CONCEPT
VERMÖGENSMANAGEMENT

Economic Nationalism

Prospects for 2019

Economic Nationalism

"We see opportunities for profits in some areas. These are completely offset by major global risks. At the moment, we do not feel, that market participants are sufficiently aware of the risk potential". So read the short summary in our Summer 2018 report. In the meantime, more and more market participants are developing an increasingly critical perspective and a stiff breeze is now blowing onto the stock exchanges from head on. Regrettably, the risks we mentioned at that time have thus far not gone away. Whether these are now being reflected in stock market quotations is precisely what we will be discussing herein.

As those of you who scan read already know, we normally make a short summary at this point. This particular one reads: "Sorry, but in the big picture, we are not able to spot any all-clear sign whatsoever". The effects of the paradigm shift, which has taken us from continually falling interest rates back to more restrictive financialconditions, are difficult to assess. In combination with declining levels of confidence in the political actors, there remains a great deal of uncertainty about whether any of the possible scenarios could actually take place. It is commonly known that uncertainty is the greatest enemy of the stock markets. An extremely cautious approach would therefore seem appropriate.

Stock markets in retreat

2018 was as challenging a year as any we've seen over the past 50 years.

The year we are leaving behind was an extremely demanding one. One must go back 50 years, in order to find a comparable period, in which almost every asset class worldwideturned in a negative performance. For a long time, the American share markets were still showing a plus, but finally in October even these began to reveal their weaknesses. By the end of the year, all the major stock exchanges were clearly in the minus[1] and even four-year federal bonds would have only brought in zero percent.

Nevertheless, we continue to read forecasts, which claim there is still no sign of an impending recession, and no reason to suspect a fall back in corporate profits. As we wrote at the half-year stage, markets tend to extrapolate forwards immediately after glancing in the rear-view mirror. But this limited perspective narrows the field of view, so that the dark around the edges is barely noticeable. Only very rarely have recessions shouted "Look out, I'm coming!" before they actually materialise. On the contrary, they often seem to appear as if from nowhere and then in hindsight explain themselves in terms of an earlier downturn in the share markets.

Economic slowdown

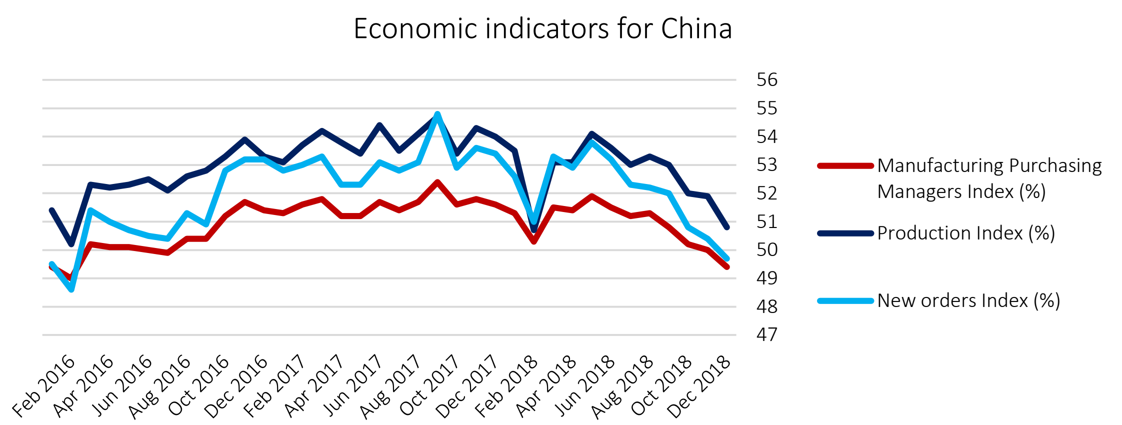
In actual fact, the harbingers of slowing growth are immediately recognisable. One of the very useful preliminary indicators are the so-called purchasing manager indices (PMI). The PMIs which, with the exception of China, lie in the world's most important regions, are all reading in excess of 50 and, therefore, still signalling no recession; but those in Europe are currently hitting a fouryear low and the trend is accelerating. Even as late as November, there were only minor adjustments to expectations in the USA, where - thanks to the major tax

