M.M.WARBURG & CO

BANK

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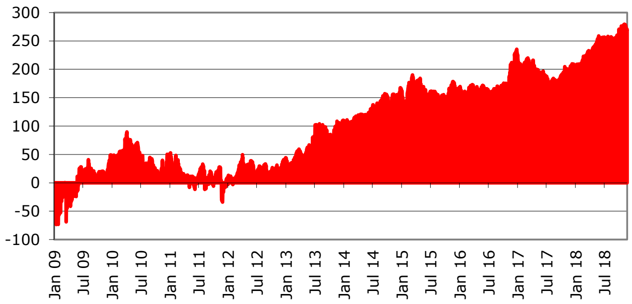
Outlook for 2019 (III): Yield level remains low

Over the past two weeks, we have looked at the economic outlook for the global economy, in particular the emerging markets, the USA, the euro zone and Germany. In the third part of our outlook for 2019, we look at the bond market yield outlook. In the coming year, too, the markets will be dominated by central bank policies and political imponderables. Since the interest rate risk should remain manageable, we will - as already in 2018 - focus primarily on the allocation of credit risks.

While the Federal Reserve (Fed) in the United States has raised its key interest rate significantly, in eight steps since last December, the European Central Bank (ECB) has not raised its main refinancing rate and has no plans to do so in 2019. Its monetary policy will remain expansionary, and the interest rate level will continue to be low. The ECB is set to end its bond-purchasing program at the end of the year, but will continue to reinvest proceeds from maturing securities from the bond holdings of euro zone central banks for the indefinite future. Moreover, ECB President Mario Draghi has stressed repeatedly that the current level of key interest rates will remain unchanged until beyond next summer. General economic and political conditions are playing into his hands in that regard. On the one hand, economic data in the euro zone have slowly but surely weakened this year. On the other, trade disputes, Brexit, and the budget policy of Italy's populist government have hung like a sword of Damocles over the economic trend in the euro zone. It is therefore not surprising that the yield difference between German government bonds (Bunds) and US Treasuries, the "transatlantic spread," has climbed to ever-higher peaks, across all maturity bands.

Spread Development US Treasuries vs. Bunds
(maturity 10 years; in basis points)



Bund yields trending sideways

Since we expect euro zone inflation to miss the ECB's target of "below but near 2%" in both the headline and core rates next year, Bund yields will rise only moderately in 2019. Our forecast for German 10-year government bonds at year's end is 0.60%t, with the increase from the current level of just under 0.4% not likely to materialize until the third and fourth quarters, when the ECB presents its outlook for monetary policy in 2020.

Credit risk the focus of allocation

In the United States, the Fed will stay on its monetary policy course for the time being and increase its policy rate once again in December 2018. However, we do not expect that it will, as if on autopilot, raise interest rates in three or four steps to a level of 3.00-3.25% in 2019 as previously announced. Weaker economic data and exceeding the inflation peak will soon move the Fed to reconsider.

Lower money supply growth and simultaneous shortening of the Fed's balance sheet will have a braking effect. Consequently, the yield curve will stop flattening and an inverse curve, which would provoke fears of recession, will be avoided. The rise of yields on 10-year Treasuries, which enjoy steady demand at yields above 3%, will therefore subside and reverse direction next year.

Given only moderate risk of interest rate change, we intend to focus primarily on credit risk in making portfolio allocations on the bond side. In the government bond segment, we are therefore sticking to our favorites from 2018. Fundamentals such as rating trends, growth and indebtedness, and attractive risk and return profiles on maturities up to ten years clearly argue in favor of Spanish and Portuguese government bonds. We expect that their credit premiums relative to Bunds will tighten, so negative performance can be avoided. We are not yet ready to consider investing in Italian government bonds despite the already significant rise of yields. Uncertainty is still too great whether the populist government in Rome will back down in the budget dispute with the EU Commission or can remain in power after doing so.

