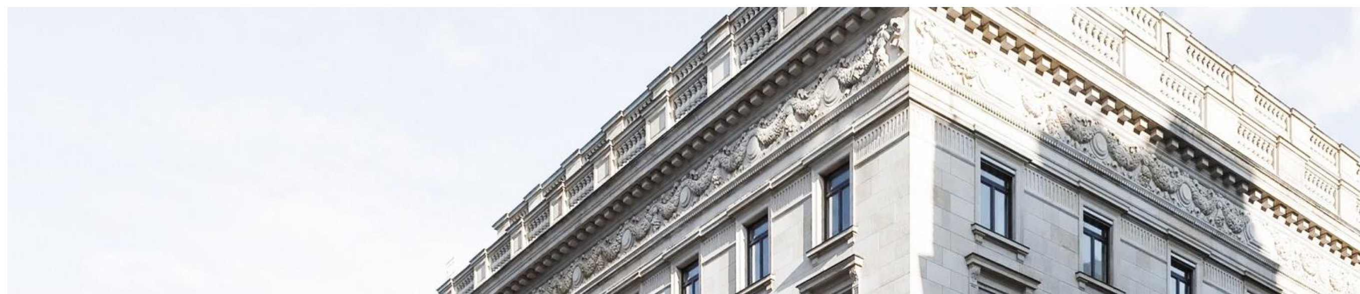
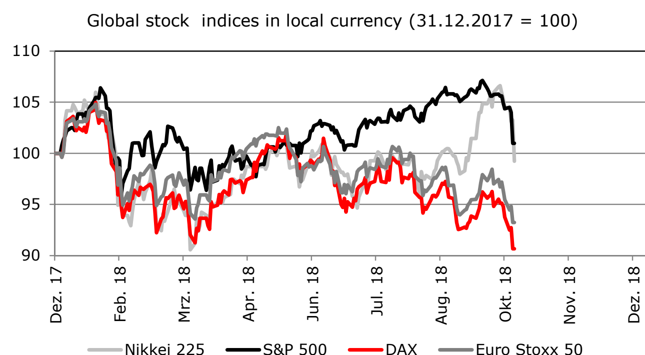


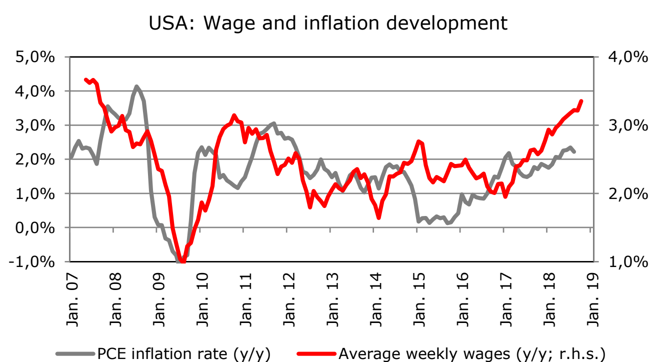
ECONOMIC SITUATION AND STRATEGY October 12, 2018

Threat of bull market ending?

The weather is giving us a bountiful October, but melancholy prevails on the stock markets. Exchanges in Europe and emerging countries have been in reverse gear for some time, but now the US markets are also correcting sharply. Technology stocks, which have supported the very positive performance of US stocks this year, are especially under pressure. The companies in the NASDAQ index have lost almost 10% in value so far in October. The DAX index has lost about 6% since the beginning of the month and just over 10% since the beginning of the year. What is the reason for this slump and what are the prospects going forward?



