M.M.WARBURG & CO
BANK

ECONOMIC SITUATION AND STRATEGY

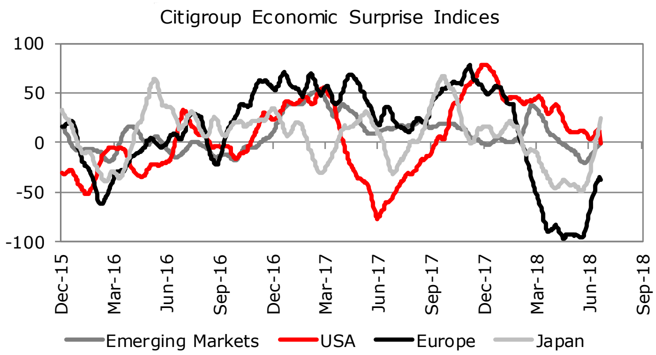
20. July 2018

No lasting downswing yet in sight

The economy and capital markets have been decidedly more on the subdued than the bright side this year. While this mostly applied to Europe, Japan and some emerging economies also ailed with their stock markets heading correspondingly down. Investors may wonder whether this trend could hold or if business momentum will pick up again.

The International Monetary Fund published an update to its World Economic Outlook this week suggesting that US President Trump’s trade war games are fuelling economic risks resulting in a now less evenly distributed global economic upswing. The good news is that the IMF did not revise its global growth forecast for this year and next downward but rather kept it at 3.9 percent.

However, this does not apply to the euro area where the IMF now projects slightly lower growth at 2.2 percent for 2018. In light of the weak economic data since the beginning of this year we already lowered our growth forecast a bit more than that to 2.1 percent in early June. In the first quarter it still looked as if the main drags on the economy were wild-card factors like the weather, strikes, and high sick leave rates but growth failed to pick up again in their absence. The main leading indicators are suggesting that at least the downtrend is slowing, albeit with no real trend reversal in sight. On the positive side, the so-called economic surprise indices have markedly improved over the past four weeks or so and not just for the euro area but for almost all regions. Yet, this does not say anything clear cut about economic development, because these indicators only measure how actual economic data measure up to expectations.

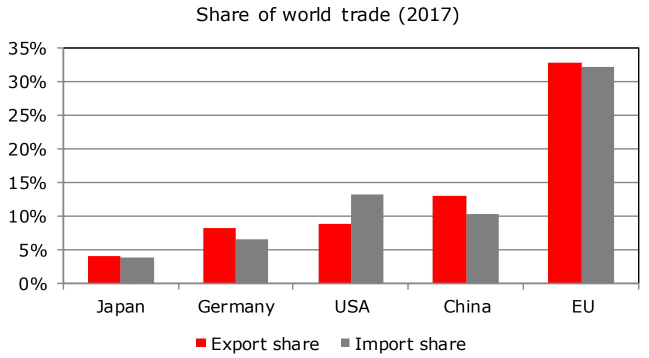


There is some silver lining to the economic cloud, though. The US economy, for instance, is booming: The annualized growth rate for the second quarter should be between four and five percent. Consumption, capital spending, and exports were all doing exceptionally well in the past few month. With low unemployment and thus more money to spend for both private households and companies, US economic growth should remain above average for the time being. That means our recently raised forecast (to three percent growth) may still turn out on the low side as would the IMF estimate (at 2.9 percent). Although growth has slowed a little in China it remains vigorous at 6.7 percent. As per usual almost all economists expect growth to slow down some more, not least because US trade policy is focusing on China.

The main wild card in forecasting economic growth going forward – and thus stock market development – is whether the global market place is indeed headed for a trade war. Although the scenario has not become less likely, we assume that the Trump administration does not really want to escalate tariff skirmishes with Europe and China. Possible import tariffs on cars are a serious threat to Europe. EU Commission President Jean-Claude Juncker will visit the US on July 25th for a meeting with President Trump. We already suggested a few weeks ago that the EU should offer the US complete abolition of import tariffs on US cars. This should cater to Trump's desire for a "trophy deal" and could lastingly take the wind out of the trade war sails.

Only Juncker knows whether he will make such an offer. If he did, though, it will ease the economic jitters that were probably at the heart of the recent economic ails in Europe and other countries. Germany should particularly benefit from a calmer business sentiment especially in light of all the positive economic news lately with order intake, industrial production, and exports reporting their strongest growth rates for the year last May.

