Helaba Research

CHIEF ECONOMIST'S COMMENT

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Markets and Trends 2018 – Update

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Four months have passed since the publication of our annual outlook for 2018 entitled "Shopping Centre – Nothing Comes For Free". In the meantime, the shop windows and displays have been rearranged a number of times, from Christmas to Carnival and Easter to Spring decorations. While the themes and motifs in shopping centres clearly only have a limited shelf-life, so far the trends that we identified for 2018 have been spot on. The general direction is right! That is why we have only made some minor adjustments to our forecasts.

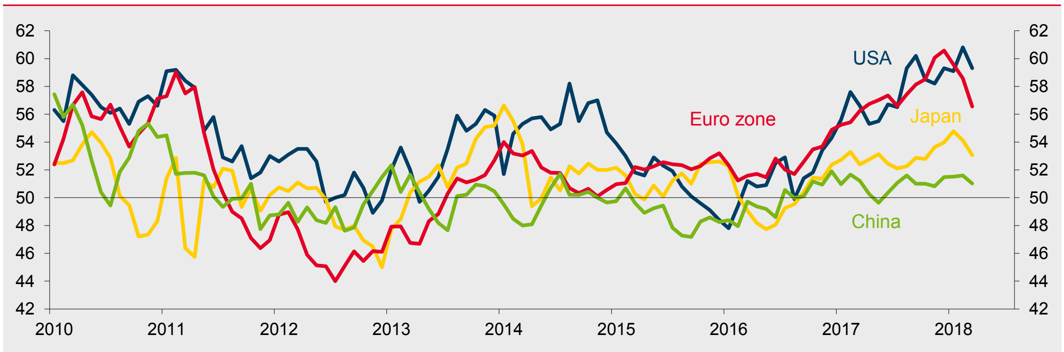
We continue to assign a probability of 70 % to our baseline scenario "shopping centre". However, an escalation in the trade dispute would have the potential of making our negative scenario "ruin" (probability 10 %) considerably more likely.

Sizeable growth – higher inflation

In 2018, the **global economy** will grow at a rate of 3.4 % and thus almost as rapidly as in the previous year. However, significant rates of growth, the prospect of which was held out by many leading economic indicators in the interim, have not materialised. One dampening factor – among others – is the debate surrounding a wave of protectionism in reaction to trade tariffs that the United States has slapped on many products.

Business confidence at a peak

Leading economic indicators in manufacturing industry, index points



Sources: Macrobond, Helaba Research

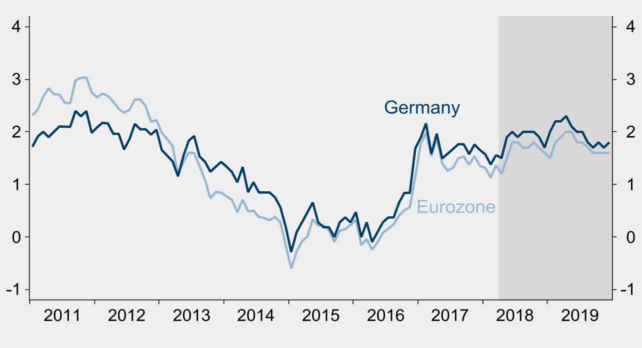
Impulses from Asia are likely to be less pronounced in 2018 than in 2017. After a period of above-average economic policy stimuli, **China** is returning to a path of slowing structural growth. Levels of debt, especially among state-run companies, have risen drastically. The Chinese real estate market remains a risk to stability. A persistently high debt-to-GDP ratio in advanced economies as well as debt financing in emerging countries, which has grown substantially in recent years, will be a burden in 2018.

For the **United States**, there are signs of a slight acceleration in average GDP growth for the year, from 2.3 % to 2.8 % (original forecast: 2.5 %). The effect of tax cuts is broadly in line with our projections, although government spending is rising more rapidly than we had forecast in the autumn. As we expected, though, the unpredictability of future trade policy under President Trump is weighing on investment sentiment.

