M.M.WARBURG & CO

BANK

ECONOMIC SITUATION AND STRATEGY

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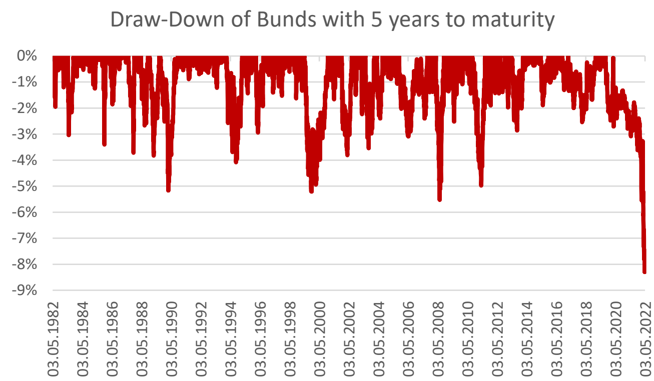
What comes next? Five scenarios for the near future

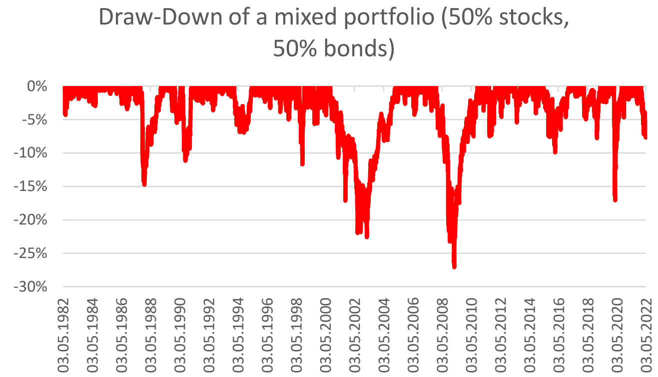
Lenin is supposed to have said that there are decades in which nothing happens and then weeks in which decades happen. Now, this quote was probably misattributed to Lenin, and there is much to suggest that he never said it that way. Nevertheless, there is a lot of truth in this quote, whereby the impression is that the world is currently experiencing precisely the weeks in which decades happen. In any case, the geopolitical situation has changed permanently and a turnaround is being heralded on the financial markets by a more restrictive monetary policy. Macroeconomic, the spectre of stagflation is looming - another issue that the global economy has not faced for decades.

And as if all this were not enough, the European economy in particular cannot get out of stutter mode, as China-related supply chain problems still persist. Even if the Corona pandemic is finally over one day, these supply chain problems will not be completely outdated, at least that is our concern. China has realised the strategic power that can be exerted on the West through reduced supplies of chips, steel and raw materials. These muscles will probably be flexed from time to time in the future, too, when the Western world perhaps does not behave as China would like it to.

Just as Russia has built up considerable blackmail potential through oil and gas supplies, the same applies to the West's dependence on Chinese industrial products. All of this is not an environment in which capital markets go into jubilation. We have shown the graph of the underwater chart of government bonds here before; however, the situation is even a little more extremely than it was a few weeks ago. In the meantime, even Bunds with a "harmless" remaining time to maturity of only five years have lost more than eight percent in value! But it gets worse: Italian government bonds with a maturity of ten years have now lost 18% from the peak. We have not seen this crash since the euro debt crisis. The stock market has also fallen in this environment; in the USA, the S&P 500 has experienced its worst start to the year in decades.



Nevertheless, the decline of the S&P from its previous high of about 13% is still relatively manageable. In past crises, setbacks on the stock market were sometimes much more dramatic. Accordingly, the underwater chart of a well-diversified global portfolio currently shows "only" setbacks that are still within the bounds of the usual. In any case, we are currently very far from having to lament setbacks like in the 2008 financial crisis, in which even very well-diversified portfolios of equities and bonds could lose 25% or more at the peak. Even in the brief Corona crisis in March 2020, mixed portfolios often fell by more than 15%, a fact that is now readily suppressed. And after the bursting of the internet bubble (2000-2003) it took several years to reach the old highs again.



How realistic is it now that a similarly critical scenario will develop in the coming months and quarters? The honest answer is: we don't know for sure. And incidentally, it would also be a presumption of knowledge to claim that it would be possible to deliver accurate forecasts here. Because if we can do this, so can other investors. But then the facts would be so obvious that they would be immediately priced in by the markets. This, in turn, would make any kind of forecast superfluous, because the future would already be perfectly reflected in prices. The truth is that markets do not trade in certainties, but only in probabilities for different scenarios. Depending on daily events and new information, new probabilities are continuously assigned to these scenarios. Therefore, it seems sensible to try to show possible scenarios here and to assign them a probability in order to gain a better understanding of the possible developments on the capital markets.

