M.M.WARBURG & CO
BANK

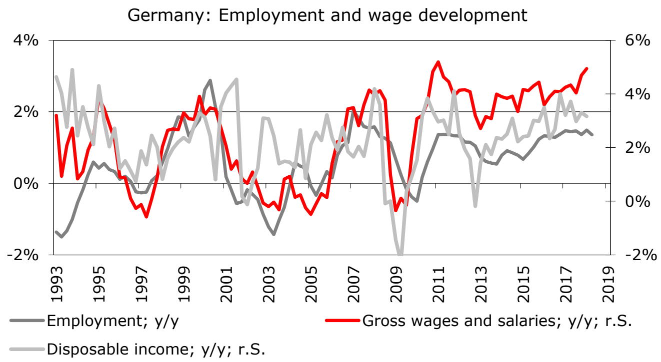
ECONOMIC SITUATION AND STRATEGY

October 5, 2018

"Thinking of Germany at night …

… puts all chance of sleep to flight." That was Heinrich Heine's frame of mind when he began the poem "Night Thoughts" with these words back in 1844. It is also how we feel looking at Germany's economic development this year and the prospects for the coming months. In past years, we have seldom seen such conflicting signals as we do today.

As we expected in mid-November 2017,[1] the German economy is experiencing a "golden age." The country is going through a construction boom beyond compare. Not only is housing construction registering another record year, but more building permits than ever are being issued in the public and commercial segments. This is obvious to anyone who counts the cranes over German cities or is annoyed by the countless highway and road construction sites. Most businesses in central city locations are seeing continuing high numbers of patrons, not least thanks to this year's warm and long summer, which has given the German tourism industry unexpectedly good visitor numbers. The labor market has been practically swept clean, and it is hardly possible to find skilled workers. The number of registered unemployed persons is 2.3 million, the lowest level since German reunification. Moreover, there are more than 800,000 job vacancies. Full employment is no longer a nice economic concept, but has almost been attained. Thanks to the booming labor market, gross wages and salaries increased in the first half of 2018 by 4.8% compared with last year. But because social benefits only went up by 2.1% and self-employment income grew less strongly at just over 3%, disposable incomes have registered a plus of "only" 3.2% this year, which is still impressive. But that is the end of the good news.



Although the most important leading economic indicators were still at or near historical highs at the beginning of the year, the German economy lost momentum surprisingly fast. Already in the first quarter, real GDP grew much more slowly than at the end of 2017. It seemed initially as if special factors such as the cold winter, the flu epidemic, and strikes could be held responsible for the loss of economic momentum, but the situation did not brighten much in the second quarter. In addition, the Federal Statistical Office (Statistische Bundesamt) put a damper on expectations that the strong upswing of 2017 would continue. Although leading indicators improved over almost the entire year of 2017, revised statistics show that economic momentum had already peaked in the first quarter. Growth in the subsequent quarters was good, but only half as strong as at the beginning of the year. The reason for the increas-

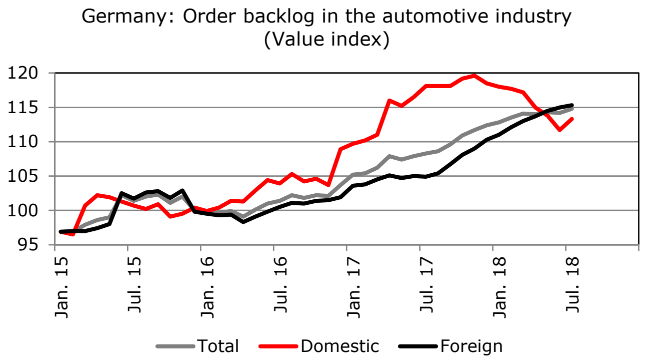
[1] Outlook for 2018 (I): "Golden Age" for the German economy, https://www.mmwarburg.de/system/galleries/download/research.mmwarburg.com/eco4717.pdf

ing discrepancy with respect to the leading indicators remains a mystery.