Ending the trade standoff with the US would pave the way for an economic recovery in Germany and Euroland this year and in 2019. There should be further benefit stemming from increased EU efforts to enter into more trade agreements with other countries. For instance, this week the EU and Japan signed their free trade accords. JEFTA (Japanese European Free Trade Accords) is to take effect in the beginning of 2019 and eliminate virtually all tariffs in European-Japanese trade. Together, the two economies account for some 30 percent of global trade, which means JEFTA thus creates the world's largest free trade zone in one fell swoop. Besides abolishing tariffs (saving European exporters some one billion euros in customs duties) the accords also harmonize certain environmental and product standards as well as eliminate further non-tariff trade barriers. The EU expects that European exports of agricultural products to Japan may rise up to 180 percent (also at the expense of US exports), chemicals exports could increase some 20 percent, and machinery and equipment exports could rise some 15 percent. Moreover, the EU made a new free trade agreement with Mexico in April and started negotiations with Australia and New Zealand last month. A new trade agreement with South America's Mercosur countries may not be far off.



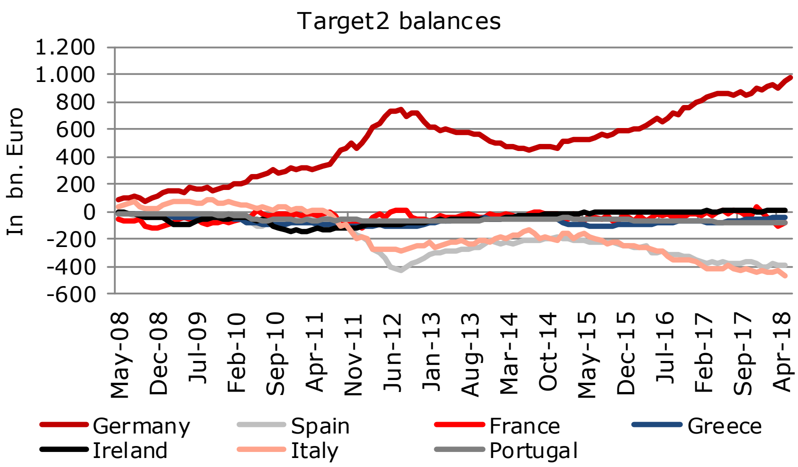
If the widely dreaded trade war fails to materialize, growth may actually accelerate again. After all, economic fundamentals remain sound. In the past, excessively restrictive monetary policies of central banks or escalating commodity prices triggered severe economic downturns to outright recessions. However, neither one of the factors are significant at the moment. As such, reports of the global economy's imminent demise are greatly exaggerated. Of course, it is not impossible that the US will launch an all out trade war. In that case, all the EU's new accords with other trade partners will not fully make up for the shortfall in US trade. Only time will tell.

Weekly outlook for July 23-27, 2018

	Mar	Apr	May	June	July	Aug	Release
DE: PMI manufacturing Flash	58.2	58.1	56.9	56.9	55.9	56.2	July, 24
DE: PMI services Flash	53.9	53.0	52.1	52.1	54.5	54.7	July, 24
DE: Ifo Business climate	103.4	102.2	102.3	101.8	102.0		July, 25
DE: Ifo Business expectations	100.1	98.7	98.6	98.6	98.8		July, 25
DE: Ifo Situation assessment	106.8	105.8	106.1	105.1	105.5		July, 25
DE: GfK Consumption climate	10.8	10.9	10.8	10.7	10.7	10.8	July, 26
EUR-19: Consumer confidence Flash	0.1	0.3	0.2	-0.5	-0.2		July, 23
EUR-19: PMI manufacturing Flash	56.6	56.2	55.5	55.5	54.9	55.2	July, 24
EUR-19: PMI services Flash	54.9	54.7	53.8	53.8	55.2	55.5	July, 24
E-19: M3, y/y	3.7%	3.9%	4.0%	4.0%			July, 25

MMWB estimates in red

Chart of the Week: Target balance nearing the one-trillion mark



Target2 is a trans-border payment platform for central banks in the euro area. If a country has a positive balance that means it received more money from other euro countries than it paid out. A positive balance also represents a receivable from the euro system. There are many reasons why a country has accumulated a positive target balance including trade flows and capital flight. During the European debt crisis Germany accumulated a massive target balance, as investors from debt-ridden countries like Spain, Greece, and Italy pulled out their capital and sought safe havens for their money. That made target balances a popular crisis gauge. At the end of June, Germany's balance reached a new record high at 976 billion euros, just shy of the one-trillion-mark. Is it due to capital flight again – possibly related to the new Italian government? Although Italy's liabilities have gone up since its government crisis last May while Germany's receivables have risen, this has been going on since 2015 when the ECB launched its Asset Purchasing Program (APP). Actually, this is a key technical reason for Germany's target balance increase. The prominence of the Frankfurt Finance hub is at the heart of it. Italy makes a good example for this: The Italian central bank buys Italian bonds under the APP. The sellers are often large European banks that maintain accounts with the Bundesbank in Frankfurt. Since this transaction runs through the Bundesbank, this alone will raise Germany's target balance for mere technical reasons. While target balances were still a good crisis indicator in 2012, their evidentiary value is far less significant at present.

