M.M. WARBURG & CO
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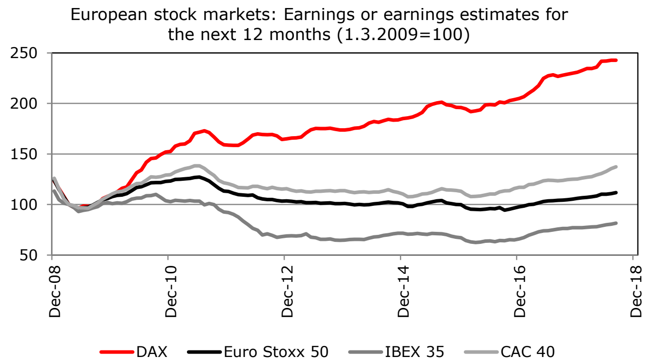
DAX in crisis mode without good reason

Investing in German blue chips has been anything but a pleasure so far this year. The DAX index started very well, even hitting a new record of 13,560 points at the end of January. However, it has tended downward since then, mostly ranging between 12,000 and 13,000 points. The index now shows a decline of about 7% compared with the beginning of the year, its worst performance since 2011. German blue chips appear weak even in European comparison, with the Stoxx 50 and Euro Stoxx 50 indexes down by just under 3% including dividend payments. What is the reason for this and is improvement likely in the foreseeable future?

To assess the potential of a stock market, we need to consider fundamental conditions that enable us to draw conclusions regarding earnings development. Usually, the better the economic prospects are for a country, the better the earnings trend of companies based there will be. Since the financial and economic crisis of 2008-2009, the German economy has grown more strongly than those of most other euro zone countries. That has found expression in a correspondingly better earnings trend for the DAX companies. Compared with the peak of the crisis in March 2009, their earnings have increased by 142%, while the earnings of Euro Stoxx 50 companies have only gained about 12%. The numbers are only slightly better for the Stoxx 50 (+19%) and Stoxx 600 (+55%). Thanks to higher earnings, the DAX also shows much better performance compared with those indexes.

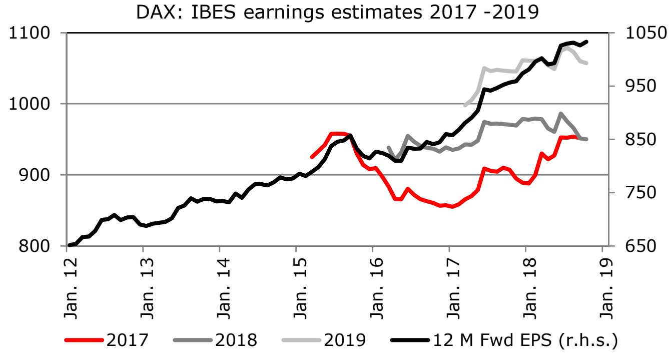


This is exactly where the problem lies. While analysts were still forecasting about 10% earnings growth for DAX companies in 2018 at the beginning of the year, they have continuously lowered their expectations in recent months. By now, they have almost arrived at earnings stagnation compared with 2017. Of the 30 DAX companies, 17 are expected to increase earnings over last year, but falling earnings are forecast for the other 13. The most significant negative earnings revisions in the past six months have been for Deutsche Bank (-63%), Deutsche Post (-25%), Continental (-15%), Bayer (-12%), and ThyssenKrupp (-12%). On the other hand, expectations of earnings growth for Euro Stoxx 50 companies have only been lowered from 10% to 7%, while estimates for French companies in the CAC 40, for example, have actually been raised from 7% to 11%. That is probably the decisive reason for the better performance of these indexes.

