ECONOMIC RESEARCH & CORPORATE DEVELOPMENT

Financial Market Outlook

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Financial markets under the spell of expansionary monetary policy

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FINANCIAL MARKETS UNDER THE SPELL OF EXPANSIONARY MONETARY POLICY

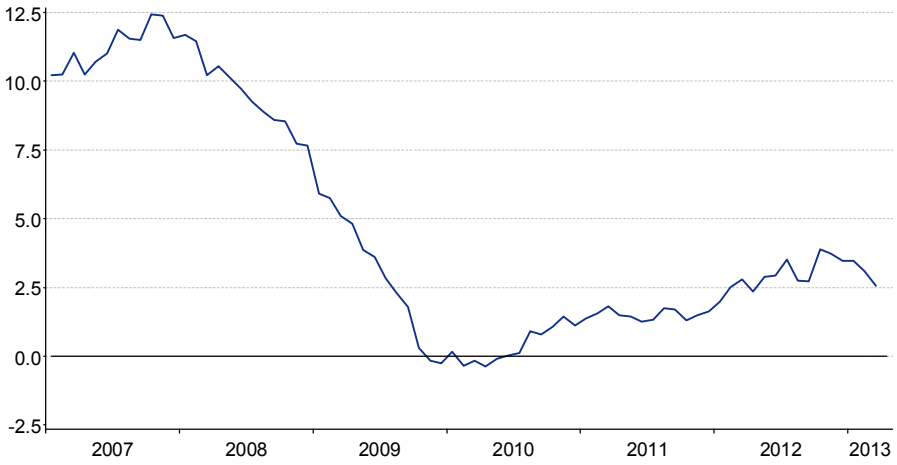
Asset markets around the globe have factored in protracted monetary expansion. Despite the occasional bout of jitters, equity markets on the whole are looking robust and many are flirting with multi-year highs. Given the weak economic indicators seen in recent weeks, this is remarkable. The pickup in the economy expected by many observers for the rest of the year is evident neither in Europe nor in the world economy. We have recently revised our GDP forecasts, now showing world growth of only 2.5 % and even a slightly negative average growth figure in the eurozone for 2013. For financial markets this is more evidence that monetary accommodation is here to stay for the foreseeable future.

Low safe haven bond yields to stay

High equity and bond prices reflect ultra-low interest rates and the central bank liquidity splurge. The low interest rate policy has just been confirmed by the ECB, with a key rate cut of 25bp to 0.5%. The main reasons for this decision are the latest economic data showing no spring pickup, an inflation rate of 1.2% at present which will probably considerably undershoot the ECB goal this year and next, and modest growth rates in private monetary holdings despite the liquidity flood (see chart below). The overall impact of the ECB move on EMU growth will, however, be fairly muted. This follows the recent announcement by the Bank of Japan that it plans to double the monetary base by the end of 2014. If in future the Japanese central bank is going to be snapping up some two-thirds of government bond issues, close to zero interest rates on Japanese government bonds are practically guaranteed. Given the size of the Japanese bond market, this will also serve to lower global yields.

Underlying growth in money supply still subdued

ECB: Money supply M3, % change on year earlier

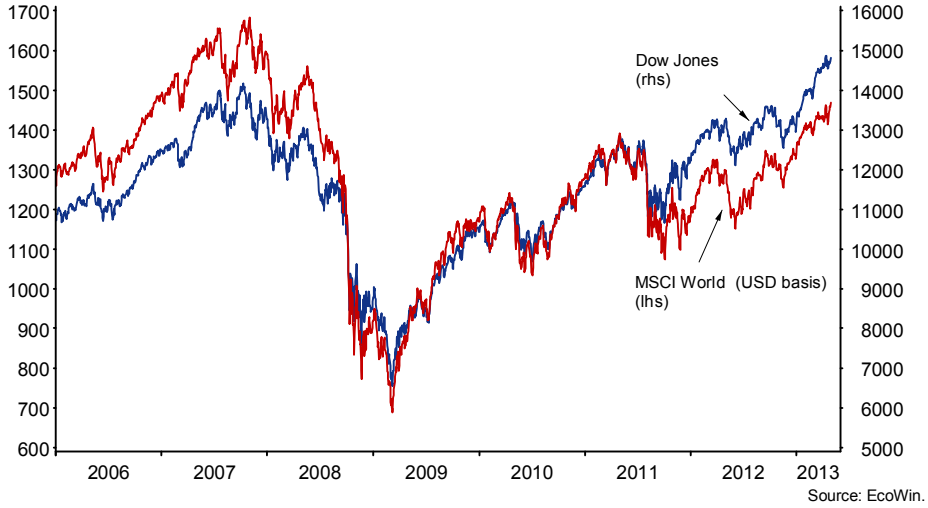


Source: EcoWin.

The current decline in inflation, which is a global phenomenon, is putting additional downward pressure on interest rates. Recent grim warnings that inflation was set to take off as result of expansionary monetary policy are now barely audible. In most industrial

countries the weak economy and moderate wage increases have eased inflationary pressure.

Stock markets at multi-year highs



However, the flood of liquidity and the low interest rates, which central banks hope will help resuscitate lending demand and unblock dysfunctional monetary transmission channels, are having ambivalent effects. On the one hand monetary accommodation is facilitating state funding of high debt levels and enhancing the attractiveness of even modestly profitable investment projects. On the other, it is negatively affecting the income flow for all savers. Safe investments generate practically no return these days, increasing the amount that needs to be saved to achieve a comfortable level of retirement provision. The alternative is to resort to investment forms with higher returns and these of course carry higher risks. Shares are benefiting from this; their charm has risen considerably despite the economic uncertainties.

