M.M.WARBURG & CO
BANK

ECONOMIC SITUATION AND STRATEGY

10. December 2021

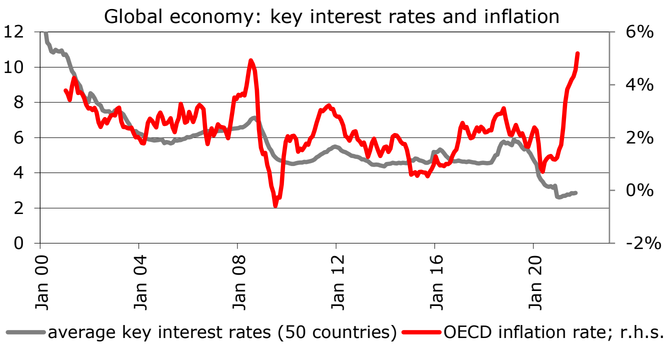
Outlook 2022 (II): Interest Rate Turnaround in Slow Motion

They are indeed moving, albeit at glacial speed - the international interest rate levels. As inflation escalated and economies recovered the first central banks started raising interest rates this year. However, most guardians of their currencies remain cautious as there is a clear and present danger of stopping the recovery by acting too early. This second part of our forecast for the year ahead looks at interest rate developments, bond market prospects, and the direction of the euro/US dollar exchange rate. Feel free to also visit our YouTube channel where you can watch and comment our presentation of these forecasts.

https://www.youtube.com/c/MMWarburgCO

Central banks across the globe kept interest rates low and monetary policy markedly more expansive in 2020. Of the fifty central banks we regularly cover almost all lowered lending rates last year. In 2021, however, the opposite applied with almost half of these central banks raising key lending rates again this year. This predominantly occurred in emerging economies, prominently in Brazil and Russia. Some industrialized countries, too, began raising interest rates again, for instance, New Zealand, Norway, and South Korea. This suggests that the interest rate turnaround has already started, albeit at a very low level.

The newest Covid variant and its potential successors are wild cards carrying great uncertainty for forecasting the future course of the economy and inflation, but we do believe that the economy will get less support from monetary policy next year. Yet, the international monetary policy environment remains complicated. If new economic constraints become necessary (which we currently do not assume) this could seriously curb economic recovery, which by itself would argue for keeping monetary policy highly expansive. There is also the possibility that the international supply chain disruption continues and further delays the availability of key manufacturing components – with possible negative impact on price development and the resulting risk of persistently high inflation. In that case, monetary policy should become more restrictive. To carefully balance these factors, central banks will be very cautious in making key lending rate adjustments for the time being. Especially 2022 monetary policy in industrialized countries will proceed in slow motion.



Source: Refinitiv Datastream

The US Federal Reserve is sentinel institution to watch. A favorable economic environment, continuing labor market recovery, and substantial inflation with rising inflation expectation are prompting the Fed to take the foot off the monetary policy gas. Since November, the Fed has been tapering its monthly purchases from originally USD 120 billion by USD 15 billion per month. At its next session on the 14th and 15th of December, the Fed is very likely to resolve an acceleration (possibly double) of its monthly tapering so that the bond purchasing program will end sometime in the second quarter of 2022 at the latest. This is not yet making monetary policy more restrictive as the Fed will continue to reinvest its maturing bond holdings, which will leave the Fed's balance sheet total unchanged. However, the quicker tapering of bond purchases is giving the Fed more flexibility to raise interest rates as early as next summer should inflation stay high. If no economic setback transpires until then, the currently expected inflation rate around four percent or three percent core inflation by June 2022 could result in an interest rate hike of 25 basis points. There may even be another rate hike in September. We believe that inflation will not get back near the two-percent mark until the fourth quarter of 2022. As such, we think that the interest rate expectations derived from Fed Funds Futures (first rate hike in May, second in September, and third in December of 2022) are exaggerated.

