M.M.WARBURG & CO
BANK

ECONOMIC SITUATION AND STRATEGY

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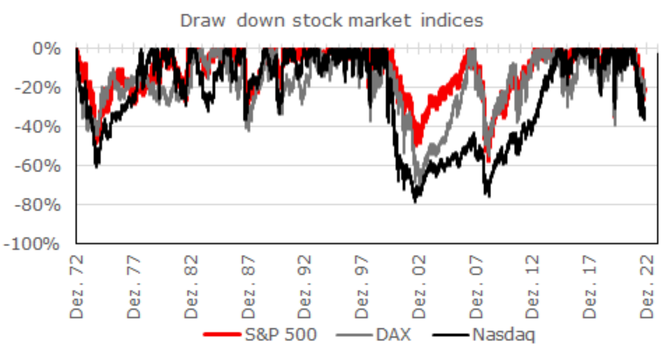
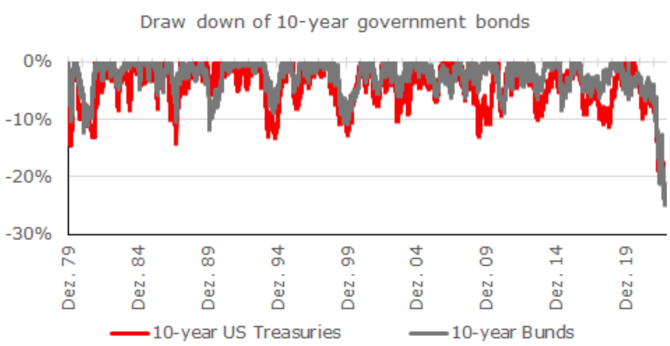
Weakening economy, higher interest rates: capital market environment remains difficult

From a capital market perspective, 2022 has been a real horror year so far. Most stocks failed to earn any money, bonds recorded unprecedented price losses, gold prices fell far short of expectations, the real estate market is showing signs of a significant slowdown, and cryptocurrencies performed particularly disastrously, demonstrating that they are completely unsuitable as a hedge against inflation. All of these developments are due to the worsening fundamental conditions: The global economy is cooling down and is on the verge of a recession, and at the same time inflation rates have risen to record levels, so that the central banks have tightened their monetary policy significantly this year.



Quelle: Refinitiv Datastream

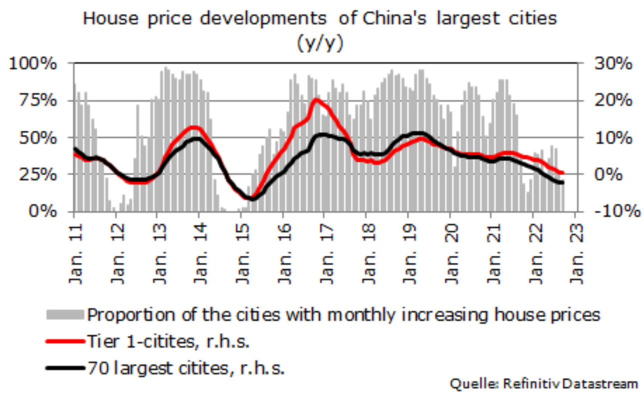
After all, most stock indices have recovered strongly since the beginning of October, with the European stock markets far outperforming the US markets. So is the worst over? Will the economic downturn be less severe than the leading indicators suggest? Will the high rates of price increases soon be a thing of the past?



