Equity

German equities – what else?

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In a nutshell

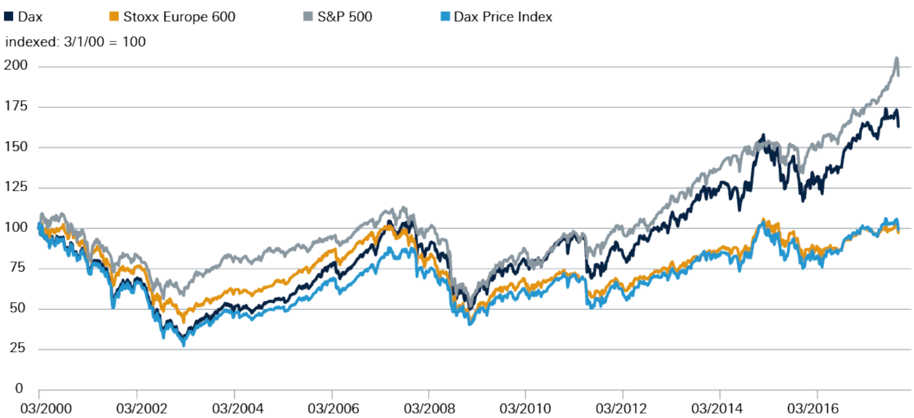
- Recently, the Dax scored new closing highs. And justifiably so. The price correction has only reinforced our optimism.
- The German economy is currently blessed with both strong domestic and rising external demand.
- Company executives are in high spirits, earnings growth is on track, and German stocks are not too expensive when compared to their global peers.

German equities have become even more appealing after the correction. Rising earnings could drive further gains.

On January 23rd, Germany's Dax jumped to a new record high. But after no more than eight trading days, the German benchmark index lost over 7%, wiping out all year-to-date gains. This was certainly grist to the many sceptics' mill who had been warning to keep clear of stocks. Our reaction is diametrically opposed: now more than ever! Even after the Dax had climbed to 13,597, our optimistic view remained intact, although we started to see a heightened risk of a temporary price correction.

The risk has now turned into reality, hence we are feeling very comfortable with German stocks from a strategic as well as from a tactical view. After all, the bond-market sell-off, which is partly to blame for plummeting equity markets, looks unlikely to continue unabated. In addition, we regard this market correction to be mainly technically driven, since many market participants might have been caught off guard after this long phase of low volatility.[1] Those who are generally worried about the indices hovering around record highs may want to take the following into account: The first may be to take a look across the Atlantic and consider the optimism over there. The S&P 500 has been trading at record levels for much longer, each new high triggering gushing enthusiasm. The second may be to ignore the Dax and watch the Dax price index instead. Only the more familiar – and flattering – Dax, which is structured as a performance index, has been well ahead of its old record highs dating back from 2000 and 2007.

The Dax price index is fighting with old resistance levels. The S&P 500 has advanced much further.



Source: Thomson Reuters Datastream; as of 2/8/18

The Dax price index, which, similar to most other major equity indices (including the S&P 500) is not based on the assumption of reinvesting dividends, is, for the second time, struggling to

[1] Particularly the short-sellers of volatility instruments, tracking funds and risk-parity strategies appear to have contributed to the self-reinforcing sell-offs.

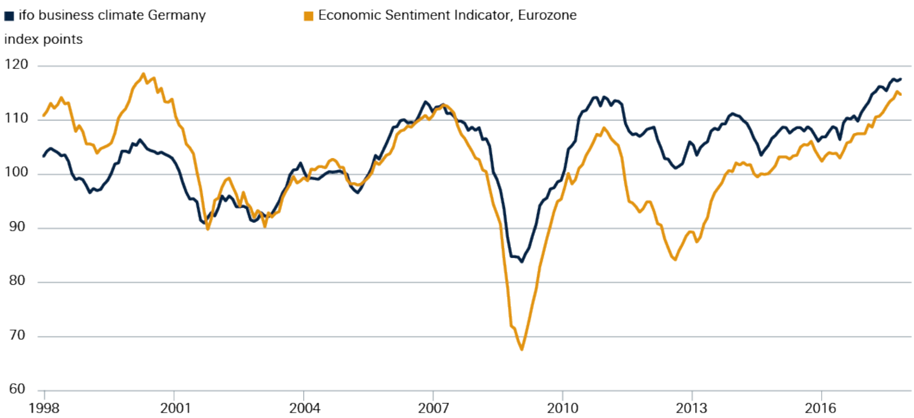
overcome its old record highs from 2000 and 2015. Only a "like with like" comparison, i.e. comparing the Dax price index and the S&P 500, unveils the performance gap. Whereas the latter has doubled since 2000, the price Dax has hardly moved at all. Even after adjustment for the dollar weakness in this period[2], U.S. equities are clearly in the lead. Also compared with its own history, the price Dax is currently looking rather appealing. Although the index has remained on the same level, Dax corporations are earning three times as much as in 2000 and are paying out more than double in dividends.[3]

