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Capital markets take a little breather

Gerhard Winzer



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The economic indicators are falling but do not suggest a [recession](#). The central banks are implementing expansive measures in order to fight deflation risks and to stabilise the financial markets. Hence, the data is slightly better than capital markets were expecting. This gives room for a little breather.

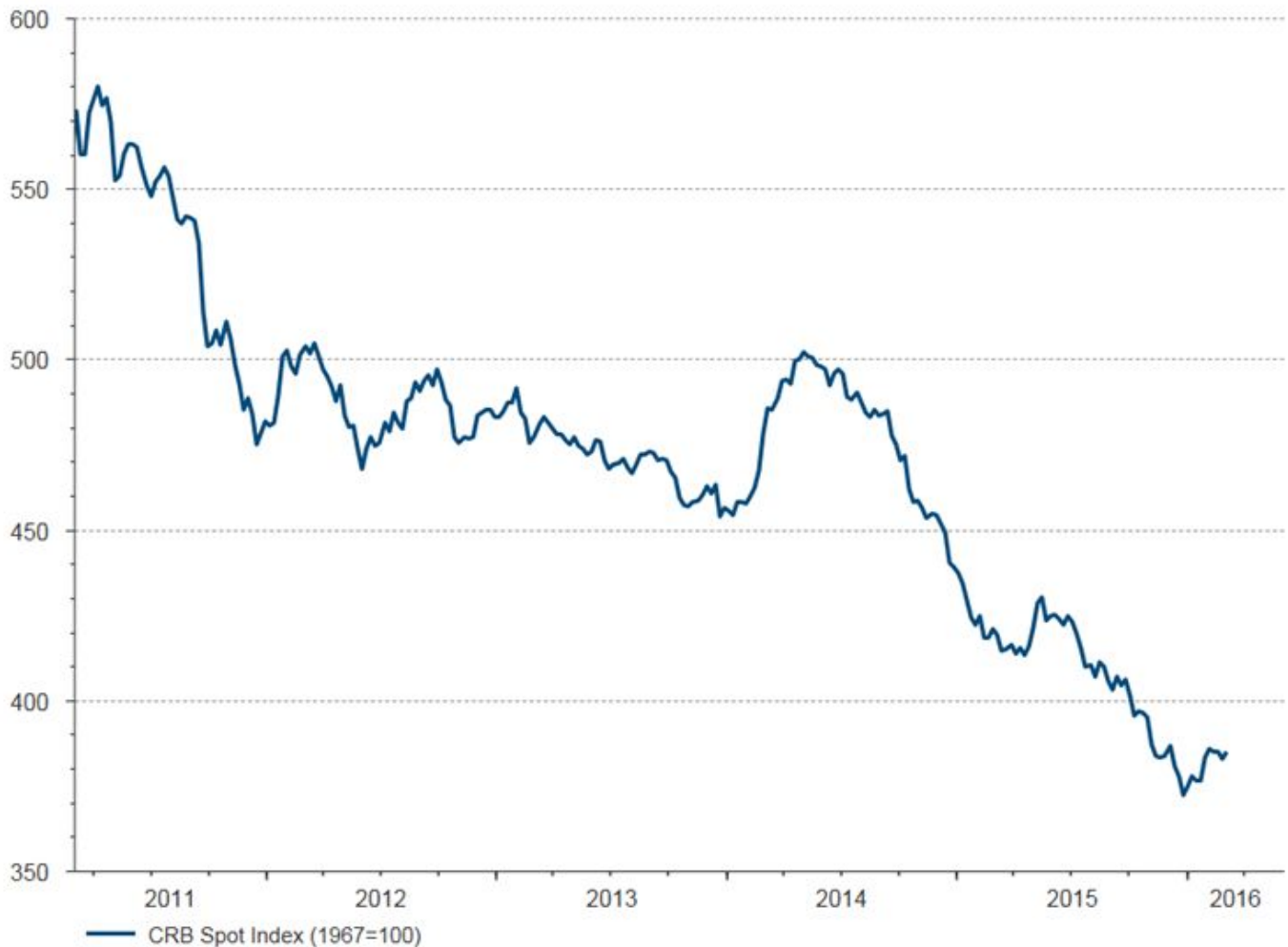
No recession

The economic indicators suggest a weakening, but at the very least no recession. The goods sector is globally very frail. Industrial production and goods exports are stagnating. The leading indicators such as purchasing managers indices for the manufacturing sector predict further deterioration. While the service sector is growing, the relevant leading indicators are falling here, too. On the upside, the consumption sector and the labour market in the industrialised economies have been resilient. That being said, the ability of companies to assert their prices has fallen, and productivity growth is low. The risk is twofold: companies might not only curb their capital expenditure, but also their employment.

Stabilising commodity prices

The stimulus measures in China in particular have helped the commodity prices stabilise. This reduces the bankruptcy risk for countries and companies. Also, commodity prices serve as economic indicator.

Commodity price index 03/2011-03/2016



Source: Thomson Financial Datastream; the index comprises 19 different [commodity](#)-futures-contracts from the energy, metals and agricultural sector; per 4.3.2016

No deflation

The price indicators suggest a sustainably low rate of inflation, but no deflation. Goods prices are on the decline, but service inflation is clearly positive. If the energy prices continue to stabilise, the annual rate of inflation will rise in Q4 due to the base effect. The focus is on a possible negative spill-over from the falling goods prices to the higher service prices. To date we cannot see any such effects. In this context, inflation expectations play an important role. Those held by the market are already very low. The survey-based inflation expectations have also fallen recently in some countries. The central banks have focused their attention on this development, as well as on the turbulences on the financial market.

Supporting monetary policies

The effectiveness of monetary policy has decreased, but is still there. The negative interest rate policy and the expansive economic measures in China help. Next week the European Central Bank will probably push the interest rate on deposits for surplus reserves from commercial banks further into the negative. In China, the expansion of credit growth is particularly remarkable. In the short run this prevents the [economy](#) from an excessively sharp cool-down, but in the long run it inflates the risk of a credit bubble. The capital outflow from China constitutes another long-term risk. The currency (renminbi) cannot be kept from depreciating as long as liquidity is expanded domestically (unless restrictions are imposed on the capital flows).

In the USA the expectations of interest rate hikes priced in by the market have fallen drastically in reaction to the market turbulences. The US central bank will continue to proclaim that it is prepared to raise interest rates. The job market is in good shape, and core inflation is rising. However, as long as the financial markets remain unstable, the Fed will be treading very carefully. This means that an interest rate hike is unlikely to happen in March.

Loosening of financial environment

The financial environment has loosened somewhat after the earlier tightening at the beginning of the year. The equity indices have increased, and the spreads for default risk have fallen, as have the volatilities. The improvement of the financial environment reduces the effect of the negative feedback from higher financing costs for companies to the real economy.

Negative maturity premium

The trend towards flattening, which the yield differential between safe government bonds with long and short maturities has experienced, does, however, support the downside risks. This also applies to the so-called term premium, which is the premium for the investment in bonds with long instead of short maturities.

Historically speaking, the maturity premium has been particularly low or falling when

1. the central bank had increased the key-lending rates excessively, or
2. the liquidity or demand for US Treasury bonds was very high, or
3. disinflation was prevalent.

At the moment the maturity premium is even negative for the 10Y segment. This suggests that another deterioration of the economic environment has already been priced in. Even a stabilisation can trigger a short-term recovery of risky asset classes in such an environment.

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