Capital Markets Outlook 2019: marked by growth and uncertainties

- Negative political stress factors in particular are expected to result in greater capital market fluctuations
- Solid corporate earnings and favourable valuations could nevertheless provide a supportive environment for moderately rising share prices
- Technology – as the biggest sector worldwide – should be a decisive factor for market development

A world in which many of the major economies have passed their growth peak and uncertainty continues to increase – these are the headline forecasts in Deutsche Bank’s Capital Markets Outlook 2019, published in Frankfurt today. While the eurozone and many emerging markets are likely to experience an economic slowdown in the coming year, negative political stress factors will drive the sharpest market reactions. “In Europe we will remain preoccupied by the budget conflict with Italy and concerns about a disorderly Brexit,” said Stefan Schneider, Chief German Economist at Deutsche Bank Research. Until the ink dries on a withdrawal agreement between the UK and the European Union, there is unlikely to be any sustained easing of tensions. In addition, Italy is clinging on to its plans for a budget that contravenes EU rules. This puts the country’s rating in jeopardy and thus also the stability of the entire eurozone. “Italy remains a serious problem and continues to keep European bond markets on edge,” concluded Schneider.

Added to this is the global trade dispute between the US and China. “This trade conflict may increasingly morph into a battle for economic and technological market leadership. It’s essentially about who’s going to set the standards,” explained Ulrich Stephan, Chief Investment Officer at Deutsche Bank’s Private & Commercial Bank. There are still hopes, however, that at a meeting scheduled for November 29, 2018, ahead of the G20 summit in Buenos Aires, a compromise could be reached between the US President Donald Trump and the Chinese President Xi. A global economic downturn is not to be expected despite the challenges.
Schneider expects a slight increase in inflation in 2019. This would likely prompt central banks – first and foremost the US Federal Reserve and the European Central Bank (ECB) – to further rein in their expansionary monetary policy. Higher interest rates would be the consequence.

**Business cycle – no signs of a recession**
While it will remain full steam ahead for the US economy, growth rates in most other major economic regions will slow in 2019 compared with 2018. "We are less sceptical than the market. There is no prospect of a global recession in the coming year", said Stephan. He is forecasting global growth of 3.8 percent. The growth cycle which began in 2009 has thus lasted roughly ten years.

**Europe: solid growth**
Despite major political challenges, Deutsche Bank expects the eurozone economy to largely continue on its growth trend next year. Although the Composite Purchasing Managers Index has fallen recently, the reading above the 50 point mark suggests that there will be further growth. The expected slight tightening of monetary policy in the eurozone, for instance by planning to end the bond purchasing programme in January 2019, is thus likely to be justified and should not put an end to the growth momentum. “The very prudent action taken by the ECB provides reason to hope that its deposit rate hike for banks that is expected in late summer of 2019 will not have any major negative consequences for credit growth in the eurozone”, said Stephan. Deutsche Bank forecasts annual economic growth in 2019 of 1.3 percent for Germany and 1.7 percent for the eurozone.

**USA: robust growth to continue**
The outlook for the US economy remains healthy. At 2.8 percent, growth in 2019 should be approximately as strong as in the current year. “The main drivers are the effects of the US tax reform and higher public expenditure,” explained Schneider. High private consumption and generally solid capital expenditure will support the trend. By contrast, economic growth could be dampened by potentially more restrictive financing conditions. “We expect the Fed to have made five rate hikes by the end of 2019 and that the key interest rate will then be 3.25 to 3.5 percent,” says Schneider.

