

<https://blog.en.erste-am.com/strong-growth-rising-rates/>

Strong growth and rising rates

Gerhard Winzer



© (c) iStock

At the beginning of 2018, economic indicators are confirming the recovery scenario. Above all, the yields of government bonds are on the rise. Why is that the case, and what does it mean for the financial market as a whole?

Surprisingly strong economic growth

Real economic growth remains strong and broadly based on a global scale at the beginning of 2018. A multitude of survey indicators suggest this, such as the purchasing managers indices. Remarkably, the growth projections are still being revised upwards. For example, the IMF revised its estimate for the growth of global real GDP in 2018 up to 3.9%. This is 0.2 percentage points above last October's estimate. The excellent environment affects many economic categories.

Increasing resource utilisation

Resource utilisation is on the rise in many economies, i.e. the unemployment rates are falling. According to the OECD, it was only slightly below the optimum scenario last year anymore in the OECD region (-0.6% relative to the optimum utilisation level). Given that the current growth rate is above long-term growth, the output gap will turn positive in 2018. This is relevant particularly due to two reasons. The longer and more pronounced the output gap remains above the estimated optimum output, the more likely the cyclical inflation pressure will rise, and the more probable is the decline of the current real economic growth rate, which is currently above the long-term trend.

So far there are only weak signals for the former, and none for the latter (to date). The focus is on the USA. Since March 2017, the actual unemployment rate has fallen short of the estimate of the natural unemployment rate (source: CBO) and continues to decline (currently: 4.1%). The labour market in the USA is getting close to the point where any weakening of employment growth is not due to weaker demand anymore, but to scarcer supply (i.e. not enough people looking for jobs).

Inflation still low

The dangerous aspect of inflation is the non-linear and inert connection between resource utilisation (i.e. the unemployment rate) and inflation. When the unemployment rate hits a low value (i.e. the natural unemployment rate, which unfortunately defies precise estimation) for a longer period of time, inflation will suddenly start rising. To date, the inflation rates across many developed economies have remained below the inflation target of the respective central bank. In the USA, core inflation was 1.5% p.a. in December, in the Eurozone it was 1.0% p.a. in January, in Japan 0.3% p.a. in December, and in Australia 1.8% p.a. in Q4. By contrast, in the UK inflation is elevated (2.5% p.a. in December), and in Canada it is within the target bandwidth of the central bank (1.9% p.a.). Inflation remains one of the most important indicators this year.

The increase of key-lending rates

Hardly a week passes without a central bank tightening its monetary policy. In the past weeks, the central banks of Canada, Malaysia, and the Czech Republic have increased their respective key-lending rate.

The big central banks in the USA, the Eurozone, and Japan will also rein in their supportive monetary stance, at different speeds and extents. In the USA, the signals given by the Fed are in line with at least three hikes this year. That would put the target band for the Fed funds rate to a bandwidth of 2.00-2.25% (currently 1.25-1.50%).

The statements made in January by the EU and the Japanese central banks were cautious. Japan: no immediate increase of the yield target for 10Y government bonds of zero percent, even in the event of accelerating inflation. ECB: no change in the core terminology of the forward guidance given by the central bank officials during the January press conference. In particular, the first increase in key-lending rates will not happen before the end of the bond purchase programme, which is scheduled to last at least until September 2018. This is due to the fact that the ECB has no confidence (yet) in there being a sustainable increase of inflation towards the inflation target (slightly below 2% in the medium term), as well as to the development on the currency markets, i.e. the appreciation of the euro.

Not only the price of money (i.e. the interest rate) has been on a gradual increase. The growth of central bank liquidity has already declined significantly. In January, the ECB reduced the net purchase volume from EUR 60 to EUR 30bn, as announced. Next year, the aggregate money supply (M0) of the central banks of the USA, the Eurozone, the UK, and Japan will probably be shrinking (by about USD 230bn). In 2016, it still recorded a rise of USD 1,900bn.

Supportive credit environment

Credit growth stopped weakening last year in the emerging markets (exclusive of China) as well. This is an important reason for the improvement of economic growth in the emerging economies. In the developed economies, the improvement of the credit environment had started a few years earlier. In January, the Bank Lending Survey by the ECB suggested a further loosening of the lending standards. This means that the credit environment supports the strong economic growth.

Widening of budget deficit

Overall, the fiscal policy in the developed economies is neutral. The USA is an important exception. Here, the tax cuts have caused the budget deficit to widen. In a *ceteris paribus* analysis, this implies higher economic growth, higher inflation, more interest rate hikes, and less surplus liquidity (i.e. the government needs more capital).

Rising commodity prices

Commodity prices have embarked on a rising trend, both for industrial metals and the energy sector. The focus is on the oil price, which in the meantime has increased to almost USD 70/barrel (from USD 47 last June). Research indicates that at least half of the increase is due to surprisingly strong demand. This is crucial because a supply shock (cuts in oil production) would be negative for economic growth.

Protectionism

The main political risk is that of substantial protectionist measures by the USA. Two events were of particular relevance at the beginning of 2018. 1) The USA increase customs duties on washing machines and solar cells. These two areas account for only a small share of total US imports. The risk is that more measures could follow. 2) The US Secretary of the Treasury said that a weak US dollar would be good for the US economy. While this is correct, it is also an unusual statement coming from the Secretary of the Treasury, who represents the most important reserve currency. On the day after, ECB president Draghi pointed out that he did not like this sort of statement. Possible trade conflicts remain an important risk factor. An important partial aspect is the fact that protectionist measures tend to come with an inflationary effect (i.e. higher import costs, higher production costs domestically).

