M.M.WARBURG & CO
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Outlook for 2019 (IV): Political topics dominate stock markets

In recent weeks, we have looked at the economic outlook for the global economy and the bond markets. In the fourth part of our outlook for 2019, we take a look at the stock markets. Here, political risks and a global slowdown in economic growth should lead to increased volatility.

After a comparatively continuous advance in 2017, marking the sixth consecutive winning year, international stock markets have seen a return of persistent, high volatility in the course of 2018. The leading German index, the DAX, reached a new all-time high of over 13,000 points in January 2018, but then corrected by over 13% in the following two months to below 12,000 points. It then went back to a level of around 13,000 points by June. Anyone who then thought to celebrate the new highs was quickly disabused of that notion. A bear market took hold in autumn and has dragged the DAX down to about 11,000 points.

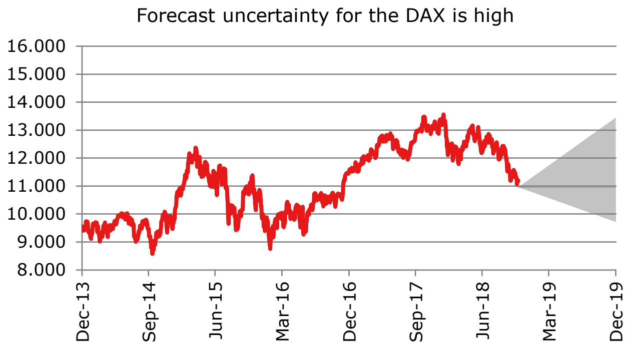
After analyzing the reasons for this year's volatile performance, we find forecasting a similar pattern for 2019 inescapable. On the one hand, the current economic cycle will continue. We expect positive GDP growth rates for Germany, Europe, and the United States next year. Nevertheless, growth rates in many countries will be lower than they have been in the past few years.

Germany is likely to be no exception, although several one-off factors have weighed on its economy in 2018, such as the Worldwide Harmonized Light Vehicle Test Procedure (WLTP), a new emissions standard, which led to temporary production losses in the automobile industry. But even with lower growth rates, companies have the potential to increase operating earnings if they keep their costs under control. This would be a good situation to foster positive stock market development. On the other hand, certain potentially destructive factors hang over these generally favorable macroeconomic conditions. They primarily include three political risks. One is the continuing danger that US President Donald Trump will implement an active trade policy ahead of the presidential election in 2020. As in 2018, there may be further tensions or de-escalation. Both scenarios are conceivable, but their probability of occurring can scarcely be forecast.

Another adverse factor, which will not become clearer until March 2019, is the final outcome of the United Kingdom's withdrawal from the European Union. Here, too, a clear result (hard or soft Brexit) is conceivable, as is a middle path. But even though the deadline of March 29, 2019 is clear, the effects on the economy and businesses will only become discernible in course of 2019 and thereafter.

The third risk factor for the stock markets already known today is Italy. The government in Rome is planning to increase borrowing further to finance its election campaign promises. The European Union has lately already rejected the budget plan for next year. But even if Italy borrows less than initially planned, its huge debt load will continue to grow. We may therefore see another debt crisis. With Italy as the main actor, however, this situation is much more critical than when Greece was the protagonist. That is because of Italy's size and importance for the European Union compared with Greece and because of the absolute amount of its national debt.

While Greece was running debt of about EUR 350 billion, Italy's debt load is now is six times as high at about EUR 2.3 trillion. Germany's debt amounts to about EUR 2.1 trillion, but its economic output is almost double that of Italy. This shows that even though a combined effort of member states can rescue a country like Greece, that would be much more difficult, if not impossible, in Italy's case.