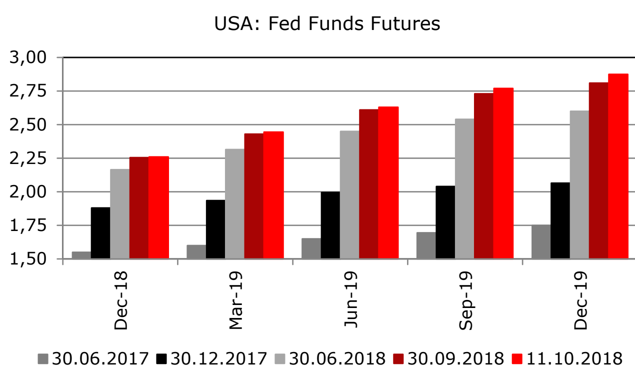
We find it hard to identify one immediate trigger for the current stock market sell-off. In the United States, the reversal of sentiment in the past few days is attributable to various factors. The most important is probably that many investors fear stronger interest rate hikes from the Fed, which would necessarily choke off the so far still booming US economy. Fed Chair Jerome Powell has recently stated that the US central bank is still far from a neutral monetary policy. This has been understood as a clear message that there will more or less automatically be a further tightening of monetary policy and it might turn out stronger than previously expected. However, we see few concrete indications that argue for a more aggressive approach by the Fed. We would expect that primarily if the inflation rate were to rise. But although the unemployment rate has reached 3.7%, almost its lowest level in 50 years, wage pressure has hardly increased. Hourly wages are 2.8% higher than last year, and unit labor costs increased by 1.5% in the first three quarters. Fear that the US economy is on the verge of overheating therefore does not make much sense.



Moreover, market participants may well have read too much into Powell's words. On close examination, the Fed's projections at the end of September concerning growth, inflation, and interest rate development for the years ahead do not give much cause for excitement. The Federal Open Market Committee (FOMC) has not changed its interest rate forecast compared with June. It expects a policy interest rate of 2.25-2.50% at the end of 2018 (which means one more rate hike), then an increase to 3-3.25% at the end of 2019 (three more steps) and to 3.25-3.5% at the end of 2020. For the long term,

the FOMC foresees a policy rate of 3%, an assessment that has remained more or less unchanged since June 2016. Market participants now have relatively high confidence in the Fed's forecast for 2019, as reflected in fed funds futures, with the last interest rate step for 2019 still not completely priced in.

This suggests that further potential for raising interest rates is limited, unless there is a surprising spike in inflation. We expect that the PCE inflation rate, which is what the Fed watches, will drop from 2.0% this year to 1.7% next year. Since real economic growth is also likely to slow from 3.0% to 2.7%, there is little reason to fear a greater tightening of US monetary policy. Current interest rate worries might therefore evaporate soon.

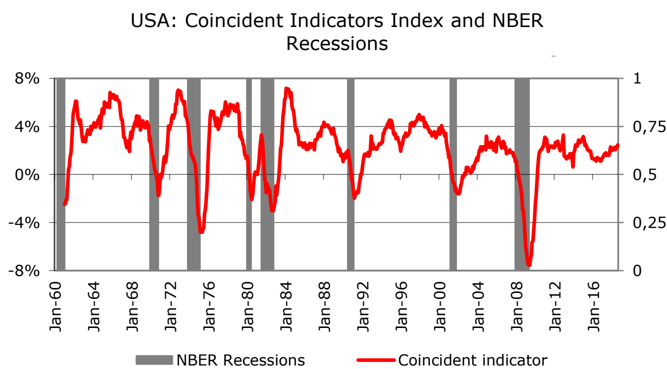


However, rising interest rates are only one negative factor to which stock markets are now exposed. News that more companies than usual are warning of weaker earnings ahead of the reporting season for the third quarter has grabbed attention. Besides higher interest rates, higher labor and raw material costs contributing to greater margin pressure might also be playing a role in that. Furthermore, a lack of skilled workers and uncertainty regarding future US trade relations with China and other countries might also make themselves felt negatively. However, the few companies that have already submitted their numbers for the third quarter have given no sign that the positive trend of the past quarters has changed. Of the 25 companies from the S&P 500 that have reported so far, 84% show better than expected earnings and 64% have beaten sales expectations. Despite these positive figures, which suggest that year-on-year earnings growth should come to over 20%, the stock prices of only 12% of these companies have reacted positively. This is an all-time negative record of extraordinary magnitude. On average, 52% of stock prices react positively to the submitted quarterly figures in the course of a reporting season, with the lowest to date being 43%. This also indicates that US stock markets have significant catch-up potential, provided the majority of reports ahead are positive and, above all, outlooks are not disappointing.