Selective additions of government bonds from Eastern Europe should mitigate the vulnerability of portfolio allocation in respect to the termination of the ECB's bond-purchasing program. For investors who focus on the investment-grade segment, these include issues from Poland, Hungary, and Rumania. However, we also consider issuers from the high-yield segment such as Croatia, Macedonia, and Montenegro attractive, but their volatility should not be overlooked.

However, the emphasis of our portfolio allocation remains on European corporate bonds, although the trend towards widening credit premiums should continue due to the termination of the ECB's bond-purchasing program at the beginning of 2019. For, corporate bonds benefit, on the one hand, from still attractive fundamentals such as continuing positive growth and a low interest rate level, which ensure that default rates stay significantly below historical averages. On the other hand, the risk and return profile of corporate bonds has improved considerably thanks to rise of yields under the influence of monetary policy and political developments. Yields are clearly above the lows of 2007 in both the investment-grade and high-yield segments, and above the figures of 2017. In particular, we believe exposure in the segment of high-yield issuers is worth the risk.

High yield bonds with positive bottom line in 2019

What speaks in favor of this segment? The first thing is the clearly improved quality of companies. That finds expression in much lower indebtedness and much improved interest service cover ratios, among other things. The rating agencies have taken account of this and given companies higher ratings in the last few years. While only 41% of companies in Europe got the best high-yield rating in 2007, the number now stands at 72%. Secondly, average duration in this segment is shorter than that of their counterparts in the investment-grade and government bond segments. And even though we do not expect a significant rise of interest rates, high-yield bonds perform the best thanks to their higher coupons and low duration in upward interest rate cycles. We expect a total return in 2019 of 2-3% for European high-yield bonds and 0.5% for corporate bonds with investment-grade ratings.

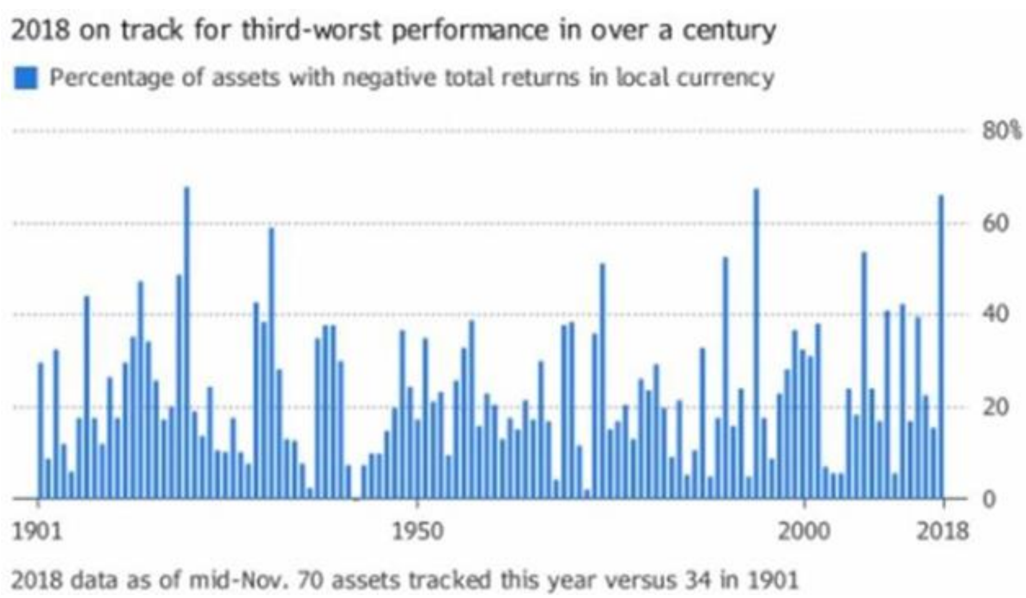
In conclusion, we would like to comment on bonds from emerging markets. We would treat this asset class with caution in the coming year, at least for the time being. Although fundamentals in these countries, such as stable growth and low debt compared with many industrialized countries, argue in their favor for allocation purposes, political risks, negative sentiment, and initially still rising US interest rates give us pause. We therefore recommend staying on the sidelines in this segment at the beginning of 2019. However, if sentiment should improve, e.g., due to a slowing US economy accompanied by a discontinuation of interest rate hikes and a weaker US dollar, hard-currency bonds from emerging markets will become interesting again.

