CONCEPT
VERMÖGENSMANAGEMENT

Are Interest Rates Set to Make a Comeback?

Half-yearly Report

Summer 2017

Are interest rates set to make a comeback?

The stock market is not some mathematical derivative of economic and corporate data. It is much more a representation of the hopes and expectations, disappointments and anxieties of its participants and is therefore something of a market place of the emotions. Suppositions trigger greater exchange rate movements than certainties and those hoping for reliable data prior to purchase or investment are in most cases already acting too late. By and large, market participants react in accordance with their expectations over a future period of six to twelve months. The short- to medium-term future is, therefore, already "priced in". So, it would be interesting to look at what is currently expected and what market participants (still) believe is unlikely to happen. Yet even that is only supposition, which gives one some idea of the complexity of the tasks facing asset managers.

In accordance with current patterns of thinking, the above question is of particular relevance in that we are now in what we have referred to in our previous reports as “the critical phase”, during which we need to pay particular attention to interest rate developments. Three-and-a-half years ago, the then president of the US Central Bank began what was referred to as “tapering”, i.e. progressive reduction in the purchasing of FED government bonds. However, it was not until December 2015 – some two years later - that key interest rates were first increased. In both of these cases, interestingly enough, the markets had already been operating during the preceding weeks and months in accordance with their expectation of the Central Bank’s decision. Consequently, US government bond interest rates were already rising at the end of 2013 and also at the end of 2015. In both cases, as soon as the market returned to “business as usual”, interest rates fell back again. Even today, the returns recorded on 10-year US treasury securities are below the levels seen at the end of 2013 and 2015. Meanwhile, the US Central Bank’s base interest rates (i.e. the “short rates”) have increased in four separate increments from 0.25 - 1.25 %.

The interest rate initiatives of the FED signal the inevitable end of the policy of cheap money.

These FED interest rate initiatives signal the inevitable end of the policy of cheap money. This is because, in the absence of interest rates, no controlling mechanism exists for the case in which the economy gets into difficulties. Unprofitable business models actually exist in the market because financing them costs nothing. Competitively, they operate like a subsidised entity, keeping wages and prices low, and they therefore have a deflationary effect. This means government deficits are more easily offset, necessary structural reforms threaten to peter out and future generations are left with a host of unsolved problems and a mountain of debt. We have been over this time and again in the past and we welcomed the first interest rate rises when they occurred. In times of full employment (at 4.3%, the USA has the lowest rate of unemployment since 2001), rising wages and inflation, the Central Bank would have been seen as unreliable, had it not followed up its statements with action and in due course taken its foot off the gas. And when else would it have made sense to do that? The incremental changes made to the interest rate were, therefore, expected, even though the last of these resulted in an immediate tightening of monetary policy, as the economy had already begun to slow down.

On the opposite side of the opinion spectrum, there are those who believe the Central Bank should under no circumstances whatsoever raise interest rates or in any way limit the money supply, since this would be likely to trigger a new financial crisis. After all, levels of debt are higher than ever before and, faced with rising interest rates, neither countries nor organisations (nor even in some cases private enterprises) would be able to refinance themselves, threatening a wave of insolvencies. As we now know, the central banks tried with the best of intentions to prevent what could not be prevented (i.e. an economic downturn), and in their dilemma simply became part of the problem. We have already discussed this phenomenon at great length in previous reports.

The beginning of the end of falling interest rates

Decreasing central bank support is not necessarily synonymous with rising interest rates.

At the moment, the perpetual motion machinery of the central bank appears to be losing its momentum, although that in principle is not necessarily synonymous with rising interest rates. There is no global consensus on this issue, even though seven of the ten largest central banks have signalled their wish to see an end in the foreseeable future to the policy of cheap money. However, Japan, the ECB and Sweden see it differently and it is this opposing pole which is now making central bank communications more challenging. Words can move billions, particularly if those holding forth are also market participants. This prompted Mario Draghi, President of the ECB, to make the comment "too much optimism", when giving a lecture on the positive economic data with which everyone was already acquainted, in Sintra, Portugal, during the last week of June. The fact that he was suggesting a “gradual adjustment of monetary policy” only for a significantly increasing inflation rate was not picked up by many. Market participants only noticed this at a later point when reviewing the positive economic outlook. They then predicted the trend towards rising inflation and were able to act quickly in respect of the interest rate rises looming on the horizon. Correspondingly, price losses linked to loans and shares quickly followed. Certainly, the big competitors attach great importance to both shares and interest rates and any palpable recovery in interest rates after 35 years of decline would normally have a negative influence on asset prices.

