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Losses reflect economic worries

Gerhard Winzer



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The losses on the stock exchanges and in other risky asset classes unsettle investors. The additional expansive signals sent by the central bank support markets, albeit only by a minor degree. From an economic perspective there are no convincing signs for a trend reversal. The current correction is due to permanently low growth and to the risk of further deterioration.

The indicators suggesting sustainably low economic growth are increasing in numbers, both with respect to real economic growth and to inflation (and thus nominal growth). The expectations/estimates for global economic growth are only gradually adjusted to these lower levels. In fact, the trend of downward revisions for economic growth is an ongoing one.

The downside risks have increased

This is due to the adjustment process in the wake of the boom years in the emerging markets and to the increase in the risk of recession in the USA. The **transformation of the growth drivers in China towards the service sector** has caused **commodity prices to slump**, setting off global ripples. Commodity-producing countries and sectors are in recession. Also, credit growth is falling as we speak. This environment weighs heavy on economic growth, industrial production, exports, and prices of goods worldwide.

In the **USA economic growth has decreased substantially**. Also, the balance sheet ratios in the corporate sector, especially gearing, have deteriorated. At the same time banks have tightened their lending conditions for companies. Both industrial production and new orders taken in the long-term capital goods segment are already sliding. Most recently, the service sector has been sending weaker signals as well. At least private housebuilding and private consumer spending are still going strong.

This environment explains the **widening of spreads demanded for default and equity risk**. This means the stress in the financial system has increased. And it also applies to European banks. The risk of negative feedback from the banking sector and the real economy has increased. Therefore the rate of inflation priced into bond yields is continuously falling to new lows. The **risk of deflation is elevated**.

Further interest rate hikes in the USA are unlikely

The "big" central banks accommodate these developments in their strategies. The Japanese central bank has joined the ranks of those central banks pursuing a **negative interest rate policy**. The European Central Bank issued clear signals of further **loosening** in March. The US Fed is monitoring these developments very closely and currently shows no intention of raising the Fed funds rate further. A rate hike by the Fed this year is unlikely. The stagnating monetary base in the USA is already restrictive enough for the global economy.

Seen from a positive angle, markets tend to price in recessions more often than they actually occur. Any slightly sustainable stabilisation of the Chinese currency, the oil price, inflation expectations, and lending conditions as well as further supporting measures especially in China could trigger a temporary recovery of equity and credit markets.

From a negative perspective, the conclusion would be: economists very rarely predict a recession. This means that it would catch many economists off-guard.

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