The last time earnings of DAX companies stagnated was in 2013. At that time, real German GDP was growing by just 0.6%, and the world economy was expanding at a rate of 3.5%. In contrast, we expect almost 2%

growth for Germany this year, and almost 4% for the world. Consequently, earnings expectations for 2018 now appear too pessimistic from a macroeconomic perspective. Set against that, however, are the economic uncertainties raised by the trade policies of the United States. Since the United States and the European Union reached a "ceasefire" agreement, the outlook in this regard has brightened at least somewhat. However, the US commitment not to impose tariffs on automobiles during the negotiations has helped neither the stock prices of German automakers nor the DAX. There seems to be too much concern about the export dependence of German companies.

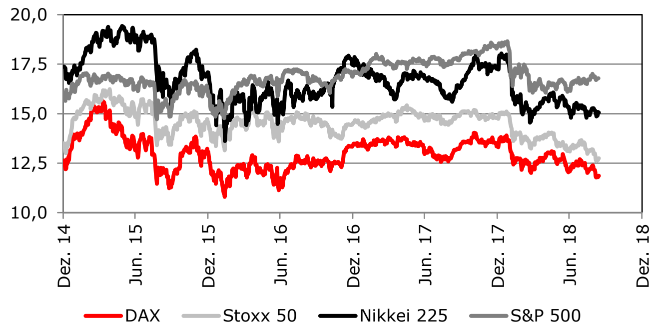
DAX: IBES earnings estimates 2017 -2019



That imposing tariffs is equivalent in economic respects to a tax increase is being overlooked here. Given rational behavior, this should mean anticipatory effects and stronger demand ahead of the tariffs, as usually observed in the case of value-added tax increases. That could positively affect sales and earnings development at least in the near term. Moreover, the devaluation of the euro since April has received little attention, which could offset tariffs to a certain extent and presents the prospect of better export opportunities for German companies. This would also suggest that earnings forecasts for this year have been revised too far downward, especially since the real economic effects of the trade conflict have so far been manageable. World trade still grew by 4% in the first six months of this year. That is somewhat less than last year (4.6%), but significantly more than in 2015 (1.9%) and 2016 (1.5%).

A look at corporate earnings also reveals that the forecast reductions only relate to 2018. The level of expectations for 2019 has fallen somewhat, but the expected rate of increase has remained stable at about 10%. This is also why (rolling) earnings forecasts for the next 12 months, which we consider the crucial figure for an index's price performance, have continued to rise for the DAX and have even hit a new record. We therefore conclude that the DAX's price decline is not due to generally poorer economic and earnings prospects, but rather to investor uncertainty, which is reflected in a lower valuation multiple. The DAX P/E ratio based on earnings expectations for the next 12 months has declined from 13.4 at the beginning of the year to 11.8. The last time the DAX was valued so low was after Great Britain's Brexit decision in summer 2016. Now, the DAX is one of the lowest-valued indexes found on the large, important stock exchanges.

Stock market indexes: PE-Ratios



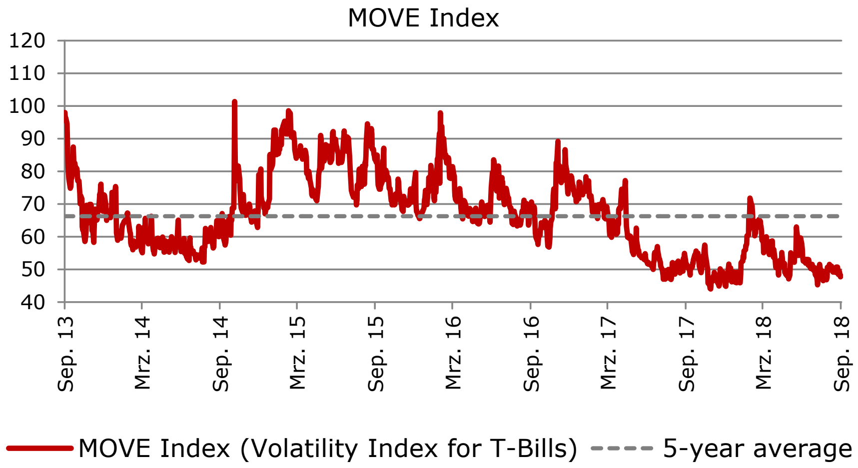
As long as Germany and the world economy do not enter a new recession, for which there is no indication at all now, the current stock prices cannot be justified in fundamental terms. Valuing earnings expectations for 2019 at a P/E ratio of 13 (average since 2001) gives us a price target of almost 13,800 points. The prerequisites for a significant price recovery will thus continue to exist in the months ahead.

