M.M.WARBURG & CO
BANK

ECONOMIC SITUATION AND STRATEGY

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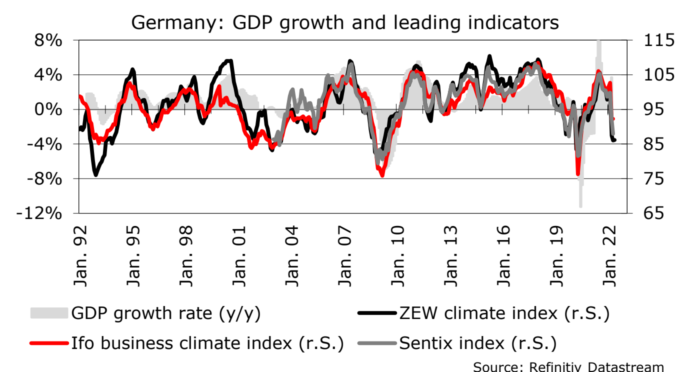
A disastrous capital market year so far: time to get in?

The capital markets have been a picture of horror this year. Whether you look at stock or bond prices, almost everywhere there have been significant price losses since the beginning of the year. Global equities, as measured by the MSCI World Index for industrialised countries and emerging markets, have each lost more than 17 percent in value, with technology stocks among the main losers with an average drop of 25 to 30 percent. Long-dated government bonds from Germany and the USA suffered losses of ten and twelve percent respectively. Cryptocurrencies such as Bitcoin or Ethereum have been underwater by around 40 percent since the beginning of January. And even the price of gold - a typical crisis currency - has barely budged since the beginning of the year.

The reasons for the falling prices are manifold: increasing economic worries, the war between Russia and Ukraine, China's zero-covid policy, high inflation rates and the central banks' more restrictive monetary policy play the main role. After the poor results caused by the capital market year 2022 so far, the question is what will happen next. Have prices already bottomed out, or what conditions must be met for the outlook to improve again? Our checklist for the next steps:

1. the economic conditions: Not much is left of the optimistic economic forecasts at the beginning of the year. The International Monetary Fund has revised its growth forecasts for the global economy downwards from 4.4 to 3.6 percent for this year and from 3.8 to 3.6 percent for 2023. However, this is probably still too optimistic for both years, as we assume a stronger economic slowdown for both the industrialised and the emerging countries. In Germany and the Eurozone we are already dealing with stagflation, i.e. stagnating economic growth with simultaneously high rates of price increases. Leading indicators such as the Ifo Business Climate or the surveys by the Centre for European Economic Research (ZEW) or the analysis company Sentix also signal a strongly increased risk of recession.



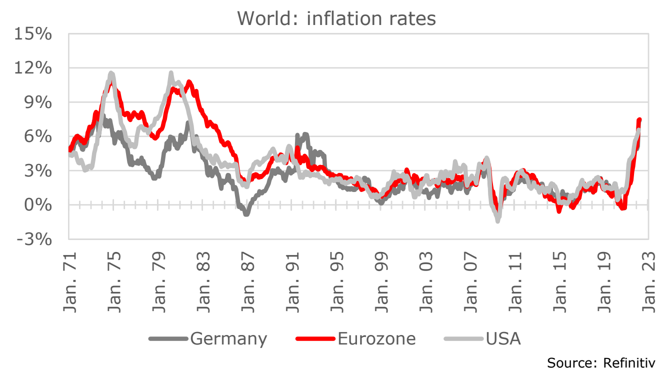
The only bright spot so far is the state of the US economy, which is benefiting from its low dependence on foreign trade and the fact that it has almost reached full employment. Conclusion: As long as economic risks dominate, a sustainable recovery of the stock market is unlikely. Investors should look for improvements in the leading indicators as a (re-)entry signal. If, for example, the Ifo index improves three times in a row and/or reaches the threshold value of 95 points again, this is a fairly reliable signal for an improvement in the economic environment.