The **euro area** and **Germany** will not be able to maintain the strong pace of economic growth they achieved in 2017. We anticipate a rise in gross domestic product, in both cases, of 2 % for this year. Consumers are becoming increasingly mindful of higher inflation rates. Moving to higher growth would require an economic policy geared towards expansion, in addition to more free trade, to counter both the demographic trend as well as the neglected infrastructure.

Consumer prices approaching ECB target

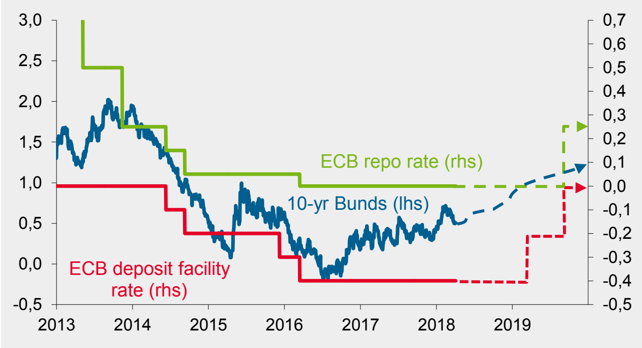
Consumer prices, % yoy



Sources: Macrobond, Helaba Research

Monetary policy: 2019 is looming large

% %



Sources: Datastream, Helaba Research

Inflation has returned

Inflation rates in many advanced countries have returned to a level of around 2 %. Labour market shortages are facilitating upward pressure on wages. This is particularly noticeable in Eastern Europe, where strong wage rises can be seen and which is also a result of a lack of skilled workers. The tide appears to be turning in the United States and Germany, too. While the rise in inflation had so far primarily been attributed to higher energy prices, core rates can gradually be expected to increase as well. In the United States, inflation will settle at a level considerably above 2 % in 2018; in the euro area and Germany, we will see a tentative shift towards the ECB's inflation target of 2 %. Consequently, there can be no more talk of "undesirably low" inflation rates.

Less expansionary monetary policy

Fed to continue interest rate hikes

A number of central banks in advanced countries will return to a policy of hiking interest rates. The **US Federal Reserve** will continue along its path of monetary policy normalisation. By the end of 2018, we expect the key rate to rise to within a corridor of between 2.00 % and 2.25 %. Furthermore, in 2018 the Fed plans a reduction in its securities holdings by year-end of around 10 %.

The **European Central Bank** has not reached this stage yet, but even it is likely to react to improvements in the fundamental economic environment. As expected, it tapered its purchase programme from a monthly volume of EUR 60 billion to EUR 30 billion at the beginning of 2018. In September 2018, the QE spending spree should finally come to an end, although this does not mean the ECB will be totally absent from the bond markets as a buyer. It will simply freeze its current holdings of securities at around EUR 2.6 trillion and replace maturing interest-bearing securities with new ones. A turnaround in interest rates will not come until 2019. We anticipate that the ECB will then raise the deposit rate from -0.4 % to -0.2 % in the spring. In the meantime, this penalty is a significant burden for banks, insurance companies and, not least, for private investors. Over the course of 2019, Mario Draghi will raise the key interest rate (main refinancing rate) from zero to 0.25 %.

Currently, the US dollar is coming under unexpectedly severe pressure from trade disputes as well as from the ballooning budget deficit. However, it is likely that the greenback will still benefit from a comparatively more restrictive monetary policy after all – even to a significant extent at times. Towards the end of the year, the euro/dollar rate should settle at around 1.20.