Weekly outlook for Sept. 17-27, 2018

	Apr.	May	June	July	Aug.	Sept.	Release
DE: PMI, manufacturing - flash	58.1	56.9	55.9	56.9	55.9	56.2	Sept. 21
DE: PMI, services - flash	53.0	52.1	54.5	54.1	55.0	55.2	Sept. 21
EUR19: Consumer prices, y/y - final	1.3%	1.9%	2.0%	2.1%	2.0%		Sept. 17
EUR19: Core inflation rate, y/y - final	0.8%	1.1%	0.9%	1.1%	1.0%		Sept. 17
EUR19: Consumer confidence – flash	0.3	0.2	-0.6	-0.5	-1.9	-1.0	Sept. 20
EUR19: PMI, manufacturing - flash	56.2	55.5	54.9	55.1	54.6	54.8	Sept. 21
EUR19: PMI, services - flash	54.7	53.8	55.2	54.2	54.4	54.6	Sept. 21

MMWB estimates in red

Chart of the Week: Volatility of bonds still low



Actually, the world economy is doing well. Even though some leading indicators have weakened since the beginning of the year, the level of most indicators remains relatively high and thus signals further growth. The International Monetary Fund continues to forecast 3.9% growth for the world economy in 2018 and no change of momentum for 2019. Nevertheless, greater uncertainty has spread among investors, causing market volatility to increase. After a long phase of extremely calm markets, the volatility of various stock indexes is now back at about its 5-year average. Trade conflicts and hence fear of a global trade war are a major uncertainty factor. With the crises in Turkey and Argentina, worries of a conflagration in other emerging markets have spread and thus contributed to general uncertainty. Even though we do not expect a trade war or an extensive crisis among emerging countries, we nevertheless see a danger that the two conflicts could lead to temporary market distortions in the near term. And there is another factor somewhat in the background but likely to gain significance in the longer term, and it could cause volatility to rise, especially on the bond markets. That is the global tightening of monetary policy and related reduction of central bank balance sheets. The Fed already allowed its bond purchase program (QE3) to expire at the end of 2014 and began to shrink its balance sheet in October 2017. The ECB is still far from taking such a step, but it is relatively certain that its bond purchase program will expire toward year's end. To sum up, the central banks will reduce their balance sheet totals appreciably in the years ahead, after a huge increase in the past several years. Absent major buyers on the bond market, volatility is likely to rise from a very low level there and spread to the stock market.