Slightly worse situation on the financial market

Rising real yields. The yield of the 10Y inflation-protected government bond in Germany has increased from -1.22% in December to currently -0.84%. The real price of money (i.e. the interest rate) is rising. This suggests a decline in surplus liquidity (strong economic growth, falling growth of central bank liquidity, higher budget deficit in the USA, rising commodity prices).

Increase in the inflation rates priced into the bond market. In the USA, the inflation rate priced into the 10Y bond segment of 1.20% two years ago has increased to 2.12%. The deflationary environment has yielded to an environment of (to date, slowly) rising inflation rates. Resource utilisation is on the rise.

Increasing expectations of interest rate hikes. The market has priced a Fed funds rate of 2.05% into the market for December 2018 in the USA. Last September, this value was still at 1.35%. Even for the Eurozone, the market expects an increase in key-lending rates for Q2 2019. Normalising monetary policy.

Rising nominal yields of government bonds. The 10Y benchmark bond yield currently amounts to 2.79% in the USA (2.04% in September). The economic environment suggests further increases.

High volatility. The volatilities (implied by option prices) have increased across various markets (equities, bonds, currencies). This reflects the rise in the risk of corrections on the markets.

Conclusion

The combination of strong economic growth, low inflation, and expansive monetary policies supports risky asset classes such as equities. However, the sustainable, strong economic growth suggests an increase in inflation, interest rate hikes, and lower liquidity. This in turn implies yield increases for government bonds. This tendency is propped up by the expansion of the budget deficit in the USA, the commodity price increases, and the protectionist measures. The main focus is on what yield level could trigger a correction on the equity markets. The rising volatility reflects this risk.

Legal note:

Prognoses are no reliable indicator for future performance.

Legal disclaimer

This document is an advertisement. Unless indicated otherwise, source: Erste Asset Management GmbH. The language of communication of the sales offices is German and the languages of communication of the Management Company also include English.

The prospectus for UCITS funds (including any amendments) is prepared and published in accordance with the provisions of the InvFG 2011 as amended. Information for Investors pursuant to § 21 AIFMG is prepared for the alternative investment funds (AIF) administered by Erste Asset Management GmbH pursuant to the provisions of the AIFMG in conjunction with the InvFG 2011.

The currently valid versions of the prospectus, the Information for Investors pursuant to § 21 AIFMG, and the key information document can be found on the website www.erste-am.com under "Mandatory publications" and can be obtained free of charge by interested investors at the offices of the Management Company and at the offices of the depositary bank. The exact date of the most recent publication of the prospectus, the languages in which the key information document is available, and any other locations where the documents can be obtained are indicated on the website www.erste-am.com. A summary of the investor rights is available in German and English on the website www.erste-am.com/investor-rights and can also be obtained from the Management Company.

The Management Company can decide to suspend the provisions it has taken for the sale of unit certificates in other countries in accordance with the regulatory requirements.

Note: You are about to purchase a product that may be difficult to understand. We recommend that you read the indicated fund documents before making an investment decision. In addition to the locations listed above, you can obtain these documents free of charge at the offices of the referring Sparkassen bank and the offices of Erste Bank der oesterreichischen Sparkassen AG. You can also access these documents electronically at www.erste-am.com.

N.B.: The performance scenarios listed in the key information document are based on a calculation method that is specified in an EU regulation. The future market development cannot be accurately predicted. The depicted performance scenarios merely present potential earnings, but are based on the earnings in the recent past. The actual earnings may be lower than indicated. Our analyses and conclusions are general in nature and do not take into account the individual characteristics of our investors in terms of earnings, taxation, experience and knowledge, investment objective, financial position, capacity for loss, and risk tolerance.

Please note: Past performance is not a reliable indicator of the future performance of a fund. Investments in securities entail risks in addition to the opportunities presented here. The value of units and their earnings can rise and fall. Changes in exchange rates can also have a positive or negative effect on the value of an investment. For this reason, you may receive less than your originally invested amount when you redeem your units. Persons who are interested in purchasing units in investment funds are advised to read the current fund prospectus(es) and the Information for Investors pursuant to § 21 AIFMG, especially the risk notices they contain, before making an investment decision. If the fund currency is different than the investor's home currency, changes in the relevant exchange rate can positively or negatively influence the value of the investment and the amount of the costs associated with the fund in the home currency.

We are not permitted to directly or indirectly offer, sell, transfer, or deliver this financial product to natural or legal persons whose place of residence or domicile is located in a country where this is legally prohibited. In this case, we may not provide any product information, either.

Please consult the corresponding information in the fund prospectus and the Information for Investors pursuant to § 21 AIFMG for restrictions on the sale of the fund to American or Russian citizens.

It is expressly noted that this communication does not provide any investment recommendations, but only expresses our current market assessment. Thus, this communication is not a substitute for investment advice, does not take into account the legal regulations aimed at promoting the independence of financial analyses, and is not subject to a prohibition on trading following the distribution of financial analyses.

This document does not represent a sales activity of the Management Company and therefore may not be construed as an offer for the purchase or sale of financial or investment instruments.

Erste Asset Management GmbH is affiliated with the referring Sparkassen banks and Erste Bank.

Please also read the "Information about us and our securities services" published by your bank.

Subject to misprints and errors.



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.