Source: Refinitiv Datastream

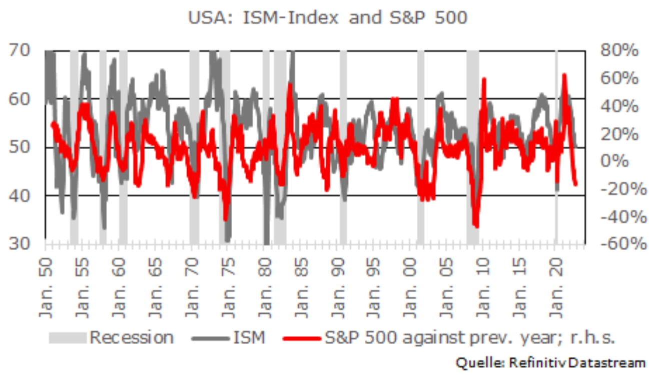
Looking at the data relevant to investors, however, we unfortunately cannot yet give the all-clear. While it is true that energy prices in Europe, which had risen exorbitantly in the summer, have recently fallen significantly, it remains to be seen how sustainable this price decline will be. Fortunately, German gas storage facilities are now almost completely full, so that the risk of rationing during the winter months has decreased. However, you would have to be a meteorologist with special foresight to be able to judge today whether we will have a mild, a normal or a hard winter. This will determine how far our stocks will last. However, if prices continue to fall, this should continue to provide a tailwind for German and European equities - especially relative to other equity market regions. The reverse is also true.

In addition, German and European equities have recently outperformed their U.S. counterparts because there have been rumors that the Chinese government could very soon abandon its strict zero-covid policy. This would lead to a recovery in the growth of the Chinese economy, which has also suffered from the recurring closures of companies, cities and regions in the case of new Corona bridges - from which China's most important trading partners (including Germany) could benefit disproportionately. Given the high economic costs of Beijing's zero-tolerance policy, these rumors are understandable, but it is likely that a complete opening of the economy will be a matter of months rather than days or weeks. But even with a faster exit from the zero-covid policy, economic growth is likely to remain weak for the time being, as the real estate market remains under pressure and China's exports suffer from weak growth in the global economy. Exports in October, for example, were unexpectedly weak, with a small year-on-year decline, as exports to the USA and the euro zone in particular weakened. However, other important Asian export nations such as South Korea and Taiwan also reported a significant slowdown in their foreign trade. With global leading indicators pointing to at least a slight recession in the world economy, China's exports will continue to fall in the coming months and thus weigh on growth prospects in the Middle Kingdom.



However, it was not only from China that political reports created a more positive mood on the stock market; in the USA, too, the mid-term elections have led to a recent easing of the situation on the capital market. This is mainly due to the fact that since 1962, the U.S. stock markets have always performed positively after the midterm elections over the following six and 12 months. In the three months following the midterm elections (calculated from October 31 to January 31), there was only a slightly negative performance in 1994, 2002, 2014 and 2018. But be careful: For the DAX, this statement is only valid with major restrictions, because for German stocks the performance was negative in 1970 (on a 12-month view), 1978 (on a 3-, 6- and 12-month view), 1986 (on a 3-, 6- and 12-month view), 1990 (on a 3-month view), 1994 (on a 3- and 6-month view), 2002 (on a 3- and 6-month view), 2010 (on a 12-month view) and 2018 on a 3-month view.

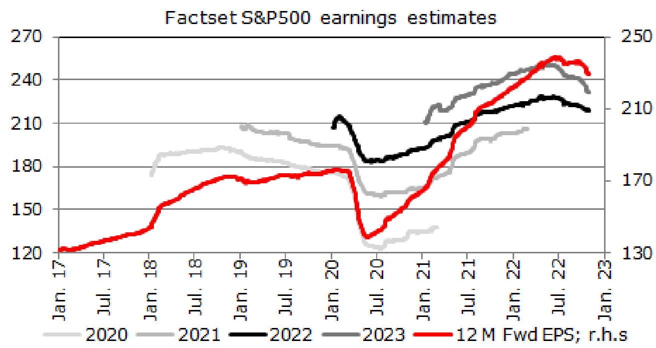
Why have U.S. equity markets performed so well post-election in the past? The most important argument may be the fading uncertainty after elections. While most voters are likely to favor political programs that lead to lower taxes and less regulatory requirements, it turns out that stock markets have been able to gain regardless of the election outcome and the winner. In this respect, there is much to suggest that political gridlock is the main argument for rising share prices, as the U.S. president's party usually loses its majority in the Senate and/or the House of Representatives in the mid-term elections. Although the final results of this year's midterm elections had not yet been determined at the time of publication, there are many indications that the Republicans will win the majority of seats in the House of Representatives. This means that no major legislation of high political significance is likely to be passed in the next two years. The capital markets like it when politics interferes less and instead "the market" can regulate things.



