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Markets in a wait-and-see mode

Gerhard Winzer



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The markets are in a wait-and-see mode. In fact, global stock indices have been moving sideways for around a year. The fluctuations are decreasing from cycle to cycle. The supporting and dampening factors have therefore balanced each other out so far.

From an economic perspective, the question is still whether either inflation or growth will be the first to take a significant and rapid downward turn. A rapid decline in inflation would allow a soft landing for the economy, because central banks could lower key interest rates. However, a rapid decline in growth indicators accompanied by uncomfortably high inflation would make it difficult to ease monetary policy, which is why recession risks would rise. Overall, the economic indicators cover both scenarios. No scenario can be ruled out with a high degree of probability.

Global equities in sideways gear

(10y performance, data from 12.5.2022)



Source: Refinitiv Datastream

Note: Past performance is not a reliable indicator for future performance.

Uncertain monetary policy

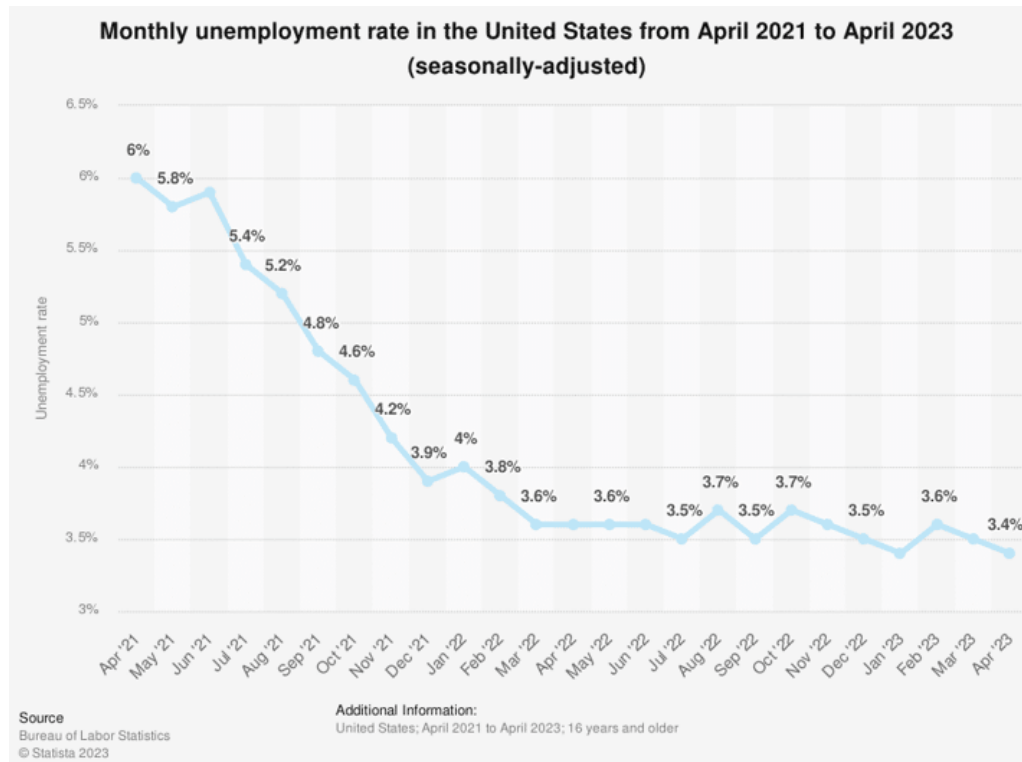
In addition, growth indicators lag monetary policy with a time lag of around one year. The impact of growth indicators on inflation again shows a considerable time lag. However, the actual time lags and the actual impact are highly uncertain. This makes it clear why more and more central banks are signaling a pause in the interest rate hike cycle. This is because the aim is to avoid, as far as possible, unnecessary interest rate hikes that could trigger a recession. Early easing, in turn, could have a negative impact on medium-term inflation dynamics (too high inflation). More and more central banks are thus also adopting a wait-and-see stance.

Negative outlook

On the negative side are stress in the U.S. banking system, the sovereign debt ceiling soon to be reached in the U.S., tightening of bank lending guidelines in the U.S., the Eurozone and Canada, inflation being too high, restrictive monetary policies, the labor market being too tight and some recession indicators. The last category includes the Conference Board's Leading Economic Index, which will be released this week for the month of April.

