M.M.WARBURG & CO
BANK

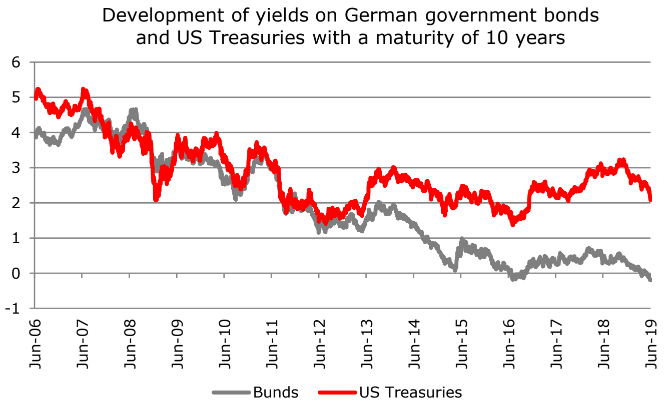
ECONOMIC SITUATION AND STRATEGY

June 7, 2019

Bond market turns pessimistic, bolsters stock market

Investors have been heatedly debating for decades which processes information more efficiently, the stock or the bond market. We tend to identify more with the side that favors the bond market. However, if that should be correct in the current market phase, we would have a problem. But first things first. German government bonds (Bunds) with a residual maturity of 10 years have reached a new all-time low at a yield of -0.22%. To obtain a positive yield on Bunds at all, you now have to aim at a maturity of 15-16 years. But even at 20 years, the yield is only 0.2%. Just imagine, you lend the German government money for 20 years and get nominally almost nothing in return. The assumption must be that of a completely risk-free investment in a deflationary environment because that is the only way this makes sense. But honestly, you cannot even be sure the bonds will be redeemed in euros over such a long period. And whether no inflation will actually arise over the 20 years remains to be seen, given expansionary monetary policy and growing demands for government financing by the central bank.

Interestingly, the situation does not look much better on the other side of the Atlantic. Yields on 10-year Treasury bonds were still above 3% a year ago, when the market consensus was that the Fed was still far from the end of its rate-raising cycle. With worsening economic data and changing US monetary policy, yields have fallen and continue to do so. The yield on 10-year US government bonds now stands at just over 2%, tending downward. Even 30-year bonds are yielding only 2.6%, with the fed funds target rate at 2.25%-2.5%.



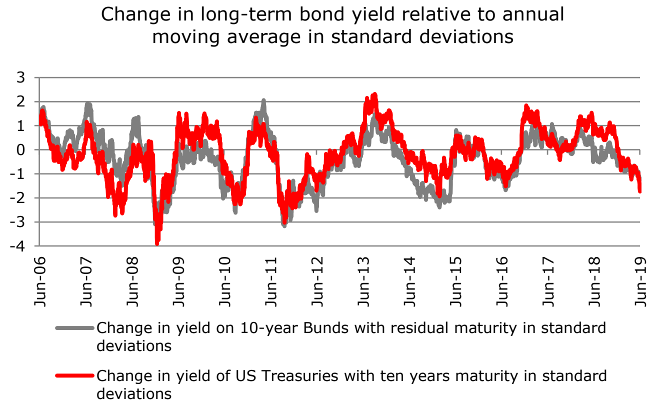
Here, we see another worrisome anomaly. Investors are getting practically no premium for accepting a longer maturity and hence higher risk. Normally, they would never be willing to buy a 10-year bond, for example, if a bond with only one year to go offers the same yield. But that is the case with US Treasuries now, and a 10-year bond is significantly more volatile. Moreover, the uncertainty regarding full redemption is higher. So, what motivates investors to buy such bonds? A rational answer is that investors expect yields to decline further in the near term (and hence the yield curve to invert), because longer bonds will then make considerable price gains on falling yields. And there is something very disconcerting about this interpretation, since further yield decline at an already record low only makes sense if something really goes wrong and investors seek a safe haven at almost any price.

What might this scenario look like for which bond investors appear to be gearing up? The natural candidate would be a global recession or at least a further economic slowdown. On a scale of 0 to 100, our business cycle model has been significantly below 50% for months and only at about 15% for many weeks. Considering that it was still nearly 100% at the beginning of 2018, this "crash" is extremely significant and reminiscent of previous slowdowns or even recessions in their early stage.

However, there are at least two other aspects likely to play a role in judging the current bond market situation and put recession worries back into perspective. Firstly, a growing trend towards unilateralism has gradually displaced multilateralism in recent decades. It is becoming increasingly clear that some countries are striving for global hegemony, whether subtly (China) or less so (United States). This makes the world a bit less safe and more complicated. Trade wars and unpredictable political interventions reduce the incentive to choose investments with longer amortization periods. That is incidentally also an approach to explaining why yields on long bonds are so low in contrast to short bonds.

Shortening the amortization periods of investment projects causes overall capital investment activity to decrease and therefore GDP growth to slow. It is presumably no coincidence that the number of foreign projects in Germany declined last year for the first time in a very long while, an effect observable in several countries and likewise indicative of significantly slowing globalization. Such a scenario would be not merely compatible with, but rather almost logically entail falling yields.