Two key questions:

It is therefore worth formulating an opinion on two issues: the first is, whether to expect, let’s say, two to three years of significantly rising interest rates. The second is, whether this represents a problem for the remaining capital markets.

Environmental conditions in the USA …

Movements in the opposite direction on the American interest rate market

In order to discuss the first issue, attention must be given to a detail of the American bond market. Here, as has already been pointed out in the introductory heading, movements can be seen in the opposite direction at both ends of the bond maturity time spectrum: at the short end, interest rates are increasing, whilst at the long end, they are falling. At the short end, the Central Bank is setting the tone with its interest rate policy; at the long end, however, the language of the remaining market participants is making itself heard. The flattening out of the interest rate curve is an expression of market expectations that, over the long term, inflation is only likely to be slightly higher than it is today. That does not

No indicators of economic optimism

signal excessive optimism about the economy. The so-called "Trump Jump" died away quickly and has been replaced by the sober realisation, that the dog which barks loudest usually bites least. So, in all probability, America will not see anything like corporation tax falling to 15% or a gigantic economic programme in the near future. Reform of the health system has been put on the back burner and there will be no construction of a 9-metre high wall on the 3,000-kilometre border with Mexico, at least for the time being. The euphoric mood and economic optimism appear to have evaporated and real data only allows at best moderate levels of growth to be predicted. So, the Surprise Index, which compares original economic expectations with actually occurring real data, has fallen to a multi-year low. In 2016, the lowest growth since 2011 (1.6%) was recorded. Even the first quarter of this year, annualised at 1.4%, turned out to be unusually poor and industrial production has been falling since November of last year. So, from this side, there doesn't appear to be any sign of an economic kick-start, which could fuel inflation and trigger an increase in capital market interest rates. Due to international competition, wages are only rising disproportionately, which is why the resulting inflationary impulse remains weak. So, we view the monetary policy of the US Central Bank merely as an attempt to win back a bit of wriggle room as quietly as possible and without harming the economy. Taken together, Central Bank communications that are testing the water, Trump's evaporating election promises, waning real data and reluctant yield movements on the bonds market allow us to predict only modest upward pressure on interest rates in the USA.

