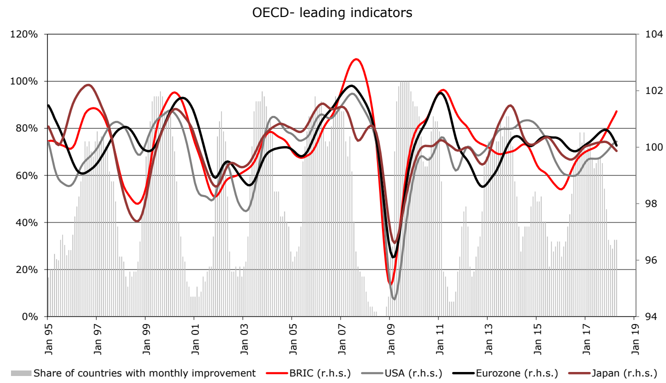
M.M.WARBURG & CO
BANK

ECONOMIC SITUATION AND STRATEGY

June 22, 2018

Stock markets: America first!

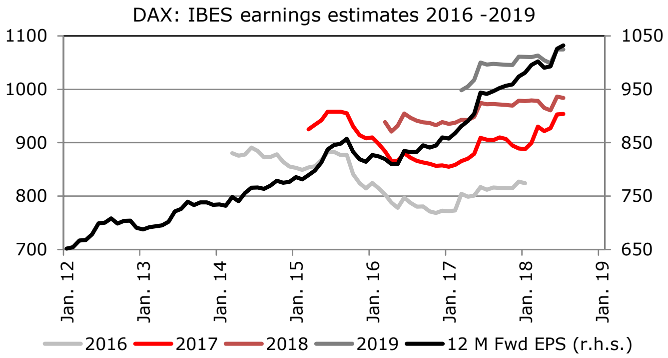
Political news has been keeping investors and stock markets on their toes for months, whether tweets from US President Donald Trump, the danger of a trade war between the United States and its most important trading partners, or the new Italian government, which would like to spend money it does not have. The short legs proverbially attributed to politically driven stock markets have grown quite long. In addition, disappointing economic news is coming from Germany, the rest of the euro zone, and Japan.



The result is that the stock markets have made practically no headway in the first half of the year. Most European exchanges have so far exhibited slightly negative performance. Above all, the stock prices of large companies have had trouble, while the firms classified as small and mid caps have done better. The situation is not much different in the emerging countries. Among the large BRIC countries, only India's stock market has gained, albeit slightly, while Brazil, Russia, and especially China are significantly in negative territory. Things look better in the United States, where the Dow Jones 30 is down only slightly, and the S&P 500 up a little. Exposure on the US exchanges has been sweetened for European investors by the US dollar's revaluation by just over 3%. Stocks on the NASDAQ, the US exchange for tech stocks, have registered by far the best performance this year (+13%). That tech stocks have managed to break away from a generally difficult environment is also shown by Germany's TecDAX index (+12%).

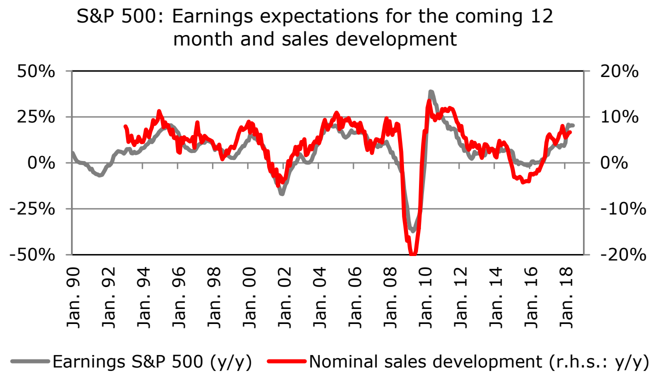
How will the second half of the year go? The key to what the stock markets will do lies mainly in the hands of Donald Trump. For investors, this means gearing up for erratic price movements in the months ahead. While the United States has been the great stabilizer for world politics and the global economy, the US president could intensify the "disruptive" tendencies between the United States, its allies heretofore, and the rest of the world. Trump is not entirely wrong to complain that in the past the United States has borne a disproportionate share of the military and economic costs of maintaining the world community. In the past, the United States has been supported by its military and economic allies in almost all matters of concern, but the extent of the cooperation has not always been adequate. But unilateral finger-pointing and looking in the rear-view mirror will not help us move forward. Strong alliances are necessary to cope successfully with future economic and military crises. Whether the West will continue to be led by the United States, however, is a more open question than ever – just as is the answer to who can fill the possible power vacuum. But we are still confident that the United States, even under Trump, will continue to fulfill its leadership function – even if the basic terms under which it is willing to bear that responsibility have to be renegotiated.

Investors should react to these changes, but that does not mean abandoning stocks. After all, the global economic upswing remains intact. However, the economic balance of power has also shifted recently, so we have revised our growth forecasts downward for the euro zone and Japan and upward for the United States. But less growth momentum does not mean a sharp downswing or even a new recession lie ahead in those two economic regions. Only if that were so would we recommend a significantly reduced stock ratio. Instead, the current development should prove to be a dip in the economic cycle – provided that a trade war is avoided. However, the European stock markets are likely to suffer a relatively long phase of uncertainty, so we consider slightly reducing exposure in the euro zone advisable now.