Scenario I: Russia decides on a general mobilisation and extends the war to Transnistria and possibly Moldova. Russia's response to arms deliveries from the West is to stop gas deliveries. Provocations by Russia on NATO's borders (for example, by invading its airspace) increase steadily and put NATO on heightened alert. Sweden and Finland join NATO, while Russia tries to win the war with extreme military force and massive attacks. Russia is also very credibly threatening to use "small" nuclear tactical weapons. At the same time, China does not behave neutrally in the conflict, but supports Russia economically and even militarily. In the end, a so-called "dictatorial peace" is reached. Shortages of raw materials and materials become more extreme, the world plunges into massive stagflation. The central banks fight an extreme wage-price spiral with a very contractionary monetary policy. In the Eurozone, a new debt crisis is prevented by the communitisation of debt. A diversified global portfolio (50% equities, 50% bonds) loses another 30%. Our probability for this scenario: 5%.

Scenario II: Russia decides on a general mobilisation; however, there is no further violent escalation of the war. Instead, a war of attrition ensues on both sides. As time goes by, it becomes obvious to all sides that Russia cannot win the war; however, a face-saving end to the war is difficult for Russia to achieve. Therefore, the world is bracing itself for a smouldering permanent conflict. A stop to gas deliveries is threatened several times, but there is no permanent cessation of deliveries. Nevertheless, the European economy falls into a severe recession, while the US economy holds up comparatively well. The central banks pursue a contractionary monetary policy, whereby the ECB tries to prevent a new euro debt crisis within the scope of its possibilities. This is finally achieved through very selective intervention. In the process, previous rules regarding the purchase of government bonds (purchase proportional to capital shares in the ECB, etc.) are completely abolished, but the ECB key interest rate nevertheless rises significantly above the previously expected level. A communitisation of debt eventually becomes inevitable in order to cushion the negative consequences of high key interest rates. Inflation remains very high, but companies manage to pass on prices and maintain margins to a certain extent. Nevertheless, there is a consensus in the market that the previous valuation levels are not sustainable; a rising risk premium leads to lower P/E ratios. Accordingly, prices are falling faster than earnings. In addition, there is a growing view in the markets that earnings growth rates will be lower in the long term, as production becomes more local again, transaction costs are permanently higher, and raw materials and various inputs remain scarce. A diversified global portfolio (50% equities, 50% bonds) loses another 20%. Our probability for this scenario: 15%.

Scenario III: Similar to scenario II, but the economic development is less problematic. Inflation also declines noticeably from the end of 2022, so that the central banks can dispense with extreme increases in key interest rates. Shortages of raw materials and materials will be less critical and less important. There is no significant change in the valuation ratios perceived as fair, but a slight reduction in trend growth in earnings cannot be avoided. A diversified global portfolio (50% equities, 50% bonds) loses another 10%. Our probability for this scenario: 25%.

Scenario IV: Macroeconomic similar to Scenario III, but the development of the Ukraine war turns out to be less burdensome. Russia realises that a victory over all of Ukraine with an accompanying regime change is not realistic. In protracted negotiations, it retreats to the position of maintaining territorial claims "only" for Crimea and the so-called separatist areas (Donetsk and Luhansk). The fighting loses intensity, but no sustainable peace is achieved. In a way, the situation resembles the time before the war, when even small-scale skirmishes were part of everyday life. There are no signs of a lasting solution in this conflict, but this situation no longer represents a particular burden for the capital markets. A diversified global portfolio (50% equities, 50% bonds) loses another 5%. Our probability for this scenario: 40%.

Scenario V: Russia realises that, on the one hand side, a short-term military victory in Ukraine has become extremely unlikely. On the other hand side, the window of opportunity to end the unsuccessful war from a propaganda point of view is closing halfway, as the Russian public's interpretation of the events in Ukraine by the same-situated media seems to be gradually eroding. Russia therefore decides to announce at short notice that the official war aims have been achieved and withdraws from Ukraine. The West gradually lifts sanctions, China behaves cooperatively towards the West and refrains from provocations in the China Sea and the South Pacific. Supply chain problems are reducing faster than expected, commodity prices are falling sharply and leading to significantly lower inflation rates. Accordingly, central banks change their wording and signal to the markets that key interest rates will rise less than previously planned. Bond yields fall significantly and equities rise sharply. The economy benefits from the change in sentiment; the substantial backlog of orders is processed faster than expected. Employment increases, profits rise, valuation ratios also rise. A diversified global portfolio (50% equities, 50% bonds) reaches and passes its trough. Our probability for this scenario: 15%.

If one calculates the expected value for a further drawdown of a globally diversified portfolio based on these scenarios, the mathematical result is a value of nine percent. This seems quite a lot, especially since the main scenario (No. IV) with a probability of 40% is only associated with a drawdown of five percent. The problem is the negative scenarios I and II. Although their cumulative probability is only 20%, the expected drawdowns would be significant. This also shows that it is sometimes not enough to base investment decisions on the median scenario or the most likely scenario alone. In the end, every investor must consider for himself whether the scenarios shown here provide a realistic picture of the range of possibilities and whether the right probabilities have been assigned to the scenarios. Assuming, however, that we are not entirely wrong in our assessment, there is much to be said for setting up portfolio structures a little more defensively. However, one should not overdo it: if there is one thing that has become apparent in recent years, it is that setbacks are recovered more quickly than most people could have imagined beforehand. Therefore, despite all caution, overreactions in tactical allocation are rarely rewarded. Those who have a steady hand usually fare better in the long run.