[1] The US stock market barometer S&P 500: - 8 %, Euro Stoxx 50: - 15 %, DAX - 19 %

Recessions are born out of the fear which they themselves create.

reform at the beginning of 2018 - corporate profits rose sharply over the past year. In December, however, PMI expectations fell by five points and in so doing marked the sharpest decline since October 2008. In Germany and in Japan, no growth in gross domestic product has been recorded since the 3rd quarter of 2018. However, the biggest growth gap could be in China, where the early indicators are developing very clearly in a southerly direction. In all, 114 months have now gone by since the beginning of the current economic upturn, and although many economists and economic researchers are avoiding use of the "R-word" in their forecasts, it is already the word on everyone's lips. It is impossible to escape the phenomenon of self-fulfilling prophecy and so the coming recession will ultimately be born out of the fear created by the thought of it actually happening. Maybe we have already slipped into the recession process; maybe that process is simply dragging itself out.

Cloudy prospects for China



Graph 1 *Source: China National Bureau of Statistics*

The main risks are those of a trade dispute, the onset of a monetary policy and economic instability.

As investors and asset managers, we actually see these risks in an escalation of the trade dispute, in excessive tightening by the US Federal Reserve, and in a worse than anticipated slowdown in economic activity. In the worst case scenario, the aforementioned risks could occur at the same time and the weaknesses of the stock markets since summer 2018 could then be explained in hindsight as the firstignition of a severe economic downturn. On the other hand, none of the above-named risks are tangible or verifiable with any concreteprobability of occurrence. In this respect, opportunities for the stock markets would arise if, for example, a constructive solution to the disputes between China and the US could be found, or if the US Federal Reserve were to row back more quickly and more strongly than expected, or if the first harbingers of recession were to simply evaporate again in 2019.

Economic Nationalism

Where the signs of weakness become visible, the causes are usually both domestic and geo-strategic. The latter were unfortunately born out of the lost opportunity to clarify and resolve the emerging trade dispute at the G20 summit in Argentina, rather than leaving it until the end of March 2019. Whenever levels of confrontation are maintained, albeit temporarily, those economic actors, who need to plan their supply chains over the long term, not only become extremely uncertain, but also delay those investment decisions. Since there is little rationality to a trade dispute, let alone a trade war, the degree of uncertainty is even greater. China is not only the major foreign buyer of American government bonds, it is also America's third largest and fastest growing export market. America also relies on those cheap imports from China, which help consumers on low incomes make ends meet financially. The misery of these consumers is likely to increase, if one half of all American imports from China is going to be subject to a 25% price increase in 2019.

There is no rational explanation for a trade dispute.

Protecting domestic jobs from foreign competition cannot be used as a convincing argument to explain the conflict which has now broken out. If Trump wanted to learn something from the experiences of his predecessors, it would be that newly-created jobs in the various sectors were offset by redundancies in their respective downstream industries. Trump's current trade policy threatens to weaken the US economy over and over again; it will not lead to any reduction in the trade deficit. If it were really "only" about the economy and a reduction in the trade deficits, America would have to become more competitive - i.e. moreefficient - or simply consume less. The US has traditionally always lived beyond its means. Americans consume more than they produce and generate a four-percent budget deficit each and every year, which is largely financed by the country's exporters.