MEETING PROBABILITIES								
MEETING DATE	0-25	25-50	50-75	75-100	100-125	125-150	150-175	175-200
15.12.2021	98,9%	1,1%	0,0%	0,0%	0,0%	0,0%		
26.01.2022	94,0%	6,0%	0,1%	0,0%	0,0%	0,0%	0,0%	0,0%
16.03.2022	63,0%	35,0%	2,0%	0,0%	0,0%	0,0%	0,0%	0,0%
04.05.2022	42,1%	44,3%	12,9%	0,7%	0,0%	0,0%	0,0%	0,0%
15.06.2022	21,3%	43,2%	28,4%	6,7%	0,3%	0,0%	0,0%	0,0%
27.07.2022	14,2%	35,9%	33,3%	14,0%	2,5%	0,1%	0,0%	0,0%
21.09.2022	8,7%	27,4%	34,3%	21,5%	6,9%	1,0%	0,0%	0,0%
02.11.2022	6,2%	22,0%	32,3%	25,2%	11,2%	2,7%	0,3%	0,0%
14.12.2022	2,3%	12,2%	25,9%	29,6%	19,9%	8,0%	1,8%	0,2%
01.02.2023	1,7%	9,6%	22,4%	28,7%	22,4%	11,1%	3,4%	0,6%

Source: CME FedWatch Tool, 9.12.2021

Since economists are already anticipating an appreciable turnaround in monetary policy for next year, we assume that the yield on ten-year treasuries will only increase moderately to about 2.0 percent by the end of 2022 with a possible range of 1.75 to 2.25 percent. The greatest risk factor in this forecast is inflation development. If inflation is not going to come down substantially over the course of the year (as we expect it to), the Fed may feel forced to react earlier and more drastically with corresponding impact on capital market returns.

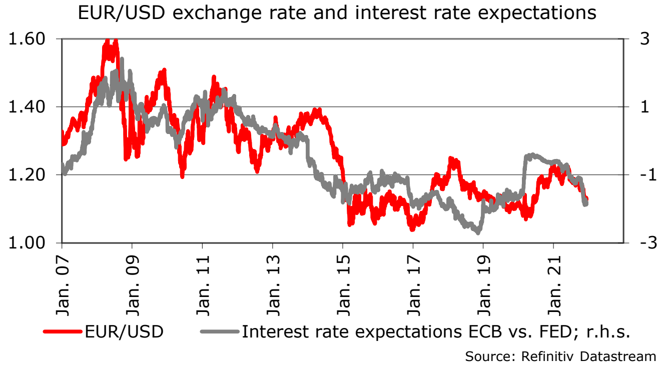
The picture looks rather different for Euroland. Over the past few weeks, ECB President Christine Lagarde and most of her colleagues repeatedly pointed out that the highly expansive monetary policy will continue for the longer term. The statements were made to counter market speculation that the European Central Bank may start raising rates already in 2022. However, the opinions stated by ECB Council members show a certain north/south slant, however, there are simply more southern members. Empirical evidence argues against betting against central banks (Don't Fight the Fed) and we therefore assume that the ECB Council will have actions follow its statement. The Pandemic Emergency Purchase Program (PEPP) will expire as planned in March 2022 but continue through the back door by advancing the smaller Asset Purchase Program (APP) to 'APP 2.0' allowing the European Central Bank to continue buying bonds on the capital market as well as reinvesting all the matured bonds in its portfolio. The new APP may get a different or no capital key and a new target volume for more flexible handling. The ECB economists assume that inflation will come down considerably over the course of 2022 and therefore a highly expansive monetary policy remains appropriate.