US Central Bank struggling for wriggle room

No inflationary scenario at play on the capital market

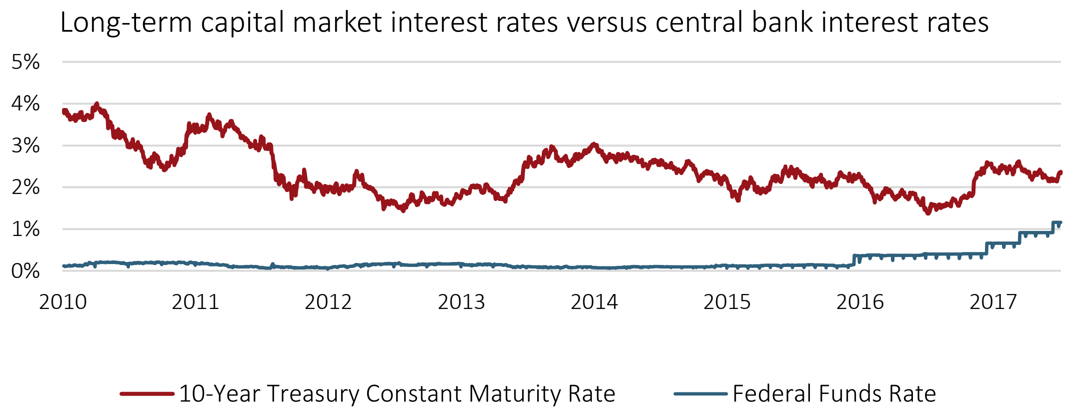

Figure 1 *Source: FED Economic Research*

… VERSUS EUROPE

In Europe, the economic data is looking significantly better. What can possibly have happened to explain the change in mood? The latest news on the main topic of Brexit shows no signs of a change for the better, because for the second time in a very short period - and for no good reason at all - the party in power played poker with the goodwill of the electorate and lost. Brexit is shaping up to be even more difficult than it started out to be, because now the time pressures are greater and bargaining power is weaker. Italy is also poised, in a worrying period of motionlessness before new elections, to use every trick in the book to prop up its failing banks with taxpayers' money whilst the EU generously turns a blind eye. Only Spain has begun to intently tackle its agenda and its economy has been growing faster than Germany's since 2015. Unemployment is falling and is now lying at its lowest level for over six years. And Spain has also earned a lot of respect for the way in which it handled the failing Banca Popular, succeeding in winding the bank down – as provided for by the regulations – without the need to deploy taxpayers' money and, in so doing, forcing creditors and shareholders to foot the bill. In Portugal too, indications are emerging that crises can be averted. EU deficit procedures against Portugal have recently been suspended, due to the country's budget deficit having fallen below the 2% threshold. The election of Emmanuel Macron – a true advocate of the European project - to the French presidency has literally sent a jolt through Europe. Based on the voting system and the poor turnout, only some 16% of the French electorate actually voted for him, but the result is nevertheless being seen as a turning point. The hope is that his election will not only strengthen France, but Europe as a whole, because following the departure of the UK, at least Germany and France will now be standing shoulder to shoulder. Europe seems to be becoming more manoeuvrable and the future of the euro is no longer being called into question - quite the opposite, in fact. The economic prospects for Europe are generally looking every bit as good as Draghi correctly described them in Sintra. In the short term, Europe is set to grow more rapidly than America. And over the longer term, that growth may become even more dynamic, particularly if the Twitter-obsessed president on the other side of the big pond remains imprisoned by his protectionist delusions. Indeed, inflationary pressures are much less evident in Europe at the present time. The inflation rate recently fell back to 1.4% and so remains below the 2% target figure. And in the meantime, as Europe speeds towards its targets, the ECB will - as Draghi suggested in April - continue to turn a blind eye to any "temporary outbreaks" of inflationary activity. However, the ECB continues to signal stable, low rates of interest, not least to ensure that those EU member states currently putting their budget deficits in order will not have the carpet pulled from under their feet. Besides, inflation rates oscillating around the target value and coupled to very low interest rates are the dream of central bankers and finance ministers alike and it is this strategy of repression which should allow the current levels of (public) debt to be reduced more quickly.

The French election has sent a jolt through Europe

The ECB is set to overlook any temporary outbreaks of inflation.

Against that – according to the IMF's prognosis – the global economy is set to grow by around 3.6% in 2017 and in doing so return to its long-term average. The greater part of that growth is expected to be achieved by the emerging countries, whilst in industrially developed countries, growth is expected to fall back to below the levels recorded in the 1980s and during the millennium years. Against such a background of expectations, a prognosis in which interest rates remain low would appear logical. And against a background of high indebtedness, low levels of inflation and (if anything) still less-than-average figures for growth, the major central banks are likely to hesitate to usher in rising interest rates with a reference to obtaining a degree of freedom to act in the event of a recession as, by increasing the interest rates, they would themselves be contributing to the likelihood of a recession.