2. Russia-Ukraine war: After Russian President Putin failed to achieve his war aims, a protracted armed conflict now threatens. A possible "war of attrition" could lead to the capital markets paying less and less attention to this

conflict. Although the West's military support for Ukraine increases the risk of a direct confrontation between Russia and NATO, Moscow's verbal threats are likely to remain. The prospects of a peace agreement in the near future are considered by us to be just as slim as the possibility of Putin being replaced, especially since no one knows what political goals a new Russian president would pursue. Conclusion: No solution in sight. Investors are watching for further sanctions by the West and for Russian countermeasures. An end to Russian gas supplies to Western Europe is an economic worst-case scenario that would significantly increase the risk of recession.

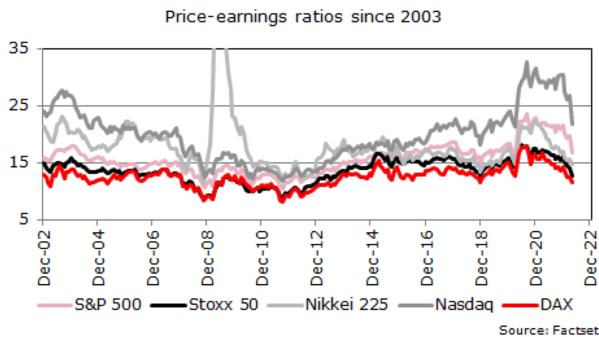
3. China's zero tolerance Covid policy: Despite many suggestions to the contrary (e.g. from the WHO), the political leadership in Beijing is sticking to its policy of completely sealing off major cities and important economic centres such as Shanghai if residents are found to have the coronavirus. It is estimated that about 375 million people in about 45 cities are currently affected by lockdown measures. This will significantly slow down China's economic momentum in the second quarter, so that consumption, but also exports and imports will decline. This development is a double-edged sword for supply chain problems: On the one hand, lower production and less foreign trade lead to lower transport costs and less congestion in and outside the ports. On the other hand, important intermediate goods are not produced and shipped, so that supply bottlenecks worsen and price pressure increases further. Conclusion: China's Corona policy is putting pressure on globalisation as companies around the world increasingly feel the disadvantages of "just-in-time production". A shift away from globalisation and towards more warehousing means higher costs (more inflation) and lower productivity (less growth) in the long run. Investors are keeping an eye on possible loosening of the lockdowns and a possible more expansionary Chinese monetary and fiscal policy in response to weaker economic data.

4) Inflation and bond markets: "Come to stay" seems to be the motto of the high rates of price increases. Even the European Central Bank, as the last of the Mohicans, no longer assumes that this is only a temporary problem that will solve itself over time. In contrast to the last few years, in which an increase in inflation was always and only due to higher energy prices, all price components of the basket of goods are now showing a clear increase. Moreover, the danger of a wage-price spiral, which could lead to an entrenchment of inflation, is greater than it has been for a long time. Even at the end of this year, inflation rates are likely to be at least five percent, more likely six percent, and a decline to two percent next year is very unlikely.