Corporate earnings growth and still moderate valuations argue against a very defensive positioning in Europe. Earnings expectations for DAX companies in the next 12 months have reached a new record level, with the weakening of the euro having a particularly positive effect. For the time being, the US dollar should continue to benefit relative to the euro from the economic and political newsflow, so a further revaluation beyond our year-end target of US 1.13 per euro has become more likely.

In contrast, the US economy does not have the euro zone's problems, so US stocks should be weighted more heavily. The tax reform, higher government spending, and deregulation of important economic sectors are providing tailwind. Earnings of S&P 500 companies will increase this year by more than 20% over last year. The reporting season for the second quarter, which will begin soon, is likely to show again that US companies are in a position to beat even this optimistic forecast. So, "America first" is not only Donald Trump's slogan, but also applies for now to regional allocation of stock investments.



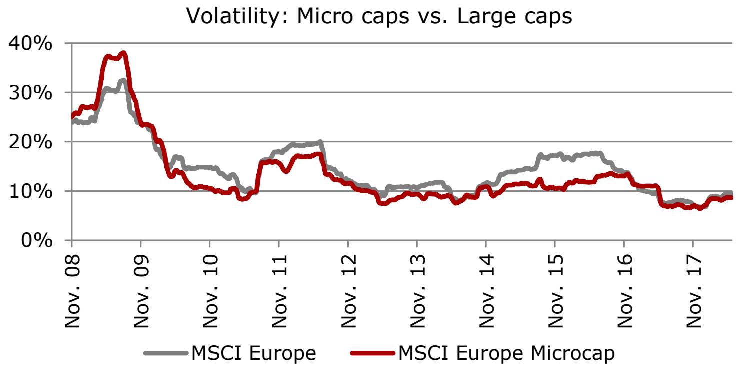
We do not share the worry that the stronger US dollar and slowing of global growth might significantly impact the financial statements of businesses. Analysts' expectations show that in contrast to the usual practice of correcting forecasts downward ahead of the reporting season, the trend towards positive earnings revisions has continued. Compared with the preceding quarter, the highest rates of increase are forecast in the sectors of energy (+140%), materials (+31%), and technology (+26%). Declining or below-average growth rates are expected in utilities (-2.5%), real estate (+2.5%), cyclical consumption (+9%), and health care (+10%). With a price-earnings ratio of 16.6 based on earnings expected for the next 12 months, US stocks are valued higher than DAX stocks (P/E of 12.6) and companies in the Euro Stoxx 50 (P/E of 13.1), but as long as we have no reason to expect a new recession, we do not regard the valuation as alarming.

Weekly outlook for June 25-29, 2018

	Feb.	Mar.	Apr.	May	June	July	Release
DE: Ifo business climate index	104.1	103.3	102.2	102.2	102.0		June 25
DE: Ifo business expectations	100.3	100.1	98.7	98.5	98.3		June 25
DE: Ifo current conditions	108.0	106.7	105.8	10.06	105.8		June 25
DE: GfK consumer climate	11.0	10.8	10.9	10.8	10.7	10.5	June 28
DE: Inflation rate, m/m – flash	0.5%	0.4%	0.0%	0.5%	0.2%		June 28
DE: Inflation rate, y/y – flash	1.4%	1.6%	1.6%	2.2%	2.2%		June 28
DE: Retail sales, m/m	-0.1%	-0.4%	2.3%	-0.8%			June 29
DE: Unemployed, change in 000s	-21	-18	-7	-12	-4		June 29
DE: Unemployment rate	5.4%	5.3%	5.3%	5.2%	5.2%		June 29
EUR19: M3 money supply, y/y	4.3%	3.7%	3.9%	3.9%			June 27
EUR19: Business climate	1.48	1.44	1.39	1.45	1.41		June 28
EUR19: Economic confidence	114.3	112.8	112.7	112.5	112.0		June 28
EUR19: Consumer confidence - final	0.1	0.1	0.3	0.2	0.0		June 28
EUR19: Industrial confidence	8.8	7.0	7.3	6.8	6.5		June 28
EUR19: Inflation rate, y/y – flash	1.1%	1.3%	1.3%	1.9%	2.0%		June 29

MMWB estimates in red

Chart of the Week: The appeal of Micro caps



Small companies almost always do better on the stock exchanges than large ones over a relatively long period of time. The lower the market capitalization is, the higher the return. This would clearly argue in favor of investing in companies with low market capitalization, if it were not for the risk. Smaller companies are considered riskier, so the higher risk is practically the price one pays for the higher return. This consideration is relatively obvious in the first instance because small companies have less diversified business models and are thus more prone to volatility. That should apply especially to very small companies (called Micro caps). They actually do exhibit a significantly higher propensity for volatility compared with large cap stocks. The risk-return connection thus seems to obtain here. However, the situation becomes interesting when one considers the index properties of large caps and micro caps. For, in reference to Europe we find that the MSCI Europe Microcap Index exhibits less volatility than the MSCI Europe, a large cap index. At the same time, the annualized return of the MSCI Europe Microcap since 2007 is 5.15% and thus significantly higher than the 3.63% of the MSCI Europe. The reason for the low volatility at the index level in the case of micro caps lies in the low correlation among the individual stocks. For Micro caps, it is considerably lower than in the case of large caps. That is also inherently logical if one considers that many of these companies are successful niche players. An investment in a portfolio of Micro caps thus seems to make very good sense – even if the markets should become more volatile.

