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Changes in the market regime

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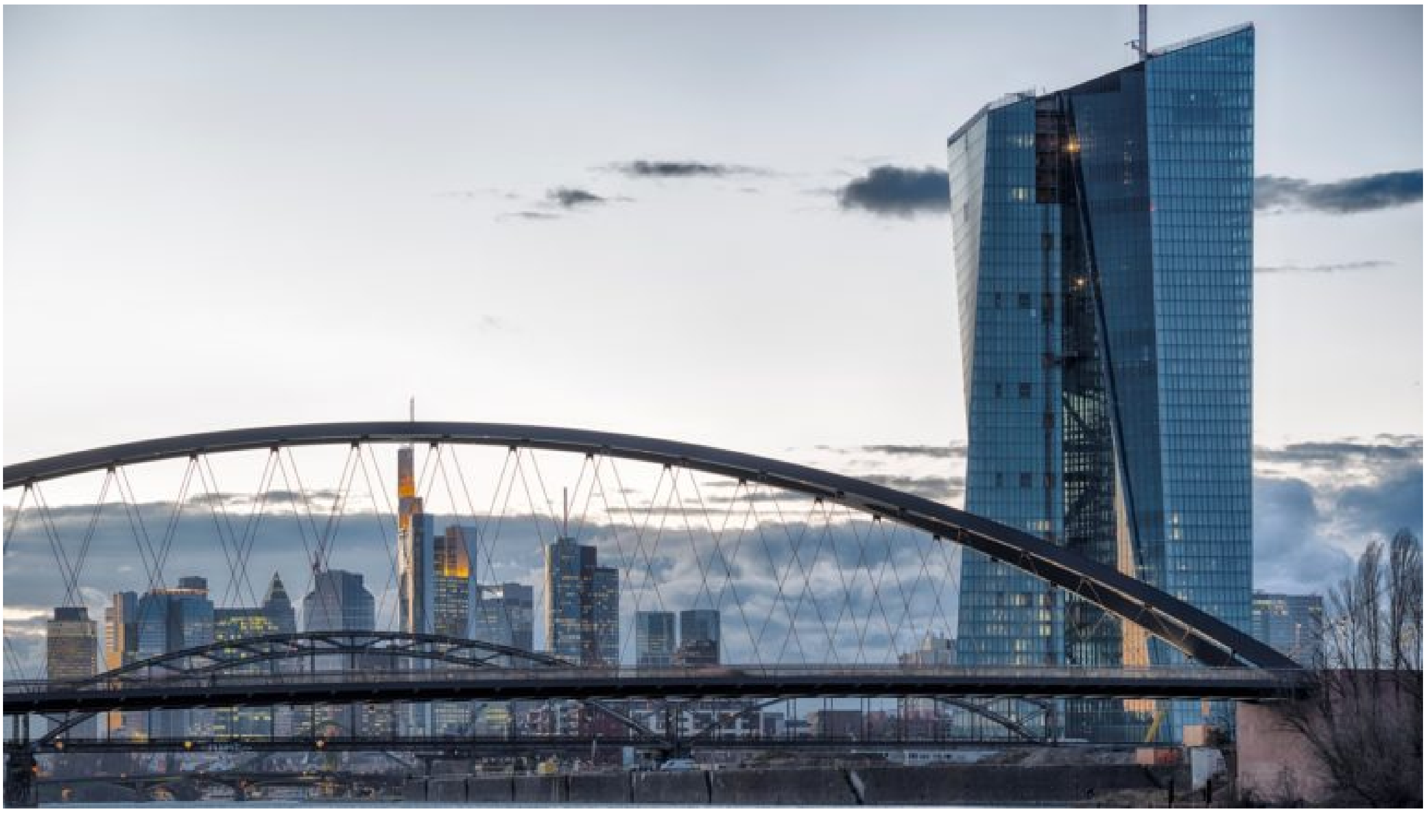

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The big trends of the past weeks such as the appreciation of the US dollar, the weakening oil price, falling yields, and the outperformance of Eurozone equities have reversed in the past days and weeks, in some cases drastically so.

What is behind all of this?

When both demand (i.e. economic growth) and supply (i.e. production growth) are weak and the central bank policies are very loose, we have a textbook example of an environment causing yields to fall and/or remain low. Indeed, yields were high after the Great Depression in 2008/2009. Having transitioned to a slow, weak, and fragile recovery, yields have started to fall and bond prices have started to rise (i.e. asset price inflation). Even if the economic regime remains unchanged, the market environment may change; the higher the asset price, the lower the expected return or yield.

The valuation indicators for bonds and the US dollar have in fact suggested lower future return rates. At the same time the positioning of many investors has been asymmetric, i.e. it has come with a focus on falling yields and an appreciating US dollar. Also, bond liquidity is lower than prior to the crisis. This combination of factors has caused an increase in the susceptibility to corrections.

The candidates that triggered the trend reversal are best summed up by the reduction of the risk of deflation (i.e. permanently falling wages and prices). Economic growth in the Eurozone has improved, the increased oil price has led to a slight increase in inflation, and the signs of an acceleration of wage growth in the USA have become more plentiful. The market therefore maintains its expectation of the beginning increases of the Fed funds rate in the USA.

At this time the drastic movements in the market are not heralding a change of the economic environment (yet). On the contrary: low yields and rates of return and temporary countermovements fit the picture of this regime. The very loose monetary policies exacerbate these features. There are neither signs of a significant, sustainable improvement of global economic growth (i.e. demand) nor of an increase in productivity growth (i.e. supply). However, with prices already very advanced, it does not take much for a countermovement to set in. The market environment has changed. The "Japan scenario" is now priced in.

Gerhard Winzer

Gerhard Winzer has worked at Erste Asset Management since March 2008. Up until March 2009, he was Senior Fund Manager in Fixed Income Asset Allocation; he has been Head Economist since April 2009.

He holds a degree from a polytechnical college and studied economics and business at Vienna University with a special focus on financial markets. He holds a CFA charter and participated from 2001 to 2003 in the doctoral programme for finance at the Center for Central European Financial Markets in Vienna.

From July 1997 to June 2007, he worked in research at CAIB, Bank Austria Creditanstalt, and UniCredit Markets & Investment Banking. His last position was as Executive Director for Fixed Income / FX Research and Strategy. He was responsible for research on asset allocation at Raiffeisen Zentralbank (RZB) in Vienna from July 2007 to February 2008.