Helaba Research

CHIEF ECONOMIST'S COMMENT

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Markets & Trends 2018: update HY1/2018
Much going on – nobody cares!

AUTHOR
Dr Gertrud R. Traud
Chief Economist/
Head of Research
Tel: +49 69/91 32-20 24
research@helaba.de

EDITOR
Markus Reinwand, CFA

PUBLISHER
Helaba
Landesbank
Hessen-Thüringen
MAIN TOWER
Neue Mainzer Str. 52-58
60311 Frankfurt am Main
Tel: +49 69/91 32-20 24
Fax: +49 69/91 32-22 44

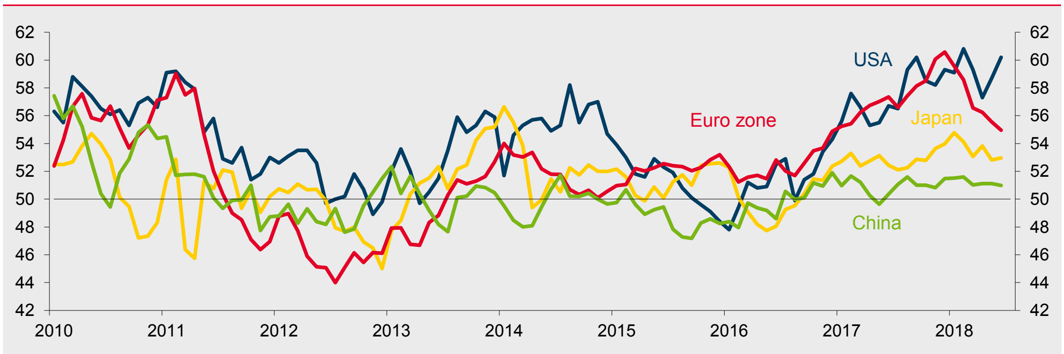
- In view of elevated political risks, we have raised the probability of our negative alternative scenario from 10 % to 15 % and reduced that of our positive alternative scenario from 20 % to 15 %. However, the key messages of our baseline scenario are still valid.
- Having lost ground in the first quarter, equities have since recovered, albeit the all-clear cannot be given just yet. On the contrary: with the trade dispute rumbling on, leading economic indicators heading south, monetary policy becoming less expansionary and stock valuations remaining high, the tendency leans towards further corrections.
- Therefore, over the next few months the DAX is likely to test the lower end of a range of between 10,500 and 13,500 points. In terms of its level at the end of the year, we stick to our previous forecast of 12,300 index points.

Respectable growth – higher inflation

In 2018, the **global economy** will grow at a similarly dynamic rate 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, will not be realised. Among other things, the fear of a wave of protectionism engulfing the world is having a dampening effect.

Economic sentiment: The United States ahead of the rest

Manufacturing PMI, index points



Sources: Macrobond, Helaba Research

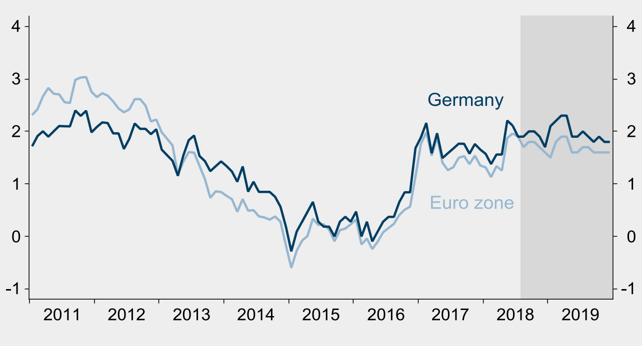
Economic impetus from Asia will be lower in 2018 than in 2017. After a phase of above-average economic policy stimuli, **China** is returning to a path of slowing structural growth. A high level of indebtedness severely restricts the potential for credit-financed expansion. The Chinese real estate market remains a risk to stability. The level of debt financing in emerging markets, which has risen sharply over the last few years, as well as persistently high debt-to-GDP ratios in advanced economies, constitute a future burden.

For the **United States**, there are signs of an acceleration in growth in 2018 from 2.3 % to 2.8 %. Aggregate demand is not only underpinned by lower income taxes but also by a stronger increase in public spending. The unpredictable nature of President Trump's trade policy, though, is weighing on the investment climate, as we expected.

The **euro area** and **Germany** will not be able to maintain the high growth rates they achieved in 2017. We expect to see a rise in gross domestic product this year of about 2 % in each case. There will only be a below-average increase in consumer spending since consumers are faced with the spectre of higher inflation. This will result in a slightly more moderate expansion in real incomes. In light of on-going political uncertainty, the growth in investment over the last few quarters is also likely to tail off somewhat. In contrast, the construction sector will continue to provide positive impulses.

Consumer prices reach ECB's target

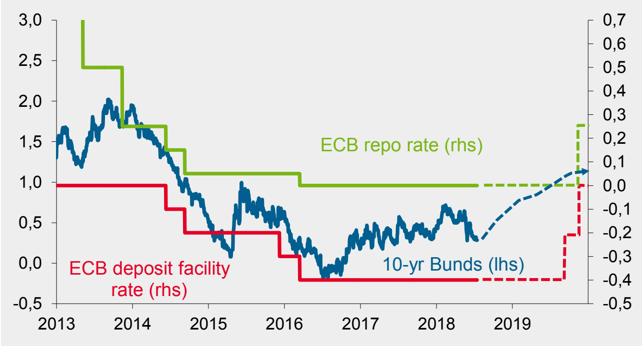
Consumer prices, % yoy



Sources: Macrobond, Helaba Research

Monetary policy: 2019 looming large

% %



Sources: Datastream, Helaba Research

The return of inflation

In 2017, **inflation rates** had already returned to a level of around 2 % in many advanced countries. Shortages on the labour market are now driving stronger wage rises. This is particularly noticeable in Central Europe where, due to a lack of skilled workers, significant wage increases can already be observed. The tables are also turning in the United States and Germany. While rising inflation had primarily been attributed to higher energy prices in the past, now core rates can also be expected to increase. In the United States, inflation has moved closer to the 3 percent-mark in 2018; in the euro area and Germany, it is hovering at around the ECB's inflation target of 2 %. Therefore, talk of "undesirably low" inflation rates is no longer warranted.

