M.M.WARBURG & CO
BANK

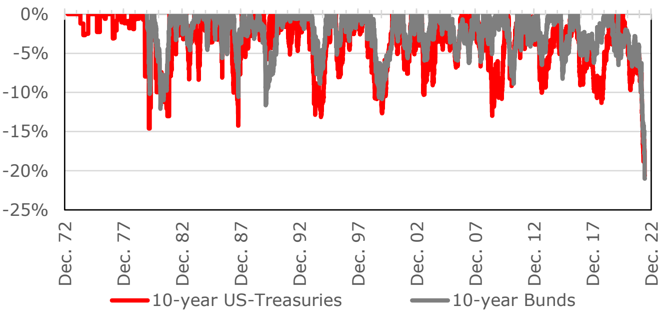
ECONOMIC SITUATION AND STRATEGY

17 June 2022

Sleeping car versus racing car: monetary policy crashes the bond market

The international bond markets are currently experiencing a memorable development. According to our calculations, never before - at least as far back as our data go - has there been such a crash in bond prices as can be observed at the moment. Bunds and US Treasuries with a remaining maturity of ten years have lost 16 percent in value since the beginning of the year. In the underwater chart, which compares the current price with the peak value previously reached, the loss even amounts to 20 percent. And the situation is not much better for euro government bonds with a remaining maturity of five to seven years and euro corporate bonds (three to five years).

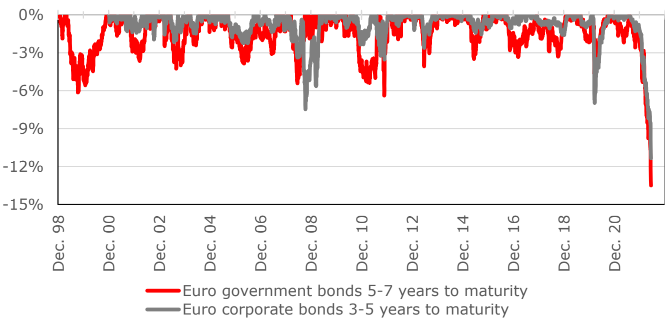
Draw down chart of 10-year government bonds



Source: Refinitiv Datastream

The cause of the crash on the bond market is the monetary policy of the central banks. For too long, the US Federal Reserve and the European Central Bank had hoped that the strong rise in inflation would only be short-lived and would virtually disappear of its own accord. This misjudgement is now taking revenge as it becomes apparent that the inflation rate will remain far above the target of two percent for a longer period and the danger of a wage-price spiral is growing greater. Not that we want to present ourselves as the know-it-all here: For a long time, we too wrongly assumed that price pressure would ease this year. But since the start of the war between Russia and Ukraine and the new Corona restrictions in China, it became clear that energy and food prices would continue to rise and that raw materials and intermediate goods would remain scarce. Since then, at the latest, it has become clear that all components of the basket of goods - and not just energy - are becoming more expensive.

Draw down chart of Euro government and corporate bonds



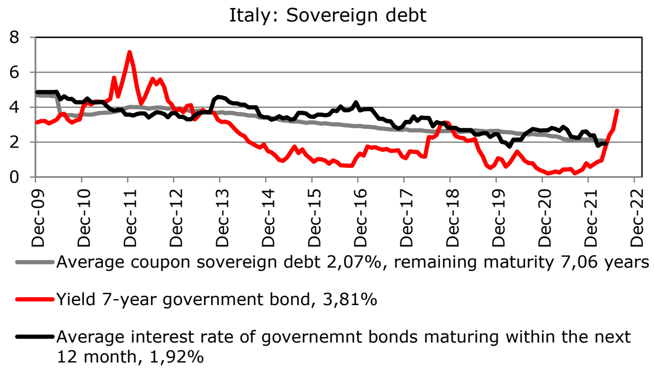
Source: Refinitiv Datastream

But instead of taking quick and decisive countermeasures with monetary policy, the Fed and the ECB have taken too much time to analyse and discuss the situation. The result: both central banks are far "behind the curve", interest rates are far too low in view of high inflation. The ECB in particular is still in "sleepwalk mode". Although the ECB's Governing Council announced at its last meeting that it intends to raise interest rates again in July for the first time since 2011, there will only be a small step of 25 basis points. With the rate of inflation in the Eurozone recently at 8.1 percent (the highest being in Estonia at 20 percent, and four other countries with rates above ten percent), one wonders why the ECB is so hesitant. In any case, we are not convinced by ECB

