Economic Situation and Strategy

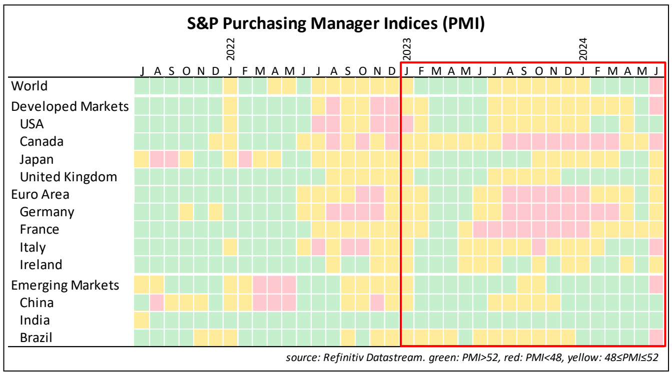
5 July 2024

Economy and capital markets: half-year review and outlook

Despite difficult economic and (geo)political conditions, 2023 was a surprisingly pleasing year on the capital markets. The main reason for the positive performance of share and bond prices was the decline in inflation rates and the associated expectation that the central banks would not have to raise their key interest rates any further. The equity markets in particular followed on from this positive development in 2024. After the first half of the year, we take stock and explore why we remain optimistic.

The economic environment is improving

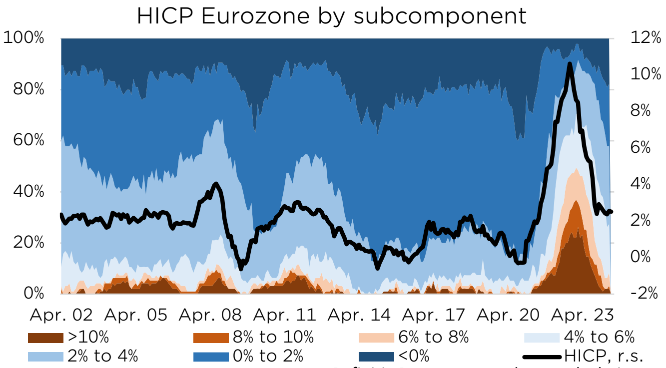
In view of the economic environment, it is certainly too early to fall into euphoria and proclaim the next economic boom. However, both conditions and expectations have improved compared to last year - starting from a low level. The business outlook in the industrialized countries deteriorated in unison in the second half of 2023. In the Eurozone in particular, company representatives were pessimistic about the future, causing the S&P Purchasing Managers' Index, for example, to fall below the growth mark of 50. Fears of recession were particularly rife in the industrial and construction sectors. This was due to the restrictive monetary policy and the associated increase in refinancing costs, which drastically reduced the profitability of many investment projects. At the same time, a lack of new orders and declining production figures in industry increased concerns about a recession. However, a recession did not materialize thanks to robust private consumer spending. Further declines in inflation rates, the expectation of falling interest rates and rising real incomes have improved the mood and economic situation in many industrialized countries since last year. This trend is likely to continue.



While economic sentiment has improved in recent months, only slight changes can be observed on the labor market in the USA and the Eurozone. While the unemployment rates in June 2023 were at historic lows of 3.6 percent in the USA and 6.5 percent in the Eurozone, they rose only slightly to four percent in the USA and even fell to 6.4 percent in the Eurozone. Looking ahead, the labor market is likely to remain robust and strengthen private consumption: On the one hand, the supply of labor remains scarce due to demographic change and, on the other, demand for skilled workers remains at a high level.

Inflation: the last mile remains difficult

The inflation rates of many economies have undergone a welcome development. After global inflation rates reached historic highs in 2022 and early 2023, with a few exceptions such as China, price pressure has since eased. In the Eurozone, the inflation rate fell from a peak of over ten percent to 2.5 percent most recently. At the same time, price pressure has decreased across the board. The following chart shows how many sub-components of the harmonized index of consumer prices (HICP) fall within a certain inflation band. At the current margin, the inflation rates of "only" eight percent of all sub-components are still above six percent. The picture was different at the end of 2022 and beginning of 2023: Here, the inflation rates of every second sub-component were above six percent and every fourth even above ten percent.