CHINA'S CENTRAL MEANING

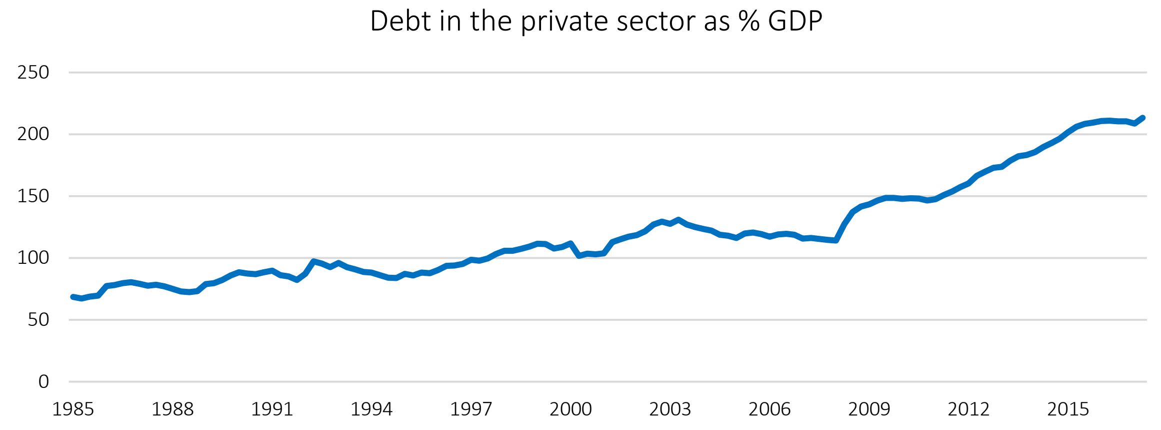
China's aims of territorial expansion are influencing America's security strategy.

Obviously, the conflict with China is by no means all about the economy, competition and tariffs. It has been clear for some time, that the primary challenge to America's national security strategy is no longer the fight against terrorism, but competition with China (and Russia)[2]. It is about nothing less than the question of how China's recapture of territorial supremacy can be prevented. With its OBOR initiatives[3], China is working to once again secure much greater influence in Eurasia, the Indo-Pacific region and Africa. For America, this particular scenario could in no way be permitted, even if there were to be a resolution of the trade dispute. For China, however, Trump's disturbing influence is coming at precisely the wrong time, because the desire was to concentrate on strengthening domestic growth, whilst at the same time pursuing debt reduction and reorganising the financial system. The trade dispute is now affecting growth and weakening the OBOR project. If China is not prepared to put up with this, it will be forced to increase lending, possibly provide more liquidity and allow still greater levels of debt. Since the private sector is already indebted to 215% of GDP, it would seem that, on the one hand, a natural limit has been set. On the other hand, however,

[2] http://nssarchive.us/national-defense-strategy-2018/

[3] Since 2013, the "One Belt, One Road" (OBOR) project has been focusing China's aims of creating and expanding inter-continental trade and infrastructure networks between the People's Republic of China and more than 60 countries in Africa, Asia and Europe.

China: little room for further debt



Graph 2 *Source: Bank for International Settlements*

China's weakening economic situation could revive memories of the 2015/16 crash.

any new loosening could accelerate the already emerging weaknesses of the yen and with undesirable consequences: by the start of 2016, the Chinese currency had already fallen from its 2014 high by 10% with respect to the USD. Together with growth concerns, this contributed to a fall of almost 50% in stock market prices in China and, beginning in November 2015, dragged down the other global stock markets over the following three months (USA -13%, Japan and Germany -25%). Even in 2018, the yen fell by a further 10%, and the Chinese economy is now facing economic challenges: retail tradeis now growing more slowly than at any time in the last 15 years. Carsales - China accounts for one-third of all new vehicles sold globally - have recently fallen back by around 16%. And industrial production is lying at a three-year low. All of this is having a knock-on effect in other parts of the globe. There is, of course, a high level of correlation between China and the rest of the world; America is no longer the world's economic engine, having long since lost this role to China. In 2018, America's GDP will be around USD 550 billion larger than in the previous year, whilst China's will have grown by some USD 720 billion. If the "Middle Kingdom" were now to change down a gear, for the rest of the world it would feel as if China had slammed on the brakes. And, last but not least, the constructive behaviour of all participants in trade disputes is, of course, desirable.

