M.M.WARBURG & CO
BANK

ECONOMIC SITUATION AND STRATEGY

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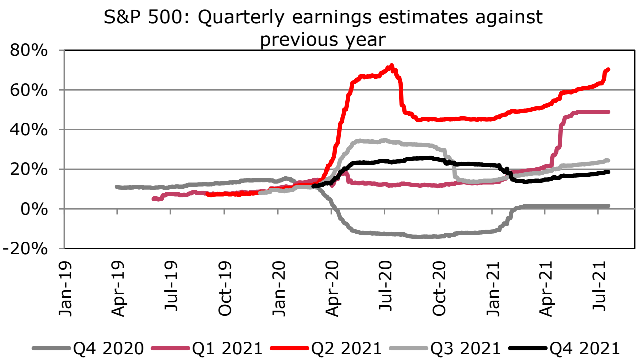
Growth Peak Reached – Bad Omen for the Stock Market?

After a brief but strong recession at the beginning of last year, the global economy has recovered continuously over the past twelve months. Impetus from monetary and fiscal policy was so strong that the vigor of the recovery surprised many investors who then greatly increased the proportion of high-risk investments in their portfolios resulting in rising stock and corporate bond prices. However, the economic boom seems to have passed its peak now. Does that mean capital markets are going to get into choppy waters?

The idea that the growth spurt passed its peak in the second quarter is based on the practice amongst economists and capital market observers of tracking economic data changes year on year. For instance, we think that US gross domestic product in the second quarter was about 12 percent above its previous year's level. The first quarter year-on-year change came to zero percent and for the third and fourth quarter we expect about six percent year on year, respectively. This should look about the same in Germany: While total domestic value creation in the first quarter of 2021 was still three percent below Q1 2020, the second quarter of 2021 should have registered almost ten percent growth year on year and then slow to four to five percent year on year in the following two quarters. Corporate profits mirror the macroeconomic data with annual growth likewise peaking in the second quarter. Corporate earnings for the S&P 500 companies should increase 70 percent year on year this reporting season (after almost 50 percent y/y growth in the first quarter). Since profit expectations are too low, the actual earnings growth in the second quarter of 2021 will probably be more on the order of 85 to 90 percent year on year. Growth in the third and fourth quarters will then slow to some 30 percent year on year.



Source: Factset

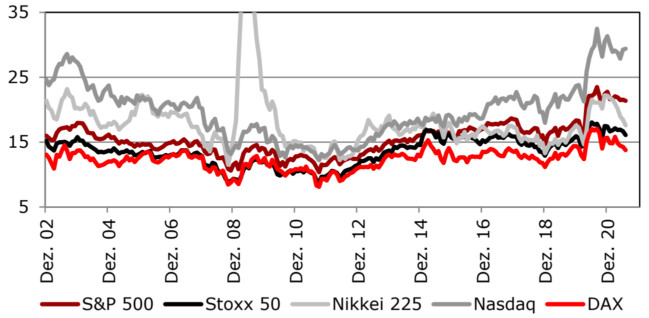
Investors should thus anticipate that year-on-year changes in most data are going to slow down going forward. Does that mean the economy is heading into tougher times and stock markets are going to be choppier? Not necessarily. As almost all economic data, GDP and corporate earnings data are strongly distorted by comparative base effects this year. The strong rates of change are not solely due to lively business and economic activity in the second quarter of this year but rather to the comparative base of the Covid slump the year before. This comparative base effect is now gradually dissolving into normalcy. While the quantitative projections of future data will undoubtedly come down, the same does not necessarily apply to the qualitative outlook. If one stepped away from the year-on-year perspective and rather looks at quarterly or monthly changes, the good times need not be over after all. We expect quarterly GDP growth in the US and Germany to remain above average until at least the middle of next year. The positive effects of expansive economic policies will probably hold until the beginning of 2023 when economic data will begin returning to “normal”.

Skeptics may argue that the pronounced yield decline of US and European government bonds in recent weeks signals that the reputedly more prescient bond market is anticipating a markedly more negative economic outlook scenario. The yield on ten-year US government bonds, for instance, has dropped from 1.75 precent this spring to nearly 1.20 percent at present. Ten-year Bunds now yield merely -0.40 percent after -0.10 in May. In light of much higher inflation and the possibility of central banks moving away from the expansive monetary policies sooner than expected, this may be quite surprising at first glance. However, both the Fed and the European Central Bank have repeatedly pointed out that they consider high inflation a temporary phenomenon related to comparative base effects that does not require immediate monetary policy intervention. Interest rates will therefore remain very low for the time being on both sides of the Atlantic.

We do not think that there is a major risk of renewed restrictions in personal freedoms with correspondingly negative economic impact due the spreading Delta variant. According to current epidemiological data, the new Covid variant is significantly more infective than the wild type and vaccinations are not entirely protective. However, it seems that vaccinated people have only mild to moderate symptoms similar to the common cold. All this suggests that new infections will rise in the near future but hospitalizations and in particular intensive care admissions will not be overly straining capacities. We are no medical experts, but it seems that Covid has come to stay while its socioeconomic impact will wane with increasing vaccination rates.

