M.M.WARBURG & CO
BANK

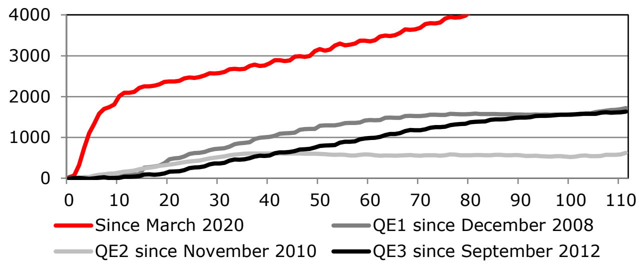
ECONOMIC SITUATION AND STRATEGY

5. November 2021

Are Interest Rates Turning Around?

US Fed Chief Jerome Powell announced last night to a very unsurprised audience that the Federal Reserve will begin to scale back its bond purchases this month. At the beginning of the Covid pandemic in March 2020, the Federal Reserve resolved to buy US sovereigns and mortgage-backed securities on the secondary market initially unlimited and later limited to 120 billion US dollars per month. This quantitative easing measure became necessary to preserve monetary policy maneuvering room as the key lending rate was already at naught. As a result of these extensive bond purchases the Fed's balance sheet total has doubled from USD 4.2 trillion to USD 8.4 trillion in the past one and a half years.

Fed balance sheet: Cumulative volume of purchases in billions of US dollars (week after the start of the program)



Source: Refinitiv Datastream

In light of the economic recovery but even more so due to the recent substantial rise in inflation, it is indeed prudent to ease off the easing and Jerome Powell emphatically reiterated that the Fed would taper out its bond purchase program very gradually and carefully. The road map has been set up so that purchases will be reduced by USD 15 billion each month for the next few months until the Fed will buy no more new bonds by June 2020. This makes one thing clear: Tapering does not mean tightening and cutting down purchase volume certainly does not mean that monetary policy becomes more restrictive since the Fed balance sheet will grow to about USD 9 trillion by next summer. Only after bond purchases have come to a complete stop the Fed may start even contemplating interest rate hikes. From today's perspective, a first interest rate hike could be possible sometime in the second half of 2022 and most Fed members share this view.

MEETING PROBABILITIES							
MEETING DATE	0-25	25-50	50-75	75-100	100-125	125-150	150-175
15.12.2021	100,0%	0,0%	0,0%	0,0%	0,0%	0,0%	
26.01.2022	98,8%	1,2%	0,0%	0,0%	0,0%	0,0%	0,0%
16.03.2022	85,4%	14,5%	0,2%	0,0%	0,0%	0,0%	0,0%
04.05.2022	74,0%	23,9%	2,1%	0,0%	0,0%	0,0%	0,0%
15.06.2022	42,3%	45,4%	11,4%	0,9%	0,0%	0,0%	0,0%
27.07.2022	33,2%	44,7%	18,7%	3,2%	0,2%	0,0%	0,0%
21.09.2022	19,3%	39,9%	29,6%	9,7%	1,4%	0,1%	0,0%
02.11.2022	14,9%	35,2%	32,0%	14,2%	3,3%	0,4%	0,0%
14.12.2022	7,8%	25,5%	33,5%	22,7%	8,5%	1,8%	0,2%
01.02.2023	6,2%	21,8%	31,8%	25,0%	11,5%	3,2%	0,5%