Weekly outlook for December 10-14, 2018

	Jul	Aug	Sep	Oct	Nov	Dec	Release
DE: Exports, m/m	-0,6%	0,1%	-0,7%	0,5%			December 10
DE: Exports, y/y	4,6%	2,4%	2,0%	2,7%			December 10
DE: Imports, m/m	3,3%	-2,4%	-0,1%	0,4%			December 10
DE: Imports, y/y	10,2%	6,7%	7,7%	6,3%			December 10
DE: ZEW Economic expectations	-24,7	-13,7	-10,6	-24,7	-24,1	-24,4	December 11
DE: ZEW Current economic situation	72,4	72,6	76	70,1	58,2	57,5	December 11
DE: Consumer prices, m/m - final	0,3%	0,1%	0,4%	0,2%	0,1%		December 13
DE: Consumer prices, y/y- final	2,0%	2,0%	2,3%	2,5%	2,3%		December 13
DE: Core inflation rate, y/y - final	1,4%	1,3%	1,5%	1,7%	1,6%		December 13
DE: PMI, manufacturing – flash	56,9	55,9	53,7	52,2	51,8	51,5	December 14
DE: PMI, services - flash	54,1	55,0	55,9	54,7	53,3	53,1	December 14
EUR19: Sentix	12,1	14,7	12,0	11,4	8,8	8,1	December 10
EUR19: Industrial production, m/m	-0,8%	1,0%	-0,3%	-0,1%			December 12
EUR19: Industrial production, y/y	0,3%	0,9%	0,9%	0,4%			December 12
EUR19: PMI, manufacturing – flash	55,1	54,6	53,2	52,0	51,8	51,5	December 14
EUR19: PMI, services - flash	54,2	54,4	54,7	53,7	53,4	53,2	December 14

MMWB estimates in red

Chart of the Week: A difficult year for asset managers



Source: Bloomberg, Deutsche Bank AG

Even though the year 2018 is not quite over yet, it can already be said: No matter how one invested, this year it was extremely difficult to achieve a positive return at all. In mid-November, the number of assets with a negative return in local currency was 66 percent. In other words, out of 70 markets surveyed, 46 recorded a negative performance. This is the third worst performance since 1901. The asset class with the best performance was the US dollar with a return of around 5%. Compared with the top performers of previous years, this is one of the worst values ever. A look at the range of returns also reveals an interesting point. The yield difference between the best and worst asset classes this year is the smallest since the financial crisis. Put simply, almost everything went down together.

After 2017 was a true paradise for investors and asset managers, these data show how ungrateful and difficult the market was in 2018. The good news: Never before have two such difficult years followed each other.