A wake-up call for investors

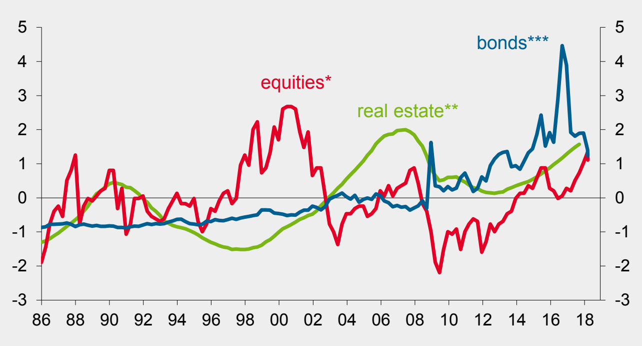
Focusing more adequately on risks

Doubt and uncertainty are words that investors had erased from their active vocabulary in 2017. The name of the game was "no matter what happens, nothing will change". This care-free attitude, which back then we believed was a dangerous illusion, has now vanished. Among other things, this is reflected in an elevated level of volatility. Just as we had forecast, a combination of geopolitics, trade disputes and emerging question marks over the state of the economy mean a return to focusing more adequately on risks.

However, the considerable surge in the valuation of equities, bonds and real estate, triggered by ultraloose monetary policy, has still not undergone any real correction yet. The upshot of this is that classic investments continue to be similarly overvalued.

High valuation across all asset classes

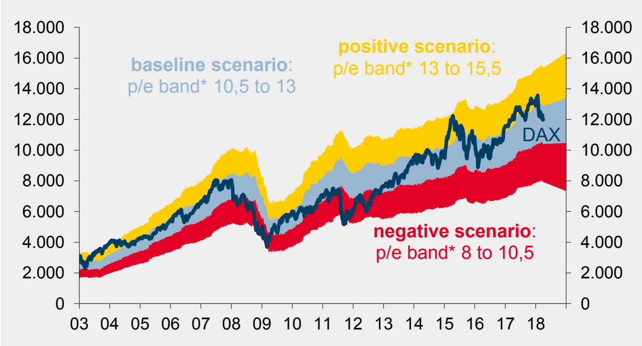
Global valuation indicators:
Difference to the long-term average in standard deviations



* price-to-cash flow ratio of global equities ** price-to-rent ratio of OECD countries
*** reciprocal of global government bond yields
Sources: Bloomberg, Datastream, Helaba Research

DAX: Back to a fair level

Index points



* based on profit forecasts for the next 12 months
Sources: Datastream, Helaba Research

Bond prices set to decline

So how should investors position themselves in this environment? In terms of **bonds**, the question of valuation is becoming more urgent in view of rising inflation. It is not very likely that investors will accept a real erosion in capital over the long term. In the course of 2018, we expect an increase in the yields of 10-year German Bunds up to 1 %. US Treasury yields with a maturity of 10 years should rise to 3 % by the end of the year. That means there is a danger of price losses. For that reason, the first choice for new investments should be in the short and medium maturity ranges.

Although the valuation of **real estate** has meanwhile also reached a high, it is able to maintain its relative attractiveness despite a pick-up in bond yields.

DAX not yet sufficiently attractive

As we predicted, the marked insouciance of **equity** investors in combination with excessively upbeat expectations for the economy and high valuations led to price corrections on equity markets in the first quarter. In fact, our price targets for the DAX and EURO STOXX 50 were reached even more quickly than forecast. Despite the correction, US stocks are still hovering at the upper end of a long-term valuation range, whereas German equities have returned to a fair price level. In light of uncertainties in relation to the trade confrontation, which is some way from being resolved, a cautious approach is advisable for the time being. Realistic assumptions for profit growth in 2018 still point to a price corridor for the DAX of between 10,500 and 13,500 points. We continue to adhere to our year-end forecast for the DAX of 12,300 points.

Gold should be on the shopping list

A combination of the high valuation of classic investment alternatives and elevated political uncertainty are propelling a continued revival in the role of **gold** as an insurance policy. Low real interest rates are also supportive for gold. Institutional investors are showing a growing interest and technical market indicators also point to a renewed upward trend. ■