Nevertheless, from our point of view, one thing above all is clear: The elections have primarily political consequences, affecting the composition of the Supreme Court and the future heads of important congressional committees. For the capital markets, however, economic consequences and developments play the main role; here, the influence of politics is minor, especially in the case of a government that is not completely in the hands of one party.

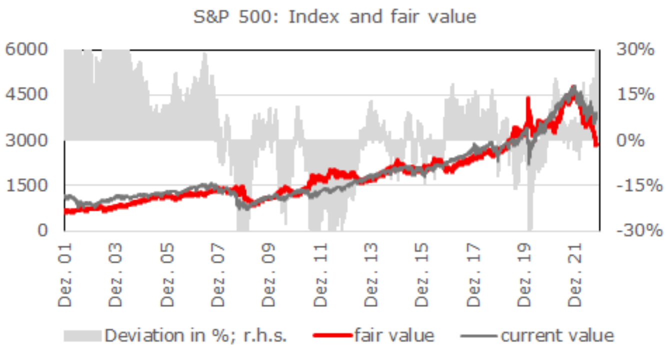
For the further development of the stock market, we believe that two questions will be decisive - irrespective of the mid-term elections: 1. will there be a recession? and 2. how quickly will inflation rates decline? With the exception of the 1974 and 1990 midterm elections, where the recession ended early in the following year, there was never a significant economic slowdown after the other midterm elections. Nor did the Federal Reserve's monetary policy prove to be a game changer during those periods in the past. However, it is precisely these two points that pose the greatest risks as we look ahead to the next few months.

In view of the fact that the inflation rate is likely to have peaked, but price pressures are only easing very slowly, the U.S. Federal Reserve will continue to raise key interest rates in the coming months. In doing so, it will reduce the speed of its interest rate steps, but the end point, the so-called "terminal rate," is likely to be above five percent. This suggests that the overall U.S. yield curve will shift upward, with the yield on 2-, 10- and 30-year government bonds moving toward five percent. At the same time, the economic environment is deteriorating, with the threat of at least a mild recession at the beginning of 2023. Although earnings expectations for the S&P 500 are falling, forecasts for next year are probably still too optimistic. At the moment, earnings growth rates of six percent are expected for both 2022 and 2023; excluding energy and commodity stocks, earnings are expected to rise by two percent this year and eight percent next year. In view of the economic scenario described above, this seems too optimistic for 2023.



Quelle: Factset

In the past six weeks, the U.S. stock market - in contrast to the year to date - has not reacted to the further rise in yields. In the U.S., the yield on 10-year government bonds has risen from 3.80 to 4.15 percent, and on 30-year U.S. Treasuries from 3.76 to 4.31 percent. This development should have led to a reduction in stock market multiples, which could only have been compensated for by higher earnings forecasts. But this has not been the case, as earnings expectations for the S&P 500 over the next 12 months have fallen from just under 236 to just over 229 index points since September 30. A simple valuation model for the S&P 500, using the price of the 30-year Treasury bond (chosen because equities are also a long-dated asset class) and expected corporate earnings as explanatory variables for the U.S. equity market, concludes that the "fair value" of the S&P 500 has fallen by ten percent since the end of September as a result of these developments. Instead of 3,300 points, this model currently forecasts a price for the S&P 500 of just under 3,000 points. From the point of view of the fundamental data, there is thus a lot to suggest that the difficult capital market environment is not yet over and that we are currently only dealing with an interim recovery on the stock market.