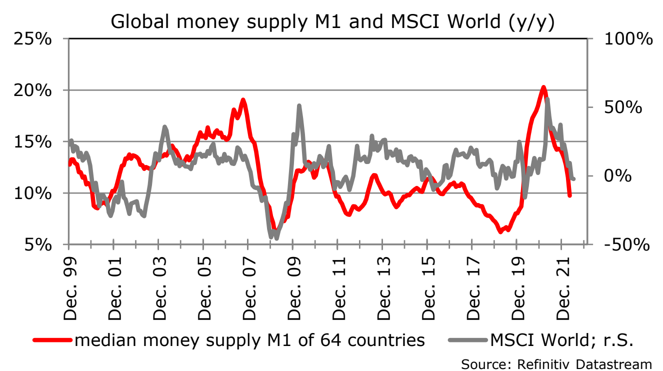


The central banks are therefore forced to raise interest rates. In the USA, the Federal Reserve will raise the key interest rate to or above its estimated "neutral" level of around 2.5 percent. Fed funds futures indicate that the path to a more restrictive monetary policy should be completed by the summer of next year with a key interest rate of around three percent. We would not be surprised, however, if the "neutral" interest rate or the target value for the key interest rate is closer to four per cent. In this case, capital market yields would also continue to rise. For the ECB, on the other hand, the task is much more complicated. In view of an inflation rate of 7.5 percent, it is obvious that monetary policy must become more restrictive. However, the economy of the Eurozone is already struggling and the further financing of the high national debt of some countries is certainly also a headache for the central bank. More than three interest rate hikes of 25 basis points each this year and three more next year are therefore not to be expected in our view. But even this could initially lead to further bond price losses. Conclusion: Inflation is proving to be more stubborn than expected. Even if the inflation trend has peaked by now, the problem is far from solved. Investors are paying attention to the wording of the central banks and to possible surprises in the inflation trend. The good news is that the high price losses recorded by government and corporate bonds this year are book losses that will gradually be reduced as long as the issuer meets its interest obligations and does not go bankrupt. In addition, investors are now once again receiving an interest rate that they were looking for in vain in the past years. When buying additional bonds, look for quality and a short duration. On weak days, courageous investors build up small positions with longer residual maturities: 10-year Bunds above one percent, 10-year US Treasuries above three percent.

5. Stock markets, corporate earnings and valuations: On the stock markets, the price losses have led to a significant decline in valuations. German and European shares, with price-earnings ratios of 11.5 and 12.5, are now more favourably valued than the historical average. However, this does not apply to US stocks: the S&P 500 has a P/E ratio of about 17 (average value is 15.6), the Nasdaq 100 index with 22.5 is also still more expensive than it has been on average since 2003 (20.0).



Even though the stock market valuations already look quite attractive, one should keep two things in mind: Despite the many risks, companies or company analysts expect record profits to continue to rise. For example, DAX profits are expected to rise by five percent this year and ten percent next year. In uncertain times like these, however, one can rely less on key figures on the earning power of companies, since one does not know whether the profits are perhaps "peak earnings" that will have to be revised downwards in the near future. If, on the other hand, the expected profit growth rates do turn out to be sustainable, it is mainly because companies manage to pass on their costs and thus keep their profit margins stable or even increase them. As pleasing as this is from a corporate perspective, it is negative from a macroeconomic perspective: if companies have a lot of pricing power, this also means that inflation rates will remain very high - and a corresponding reaction from the central banks is required. This is precisely our biggest worry at the moment: not that there will be a severe economic crisis, i.e. a recession, in the foreseeable future, but that the central banks will raise interest rates significantly and that the liquidity that has driven the stock markets in the past years and decades will therefore dry up. Buzzwords that have dominated stock market events for a long time, such as "TINA" (there is no alternative), "FOMO" (fear of missing out) or "buy the dip", could therefore disappear for a while. Conclusion: As the risks for the equity markets remain high, we consider a further reduction of the equity quota justifiable, even at the meanwhile lower price level. In view of the poor sentiment and the technical constellation of an oversold market, a strong price recovery is likely in the short term, but the lean period is probably not over yet. Investors are taking advantage of this to reduce their holdings, especially in highly valued and unprofitable companies, and to broaden their portfolios. Signs of easing in the war between Russia and Ukraine are leading to better economic expectations and are having a positive impact on profit expectations. The most important influencing factor, however, is international monetary policy. Signals from the US Federal Reserve to raise interest rates less than expected can lead to a trend reversal and to a sustained rise in share prices.