If one looks at the stock markets in 2019 with these opportunities and risks in mind, it appears more difficult than ever to make a concrete forecast for the DAX, the Euro Stoxx 50, and S&P 500. This forecasting uncertainty is based not only on the above-mentioned risks, but also primarily on the considerable outcome variance of the relevant events. Against this background, we approach forecasting the stock market for 2019 with scenarios and fluctuation ranges for the indexes. Though about 15 on average since 1988, the price-earnings ratio (P/E) for the DAX in 2018 is only 12.4. Multiplied by earnings expected for 2020, that yields a DAX target of about 12,600 points. However, a DAX of about 10,000 points is also possible in the course of 2019, if the negative variants of the above-mentioned risk factors occur. For that case, we assume a P/E of 10, which was also observed on average in 2011 and 2012. At that time, the financial markets were focused on the debt crisis, and economic growth was cooling off sharply after a boom phase. However, assuming positive outcomes for all the political risks, one can also derive DAX targets of up to 13,700 points. That would correspond to a P/E of 13.5 based on earnings forecasts for 2020. This value was last seen in the beginning of 2018, when the financial world was not yet under pressure from Trump, Brexit, and Italian debt.

Analogously to this procedure, one may derive price targets for the Euro Stoxx 50 between 2,700 and 4,100 points. This represents a range in the underlying P/E from 9.1 (average of 2011 and 2012) and 13.9 (peak in 2018). In contrast to our outlook for the leading German and European indexes, we are more optimistic regarding the US stock market. The political risks of Brexit and Italian debt are primarily European issues. However, an escalation of trade disputes would also negatively impact the United States. Again in contrast to the DAX and Euro Stoxx 50, we do not assume a politically influenced negative scenario for the S&P 500 in 2019. Based on the current P/E of 15.6 and earnings estimates for 2020, we arrive at a price target of about 3,000 points for the S&P 500.

After the sharp stock market correction at the end of 2018, we believe especially weak stocks may recover as we move into the new year. That will likely be the case for automobile stocks, which have suffered in the second half of 2018 from production losses due to the WLTP. Passenger vehicle production has already normalized in the last two months of 2018, and the first quarter of 2019 should benefit from catch-up effects and a high number of working days compared with 2018. Since the automobile industry is an important customer for other cyclical areas, such as chemicals and raw materials, a recovery is also likely in those sectors.

We also believe technology firms, especially in the United States, will be interesting again after the price corrections. Many of these companies will continue to benefit from the structural change brought by automation and digitalization. The megatrends include e-commerce, cybersecurity, and cloud-based data processing. This is reflected in continuing high growth rates and strong margins.

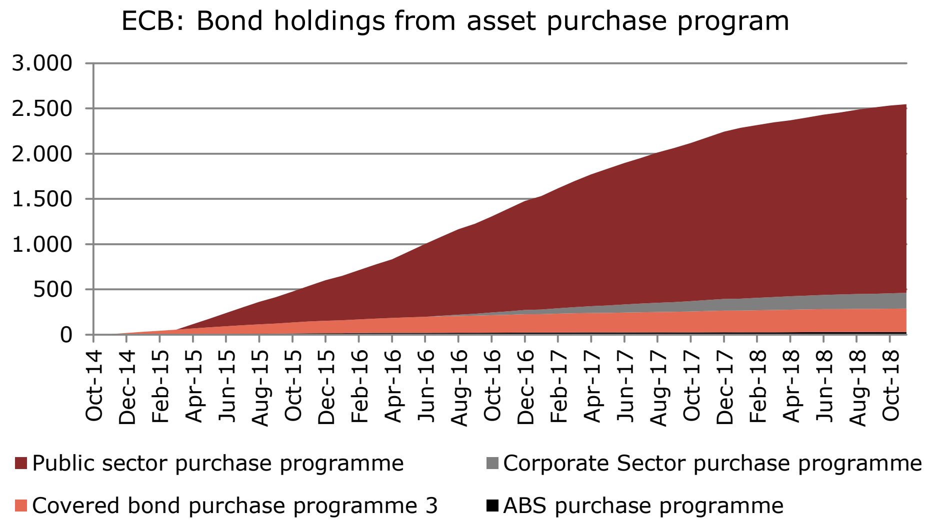
As 2019 moves along, we recommend using good stock market phases for selling to make portfolios more "weather-resistant" and focusing on investments in high-quality companies. Those include companies with good financial ratios, high market entry barriers, good pricing power, and less cyclical sales and earnings. The background for this is the cooling economic trend and increased attractiveness of short-dated debt securities in the United States as well as decreasing liquidity on the capital markets due to the Fed's tighter monetary policy.