That being said, the essential reason for our preference of German equities is the healthy macroeconomic environment and state of German corporations.

Global economic growth as a driver of German equities

Although China is generally labelled as the key region driving demand for German industry, it is important to keep in mind that the European Union (EU) absorbs 60% of German exports, making the EU the most important export region for Germany. German corporations are, therefore, among the main beneficiaries of improving growth dynamics in Europe. After all, the Eurozone appears well placed to surpass the United States in terms of growth in gross domestic product (GDP) for the second year in a row. We expect the Eurozone GDP growth rate to have reached 2.3% in 2017, a significant rise over the 2016 rate of 1.7%. Growth might slow slightly in 2018 to 2.0%. But this is not really troubling since the growth rate would still be well above the potential of 1.0 to 1.2% originally forecast for the Eurozone.[4] We also expect the German growth rate to modestly fall from 2.4% in 2017 to 2.1% in the current year. Sentiment indicators in Germany and in the Eurozone continue to stay on record highs, however.

Sentiment in Europe and Germany better than ever



Sources: Thomson Reuters Datastream; as of 2/8/18

The upswing in Europe is mainly driven by consumption. On top of that, Germany looks set to benefit from a further pick-up

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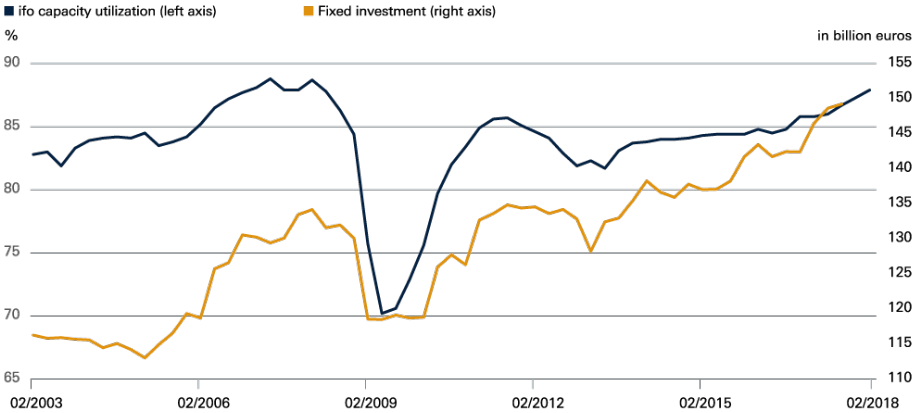
[2] During this period, the dollar lost 28% versus the euro.
[3] Based on previous year's earnings and dividend pay outs
[4] However, we cannot deny that traditional econometric models have struggled in recent years to correctly forecast the interrelated patterns in real economic growth, inflation and the labor market. Therefore, there is some scope for doubts about how quickly the Eurozone could grow precisely, and for how long, before causing inflation to accelerate.

in investment activity, which is partly caused by high capacity utilization.

Investment demand rising in line with capacity utilization in Germany



Source: Thomson Reuters Datastream; as of 2/8/18

German investment activity might, however, be hampered if the President of the United States follows up his protectionist rhetoric with specific additional policy measures. These could adversely affect global trade. Other risk scenarios actually include a further acceleration of global trade driven by economic overheating in the United States. We see this as a key (residual) risk to our base scenario. Should inflation expectations rise significantly in the wake of such an overheating in the United States, central banks might be forced to tighten monetary policy more than currently expected. In our view, this risk is higher in the United States than in Europe, although the consequences would probably spread across the globe.