However, the smaller statistical overhang for the year 2018 is only one reason why we have revised our original growth forecast downward from 2.7% to 1.9%. The main reason is that all the important figures from the real economy this year have so far disappointed. For example, new orders have fallen in six out of seven months, industrial production has developed negatively in five out of seven months, and retail sales have shown a declining tendency in four out of eight months. The weak development of private consumption is surprising not only in view of the good labor market situation and higher wages. Purchasing power has been impeded by the higher inflation rate, but the economically implausible rise of the saving ratio suggests that Germans have actually become reticent consumers. Consumer spending is therefore likely to grow by only 1.4% this year, more slowly than in any year since 2014.

Growth of equipment spending and exports has been equally disappointing this year. Given exceptionally high capacity utilization of about 88%, difficulty in finding suitable employees is likely to have played a role in this. However, the economic uncertainties arising from US trade policy are probably the more influential factor. This becomes especially clear if one looks at the German automobile industry, which has not been running smoothly at all this year. Profit warnings from some companies and declining production and order numbers are fueling concern that Germany's flagship sector is going downhill. The explanations for this appear simple and clear. The diesel scandal, a supposed lag in switching from conventional to electric motors, and Trump's threats of trade tariffs have substantially impaired the industry environment.

But these factors have little to do with reality. We believe the situation this year mainly has to do with "homemade" problems of adjusting to the new Worldwide Harmonized Light Vehicle Test Procedure (WLTP). German automakers are reducing production significantly now because many of their models have not been certified yet. This could mean that the German economy has not grown at all in the third quarter, or might even have contracted, since the auto industry accounts for 14% of total industrial production. The German Association of the Automotive Industry (VDA) reports that auto production was down by about 30% in August and by just over 20% in September compared with last year. The last time similar declines occurred was in the beginning of 2009. However, this cannot be called lasting crisis in view of the high order backlogs of German automakers. After all, at three months, the cushion of existing orders is more than comfortable. And despite the weaker domestic trend, the value of orders on hand is higher than ever before due to still high foreign demand.



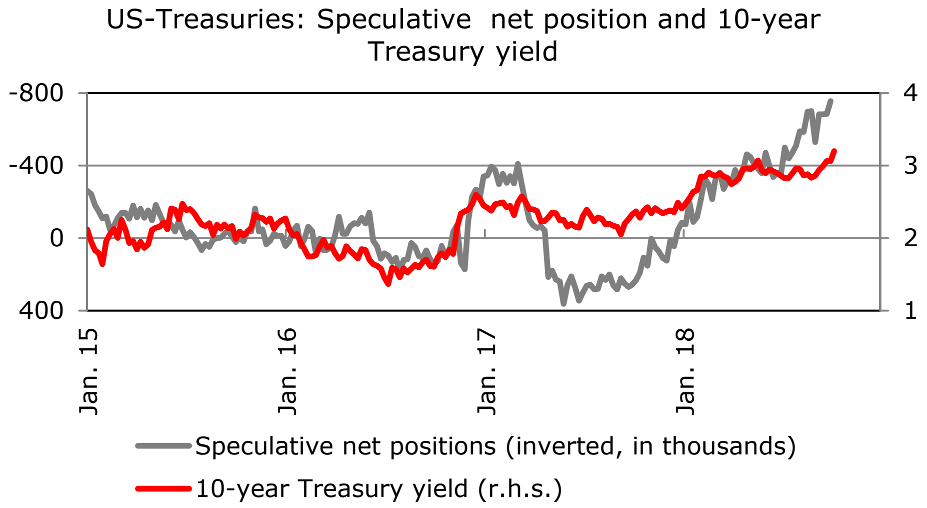
But even if the dramatic decline of production is only a temporary disturbance, it might necessitate another revision of the economic forecast. How long it takes to overcome these problems will be the decisive factor. If automobile production picks up again significantly during the fourth quarter, a growth rate of 1.7% could still be achieved for the year as a whole. On the other hand, if the process of catching up does not start until next year, German GDP might grow by only 1.6% this year. But we regard a further slowdown as unlikely, so such a growth rate should also be achieved in 2019. As Heine wrote in 1844: "Germany shall last evermore, she is healthy to the core!" The sleepless nights should soon become a thing of the past.

