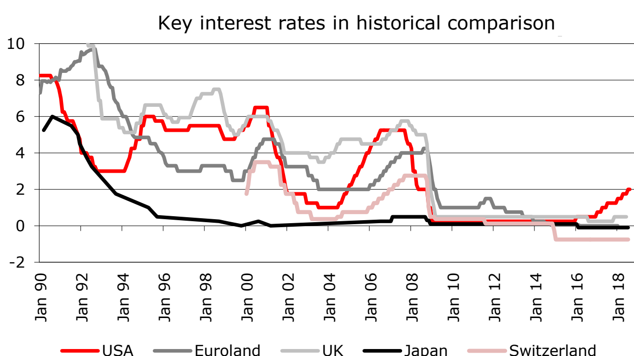
ECONOMIC SITUATION AND STRATEGY

3. August 2018

When will interest rates turn around?

For many years, key lending rates in the US and Europe were in unison with the Fed almost always holding the baton. During the global economic crisis the Fed started lowering interest rates in the fall of 2007 from 5.25 to 4.75 percent as a swift reaction to a deteriorating economy. Over the course of 2008, US key lending rates dropped in seven quick steps to zero percent while the ECB maintained a more restrictive monetary policy until July of 2008. Only after the Lehman Brothers bankruptcy on September 15th 2008 did the ECB realize that its monetary policy should take account of the adverse economic environment and financial market turmoil. At their joint central bank conference on October 8th, with the US, Canada, Great Britain, Sweden, and Switzerland all decided to lower interest rates.



This decision and the later on escalating financial and economic crisis rang in a new era of monetary policy resulting in a continuous decline of capital market interest rates. After central banks had fully exhausted the possibilities of typical monetary policy by bringing key lending rates down to zero percent they embarked on a new broad-based experiment in monetary policy called quantitative easing or QE for short. Quantitative easing means that central banks buy large quantities of securities mostly government bonds but also corporate bonds and mortgage bonds on the capital market. These purchases drive up bond prices and conversely bring down yields and thus interest rates whilst simultaneously injecting the banking system with liquidity. While this leaves fixed-income investors with progressively less attractive investment conditions, borrowers get ever more favorable interest and repayment terms. Increasing private and corporate credit demand should then drive consumption and business investment, which will boost economic growth and raise inflation.

The Fed led the way in December 2008 with its first QE program followed by two successor programs in 2010 and 2012. Great Britain and Switzerland were quick to follow in contrast to the ECB. Despite a dramatic recession in Euroland and a drop in inflation from over 3 percent in 2008 to near zero the next year with a recovery to 1.6 percent in 2010, the ECB lowered its key lending rate to one percent by spring 2009 where it remained until April 2011. In contrast to all other major central banks, the ECB interpreted the temporary recovery in 2010 and occasional inflation spikes as sufficient reason to raise interest rates again in April and July of 2011. This proved to be a dire mistake when the European debt crisis hit. In March 2015 the ECB finally launched its own QE program. At that time – six years after the US's first QE program – the Fed had already stopped its bond purchases. The ECB, however, expanded its bond purchase program in March 2016 and intends to phase it out at the end of 2018. Will this be the end of highly expansive monetary policy across the

globe? And – may investors assume that interest rates are going to rise substantially in the foreseeable future?

One may safely assume that monetary policy decisions of the major central banks will continue to diverge rather than follow a leader in lockstep as prior to 2008. It is quite obvious that the Fed will maintain its leading role in monetary policy as the US economy still keeps its cyclical lead. The Fed has made it clear that there are two more rate hikes coming this year - probably in September and December. Since the end of 2015, the Fed has raised the Fed Funds Target Rate in seven increments from the range of 0-0.25 percent to 1.75-2.0 percent. At the end of this year the target range should reach 2.25 to 2.5 percent with three more hikes expected for 2019. That means the interest rate trend has already turned around in the US as the higher rate level has correspondingly impacted capital market yields. The yield on 10-year treasuries has gone up from just under 1.4 percent in July 2016 to 3 percent just recently. And yields will rise further since the Fed Funds Target Rate is supposed to increase another 125 basis points in probably five increments by the end of 2019. Considering the fact that inflation should drop from currently 2.2 percent to about 1.5% by the middle of next year and hedge funds and other market speculators are already making record-high bets for rising interest rates on US government bonds, the yield on 10-year treasuries should remain at around three percent until the end of the year and then advance some 50 basis points next year. Even though a three percent yield is rather attractive investors should heed that already a yield increase of just under 40 basis points would cause the price drop on the bond to exceed its coupon leaving the value development slightly negative for the year. Investment profits on US bonds will therefore largely depend on how the exchange rates develop.

A glance at international monetary policy shows that only a few major central banks followed the Fed's interest lead in the past twelve months including those of Mexico, Canada, Great Britain, India, Indonesia, Romania, and the Czech Republic. We monitor about 50 central banks. Almost 20 of them raised interest rates and 30 of them kept interest rates unchanged in the past twelve months and we do not expect this picture to change much in the next 12 months. Au contraire, as the latest round of economic data turned out rather weak and inflation should go down again due to base line effects, Euroland, Japan, and many emerging economies have no incentive to appreciably raise interest rates.