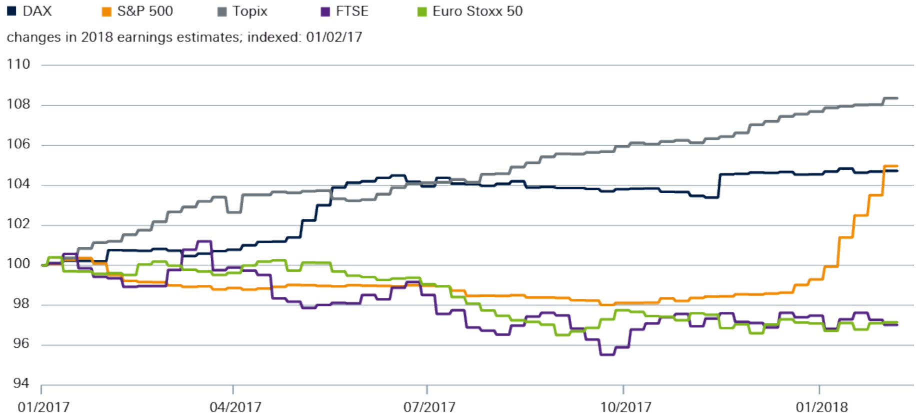
Inflation in the Eurozone should remain rather modest. After 1.5% last year, we expect consumer price inflation to hit 1.4% in 2018. In the United States, our forecast is 1.8%, after 1.5% in 2017. Due to the U.S. tax reform and the potential for further protectionist measures, inflation might even rise faster. For the time being, equities continue to benefit from the historically accommodative monetary policy by major central banks.

We do not, however, expect the German government coalition in the making - (once more a "grand" coalition of the center-right Christian Union (CDU/CSU) and the Social Democrats (SPD)) to give any sustainable – positive or negative – economic impetus.

On a 2-year horizon, the Dax could even climb to 15,000

The changed consensus earnings estimates help underpin our favorable assessment of German equities. The chart shows that 2018 earnings estimates for the Dax have risen by 5% since the start of 2017. This not only contradicts traditional patterns – in most cases in the past, analysts have had to downscale their estimates in the course of the year - but takes Dax corporations to a top spot among all major equity markets. The stability of the last few weeks is even more surprising in the face of a stronger euro, since analysts are usually rather quick to incorporate negative translation effects.

Dax earnings expectations continue to be stable despite a strong euro

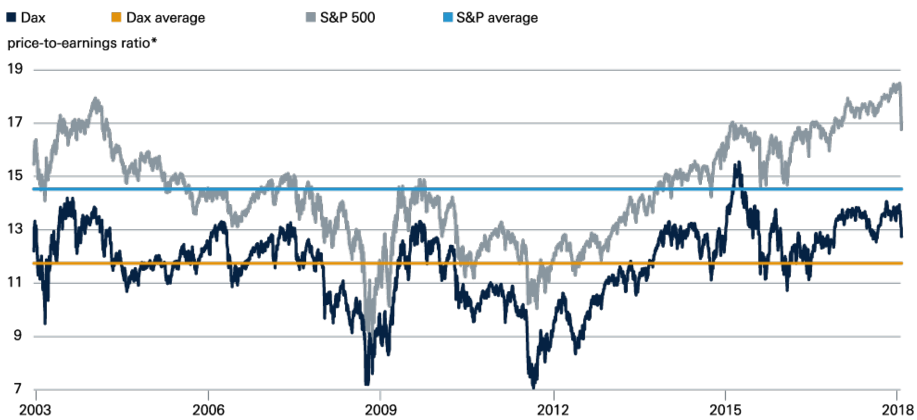


Source: Thomson Reuters Datastream; as of 2/8/18

Based on our estimates, Dax earnings appear likely to grow by 8.0% in the current year, in line with growth in 2017. Although Dax performance gains of the past two years have also been supported by higher multiples, the chart below clearly shows a rather stable price-to-earnings (P/E) band over the last five years. To achieve our performance target of 14,100 by the end of 2018, we don't expect the P/E to widen any further. That said, the ongoing monetary stimulus by central banks and the synchronous recovery alongside moderate inflation could, all else being equal, result in higher multiples.