**Currencies – the search for a “safe haven”**
Although global capital markets remain in thrall to the dominance of the US dollar, the twin deficits (the combination of the fiscal and current account deficits) of the United States could weigh on confidence in the greenback in future. For the euro to rise all doubts regarding the continued existence of the European Monetary Union would first have to be dispelled. As long as political risks exist in Europe, the euro should remain under pressure. Only if there is progress on topics such as Brexit and the Italian budget would it be expected to strengthen. “As of end-2019 I expect a EUR/USD exchange rate of 1.15,” said Stephan. The Chinese renminbi is ailing due to the trade dispute and the narrowing of the current account deficit. The renminbi can therefore be expected to weaken in 2019.
Asset classes, regions and sectors

Bonds – free of charge is still too expensive
Fixed-income investors are unlikely to see any improvements in the situation in the coming year. On the contrary, bond yields can be expected to continue rising in the US and the eurozone as a result of a generally positive economic development. By September 2019 the yields on US government bonds should therefore continue to grow across all maturities. Only after that are we likely to see yields drop slightly on account of the approaching economic slowdown. “I expect capital market rates to rise, not only in the USA, but also in the eurozone”, said Stephan. Ten-year German Bunds should rise gradually to slightly above 1 percent by year-end. This means there is hardly any money to be made in eurozone bond markets in 2019. “The environment remains difficult. Returns on bonds can only be earned by accepting risk,” said Stephan. Emerging markets for example will offer comparatively high yields, but they are particularly susceptible to currency fluctuations. “If the Fed raises its rates, the bonds issued by many emerging markets will remain under pressure – especially those denominated in local currency,” said Stephan. In the portfolio context, nevertheless, bonds play a major role in diversifying and controlling overall risk. The bonds preferred for this have short maturities or variable interest rates.

Equities – good in the USA, inexpensive in Europe, good and inexpensive in Asia
Stock market investors became more nervous in 2018; despite companies generally reporting good figures, stocks declined sharply at times. After nearly 10 years of prices trending upwards, market participants are reacting more sensitively – especially to political news. “We see further upside potential for equities in 2019 despite uncertainties. Investors could consider using the decline in valuations caused by share price declines in H2 2018 as an entry opportunity,” said Stephan. The decisive criteria for this are corporates’ robust earnings expectations and attractive valuation levels. However, the increasingly nervy market means that investors should get accustomed to sustained price fluctuations, as well as regularly evaluating and actively managing their portfolios. For those with a long-term investment horizon it is important not to let themselves be unsettled by short-term market occurrences.

USA: good prospects for corporates
US firms are likely to continue to benefit from the strength of the US economy and the fiscal measures of the Trump administration. “US firms generate the vast majority of their revenues in their domestic market. Thriving domestic consumption there has a positive impact on company results,” said Stephan. For 2019 he expects solid earnings growth of up to 10 percent. Another major stock market driver is share buybacks, which play a much bigger role in the US than in Europe, for example. These buybacks bolster share prices. For the coming year total buyback volume could climb to a new record of around 1 trillion US dollars. “US stocks will thus remain attractive, although they are not cheap by international standards,” Stephan summarised. In the USA the commodities, industrials and financial sectors, for example, might be appealing to correspondingly risk-seeking investors. They are valued lower than the market as a whole but at the same time offer high earnings prospects.
Europe: favourable valuations
In Europe it is valuations in particular that make equities interesting for investors. “European equities are particularly inexpensive at present,” said Stephan. As soon as the situation eases with regard to the Brexit negotiations or in the conflict with Italy, investors are likely to regain confidence and start buying again. “Selected stocks from Europe also belong in the portfolio in 2019,” Stephan asserted. This also includes the German stock market. He does not recommend a strong focus on the DAX, however: “The German benchmark index is highly sensitive to business cycle developments because of its cyclical orientation and large proportion of auto stocks. And it is composed of only 30 stocks. That makes it prone to fluctuation,” Stephan explained. In Europe, the most attractive stocks seem to be those from the basic resources, construction and materials, and financial services sectors as well as oil and gas. Value stocks will generally be a focus of attention.

