IV. Outlook

1. Economic conditions

1.1 Global economic trends

In mid-2018, the global economy remains in a phase of expansion. However, political tensions have led to a general increase in uncertainty. Issues such as the unresolved conflict in Syria, the US withdrawal from the Iran nuclear deal, the trade dispute between the United States and China, and the imposition of US protectionist tariffs on steel and aluminum imports are likely to continue depressing sentiment in the global economy. If the United States were to ramp up its protectionist action and Europe and China were to initially respond, as has already happened, with retaliatory measures, thereby escalating the trade dispute, the consequence could be a trade war that would have a negative impact on global trade as a whole. Above all, this would affect growth in particularly open economies that are strongly interlinked with those of other countries.

In this environment, global economic growth in 2018 is likely to be 3.6 percent, which is the same rate as in 2017. This rate is also currently predicted for 2019.

The price of crude oil has recently risen sharply on the global markets. It is predicted to remain at its current level of around US$ 75 for an extended period, falling only gradually between now and the end of 2019.

The forecast for inflation has been raised accordingly. Inflation is expected to be around 2.0 percent in industrialized countries and approximately 3.8 percent worldwide in 2018.

1.2 Trends in the USA

The economic outlook for the United States continues to be positive. The US economy appears to be increasingly diverging from the economy in Europe. Recent data shows that consumer spending in the United States has picked up significantly again. Once again, consumers' propensity to spend seems to have injected momentum into the country's economy.

With consumer sentiment remaining very high, personal spending continues to be the driver of growth in the US economy. The services sector is also providing particular growth stimulus. Industrial output is showing signs of a stronger recovery, too.

The steady rise in employment is now underpinned by an uptrend in the manufacturing sector. However, the services sector continues to be the main source of jobs. The number of people employed in the services sector has risen by three-quarters of a million since the start of the year. In 2019, the rise in employment is likely to be sustained, with the rate of unemployment possibly falling to around 3.8 percent.

In these conditions, the US growth rate is forecast to be approximately 2.9 percent in 2018 and around 2.5 percent in 2019.

The robust state of the economy continues to be accompanied by only muted domestic pressure on prices. Although services are steadily becoming more expensive and energy prices have recently risen sharply, there has only been a weak increase in prices for food and used vehicles. An average inflation rate of around 2.6 percent is projected for both 2018 and 2019.

1.3 Trends in the eurozone

In contrast to the US Federal Reserve's policy of gradually raising the key interest rate, the European Central Bank is retaining its extremely expansionary monetary policy for the time being and has delayed possible interest-rate hikes. However, the ECB has decided that it will incrementally reduce the purchase volume under its bond-buying program from October 2018.

Various sentiment indicators for the eurozone and its member countries have been deteriorating since the start of this year. This is not simply a correction to compensate for the growth forecasts that were previously almost too exuberant. Rather, sentiment is being depressed by the deteriorating situation on the global political stage over the course of 2018.

Against this backdrop, growth in the euro area has already slowed markedly since the start of the year. Following a growth rate at the end of 2017 of 0.7 percent compared with the previous quarter, the growth achieved at the beginning of 2018 was just 0.4 percent. In particular, the two big eurozone countries of Germany and France saw their growth rates slow down significantly. The Italian economy maintained its moderate pace of growth. There is unlikely to have been an improvement in the second quarter. Indicators such as industrial output and the level of orders in industry are not currently pointing to any real turnaround.

Consequently, a stronger recovery is not anticipated in the second half of 2018. The euro area's economy is forecast to expand by 1.9 percent in 2018 and by 1.5 percent in 2019.

The recent sharp rise in the price of crude oil on the global markets has also left its mark on consumer prices in the eurozone. Inflation climbed to 2.0 percent in June 2018, its highest rate in 15 months. Besides the substantial increase in energy prices, there was also a slightly stronger rise in food prices compared with the prior-year period.

Consequently, the average inflation rate for 2018 is expected to be in the region of 1.6 percent. Current forecasts for 2019 are predicting an inflation rate in the vicinity of 1.7 percent.

1.4 Trends in Germany

The potential escalation of the trade dispute between the US and China along with the threat of US punitive tariffs on German car exports are likely to have been the main negative factors for corporate sentiment. Sentiment indicators such as the ifo Business Climate Index, the ZEW index, purchasing managers' indices, and economic confidence show that uncertainty has also increased significantly. This is particularly clear to see in the ZEW survey, which revealed a huge discrepancy – the widest in a long time – between the assessment of the current situation and the evaluation of economic expectations for Germany. Companies' capital spending and export activities are expected to be particularly adversely affected by this uncertainty.

The economy is likely to expand by around 1.7 percent in 2018. GDP is predicted to rise by just 1.4 percent in 2019.

Against this backdrop, Germany's unemployment rate for 2018 is predicted to fall to around 5.2 percent. A rate of approximately 5.0 percent is forecast for 2019.

According to preliminary calculations, Germany's inflation rate in June stood at 2.1 percent and at 2.2 percent in the previous month. However, energy and food saw much higher inflation rates of 6.4 percent and 3.4 percent respectively. The projected average rate of inflation for 2018 as a whole is around 1.8 percent. Pressure on prices is expected to change very little in the coming year.

1.5 Trends in the financial sector

For some years, the financial sector has faced considerable pressure in terms of both adjustment and costs caused by the need to comply with regulatory reforms (see also the opportunity and risk report, section 1.2.1) and implement structural change to adapt to competitive conditions.

In response to these regulatory requirements, banks have reduced their leverage over the last few years and substantially bolstered their risk-bearing capacity by improving capital and liquidity adequacy.