So, what prevents us from being carried away by euphoria? Among other issues, we would mention uncertain implications of the end of ultra-loose monetary policy, given how mature this economic cycle already is. In the medium term, there are also question marks over China as its economic model continues to evolve; as already mentioned, China is an important market for German exporters, even if it is not the most important one.

Dax valuation less strained than S&P 500



Source: FactSet Research Systems Inc; as of 2/8/18
*based on consensus earnings estimates for the next twelve months

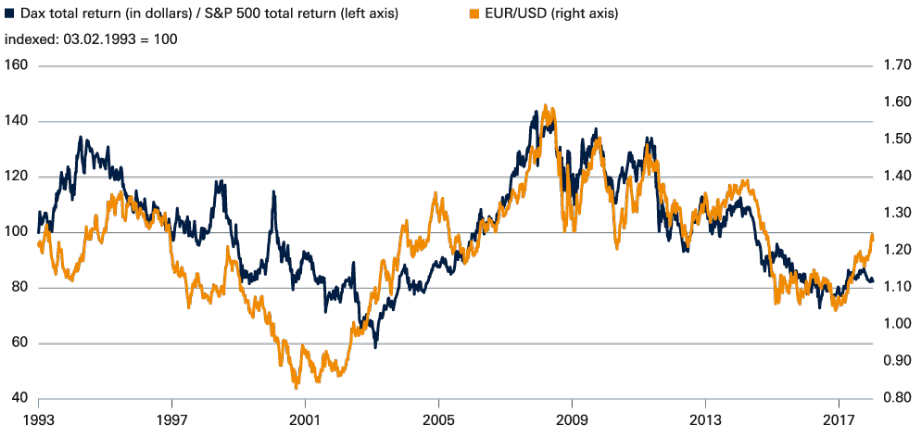
In the United States, the S&P 500 has benefited much more from multiple expansion in the last few years. As a result, its P/E multiple is now, even after the market setback, trading 17% above the 15-year average, while this number is only 9% for the Dax. Lately, the

S&P 500 has been trading near its highest premium to the Dax in decades.

This takes us back to the comparison of the Dax and S&P 500. The chart below shows that there have been three longer phases in the last 25 years, in which the Dax performed significantly better or worse than the S&P 500. It is too early to judge whether the consolidation of the last two years marks the end of the almost ten-year-long performance slump of the Dax versus the S&P 500. Although comparing Dax and S&P 500 seems to be futile with a view to an absolute Dax price forecast, relative viewpoints have, in the end, historically played a major role in prompting big investors to shift assets from one region to another.

The chart also illustrates another aspect of great importance for globally active investors: the right positioning in the face of major currency movements. As will be described in detail later on, a strong euro does not necessarily diminish the appeal of the European market for international investors.

The stronger the euro, the stronger the Dax versus the S&P 500

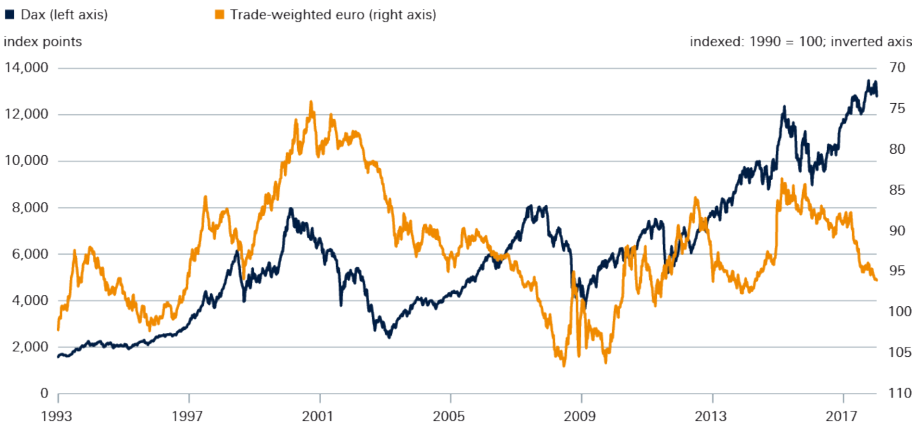


Source: Thomson Reuters Datastream; as of 2/8/18

Relative to the S&P 500, the Dax actually has tended to do quite well during periods of euro appreciation. This makes some intuitive sense: for a U.S. investor buying stocks in German export companies, a stronger euro typically means that the dollar value of German equities goes up, even as it erodes euro-denominated earnings. Currency movements are thus having less of an impact than you might think, when it comes to comparing the relative appeal of an equity index of one country to that of another country. So, while a strong euro is assumed to impair German export-driven companies, the chart suggests otherwise. It reveals that from an (overseas) investor's viewpoint, currency appreciation more than offsets the negative real economic factors.