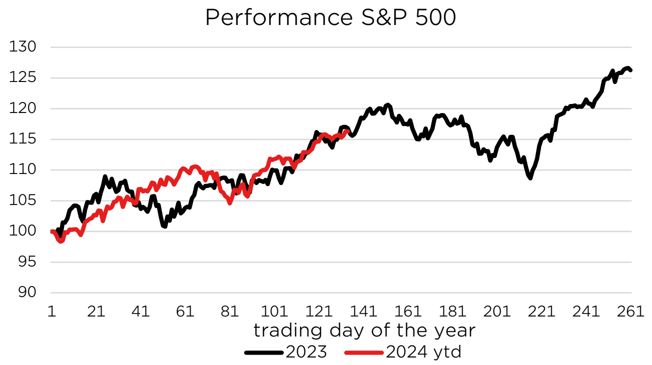
source: Refinitiv Datastream and own calculations

A similar development took place in the USA. Here, the PCE inflation rate has fallen from over seven percent to 2.6 percent recently. Recently, however, the downward trend in the Eurozone and the USA has come to a halt. One reason for this is the continuing price pressure in the service sector, which in turn is due to above-average wage growth. However, inflation rates should continue to approach the two percent mark over the remainder of the year - even if the decline is not linear. For 2024, we expect an average inflation rate of 2.4 percent in the USA (after 3.8 percent in 2023) and 2.2 percent in the Eurozone (after 5.5 percent in 2023).

The combination of an advanced decline in inflation in the Eurozone and relatively weaker economic data has led to the ECB lowering its key interest rates before the Fed. In June, the ECB lowered the interest rate for its main refinancing operations by 25 basis points to 4.25 percent, ahead of the Fed. Prior to this, several central banks from emerging markets (especially South America) and Europe, including Switzerland and Sweden, had lowered their key interest rates. We expect a less restrictive monetary policy stance until the end of the year: the ECB is likely to cut its key interest rate by 25 basis points up to two more times. The Fed is likely to follow with a time lag and make up to two interest rate cuts of 25 basis points each in 2024.

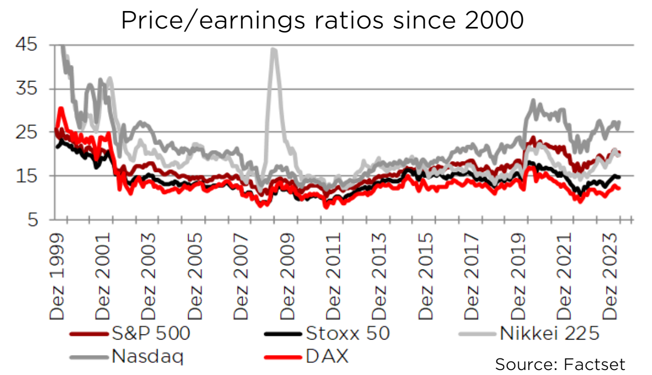
The environment for equities remains constructive

Hopes of interest rate cuts and the absence of a recession led to pleasing gains on the stock markets in 2023. The S&P 500 Index has increased in value by around 26 percent, the DAX by 20 percent and the STOXX 50 by just under 16 percent. Since the beginning of 2024, many stock market indices have built on their positive performance from the previous year and reached new all-time highs. The S&P 500 is up around 16 percent this year and the DAX has gained around 8 percent since the start of the year.



source: Refinitiv Datastream

Is the stock market rally now over or is the upward trend continuing? As outlined above, the economic environment offers scope for further price rises and higher dividend payments. Analysts also expect share buybacks to rise. For the companies in the S&P 500 alone, share buybacks this year are estimated at USD 925 billion - that would be 13 percent more than in the previous year. At the same time, falling interest rates are providing a tailwind for the stock markets. Why? Falling interest rates reduce the discount factor for future profits, so that the present value or current company value increases.