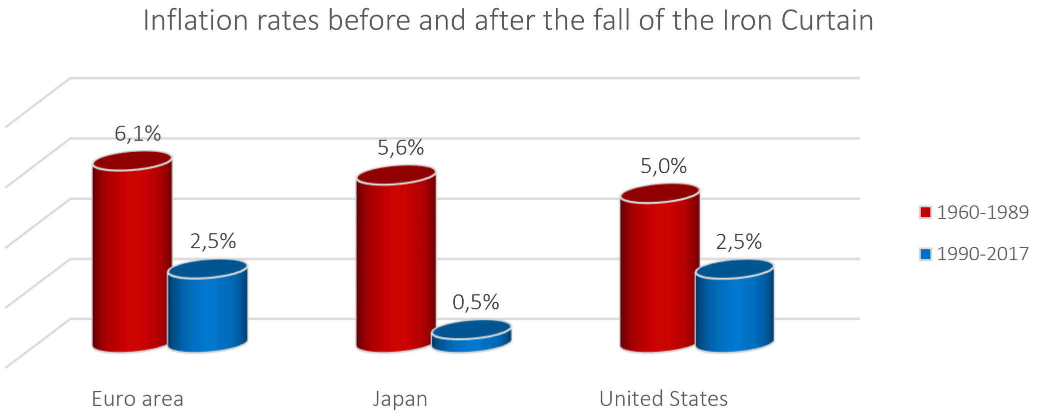
We First

So far, however, this doesn't appear to be happening. In fact, the cry we hear, not only from America, but also from China - and indeed, from England, Italy and Russia to name just a few - is "We first!". In the face of the global challenge of having to reduce the burgeoning mountain of debt by means of funding costs, which are now very much on the rise, it would be good to see politicians reaching out to each other with a willingness to adopt concerted measures to counter the threatened slowdown. Instead, all we are seeing is national egoism and an unconcealed desire for political confrontation for which the achievements and alliances developed over decades are now being sacrificed. This is all the more alarming, because it is happening at a time when the volumeof global trade by comparison to world GDP is already declining sharply. For it is not only the end of the interest-rate paradigm that must be confronted, but also the fracturing of international politicalnetworks that have been in place since the fall of the Iron Curtain. America's rejection of strategic alliances, demonstrated not least in its withdrawal from Syria, is a further destabilising factor that must be taken into account by the stock exchanges.

Globalisation is one of the reasons for prices having stayed low over a period of many years.

The fall of the Iron Curtain resulted, not least, in a quickening of globalisation, the coming into being of new sales markets and, in many emerging countries, a new middle class with rising incomes and a higher standard of living. By extending the value chain, competitive suppliers accelerated the pace of innovationand this has been the main contributing factor to the long years of low global inflation. Since the beginning of the 1990s, inflation rates in the industrialized countries have fallen by at least 50%. If, in the near future, the global economy is paralysed by a trade war and the differentiated supply chains are fragmented into economicand diplomatic detail work around the globe,

Globalisation with a de-inflationary effect



Graph 3 *Source: Weltbank*

the resulting fractures would then have to be bridged by "short-cuts". This would exclude a significant number of economic entities from the global supply process (not least the US). And, at the same time, the fragile model of globally-balanced cost optimisation would collapse and inflation could rise sharply. Experience has shown, that whenever costs and prices rise, consumption falls and there is a reduction in the supply of goods and services. Expectations based on the popular belief that the present historically-high margins can be maintained or increased would then no longer be tenable.

INTEREST RATE RISKS

Against such a background, it is less than comforting, when the world's most influential politician opens up another front, declares "his" central bank to be bonkers and orders it not to make any further errors. After the governors of the central bank had been exposed to his very public attacks, no one wanting to forecast the decision on interest rates to be made in December had to do much thinking outside of the box. And so, one week

The FED is signalling caution with regard to further decisions on interest rates.