Market data

Stock marktes	As of 13.05.2022 10:14	Change versus 05.05.2022 -1 week	11.04.2022 -1 month	11.02.2022 -3 months	11.05.2021 -1 year	31.12.2021 YTD
Dow Jones	31730	-3,8%	-7,5%	-8,7%	-7,4%	-12,7%
S&P 500	3930	-5,2%	-10,9%	-11,1%	-5,3%	-17,5%
Nasdaq	11371	-7,7%	-15,2%	-17,5%	-15,1%	-27,3%
DAX	13845	-0,4%	-2,5%	-10,2%	-8,4%	-12,8%
MDAX	28590	-2,7%	-6,5%	-14,4%	-10,0%	-18,6%
TecDAX	3028	-1,6%	-5,9%	-9,3%	-8,1%	-22,8%
EuroStoxx 50	3645	-1,4%	-5,1%	-12,3%	-7,6%	-15,2%
Stoxx 50	3557	-2,2%	-5,8%	-5,5%	5,1%	-6,8%
SMI (Swiss Market Index)	11570	-2,6%	-7,6%	-5,4%	5,3%	-10,1%
Nikkei 225	26428	-1,5%	-1,5%	-4,6%	-7,6%	-8,2%
Brasilien BOVESPA	105688	0,4%	-9,6%	-6,9%	-14,0%	0,8%
Russland RTS	1143	2,1%	12,4%	-22,2%	-26,4%	-28,4%
Indien BSE 30	53651	-3,7%	-9,0%	-7,7%	9,1%	-7,9%
China CSI 300	3989	-0,5%	-2,7%	-13,3%	-20,6%	-19,3%
MSCI Welt	2640	-5,2%	-11,2%	-13,1%	-9,9%	-18,3%
MSCI Emerging Markets	988	-6,7%	-11,1%	-20,4%	-25,7%	-19,8%
Bond markets						
Bund-Future	154,76	221	-27	-1019	-1469	-1661
Bobl-Future	127,87	105	48	-262	-670	-537
Schatz-Future	110,54	40	20	-99	-151	-149
3 Monats Euribor	-0,41	17	17	16	12	18
3M Euribor Future, Dec 2017	0,52	-15	9	-9948	105	1
3 Monats $ Libor	1,40	3	38	89	124	119
Fed Funds Future, Dec 2017	2,63	-9	20	0	255	2
10 year US Treasuries	2,92	-15	14	96	130	142
10 year Bunds	0,92	-13	13	65	107	109
10 year JGB	0,25	2	1	2	17	18
10 year Swiss Government	0,73	-19	-8	44	86	86
US Treas 10Y Performance	611,62	1,4%	-2,1%	-8,9%	-10,0%	-12,4%
Bund 10Y Performance	595,93	0,5%	-1,6%	-6,2%	-9,7%	-10,0%
REX Performance Index	465,98	0,8%	-0,1%	-2,9%	-5,2%	-5,1%
US mortgage rate	0,00	0	0	0	0	0
IBOXX AA, €	1,96	6	39	93	166	148
IBOXX BBB, €	2,89	12	58	127	218	201
ML US High Yield	7,57	36	85	176	278	266
Convertible Bonds, Exane 25	6864	0,0%	-6,7%	-10,0%	-16,2%	-16,2%
Commodities						
MG Base Metal Index	462,44	-5,0%	-12,1%	-5,8%	1,8%	0,3%
Crude oil Brent	108,55	-2,2%	10,0%	14,7%	58,1%	38,5%
Gold	1824,40	-3,0%	-6,6%	-0,5%	-0,3%	0,1%
Silver	21,75	-3,2%	-12,9%	-6,5%	-21,0%	-6,5%
Aluminium	2745,25	-4,8%	-14,7%	-12,8%	9,8%	-2,2%
Copper	9358,75	-1,6%	-8,1%	-5,4%	-10,4%	-3,9%
Iron ore	131,98	-8,9%	-15,4%	-12,5%	-38,7%	17,3%
Freight rates Baltic Dry Index	3117	17,9%	53,5%	57,7%	-4,2%	40,6%
Currencies						
EUR/ USD	1,0409	-1,5%	-4,5%	-8,8%	-14,5%	-8,1%
EUR/ GBP	0,8519	0,1%	2,0%	1,6%	-0,9%	1,5%
EUR/ JPY	134,06	-2,3%	-2,2%	1,4%	1,5%	2,8%
EUR/ CHF	1,0412	0,6%	2,3%	-1,4%	-5,1%	0,8%
USD/ CNY	6,7799	1,9%	6,4%	6,7%	5,4%	6,7%
USD/ JPY	129,98	-0,1%	3,7%	12,6%	19,7%	12,9%
USD/ GBP	0,82	1,3%	6,8%	11,4%	15,8%	10,9%

Source: Refinitiv Datastream

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