Source: CME FedWatch Tool, 4 November 2021

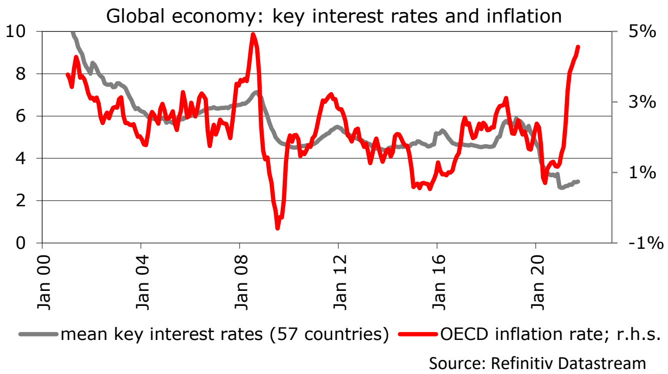
The announced Fed procedure is somewhat controversial, though. With GDP being above pre-pandemic level now, unemployment greatly reduced, and inflation markedly above the traditional 2-percent benchmark – quite a few market players and economists accuse the Fed of being behind the curve and that its ex-post-facto action to combat inflation is actually making it worse. Especially the sentiment that high inflation may be due to 'presumably temporary factors' is increasingly coming under scrutiny. Market players have booked their bets by now: Most of them expect an initial rate hike by 25 basis points around June 2022 and two more interest rate steps with an increase in the Fed Funds rate from 0.5 to 0.75 percent by the end of next year.

Whether the market is right on the money remains to be seen. We still think it is likely that price pressure will ease next year even though it looks like supply chain problems will probably stay with us for the long haul. However, it should be noted that forecast uncertainties resulting from the vicissitudes of pandemic reality are a bit like Jurassic Park. The M.M.Warburg & CO Research Team, too, has been surprised a few times this past year even though we had honed our senses for economic and price developments over the decades.

Our expectation that inflation will come down again mostly stems from our assumption that some statistical base effects will cause deflation next year. Crude oil, for instance, was at around USD 35 per barrel last year but is now at almost USD 85 per barrel representing an increase of 140 percent. To get the same effect next year, crude oil would have to get up to about USD 200 per barrel. Inconceivable? Not entirely. But is it probable? In the past six weeks, US oil stockpiles increased substantially after dwindling away in the second and third quarter as the economy picked up again. This should at least safeguard against further escalating oil prices. For next year, one may assume that oil supply will exceed oil demand so that the oil price rally should peter out. Transport costs, too, seem to be coming down: The Baltic Exchange Index for commodities like coal and iron ore recently dropped to its lowest level since the middle of June; the reason being lower demand at increasing cargo capacity.

We therefore think that the Fed may raise interest rates once next year but probably not twice. In contrast to the Fed, we do not expect the European Central Bank (ECB) to raise interest rates next year although many market players recently put money – as for the US – on an initial rate hike sometime after September 2022. Even though Euroland inflation turned out surprisingly high at 4.1 percent in October, there are many indications that this situation will calm down next year. We believe that European inflation will drop below three percent by the beginning of next year and then go back down below two percent by midyear. However, the ECB, too, will phase down its bond purchases but – in contrast to the Fed, not entirely stop them.

We thus assume that monetary policy in Euroland and (to a slightly lesser extent) in the US will remain expansive. This argues against a sustained trend reversal in interest rates. One should not overlook, though, that some central banks have already raised interest rates this year and thus tightened monetary policy. These were primarily central banks in emerging economies notably Brazil (+575 basis points since the beginning of this year). Russia (+325 basis points), and - this week – the central bank of Poland. There were also some interest rate hikes in industrialized countries including Norway, New Zealand, and South Korea but thus far only in baby steps of 25 basis points. One may conclude that the trend reversal in interest rates is already underway even if somewhat covertly.



For investors that means remaining cautious in bond purchasing as particularly sovereigns are likely to suffer some more price losses. In a market phase of no longer expansive and tentatively more restrictive monetary policy, stock markets may offer better prospects.

