BELVÉDÈRE
Asset Management

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WHATEVER IT TAKES 2.0

MARKET INSIGHTS

WHATEVER IT TAKES 2.0

Is the eurozone facing a new debt crisis? Something may be brewing, anyway in Italy. The interest rate premium (risk premium) for Italian 10-year government bonds over the German ones has spiked markedly, amid a general increase in interest rate levels. The Italian government now has to pay interest of around 3 %, two and a half times higher than at the beginning of the year (1.2 %), let alone the mere 0.55 % in mid-2021. With public debt exceeding 150 % of Gross Domestic Product (GDP), the second-highest in the monetary union, and interest payments of 3.5 % of GDP last year (the highest in the EU!), it is not hard to imagine the difficulties Italy is facing in the wake of the interest rate increase. High debt, rising interest rates, high interest payments, along with political instability and an ailing economy – an explosive combination. The European Central Bank (ECB) is alarmed.

Exactly ten years ago, Mario Draghi, the then ECB President, famously proclaimed the ECB would do “whatever it takes” to overcome the euro crisis. And he added: “And believe me, it will be enough”. Meanwhile, Draghi’s speech has gained historic status as it marked the turning point in the euro crisis. Shortly afterwards, the ECB launched the Outright Monetary Transactions (OMT) programme, which was designed to provide monetary stability by buying government bonds from countries experiencing an acute crisis. However, the OMT programme was never implemented, since the announcement in itself was sufficient to soothe the markets.

Transmission Protection Instrument (TPI) is now the ECB’s latest intervention tool. Under specific circumstances, it allows the ECB to buy (unlimited) government bonds in response to any unwarranted, disorderly market dynamics in countries experiencing a deterioration in financial conditions that is not justified by country-specific characteristics. The ECB thus implies that an unjustified, i.e. flawed reaction is possible, which would be tantamount to a market failure. Naturally, this is not the case. The market is working perfectly fine. Today's interest rates and risk premiums are the result of market players' assessment of opportunities and risks. Sure, market players may make mistakes, change their minds, increase the risk premium or lower it. Only, that does not constitute a market failure, but is the result of a reassessment, which is not more than the purpose of markets.

TPI is now supposed to suppress this market mechanism. The ECB’s plans to step in again cannot come as a surprise, but is based on its long-standing tradition of (excessive) intervention – “Whatever it takes 2.0”, as it were. Only, this is now part of the problem rather than the solution. Will the announcement alone be sufficient to appease the markets again, as it did ten years ago? This time round, words alone just might not do the trick.

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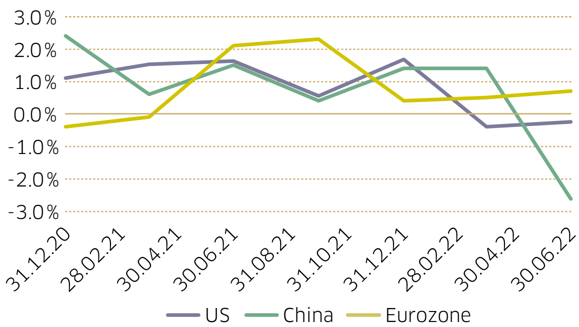
ECONOMY

The European economy, which was presumed to be particularly affected by the Ukraine crisis, performed surprisingly well in the second quarter and grew by 0.7 % (see chart) compared with the prior quarter. However, several factors contributed to this, including a strong inventory build-up, increased travel activity after the lifting of the corona measures and unexpected bustle in investment activity, none of which are here to last. In view of the weakening consumer and business sentiment as well as the looming energy crisis, Europe is at risk of grinding toward stagnation or even sliding into a recession.

Unlike the eurozone, the world's two largest economies – the US and China, which together account for more than one third of global economic output – shrank in the second quarter. China's GDP declined by 2.6 % compared with the first quarter. US GDP decreased for the second consecutive quarter by 0.2 %, which is generally considered a recession. However, it does not (yet) feel recessionary at all, given the persistently strong US labour market, robust consumer spending and the overall resilience of the industrial sector. However, sentiment indicators are weakening in the US, as well, which may well be reflected in the hard economic data over the coming months.