All these considerations lead us to conclude that the prospects for stock investments will remain favorable for the second half of the year. This does not mean that the stock market with remain on the same straight path at the same speed as it did in the past 12 months. There is always a risk of market setbacks. We do not see many investment alternatives with comparable value growth prospects, though. We must caution our readers that on the capital markets greater opportunities come at higher risk. That is and always has been the case. Moreover, thanks to good corporate earnings development, the relatively high valuations of many stock markets has come down a bit. The DAX P/E has dropped from 17 in July 2020 to just under 14 recently. That makes the German stock market compared to both its own history and relative to other indices favorably valued. This is not yet true of US stocks, even though the S&P 500 and NASDAQ P/Es have come down a touch since the beginning of this year they still are above their averages for the past few years.

P/Es since 2003



Source: Factset

Market data

Stock marktes	As of 23.07.2021 10:30	Change versus 16.07.2021 -1 week	22.06.2021 -1 month	22.04.2021 -3 months	22.07.2020 -1 year	31.12.2020 YTD
Dow Jones	34823	0,4%	2,6%	3,0%	28,9%	13,8%
S&P 500	4367	0,9%	2,9%	5,6%	33,3%	16,3%
Nasdaq	14685	1,8%	3,0%	6,3%	37,2%	13,9%
DAX	15599	0,4%	-0,2%	1,8%	19,0%	13,7%
MDAX	35086	1,8%	2,5%	6,7%	28,1%	13,9%
TecDAX	3658	1,3%	4,1%	3,6%	15,3%	13,9%
EuroStoxx 50	4082	1,1%	-1,0%	1,7%	21,1%	14,9%
Stoxx 50	3535	0,2%	-0,4%	3,8%	15,5%	13,7%
SMI (Swiss Market Index)	12052	0,2%	0,6%	7,4%	15,4%	12,6%
Nikkei 225	27548	-1,6%	-4,6%	-5,6%	21,1%	0,4%
Brasilien BOVESPA	126147	0,1%	-2,0%	5,7%	21,0%	6,0%
Russland RTS	1598	-0,3%	-2,9%	6,4%	27,4%	15,2%
Indien BSE 30	53053	-0,2%	0,9%	10,3%	40,1%	11,1%
China CSI 300	5089	-0,1%	-0,6%	0,0%	7,9%	-2,3%
MSCI Welt (in €)	3047	0,9%	2,5%	6,6%	28,6%	18,0%
MSCI Emerging Markets (in €)	1326	-0,8%	-0,6%	1,1%	21,0%	7,0%
Bond markets						
Bund-Future	175,94	107	399	500	-99	-170
Bobl-Future	135,04	35	108	13	1	-14
Schatz-Future	112,28	8	16	18	16	0
3 Monats Euribor	-0,55	2	2	2	-9	4
3M Euribor Future, Dec 2017	-0,53	0	-2	1	-3	0
3 Monats $ Libor	0,14	0	0	-4	-13	-10
Fed Funds Future, Dec 2017	0,08	-1	-1	-1	10	0
10 year US Treasuries	1,28	-2	-19	-27	69	37
10 year Bunds	-0,41	-1	-20	-11	12	17
10 year JGB	0,02	2	-3	-4	1	0
10 year Swiss Government	-0,37	-5	-18	-12	11	12
US Treas 10Y Performance	705,17	0,3%	2,0%	3,2%	-3,9%	-1,5%
Bund 10Y Performance	679,17	0,6%	2,5%	2,0%	-0,2%	-0,8%
REX Performance Index	497,62	0,2%	0,9%	0,9%	-0,1%	-0,3%
US mortgage rate	0,00	0	0	0	0	0
IBOXX AA, €	0,13	-5	-16	-9	-9	11
IBOXX BBB, €	0,50	-5	-19	-15	-56	-5
ML US High Yield	4,60	0	-3	-16	-156	-38
Convertible Bonds, Exane 25	8319	0,0%	-0,8%	-0,5%	7,9%	-0,1%
Commodities						
MG Base Metal Index	428,30	-0,6%	3,3%	3,9%	43,6%	20,8%
Crude oil Brent	73,61	-0,1%	-1,7%	12,4%	66,0%	41,9%
Gold	1805,50	-0,4%	1,4%	1,2%	-2,8%	-4,9%
Silver	25,35	-1,5%	-1,6%	-3,3%	13,0%	-3,9%
Aluminium	2468,50	0,0%	3,0%	4,4%	49,2%	25,1%
Copper	9417,78	0,3%	1,5%	0,0%	44,8%	21,5%
Iron ore	213,81	-2,7%	0,2%	21,2%	97,9%	37,2%
Freight rates Baltic Dry Index	3103	2,1%	-0,5%	12,8%	110,7%	127,2%
Currencies						
EUR/ USD	1,1779	-0,2%	-1,0%	-2,2%	1,7%	-4,0%
EUR/ GBP	0,8578	0,2%	0,3%	-1,2%	-5,8%	-4,2%
EUR/ JPY	130,08	0,0%	-1,1%	-0,2%	5,0%	2,8%
EUR/ CHF	1,0830	-0,2%	-1,0%	-1,9%	0,4%	0,3%
USD/ CNY	6,4756	0,0%	-0,1%	-0,2%	-7,5%	-0,8%
USD/ JPY	110,16	0,1%	-0,5%	2,0%	2,8%	6,7%
USD/ GBP	0,73	0,5%	1,4%	0,9%	-7,3%	-0,4%

Source: Refinitiv Datastream

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