Moderate growth with no excesses

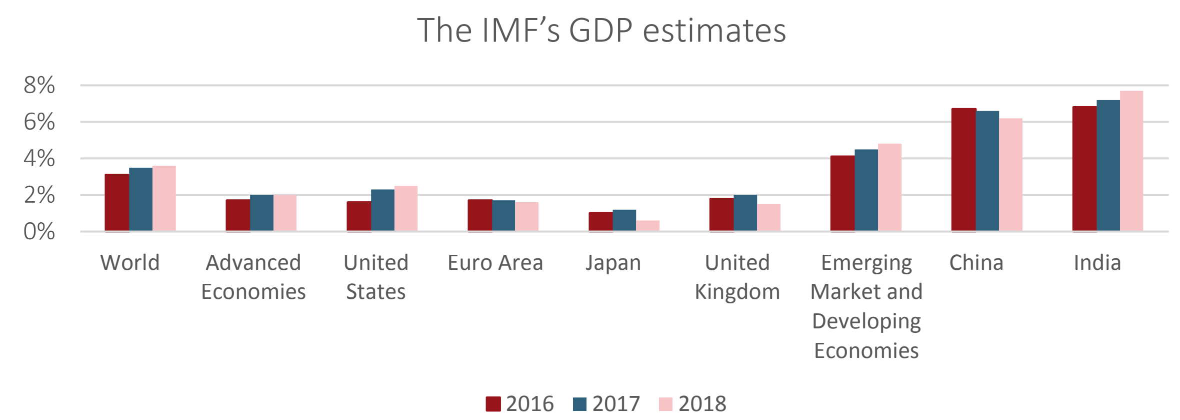

Figure 2 *Source: IMF*

Stumbling blocks

Alternative scenarios are possible. Increasing interest rates heighten nervousness.

What if we are mistaken and the expectation of low interest rates over *the medium term proves to be incorrect? Because, as we all know, the* triggers for higher rates of inflation are still out there: the possibility of higher oil prices, more scope to pass on price increases under the clearly improving employment situation in Europe, stronger than expected earnings and an enlivened lending cycle. As we are now seeing, rising interest rates are possible, even against a background of persistent inflation. Central bank communication is difficult – precisely because some sort of "normalisation" is desirable, but must be achieved without unsettling the markets and creating room for some self-fulfilling prophecy. But what needs to be said is that we cannot be entirely sure of our long-term expectations in respect of lower interest rates.

And with that we come to Question 2: namely whether rising interest rates actually carry with them any significant potential for disruption. It would, of course, probably depend on the level of increase, but that is only apparent in hindsight, so even the spectre of rising interest rates is sufficient to increase nervousness among market participants. In principle, the attractiveness of sharply rising returns in the other asset classes (shares, property, art, automobiles and wine) would diminish.

Analysts are correcting profit expectations upwards.

Shares can have a relative advantage in situations where company performance (turnover, profits) improves sufficiently to allow the effects of any interest rate rise to be offset. So, in this respect, the initial signs are not at all bad. Both the expectations of the analysts and the "real figures" are currently better than they have been for a long time. In the past, most analyst evaluations tended to be far too optimistic at the outset and had to then be adjusted downwards as the year progressed. This is not now the case, and it is not only upwardly corrected estimates that are affected. To an extent, growth in profits is also extremely dynamic. That applies not only to corporations rated in accordance with European indices, but also to their American counterparts, even though the dynamics of the US economy are currently flat. In Germany, corporate profits are up above 10% for the first time in years. That would be the suitable prerequisite to compensate for a very moderate rise in interest rates on the share markets. At this point, it is of interest to mention one of the JP Morgan brokerage's historical analyses, in which the highest ever average price-earnings ratio on US shares was recorded against a background of one- to three-percent inflation. According to the study, American securities would today have received a "fair" rating, and even more so given the low rates of interest. This is because although today those shares yield a dividend return lying roughly on a par with the interest on 10-year government bonds, 35 years ago equity investors were content with a third of the rate of return on government bonds. In Europe, dividend returns are actually higher than bond yields. This is rarely taken into account, but actually makes shares highly attractive at the present time.

Graph of results estimates for companies in the Euro Stoxx 50 with current corrections pointing upwards.