President Lagarde's explanation that it is international practice to start an interest rate increase cycle with a small step. In any case, the Swiss central bank SNB shows with its interest rate hike of 50 basis points that there is another way. At least the ECB is holding out the prospect of a larger rate hike at the September meeting if the medium-term inflation outlook has not improved by then. Since we assume that the inflation rate will still be close to eight percent in late summer, we consider an increase of 50 basis points very likely. The next two ECB monetary policy meetings on 27 October and 15 December are likely to decide on further interest rate hikes, so that the main refinancing rate at the end of the year should be 1.25 to 1.5 percent - if (and this is a big if) the ECB does not decide on a more cautious approach out of consideration for the countries of the European periphery.

The ECB's reputation, and thus that of the euro, is already suffering considerably because the central bank was forced to convene an unscheduled special meeting this week. The reason for this was the significant rise in yields on government bonds, especially from Italy, but also from Greece, Spain and Portugal. The fact that Italian bond yields are rising more strongly than German yields is hardly surprising in the current situation, given a government debt ratio of 150 percent and the fact that the ECB is ending its PEPP and APP bond-buying programmes. This means that the biggest buyer of Italian government bonds has disappeared, so that many other investors, who have so far acted in the slipstream of the ECB, are also keeping their hands off these securities. The fact that the ECB feels compelled to consider a new emergency programme even before the first interest rate hike is an indictment. This reveals the fundamental weakness of the monetary and debt union, which has been concealed over the past ten years by the various bond-buying programmes.

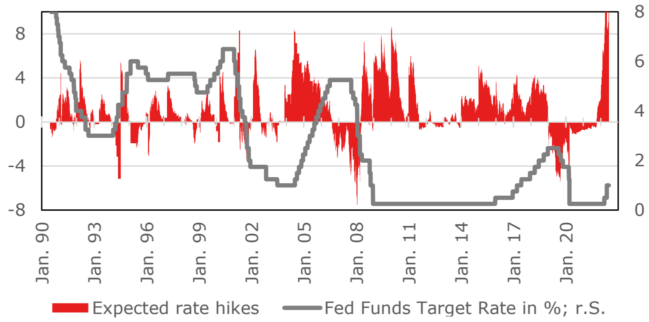
We also consider the announcement of a new monetary policy instrument, the concrete form of which is still open, to be unnecessary at this point in time, as we do not see any refinancing problems for the Italian state. Although the ECB says that the yield premium is not fundamentally justified, such a statement is tantamount to presuming knowledge. The average interest rate for the outstanding Italian government bonds of 2.3 trillion euros is 2.07 percent with an average remaining term of just over seven years. Since around 340 billion euros will have to be refinanced in the next 12 months, even if yields were to rise permanently to four percent, the average interest rate on all government debt would only rise to around 2.3 percent by the end of the year. If yields climb to five or six percent, average refinancing will become more expensive at 2.5 or 2.6 percent. As unpleasant as this development is for the Italian finance minister, it does not yet suggest a scenario of a new sovereign debt crisis; after all, Italy still had to pay an average of a good three percent for borrowing in 2016. We also do not consider it conclusive that a new bond-buying programme should be launched and benefit countries that also have higher economic growth than Germany. For example, the EU Commission forecasts average economic growth of 2.0 percent for Germany over the next two years; in contrast, economic growth of 2.2 percent is expected for Italy, 3.7 percent for Spain, 4.3 percent for Portugal and 3.3 percent for Greece. We therefore consider the decisions of the ECB Governing Council to be wrong and superfluous at this point in time. Confidence in the euro is more likely to be damaged than strengthened by these measures.