before Christmas, the FED - not least for the purposes of proclaiming its independence - reset interest rates for the ninthtime. By definition, the central bank prefers to make its decisions according to the situation, rather than on the basis of a guideline founded upon perspectives. This represents a practical alternative to actions carried out previously by Bernanke and Yellen[4], but makes any assessment of impending decisions on monetary policy a lot more difficult. Against the background of potential inflation, arising from full employment, massive tax reductions and, not least, an escalation of the trade war, the increase in interest rates made by the FED in December is understandable. The interest rate increases should probably have been made earlier, since that would have dampened the boom that is now taking place in the USA. In the past, it has often been noted, that the central banks are reluctant to put up interest rates in the first instance, and then tend to keep them high in the wake of the boom. It is the declared aim of the FED not to make another mistake, as was confirmed at the recent press conference, so instead of three rate increases in 2019, there will now only be two. At the same time, however, the US Federal Reserve will shorten its balance sheet by a further USD 600 billion, after having given a good USD 380 billion back to the market in 2018. Under these circumstances, it would be difficult for the minister of finance to bring a trillion dollars of new debt (twice as much as in 2018) onto the market, without this leading to rising interest rates.

DEBT WITH DISRUPTION POTENTIAL

Due to high prices in the USA, the level of government debt is now soaring.

This - against the background of the global debt mountain, which starting from a level of 70 billion USD in 2000, stood at more than 150 billion USD before the start of the crisis and has now reached 250 billion USD - is not a particularly good sign. In America, government debt is growing exponentially. This growth is financed at the pump and only because of that is greater, for example, than the debt level in Europe. An annual growth quota of 2.5% is being financed with a permanent 4% deficit (i.e. new debt levels year on year). The level of debt continues to grow, even though the economy is booming, full employment reigns and companies are doing well. Daily borrowing in the USA has risen from USD 1.2 billion to USD 2.7 billion over the last three years. An economic downturn in the USA could therefore be more painful than in comparable phases. Overall debt in relation to GDP is as high now as it has ever been since the end of the Second World War and, according to IMF estimates, will overtake Italy's debt during the next five years.

In Europe, it appears that the road to achieving noticeably rising interest rates is still rather long. Europe's central banks are all expected to keep their interest rates low in 2019. Nevertheless, Europe remains challenged: although there has been a learning curve for Italy since our last report, because the market was so much in need of clear mark-ups in interest rates, the government was forced to give in and agree on a compromise with the EU. However, it is now France - under pressure from the streets - which is stepping out of line. The sedatives currently being administered to the yellow vests are so expensive that they have increased the budget deficit from 2.6 to 3.2%. It is astonishing that no comment is being made

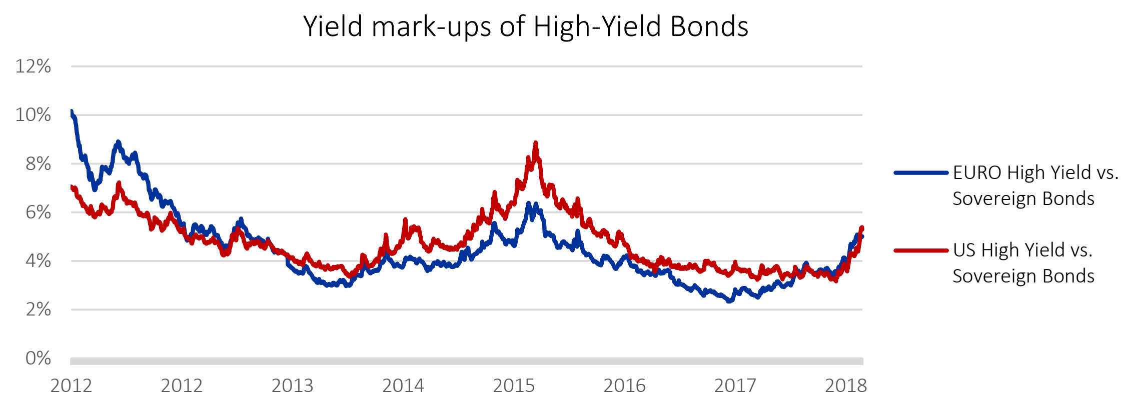
[4] Bernanke was Head of the US Central Bank from 2006 to the beginning of 2014 and was replaced by Janet Yellen, who was in turn succeeded in February 2018 by Jerome Powell.

in the EU despite this infringement of the provisions of the Maastricht Treaty. Yet again, a case of double standards. It should be remembered that Germany was the guilty party when the rules were first broken in 2005. And the lack of discipline and consistency affecting the EU to this day can be traced back to that first bad example. This is one reason why the UK does not want to deviate from its Brexit experiment despite the serious difficulties it is experiencing with implementation and the threat of a hard landing.