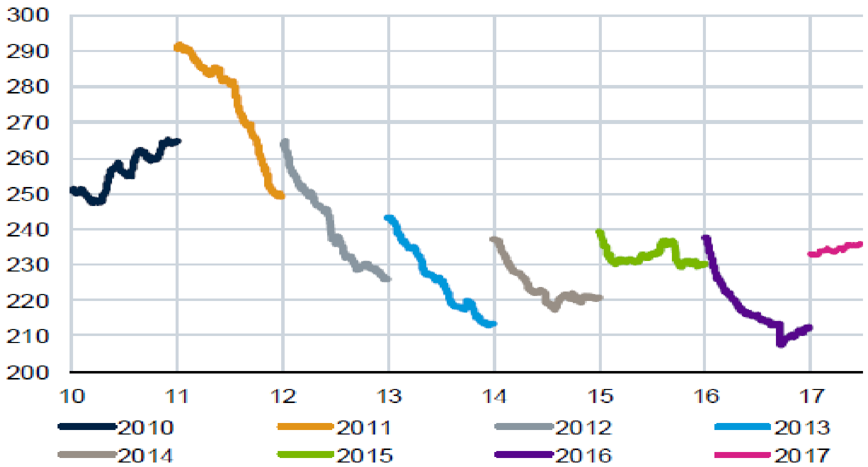

Figure 3 *Source: Bloomberg Finance, Deutsche Bank*

All in all, the lights are still on green

The best of all worlds

Keeping in mind the aspects described above, we rather surprisingly find ourselves once again in the best of all worlds for the capital markets. We would explain that as follows:

- A favourable monetary environment (low interest rates, on balance expansive central banks)
- Moderate economic growth and rising corporate profits (the economy neither in recession nor over-heating)
- Cautious investors (concerns, no over-investment, no euphoria)

The highest price-earnings ratios afforded at a moderate level of inflation

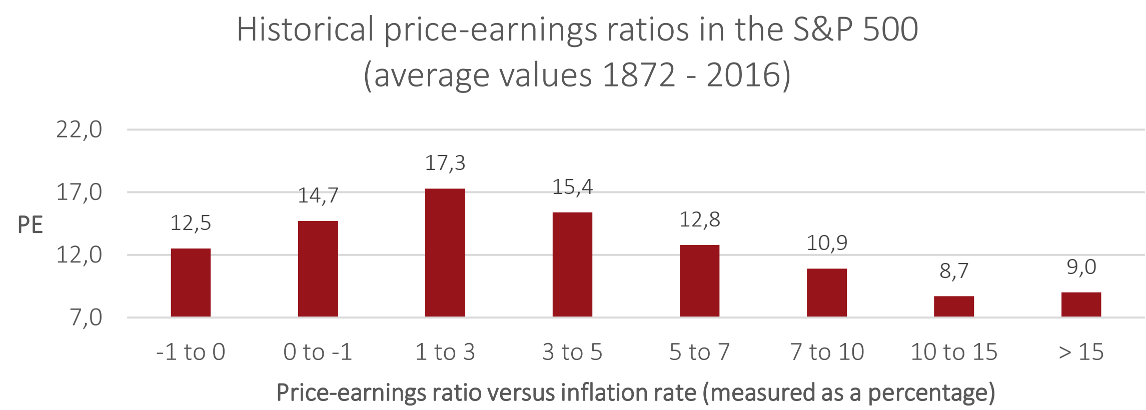

Figure 4 *Source: J.P.Morgan Asset Management*

Possible investment quotas are still not exhausted and continue to be optimistic for shares.

Regarding the last point, the sights will have to be lowered somewhat, because certain well-known actors on the global political stage are creating a high degree of uncertainty. It speaks volumes when the IMF finds itself constrained like a referee to note that “the global economy works much better for all, if political leaders maintain regular dialogue and work in the context of agreed mechanisms to reconcile their differences”. Against that, the capital markets had – at least until the “economic promise” of Draghi - reached an all-time high, or something approaching it - and that at extremely low levels of volatility. This, of course, makes the drop height greater and also increases the probability of setbacks in the interim period. For this reason, we are not exhausting the investment quotas in the assets we currently manage. At the same time, we are not put off by “very high levels”, because the long-term asset-maintaining character of share investments means that markets will always be subject to new highs. We do not actually regard the markets as over-valued and remain optimistic with respect to shares, but we expect increasing nervousness due to the uncertainty created by the "wording" of the central banks. Such statements can trigger the need for corrections, but the timing of these is extremely difficult to gauge. From today’s perspective, however, such phases would be suitable for raising share investment ratios.

Bielefeld, 11th July 2017,
Matthias Steinhauer