Positive outlook

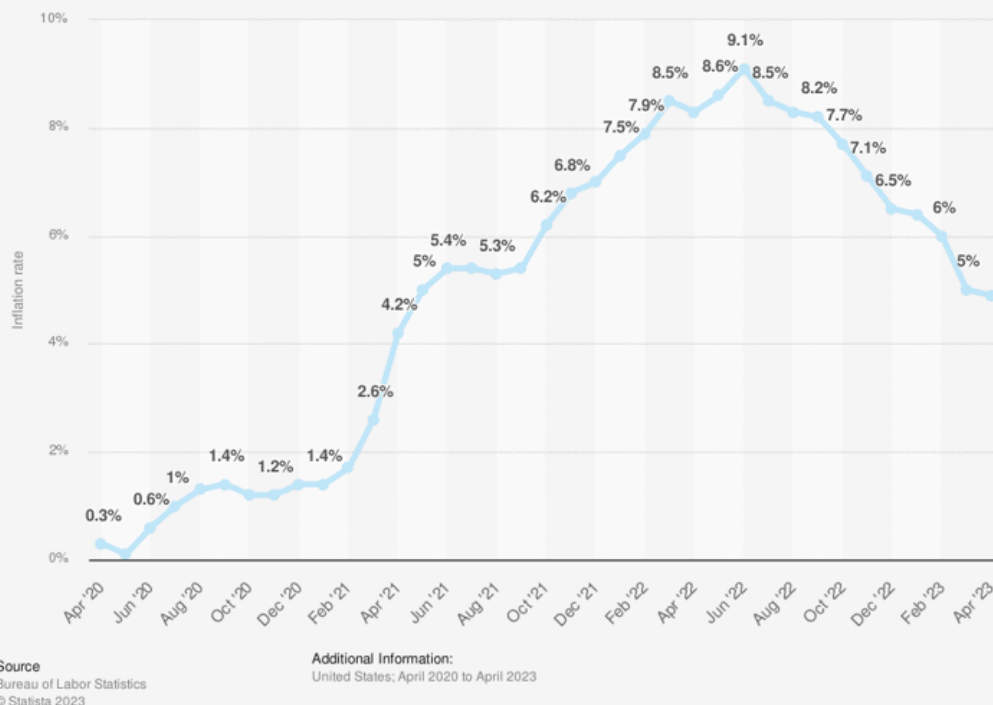
On the positive side, economic growth has so far proven surprisingly resilient to the numerous negative factors. In addition, there are signs that the labor market is easing from the right side. Job vacancies have followed a downward trend in the U.S., while the unemployment rate has remained at a low level. Inflation rates have also followed a downward trend, although the pace is too slow. In addition, more and more central banks are signaling a pause in the rate hike cycle to better assess the effects of the previous rapid rate hikes.



Inflation: come to stay?

Inflation rates show a falling trend, albeit at different speeds. Overall, the level of inflation is too high. In the U.S., consumer prices increased by 0.4% month-on-month and 4.9% year-on-year in April (high: 9% in June 2022). On the positive side, inflation in the services sector excluding housing has been on a downward trend. The central bank is looking closely at this metric. On the negative side, however, inflation for price components with high persistence is still 6.3% year-over-year (Atlanta Fed Sticky Core Prices). In addition, consumers' long-term inflation expectations unexpectedly increased in the month of May. The University of Michigan survey shows an increase from 3.0% in April to 3.2% in May (preliminary estimate). This is worrisome because it represents the highest level in the current inflation cycle. Something similar can be seen for the Eurozone. According to a report by the European Central Bank (Consumer Expectations Survey), consumers' short- and medium-term inflation expectations have increased. The risks of losing the two percent inflation anchor remain elevated.

Monthly 12-month inflation rate in the United States from April 2020 to April 2023



Weak growth

Signs of the effects of rapid key rate hikes are growing. In both the eurozone (Bank Lending Survey) and the U.S.A. (Senior Loan Officer Opinion Survey), reports on lending show a further tightening of guidelines and a further weakening of credit demand. In addition, in the U.S., the trend increase in initial claims for unemployment insurance has continued and both consumer sentiment (University of Michigan) and small and medium-sized business sentiment (NFIB) have fallen. On the goods front, poor manufacturing data in the Eurozone stood out last week. This week, industrial production in the eurozone is expected to contract significantly for the month of March. Last but not least, in China, both exports and imports contracted month-on-month. The V-shaped recovery in China is mainly in the service sector.

Debt ceiling

In June, the USA will probably reach the limit above which the Treasury is not allowed to increase the debt any further (debt ceiling). This means that the USA would not be able to service its financial obligations. President Biden and congressional representatives are in negotiations. The problem is the pronounced polarization of the two parties (Democrats and Republicans). A technical bankruptcy of the U.S. would trigger a strong uncertainty, because the government bond curve is the most important reference for the entire global financial market. The working assumption is a further postponement of reaching the debt ceiling by a few months.

CONCLUSION

Overall, the positive and negative factors have balanced each other out so far. Market participants continue to wait for the decisive indication as to whether a soft landing (including a mild contraction of GDP) or hard landing (recession) is more likely.

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