As the following section explains, however, even this aspect seems to be overstated. This is also confirmed by the performance of the Dax (in euros this time) compared with the trade-weighted euro.

The fate of the Dax does not depend on the strength of the euro



Source: Thomson Reuters Datastream as of 2/8/18

Euro exchange rate and Dax

Due to the German economy's high dependence on exports, the exchange rate has always been a key point of interest among companies and investors. In our view, its significance for stock prices is, however, often overstated. It is true that at least on a short-term horizon, there seems to be a close correlation between the euro and the Dax, with the Dax tumbling when the euro strengthens. But little is left of this correlation in the long run. The path from a weaker exchange rate to better sales conditions abroad, subsequent higher earnings and rising stock prices is often very long, in some cases even never-ending.

Here are just some of the factors which should be taken into account when analyzing the exchange-rate sensitivity of German corporations and their products, using the dollar as an example:

- share of sales in dollars versus share of costs in dollars,
- substitutability of products,
- long-term supply contracts and/or currency hedges,
- greater focus on productivity increases due to a stronger home currency and finally
- the reaction patterns of competitors.

One last word on the dollar and the U.S. dependence of German corporations: even if export-driven companies, particularly from countries recording a positive trade balance with the United States, have little to expect from the incumbent U.S. president's gift box, they should not be left empty-handed. After all, they, too, look set to benefit from U.S. tax cuts. European as well as German listed companies generate roughly one fifth of their revenues in the United States.

German exports are not driven by the euro

Source: Thomson Reuters Datastream; as of 2/8/18

In general, we should not entirely ignore the typical reflex pattern of the stock exchanges: from an accounting point of view, a stronger euro will curtail earnings generated abroad, resulting in fewer euros (the so-called "translation effect"). After the euro has rallied from 1.05 to roughly 1.25 vs. the dollar within one year, the dollar should now experience some consolidation, thus losing some of its dynamic as a driver of earnings and stock-price volatility. In our view, the exchange-rate movements since the end of December have mostly been a sign of dollar weakness and not of euro strength.

Our preferences in the German market

The favorable economic environment already mentioned before as well as analysts' optimistic earnings estimates are reflected in the majority of corporate outlooks. "German managers sounded very confident during various investor conferences at the start of this year. Order books are filled with orders from all regions of the world. Here we are seeing the often quoted global synchronous recovery at play. It is particularly beneficial for the export-driven German equity indices," states Tim Albrecht, Head of German, Austrian and Swiss Equities at Deutsche Asset Management, and continues: "and it is not only sales that we see growing; we also observe wider margins across many sectors."

For example, **basic-resource sectors** such as steel and chemistry benefit from an ideal climate – a growing demand going hand in hand with partly dwindling supplies. "Some sectors are real winners of the strategic turn in China's economic approach. Against the backdrop of disastrous pollution in many Chinese regions, Beijing has shut down a number of extremely high-emission, obsolete factories. This should also increase the pricing power of German suppliers," Albrecht adds.

Besides the classic export-oriented **industrial sectors**, we also favor **technology firms** which should continue to benefit from structural growth, since IT investments are and will remain a top priority for every industrial sector and every corporation driven by the current wave of digitalization.

But we also like the **financial sector** which stands to benefit from the looming turn in interest rates. Particularly European banks, however, might also face stronger pressure from their U.S. counterparts which are going to enjoy some deregulation under the current U.S. government. Therefore, we prefer insurers, particularly those with sound balance sheets and generous dividend payments.

The German auto sector also presents a mixed picture. German auto makers are currently facing major challenges requiring heavy investment in research and development. Although auto companies have proved to be innovative and able to cope with structural changes in the past, we slightly underweight this subsector and focus on selected auto suppliers.

