M.M.WARBURG & CO
BANK

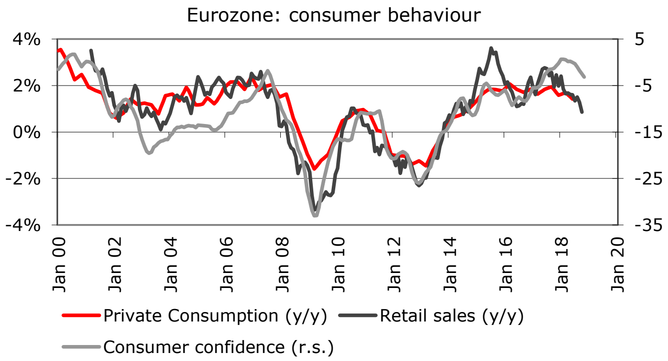
ECONOMIC SITUATION AND STRATEGY November 30, 2018

Outlook for 2019 (II): Going downhill

Having dealt with the economic prospects for emerging markets and the United States last week, we now turn in Part II of our 2019 outlook to the situation in the euro zone and Germany. The German economy has slowed more than expected this year mainly due to a slump in the automotive sector, and momentum will be even weaker in 2019. So, Germany will give little economic impetus to the euro zone, which is suffering from uncertainty regarding Brexit and the budget dispute between the EU and Italy.

Euro zone: Political risks gaining the upper hand

Economic momentum in the 19 euro zone states has diminished significantly this year. Growth will still come to 1.9% for 2018, but we expect it to slow to only 1.3% next year. There are huge economic risks involved. Export business, on which the euro zone economy heavily depends, has already waned significantly. Besides heightened uncertainty related to trade disputes, revaluation of the euro is partly responsible for declining foreign demand.



However, domestic demand has also provided less economic impetus than originally expected. Despite falling unemployment in most of the countries, wage growth has been limited. At the same time, purchasing power has declined due to rising inflation.

Brexit: A disorderly withdrawal will be costly

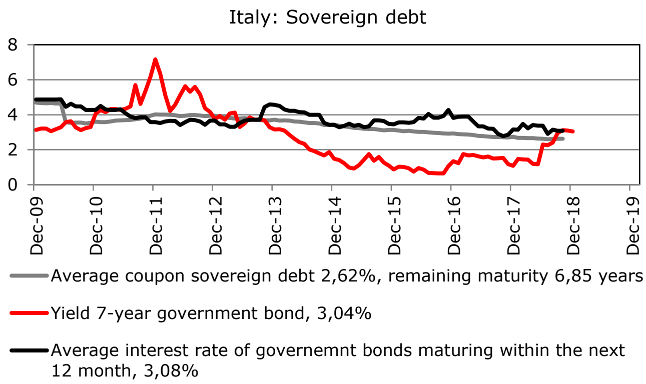
Moreover, Brexit is proving to be especially burdensome, as negotiations for Great Britain's withdrawal from the European Union have been chaotic, to say the least. Whether the deal negotiated by British Prime Minister Theresa May will find a majority in the British parliament is still entirely open. If it does not, various scenarios are possible including renegotiation with the European Union and a second agreement, withdrawal on March 29, 2019 without a deal (orderly or not), new elections, or even a second referendum, which we consider the least likely possibility. It now appears that the British politicians who agitated for Brexit have totally underestimated the complexity of withdrawing. As feared, the expectations stoked in the United Kingdom ahead of the Brexit decision are proving unrealistic. A disorderly withdrawal by Great Britain could drive the country into a recession next year because it would no longer have any special trade relations with the European Union. The rules of the World Trade Organization would apply to future trade, which means that duty would be levied on almost all goods. But so far, no logistics or personnel preparations have been made for that eventuality. It remains unclear where and how border checks are to be conducted from April 2019 onward. The economic effects would likewise be negative for the EU countries as a whole, but probably not as much as for Great Britain. However, this does not apply to member states that have especially close economic ties to Great Britain like Ireland, Malta, and Cyprus. A recession in those countries would also be likely.

France: Reforms take time

Besides Germany, the other two large economies of the euro zone, France and Italy, have also registered slower growth. After the election of Emmanuel Macron last year made for a climate of change in France, implementing some of the urgently needed reforms has disillusioned many citizens. The eagerness of French workers to strike has led to production losses that have adversely affected the overall economy. Moreover, French companies have had to struggle with declining demand from abroad. However, we believe France is in good shape structurally, so its economy should grow at a moderate pace next year.

