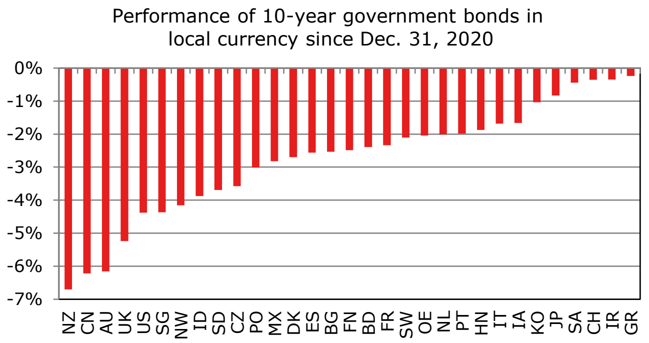
ECONOMIC SITUATION AND STRATEGY

March 5, 2021

Central banks: Speech is silver, but action is golden

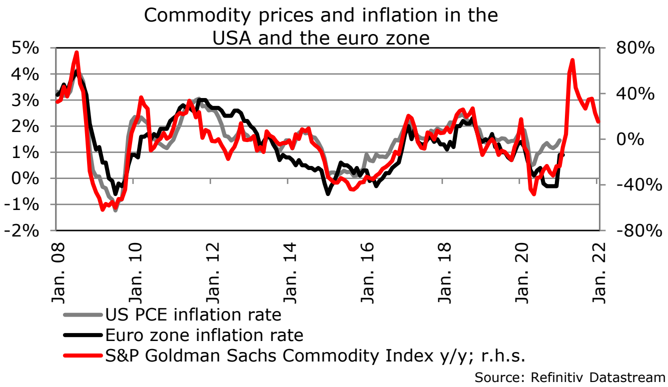
The sharp rise of yields in the past few weeks now also has the attention of the central banks. Some governors of the US Federal Reserve and the European Central Bank have commented on this development, with one aspect clearly in focus. Both central banks have emphasized that they intend to keep policy interest rates at current levels for a long period despite the emerging economic recovery and expectation of temporarily rising inflation rates. Even though central banks can only indirectly influence short-term interest rates by means of monetary policy, the development of long-term interest rates depends largely on expectations of how their policy interest rates will develop.

However, central bank attempts to communicate have not impressed the bond market. The yield on 10-year US Treasuries is now just under 1.5%, almost 60 basis points higher than at the beginning of the year. German government bonds (Bunds) with a 10-year residual maturity are yielding about 25 points higher at -0.31%. No country can successfully resist the phenomenon of rising capital market yields now. All of the more than 30 markets with 10-year government bonds that we have studied exhibit higher yields than at the beginning of the year. At about -6%, the negative performance (calculated from price and pro rata coupon, each in local currency) is especially pronounced in New Zealand, Canada, Australia, while Greece, Ireland, China, and South Africa have seen only small losses.