Market data

Stock marktes	As of 06.05.2022 09:32	Change versus 01.04.2022 -1 week	07.03.2022 -1 month	07.01.2022 -3 months	07.04.2021 -1 year	31.12.2021 YTD
Dow Jones	32998	-5,2%	0,6%	-8,9%	-1,3%	-9,2%
S&P 500	4147	-8,8%	-1,3%	-11,3%	1,6%	-13,0%
Nasdaq	12318	-13,6%	-4,0%	-17,5%	-10,0%	-21,3%
DAX	13848	-4,1%	7,9%	-13,2%	-8,8%	-12,8%
MDAX	29220	-6,3%	3,1%	-16,5%	-10,1%	-16,8%
TecDAX	3061	-7,4%	2,1%	-17,5%	-11,2%	-21,9%
EuroStoxx 50	3667	-6,4%	4,4%	-14,8%	-7,3%	-14,7%
Stoxx 50	3620	-3,1%	6,6%	-5,2%	8,1%	-5,2%
SMI (Swiss Market Index)	11840	-2,8%	5,7%	-7,5%	6,4%	-8,0%
Nikkei 225	27004	-2,4%	7,1%	-5,2%	-9,2%	-6,2%
Brasilien BOVESPA	105304	-13,4%	-5,6%	2,5%	-10,5%	0,5%
Russland RTS	1125	8,9%	20,1%	-27,2%	-21,3%	-29,5%
Indien BSE 30	54842	-7,5%	3,8%	-8,2%	10,4%	-5,9%
China CSI 300	3909	-8,6%	-10,2%	-18,9%	-23,4%	-20,9%
MSCI Welt (in €)	2784	-4,2%	2,4%	-5,7%	9,3%	-7,1%
MSCI Emerging Markets (in €)	1059	-2,8%	-0,8%	-7,1%	-10,5%	-7,3%
Bond markets						
Bund-Future	152,55	-580	-1735	-1745	-1912	-1882
Bobl-Future	126,79	-196	-624	-603	-843	-645
Schatz-Future	110,13	-59	-218	-186	-199	-190
3 Monats Euribor	-0,43	16	15	15	12	16
3M Euribor Future, Dec 2017	0,67	38	78	-9933	123	1
3 Monats $ Libor	0,99	2	34	75	79	78
Fed Funds Future, Dec 2017	2,72	35	123	0	263	2
10 year US Treasuries	3,07	68	132	130	141	157
10 year Bunds	1,04	50	109	111	140	122
10 year JGB	0,24	3	10	12	15	17
10 year Swiss Government	0,91	30	73	90	119	104
US Treas 10Y Performance	631,39	-2,4%	-7,6%	-7,4%	-6,7%	-9,6%
Bund 10Y Performance	613,30	-1,0%	-6,3%	-6,5%	-8,4%	-7,4%
REX Performance Index	462,13	-1,7%	-5,6%	-5,5%	-6,6%	-5,8%
US mortgage rate	0,00	0	0	0	0	0
IBOXX AA, €	1,45	10	47	91	126	96
IBOXX BBB, €	2,18	12	43	123	155	130
ML US High Yield	6,48	22	44	138	170	158
Convertible Bonds, Exane 25	7369	0,0%	2,9%	-9,7%	-11,3%	-10,0%
Commodities						
MG Base Metal Index	532,24	-0,6%	-8,6%	14,5%	34,1%	15,4%
Crude oil Brent	111,83	7,0%	-9,2%	36,6%	76,8%	42,6%
Gold	1874,41	-2,8%	-5,3%	4,6%	7,6%	2,9%
Silver	24,51	-1,0%	-3,7%	9,9%	-2,7%	5,3%
Aluminium	3361,26	-2,2%	-9,9%	15,7%	50,0%	19,8%
Copper	10314,50	-0,3%	0,6%	6,4%	15,6%	5,9%
Iron ore	144,90	-9,4%	-8,8%	14,8%	-14,4%	28,8%
Freight rates Baltic Dry Index	2644	12,2%	18,3%	15,5%	24,3%	19,3%
Currencies						
EUR/ USD	1,0502	-5,0%	-3,6%	-7,0%	-11,6%	-7,3%
EUR/ GBP	0,8531	1,3%	3,0%	2,0%	-1,2%	1,6%
EUR/ JPY	136,95	1,2%	9,1%	4,6%	4,9%	5,0%
EUR/ CHF	1,0338	1,2%	2,7%	-0,8%	-6,4%	0,1%
USD/ CNY	6,6779	5,0%	5,7%	4,7%	2,1%	5,1%
USD/ JPY	123,94	1,2%	7,5%	7,2%	12,8%	7,7%
USD/ GBP	0,81	6,5%	6,7%	10,3%	12,0%	10,0%

Source: Refinitiv Datastream

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