M.M. WARBURG & CO
BANK

ECONOMIC SITUATION AND STRATEGY

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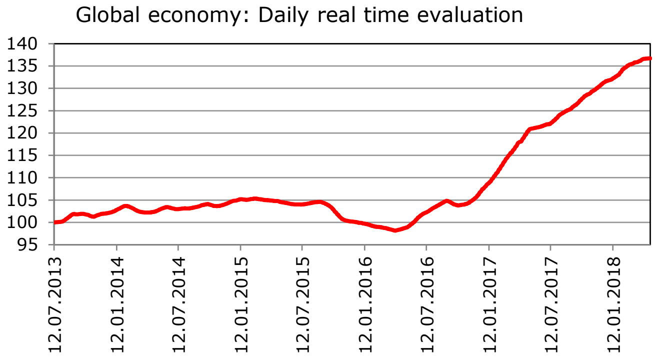
Economic cycle peaks – crash unlikely

Many economic metrics have dimmed in recent weeks and months, including US consumer confidence, German labor productivity, the German ZEW index, British retail sales, many purchasing manager indexes, German industrial production, the Ifo index, Japanese exports, German retail sales, and the Belgian business confidence index. At first glance, that seems comparatively dramatic, but it is easy to overlook that not all economically relevant time series have declined. To bring a little light into the darkness given the large number of economic metrics, we at Warburg developed a business cycle model many years ago that condenses a great deal of data into an index "in real time" (on their publication). We have been calculating a variant of this model based on especially numerous time series daily for almost five years. A global economic indicator may be derived from this model that has increased enormously, especially since mid-2016, and thus underscores how significantly global GDP has been above trend growth in this period. Now, the indicator has scarcely improved in the past weeks, and this may point to a trend reversal. If the coming weeks and months confirm this, the global economy will have actually passed its peak after a relatively long upswing.

This is a terrifying prospect for many analysts and investors, reminding them of late autumn 2007. The world economy had also peaked at that time and six months later was on its way to the worst recession in recent decades. In autumn 2000, the situation was similar. The global economy passed its cyclical high point and slid into a recession only a few quarters later, accompanied by hefty market corrections. But must this pattern repeat itself? We are not convinced of that.



Often made, the claim "this time is different" has almost equally seldom paid off by proving true. However, we see good reasons to believe this time things might actually be different in that respect.

The main reason lies in the broad absence of systemic risks. In 2000, the stock market was dramatically overvalued according to all the usual criteria. In 2007, a real estate bubble of unimagined proportions had arisen in the United States. It was not clear at the time what dislocations it would create, but no perceptive observer could fail to notice its existence. In contrast, it is difficult to see now where a systemic crisis or bubble might be lurking. The stock market is somewhat more expensive than on the average of recent years, but is still far from being dramatically overvalued. There is a bond market bubble to some extent, but that is mostly intended by monetary policymakers and a bursting is thus extremely unlikely. The real estate market is also not a good candidate for a bubble or systemic risk. Although real estate prices are now significantly above their lows of 2009, there are no critical securitization structures or toxic debt associated with them in contrast to 2008.

At most, China comes to mind when we think of debt, because total debt there (government, corporate, and household) has risen almost perilously in the last ten years. While the country's debt-to-GDP ratio was 150% about a decade ago, it is now nearly 250%. Under normal circumstances, that would be considered problematic; the only question is what is "normal" for China. After all, the debt is part of the economic plan and thus ultimately covered and guaranteed by the government. Moreover, it is not external debt, involving other countries as creditors. On the contrary, China has helped finance the US national debt by buying US government bonds. From this perspective, it is difficult to infer an inevitable threat of systemic crisis from China's undoubtedly high debt level.

We are therefore sticking to our long-held standard scenario, according to which the world economy will reach and pass its peak in the first half of 2018 but not slide into a recession then, because it can and will continue to grow approximately in line with the long-term trend.

The same applies analogously to the world's largest national economy and to the European Union, even though the United States is slightly ahead at the moment. The US economy has managed to perform better lately in respect to both real data and leading indicators. This is also reflected in the Economic Surprise Index, which measures the development of published data compared with expectations. It might also be one reason for the revaluation of the US dollar. After trading in a range of 1.22-1.25 EUR/USD since the beginning of the year, the dollar has increased in value to below 1.20 EUR/USD. Another reason for the dollar's revaluation lies in the interest rate difference between dollar and euro investments. For a long time, the exchange rate was able to decouple from the interest rate trend, with the result that the lower interest-bearing euro steadily revalued contrary to the correlation observed in the past. However, with the rise of the 10-year US Treasury yield to about 3%, investors are focusing more on interest now. And rightly so, as the yield difference between 10-year Treasuries and Bunds has risen recently to over 240 basis points, the highest level in 29 years. Although we believe even further catch-up potential for the dollar may be inferred from this, we do not expect that the US Treasury yield will advance significantly beyond the psychologically relevant mark of 3%. There are several reasons for that. One is that the base scenario for market participants is now three more interest rate hikes by the Fed in contrast to the previously expected two. There is thus hardly any surprise potential for more restrictive monetary policy. Another is that despite surpassing 3%, the Treasury yield has not achieved an upward breakthrough from a technical standpoint. That would require breaking a line of resistance at 3.05% to make a further yield increase likely. Finally, inflation worries have also contributed lately to the yield rise. However, as we argued in the last issue of *Economic Situation and Strategy*, inflation should only make a brief comeback in the United States and then fall back below 2% after the summer months.