Market data overview

Stock marktes	As of 14.09.2018 13:40	Change versus 07.09.2018 -1 week	13.08.2018 -1 month	13.06.2018 -3 months	13.09.2017 -1 year	29.12.2017 YTD
Dow Jones	26146	0,9%	3,8%	3,7%	18,0%	5,8%
S&P 500	2904	1,1%	2,9%	4,6%	16,2%	8,6%
Nasdaq	8014	1,4%	2,5%	4,1%	24,0%	16,1%
DAX	12080	1,0%	-2,3%	-6,3%	-3,8%	-6,5%
MDAX	26279	0,4%	-1,6%	-2,1%	4,1%	0,3%
TecDAX	2898	-0,5%	-1,4%	-0,2%	22,9%	14,6%
EuroStoxx 50	3339	1,4%	-2,1%	-4,0%	-5,2%	-4,7%
Stoxx 50	3007	1,2%	-2,6%	-2,3%	-3,3%	-5,4%
SMI (Swiss Market Index)	8964	1,4%	-0,5%	3,8%	-1,0%	-4,5%
Nikkei 225	23095	3,5%	5,7%	0,6%	16,3%	1,4%
Brasilien BOVESPA	74687	-2,3%	-3,6%	3,6%	-0,1%	-2,2%
Russland RTS	1093	4,0%	3,1%	-4,8%	-2,3%	-5,3%
Indien BSE 30	38091	-0,8%	1,2%	6,6%	18,3%	11,8%
China Shanghai Composite	2682	-0,8%	-3,7%	-12,1%	-20,8%	-18,9%
MSCI Welt (in €)	2163	0,5%	-0,9%	1,6%	11,5%	5,4%
MSCI Emerging Markets (in €)	1018	-1,2%	-4,9%	-9,9%	-5,2%	-9,9%
Bond markets						
Bund-Future	159,46	-49	-390	-61	-226	-222
Bobl-Future	131,00	-28	-140	-13	-45	-61
Schatz-Future	111,82	-4	-22	-10	-36	-15
3 Monats Euribor	-0,32	0	0	0	1	1
3M Euribor Future, Dec 2017	-0,30	-1	-3	-2	-8	0
3 Monats $ Libor	2,33	0	2	-1	101	64
Fed Funds Future, Dec 2017	2,25	1	4	6	81	0
10 year US Treasuries	2,99	5	10	1	79	58
10 year Bunds	0,45	6	13	-3	4	2
10 year JGB	0,11	0	1	6	10	6
10 year Swiss Government	-0,03	4	8	-6	7	10
US Treas 10Y Performance	560,52	-0,2%	-0,6%	0,7%	-4,8%	-3,6%
Bund 10Y Performance	615,94	-0,3%	-1,0%	1,1%	1,4%	1,4%
REX Performance Index	483,40	-0,3%	-0,5%	0,3%	-0,1%	0,6%
US mortgage rate	0,00	0	0	0	0	0
IBOXX AA, €	0,81	2	15	-8	8	13
IBOXX BBB, €	1,69	-2	15	5	40	46
ML US High Yield	6,53	-7	-4	8	46	38
JPM EMBI+, Index	783	0,9%	1,6%	-0,1%	-7,3%	-6,4%
Convertible Bonds, Exane 25	7414	0,0%	0,2%	-0,5%	2,9%	0,2%
Commodities						
CRB Spot Index	409,47	-0,6%	-2,3%	-9,3%	-4,7%	-5,3%
MG Base Metal Index	306,03	0,7%	-2,3%	-15,9%	-8,0%	-14,7%
Crude oil Brent	78,24	2,3%	7,8%	2,5%	42,2%	17,5%
Gold	1204,96	0,5%	0,8%	-7,2%	-8,9%	-7,6%
Silver	14,24	0,1%	-5,6%	-16,1%	-19,6%	-16,3%
Aluminium	2028,00	-0,1%	-1,7%	-11,1%	-2,4%	-10,1%
Copper	6013,50	1,7%	-1,8%	-17,1%	-7,6%	-16,6%
Iron ore	68,31	0,4%	-0,4%	4,5%	-8,8%	-4,2%
Freight rates Baltic Dry Index	1382	-7,2%	-19,1%	-1,6%	3,4%	1,2%
Currencies						
EUR/ USD	1,1696	0,7%	2,6%	-0,6%	-2,4%	-2,5%
EUR/ GBP	0,8916	-0,3%	-0,2%	1,2%	-1,0%	0,4%
EUR/ JPY	130,87	1,7%	3,8%	0,6%	-0,7%	-3,1%
EUR/ CHF	1,1275	0,5%	-0,6%	-2,9%	-1,9%	-3,6%
USD/ CNY	6,8513	0,1%	-0,6%	7,1%	4,7%	5,3%
USD/ JPY	111,93	0,8%	1,1%	1,4%	1,3%	-0,7%
USD/ GBP	0,76	-1,2%	-2,6%	1,9%	0,9%	3,2%

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