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High noon in Greece and the trend to volatility

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Summary: The economic recovery in the developed economies is supported by the very expansive monetary policies, lower austerity pressure on the government front and among banks, and the fallen oil price. Growth rates remain moderate. In the emerging markets we can see signs of low-level stabilisation at best. The possible default of Greece, excessive interest rate hikes in the USA, a further decline of productivity, and continued economic weakening in the emerging markets are the main risks the markets are faced with.

What are the details?

High Noon with Greece

The current bailout programme with Greece is about to expire at the end of June. The new government in Greece has not accepted the terms of the programme right from the start. It hopes that the creditors will agree to a new programme with more favourable terms for Greece. It would be a rational move to reach an agreement both for the institutions and for Greece, with massive welfare losses and chaos in Greece as well as spill-over effects and the increase of the disintegration risk in the Eurozone looming in the absence of an agreement. It should be possible to reach a compromise between austerity and haircut if both parties are negotiating in good faith.

Nevertheless, a possible default and an ensuing exit from the Eurozone would not come as a surprise to anyone anymore at this point. The instruments of the central bank – unlimited provision of liquidity for a country in case of emergency and the bond purchase programme – restrict possible spill-over effects to equities and government bonds. Still, in the event of a default, risky assets are likely to incur temporary losses. In Greece, capital control would be implemented, and savings would be frozen. The Greek government would probably use (worthless) vouchers for its expenses at the beginning. In this scenario,

new elections are realistic. But even in case of an agreement in the eleventh hour a sustainable solution is unlikely. After the crisis is before the crisis. Here one of the weaknesses of the Eurozone becomes apparent: the lack of the necessary institutions that would facilitate a common economic and financial policy. The countries of the Eurozone are not irrevocably tied to each other.

From trend to volatility

Some important trends have come to an end in the first half of the year and have given way to increased volatility. The yields of bonds and the oil price have not fallen further, and the [US dollar](#) and the share prices have not increased any more. Where are we going next?

Weak growth

After a weak first quarter initial signs are indicating a slightly higher growth rate of real GDP for Q2. This is mainly due to the improved economic activity in the USA after it had shrunk slightly in Q1. Overall, however, global growth remains modest because the growth rates of industrial production, of retail sales, of exports, and company investments remain subdued on a global scale. In the emerging markets especially, a number of leading indicators are suggesting sustainably weak growth.

Boom in the Eurozone

Even if it does not feel that way: technically speaking, the Eurozone is currently in a boom phase. The Eurozone [economy](#) grew by an annualised 1.5% on a quarter-on-quarter basis. For Q2 indicators suggest a growth rate of 2%. This would mean a full percentage point above the estimated long-term average growth rate.

Improvement on the labour market

In this environment employment growth has improved in some developed economies. This implies the deterioration of labour productivity, i.e. the relationship between production and employment. Accordingly, wage inflation in the USA and the UK has increased slightly.

Market correction

The increase in yields, or actually, the decline in prices of many government bonds between the end of April and the beginning of June has caused uncertainty among many investors. Generally speaking, the more exhausted the valuation potential, the more susceptible the asset class is to a correction. The decline in liquidity on the government bond [market](#) exacerbates this characteristic.

In Germany, the real yield (i.e. nominal yield minus priced-in inflation) of a maturity of ten years amounted to -1.37% in mid-April. At the same time the economic data have increasingly suggested a cyclical recovery in the Eurozone. In line with this situation, real yields have increased (to -0.30% at the beginning of June). However, the recovery in the Eurozone is not self-supporting. One condition for this to be the case is a low level of interest rates and yields. At this point, it is realistic to expect negative real yields in the Eurozone for a sustainable period of time. It is too soon for an increase towards the long-term fair level of about 1%. This has been achieved by the indication put forth by the ECB to keep the key-lending rates at zero percent for the foreseeable future (N.B. the interest rate on deposits is even negative) and by the bond purchase programme.

At 1.9 percentage points, the yield differential between 10Y Treasury bonds in the USA and German government bonds has reached the highest level since 1989. At the same time the expectations for the increase of the Fed funds rate in the USA have fallen. The Fed is signalling that it wants to raise the Fed funds rate, but that it will be going about this step very carefully. The interest hike cycle will be no case of a lift-off; instead we will see a "crawling" scenario. The attractiveness of US Treasury bonds has therefore increased in comparison with German government bonds.

The yield differential between 10Y government bonds in Japan and Germany turned negative in February for the first time, and reached -0.24% in April. The attractiveness of German government bonds has therefore decreased in comparison with Japanese government bonds.

The increases in yields are largely of a technical nature. The economic environment suggests sustainably low yield levels. Investors will have to get used to bigger price fluctuations because valuations have no upward potential left, i.e. are expensive.

Oil price: too high?

Oil production remains in excess of demand. The difference disappears in massive building of stocks. As soon as they are full, the oil price will come under pressure if demand does not pick up or production is reduced.

US dollar: appreciation has come to an end

The main reason for the significant appreciation of the US dollar vis-à-vis many other currencies in the second half of 2014 was the expectation of a clear increase of the Fed funds rate in the USA. However, these expectations have fallen. Since March the US dollar has been consolidating.

Conclusion

The economic recovery in the developed economies is supported by the very expansive monetary policies, lower austerity pressure on the government front and among banks, and the fallen [oil](#) price. Growth rates remain moderate. In the emerging markets we can see signs of low-level stabilisation at best. The possible default of [Greece](#), excessive interest rate hikes in the USA, a further decline of [productivity](#), and continued economic weakening in the emerging markets are the main risks the markets are faced with.

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