Macroeconomic conditions will critically determine earnings development going forward. In its latest *World Economic Outlook*, published this week, the International Monetary Fund (IMF) has lowered its global growth forecast for this year and next from 3.9% to 3.7%. This forecast revision is not pleasing to the eye, but is also not a disaster provided the growth rate is achieved. For, ultimately, this adjustment only undoes the forecast increase made last January. The decisive reasons for the new forecast were lower economic growth in Great Britain and the euro zone in the first half of the year and weak economic activity in emerging countries like Argentina, Brazil, Iran, and Turkey. Moreover, trade disputes and tariffs have negatively affected business investment and global exports. Nevertheless, the IMF concludes that "overall, world economic growth is still solid compared with earlier this decade, but it appears to have plateaued."

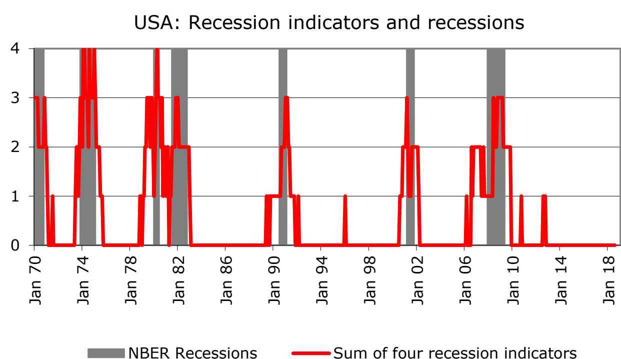
However, there are some additional risks that could make this forecast too optimistic. The main ones are escalating trade disputes, more restrictive central bank monetary policy, and greater investor risk aversion, which could lead to capital flight from emerging countries. Also, stock market valuation and the comparatively high debt levels of some countries and businesses increase the economy's susceptibility to exogenous shocks.

Despite these risks, we expect the upswing in the United States to continue. Two recession indicators that we follow closely support this view. In the past, there has been a recession whenever the annual rate of change of the coincident indicator calculated by the Conference Board, an economic research institute, has slipped into negative territory. This indicator tracks the development of four different time series: employment, industrial production, disposable incomes, and sales. It has not fallen in the past months, but has rather increased.



We also look at a further indicator consisting of four other individual components: yield curve steepness (10 years minus 3 months), the difference between the purchasing manager components of new orders versus inventory levels, the annual rate of change of the Conference Board's leading indicator, and unemployment rate change. This indicator also signals no danger of recession at present.

In contrast, economic risks are greater in Europe than in the United States. That is due to greater dependence on exports, but also to uncertainties arising with the approach of Brexit. Moreover, the Italian government's idiosyncratic budget plans and disruptions in the automobile industry posed by conversion to the new emissions standard, the Worldwide Harmonized Light Vehicles Test Procedure (WLTP), are weighing on investor sentiment. However, the economic risks of a disorderly Brexit and a further escalation of disputes between Italy and the rest of the euro zone or the EU can hardly be quantified at present.



These uncertainties have affected both earnings estimates and valuations of European stock markets. Analysts have lowered their earnings estimates for the DAX companies significantly since the summer. They now expect earnings stagnation for 2018, but profits are then supposed to increase by about 10% in 2019. On an earnings per share basis, the earnings of 13 of the 30 DAX companies are expected to decline in 2018, while 16 companies are supposed to hit record highs in earnings per share. On the other hand, analysts forecast declining earnings per share for only two companies in 2019, while 19 are supposed to achieve record levels. The estimates for next year might prove too optimistic in order of magnitude, but earnings should increase nevertheless as long as there is no recession. We do not expect a recession in Germany. Moreover, the low price-earnings ratio of 11.5 signals there is a safety margin deducted for lower earnings.