Weekly outlook for December 17-21, 2018

	Aug.	Sep.	Oct.	Nov.	Dec.	Jan.	Release
DE: Ifo business climate index	103,9	103,8	102,9	102,0	102,1		December 18
DE: Ifo business expectations	101,1	101,0	99,7	98,7	98,6		December 18
DE: Ifo current conditions	106,7	106,6	106,1	105,4	105,6		December 18
DE: Producer prices, m/m	0,3%	0,5%	0,3%	0,2%			December 19
DE: Producer prices, y/y	3,1%	3,2%	3,3%	3,4%			December 19
DE: Gfk consumer climate	10,6	10,5	10,6	10,6	10,4	10,5	December 21
EUR19: Inflation rate, y/y - final	2,0%	2,1%	2,2%	2,0%			December 17
EUR19: Core inflation rate, y/y - final	0,9%	0,9%	1,1%	1,1%			December 17
EUR19: Consumer confidence - flash	-1,9	-2,9	-2,7	-3,9	-3,1		December 21

MMWB estimates in red

Chart of the Week: ECB halts bond-buying program



Since the end of 2014, the ECB has launched several purchase programs for securities in order to raise inflation to the target level of almost two percent. In total, the various programs bought securities worth around EUR 2.6 trillion. By far the largest part of these purchases is attributable to the so-called public sector purchase program, PSPP for short. Under this program, the national central banks buy bonds issued by their own state. This program, launched in March 2015, accounts for more than 80% of the bond holdings.

Already since April 2017, the net purchases of 80 billion have been reduced in several steps from EUR 80 billion per month to currently EUR 15 billion per month. Today, as expected, the ECB President announced that the purchase programs would be discontinued at the end of 2018. However, this only applies to net purchases, as the proceeds from maturing bonds will continue to be reinvested. According to Draghi, a concrete timeframe for the end of reinvestments was not discussed in the Governing Council. In principle, the proceeds of the maturing bonds should continue to be invested in bonds of the respective country. At the same time, however, the aim is to ensure that the portfolio of acquired bonds is geared more closely to the new ECB capital key, which will come into force in January 2019. The capital key expresses the share of the individual central banks in the share capital of the ECB. Under the PSPP, it will continue to be possible to purchase securities with a yield below the interest rate of the ECB's deposit facility to the extent necessary. Draghi also stressed that the QE program is now a permanent part of the ECB's toolbox and can be used as needed.

What is certain is that after today's monetary policy decision, the ECB's net bond purchases will end in January 2019. However, the effects on the bond market are unclear. However, it can be assumed that the markets could come under pressure due to the lack of ECB demand and that spreads would widen somewhat at the same time.