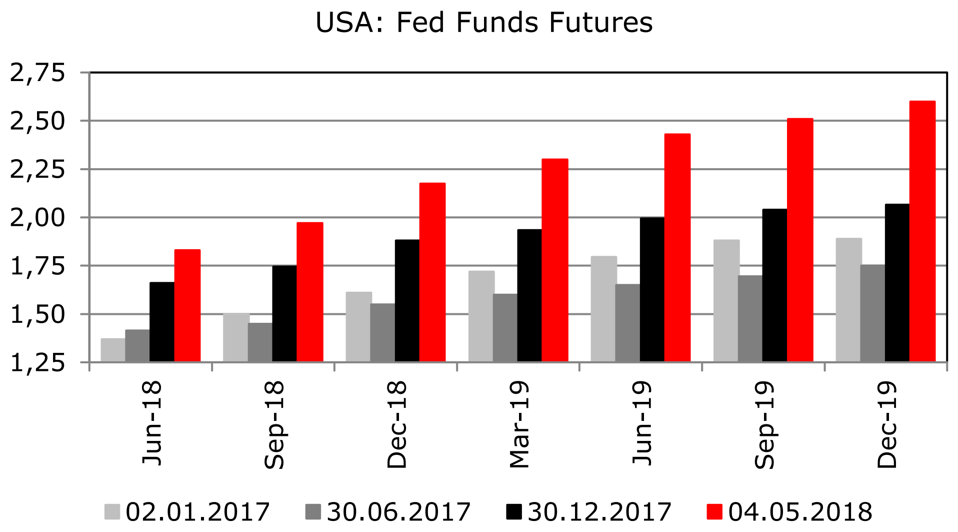
Overall, this combination of influences should be positive for the stock markets. For one thing, the limitation on advancing US Treasury yields limits the opportunity costs for buying stocks. For another, the revaluation of the US dollar gives uplift to European stocks and especially to the export-heavy German stock market. That could counteract the recently weak leading indicators.

Weekly outlook for May 7-11, 2018

	Dec.	Jan.	Feb.	Mar.	Apr.	May	Release
DE: New orders, m/m	2.6%	-3.5%	0.3%	0.3%			May 7
DE: New orders, y/y	7.2%	8.6%	3.7%	4.9%			May 7
DE: Industrial production, m/m	-0.6%	0.1%	-1.6%	0.4%			May 8
DE: Industrial production, y/y	6.5%	5.9%	2.4%	2.9%			May 8
DE: Exports, m/m	0.0%	-0.4%	-3.1%	0.2%			May 8
DE: Exports, y/y	10.0%	7.4%	2.4%	2.5%			May 8
DE: Imports, m/m	0.9%	-0.2%	-1.3%	0.3%			May 8
DE: Imports, y/y	9.0%	5.9%	4.7%	3.8%			May 8
EUR19: Sentix	31.2	32.9	31.9	24.0	19.6	21.0	May 7

MMWB estimates in red

Chart of the Week: Next Fed interest rate hike likely in June



Yesterday, the Federal Open Market Committee (FOMC) announced the results of its two-day monetary policy meeting and left the fed funds target rate unchanged at 1.50-1.75%. Since it had already raised its policy interest rate in March and recent changes have always been made on meeting dates with subsequent press conferences, a further increase had also not been expected. Moreover, that would have conflicted with the declared intention to raise interest rates gradually. So, since it was already understood that policy interest rates would be maintained, the focus was rather on observing possible changes in the tonality of the published statements, with particular interest in the economic outlook and advancing inflation. The inflation figures published on Monday in fact showed that the inflation target of 2% has been reached, with base effects likely to make inflation increase further in the coming months. Even excluding volatile food and energy prices, inflation stands at 1.9%. The possibility of a short-term overshooting of the inflation target is seen also by the Fed. In its statement, however, the US central bank apparently wants to calm the markets so they do not overreact to the expected overshooting, and thus does not want to leave the gradual interest rate path. The Fed is maintaining its positive outlook regarding economic development, while continuing not to mention the risks arising from a potential trade war. It seems to be sticking to its wait-and-see posture. Overall, the meeting gave rise to no surprises, so changes of the interest rate trajectory may not be inferred from the statement. The next interest rate step is expected at the coming meeting in June.

