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Brexit or secular stagnation?

Gerhard Winzer

Risk-averse markets

The classic indicators on the capital market suggest rising risk with respect to the economy and risky assets. Spreads have widened, and the yield differential between long-term and short-term government bonds has fallen; volatility has increased. Also, the inflation rate priced in has decreased, the Japanese yen and the Swiss franc have appreciated, and the gold price has risen. The decline in the yields of safe government bonds is conspicuous, given that the yield of the German benchmark 10Y government bond is currently at -3bps.

Brexit uncertainty

The volatility of at-the-money options with a maturity of one month on the British pound to the euro is at 24%, which is one indicator suggesting a crisis. This value was last seen in the crisis year of 2008. As a matter of fact, some surveys have been published in the past days in relation to the referendum in the UK on 23 June that have seen the supporters of a Brexit take a slight lead. In line with this scenario, the yield differential between UK gilts, which pay higher yields, and German and Japanese government bonds has fallen, while the one between US Treasury bonds and UK gilts has widened. This suggests that UK gilts are the drivers for yield declines.

Cautious Fed

The imminent Brexit referendum does not only affect the capital markets. Within the framework of the meeting of the FOMC, the chairwoman of the US Fed, Janet Yellen, addressed the Brexit issue as one of the parameters in the central bank's decision-making process. Unsurprisingly, the bandwidth of the Fed funds rate was left at 0.25 – 0.50%.

Fallen rate projections

There are also other important strands of development aside from the uncertainty caused by the Brexit referendum. The outlook for the Fed funds rate has seen a significant revision. The projection for the rate remained unchanged for the end of 2016 at 0.9%, but the forecasts for 2017 and 2018 were revised downward from 1.9% to 1.6% and from 3.0% to 2.4%, respectively. The estimate for the average Fed funds rate was reduced as well (from 3.3% to 3.0%). The Fed thus continues to display readiness to increase the rate as soon as the environment is conducive to this step. The estimate for economic growth was reduced by a bit, while the one for inflation was raised. The data imply that full employment has been achieved and that productivity will not improve as substantially as recently assumed.

Fallen inflation expectations

The hurdles for rate hikes have become higher yet again. The most important statement in the press release by the Fed was that only most of the surveys for the long-term inflation expectations were unchanged anymore. This may be a result of the report by the University of Michigan published last week, according to which the long-term inflation expectations of consumers have fallen to an all-time-low of 2.3% in June. Firmly entrenched inflation expectations are a crucial prerequisite for the avoidance of a Japan scenario.

Conclusion

The markets are afraid of a negative shock to the global economy and the financial markets in the case of a Brexit. The uncertainty premium pushes the yield of risk-free government bonds down and dampens risky assets. In the "Bremain" (the UK remains in the EU) case, this premium will decline a bit and support the risky asset classes at the expense of credit-safe government bonds.

In addition to the Brexit issue, there are developments that suggest sustainably low levels of interest rates and yields. The assets prices have been gradually moving closer to the so-called liquidity trap, where on low interest levels there is no difference between the money market and the (safe) capital market, as well as to the scenario of "secular stagnation", which requires negative interest rates for the economy to grow.

Legal disclaimer

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.