Quelle: Factset

Market data

Stock marktes	As of 11.11.2022 08:16	Change versus 04.11.2022 -1 week	10.10.2022 -1 month	10.08.2022 -3 months	10.11.2021 -1 year	31.12.2021 YTD
Dow Jones	33715	4,0%	15,5%	1,2%	-6,6%	-7,2%
S&P 500	3956	4,9%	9,5%	-6,0%	-14,9%	-17,0%
Nasdaq	11114	6,1%	5,4%	-13,5%	-28,9%	-29,0%
DAX	14146	5,1%	15,3%	3,2%	-12,0%	-10,9%
MDAX	25271	6,1%	12,4%	-9,2%	-29,8%	-28,1%
TecDAX	3068	8,2%	13,8%	-2,8%	-20,8%	-21,7%
EuroStoxx 50	3847	4,3%	14,6%	2,6%	-11,5%	-10,5%
Stoxx 50	3677	2,2%	9,4%	0,5%	-2,2%	-3,7%
SMI (Swiss Market Index)	11120	3,1%	8,4%	-0,3%	-10,3%	-13,6%
Nikkei 225	28264	3,9%	4,2%	1,6%	-2,9%	-1,8%
Brasilien BOVESPA	109775	-7,1%	-5,3%	-0,4%	3,6%	4,7%
Russland RTS	1159	5,9%	20,2%	3,6%	-37,5%	-27,4%
Indien BSE 30	61744	1,3%	6,5%	5,0%	2,3%	6,0%
China CSI 300	3788	0,6%	1,8%	-7,8%	-21,4%	-23,3%
MSCI Welt	2637	5,2%	10,1%	-6,0%	-17,6%	-18,4%
MSCI Emerging Markets	890	0,5%	0,5%	-10,8%	-30,2%	-27,8%
Bond markets						
Bund-Future	140,50	378	442	-1636	-3019	-3087
Bobl-Future	119,98	123	121	-732	-1490	-1326
Schatz-Future	106,87	25	1	-301	-541	-516
3 Monats Euribor	1,80	40	115	189	237	239
3M Euribor Future, Dec 2017	2,24	-5	-3	0	280	3
3 Monats $ Libor	4,63	8	71	171	448	442
Fed Funds Future, Dec 2017	4,13	-3	0	0	405	3
10 year US Treasuries	3,81	-35	-15	102	227	231
10 year Bunds	2,04	-25	-29	122	229	222
10 year JGB	0,24	-1	0	5	18	17
10 year Swiss Government	1,01	-17	-50	57	120	115
US Treas 10Y Performance	578,78	2,7%	1,4%	-7,5%	-16,5%	-17,1%
Bund 10Y Performance	550,02	2,6%	3,1%	-9,4%	-17,5%	-17,0%
REX Performance Index	435,19	0,0%	-0,8%	-6,9%	-11,8%	-11,3%
US mortgage rate	0,00	0	0	0	0	0
IBOXX AA, €	3,25	-29	-36	136	296	277
IBOXX BBB, €	4,58	-33	-33	156	387	370
ML US High Yield	8,97	-32	-33	141	422	407
Convertible Bonds, Exane 25	6524	0,0%	4,7%	-4,4%	-21,4%	-20,3%
Commodities						
MG Base Metal Index	390,28	1,7%	3,7%	-2,7%	-12,0%	-15,4%
Crude oil Brent	95,73	-3,1%	-0,6%	-1,9%	15,8%	22,1%
Gold	1757,40	5,0%	5,4%	-2,4%	-5,2%	-3,6%
Silver	21,63	4,9%	10,2%	4,3%	-13,3%	-7,0%
Aluminium	2309,75	-1,5%	2,2%	-7,5%	-9,8%	-17,7%
Copper	8282,50	1,8%	8,4%	2,5%	-14,7%	-15,0%
Iron ore	88,19	3,6%	-9,4%	-19,6%	-4,3%	-21,6%
Freight rates Baltic Dry Index	1390	5,1%	-28,5%	-12,7%	-51,4%	-37,3%
Currencies						
EUR/ USD	1,0226	3,6%	5,5%	-0,3%	-11,5%	-9,7%
EUR/ GBP	0,8728	-0,5%	-0,6%	3,4%	2,1%	4,0%
EUR/ JPY	144,67	-0,4%	2,5%	4,7%	10,5%	11,0%
EUR/ CHF	0,9850	-0,1%	1,8%	1,4%	-6,7%	-4,7%
USD/ CNY	7,0984	-1,3%	-0,8%	5,5%	11,1%	11,7%
USD/ JPY	140,98	-3,8%	-3,2%	6,1%	23,8%	22,5%
USD/ GBP	0,85	-3,7%	-5,7%	4,7%	15,0%	15,6%

Source: Refinitiv Datastream

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