Market data overview

Stock marktes	As of 04.05.2018 11:28	Change versus 26.04.2018 -1 week	02.04.2018 -1 month	02.02.2018 -3 months	29.12.2017 YTD
Dow Jones	23930	-1,6%	1,2%	-6,2%	-3,2%
S&P 500	2630	-1,4%	1,9%	-4,8%	-1,6%
Nasdaq	7101	-0,2%	3,4%	-1,9%	2,9%
DAX	12715	1,7%	5,1%	-0,5%	-1,6%
MDAX	26317	2,1%	2,8%	1,1%	0,4%
TecDAX	2693	2,9%	8,0%	3,6%	6,5%
EuroStoxx 50	3526	0,6%	4,9%	0,1%	0,6%
Stoxx 50	3075	0,3%	3,7%	-2,2%	-3,2%
SMI (Swiss Market Index)	8873	0,4%	1,5%	-3,8%	-5,4%
Nikkei 225	22473	0,7%	5,1%	-3,4%	-1,3%
Brasilien BOVESPA	83288	-3,6%	-1,6%	-0,9%	9,0%
Russland RTS	1137	-0,8%	-7,8%	-10,6%	-1,5%
Indien BSE 30	34881	0,5%	4,9%	-0,5%	2,4%
China Shanghai Composite	3091	0,5%	-2,3%	-10,7%	-6,5%
MSCI Welt (in €)	2071	0,7%	4,6%	-0,4%	-1,3%
MSCI Emerging Markets (in €)	1138	1,1%	0,2%	-3,5%	-1,5%
Bond markets					
Bund-Future	163,14	483	371	527	146
Bobl-Future	131,16	34	-9	83	-45
Schatz-Future	111,92	5	-5	9	-5
3 Monats Euribor	-0,33	0	0	0	0
3M Euribor Future, Dec 2017	-0,31	0	0	-5	0
3 Monats $ Libor	2,35	-1	4	56	66
Fed Funds Future, Dec 2017	2,18	-2	11	13	0
10 year US Treasuries	2,94	-5	21	9	53
10 year Bunds	0,54	-5	4	-16	12
10 year JGB	0,04	-2	0	-4	-1
10 year Swiss Government	0,05	-7	3	-4	18
US Treas 10Y Performance	558,54	0,2%	-1,7%	-0,4%	-3,9%
Bund 10Y Performance	602,74	0,1%	-0,7%	1,8%	-0,8%
REX Performance Index	479,77	0,2%	-0,2%	1,0%	-0,2%
US mortgage rate	0,00	0	0	0	0
IBOXX AA, €	0,82	-2	5	3	15
IBOXX BBB, €	1,45	0	6	13	22
ML US High Yield	6,51	2	-8	25	36
JPM EMBI+, Index	799	-1,1%	-2,4%	-3,2%	-4,4%
Convertible Bonds, Exane 25	7428	-0,1%	2,0%	1,1%	0,4%
Commodities					
CRB Spot Index	445,94	0,0%	2,2%	0,6%	3,1%
MG Base Metal Index	349,23	-0,1%	2,6%	-4,2%	-2,7%
Crude oil Brent	73,38	-1,7%	4,7%	7,5%	10,2%
Gold	1308,94	-0,7%	-2,2%	-1,6%	0,4%
Silver	16,42	-0,4%	-1,1%	-1,6%	-3,5%
Aluminium	2326,00	2,1%	17,1%	5,3%	3,1%
Copper	6784,50	-2,1%	1,6%	-3,1%	-5,9%
Iron ore	65,27	0,0%	-1,4%	-10,5%	-8,4%
Freight rates Baltic Dry Index	1376	0,1%	30,4%	25,7%	0,7%
Currencies					
EUR/ USD	1,1965	-1,7%	-2,9%	-4,2%	-0,2%
EUR/ GBP	0,8825	1,5%	0,7%	0,2%	-0,6%
EUR/ JPY	130,45	-1,8%	-0,5%	-4,9%	-3,4%
EUR/ CHF	1,1940	-0,3%	1,4%	3,0%	2,0%
USD/ CNY	6,3582	0,4%	1,2%	0,9%	-2,3%
USD/ JPY	109,85	0,5%	3,7%	-0,2%	-2,5%
USD/ GBP	0,74	2,8%	3,7%	4,2%	-0,2%

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