Market Data

Stock marktes	As of 05.11.2021 10:04	Change versus 30.09.2021 -1 week	06.09.2021 -1 month	06.07.2021 -3 months	06.10.2020 -1 year	31.12.2020 YTD
Dow Jones	36124	6,7%	2,1%	4,5%	30,1%	18,0%
S&P 500	4680	8,6%	3,2%	7,7%	39,2%	24,6%
Nasdaq	15940	10,3%	3,8%	8,7%	42,9%	23,7%
DAX	16020	5,0%	0,6%	3,3%	24,1%	16,8%
MDAX	35855	4,3%	-1,0%	3,8%	29,6%	16,4%
TecDAX	3961	5,8%	-0,2%	10,0%	27,3%	23,3%
EuroStoxx 50	4342	7,3%	2,3%	7,1%	34,3%	22,2%
Stoxx 50	3760	7,4%	3,2%	6,8%	28,7%	21,0%
SMI (Swiss Market Index)	12456	7,0%	0,2%	4,1%	21,7%	16,4%
Nikkei 225	29612	0,5%	-0,2%	3,4%	26,4%	7,9%
Brasilien BOVESPA	103412	-6,8%	-12,3%	-17,3%	8,2%	-13,1%
Russland RTS	1831	3,0%	5,4%	11,3%	56,7%	31,9%
Indien BSE 30	60068	1,6%	3,0%	13,6%	51,8%	25,8%
China CSI 300	4842	-0,5%	-1,9%	-4,7%	5,6%	-7,1%
MSCI Welt (in €)	3225	7,6%	4,6%	8,7%	38,3%	27,4%
MSCI Emerging Markets (in €)	1268	1,5%	-1,6%	-3,4%	17,6%	4,4%
Bond markets						
Bund-Future	170,21	39	-504	-339	-406	-743
Bobl-Future	134,98	5	5	60	-16	-20
Schatz-Future	112,24	4	-1	6	-3	-3
3 Monats Euribor	-0,57	1	0	-1	-7	1
3M Euribor Future, Dec 2017	-0,55	-1	-1	-2	-1	0
3 Monats $ Libor	0,12	-1	1	-1	-11	-11
Fed Funds Future, Dec 2017	0,08	0	0	-2	3	0
10 year US Treasuries	1,52	0	20	15	78	61
10 year Bunds	-0,24	-4	13	8	27	34
10 year JGB	0,06	-1	2	3	3	4
10 year Swiss Government	-0,16	1	16	11	34	34
US Treas 10Y Performance	692,88	0,1%	-1,6%	-0,8%	-4,5%	-3,2%
Bund 10Y Performance	662,94	-0,1%	-1,8%	-1,0%	-2,6%	-3,2%
REX Performance Index	490,91	-0,2%	-1,0%	-0,7%	-1,5%	-1,7%
US mortgage rate	0,00	0	0	0	0	0
IBOXX AA, €	0,34	1	14	11	19	32
IBOXX BBB, €	0,72	4	15	10	-17	16
ML US High Yield	4,76	8	17	20	-116	-22
Convertible Bonds, Exane 25	8153	0,0%	-2,4%	-2,8%	3,8%	-2,1%
Commodities						
MG Base Metal Index	435,13	0,7%	-1,3%	0,4%	41,9%	22,7%
Crude oil Brent	81,02	3,1%	12,4%	8,5%	89,5%	56,1%
Gold	1796,84	2,0%	-1,4%	-0,3%	-6,1%	-5,3%
Silver	22,54	2,1%	-8,9%	-13,8%	-5,4%	-14,6%
Aluminium	2883,75	1,5%	4,6%	15,0%	65,8%	46,1%
Copper	9052,60	1,2%	-4,1%	-2,5%	39,0%	16,8%
Iron ore	97,17	-18,8%	-32,9%	-55,3%	-20,2%	-37,6%
Freight rates Baltic Dry Index	2769	-46,4%	-27,6%	-12,9%	32,0%	102,7%
Currencies						
EUR/ USD	1,1544	-0,3%	-2,7%	-2,5%	-2,1%	-5,9%
EUR/ GBP	0,8580	-0,2%	0,0%	0,2%	-5,6%	-4,1%
EUR/ JPY	131,36	1,3%	0,8%	0,3%	5,4%	3,9%
EUR/ CHF	1,0545	-2,6%	-3,0%	-3,5%	-2,2%	-2,4%
USD/ CNY	6,3996	-0,8%	-0,9%	-1,2%	-5,8%	-2,0%
USD/ JPY	111,43	0,1%	1,4%	0,7%	5,5%	7,9%
USD/ GBP	0,74	0,2%	2,8%	2,7%	-3,6%	1,6%

Source: Refinitiv Datastream

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