Weekly outlook for October 8-12, 2018

	May	June	July	Aug.	Sept.	Oct.	Release
DE: Industrial production, m/m	2-2%	-0-7%	-1-1%	-2-5%			October 8
DE: Industrial production, y/y	2-9%	2-7%	1-2%	-3-0%			October 8
DE: Exports, m/m	1-7%	0-1%	-0-8%	0-6%			October 9
DE: Exports, y/y	3-6%	5-7%	4-6%	2-9%			October 9
DE: Imports, m/m	1-1%	1-3%	2-8%	-0-2%			October 9
DE: Imports, y/y	4-3%	8-9%	9-8%	8-8%			October 9
DE: Consumer prices, m/m - final	0-5%	0-1%	0-3%	0-1%	0-4%		October12
DE: Consumer prices, y/y- final	2-2%	2-1%	2-0%	2-0%	2-3%		October 12
EUR19: Sentix investor confidence	19-2	9-3	12-1	14-7	12-0	12-3	October 8
EUR19: Industrial production, m/m	1-4%	-0-8%	-0-8%	-0-5%			October12
EUR19: Industrial production, y/y	2-3%	2-2%	0-1%	-1-5%			October 12

MMWB estimates in red

Chart of the Week: Rising yields in the United States



The yield on 10-year US Treasury bonds has been back above 3% since mid-September. It has meanwhile climbed to 3.2%, its highest level since 2011. We consider the continuing high-quality good data on the US economy to be the main reason for this. Good labor markets numbers have especially driven yields. While wage increases in August were surprisingly higher than expected, more good data has come out this week. Private data service provider ADP reports 230,000 new jobs for September, which is significantly above the year's average of about 200,000. Even though the ADP figures do not always correlate with the Fed's statistics and usually fluctuate more, the official labor market report due out this Friday should confirm the positive direction of employment. Also, a significant rise of US government bond yields followed the ISM index for the services sector released yesterday. At 61.6 points, the index has reached its second-highest level since the time series began in 1997. The good numbers have also brought changes in expectations of future interest rate actions by the Fed. While only one interest rate hike was expected two months ago, the majority of investors now expect two rate steps in 2019. However, this is still below the Fed's projection of three rate hikes, which shows that room exists for further yield increases. Short positions, which are now at a record level and should entail further yield increases, also support this view. In addition, the Fed is reducing its balance sheet now by USD 50 billion per month. This withdrawal of liquidity is likely to reinforce the trend toward falling prices for 10-year US government bonds.