Market data overview

Stock marktes	As of 22.06.2018 11:47	Change versus 15.06.2018 -1 week	21.05.2018 -1 month	21.03.2018 -3 months	29.12.2017 YTD
Dow Jones	24462	-2,5%	-2,2%	-0,9%	-1,0%
S&P 500	2750	-1,1%	0,6%	1,4%	2,8%
Nasdaq	7713	-0,4%	4,3%	5,0%	11,7%
DAX	12561	-3,5%	-4,0%	2,0%	-2,8%
MDAX	26379	-2,1%	-1,7%	2,3%	0,7%
TecDAX	2801	-2,2%	-0,2%	5,1%	10,8%
EuroStoxx 50	3430	-2,1%	-4,0%	0,8%	-2,1%
Stoxx 50	3056	-1,0%	-3,4%	2,4%	-3,8%
SMI (Swiss Market Index)	8541	-1,2%	-4,5%	-2,8%	-9,0%
Nikkei 225	22517	-1,5%	-2,1%	5,3%	-1,1%
Brasilien BOVESPA	70075	-1,0%	-14,3%	-17,5%	-8,3%
Russland RTS	1127	0,9%	-5,4%	-11,2%	-2,3%
Indien BSE 30	35646	0,1%	3,0%	7,6%	4,7%
China Shanghai Composite	2890	-4,4%	-10,1%	-11,9%	-12,6%
MSCI Welt (in €)	2106	-1,9%	-0,3%	5,2%	3,0%
MSCI Emerging Markets (in €)	1080	-3,6%	-4,2%	-5,9%	-4,1%
Bond markets					
Bund-Future	163,14	198	390	526	146
Bobl-Future	132,09	41	76	145	48
Schatz-Future	112,09	9	10	19	12
3 Monats Euribor	-0,32	0	0	1	1
3M Euribor Future, Dec 2017	-0,28	2	1	2	0
3 Monats $ Libor	2,33	1	0	6	64
Fed Funds Future, Dec 2017	2,19	0	-3	9	0
10 year US Treasuries	2,92	0	-16	1	51
10 year Bunds	0,35	-6	-17	-25	-8
10 year JGB	0,03	-1	-3	1	-2
10 year Swiss Government	-0,03	0	-13	-5	10
US Treas 10Y Performance	561,27	0,3%	1,2%	0,5%	-3,5%
Bund 10Y Performance	617,23	0,7%	1,8%	2,6%	1,6%
REX Performance Index	484,82	0,2%	1,3%	1,2%	0,9%
US mortgage rate	0,00	0	0	0	0
IBOXX AA, €	0,75	-6	-7	-6	7
IBOXX BBB, €	1,53	-2	0	11	30
ML US High Yield	6,43	3	-10	-14	28
JPM EMBI+, Index	785	0,2%	-0,1%	-3,3%	-6,1%
Convertible Bonds, Exane 25	7375	0,0%	-1,4%	0,7%	-0,3%
Commodities					
CRB Spot Index	444,11	-1,3%	-0,3%	0,9%	2,7%
MG Base Metal Index	345,68	-3,9%	-2,1%	1,4%	-3,6%
Crude oil Brent	74,10	1,0%	-6,1%	6,9%	11,2%
Gold	1269,85	-0,9%	-1,5%	-4,1%	-2,6%
Silver	16,32	-1,6%	-1,0%	-1,0%	-4,1%
Aluminium	2180,50	-1,1%	-4,2%	5,9%	-3,3%
Copper	6788,75	-3,3%	-0,8%	0,4%	-5,8%
Iron ore	64,93	-0,7%	-2,9%	-9,3%	-8,9%
Freight rates Baltic Dry Index	1347	-6,8%	8,7%	20,6%	-1,4%
Currencies					
EUR/ USD	1,1661	0,6%	-0,8%	-5,1%	-2,8%
EUR/ GBP	0,8760	0,2%	-0,1%	0,4%	-1,3%
EUR/ JPY	128,45	0,1%	-1,8%	-1,6%	-4,9%
EUR/ CHF	1,1536	-0,3%	-1,8%	-1,5%	-1,4%
USD/ CNY	6,4937	0,9%	1,7%	2,6%	-0,2%
USD/ JPY	110,00	-0,6%	-1,0%	3,7%	-2,4%
USD/ GBP	0,75	-0,2%	0,7%	5,7%	1,7%

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