BELVÉDÈRE
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GERMANY IS BOOMING

MARKET INSIGHTS

GERMANY IS BOOMING

An intentionally tantalising headline, for sure. You may find it even somewhat confusing, since the media have done everything to convince you of the reverse over the past weeks and months. The general anchor was Germany's trade balance slipping into negative territory in May 2022 for the first time in 30 years, which means that the value of goods Germany imported exceeded its exports. There was even talk of the exporting world champion's demise.

What are the implications of Germany's trade deficit? First of all, foreign trade balance is a zero-sum game. Every export surplus is matched somewhere by an import surplus. A trade deficit is neither good nor bad per se. What really matters is the overall trade activity. In absolute figures, Germany's recent exports and imports hit all-time highs. However, to be fair, these figures are nominal and have been ballooned by inflation – particularly imports. Moreover, today's imports are tomorrow's domestic investments and consumption. This means that imports are initially recorded in the GDP calculation as a negative value, but they then resurface as a positive contributor in other GDP components.

In terms of current account balance, which includes cross-border services in addition to trade in goods, Germany remains the unmitigated world champion. Despite a slight decline, Germany's current account surplus of 7% of GDP is still exceptionally high, taking the top rank among the G20 countries. Many countries – notably vociferously the US under Donald Trump – have taken exception to Germany's surplus for being excessive, claiming Germany invests and consumes too little and saves too much. A few years ago, I made the case for our Northern neighbour under the title "Is Germany being too successful?" To blame Germany for its economic strength, I argued, misses the point. It would be like asking Roger Federer to let the others win, too, occasionally.

To return to our headline: Germany is not actually booming, of course. The economy is weakening as in the rest of the world. A partly dated infrastructure, failed major projects such as Berlin airport, looming energy shortages, which might hit Germany particularly hard, or Deutsche Bahn's notorious delays, taken all together, may reinforce the impression of a decline. However, this cannot be attributed to the latest trade balance figures. Quite the reverse – if you are looking for positive news, you will find it in German foreign trade. Incidentally: the trade balance figures for May have been subsequently revised upwards and they are now showing a surplus!

Thomas Heller
CIO, Belvédère Asset Management

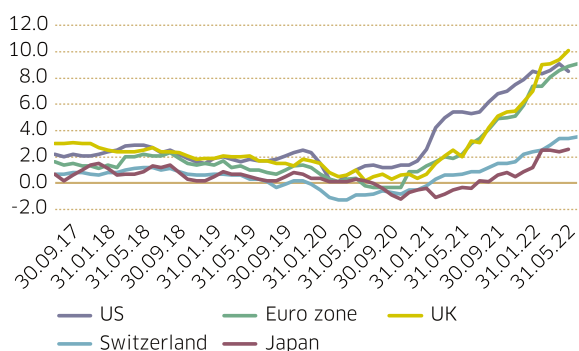
ECONOMY

In July, inflation in the US surprised favourably for the first time in quite a while. It fell to 8.5% instead of the anticipated 8.7%, from previously 9.1%. Even more importantly, core inflation did not rise as expected, but remained at 5.9%. US inflation has most likely peaked out at long last, but it remains elevated nonetheless. In the euro zone and the UK inflation has reached record levels and may possibly rise a little more. Prices have been rising even in countries with traditionally low inflation, such as Japan or Switzerland (see chart).

The US economy is still holding up surprisingly well. The labour market remains very strong and even sentiment indicators (e.g. consumer sentiment) have surprised on the bright side lately. The uncommonly fast widening gap between productivity (-3% in the first half of the year) and unit labour costs (+5.7%) might lead to trouble, though. In the euro zone, all signs continue to indicate a downturn. This is mainly reflected in leading and sentiment indicators at the moment, but it is only a matter of time before hard economic data follow suit.

With all this said, we believe the economy has been keeping up better than feared, although we do not foresee an imminent improvement. There is still a risk of a perceptible dent in growth. Based on the current data set, we do not expect a recession for the time being, anyway in the US, while we are less certain with regard to the euro zone.

Year-on-year inflation in %



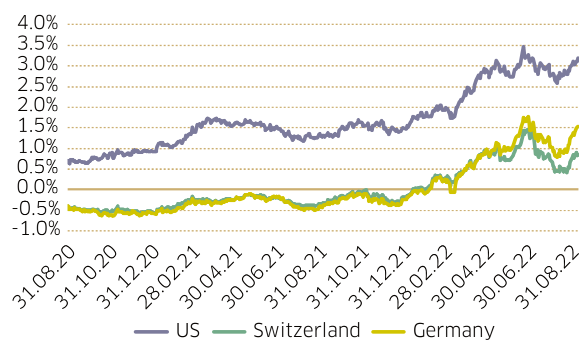
Source: Bloomberg, BAM

INTEREST RATES

Capital market yields are still subject to exceptionally wide swings. Preceded by a surprisingly sharp decline, long-term interest rates have bounced up again noticeably since the beginning of August, but remain below the peaks of June (see chart). Albeit expected, the extent and speed of the rebound once again exceeded estimates. It is difficult to discern a specific cause for this development. One month ago, we attributed the declining interest rates to the central banks' determination to fight inflation, even at the expense of the economy. Market players seemed convinced the dampening effect of the slowdown in economic growth should outweigh the interest-rate-driving forces of high inflation and the impending key interest rate hikes.

Has this wind changed? It most definitely did ever since Federal Reserve Chair Jerome Powell's speech at the Fed's annual policy forum in Jackson Hole on 26 August. Powell pointed out emphatically that there was no alternative to restoring price stability – which in the Fed's definition is achieved at 2% – even if it were to cause pain to households and the economy. Hopes that the Fed would end its tightening cycle earlier if the economy starts to cave in have thus been dashed. However, much of this is probably already reflected in current long-term interest rates. We still do not expect the peaks of June to be reached again or even exceeded.

Yield 10yr government bonds



Source: Bloomberg, BAM

EQUITIES

Rising inflation, tighter monetary policies, lockdowns in China, supply chain issues and the war in Ukraine had brewed up a veritable storm in the first half of the year and sent the stock markets dwindling well into the red. At times, indices were down 20% or more. By mid-year, however, a great deal of negativity had been priced into equities and a recovery was foreseeable (see Market Perspectives of July 2022). Yet, the duration and extent of the rally did come as a surprise.

At present, other signs prevail: While equity prices reflected much negativity in June, things look different now after a two-month rally. No negative aspects are currently priced in any more – no possible recession, no escalation of geopolitical tensions, no monetary tightening. The markets' negative reaction to US Fed Chair Jerome Powell ruling out a less restrictive interest rate policy only reveals that they have become more vulnerable. At the moment, we see no likely trigger for the next uptick in prices. Equity markets may have rather run out of steam, but we do not expect the downward trend of the last two weeks to last, either.

Asset class	Appraisal	Commentary
Bonds		Central banks will continue to raise key interest rates. Long-term interest rates have already moved up substantially and may be close to, if not at, a peak.
Government bonds		
Corporate bonds		
Equities		There is currently no trigger in sight for the next upward price movement. The recent downward trend is not expected to last, although markets will remain volatile.
Switzerland		
Eurozone		
United Kingdom		
US		
Emerging markets		
Real Estate		Real estate investments have also lost ground lately. Comparatively favourable valuations and the strong demand for housing provide some support.
Switzerland		
Commodities		Gold is under pressure due to higher interest rates and a strong US dollar. The oil price is caught between economic slowdown and supply shortages.
Oil		
Gold		

unattractive — attractive   Current asset class assessment

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Belvédère Asset Management AG
info@belvedere-am.com | www.belvedere-am.com