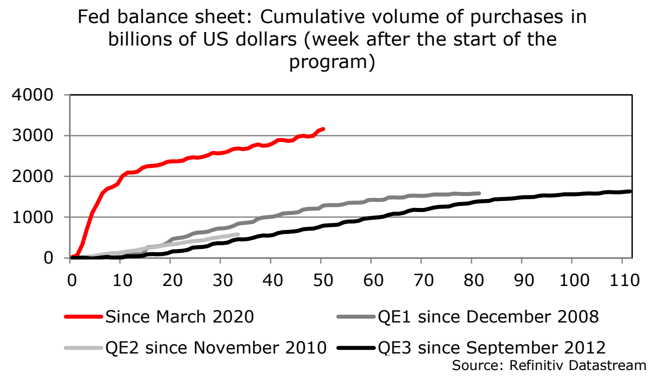


Source: Refinitiv Datastream

Heightened inflation expectations – and related implicit fears that central banks will not be able to keep their promises of continuing low interest rates – are the main reason for this poor government bond performance. For example, prices of commodities have risen sharply since the end of last year. Copper and iron ore are more expensive than at any time in the past ten years, and oil has made up last year's price slump due to the pandemic. This reflects both higher demand (copper and iron ore, for example, are benefiting from the economic upswing in China) and lower supply (reduced OPEC production and weather-related shutdowns in Texas). The S&P Goldman Sachs Commodity Index, which covers the prices of more than 20 different commodities, is now about 60% above its April 2020 level. The bad news is that the rise of commodity prices will inevitably lead to significantly higher inflation rates in the coming months, since synchronization with US and euro zone consumer price indexes is comparatively high. Headline inflation rates will therefore increase to 3% or maybe even 4% in the summer months, if commodity prices stabilize at the current level. The good news is that the effects on the core inflation rate, which the central banks consider decisive, is substantially lower. Moreover, the sharp price increase is attributable to the low year-earlier base, so it is likely to be a temporary development. But it will take a few months until everyone clearly recognizes that this is just a "price hump." And the advance of government bond yields might continue in the meantime.



What options do the central banks have to rein in this rise of interest rates and yields, which is undesirable from their perspective? When talk gets you nowhere, action is the only thing that will help. The Fed could increase the volume of its asset purchases, as it already has in the past two weeks. However, there is so far no unanimity among FOMC members about whether to accelerate expansion of the Fed's balance sheet again. Nevertheless, a policy of yield curve control, in which the central bank would set an explicit upper limit on the yields of certain bond maturities, would be by far the most effective instrument for preventing a development like that of the past few weeks. However, such a measure is presumably unlikely to find a majority in a phase of economic recovery. Another possibility would be for the central bank to change the maturity structure of its bond holdings. Such an "Operation Twist," in which short-dated bonds are sold, and long-dated bought, was last adopted in September 2011. At that time, the desired effect was achieved, and the yield on 10-year US Treasuries declined significantly. However, the economic outlook was more negative in 2011 than it is today, so presumably yields will first have to continue rising until the Fed makes such a decision.



The ECB has similar options as the Fed. It is now actually fighting on two fronts that are making financing conditions for businesses worse: higher yields and a stronger euro. That is why many members of the ECB Council have expressed concern about the current developments in the past days. Moreover, unlike in the United States, the scenario for the economy and inflation is significantly more contradictory. For, while the United States is likely to see spectacular growth thanks to rapid vaccination progress and expectations of a large fiscal program in 2021, the situation in the euro zone is less positive and especially more heterogeneous. That applies not only to growth prospects, but also to the inflation outlook. The significant rise of inflation rates in the beginning of the year, which was much stronger than in the United States, is attributable to a few countries and to some special factors. While, for example, inflation rates have risen sharply in Germany and the Netherlands, France and Spain show lower inflation rates, and those were again lower in February compared with January. Moreover, the upsurge of prices in the beginning of the year was limited to a few types of goods, such as clothing and shoes. Considering that almost all retailers from those two segments have had to keep their shops closed, one wonders how accurately prices there could be measured at all. It is quite possible that the sharp increase exaggerates the actual situation. We believe this shows that the ECB should soon substitute action for words to keep the yield upsurge from choking off fragile growth.