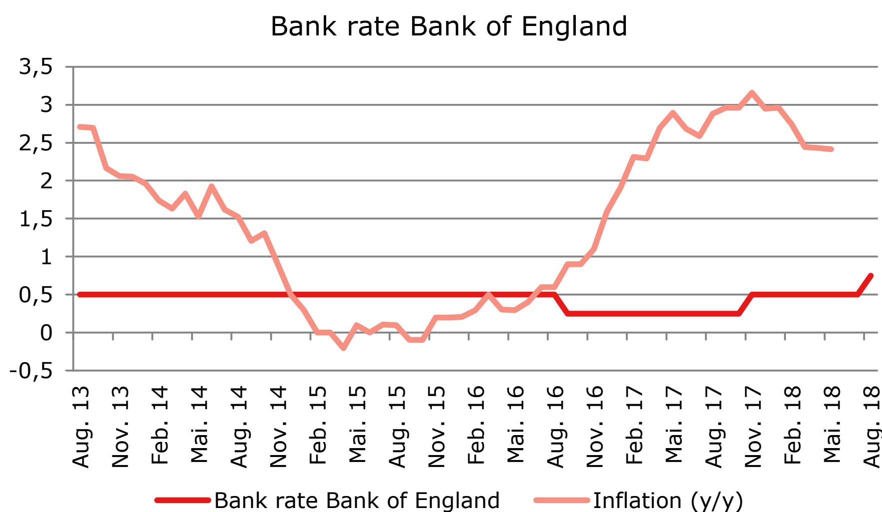
The ECB made it abundantly clear at its last meeting that it will not raise interest rates until after the summer of 2019. That means the first rate hike since 2011 will happen in October 2019 at the earliest. This argues in favor of there being no significant turnaround of interest rates in the next twelve months. Slightly higher yields, for instance, on German Bunds still remain likely as central banks are buying less of them. Yet, even with no new budget for bond purchases and therefore no more ECB balance sheet expansion maturing bonds will still be replaced. Just for the first six months of 2019, the ECB will reinvest an average of some 17 billion euros per month into bonds. This should prevent a major yield increase. If yields were to rise more strongly nonetheless, the ECB has the option of “Operation Twist” where it would favor new long bond issues in its reinvestments. For fixed–income investors this entails the bad news that yields on 10-year bunds will continue to grow at a snail's pace.

Weekly outlook for August 6-10, 2018

	Mar	Apr	May	June	July	Aug	Release
DE: Order intake, m/m	1.4%	-1.3%	2.6%	0.2%			August, 6
DE: Order intake, y/y	3.6%	1.4%	3.1%	3.8%			August, 6
DE: Industrial production, m/m	-1.1%	-1.6%	2.6%	0.3%			August, 7
DE: Industrial production, y/y	3.0%	0.8%	4.4%	3.9%			August, 7
DE: Exports, m/m	1.9%	-0.3%	1.8%	-0.1%			August, 7
DE: Exports, y/y	4.2%	3.1%	3.6%	5.4%			August, 7
DE: Imports, m/m	-0.5%	2.6%	0.7%	0.2%			August, 7
DE: Imports, y/y	2.3%	4.3%	4.3%	7.8%			August, 7
EUR-19: Sentix	24.0	19.6	19.2	9.3	12.1	12.4	August, 6

MMWB estimates in red

Chart of the Week: Second rate hike in 11 years



In the past eleven years, the Bank of England (BoE) had raised interest rates only once. Yesterday, the BoE's Monetary Policy Committee resolved to increase interest rates for the second time by 25 basis points to 0.75 percent. Although most market participants expected this to happen, it was by no means an inevitable move. Indeed, the committee's unanimity was surprising considering how ambiguous the recent data releases were. The BoE's inflation target is 2.0 percent. Current inflation is above target at 2.4% arguing in favor of a rate hike as do some of the other data. For example, economic growth remains robust at a forecast 1.75% y/y, which is above potential growth and could lead to further inflation pressure. The labor market is also in very good shape with record employment and the lowest unemployment rate since the 1970s. This could cause wage hikes resulting in more disposable income, which in turn fuels consumption and thus inflation. On the other hand, some economic data have recently taken a turn for the worse. The current purchasing managers' index shows weaker growth than in the past few months. Inflation, too, has been letting up in the past few months and consumer confidence is going down as well. In light of a possible trade war with the US and the imminent Brexit at still unresolved conditions this is quite understandable. However, the BoE seems to take a somewhat hawkish stance as its first-time publication of an estimated natural interest rate suggests. The natural interest rate may be considered indicative of medium-term rate levels and at an estimated two to three percent would suggest further interest increases. It is entirely unclear, though, how things will actually turn out given the political vicissitudes.

