

Investment Insight

September 2018

Bloodless recovery

The IFO Business Climate's strong rise stirs up false hopes. This is because growth is slackening in Europe and China. If the American economy and stock market also weaken, we could see a significant correction globally.

The IFO index created a sensation last week. After a series of disappointments this year, it began a powerful countermovement in August. The barometer improved by 2.1 points to 103.8 – its largest monthly rise in three and a half years. The recovery in business expectations was particularly impressive. These leapt by 3.0 points (101.2 points following 98.2). The improvement in the assessment of the business situation, by contrast, was not quite so strong (106.4 points following 105.3).

Sector results show the reasons for the unexpected rise. To start with, the construction sector was a huge surprise – and not for the first time this year. Contrary to the trend in all other sectors, sentiment in the construction industry has improved noticeably since the start of 2018. In July, the IFO Business Climate in fact recorded the largest monthly rise for the construction sector of all time (+8.0 points). A countermovement in August seemed likely. Instead it continued its upward trend (+2.5 points) and in construction, the business climate saw a new all-time high.

The euphoria in the construction sector is now also spreading to other sectors – service sectors close to the construction trade in particular are benefiting. These include service providers in the field of real estate and housing (estate agents, property managers), architects, engineering firms and leasing companies. These areas strongly boosted the service sector's business climate in August. It

leapt from 26.7 points to 32.3. Due to the high weighting of the service sector (50%), this movement alone explains 80% of the rise in the overall IFO index. The improvement in the manufacturing industry is significantly smaller and is primarily concentrated on business expectations. The *Trump-Juncker* deal was announced immediately after the closing date of the preceding IFO survey. The automotive industry was particularly threatened by additional tariffs – accordingly, the relief was felt most strongly here.

German industry faces severe headwind overall

We see the latest rise in IFO expectations as merely a temporary phenomenon. Although the possible agreement on a revision of the NAFTA agreement might improve sentiment again, German industry continues to face a severe headwind from elsewhere. In addition to the slowing expansion in China, numerous important markets are contending with problems (the UK, Italy, Turkey, Russia, South America etc.). In addition, companies are complaining more about growing cost pressure (wages and prices of raw materials). Finally, punitive tariffs are already in force in the trade conflict between China and the USA.

The positive surprise in the IFO Business Climate is no coup for the Eurozone either. Most other national business climate indicators moved sideways or even downwards in August. The »economic confidence« calculated by the European

Commission has stabilised in Germany. In France, Italy and Spain, however, the barometer hit new cyclical lows. Italian industry in particular is suffering from the global economic slowdown and the uncertainty about future national economic policy. We therefore expect GDP growth in the Eurozone to weaken again in the final quarter after a bloodless recovery in the 3rd quarter.

In the USA, by contrast, the economy's revised GDP figures also bear testimony to robust growth in the 2nd quarter. The growth rate was revised upwards from 4.1% to 4.2%. Exports increased significantly prior to China introducing import tariffs in July (+9.3%) and thus appreciably boosted GDP. On the other hand, a decrease in stocks had a powerful dampening effect. The latest activity data for July now confirms the expectation that these effects will reverse in the 3rd quarter. The trade deficit widened significantly in July according to initial estimates. With exports 2% lower and imports 1% higher, the negative balance increased to USD -72.2 billion, which should noticeably curb GDP growth in the current quarter. By contrast, however, warehouses are filling up and consumption appears to be a stabilising element. In July, spending by private households increased by 0.4%, a trend that is likely to continue until into September. Not least the robust development of consumer confidence is also suggestive of this. The Conference Board's monthly indicator marked a new 17-year high in August at 133.4.

In line with the encouraging GDP result in Q2, corporate profits have also developed positively. In comparison to the previous year, they increased by 7.7%. Earnings after tax look even better. The annual growth rate climbed

to 16.1% thanks to *Donald Trump's* tax cuts. In future, however, the gains are likely to be smaller again. Following the latest interest hikes, we see tighter financing conditions as the key dampener. If economic growth weakens in the next few quarters, the increase in corporate profits is also likely to decrease.

The S&P500 and the NASDAQ are far ahead of the rest of the world

However, growth is still intact and the US stock exchanges' upturn is not coming to an end. The S&P500 and the NASDAQ have reached new all-time highs again and are far ahead of the rest of the world, where indices are hovering around the zero line (Europe, Japan) or are deep in the red (emerging markets, especially China). A driving factor for US investors' good mood was the news at the end of August about the agreement in the trade conflict between the USA and Mexico.

In our view, however, the trade issue is not at all key, because there will probably be agreement in the end. The problem rather is decreasing economic impetus, which, for example, can be seen in the decreasing liquidity growth. The monetary aggregates have not expanded this slowly on average since before the start of the financial crisis. This is normally reflected in asset prices with a time lag of six to twelve months. Together with the technically overbought overall situation in the USA and the extremely poor market breadth (only a few equities are driving up the indices), there are more and more indicators that a correction is coming, including on the US stock exchanges. In light of this, the risk of price drops in equity markets worldwide has increased. We therefore remain cautious.

BANTLEON BANK AG
Bahnhofstrasse 2 | CH-6300 Zug
Telephone +41 (0) 41 728 77-58 | bantleon@bantleon.com

Important legal information:

The commentary, analysis and opinions herein are provided for information only and do not constitute investment advice or a recommendation or solicitation to buy or sell investment instruments. The information provided is based on reports and evaluations from sources in the public domain. BANTLEON BANK AG believes these sources to be reliable, but it cannot guarantee that their information is of high quality, accurate, up to date or complete. Consequently, it cannot accept any liability whatsoever for damages arising from the use of this information. Past performance is not indicative of future results.