Market data overview

Stock marktes	As of 14.12.2018 10:26	Change versus 07.12.2018 -1 week	13.11.2018 -1 month	13.09.2018 -3 months	13.12.2017 -1 year	29.12.2017 YTD
Dow Jones	24597	0,9%	-2,7%	-5,9%	0,0%	-0,5%
S&P 500	2651	0,7%	-2,6%	-8,7%	-0,5%	-0,9%
Nasdaq	7070	1,5%	-1,8%	-11,8%	2,8%	2,4%
DAX	10762	-0,2%	-6,2%	-10,7%	-18,0%	-16,7%
MDAX	22177	-1,6%	-8,0%	-15,5%	-15,3%	-15,4%
TecDAX	2504	-0,5%	-4,0%	-13,0%	-1,3%	-1,0%
EuroStoxx 50	3069	0,3%	-4,8%	-7,9%	-14,3%	-12,4%
Stoxx 50	2829	0,0%	-4,6%	-5,7%	-11,7%	-11,0%
SMI (Swiss Market Index)	8682	-0,7%	-3,7%	-3,1%	-7,6%	-7,5%
Nikkei 225	21375	-1,4%	-2,0%	-6,3%	-6,1%	-6,1%
Brasilien BOVESPA	87838	-0,3%	3,4%	17,6%	20,5%	15,0%
Russland RTS	1118	-3,5%	1,6%	3,1%	-2,1%	-3,2%
Indien BSE 30	35942	0,8%	2,3%	-4,7%	8,7%	5,5%
China Shanghai Composite	2594	-0,5%	-2,3%	-3,5%	-21,5%	-21,6%
MSCI Welt (in €)	1974	1,2%	-2,8%	-6,0%	-1,5%	-0,3%
MSCI Emerging Markets (in €)	986	1,1%	1,8%	-0,3%	-8,4%	-9,6%
Bond markets						
Bund-Future	162,87	-30	279	341	-40	119
Bobl-Future	132,33	-3	89	125	-16	72
Schatz-Future	111,89	0	-6	6	-28	-8
3 Monats Euribor	-0,31	0	0	1	2	2
3M Euribor Future, Dec 2017	-0,31	0	0	-1	-4	0
3 Monats $ Libor	2,78	1	16	44	119	108
Fed Funds Future, Dec 2017	2,27	0	-2	2	46	0
10 year US Treasuries	2,87	2	-28	-10	52	46
10 year Bunds	0,25	0	-16	-17	-7	-17
10 year JGB	0,04	-2	-8	-8	0	-1
10 year Swiss Government	-0,09	5	-10	-6	6	4
US Treas 10Y Performance	566,82	-0,5%	2,5%	1,1%	-2,9%	-2,5%
Bund 10Y Performance	624,94	-0,3%	1,2%	1,5%	1,9%	2,9%
REX Performance Index	486,35	-0,2%	0,3%	0,5%	0,5%	1,2%
US mortgage rate	0,00	0	0	0	0	0
IBOXX AA, €	0,90	1	7	9	36	23
IBOXX BBB, €	2,07	-4	22	38	96	84
ML US High Yield	7,40	-3	30	87	123	125
JPM EMBI+, Index	790	0,6%	1,1%	0,9%	-5,3%	-5,5%
Convertible Bonds, Exane 25	6966	0,0%	-3,2%	-6,0%	-5,5%	-5,8%
Commodities						
CRB Spot Index	415,27	-0,6%	0,3%	1,4%	-3,2%	-4,0%
MG Base Metal Index	304,18	-0,3%	0,7%	-0,6%	-9,2%	-15,2%
Crude oil Brent	61,01	-3,1%	-8,8%	-22,0%	-2,8%	-8,4%
Gold	1238,85	-0,6%	2,9%	3,0%	-0,7%	-5,0%
Silver	14,78	1,3%	5,1%	3,8%	-6,1%	-13,1%
Aluminium	1913,75	-1,9%	-0,4%	-5,6%	-3,8%	-15,2%
Copper	6158,50	0,2%	1,1%	2,4%	-8,0%	-14,5%
Iron ore	67,26	0,7%	-10,3%	-1,5%	-3,0%	-5,6%
Freight rates Baltic Dry Index	1365	-0,5%	28,3%	-1,2%	-21,1%	-0,1%
Currencies						
EUR/ USD	1,1290	-0,7%	0,3%	-2,8%	-3,8%	-5,9%
EUR/ GBP	0,8976	0,5%	3,4%	0,7%	2,0%	1,1%
EUR/ JPY	128,15	-0,2%	-0,1%	-1,2%	-3,6%	-5,1%
EUR/ CHF	1,1249	-0,4%	-1,0%	-0,1%	-3,4%	-3,9%
USD/ CNY	6,9019	0,4%	-0,8%	0,9%	4,2%	6,1%
USD/ JPY	113,64	0,8%	-0,2%	1,5%	1,0%	0,8%
USD/ GBP	0,80	1,5%	3,4%	4,2%	6,3%	7,6%

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