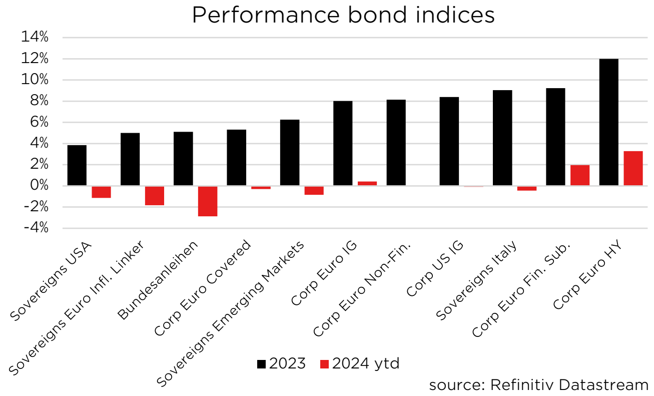
Source: Factset

What do the valuations look like? While US equities are relatively expensive, European equities are trading at more attractive valuation levels. The price/earnings ratio (P/E ratio) for the S&P 500 is around 21, which is well above the historical average. In contrast, the P/E ratio for the DAX is only around 12, which is in line with the long-term average. Technology stocks in particular stand out with their high valuations - although they were even more expensive at times in the past. At the end of the 1990s during the so-called dotcom bubble, for example, the P/E ratio was almost twice as high as it is today.

Overall, we expect new all-time highs in the second half of the year and expect the S&P 500 and DAX to reach 5,300 and 19,500 points respectively by the end of the year.

Further potential for bonds

Declining inflation rates and falling key interest rates also provide support for bond prices. The expectation of falling key interest rates has already led to strong increases in value in 2023. All sub-asset classes recorded a positive performance, but bonds with a higher risk in particular achieved greater value growth (the frontrunners in 2023 were euro high-yield corporate bonds at around 12 percent). Since the beginning of 2024, the picture has been quite mixed: unlike in 2023, not all sub-asset classes have recorded a positive performance to date. However, the pattern is similar. While bonds with a lower risk have recorded lower value growth or even losses since the start of the year, bonds with a higher risk have benefited from narrowing spreads.



Looking ahead, we expect prices to rise moderately and yields to fall. By the end of the year, yields on 10-year US Treasuries should fall to around 4.20 percent; we expect yields on 10-year German government bonds to fall to 2.15 percent. The absence of recessionary trends and persistently low default rates should continue to have a positive impact on credit spreads.

What are the risks?

Of course, our forecasts are subject to uncertainty. One of the biggest risks is probably more persistent inflation. In the short term, rising energy prices and persistently high services inflation could put pressure on prices. In the medium to long term, trade tensions could lead to higher tariffs and thus make imports more expensive. In May, for example, the Biden administration increased tariffs on electric cars from China from 25 percent to 100 percent and the EU also announced tariffs on electric cars from China. At the same time, companies are likely to pass on expenses for the climate-friendly conversion of production facilities to consumers, thereby maintaining price pressure. In addition to inflation uncertainty, increasing geopolitical tensions represent a serious and growing risk. These include the ongoing war between Russia and Ukraine and the conflict in the Middle East, as well as tensions between Taiwan and China. Overall, however, the economic environment for the capital markets remains constructive, so we remain optimistic about the future.