Source: Refinitiv Datastream

Unlike the ECB, the US Federal Reserve has recognised its mistake and has now ignited the monetary policy turbo. Fed President Powell has thus got out of the sleeping car and into the racing car. After raising the key interest rate by 25 basis points in March, the Fed Funds Rate was raised by 50 basis points in May. Last wednesday, the Fed raised its key interest rate by another 75 basis points, so that it now stands at 1.5 to 1.75 percent. And that is by no means the end of the story: Fed members now expect further rate hikes of 175 basis points by the end of the year, subject to the condition that the inflation rate declines significantly in the second half of the year. In its macroeconomic projections, the Fed expects the PCE inflation rate to fall to 5.2 percent and the core inflation rate to 4.3 percent by the end of the year. This will be a difficult undertaking; we expect the inflation rate to still be around six percent at the end of the year. However, core inflation could reach or even fall slightly below the Fed's target by then. What would this mean for the US central bank's monetary policy?

USA: key interest rate and interest rate expectations



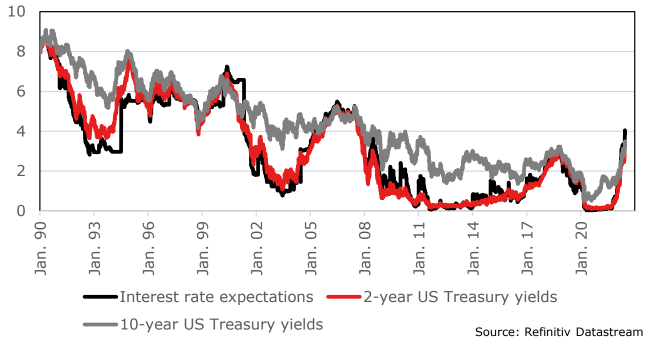
Source: Refinitiv Datastream

Since Fed President Powell made it abundantly clear at his press conference that it is essential for the central bank to move the inflation rate back towards two percent and that all other goals are secondary to this task, we also expect a rate hike of 75 basis points at the next FOMC meeting on 26 and 27 July. In contrast to 1994, when the Fed raised rates by "only" 50 basis points at the next meeting after a 75 basis point hike, this time the rate of inflation is much higher (then a good two percent, now a good six percent), while the unemployment rate is much lower (then 5.5 percent, now 3.6 percent). At the end of the year, the US key interest rate should then be in a range of 3.50 to 3.75 percent and be raised to a good four percent next year. A more favourable development of the core inflation rate should have no impact on this scenario as long as the overall inflation rate does not fall significantly.

For the bond markets, therefore, there are still no signs of relief. Although capital market yields have meanwhile anticipated a good part of the expected turnaround in monetary policy in prices, the yield on 2-year US Treasuries is still about 60 basis points too low measured against key interest rate expectations. Since the yield curve (the difference in yields between government bonds with ten and two-year residual maturities) is usually very flat at the end of the interest rate hike cycle, the yield on 10-year US Treasuries should also rise towards four percent.

Transferred to the interest rate forecast for ten-year Bunds, these should also rise to two percent or slightly above if the ECB raises key interest rates further next year to two or even 2.5 percent. In other words, even if prices on the bond market have become much more attractive for new investments, it is still too early to enter the market. Only when it becomes clear that the cycle of interest rate hikes has reached its zenith will the bond market, and especially the purchase of bonds with longer residual maturities, become attractive again. Until then, one should wait and see.