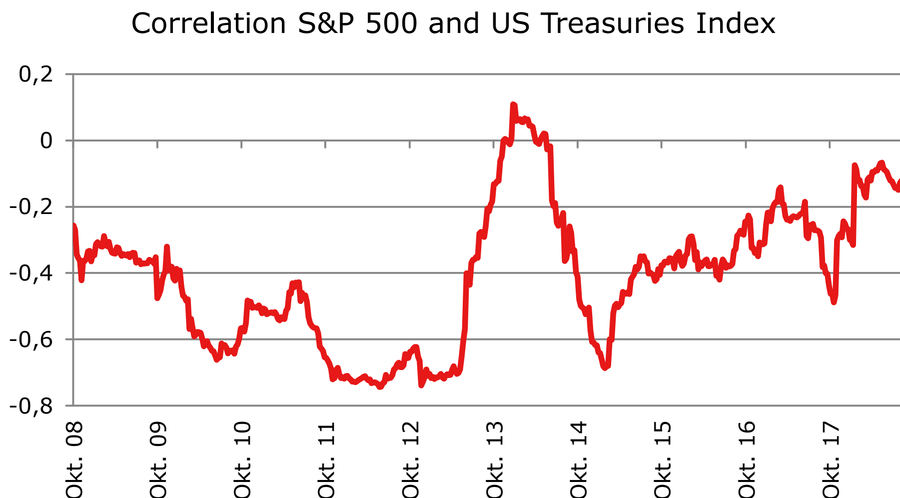
This means investors should temporarily position themselves more defensively and reduce their portfolio stock ratio in favor of cash. It will take some time for the current uncertainty to settle. Statements from the Fed that it is not firmly set on a predetermined course and a positive earnings season would both be helpful. But if those should not materialize, stock prices might continue to slump. However, the models we use to guide asset allocation do not signal that great caution is advisable at present. Hopefully, it is too soon to call "game over" on the stock markets.

Weekly outlook for October 15-19, 2018

	May	June	July	Aug.	Sept.	Oct.	Release
DE: ZEW economic expectations	-8.2	-16.1	-24.7	-13.7	-10.6	-11.8	October 16
DE: ZEW current conditions	87.4	80.6	72.4	72.6	76.0	74.3	October 16
EUR19: Consumer prices, y/y - final	1.9%	2.0%	2.1%	2.0%	2.1%		October 17
EUR19: Core inflation rate, y/y - final	1.1%	0.9%	1.1%	1.0%	0.9%		October 17

MMWB estimates in red

Chart of the Week: Correlation nears zero line



Normally, stock and bond price movements are related inversely, which means bond prices advance when stock prices decline and vice versa. The simple explanation is that investors sell stocks when risks increase and buy safe (government) bonds. This long-observed connection has no longer obtained in recent trading days in the United States. The negative correlation of the time series is nearing the zero line. What has happened? On the one hand, the Fed's interest rate steps and expansionary US fiscal policy have led to rising yields on US Treasuries. On the other, worries have also mounted about an overshooting of inflation and hence lower real interest rates. The latter factor in particular is likely to have contributed to the recent yield advance. As interest rates go up, businesses see their refinancing costs rise and their profitability fall. At the same time, climbing interest rates are reflected in a higher discounting factor, which reduces the net present value of future cash flows and hence the "fair" stock price. However, this analysis overlooks two points. First, company sales are a nominal measure and should therefore likewise increase on rising inflation. Second, higher refinancing costs only lead very slowly to an increase of average refinancing costs, especially if one considers the longer terms of corporate debts in the United States. The current movement therefore seems exaggerated and partly attributable to sentiment. If one still expects the current inflation fears not to come true, the stronger negative correlation between stocks and bond yields should return.