Simon Landt

Market data

Stock marktes	As of 05.07.2024 08:41	Change versus 28.06.2024 -1 week	04.06.2024 -1 month	04.04.2024 -3 months	04.07.2023 -1 year	29.12.2023 YTD
Dow Jones	39308	0,5%	1,5%	1,8%	14,2%	4,3%
S&P 500	5597	2,5%	5,8%	8,7%	25,6%	17,3%
Nasdaq	18188	2,6%	7,9%	13,3%	31,6%	21,2%
DAX	18450	1,2%	0,2%	0,3%	15,0%	10,1%
MDAX	25539	1,4%	-4,6%	-6,3%	-8,2%	-5,9%
TecDAX	3348	0,6%	-0,3%	-1,8%	5,1%	0,3%
EuroStoxx 50	4987	1,9%	0,7%	-1,6%	13,6%	10,3%
Stoxx 50	4532	0,9%	1,2%	2,7%	13,6%	10,7%
SMI (Swiss Market Index)	12069	0,6%	0,5%	3,2%	7,6%	8,4%
Nikkei 225	40912	3,4%	5,3%	2,9%	22,4%	22,3%
Brasilien BOVESPA	126164	1,8%	3,6%	-1,0%	6,0%	-6,0%
Russland RTS	1137	0,0%	0,5%	-2,3%	15,2%	5,0%
Indien BSE 30	79822	1,0%	10,7%	7,5%	21,9%	10,5%
China CSI 300	3428	-1,0%	-5,2%	-3,9%	-12,1%	-0,1%
MSCI Welt	3569	1,6%	3,3%	5,4%	20,1%	12,6%
MSCI Emerging Markets	1104	1,7%	5,0%	5,3%	9,5%	7,9%
Bond markets						
Bund-Future	130,57	-105	17	-217	-249	-665
Bobl-Future	115,87	-57	-63	-213	45	-341
Schatz-Future	105,48	-22	37	-18	69	-107
3 Monats Euribor	3,71	5	-21	-21	9	-18
3M Euribor Future, Dec 2024	3,33	4	0	28	-14	104
3 Monats $ Libor	5,58	-1	-2	1	5	-2
Fed Funds Future, Dec 2024	4,96	-3	-2	27	72	112
10 year US Treasuries	4,36	-2	2	5	50	49
10 year Bunds	2,58	12	6	24	12	58
10 year JGB	1,07	4	5	32	69	45
10 year Swiss Government	0,70	16	-16	0	-22	0
US Treas 10Y Performance	590,53	0,2%	0,2%	0,7%	-0,1%	-1,7%
Bund 10Y Performance	547,75	-0,8%	-0,1%	-1,2%	1,7%	-3,1%
REX Performance Index	441,25	-0,5%	0,2%	-0,3%	2,3%	-1,5%
IBOXX AA, €	3,48	1	2	22	-27	41
IBOXX BBB, €	4,01	-1	0	19	-63	26
ML US High Yield	8,11	9	3	10	-49	32
Commodities						
MG Base Metal Index	438,03	1,5%	-2,0%	5,8%	14,9%	12,1%
Crude oil Brent	87,10	0,8%	12,3%	-2,4%	14,4%	12,1%
Gold	2364,37	1,6%	1,6%	3,1%	22,7%	14,5%
Silver	30,59	4,5%	3,4%	12,8%	34,4%	26,1%
Aluminium	2473,53	-0,6%	-5,5%	2,8%	16,5%	5,5%
Copper	9734,08	2,9%	-0,9%	5,3%	16,6%	15,0%
Iron ore	113,06	6,1%	5,0%	13,2%	2,0%	-17,1%
Freight rates Baltic Dry Index	2021	-1,4%	11,5%	21,1%	93,6%	-3,5%
Currencies						
EUR/ USD	1,0823	1,1%	-0,4%	-0,3%	-0,7%	-2,1%
EUR/ GBP	0,8472	-0,1%	-0,5%	-1,2%	-1,1%	-2,2%
EUR/ JPY	173,96	1,2%	3,4%	5,6%	10,6%	11,3%
EUR/ CHF	0,9721	0,9%	0,2%	-1,3%	-0,4%	5,0%
USD/ CNY	7,2682	0,0%	0,4%	0,4%	0,7%	2,3%
USD/ JPY	161,27	0,3%	4,1%	6,6%	11,6%	14,3%
USD/ GBP	0,78	-1,0%	0,1%	-0,8%	-0,4%	-0,2%

Source: Refinitiv Datastream

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