Market Data

Stock marktes	As of 05.03.2021 16:03	Change versus 26.02.2021 -1 week	04.02.2021 -1 month	04.12.2020 -3 months	04.03.2020 -1 year	31.12.2020 YTD
Dow Jones	30924	0,0%	-0,4%	2,3%	14,1%	1,0%
S&P 500	3768	-1,1%	-2,7%	1,9%	20,4%	0,3%
Nasdaq	12723	-3,6%	-7,7%	2,1%	41,1%	-1,3%
DAX	13972	1,3%	-0,6%	5,1%	15,2%	1,8%
MDAX	31165	-0,3%	-3,7%	5,6%	19,4%	1,2%
TecDAX	3265	-2,4%	-6,8%	4,7%	10,7%	1,6%
EuroStoxx 50	3692	1,5%	1,4%	4,3%	7,9%	3,9%
Stoxx 50	3178	1,7%	0,1%	2,8%	0,1%	2,2%
SMI (Swiss Market Index)	10680	1,5%	-1,7%	3,0%	4,2%	-0,2%
Nikkei 225	28864	-0,4%	1,8%	7,9%	36,8%	5,2%
Brasilien BOVESPA	112690	2,4%	-5,5%	-0,9%	5,1%	-5,3%
Russland RTS	1441	2,1%	2,8%	6,2%	6,9%	3,9%
Indien BSE 30	50405	2,7%	-0,4%	11,8%	31,2%	5,6%
China Shanghai Composite	3502	-0,2%	0,0%	1,7%	16,3%	0,8%
MSCI Welt (in €)	2706	0,8%	-1,4%	4,4%	12,5%	3,4%
MSCI Emerging Markets (in €)	1346	2,1%	-2,5%	9,6%	20,9%	7,2%
Bond markets						
Bund-Future	174,27	87	-205	-55	-363	-337
Bobl-Future	134,58	37	-37	-79	-140	-60
Schatz-Future	112,20	3	-6	-12	-22	-8
3 Monats Euribor	-0,54	2	2	1	-7	4
3M Euribor Future, Dec 2017	-0,53	-3	3	0	6	0
3 Monats $ Libor	0,19	1	0	-3	-81	-4
Fed Funds Future, Dec 2017	0,08	-1	1	0	-30	0
10 year US Treasuries	1,56	11	42	59	56	64
10 year Bunds	-0,30	-1	19	25	34	28
10 year JGB	0,09	-7	4	7	24	7
10 year Swiss Government	-0,26	-5	13	19	62	24
US Treas 10Y Performance	679,58	-0,9%	-3,1%	-4,5%	-2,0%	-5,1%
Bund 10Y Performance	669,45	0,5%	-1,3%	-2,0%	-2,9%	-2,2%
REX Performance Index	493,69	0,2%	-0,8%	-1,1%	-1,6%	-1,1%
US mortgage rate	0,00	0	0	0	0	0
IBOXX AA, €	0,19	-6	9	17	9	17
IBOXX BBB, €	0,67	-5	10	9	-9	12
ML US High Yield	4,91	7	8	-24	-127	-7
Convertible Bonds, Exane 25	8101	0,0%	-3,4%	-0,7%	4,7%	-2,7%
Commodities						
MG Base Metal Index	386,62	-4,3%	8,0%	8,5%	39,1%	9,0%
Crude oil Brent	68,55	3,7%	16,3%	38,9%	32,2%	32,1%
Gold	1696,20	-1,8%	-5,2%	-7,5%	3,4%	-10,6%
Silver	26,16	-0,3%	-0,1%	8,5%	52,4%	-0,8%
Aluminium	2153,75	0,2%	8,3%	6,1%	25,5%	9,1%
Copper	8932,75	-2,3%	14,1%	15,3%	57,7%	15,3%
Iron ore	174,94	5,6%	12,6%	23,6%	95,2%	12,3%
Freight rates Baltic Dry Index	1779	6,2%	34,1%	48,6%	216,5%	30,2%
Currencies						
EUR/ USD	1,1937	-1,5%	-0,5%	-1,8%	7,3%	-2,7%
EUR/ GBP	0,8634	-0,6%	-1,6%	-4,2%	-0,7%	-3,5%
EUR/ JPY	129,29	0,4%	2,4%	2,3%	8,1%	2,2%
EUR/ CHF	1,1074	0,8%	2,4%	2,3%	4,0%	2,5%
USD/ CNY	6,4902	0,2%	0,3%	-0,6%	-6,3%	-0,6%
USD/ JPY	107,98	1,3%	2,3%	3,7%	0,4%	4,6%
USD/ GBP	0,72	1,1%	-1,2%	-2,5%	-7,3%	-1,1%

Source: Refinitiv Datastream

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