Market data overview

Stock marktes	As of 05.10.2018 11:53	Change versus 28.09.2018 -1 week	04.09.2018 -1 month	04.07.2018 -3 months	04.10.2017 -1 year	29.12.2017 YTD
Dow Jones	26627	0,6%	2,6%	10,1%	17,5%	7,7%
S&P 500	2902	-0,4%	0,2%	6,9%	14,3%	8,5%
Nasdaq	7880	-2,1%	-2,6%	5,0%	20,6%	14,1%
DAX	12145	-0,8%	-0,5%	-1,4%	-6,4%	-6,0%
MDAX	25292	-2,7%	-4,7%	-1,5%	-3,3%	-3,5%
TecDAX	2749	-2,3%	-8,0%	1,9%	10,0%	8,7%
EuroStoxx 50	3356	-1,3%	-0,1%	-1,6%	-6,6%	-4,2%
Stoxx 50	3041	-0,9%	0,5%	-0,5%	-4,7%	-4,3%
SMI (Swiss Market Index)	9054	-0,4%	1,1%	4,5%	-2,5%	-3,5%
Nikkei 225	23784	-1,4%	4,8%	9,5%	15,3%	4,5%
Brasilien BOVESPA	82953	4,6%	11,0%	11,0%	8,3%	8,6%
Russland RTS	1154	-3,2%	6,6%	0,6%	1,5%	0,0%
Indien BSE 30	34512	-4,7%	-9,6%	-3,2%	9,0%	1,3%
China Shanghai Composite	2821	0,0%	2,6%	2,3%	-15,8%	-14,7%
MSCI Welt (in €)	2165	-0,1%	0,7%	5,4%	10,5%	7,5%
MSCI Emerging Markets (in €)	1010	-2,9%	-2,3%	-3,1%	-5,9%	-9,0%
Bond markets						
Bund-Future	158,04	-75	-483	-451	-328	-364
Bobl-Future	130,43	-27	-166	-172	-86	-118
Schatz-Future	111,76	-2	-20	-31	-41	-22
3 Monats Euribor	-0,32	0	0	0	1	1
3M Euribor Future, Dec 2017	-0,30	-1	-1	-1	-9	0
3 Monats $ Libor	2,41	1	9	7	106	71
Fed Funds Future, Dec 2017	2,27	2	5	10	66	0
10 year US Treasuries	3,20	14	30	37	88	79
10 year Bunds	0,55	7	19	24	9	12
10 year JGB	0,15	2	3	12	10	10
10 year Swiss Government	0,07	3	16	18	8	20
US Treas 10Y Performance	548,96	-1,1%	-2,6%	-2,9%	-5,8%	-5,6%
Bund 10Y Performance	609,52	-0,6%	-1,7%	-1,5%	0,7%	0,4%
REX Performance Index	481,14	-0,2%	-0,8%	-1,0%	-0,3%	0,1%
US mortgage rate	0,00	0	0	0	0	0
IBOXX AA, €	0,90	6	13	13	14	22
IBOXX BBB, €	1,76	5	7	10	46	53
ML US High Yield	6,61	12	6	-11	63	46
JPM EMBI+, Index	784	-1,6%	2,1%	-0,6%	-6,6%	-6,2%
Convertible Bonds, Exane 25	7374	0,0%	-0,5%	0,7%	1,5%	-0,3%
Commodities						
CRB Spot Index	416,85	0,5%	1,4%	-4,7%	-2,8%	-3,6%
MG Base Metal Index	324,57	4,5%	6,9%	-1,7%	-4,1%	-9,5%
Crude oil Brent	84,97	2,6%	8,4%	8,6%	51,5%	27,6%
Gold	1200,91	0,8%	0,7%	-4,4%	-5,8%	-7,9%
Silver	14,63	-0,3%	3,6%	-8,8%	-12,0%	-14,0%
Aluminium	2168,00	5,9%	6,8%	2,5%	1,1%	-3,9%
Copper	6288,25	0,4%	8,5%	-1,6%	-2,8%	-12,7%
Iron ore	68,51	-0,3%	2,8%	6,9%	8,8%	-3,9%
Freight rates Baltic Dry Index	1554	0,9%	2,7%	-0,8%	17,7%	13,8%
Currencies						
EUR/ USD	1,1490	-0,7%	-0,6%	-1,3%	-2,5%	-4,2%
EUR/ GBP	0,8816	-1,0%	-2,1%	0,0%	-0,4%	-0,7%
EUR/ JPY	130,81	-0,3%	1,7%	1,7%	-1,3%	-3,1%
EUR/ CHF	1,1422	0,9%	1,4%	-1,2%	-0,3%	-2,4%
USD/ CNY	6,8680	0,0%	0,4%	3,5%	3,2%	5,6%
USD/ JPY	113,92	0,2%	2,2%	3,1%	1,0%	1,1%
USD/ GBP	0,77	0,1%	-1,5%	1,4%	1,9%	3,8%

Carsten Klude
+49 40 3282-2572
cklude@mmwarburg.com

Dr. Rebekka Haller
+49 40 3282-2452
rhaller@mmwarburg.com

Martin Hasse
+49 40 3282-2411
mhasse@mmwarburg.com

Dr. Christian Jasperneite
+49 40 3282-2439
cjasperneite@mmwarburg.com

Bente Lorenzen
+49 40 3282-2409
blorenzen@mmwarburg.com

Julius Böttger
+49 40 3282-2229
jboettger@mmwarburg.com