Less expansionary monetary policy

Fed to forge ahead with rate hikes

In advanced economies, some central banks will return to a policy of interest rate hikes. The **US Federal Reserve** will continue to pursue a strategy of monetary policy normalisation. By the end of 2018, we anticipate two further key rate hikes in a corridor of between 2.25 % and 2.50 %. In addition, the Fed will reduce its portfolio of securities as planned - this will also gradually diminish the rate of monetary policy expansion.

ECB also tapering its QE programme

The **European Central Bank** has not reached this stage yet, but it is also changing course: from October 2018 it will taper its purchasing programme from EUR 30 billion to EUR 15 billion per month and terminate it altogether in December. However, the ECB will remain a buyer on the bond market. After all, upon reaching maturity the securities in the 2.6-euro strong portfolio will need to replaced by new ones. Presumably, there will not be a hike in key rates until the second half of 2019. We now expect that the ECB will cut the deposit rate from -0.4 % to -0.2 % in the third quarter of 2019. Meanwhile, this penalty rate has become a significant burden for banks, insurance companies and, at the end of the day, for private investors as well. In the last quarter of 2019, the ECB will raise the key interest rate (main refinancing rate) from zero to 0.25 %.

In the meantime, the **US dollar** is benefiting from increasingly divergent monetary policy regimes. While the yield pickup and cyclical tailwind support the greenback, the Trump administration's protectionist policy is limiting its upside potential. The euro/dollar rate is likely to end the year at around 1.15.

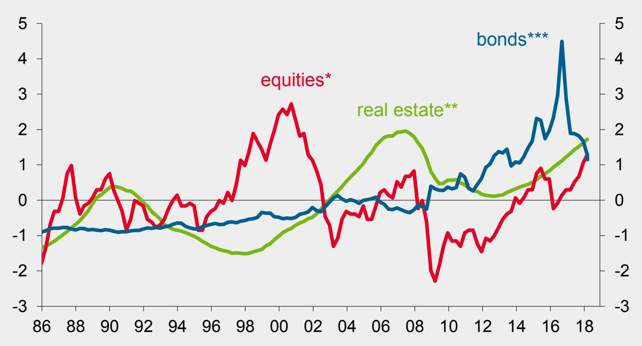
Investors still too relaxed

Risk premia at historic low

Although continuing (geo)political tensions, trade disputes and looming question marks over the economy are the subject of intense discussions among market participants, investors have so far remained fairly relaxed. Indicators such as risk aversion and implied volatility indices remain significantly below their long-term average. A correction of high valuation levels is still outstanding. The bottom line is that classic investments remain similarly expensive.

High valuation of all asset classes

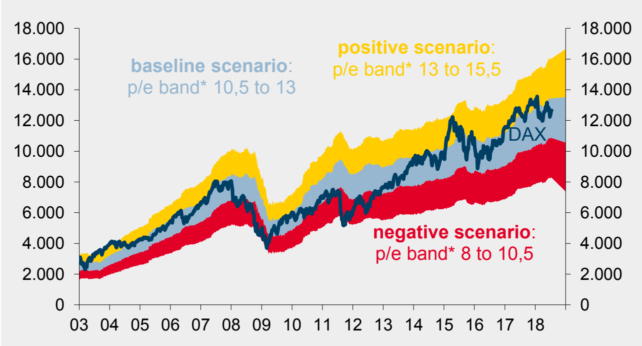
Global valuation indicators:
Difference to long-term average in standard deviations



* 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 in a fair value range

Index points



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

How should investors position themselves in this environment?

Price declines on bond market

In terms of **bonds**, the question of valuation is becoming more pertinent in view of higher inflation. In the long run, investors will not be prepared to accept an ever-increasing erosion of capital. We now expect the yield on 10-year German government bonds to rise to as much as 0.8 % by the end of 2018. Yields on 10-year US Treasuries should increase up to 3.3 % by the end of the year. Therefore, there is a danger of declining prices on both sides of the Atlantic, especially in the case of longer maturities. For this reason, shorter and medium durations should be the first choice for new investments.

DAX not sufficiently attractive yet

Meanwhile, **equities** have recovered from their price falls in the first quarter, but are not out of the woods just yet. On the contrary: with the trade dispute rumbling on, leading economic indicators heading south, monetary policy becoming less expansionary and stock valuations remaining high, the tendency leans towards further corrections. Thus, over the next few months the DAX is likely to test the lower end of a range of between 10,500 and 13,500 points. In terms of its level at the end of the year, we stick to our previous forecast of 12,300 index points.

Real estate still in demand

As for **real estate**, the high prices already seen in many submarkets are rising further. The robust demand for land continues to drive this development. In addition, the persistently low level of interest rates is stimulating investment demand. An end to rising prices is not yet in sight, despite the slight pick-up in bond yields. Thus, real estate will remain attractive for the time being.

Gold should be on the shopping list

Despite elevated political and economic risks over the last few months, **gold** suffered considerable losses. One likely reason for this is the stronger US dollar. However, this temporary decline in gold prices has almost reached a trough. Due to a renewed increase in the need for security, the gold price is likely to rise towards a level of 1,400 USD/oz. ■