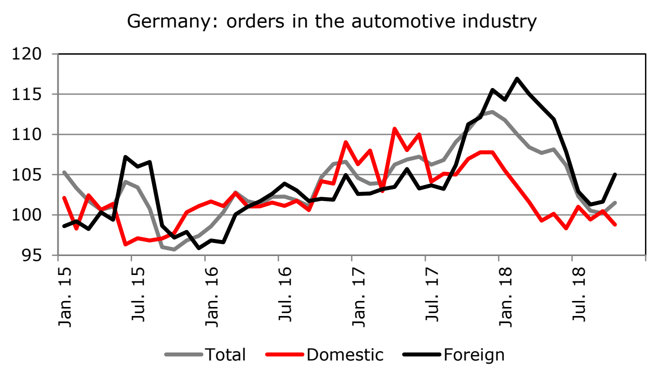
Italy: Playing with fire

On the other hand, Italy is a very worrisome case. The confrontational dealings of the populist government in Rome with EU partners are fueling concerns about a new debt crisis. The announcement that next year's budget deficit is to be larger than originally agreed has led to higher risk premiums on Italian government bonds. The interest rate for taking on new debt or rolling existing debt forward is already higher than the interest rate on maturing bonds. That further narrows already limited maneuvering room for Italian government spending. If all the new government's planned fiscal measures were implemented, the deficit would even exceed the announced amount, especially since the underlying growth expectations are presumably too optimistic. However, we believe there will be a compromise that will lead to a budget deficit that is larger than the old government's planned amount, but is somewhat lower than what the League and the Five Star Movement have announced. But as long as no agreement is reached, capital market interest rates will continue to climb and thereby increase pressure on the government in Rome. As in Greece in 2015, reaching an agreement is also likely to be a painful process in Italy. On the other hand, we think it is very unlikely that Italy will leave the euro zone and return to a currency of its own. For, like the Greeks before them, the Italians have elected a government that is critical of the euro, but the majority of the population would nevertheless prefer to keep the euro as legal tender.



Germany: Going downhill

The German economy has slowed more than expected this year. At first, it looked as if special factors were responsible for that (a very cold winter followed by a hot, dry summer, labor strikes, and a flu epidemic at the beginning of the year), but the picture did not improve subsequently. In the third quarter, a slump in automobile production then drove the economy in reverse for the first time since the beginning of 2015. The problems of adjusting to comply with the new Worldwide Harmonized Light Vehicle Test Procedure (WLTP) meant that German automobile production in August and September was about one-fourth lower than in the year-earlier period. Moreover, delivery difficulties have led to a decline of exports and negatively affected private consumption. But production recovered in October, and that trend should continue for the time being. Existing unfilled orders in vehicle manufacturing are at a record level. Growth in the fourth quarter will therefore benefit from this catch-up process. Nevertheless, only a real GDP growth rate of 1.6% may be achieved this year. Revisions by the German Federal Statistical Office for the year 2017 have also not helped much in this connection. In contrast to leading economic indicators, which did not reach their best levels until the beginning of 2018, economic momentum had already peaked in the first quarter of 2017 according to the revised figures. However, that came to be known too late for the growth forecast last year. On the other hand, the international trade dispute emanating from the United States has so far had little directly measurable impact. German exports to China and the United States have increased significantly this year. The development of exports in 2018 has nevertheless been disappointing, and that is primarily because exports to Great Britain and other countries outside the euro zone have declined considerably.



Dragging effects of trade dispute more visible in 2019, exports and business investment suffer

We expect even lower economic growth in Germany of 1.3% for 2019. This rate roughly matches potential growth, so the forecast does not imply that the upswing in Germany is over. This is both good and bad news. Good because it asserts only cyclical normalization, but bad because the danger exists that this estimate might be too optimistic if the various above-mentioned risks are realized. The economic slowdown in the United States, China, and neighboring European countries will be a drag on exports and business investment. German exports to China and the United States have increased significantly in 2018, but new orders from abroad have been falling steadily in recent months. Export momentum will therefore weaken. The devaluation of the euro might be a ray of hope on the horizon. Usually, it takes about half a year before exchange rate movements are reflected in the real economy. However, since the global economy will slow in 2019, the more competitive exchange rate will only be of limited help. We therefore expect that exports will grow by 1.7% next year (2018: 2.2%). On the other hand, imports will increase more strongly, so the result will be another negative growth contribution from trade. Moreover, the heightened business uncertainty reflected in major leading indicators like the Ifo index and the PMIs means that investments will be postponed or cancelled altogether despite high capacity utilization. Capital spending on equipment will therefore increase by only 2.4% in 2019 (2018: 4.0%). That will contribute to a further decline of potential growth in the years ahead.

