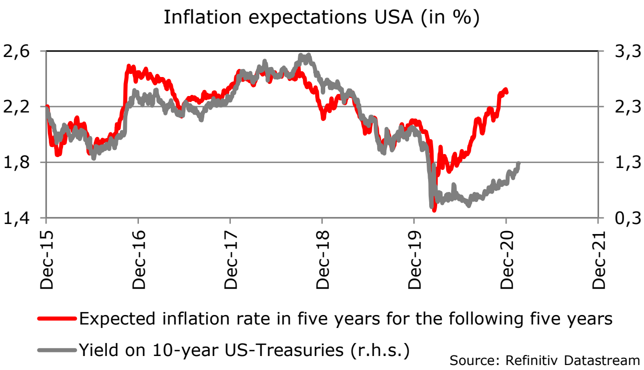
ECONOMIC SITUATION AND STRATEGY February 19, 2021

Higher interest rates: A threat to the stock market?

Government bond yields have advanced significantly in the United States and Europe since the beginning of the year. US Treasuries with 10-year maturities are now yielding about 1.3% compared with 0.9%, and the yield on 10-year German Bunds has risen from almost -0.6% to -0.35% in the same period. Yields are thus almost back to the same level as before the pandemic outbreak last year. Rising yields lead to falling prices, so investors in government bonds have experienced negative performance in the year to date. In our outlook for 2021, we expected that nothing could be earned with government bonds this year, but we are nevertheless surprised by the velocity and extent of the price declines. In the euro zone, the negative performance ranges from -0.2% for Italian government bonds ("Mario Draghi bonus") to -2% and -3% for German and Austrian government bonds, respectively. In the United States, 10-year government bonds show negative performance year-to-date of almost -3%.

Significantly heightened inflation expectations are the main cause of the yield advance. The inflation rate expected for the five-year period that begins five years from the present (this "5-year, 5-year forward inflation expectation rate" is the measure preferred by central banks) has increased to almost 2.5% in the United States and almost 1.4% in the euro zone. However, there will be even higher inflation rates at times this year, so inflation expectations, and hence government bond yields, might rise even further. Assuming a "normal" development of monthly inflation rates, as observed on average of the past five years, the PCE price index, on which the Federal Reserve primarily bases its monetary policy decisions, would reach about 2.5% in the second quarter solely due to base effects and then settle in at 2% by year's end. The base effect is due to the development of oil prices, which literally collapsed in April and May 2020. The current sharp increase of some commodity prices actually suggests that there will be an above-average monthly rise of the inflation rate in January and February at least, so an inflation rate in the second quarter at or even slightly above 3% is conceivable.

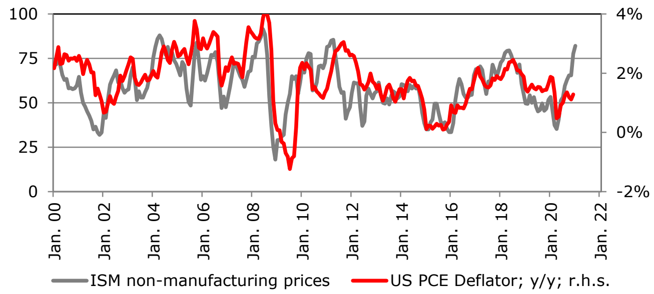


The price components of the purchasing manager indexes (PMIs) also support this. A regression equation that uses the price component of the national PMI for the manufacturing sector to explain the PCE inflation rate yields the conclusion that the price level at the beginning of 2021 might be almost 3% above its year-earlier value. However, this estimation equation has continuously and significantly overestimated the actual upward movement of prices in the past months. More reliable results are obtained by using instead the price component of the PMI for the services sector. This estimation equation currently yields an inflation rate of somewhat more than 2%, so an inflation rate of about

3% from the second quarter onward would also be likely on this approach.

However, we still do not believe there will be a lasting rise of inflation. The inflation-lowering effects of the past years and decades remain in force. Globalization could experience a revival with the new US administration, and technological progress continues unabated. Competition around most goods and services remains intense, not least because the monetary and fiscal policy rescue measures of the past 12 months have ensured that companies are not disappearing from the market. Finally, surplus capacities still exist in many sectors, thus limiting the pricing power of companies.