Market data overview

Stock marktes	As of 12.10.2018 15:43	Change versus 05.10.2018 -1 week	11.09.2018 -1 month	11.07.2018 -3 months	11.10.2017 -1 year	29.12.2017 YTD
Dow Jones	25398	-4,0%	-2,2%	2,8%	11,0%	2,7%
S&P 500	2728	-5,4%	-5,5%	-1,6%	6,8%	2,0%
Nasdaq	7329	-5,9%	-8,1%	-5,0%	11,0%	6,2%
DAX	11602	-4,2%	-3,1%	-6,6%	-10,6%	-10,2%
MDAX	23966	-5,2%	-9,0%	-8,3%	-7,6%	-8,5%
TecDAX	2598	-5,4%	-10,3%	-7,0%	3,5%	2,7%
EuroStoxx 50	3224	-3,6%	-2,6%	-5,8%	-10,6%	-8,0%
Stoxx 50	2930	-3,3%	-1,7%	-4,1%	-8,2%	-7,8%
SMI (Swiss Market Index)	8722	-3,5%	-2,2%	0,4%	-5,9%	-7,0%
Nikkei 225	22695	-4,6%	0,1%	3,5%	8,7%	-0,3%
Brasilien BOVESPA	82921	0,7%	11,1%	11,5%	8,2%	8,5%
Russland RTS	1142	-1,5%	8,1%	-3,7%	-0,1%	-1,1%
Indien BSE 30	34734	1,0%	-7,2%	-4,2%	9,1%	2,0%
China Shanghai Composite	2607	-7,6%	-2,2%	-6,2%	-23,1%	-21,2%
MSCI Welt (in €)	2045	-5,3%	-4,6%	-1,9%	3,4%	0,9%
MSCI Emerging Markets (in €)	955	-5,0%	-4,7%	-8,9%	-12,5%	-14,5%
Bond markets						
Bund-Future	158,35	74	-95	-418	-291	-333
Bobl-Future	130,74	39	-30	-130	-47	-87
Schatz-Future	111,84	8	3	-17	-30	-14
3 Monats Euribor	-0,32	0	0	0	1	1
3M Euribor Future, Dec 2017	-0,30	0	0	-1	-9	0
3 Monats $ Libor	2,44	3	10	10	108	74
Fed Funds Future, Dec 2017	2,27	0	2	8	63	0
10 year US Treasuries	3,16	-6	18	32	81	75
10 year Bunds	0,51	-6	8	20	4	8
10 year JGB	0,15	0	4	11	9	10
10 year Swiss Government	0,09	1	12	16	11	22
US Treas 10Y Performance	554,73	1,3%	-1,0%	-1,9%	-4,7%	-4,6%
Bund 10Y Performance	610,62	0,5%	-0,8%	-1,3%	1,0%	0,5%
REX Performance Index	481,36	0,1%	-0,5%	-0,8%	-0,2%	0,1%
US mortgage rate	0,00	0	0	0	0	0
IBOXX AA, €	0,88	-4	6	12	12	20
IBOXX BBB, €	1,78	1	6	19	50	55
ML US High Yield	6,79	14	21	14	81	64
JPM EMBI+, Index	781	-0,1%	1,3%	-1,8%	-6,9%	-6,6%
Convertible Bonds, Exane 25	7182	0,0%	-3,0%	-2,4%	-1,2%	-2,9%
Commodities						
CRB Spot Index	417,53	0,0%	1,7%	-4,0%	-2,7%	-3,5%
MG Base Metal Index	309,21	-2,1%	2,6%	-2,8%	-9,6%	-13,8%
Crude oil Brent	80,84	-4,8%	2,7%	5,5%	43,4%	21,4%
Gold	1222,14	1,7%	2,6%	-1,9%	-5,2%	-6,2%
Silver	14,60	-0,1%	3,5%	-7,9%	-14,7%	-14,2%
Aluminium	2013,00	-5,4%	0,4%	-4,0%	-4,4%	-10,8%
Copper	6258,25	1,5%	7,1%	2,1%	-7,4%	-13,2%
Iron ore	70,24	1,4%	3,6%	11,2%	18,5%	-1,5%
Freight rates Baltic Dry Index	1515	-0,6%	5,3%	-4,5%	5,7%	10,9%
Currencies						
EUR/ USD	1,1553	0,4%	-0,2%	-1,6%	-2,3%	-3,7%
EUR/ GBP	0,8760	-0,5%	-1,7%	-1,0%	-2,4%	-1,3%
EUR/ JPY	129,62	-1,1%	0,6%	-0,7%	-2,3%	-4,0%
EUR/ CHF	1,1451	0,2%	1,6%	-1,7%	-0,6%	-2,1%
USD/ CNY	6,9154	0,7%	0,6%	3,5%	4,9%	6,3%
USD/ JPY	112,17	-1,4%	0,5%	0,1%	-0,3%	-0,5%
USD/ GBP	0,76	-0,8%	-1,4%	0,5%	0,0%	2,6%

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