Germans remain reluctant consumers, raise saving ratio sharply

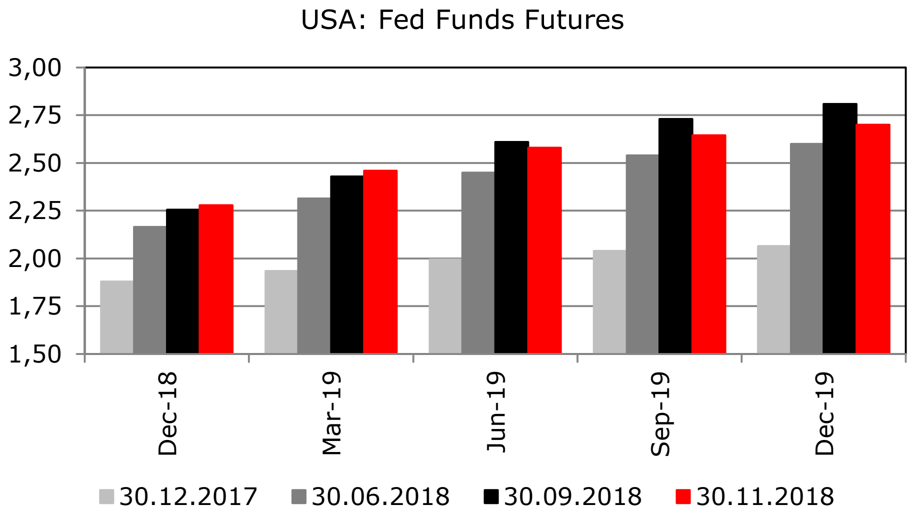
In contrast, consumption in Germany might grow somewhat more strongly in 2019, by 1.4%, compared with this year (1.2%), provided the current oil price decline is sustained. In that case, inflation would fall from 1.9% to an average 1.6% next year, giving households more spending leeway. While e-commerce continues to flourish, bricks-and-mortar retailers are struggling with a variety of problems. Moreover, the auto industry's problems and related unresolved issues (driving bans, retrofitting old diesel cars, and transition to e-mobility) have made customers very uncertain. Their buying restraint is most evident in the fact that the saving ratio has risen sharply in the last few quarters. That is normally not what one would observe in such a phase of the economic cycle. At 10.7%, Germans' fear-driven saving in the third quarter of 2018 was almost as pronounced as in the 2008-2009 crisis. Overall, the financial situation may be described as very comfortable, though. As long as the above-mentioned problems are not resolved, Germans will probably not change their role as reluctant consumers. However, the potential exists for stronger growth of consumer spending in the future.

Weekly outlook for December 3-7, 2018

	June	July	Aug.	Sept.	Oct.	Nov.	Release
DE: PMI, manufacturing - final	55-9	56-9	55-9	53-7	52-2	51-6	December 3
DE: PMI, services - final	54-5	54-1	55-0	55-9	54-7	53-3	December 5
DE: New orders, m/m	-3-9%	-0-9%	2-5%	0-3%	0-4%		December 6
DE: New orders, y/y	-0-8%	-0-8%	-1-7%	-2-2%	-2-5%		December 6
DE: Industrial production, m/m	-0-7%	-1-3%	0-1%	0-2%	0-3%		December 7
DE: Industrial production, y/y	3-2%	1-6%	0-0%	0-8%	2-3%		December 7
EUR19: PMI, manufacturing - final	54-9	55-1	54-6	53-2	52-0	51-5	December 3
EUR19: Producer prices m/m	0-4%	0-7%	0-4%	0-5%	0-3%		December 4
EUR19: Producer prices y/y	3-6%	4-2%	4-3%	4-5%	4-3%		December 4
EUR19: PMI, services - final	55-2	54-2	54-4	54-7	53-7	53-1	December 5
EUR19: Retail sales, m/m	0-4%	-0-6%	0-3%	0-0%	0-3%		December 5

MMWB estimates in red

Chart of the Week: Just below neutral



The Fed has raised interest rates already three times this year. Another rate increase in December is considered almost a foregone conclusion. This approach was and is understandable in view of strong US growth and rising inflation (also driven by commodity prices). The dot plot of the last FOMC meeting indicates three more rate hikes for the coming year. That would put the key interest rate at a range of 3.00-3.25%. At the moment, however, the market expects the Fed to take a different course. Fed funds futures price in only one further interest rate step. For one thing, energy and raw material prices are declining now, which will negatively affect the inflation rate. For another, growth prospects for the United States have dimmed somewhat. This suggests that the neutral interest rate, which neither boosts nor brakes the economy, is lower than previously assumed. The room for interest rate increases would thus be limited. In his speech on Wednesday, Fed Chair Jerome Powell shared this assessment. He expressed the view that interest rates were "*just below* the broad range of estimates of the level that would be neutral for the economy." The market has interpreted this as confirmation that fewer interest rate steps are likely next year. Accordingly, yields on US bonds declined on Powell's remarks. It will be interesting now to see whether the dot plot of the FOMC meeting in December will confirm this direction.