Secondly, at least one further "problem" still exists (at least in Europe) that should not be underestimated. It has to do with a development that Italy has been experiencing for some time. The government there is increasingly distancing itself, at least verbally, from all rules and agreements pertaining to budget policy. It has been true for many years that things are never as bad as they seem in Italy. On the other hand, the statements are anything but harmless when viewed in the cold light of day. What are we to think of a government that wants to cut taxes without sense or understanding and does not care at all about the resulting net new debt, or seriously demands that the European Central Bank issue an explicit guarantee for Italian government debts?



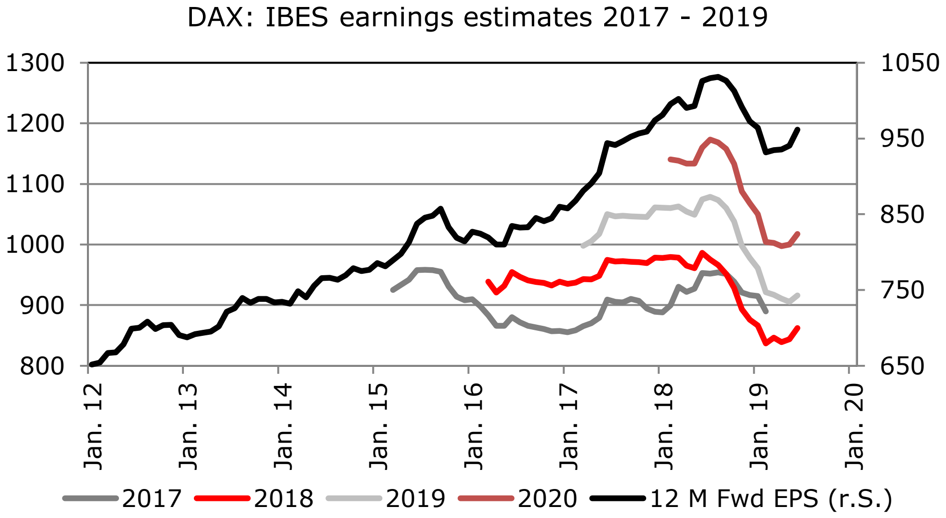
It is no wonder investors are turning away from Italian bonds in disgust and seeking a safe haven by purchasing German bonds instead. Here, if not sooner, the question becomes how long yields can keep falling before a correction may be expected. If you represent the yield changes in standard deviations, the answer is clear. The current decline is not historically unique, and there is definitely still potential for further downward movement. The end of the flagpole has therefore not been reached from a technical standpoint. Above all, however, there is fundamentally no reason that the processes and connections described should not cease starting tomorrow. Yields could thus first decline further and – as paradoxical as it may sound – actually bolster the stock market even though the newsflow has worsened. The world has certainly become a complicated place!

Weekly Outlook for June 10-14, 2019

	Jan.	Feb.	Mar.	Apr.	May	June	Release
DE: Consumer prices, m/m – final	-0.8%	0.4%	0.4%	1.0%	0.2%		June 13
DE: Consumer prices, y/y – final	1.4%	1.5%	1.3%	2.0%	1.4%		June 13
DE: Core inflation rate, y/y – final	1.3%	1.4%	1.1%	1.8%	1.3%		June 13
EUR19: Sentix sentiment index	-1.5	-3.8	-2.2	-0.3	5.3	2.9	June 10
EUR19: Industrial production, m/m	2.0%	-0.1%	-0.3%	-0.2%			June 13
EUR19: Industrial production, y/y	-0.8%	0.2%	-0.5%	-0.2%			June 13

MMWB estimates in red

Chart of the Week: Profit warnings bound to come



Global economic momentum has clearly diminished in the past months. Above all, the continuing trade disputes and uncertain outcome of Brexit have substantially dampened corporate and household sentiment and led to a weakening of capital investment, exports, and consumer spending. The economic and political challenges in Europe remain enormous, but a recession is unlikely thanks to a solid business trend in the services sector. As an export-oriented country, Germany in particular is suffering from the continuing uncertainties regarding world trade. Nevertheless, most stock indexes (including Germany's) have performed quite positively since the beginning of 2019. However, because of the slowing economic trend, ambitious earnings expectations currently pose the greatest risk for the stock markets. And even though the reporting season for the first quarter was respectable, the bottom line is a decline of DAX earnings by 10% over the year-earlier quarter. Nevertheless, corporate analysts have actually raised their forecasts for the coming quarters again. To achieve the expected plus of 8% for 2019 overall, companies will have to grow earnings by double-digit percentage rates in the next three quarters. Consensus data from FactSet show that analysts expect year-over-year earnings growth rates of almost 10% for the second quarter, almost 20% for the third, and almost 30% for the fourth. A further earnings increase of 11% is expected in 2020. Apart from base effects in the case of certain companies, where this optimism comes from remains a mystery. If the political risks do not recede quickly, accompanied by a recovery of the global economic trend, a new wave of profit warnings are bound to come in the second half of the year.