Market data overview

Stock marktes	As of 20.07.2018 15:23	Change versus 13.07.2018 -1 week	19.06.2018 -1 month	19.04.2018 -3 months	19.07.2017 -1 year	29.12.2017 YTD
Dow Jones	25065	0,2%	1,5%	1,6%	15,8%	1,4%
S&P 500	2804	0,1%	1,5%	4,1%	13,4%	4,9%
Nasdaq	7825	0,0%	1,3%	8,1%	22,6%	13,4%
DAX	12481	-0,5%	-1,6%	-0,7%	0,2%	-3,4%
MDAX	26470	0,2%	0,1%	1,7%	5,8%	1,0%
TecDAX	2866	1,5%	2,3%	8,6%	25,0%	13,3%
EuroStoxx 50	3435	-0,6%	0,0%	-1,5%	-1,9%	-2,0%
Stoxx 50	3077	-0,4%	0,9%	1,2%	-2,5%	-3,2%
SMI (Swiss Market Index)	8931	0,8%	5,5%	1,1%	-1,0%	-4,8%
Nikkei 225	22698	0,4%	1,9%	2,3%	13,4%	-0,3%
Brasilien BOVESPA	78395	2,4%	9,8%	-8,7%	20,3%	2,6%
Russland RTS	1114	-6,4%	1,5%	-3,5%	6,7%	-3,5%
Indien BSE 30	36496	-0,1%	3,4%	6,0%	14,2%	7,2%
China Shanghai Composite	2829	-0,1%	-2,7%	-9,2%	-12,4%	-14,5%
MSCI Welt (in €)	2135	-0,6%	-0,4%	6,7%	7,3%	3,9%
MSCI Emerging Markets (in €)	1061	-2,0%	-3,7%	-5,3%	-1,5%	-6,2%
Bond markets						
Bund-Future	163,14	16	161	497	122	146
Bobl-Future	132,10	-12	22	134	32	49
Schatz-Future	112,01	-2	-1	15	3	4
3 Monats Euribor	-0,32	0	0	1	1	1
3M Euribor Future, Dec 2017	-0,30	0	-1	1	-18	0
3 Monats $ Libor	2,35	1	2	-1	104	65
Fed Funds Future, Dec 2017	2,21	1	3	5	72	0
10 year US Treasuries	2,86	3	-3	-5	59	45
10 year Bunds	0,35	7	-3	-25	-13	-8
10 year JGB	0,04	0	0	0	-4	-1
10 year Swiss Government	-0,07	-1	-3	-15	-5	6
US Treas 10Y Performance	565,30	-0,1%	0,7%	0,8%	-2,8%	-2,8%
Bund 10Y Performance	621,03	0,1%	1,0%	3,3%	3,6%	2,3%
REX Performance Index	485,79	0,0%	0,2%	1,3%	1,2%	1,1%
US mortgage rate	0,00	0	0	0	0	0
IBOXX AA, €	0,73	-1	-6	-12	-10	5
IBOXX BBB, €	1,56	0	1	11	19	32
ML US High Yield	6,60	-2	17	23	62	45
JPM EMBI+, Index	799	-0,2%	2,8%	-2,0%	-3,2%	-4,4%
Convertible Bonds, Exane 25	7436	0,3%	0,4%	0,6%	3,1%	0,5%
Commodities						
CRB Spot Index	430,58	-1,0%	-2,9%	-3,4%	-3,2%	-0,4%
MG Base Metal Index	308,38	-2,6%	-11,2%	-16,9%	1,3%	-14,0%
Crude oil Brent	73,03	-3,3%	-2,5%	-2,3%	47,3%	9,6%
Gold	1229,51	-1,0%	-3,5%	-8,6%	-1,0%	-5,7%
Silver	15,29	-3,6%	-6,7%	-11,1%	-6,0%	-10,1%
Aluminium	2041,75	-1,2%	-6,0%	-18,1%	7,8%	-9,5%
Copper	6039,50	-2,9%	-11,6%	-13,0%	1,9%	-16,2%
Iron ore	63,58	0,5%	-2,2%	-2,9%	-3,7%	-10,8%
Freight rates Baltic Dry Index	1657	-0,5%	16,8%	38,0%	74,8%	21,3%
Currencies						
EUR/ USD	1,1712	0,6%	1,5%	-5,4%	1,6%	-2,3%
EUR/ GBP	0,8941	1,2%	1,8%	2,8%	1,2%	0,7%
EUR/ JPY	130,95	-0,1%	3,3%	-1,5%	1,5%	-3,0%
EUR/ CHF	1,1641	-0,5%	1,2%	-2,8%	5,9%	-0,5%
USD/ CNY	6,7689	1,1%	4,4%	7,8%	0,2%	4,0%
USD/ JPY	112,47	0,1%	2,2%	4,7%	0,4%	-0,2%
USD/ GBP	0,76	0,8%	0,6%	8,6%	-0,4%	3,3%

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