Bad debtor quality harbours the risk of a cascade of worsening financing conditions and payment defaults.

But it is not only states that are in debt, companies are also affected and to a greater extent than ever before, whilst solvency among debtors continues to decline. At the beginning of the millennium, only 6% of all the corporate bonds were given the "least advisable" BBB rating. That figure is now almost 50%. Sharply and/or rapidly rising interest rates can quickly cause a domino effect: following the first payment defaults, any remaining bonds would be downgraded and result in higher interest rates for the companies affected. This would in turn cause further business models to fail and lead to new defaults. The first signs of such a toppling are already visible because the risk premiums for poor quality issuers have taken off during the last six months and have now reached their highest level in two and a half years. If this trend continues, bond holders will sooner or later come under increasing pressure to sell into an unreceptive market. This is because, due to the last crisis, the capital requirements for banks and brokers were intensified to such an extent that these players have almost completely withdrawn from the bond market.

And risk premiums for bad debtors are edging upwards.



Graph 4 *Source: US Federal Reserve Board (FED)*

The US corporate bond holdings of US banks and brokers have been atomized from 10% to just 0.3% during the last 15 years, whilst the bond volume itself has doubled to approximately USD 9 billion. As a result, banks have largely been eliminated as market makers, which calls into question how pricing can be guaranteed as orderly and fair when the bond market is under pressure.

MARKETS ARE REACTING NERVOUSLY

The potential for disruption inherent in the bond market should not be underestimated. Many analysts and economic research institutes see the real bubble in the lending volumes of bad debtors inflated by long-term low interest rate policies. It is very likely that current levels of US debt would not be sustainable in a recession. And it cannot be ruled out, that it is this consideration, which is contributing to the increasing nervousness on the markets and that the financing conditions for companies are already beginning to deteriorate noticeably. Oil prices are also sending out a warning signal. Indeed, the fall in prices is being caused by the peaks in output achieved as a result of America's development. But this alone cannot account for the pace of that fall which has seen prices dropping by some 40% during the last three months.

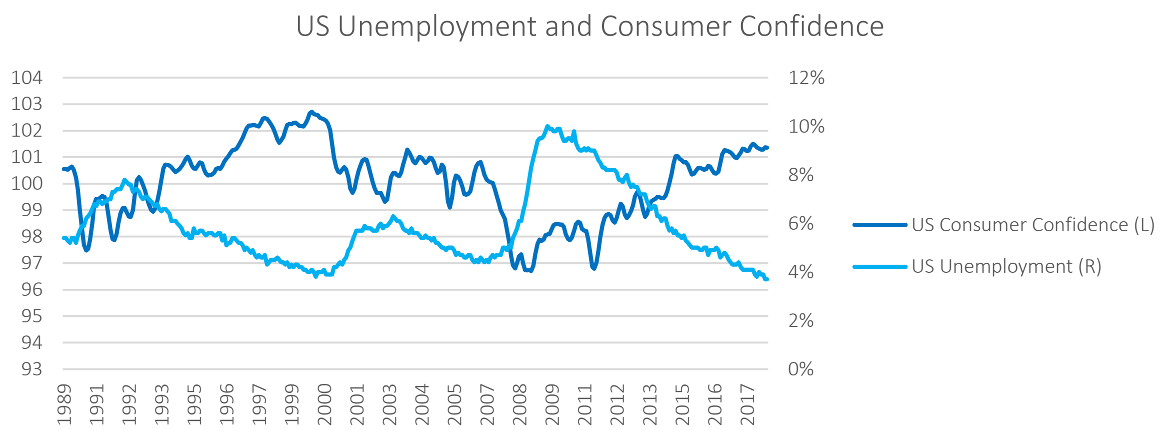
Historically, the share markets are always well capitalised.