However, in addition to the regulatory environment, new competitors with approaches based on the use of data and technology are presenting the financial sector with the challenge of scrutinizing its existing business models, adapting them as required, and substantially improving its efficiency by digitalizing business and IT processes. The corresponding capital investment is initially likely to push up costs in the industry before the anticipated profitability gains can be realized.

As before, efforts to address the challenges described above are being made more difficult by the persistently low nominal interest rates in the eurozone, which are still accompanied by a relatively flat yield curve and are likely to prevent any significant increase in margins in interest-related business. This assessment is based on the ECB's continuing expansionary monetary policy.

The expected growth in large swathes of the global economy is also forecast to provide a boost for the financial position and financial performance of the European financial sector.

However, the potential implications from uncertain political and economic trends for the economic position of banks and insurance companies should not be ignored. Information on the relevant macroeconomic risk factors can be found in section 1.2.1 of the opportunity and risk report.

2. Financial performance

Based on a current assessment, **profit before taxes** will be at the lower end of the long-term target range of €1.5 billion to €2.0 billion in the current financial year. While profit before taxes in the DZ BANK, BSH, R+V, and UMH operating segments is expected to be above the budgeted figures, the DVB operating segment will, from the current perspective, report a loss. However, this loss will be significantly smaller than in 2017.

In 2019, profit before taxes is expected to be on a par with the level in 2018.

The future financial performance of the DZ BANK Group could be subject to risks arising from the general economic environment and, in particular, from monetary policy, above all in the US, the eurozone, and Germany.

Net interest income including net income from long-term equity investments is predicted to be lower in 2018 than in 2017.

In 2019, net interest income is expected to go up in nearly all management units, assuming that interest rates rise moderately.

The possible slowdown of economic growth in the euro area, coupled with a yield curve that continues to hold steady at a low level, may lead to falls in income, especially in relation to the interest-rate-sensitive business models within the DZ BANK Group.

Expenses for **loss allowances** in 2018 are currently anticipated to decrease substantially compared with 2017, above all because the loss allowances required in the DVB operating segment are returning to normal levels.

In 2019 too, expenses for loss allowances are likely to change in line with the lending portfolio, the targeted volume of new business, and the long-term costs for covering expected losses arising from the lending business.

Loss allowances could increase if the markets relevant to the DZ BANK Group's earnings deteriorated significantly or if there was an adverse impact from political risk combined with rising government debt in Europe.

Net fee and commission income is predicted to rise in 2018 from an already high base level in 2017. This assessment is based, in particular, on the anticipated significant contribution to earnings from the UMH operating segment.

In 2019, net fee and commission income is likely to continue rising on the back of business growth, especially in the UMH and DZ PRIVATBANK operating segments.

Any lasting uncertainty in capital and financial markets could have a negative impact on confidence and sentiment among retail and institutional investors, thereby depressing net fee and commission income.

In all probability, **gains and losses on trading activities** in 2018 will be at a similar level to those in 2017.

According to the planning for 2019, gains and losses on trading activities will be slightly better than in 2018. Impetus is particularly likely to come from customer-driven capital markets business in the DZ BANK operating segment.

The factors enabling a steady level of net gains under gains and losses on trading activities will be the continuation of the stable capital markets environment and the successful positioning of DZ BANK so that it can unlock market potential.

Gains and losses on investments will be boosted by sales of securities in 2018, with a significantly higher net gain than in 2017 expected.

From the current perspective, gains and losses on investments are forecast to deteriorate significantly in 2019 because no substantial non-recurring items are anticipated.

In 2018, **other gains and losses on valuation of financial instruments** are likely to decline significantly year on year, above all due to the effects of measuring securities from government issuers in European periphery countries.

Volatility in capital markets and especially the widening of credit spreads on securities from the aforementioned issuers could continue to have a negative impact on the forecast gains and losses.

Net income from insurance business is currently expected to be at a high level in 2018, albeit far lower than in 2017. The growth-related increases in premiums earned will be accompanied by a year-on-year decline in gains and losses on investments held by insurance companies and a rise in claims expenses for natural disasters.

In 2019, net income from insurance business is expected to be a lot higher than in 2018 thanks to growth in premiums.

Exceptional events in financial and capital markets, changes in underwriting practices, or potential changes in the regulatory requirements faced by insurers may adversely affect the level of net income expected to be earned from insurance business.

As budgeted, **administrative expenses** are set to rise slightly this year.

The major areas of spending are the high level of expenses for regulatory and strategic projects, especially in connection with the merger of DG HYP and WL BANK to form the DZ HYP operating segment, the restructuring of the DVB operating segment, and the transformation of the VR LEASING operating segment into a digital provider of finance for the self-employed and small businesses.

Given the higher expenses coupled with lower income forecasts, the **cost/income ratio** for the DZ BANK Group is likely to go up in 2018.
In view of rising expenses, one of the main strategic aims is to bring the cost/income ratio back down by rigorously managing costs and ensuring long-term synergy management in the DZ BANK operating segment on the one hand and by accelerating growth in the operating business of all segments on the other.

As expected, **regulatory RORAC**, the risk-adjusted performance measure based on regulatory risk capital, will decrease in 2018 because of the forecast of lower earnings.

3. Liquidity and capital adequacy

The DZ BANK Group is assuming that it can continue to maintain a sufficient level of liquidity in 2018 and 2019 in terms of both economic and regulatory **liquidity adequacy** requirements. Further information on liquidity adequacy can be found in section 3 of the opportunity and risk report.

As matters currently stand, the DZ BANK Group's **capital adequacy** is assured for 2018 and 2019 from both economic and regulatory perspectives; that is to say, it will continue to have at its disposal the available internal capital necessary to cover the risks associated with the finance business and other risks arising from the group's business operations. Further information on capital adequacy can be found in section 4 of the opportunity and risk report.