USA: Inflation rate and price component of the ISM non-manufacturing index

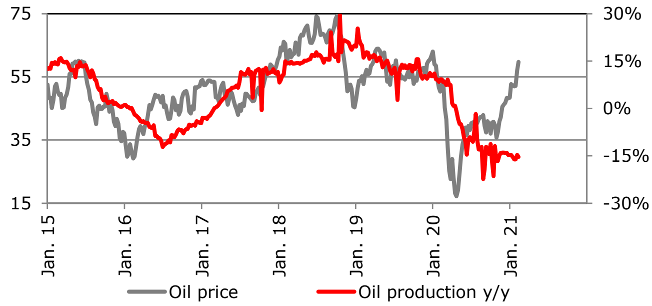


Source: Refinitiv Datastream

Rising commodity prices and higher shipping costs, partly attributable to bottlenecks in container ships, still have much to do with pandemic-related supply shortages and base effects. For example, the oil price has increased sharply in recent days due to severe winter weather in Texas. But as soon as the weather returns to normal, fracking companies are likely to significantly expand their oil production, as has always happened when the oil price rises. And since Saudi Arabia will abandon its self-imposed production limit for February and March, this should likewise contribute to higher supply and hence to price stabilization. The same might be observed in the case of copper and iron ore. Since the most important mines are located in emerging countries like Brazil, India, South Africa, Chile, and Peru, a successful vaccination strategy, as in Chile since the beginning of February, should help make the now tight supply situation quickly return to normal.

Nevertheless, it is possible that the capital markets expect a stronger and longer rise of inflation than what we consider likely. In that case, we would have to reckon with a further increase of yields. In the past, rising interest rates and capital market yields have often become a wet blanket on a booming stock market. That happened, for example, in 2015, when yields on 10-year German Bunds and 10-year US Treasuries advanced almost 100 basis points from mid-April to mid-June and Germany's DAX stock index corrected by more than 10% in the same period. However, that the stock market did not then recover as the year proceeded was not due to yields (which subsequently fell back, though not to original levels), but rather to other factors such as worries about the Chinese economy and the Volkswagen emissions scandal. The poor stock market year of 2018 was also directly connected with interest rate development. But that time, capital market yields did not cause the gyrations, but rather Fed monetary policy. For, after the Federal Reserve had raised interest rates for the first time in nine years in December 2015 (still under Janet Yellen then), newly appointed Fed Chair Jerome Powell continued on that course at an increased tempo – despite inconspicuous inflation rates. This shows that higher interest rates can harm the stock market especially when they result from more restrictive monetary policy.

USA: Oil production and oil price

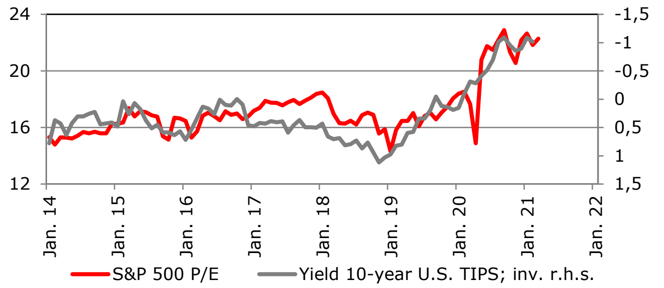


Source: Refinitiv Datastream

How the current development in government bonds will affect the stock market depends, among other things, on the extent of the yield increase. Unfortunately, no one can say exactly whether the stock markets will come under greater pressure already at a yield of 1.5% or not until at a yield of 2% on 10-year US Treasuries. Both the Fed and the European Central Bank have made it comparatively clear that they will keep interest rates low and continue their bond purchase programs without reservations despite better economic data. Investors should therefore watch closely to see whether quantitative easing programs are able to stop the rise of yields. If the Fed allows the yield on 10-year US Treasuries to rise above 1.5%, for example, it might be appropriate to reduce risks. A positive aspect is that the declines of government bond prices have so far hardly affected other bond market segments negatively. In contrast to the second quarter of 2015 or the fourth quarter of 2018, corporate bond prices have remained relatively stable (especially in the euro zone). Low-rated corporate bonds from the United States and the euro zone have even registered price advances. Consequently, financing terms for most companies have not worsened, thus keeping the economic recovery out of jeopardy. There have only been price declines in some emerging countries that are heavily influenced by the development of the US Treasury market.

Since higher interest rates per se are not negative for stocks, it makes more sense in any case to keep an eye on real yields rather than nominal yields. Only if they rise do we see the threat of a sustained drawdown on the stock market. For, the stock prices of technology companies, which have benefited greatly in the past years from falling interest rates, would probably come under pressure in that case.