Market data overview

Stock marktes	As of 30.11.2018 10:56	Change versus 23.11.2018 -1 week	29.10.2018 -1 month	29.08.2018 -3 months	29.11.2017 -1 year	29.12.2017 YTD
Dow Jones	25339	4,3%	3,7%	-3,0%	5,8%	2,5%
S&P 500	2738	4,0%	3,7%	-6,0%	4,3%	2,4%
Nasdaq	7273	4,8%	3,2%	-10,3%	6,6%	5,4%
DAX	11228	0,3%	-0,9%	-10,6%	-14,0%	-13,1%
MDAX	23405	0,8%	-1,3%	-14,2%	-13,0%	-10,7%
TecDAX	2590	2,1%	1,4%	-14,8%	2,8%	2,4%
EuroStoxx 50	3160	0,7%	0,2%	-8,6%	-12,0%	-9,8%
Stoxx 50	2919	1,0%	0,8%	-5,3%	-8,1%	-8,1%
SMI (Swiss Market Index)	8980	1,5%	2,5%	-1,1%	-3,5%	-4,3%
Nikkei 225	22351	3,3%	5,7%	-2,2%	-1,1%	-1,8%
Brasilien BOVESPA	89710	4,0%	7,1%	14,4%	23,4%	17,4%
Russland RTS	1124	0,9%	1,0%	3,6%	-1,8%	-2,6%
Indien BSE 30	36213	3,5%	6,3%	-6,5%	7,8%	6,3%
China Shanghai Composite	2588	0,3%	1,8%	-6,5%	-22,5%	-21,7%
MSCI Welt (in €)	2035	2,8%	3,1%	-4,8%	2,4%	2,0%
MSCI Emerging Markets (in €)	998	2,8%	6,8%	-4,4%	-9,1%	-9,2%
Bond markets						
Bund-Future	161,41	31	106	-77	-107	-27
Bobl-Future	131,94	19	46	4	47	33
Schatz-Future	112,01	4	4	7	-17	4
3 Monats Euribor	-0,32	0	0	0	1	1
3M Euribor Future, Dec 2017	-0,31	0	-2	-2	-5	0
3 Monats $ Libor	2,71	2	18	39	123	101
Fed Funds Future, Dec 2017	2,28	0	1	5	50	0
10 year US Treasuries	3,02	-4	-7	13	64	61
10 year Bunds	0,31	-3	-7	-10	-7	-11
10 year JGB	0,09	-1	-2	-1	5	4
10 year Swiss Government	-0,09	-2	-7	-1	1	3
US Treas 10Y Performance	560,69	0,4%	0,6%	-0,7%	-3,7%	-3,6%
Bund 10Y Performance	622,51	0,2%	0,6%	1,0%	2,2%	2,5%
REX Performance Index	485,94	0,1%	0,1%	0,3%	0,6%	1,1%
US mortgage rate	0,00	0	0	0	0	0
IBOXX AA, €	0,90	0	9	12	20	22
IBOXX BBB, €	2,00	1	18	33	82	77
ML US High Yield	7,29	-8	32	80	114	114
JPM EMBI+, Index	778	0,3%	-0,3%	-0,4%	-6,4%	-7,0%
Convertible Bonds, Exane 25	7020	0,0%	-1,9%	-6,0%	-4,9%	-5,1%
Commodities						
CRB Spot Index	414,23	-0,3%	-0,5%	0,6%	-3,5%	-4,2%
MG Base Metal Index	303,18	-0,1%	-2,3%	-3,6%	-10,3%	-15,5%
Crude oil Brent	59,26	0,6%	-23,3%	-22,6%	-6,5%	-11,0%
Gold	1222,87	0,0%	-0,6%	1,6%	-4,8%	-6,2%
Silver	14,35	0,3%	-1,9%	-2,6%	-13,6%	-15,6%
Aluminium	1936,75	-0,1%	-1,3%	-9,8%	-5,7%	-14,2%
Copper	6247,50	0,2%	1,1%	2,9%	-7,2%	-13,3%
Iron ore	72,60	-2,2%	0,0%	7,9%	15,0%	1,9%
Freight rates Baltic Dry Index	1281	17,2%	-15,8%	-22,9%	-16,6%	-6,2%
Currencies						
EUR/ USD	1,1374	0,2%	-0,1%	-2,5%	-3,8%	-5,2%
EUR/ GBP	0,8894	0,4%	0,0%	-1,2%	0,6%	0,2%
EUR/ JPY	129,06	0,8%	0,9%	-0,5%	-2,4%	-4,4%
EUR/ CHF	1,1329	0,1%	-0,5%	-0,5%	-2,9%	-3,2%
USD/ CNY	6,9438	-0,1%	-0,3%	1,8%	5,0%	6,7%
USD/ JPY	113,49	0,5%	1,0%	1,6%	1,4%	0,7%
USD/ GBP	0,78	0,2%	0,2%	1,6%	4,9%	5,8%

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