Rotation into equities, but no excessive valuation as yet

Excessive liquidity supply can spawn asset bubbles without fueling inflation in goods prices. But as a matter of fact, looking at the equity markets, only lonely voices already see evidence of a bubble as a number of fundamental factors argue for equities. Equities have a decade of low gains behind them. The corporate earnings picture is currently broadly upbeat and if the expected economic pickup, supported by monetary policy, materializes, then there will be ongoing earnings momentum, making current valuations on most stock markets look moderate.

From this viewpoint, therefore, there are no reasons for a steep slide on stock markets. A downright collapse would only be on the cards if the euro debt crisis were to escalate again or, in the event of buoyant economic growth with higher inflation, monetary policy were to slam on the brakes and reverse direction after all. Both scenarios currently look unlikely. Equities are therefore set to remain attractive, even if gains are unlikely to match those seen in 2012.

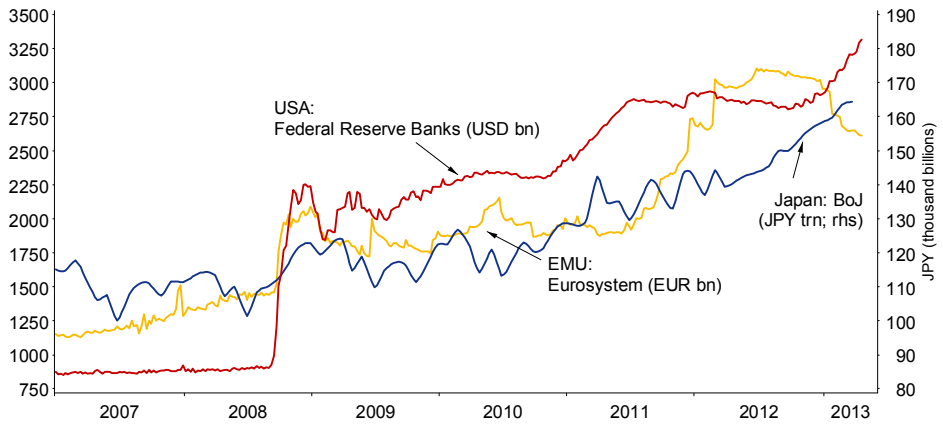
Sharp depreciation of yen

Source: EcoWin.

Risks for FOREX markets

Forecasting exchange rates is a mug's game. But it is clear that differing monetary policy directions in the various currency blocs can trigger severe gyrations. At present, the policies being pursued by the Fed, the ECB, the Bank of Japan and the Bank of England have in common that they are operating a low interest rate policy and are deploying unconventional measures to provide long-term liquidity. The dogged expansion of balance sheets, which was necessary and welcome in the financial crisis, is being continued with ever-new arguments, for instance the Fed's increased focus on quantitative labor market targets or the Bank of England's deliberations around nominal income targeting. In Japan we are witnessing a paradigm change. The BoJ shift from interest rate policy to a target for the monetary base is intended to raise inflation expectations substantially and quash the deflationary trends plaguing the Japanese economy. Whether this will work is by no means certain, but it is certain that it has promptly caused the Japanese yen to swoon, reinforcing the downward trend in the yen seen since mid-2012. Since last summer the dollar has risen by around 25% and the euro by around 30% against the yen. The backdrop created by monetary policy is key to exchange rate developments. Should we prepare for major exchange rate changes for this reason? As a matter of fact, the ECB's balance sheet has been declining for months, whereas the Fed's and especially the BOJ's balance sheets have been rising forcefully again. On their own, these divergent trends would suggest a stronger euro.

Balance sheets of FED, ECB, BoJ



Source: EcoWin.

This, however, is not our forecast. Some other considerations have to be taken into account. First of all, the eurozone economy is weak compared with the US. With respect to the yen, there are signs of capital repatriation by Japanese investors taking advantage of the sizeable valuation gains on foreign currency holdings. This should limit further yen devaluation. Secondly, the ECB's declining balance sheet is not attributable to any active mopping up of liquidity; rather banks' liquidity needs have eased somewhat thanks to the thaw on the markets. The ECB's announcement of 02 May not only signaled the continuation of low interest rate policies for "as long as needed" but also that further unconventional measures were being explored (this time focusing on better credit conditions for small and medium-sized companies). So, at present, anything but an exit from unconventional monetary policy is on the agenda, even though all are aware of the considerable risks this entails.

One reason why the ECB will be reluctant to undock from the other central banks is the aforementioned impact on the currency itself. In the current environment, a steep rise in the euro could spawn deflationary risks in the eurozone. As long as the US Fed, the BoJ and the Bank of England remain on a path of forceful accommodation, and there are no indications of change at least until the year's end, it would be difficult and risky for the ECB to abandon ultra-loose monetary policy. For this reason, a genuine turnaround in European monetary policy is not very likely in the foreseeable future – even if evidence of an economic recovery firms up.

The bottom line

In the environment of ongoing monetary expansion, yields on benchmark government bonds look unlikely to move very much in 2013. Real interest rates will thus remain close to zero or negative depending on the region. In the event of an economic recovery beginning in the latter part of 2013, the yields on ten year German bonds may rise to around 2% in 2014, but not much higher. The difficulties for defensive investment strategies will therefore persist. Stocks will continue to show a solid performance, powered by low interest rates, still relatively strong earnings and a continuing rotation in asset allocation. On the exchange rate front, we expect only moderate further depreciation of the yen vis-à-vis the euro and the dollar. Major swings in the euro/dollar rate are not likely as long as both central banks continue on the course of strong accommodation. A change in that stance looks unlikely to occur before 2014 and, hopefully, any moves towards gradual exit from unconventional policies will take place in a co-ordinated fashion, limiting frictions on forex markets

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