG Base Metal Index	300,64	1,5%	3,9%	-4,0%	-3,6%	2,0%
Crude oil Brent	62,93	-5,8%	0,6%	-12,5%	-12,6%	18,4%
Gold	1438,20	2,1%	6,6%	12,8%	17,3%	12,2%
Silver	16,21	6,9%	8,1%	8,0%	4,6%	4,5%
Aluminium	1835,75	1,9%	4,8%	-0,9%	-10,6%	-1,4%
Copper	5970,50	0,7%	0,8%	-7,6%	-2,5%	0,4%
Iron ore	120,87	0,5%	14,3%	30,1%	90,9%	74,7%
Freight rates Baltic Dry Index	2130	14,2%	87,7%	169,6%	26,2%	67,6%
Currencies						
EUR/ USD	1,1241	-0,1%	0,5%	-0,1%	-3,2%	-1,8%
EUR/ GBP	0,8983	0,3%	0,7%	3,9%	0,7%	0,1%
EUR/ JPY	121,01	-0,7%	-0,1%	-3,9%	-7,6%	-3,8%
EUR/ CHF	1,1043	-0,4%	-1,2%	-3,0%	-4,9%	-2,0%
USD/ CNY	6,8776	-0,1%	-0,4%	2,5%	2,3%	0,0%
USD/ JPY	107,30	-0,6%	-1,1%	-4,2%	-4,9%	-2,1%
USD/ GBP	0,80	0,4%	0,2%	4,0%	4,3%	1,8%

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