S&P 500: Price earnings ratio for the coming 12 month and 10-year TIPS



Source: Refinitiv Datastream

Market Data Overview

Stock marktes	As of 19.02.2021 11:17	Change versus 11.02.2021 -1 week	15.01.2021 -1 month	17.11.2020 -3 months	17.02.2020 -1 year	31.12.2020 YTD
Dow Jones	31493	0,2%	2,2%	5,7%	7,1%	2,9%
S&P 500	3914	-0,1%	3,9%	8,4%	15,8%	4,2%
Nasdaq	13865	-1,1%	6,7%	16,5%	42,5%	7,6%
DAX	13956	-0,6%	1,2%	6,3%	1,2%	1,7%
MDAX	32249	-0,9%	3,9%	12,6%	10,0%	4,7%
TecDAX	3513	-0,7%	7,7%	17,1%	7,7%	9,4%
EuroStoxx 50	3698	0,7%	2,7%	6,6%	-4,0%	4,1%
Stoxx 50	3202	0,5%	0,5%	4,3%	-9,0%	3,0%
SMI (Swiss Market Index)	10728	-1,2%	-1,4%	1,5%	-3,9%	0,2%
Nikkei 225	30018	1,5%	5,3%	15,4%	27,6%	9,4%
Brasilien BOVESPA	119199	-0,1%	-1,0%	11,1%	3,4%	0,2%
Russland RTS	1457	-0,3%	-1,2%	15,8%	-5,6%	5,0%
Indien BSE 30	50890	-1,2%	3,8%	15,8%	24,0%	6,6%
China Shanghai Composite	3696	1,1%	3,6%	10,7%	23,9%	6,4%
MSCI Welt (in €)	2803	-0,1%	3,1%	7,3%	3,0%	5,4%
MSCI Emerging Markets (in €)	1425	-0,1%	4,8%	16,1%	14,8%	11,6%
Bond markets						
Bund-Future	174,68	-175	-298	-50	23	-296
Bobl-Future	134,54	-53	-72	-82	-21	-64
Schatz-Future	112,22	-6	-9	-9	17	-6
3 Monats Euribor	-0,54	2	2	1	-13	4
3M Euribor Future, Dec 2017	-0,55	2	2	-2	-8	0
3 Monats $ Libor	0,18	-2	-4	-5	-151	-6
Fed Funds Future, Dec 2017	0,09	1	2	1	-115	0
10 year US Treasuries	1,30	16	21	45	-29	39
10 year Bunds	-0,33	16	24	23	7	25
10 year JGB	0,11	3	9	8	14	9
10 year Swiss Government	-0,25	11	22	23	50	24
US Treas 10Y Performance	695,63	-0,9%	-1,2%	-3,2%	6,0%	-2,8%
Bund 10Y Performance	672,95	-0,8%	-1,7%	-1,6%	-0,1%	-1,7%
REX Performance Index	495,32	-0,5%	-0,8%	-0,7%	-0,3%	-0,8%
US mortgage rate	0,00	0	0	0	0	0
IBOXX AA, €	0,15	7	13	14	3	13
IBOXX BBB, €	0,60	6	8	-2	-7	5
ML US High Yield	4,72	0	-18	-74	-114	-26
Convertible Bonds, Exane 25	8289	-0,6%	-0,7%	2,4%	4,7%	-0,5%
Commodities						
MG Base Metal Index	382,48	1,5%	5,3%	14,4%	35,3%	7,8%
Crude oil Brent	63,19	3,3%	14,5%	44,2%	9,9%	21,8%
Gold	1770,10	-3,6%	-3,0%	-6,2%	11,9%	-6,7%
Silver	27,28	0,9%	10,0%	11,2%	53,3%	3,4%
Aluminium	2101,55	1,2%	5,5%	7,2%	24,2%	6,5%
Copper	8403,25	1,4%	5,9%	19,2%	45,0%	8,4%
Iron ore	164,59	2,8%	-3,2%	34,9%	94,0%	5,6%
Freight rates Baltic Dry Index	1770	34,8%	0,9%	59,2%	307,8%	29,6%
Currencies						
EUR/ USD	1,2135	-0,1%	0,1%	2,1%	12,0%	-1,1%
EUR/ GBP	0,8672	-1,2%	-2,6%	-3,2%	4,1%	-3,1%
EUR/ JPY	127,84	0,6%	1,7%	3,3%	7,4%	1,1%
EUR/ CHF	1,0846	0,4%	0,7%	0,3%	1,9%	0,4%
USD/ CNY	6,4550	0,0%	-0,4%	-1,6%	-7,5%	-1,1%
USD/ JPY	105,87	1,1%	1,9%	1,6%	-3,7%	2,5%
USD/ GBP	0,71	-1,2%	-2,9%	-5,2%	-7,0%	-2,3%

Source: Refinitiv Datastream

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