With labor markets and consumer sentiment having improved in Germany and Europe for quite some time now, we are keeping a close eye on **consumer-related cyclical names.**

We also continue to see excellent earnings potential in German **small- and mid-cap stocks**. However, one needs to be selective in this area, as some of these stocks have lately been trading at a significant valuation premium compared to the Dax. We do not expect the strong run of the MDax and TecDax, also vs. the Dax, to come to an end soon. These companies do not only stand to benefit from sound earnings and growth rates but also from the unabated interest of foreign strategic buyers. The sound state of small- and mid-caps is also reflected in the most recent equity corrections. Whereas small- and mid-caps as well as technology stocks are historically regarded as being more volatile and prone to a sell-off during corrections, all types of German stocks behaved in a very similar way during the most recent correction.

We continue to underweight defensive sectors such as non-cyclical consumer goods, utilities and real estate. They should particularly suffer from concerns about further rate hikes.

We are also skeptical of certain companies that start preparing themselves for a shopping spree abroad. In our view, a lot of money has been wasted on acquisitions, particularly in the United States. Unfortunately, we do not see visible progress being made on the learning curve yet.

Conclusion: There are more pros than cons for German equities.

We remained optimistic on German equities after the strong start to the year. The recent correction has reinforced our stance. "We see the Dax closer to 15,000 than to 10,000 points. Stock prices are not only supported by earnings growth, but also by record dividends expected to be paid out in the upcoming dividend season. On average, we expect a dividend yield of above 3%, which should further support German equities in the medium run," Tim Albrecht is convinced. While a strong euro even favors the Dax in a relative perspective to equity markets overseas, we see inflationary risks as more of a potential threat in the United States than in Europe. Our positive strategic view of German equities is currently supplemented by tactical considerations, since we are using pullbacks as an opportunity to add positions.

At the same time, we do not want to gloss over the fact that the German equity market cannot decouple itself from potential global market jitters. Investors might start to shift assets for fear of longer inflationary bouts, thereby reducing their currently high positions in equities and corporate bonds. In this context, we do, of course, see sharp rises in government-bond yields as one of the main risks to our economic framework. This is, however, not our base scenario.

Glossary

Correlation

Correlation is a measure of how closely two variables move together over time.

Dax

The **Dax** is a blue-chip stock-market index consisting of the 30 major German companies trading on the Frankfurt Stock Exchange.

Euro (EUR)

The **euro (EUR)** is the common currency of states participating in the Economic and Monetary Union and is the second most held reserve currency in the world after the dollar.

European Union (EU)

The **European Union (EU)** is a political and economic union of 28 member states located primarily in Europe.

Eurozone

The **Eurozone** is formed of 19 European Union member states that have adopted the euro as their common currency and sole legal tender.

Gross domestic product (GDP)

The **gross domestic product (GDP)** is the monetary value of all the finished goods and services produced within a country's borders in a specific time period.

Hedge

A **hedge** is an investment to reduce the risk of adverse price movements in an asset.

Inflation

Inflation is the rate at which the general level of prices for goods and services is rising and, subsequently, purchasing power is falling.

MDax

The **MDax** is an equity index, which includes the 50 German Prime Standard companies ranked directly behind the 30 Dax companies, from sectors excluding technology.

Multiple

A multiple is a ratio that is used to measure aspects of a company’s well-being by setting various of the company’s metrics against each other and thereby building indicative ratios.

Performance index

A **performance index** (as opposed to a price index) assumes that dividends and other payouts are reinvested and therefore reflects the total return of an investment in the index.

Price-to-earnings (P/E) ratio or multiple

The **price-to-earnings (P/E) ratio** compares a company's current share price to its earnings per share.

Pro-cyclical sectors

Pro-cyclical sectors are those throught likely to particularly benefit from an upturn in the economic cycle (i.e. stronger growth).

S&P 500

The **S&P 500** is an index that includes 500 leading U.S. companies capturing approximately 80% coverage of available U.S. market capitalization.

TecDax

The **TecDax** is an equity index tracking the 30 largest German technology companies, ranked below those included in the Dax.

Volatility

Volatility is the degree of variation of a trading-price series over time. It can be used as a measure of an asset's risk.

Risk warning

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