Market data overview

Stock marktes	As of 07.12.2018 13:19	Change versus 30.11.2018 -1 week	06.11.2018 -1 month	06.09.2018 -3 months	06.12.2017 -1 year	29.12.2017 YTD
Dow Jones	24948	-2,3%	-2,7%	-4,0%	3,3%	0,9%
S&P 500	2696	-2,3%	-2,2%	-6,3%	2,5%	0,8%
Nasdaq	7188	-1,9%	-2,5%	-9,3%	6,1%	4,1%
DAX	10871	-3,4%	-5,3%	-9,1%	-16,4%	-15,8%
MDAX	22758	-3,0%	-6,0%	-12,9%	-13,7%	-13,1%
TecDAX	2540	-2,0%	-4,4%	-12,3%	2,6%	0,4%
EuroStoxx 50	3076	-3,1%	-4,1%	-6,7%	-13,6%	-12,2%
Stoxx 50	2839	-3,2%	-3,5%	-4,3%	-10,2%	-10,7%
SMI (Swiss Market Index)	8780	-2,8%	-2,4%	-0,4%	-5,7%	-6,4%
Nikkei 225	21679	-3,0%	-2,1%	-3,6%	-2,2%	-4,8%
Brasilien BOVESPA	88760	-0,8%	0,1%	16,2%	21,1%	16,2%
Russland RTS	1142	1,4%	-0,8%	8,3%	0,9%	-1,1%
Indien BSE 30	35673	-1,4%	1,9%	-6,7%	9,4%	4,7%
China Shanghai Composite	2606	0,7%	-2,0%	-3,2%	-20,9%	-21,2%
MSCI Welt (in €)	1991	-2,6%	-2,5%	-5,1%	0,5%	-0,2%
MSCI Emerging Markets (in €)	979	-1,8%	-0,9%	-1,7%	-7,7%	-10,9%
Bond markets						
Bund-Future	163,55	201	385	93	-23	187
Bobl-Future	132,40	43	111	41	39	79
Schatz-Future	111,92	-8	-2	2	-41	-5
3 Monats Euribor	-0,32	0	0	0	1	1
3M Euribor Future, Dec 2017	-0,31	0	0	-1	-3	0
3 Monats $ Libor	2,77	3	18	44	124	107
Fed Funds Future, Dec 2017	2,27	0	-1	4	47	0
10 year US Treasuries	2,89	-13	-34	1	55	48
10 year Bunds	0,25	-6	-18	-10	-5	-17
10 year JGB	0,06	-2	-7	-5	2	1
10 year Swiss Government	-0,14	-4	-15	-6	3	-1
US Treas 10Y Performance	568,05	1,1%	3,0%	0,6%	-2,8%	-2,3%
Bund 10Y Performance	628,40	0,8%	2,0%	1,3%	2,3%	3,5%
REX Performance Index	487,46	0,2%	0,7%	0,6%	0,6%	1,4%
US mortgage rate	0,00	0	0	0	0	0
IBOXX AA, €	0,87	-3	2	10	34	19
IBOXX BBB, €	2,09	7	26	39	98	85
ML US High Yield	7,48	11	51	90	130	133
JPM EMBI+, Index	782	0,4%	-0,4%	0,8%	-6,2%	-6,4%
Convertible Bonds, Exane 25	6951	0,0%	-3,6%	-5,5%	-5,7%	-6,0%
Commodities						
CRB Spot Index	416,56	0,1%	-0,2%	1,5%	-2,6%	-3,7%
MG Base Metal Index	302,33	-0,4%	-1,2%	-1,2%	-8,7%	-15,7%
Crude oil Brent	60,47	2,9%	-15,7%	-21,0%	-1,9%	-9,2%
Gold	1241,19	1,8%	1,1%	3,5%	-1,7%	-4,8%
Silver	14,46	2,0%	-0,6%	2,0%	-9,2%	-15,0%
Aluminium	1937,00	-1,0%	0,1%	-3,3%	-3,2%	-14,1%
Copper	6079,50	-2,4%	-1,7%	3,0%	-6,7%	-15,6%
Iron ore	66,81	-7,6%	-9,9%	-1,9%	-1,0%	-6,3%
Freight rates Baltic Dry Index	1339	8,8%	-4,0%	-9,8%	-19,8%	-2,0%
Currencies						
EUR/ USD	1,1378	0,2%	-0,4%	-2,2%	-3,7%	-5,1%
EUR/ GBP	0,8902	0,3%	2,0%	-0,9%	1,1%	0,3%
EUR/ JPY	128,33	-0,5%	-0,8%	-0,9%	-3,2%	-4,9%
EUR/ CHF	1,1292	-0,4%	-1,5%	0,2%	-3,3%	-3,5%
USD/ CNY	6,8817	-1,1%	-0,5%	0,7%	4,0%	5,8%
USD/ JPY	112,68	-0,7%	-0,7%	1,7%	0,3%	0,0%
USD/ GBP	0,78	-0,1%	2,4%	1,4%	4,8%	5,9%

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