Market data overview

Stock marktes	As of 03.08.2018 11:14	Change versus 27.07.2018 -1 week	02.07.2018 -1 month	02.05.2018 -3 months	02.08.2017 -1 year	29.12.2017 YTD
Dow Jones	25326	-0,5%	4,2%	5,9%	15,0%	2,5%
S&P 500	2827	0,3%	3,7%	7,3%	14,1%	5,7%
Nasdaq	7803	0,8%	3,1%	9,9%	22,6%	13,0%
DAX	12603	-2,0%	3,0%	-1,6%	3,5%	-2,4%
MDAX	26910	-0,2%	4,9%	2,3%	8,5%	2,7%
TecDAX	2928	-0,8%	9,8%	8,7%	29,0%	15,8%
EuroStoxx 50	3479	-1,4%	3,2%	-2,1%	0,6%	-0,7%
Stoxx 50	3127	-1,1%	3,5%	1,0%	1,2%	-1,6%
SMI (Swiss Market Index)	9149	-0,3%	7,3%	2,8%	0,3%	-2,5%
Nikkei 225	22525	-0,8%	3,3%	0,2%	12,2%	-1,1%
Brasilien BOVESPA	79637	-0,3%	9,3%	-5,8%	18,6%	4,2%
Russland RTS	1137	-1,3%	-1,3%	0,1%	11,3%	-1,5%
Indien BSE 30	37543	0,6%	6,5%	6,7%	15,6%	10,2%
China Shanghai Composite	2741	-4,6%	-1,2%	-11,0%	-16,6%	-17,1%
MSCI Welt (in €)	2148	0,0%	3,7%	7,2%	11,3%	5,7%
MSCI Emerging Markets (in €)	1067	-1,9%	1,3%	-3,9%	1,9%	-4,6%
Bond markets						
Bund-Future	163,14	107	51	455	28	146
Bobl-Future	131,77	-8	-48	82	-57	16
Schatz-Future	111,94	-2	-18	3	-17	-3
3 Monats Euribor	-0,32	0	0	1	1	1
3M Euribor Future, Dec 2017	-0,30	0	0	2	-13	0
3 Monats $ Libor	2,35	1	1	-1	104	65
Fed Funds Future, Dec 2017	2,22	0	5	3	76	0
10 year US Treasuries	2,98	2	11	2	71	57
10 year Bunds	0,43	8	13	-15	1	0
10 year JGB	0,11	1	8	7	4	6
10 year Swiss Government	-0,01	3	8	-10	0	12
US Treas 10Y Performance	558,81	-0,2%	-0,8%	0,0%	-4,1%	-3,9%
Bund 10Y Performance	613,44	-0,5%	-0,9%	1,8%	1,8%	1,0%
REX Performance Index	482,73	-0,3%	-0,6%	0,7%	0,2%	0,4%
US mortgage rate	0,00	0	0	0	0	0
IBOXX AA, €	0,78	2	2	-4	3	10
IBOXX BBB, €	1,60	4	-5	15	32	37
ML US High Yield	6,57	2	-19	5	61	42
JPM EMBI+, Index	796	-0,9%	1,4%	-0,4%	-3,7%	-4,9%
Convertible Bonds, Exane 25	7378	0,0%	0,6%	-0,8%	2,7%	-0,3%
Commodities						
CRB Spot Index	427,83	-1,1%	-2,3%	-4,1%	-3,3%	-1,1%
MG Base Metal Index	312,81	-1,9%	-7,1%	-10,4%	-0,3%	-12,8%
Crude oil Brent	73,14	-2,3%	-6,1%	0,5%	40,0%	9,8%
Gold	1207,84	-1,3%	-3,1%	-7,5%	-4,9%	-7,3%
Silver	15,40	-0,9%	-3,0%	-6,2%	-7,9%	-9,5%
Aluminium	2010,75	-2,1%	-5,2%	-13,6%	5,7%	-10,9%
Copper	6110,50	-2,6%	-6,3%	-9,9%	-3,3%	-15,2%
Iron ore	66,86	4,3%	4,3%	-0,9%	-7,2%	-6,2%
Freight rates Baltic Dry Index	1756	4,8%	23,5%	30,5%	76,8%	28,6%
Currencies						
EUR/ USD	1,1582	-0,4%	-0,5%	-3,5%	-2,1%	-3,4%
EUR/ GBP	0,8909	0,4%	0,7%	1,3%	-0,6%	0,4%
EUR/ JPY	129,35	0,1%	0,4%	-1,9%	-1,2%	-4,2%
EUR/ CHF	1,1522	-0,6%	-0,4%	-3,6%	0,5%	-1,5%
USD/ CNY	6,8682	0,8%	3,0%	7,9%	2,1%	5,6%
USD/ JPY	111,66	0,5%	0,7%	1,6%	0,8%	-0,9%
USD/ GBP	0,77	1,0%	1,0%	4,6%	1,8%	4,1%

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