Growth in % vs. prior quarter



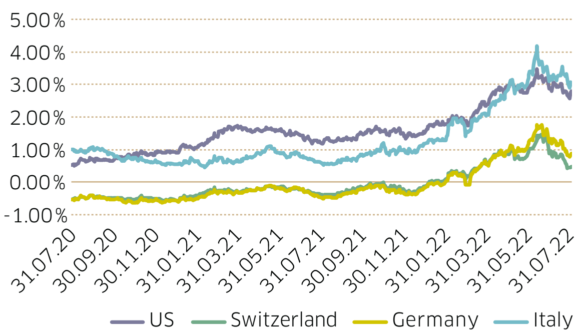
Source: Bloomberg, BAM

INTEREST RATES

On 21st July, the European Central Bank (ECB) raised its key interest rates for the first time in eleven years, and this by 0.5 percentage points. Since its establishment in 1998, the ECB has ventured hikes on this scale only twice – in 1999 and 2000. Banks can now borrow money from the ECB at a refinancing rate of 0.5%. The deposit rate was raised from -0.5% to 0%, thus ending the negative interest rate regime after more than eight years. At long last, one is inclined to say. With the exception of the Bank of Japan, all major central banks began raising interest rates months ago. Even the Swiss National Bank beat the ECB to the punch with its surprise rate hike in mid-June. We have not yet seen the end of the interest rate cycle, as further interest rate hikes are expected before the year is over.

Another increase in long-term interest rates from the peaks reached in June would have surprised us. Even more surprising, however, was how sharply they have declined again since then (see chart). This is despite record high inflation and despite key interest rate hikes – or perhaps rather because of the interest rate hikes. The decline in interest rates is perhaps mostly due to the fact that the monetary watchdogs are serious about fighting inflation and prepared to let the economy take a deep plunge to achieve it. We believe that long-term interest rates had reached the top tier of the range earlier and that they have quite possibly bottomed out now after the sharp decline. While interest rates may continue to rise a little more, we do not expect them to bounce back quite to the year's highs.

Yield 10yr government bonds

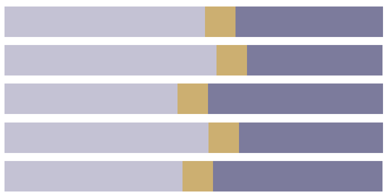


Source: Bloomberg, BAM

EQUITIES

Equity prices have recently rallied considerably after the heavy setback in the first half of the year. Given that a whole host of negative factors had been priced in earlier, the mere absence of more bad news sufficed to bring about a stabilisation. On the one hand, the recovery was driven by hints from the US Federal Reserve that its interest rate tightening action is not yet complete, but could turn out less rigorous than anticipated. On the other hand, companies – not only in the US – reported better half-year results and presented brighter outlooks than expected.

However, the potential for the recent price recovery to carry on with the same vigour has worn itself out. It would take clear signals that certain critical factors (geopolitical situation, economy, inflation, monetary policy) were taking a turn for the better. It will remain a bumpy ride, but the situation seems reasonably steady at the moment. We have currently no reason to expect a setback to or even below the rock bottom seen so far this year.

Asset class	Appraisal	Commentary
Bonds Government bonds Corporate bonds		Central banks will continue to raise key interest rates. A slight increase is expected for long-term rates.
Equities Switzerland Eurozone United Kingdom US Emerging markets		The potential for a continued price recovery has already worn itself out. It will remain a bumpy ride. We do not currently expect a setback to or even below this year's rock bottom.
Real Estate Switzerland		Real estate investments have risen along with the equity recovery and might continue to benefit from the comparatively favourable valuation.
Commodities Oil Gold		Gold price benefits hardly from geopolitical tensions. Oil price could come under pressure, should OPEC increase production.

unattractive — attractive Current asset class assessment

Imprint

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