USA: development of interest rates



Source: Refinitiv Datastream

Market data

Stock marktes	As of 17.06.2022 08:38	Change versus 08.06.2022 -1 week	13.05.2022 -1 month	14.03.2022 -3 months	14.06.2021 -1 year	31.12.2021 YTD
Dow Jones	29927	-9,1%	-7,0%	-9,2%	-13,0%	-17,6%
S&P 500	3667	-10,9%	-8,9%	-12,1%	-13,8%	-23,1%
Nasdaq	10646	-11,9%	-9,8%	-15,4%	-24,9%	-32,0%
DAX	13038	-9,7%	-7,1%	-6,4%	-16,8%	-17,9%
MDAX	26736	-11,4%	-7,2%	-12,4%	-21,8%	-23,9%
TecDAX	2793	-12,2%	-9,2%	-10,4%	-20,4%	-28,8%
EuroStoxx 50	3428	-9,5%	-7,4%	-8,4%	-17,1%	-20,3%
Stoxx 50	3371	-7,6%	-6,5%	-4,2%	-5,0%	-11,7%
SMI (Swiss Market Index)	10475	-8,7%	-10,1%	-10,3%	-11,7%	-18,6%
Nikkei 225	25963	-8,0%	-1,8%	2,6%	-11,0%	-9,8%
Brasilien BOVESPA	102807	-5,1%	-3,9%	-6,5%	-21,0%	-1,9%
Russland RTS	1317	6,9%	16,3%	40,5%	-22,0%	-17,5%
Indien BSE 30	51092	-6,9%	-3,2%	-9,5%	-2,8%	-12,3%
China CSI 300	4307	2,1%	8,0%	3,2%	-17,6%	-12,8%
MSCI Welt	2491	-10,5%	-7,8%	-11,9%	-17,5%	-22,9%
MSCI Emerging Markets	1008	-6,1%	0,4%	-4,4%	-27,1%	-18,2%
Bond markets						
Bund-Future	143,74	-524	-1002	-1747	-2890	-2763
Bobl-Future	121,35	-395	-643	-924	-1298	-1189
Schatz-Future	108,10	-172	-243	-319	-409	-394
3 Monats Euribor	-0,18	40	40	40	36	41
3M Euribor Future, Dec 2017	1,57	50	101	0	210	2
3 Monats $ Libor	1,83	14	39	94	171	162
Fed Funds Future, Dec 2017	3,47	72	83	0	338	3
10 year US Treasuries	3,27	24	33	113	177	177
10 year Bunds	1,72	36	77	138	197	190
10 year JGB	0,24	-1	-1	4	20	17
10 year Swiss Government	1,46	41	70	107	169	160
US Treas 10Y Performance	587,20	-3,7%	-3,8%	-11,0%	-14,8%	-15,9%
Bund 10Y Performance	555,86	-3,5%	-7,2%	-11,9%	-16,5%	-16,1%
REX Performance Index	445,09	-2,3%	-4,4%	-6,8%	-9,9%	-9,3%
US mortgage rate	0,00	0	0	0	0	0
IBOXX AA, €	2,90	61	101	159	265	241
IBOXX BBB, €	3,89	70	107	186	326	302
ML US High Yield	8,55	106	91	208	392	365
Convertible Bonds, Exane 25	6426	0,0%	-6,2%	-12,1%	-23,4%	-21,5%
Commodities						
MG Base Metal Index	447,55	-6,3%	-0,7%	-17,5%	2,0%	-3,0%
Crude oil Brent	119,64	-3,2%	7,1%	13,6%	63,9%	52,6%
Gold	1846,15	-0,6%	1,7%	-5,6%	-1,0%	1,3%
Silver	20,95	-5,7%	-0,2%	-16,9%	-25,1%	-10,0%
Aluminium	2544,25	-8,8%	-7,8%	-22,5%	1,4%	-9,3%
Copper	9218,75	-5,3%	0,4%	-6,8%	-7,2%	-5,4%
Iron ore	137,85	-5,2%	4,2%	-8,2%	-35,6%	22,5%
Freight rates Baltic Dry Index	2462	2,2%	-20,7%	-9,7%	-16,4%	11,1%
Currencies						
EUR/ USD	1,0504	-2,2%	1,1%	-4,2%	-13,3%	-7,3%
EUR/ GBP	0,8568	0,2%	0,7%	1,8%	-0,2%	2,0%
EUR/ JPY	141,05	-2,0%	5,3%	9,1%	6,1%	8,2%
EUR/ CHF	1,0178	-2,9%	-2,0%	-0,7%	-6,5%	-1,5%
USD/ CNY	6,6984	0,2%	-1,4%	5,2%	4,7%	5,4%
USD/ JPY	135,48	0,9%	4,9%	14,6%	23,1%	17,7%
USD/ GBP	0,82	2,4%	-0,3%	6,5%	15,2%	10,5%

Source: Refinitiv Datastream

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