Asia: good and inexpensive equity markets
In Asian equity markets it is primarily the trade dispute between China and the US that is generating negative sentiment and has driven down share prices. However, sentiment is worse than the actual situation: “Generally high earnings expectations and comparatively low valuations could send stock prices rising in Asia’s emerging markets in 2019 and make the region attractive to investors,” said Stephan. A lot depends on how the Chinese economy develops, he said, and about which he is fundamentally positive: “The monetary policy and fiscal stimuli applied by the government are likely to further stabilise growth and thus the capital markets. We forecast solid economic growth in China of 6.3 percent in the coming year. That should have a positive effect on the entire region.” While the industrial firms from the old economy are taking a back seat, new sector giants are emerging with the corresponding growth potential in promising technology sectors. Stephan sees opportunities in North Asia rather than in South Asia. His regional favourites are China, Korea and Japan.

Sectors – Technology determining market trends and performance
Besides selecting on a regional basis, investors should also pay particular attention to sector differences in 2019. The tech sector, for instance, has become much more important in recent years. Technology companies already account for between 25 and 35 percent of the stock market capitalisation in the US and Asia according to the conventional definition. “Tech now has very little left in common with the speculative companies in the dotcom-bubble of 20 years ago; today the companies earn high margins and profits. After a 10-year boom, technology determines the trend in the economy and the markets. However, tech stocks should no longer perform considerably better than the market as a whole,” explained Stephan.

Also the diversity of companies within the sector has increased. The leading index providers Standard & Poor’s and MSCI even adjusted their classification of the sectors last September. Tech firms can now be found in the technology segment (for example hardware manufacturers), consumer discretionary (online retailers) and in the newly-created communications service provider segment (companies from the entertainment and software services sector). "Not all tech firms are the
same. In future, tech stocks will have to be discussed in much greater detail, and investors will have to look even more closely at the individual business models,” prompted Stephan. Many tech groups are highly diversified and are simultaneously active in the online retailing, cloud computing and artificial intelligence segments, for example. “The potential for innovation in these areas is huge. But it will take years rather than months for them to reach the real economy,” said Stephan.

Real estate – boom doesn’t automatically mean bubble
Housing shortage, full capacity in the construction industry, moderate mortgage debt: the bursting of a supposed real estate bubble in Germany, which is a frequent topic of discussion, is also not expected in the coming year, according to Deutsche Bank. “The average prices of residential property will continue to rise in Germany. The increase in prices to date has not come from an increase in lending, as the household debt to GDP ratio in Germany has remained largely unchanged in recent years”, said Stephan. This increase is however unlikely to be seen throughout Germany. “It is mainly in conurbations and large metropolitan regions where there is still too little being built to satisfy the high demand. That is bolstering prices,” explained Stephan. Yield potential is also to be expected from commercial real estate thanks to the sound economic situation. For Berlin, for example, Deutsche Bank is forecasting an increase in rents totalling over 20 percent by 2022. This outlook for Germany, however, contrasts with the situation in individual foreign real estate markets such as Australia or Canada that are already showing signs of overheating. Nevertheless, broadly diversified global real estate investments should generally pay off.

Commodities – high volatility, low investment potential
Although crude oil and industrial metals are equally vital for global economic growth, their prices are influenced by different factors. “While the crude oil market is more dependent on demand in developed markets, the prices of copper, aluminium and the like largely mirror consumption in emerging markets, and especially in China,” explained Stephan. The oil price could rise on account of the expected solid economic situation in the USA and the eurozone. The production side will remain a political issue, however, which means there is greater forecasting uncertainty in this respect. The industrial metals segment has upside potential. “In my opinion, several market participants seem to value the Chinese economy in particular too negatively,” said Stephan. “There are simply too many negative scenarios priced in. If they don't materialise in 2019, metals prices should trend upwards.” Deutsche Bank nevertheless again recommends for this coming year that investors do not invest directly in commodities. “Investors who want to invest in the commodities sector are likely to fare better by choosing stocks in this sector,” said Stephan. The bank is also sceptical about gold. “Gold has lost its status as a safe haven in uncertain times, at least for the time being. I see too little upside potential to enter now,” said Stephan.
Forecasts for the end of 2019.

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