In spring 2018, the market capitalisation of globally-listed equities once again exceeded the total volume of world gross domestic product. This last happened in the years 2000 and 2007 and in each case reflected the degree of over-optimism which prevailed following a period in which stock markets had performed well. Over the past few years, market participants have been conditioned to assume that even when smoke is rising, there will be no fire for a long time afterwards. On the contrary, weak phases were always seen as purchasing opportunities and it was the hesitant who would be the ones to suffer at some later point in time. The returns on reductions in price are apparently no longer self-evident. We should not negate the possibility of developing a new pattern in which medium-term price recoveries are used to avoid greater losses.

NO SHADE WITHOUT LIGHT

Once it is clear that the markets have in part been corrected, we should - in an attempt to develop satisfactory forecasts - consider the option of looking at the future from the gloomiest and most pessimistic perspectives. Since unemployment rates are still falling back, consumer confidence in the USA - the world's largest consumer market - has continued to increase and, in many places, PMIs are still in the so-called

Full employment raises consumer mood



Graph 5 — *Sources: FED, US Bureau of Labour Statistics* "growth area". Even with the earlier mentioned interest rate structure curve lying close to the zero point, it has not yet become inverted. The growth trend could possibly therefore continue, the sharp drop in the price of oil at most bringing about a reduction in costs and putting inflationary pressures into perspective, and this would in turn enable a less restrictive monetary policy. This would slow the current trend towards rising interest rates which, in turn, would then favour the share markets. These could become "oversold" following the earlier price corrections and the weakest hands may therefore already be "outside". There is potential therein for a longer-lasting price upswing, which will outlast a strong January, during which risk budgets are replenished. Last but not least, these feuds could be resolved around the trading conditions - or at least clarified in a constructive way - which would in any case be appropriate in the interests of stimulating growth.

Risks could also be over-estimated and growth can go to extra time.

Conclusions

Forecasting uncertainty is currently running high. Forecasting uncertainty is high, because the foreseeable consequences of the decision-making options currently on the table are diametrically opposed one to the other, like fire and water. The emotional state of many of the political actors also makes it impossible to estimate with any reasonable probability the direction into which pent-up tensions will be discharged.

It would seem obvious for the markets to have already compensated for part of the current uncertainty surrounding falls in valuation, but this has not yet happened in all market sectors. And so, in America, the country which defines the market, the drop in prices on the stock exchanges is still modest. An asymmetrical opportunity/risk ratio exists, in that, should developments turn out to be unfavourable, the greater part of the downturn - in that case driven by the US markets - could still be imminent, whilst in the favourable case, a strong and sustainable upswingin prices would disguise the fact that the stock markets have already been running a ten-year marathon. Consequently, the high level of forecastinguncertainty which currently prevails makes a cautious approach advisable.

The high levels of forecasting uncertainty are leading to cautious investment behaviour.

It is already becoming clear that 2019 promises to be an exciting year on the stock markets because increased volatility always offers opportunities to use the hectic price fluctuations in a tactical way. On the one hand, many securities are now so cheap that they have already become a lot more attractive. On the other hand, sector rotation brings with it incipient digitalisation, which will strongly favour some industries in the long term. It is in periods of adjustment that interesting market sectors and regions are often identified. Those securities, which are based on less economy-sensitive business models remain attractive, although even some of these are already recording considerable price reductions.

During the first half of the year, continuation of the price down-swing is a distinct possibility. At the same time, there are some indications that this phase will allow the rebuilding and expansion of shareholder engagement in order to secure long-term share development. Bonds continue to look only moderately attractive, especially in Europe. When uncertainty rules, people head for safe havens. The price of gold rose by 8% in the last quarter of the year and, in so doing, stabilised investments. Should economic or political factors continue to deteriorate, this could also drive demand in 2019 and gold may experience a renaissance as the safest bet in a crisis.

Bielefeld, 7th January 2019
Matthias Steinhauer