We expect that the ECB will begin raising key lending rates at the earliest in the second half of 2023 but probably rather sometime in 2024 even if the capital market as measured by the Euribor Futures may have arrived at a different conclusion for now. We see little chance for change in the development of 10-year Bund yields next year. Since Europe cannot entirely decouple from US treasuries development, we expect ten-year Bunds to yield +0.1 percent by the end of 2022 with a possible range of -0.1 percent to +0.3 percent. For investors, that means we expect price erosion to give Euroland and US government bonds again negative performance of about two to three percent in the ten-year maturity segment.

As in the past few years, we believe that in 2022 corporate bonds are more likely to show positive performance than sovereigns. We have several arguments for this assessment. Earnings of companies that nosedived during the height of the pandemic crisis have recovered by now. Many companies are showing record earnings and often also sufficient liquidity. From a technical perspective, corporate bonds are looking good. Although low-cost refinancing terms are largely used for new issues, we assume that the increasing number of maturing bonds will more than make up for this. Loan premiums should therefore come down further. Yet, spreads remain attractive even after having narrowed. Premiums are still three times as high in the BB range as compensating for historical default rates would justify.

Rating agencies assume default rates will come down further next year. We see this reflected in the ratio of rating improvements to rating downgrades that came to a factor of four in the third quarter of this year. Moreover, in contrast to sovereigns, corporate bonds have a build-in buffer to compensate for any interest rate or yield increases. The higher the risk level within the corporate bond sector, the higher this buffer will be. It is therefore not surprising that high-yield bonds can normally pull off a positive performance in times of more restrictive monetary policies and thus perform better than investment-grade corporate bonds or sovereigns.

In addition to continued ECB demand, this argues in favor of still preferring corporate bonds over sovereigns for investment into fixed-income securities next year. However, we expect net zero performance at best for investment grade corporate bonds. Our preferred segments include high-yield and junior bonds. These have the highest buffers to compensate for increasing capital market yields and we expect them to gain two to three percent in value. Catastrophe bonds (risk-linked securities also called Cat bonds) and micro finance products remain good alternatives to classic bond segments next year. These types of securities yielded returns of up to three percent this year with their particular charm being that their performance does not correlate very much to the traditional bond market. This should continue to hold true in 2022.



One of the greatest surprises of this year was the US currency's strength not just relative to the euro but also to most other currencies. The principal reason for the greenback's strength was the economic recovery in the US with accompanying price upcreep. As the market expects the Fed to leave its expansive monetary policy course this caused a widening of the interest advantage on the US money and capital markets. A look at the difference in the three-month money market futures for the US and Euroland reveals a widening to 66 basis points as per December 2021, to 105 basis points as per December 2022, 165 basis points as per end of 2023, 173 basis points as per end of 2024, and 183 basis points as per end of 2025. This is getting support from the expectation that inflation in the dollar sphere will be considerably higher than in Euroland. We therefore expect further moderate strengthening of the greenback to EUR 1.10/USD by the end of next year with conceivable interim peaks around EUR 1.06 EUR/USD. An even stronger dollar would only be reasonable if a wage-price spiral were to drive up inflation. That would trigger swift and strong interest rate increases in the US, which could lead to a recession by 2024 or 2025 at the latest. That is not our favorite scenario.