Market Data Overview

Stock marktes	As of 07.06.2019 10:53	Change versus 31.05.2019 -1 week	06.05.2019 -1 month	06.03.2019 -3 months	06.06.2018 -1 year	31.12.2018 YTD
Dow Jones	25721	3,6%	-2,7%	0,2%	2,3%	10,3%
S&P 500	2843	3,3%	-3,0%	2,6%	2,6%	13,4%
Nasdaq	7616	2,2%	-6,3%	1,5%	-1,0%	14,8%
DAX	12032	2,6%	-2,1%	3,8%	-6,2%	13,9%
MDAX	25081	1,2%	-2,3%	1,6%	-6,4%	16,2%
TecDAX	2781	1,2%	-2,4%	5,2%	-2,2%	13,5%
EuroStoxx 50	3368	2,7%	-2,8%	1,3%	-2,7%	12,2%
Stoxx 50	3116	2,4%	-1,6%	1,9%	1,5%	12,9%
SMI (Swiss Market Index)	9727	2,1%	0,7%	3,4%	13,8%	15,4%
Nikkei 225	20885	1,4%	-6,2%	-3,3%	-7,7%	4,3%
Brasilien BOVESPA	97205	0,2%	2,3%	3,2%	27,7%	10,6%
Russland RTS	1323	2,8%	6,2%	11,0%	12,3%	24,1%
Indien BSE 30	39458	-0,6%	2,2%	7,7%	12,2%	9,4%
China Shanghai Composite	2828	-2,4%	-2,7%	-8,8%	-9,2%	13,4%
MSCI Welt (in €)	2104	1,8%	-3,5%	1,6%	2,8%	13,5%
MSCI Emerging Markets (in €)	1003	-0,5%	-6,2%	-4,7%	-8,9%	5,5%
Bond markets						
Bund-Future	171,39	305	595	528	1115	785
Bobl-Future	133,96	4	97	103	223	144
Schatz-Future	112,09	-1	15	25	6	15
3 Monats Euribor	-0,32	0	-1	-1	0	-1
3M Euribor Future, Dec 2017	-0,38	0	-6	-11	-36	0
3 Monats $ Libor	2,47	-3	-9	-12	15	-34
Fed Funds Future, Dec 2017	1,80	-13	-44	-61	-83	-1
10 year US Treasuries	2,12	-2	-38	-57	-86	-57
10 year Bunds	-0,23	-4	-25	-36	-70	-48
10 year JGB	-0,12	-2	-7	-11	-17	-12
10 year Swiss Government	-0,50	5	-11	-16	-52	-26
US Treas 10Y Performance	616,98	0,3%	3,6%	5,5%	10,6%	6,3%
Bund 10Y Performance	660,45	0,4%	2,4%	3,6%	8,3%	5,3%
REX Performance Index	496,65	0,1%	1,0%	1,7%	2,8%	1,8%
US mortgage rate	0,00	0	0	0	0	0
IBOXX AA, €	0,41	-1	-2	-21	-47	-46
IBOXX BBB, €	1,31	-5	5	-36	-32	-75
ML US High Yield	6,81	-13	23	-5	30	-120
JPM EMBI+, Index	855	1,5%	2,1%	3,4%	8,1%	8,0%
Convertible Bonds, Exane 25	7260	0,0%	-0,6%	2,2%	-2,4%	5,3%
Commodities						
CRB Spot Index	415,78	0,0%	-0,4%	0,7%	-6,9%	1,6%
MG Base Metal Index	289,39	0,1%	-4,6%	-9,0%	-20,8%	-1,8%
Crude oil Brent	62,76	-3,3%	-12,2%	-4,5%	-16,3%	18,1%
Gold	1335,52	2,7%	4,4%	3,8%	2,8%	4,2%
Silver	14,90	2,1%	-0,1%	-1,1%	-11,0%	-3,9%
Aluminium	1745,75	-1,5%	-1,3%	-5,3%	-25,5%	-6,3%
Copper	5790,25	-0,3%	-7,0%	-10,9%	-19,7%	-2,7%
Iron ore	97,76	-1,0%	4,5%	14,0%	50,0%	41,3%
Freight rates Baltic Dry Index	1138	3,8%	15,5%	71,4%	-15,1%	-10,5%
Currencies						
EUR/ USD	1,1265	1,0%	0,6%	-0,4%	-4,2%	-1,6%
EUR/ GBP	0,8858	0,2%	3,6%	2,9%	1,0%	-1,3%
EUR/ JPY	122,20	0,8%	-1,6%	-3,3%	-5,7%	-2,9%
EUR/ CHF	1,1194	-0,2%	-1,8%	-1,5%	-3,7%	-0,7%
USD/ CNY	6,9057	0,0%	2,1%	2,9%	8,0%	0,4%
USD/ JPY	108,42	0,1%	-2,1%	-3,0%	-1,6%	-1,1%
USD/ GBP	0,79	-0,9%	3,0%	3,4%	5,6%	0,2%

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