Market Data

Stock marktes	As of 10.12.2021 10:48	Change versus 02.12.2021 -1 week	08.11.2021 -1 month	08.09.2021 -3 months	08.12.2020 -1 year	31.12.2020 YTD
Dow Jones	35755	3,2%	-1,9%	2,1%	18,5%	16,8%
S&P 500	4667	2,0%	-0,7%	3,4%	26,1%	24,3%
Nasdaq	15517	0,9%	-2,9%	1,5%	23,3%	20,4%
DAX	15581	2,1%	-2,9%	-0,2%	17,3%	13,6%
MDAX	34416	1,9%	-4,7%	-4,3%	16,1%	11,8%
TecDAX	3815	1,1%	-2,9%	-3,1%	21,5%	18,7%
EuroStoxx 50	4192	2,1%	-3,7%	0,4%	18,9%	18,0%
Stoxx 50	3708	2,3%	-1,2%	3,4%	19,9%	19,3%
SMI (Swiss Market Index)	12523	2,8%	1,4%	2,5%	20,5%	17,0%
Nikkei 225	28438	2,5%	-3,6%	-5,8%	7,4%	3,6%
Brasilien BOVESPA	106291	1,7%	1,4%	-6,3%	-6,6%	-10,7%
Russland RTS	1622	-4,0%	-13,1%	-6,1%	18,8%	16,9%
Indien BSE 30	58799	0,6%	-2,9%	0,9%	28,9%	23,1%
China CSI 300	5055	4,1%	4,3%	1,7%	0,9%	-3,0%
MSCI Welt (in €)	3172	2,5%	0,6%	5,7%	28,9%	28,3%
MSCI Emerging Markets (in €)	1248	1,4%	0,9%	-0,4%	6,8%	5,1%
Bond markets						
Bund-Future	174,19	144	350	-41	-124	-345
Bobl-Future	134,00	-152	-105	-77	-154	-118
Schatz-Future	112,16	-23	-12	-5	-22	-12
3 Monats Euribor	-0,57	0	0	-1	-4	1
3M Euribor Future, Dec 2017	-0,58	-1	-2	-4	0	0
3 Monats $ Libor	0,20	2	5	8	-3	-4
Fed Funds Future, Dec 2017	0,08	0	0	0	-1	0
10 year US Treasuries	1,52	8	2	18	60	60
10 year Bunds	-0,34	3	-9	-2	27	24
10 year JGB	0,06	0	0	2	4	4
10 year Swiss Government	-0,30	-5	-10	-4	18	19
US Treas 10Y Performance	695,16	-0,5%	-0,1%	-1,3%	-2,8%	-2,9%
Bund 10Y Performance	670,96	-0,6%	0,6%	-0,2%	-2,4%	-2,0%
REX Performance Index	495,13	0,0%	0,4%	0,0%	-1,0%	-0,8%
US mortgage rate	0,00	0	0	0	0	0
IBOXX AA, €	0,38	2	9	14	41	36
IBOXX BBB, €	0,78	-1	8	18	26	23
ML US High Yield	4,95	-18	25	36	-18	-2
Convertible Bonds, Exane 25	8193	0,0%	-1,1%	-1,3%	0,2%	-1,6%
Commodities						
MG Base Metal Index	445,99	0,7%	0,9%	1,4%	25,9%	25,7%
Crude oil Brent	74,66	6,8%	-10,7%	2,7%	52,4%	43,9%
Gold	1770,50	0,3%	-2,9%	-1,3%	-5,2%	-6,7%
Silver	22,41	0,1%	-8,3%	-6,6%	-8,9%	-15,0%
Aluminium	2630,25	0,6%	1,8%	-5,3%	33,5%	33,3%
Copper	9654,75	0,7%	-2,6%	4,6%	25,7%	24,6%
Iron ore	106,49	4,6%	12,9%	-21,4%	-26,6%	-31,7%
Freight rates Baltic Dry Index	3343	7,3%	23,0%	-7,6%	198,2%	144,7%
Currencies						
EUR/ USD	1,1283	-0,5%	-2,6%	-4,6%	-6,9%	-8,1%
EUR/ GBP	0,8545	0,5%	0,0%	-0,6%	-5,7%	-4,5%
EUR/ JPY	128,24	0,2%	-2,3%	-1,6%	1,6%	1,4%
EUR/ CHF	1,0419	0,0%	-1,6%	-4,3%	-3,4%	-3,5%
USD/ CNY	6,3668	-0,2%	-0,4%	-1,5%	-2,6%	-2,5%
USD/ JPY	113,68	0,5%	0,4%	3,1%	9,1%	10,1%
USD/ GBP	0,76	0,8%	2,7%	4,1%	1,2%	3,5%

Source: Refinitiv Datastream

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