Helaba

CAPITAL MARKETS BRIEFLY

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Pandemic!

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- The coronavirus pandemic is convulsing the economy and financial markets. The **US dollar** is benefitting from the turbulence in the short term, as there are likely to be shortages in the US currency. However, the declining interest rate advantage and exploding budget deficits are warning us to be cautious with the US dollar. The euro-dollar exchange rate should recover till the end of the year.

- The recent rise in yields on **bond** has been remarkable. However, the changed fiscal policy situation should now be largely priced in. The central banks' purchasing programs can unfold their interest-reducing effect. These effects are already clearly visible in euro peripheral bonds.

- After the significant falls in **stock** prices in recent weeks, we are attempting to assess the situation on the basis of historical cycles and valuation ratios. However, this can provide only a rough guide.

Financial markets: review and forecasts

	Performance			Helaba-Forecasts			
	year to date	1 month	current*	Q2/2020	Q3/2020	Q4/2020	Q1/2021
Currencies	(cross rate, %)		(cross rate)				
EUR-USD	4,9	0,9	1,07	1,10	1,15	1,20	1,20
EUR-JPY	2,7	2,0	119	117	120	125	125
EUR-GBP	-8,1	-9,1	0,92	0,90	0,90	0,85	0,85
EUR-CHF	2,9	0,6	1,05	1,05	1,07	1,10	1,10
Money/Bond Markets	(in basis points)		(in %)				
3M Euribor	1	4	-0,37	-0,50	-0,50	-0,50	-0,50
3M USD Libor	-70	-48	1,20	0,90	0,80	0,70	0,50
10y Bunds	-14	12	-0,32	-0,50	-0,50	-0,40	-0,20
10y Treasuries	-107	-67	0,85	1,00	1,00	1,25	1,50
Stock Markets	(in local currency, %)		(index)				
DAX	-32,6	-34,7	8.929	9.500	10.500	11.500	12.000
Euro Stoxx 50	-32,0	-33,3	2.549	2.700	2.900	3.100	3.300
Dow Jones	-32,8	-34,4	19.174	22.000	24.000	25.000	26.000
Nikkei 225	-30,0	-29,5	16.553	18.000	20.000	21.500	22.500

* 20.03.2020; Numbers in German notation

Sources: Bloomberg, Helaba Research

Christian Apelt, CFA

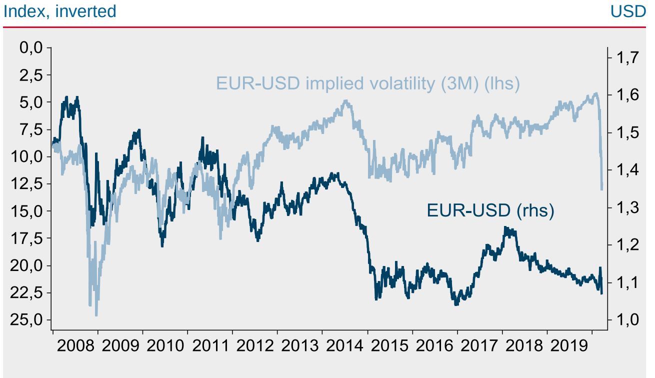
Currencies: dollar run goes by

The spread of the coronavirus has turned into a pandemic. The drastic countermeasures result in deep economic downturns. Accordingly, the financial markets are currently in crisis mode. Measured against the market turbulence, the euro-dollar exchange rate has been moving almost modestly: still, the euro initially climbed to 1.15 and then fell back to 1.07 US dollars. The Japanese yen was able to make significant gains only temporarily. With respect to the Swiss franc, the central bank has been able to stem the appreciation so far. The British pound came under massive pressure.

Temporary dollar shortages

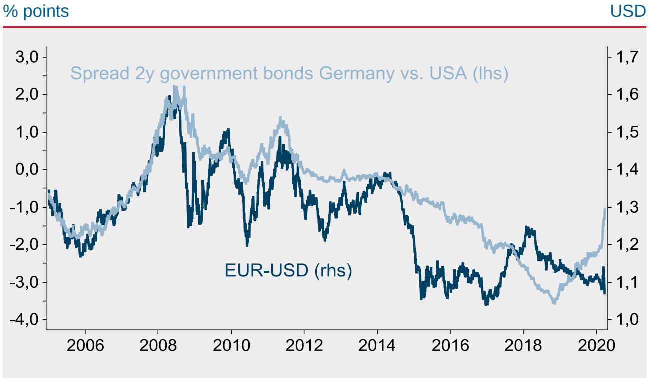
Fundamental explanations for the recent price swings are not sufficient. In the financial crisis of 2008/09, the US dollar – although to a certain extent the "cause of the crisis" – was able to appreciate strongly at times, as market participants suffered from a shortage of dollar liquidity, among other things. To some extent this is also likely to be the case this time; after all, the Greenback was recently even able to make strong gains against the safe-haven yen. Italy, which has been especially hard hit by the coronavirus, bears risks for the euro, even though European aid measures will presumably prevent the worst economic consequences. However, the positions on the futures exchange and the valuation – the US dollar is very expensive, unlike in 2008 – suggest smaller price swings this time. In addition, the central banks appear to be reacting very quickly with dollar swaps and liquidity injections. Implied volatility on the currency market has risen, but not to the levels seen in 2008. A continued strength of the dollar cannot be ruled out in the short term, but a variety of factors argue against it in the medium and long term.

US dollar in demand due to heightened nervousness



Sources: Macrobond, Helaba Research

Massive decline in US interest rate advantage



Sources: Macrobond, Helaba Research

Normalisation helping the euro

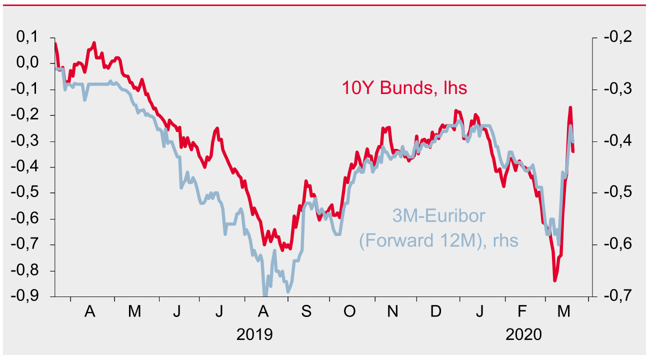
We are working on the assumption that – in analogy to China – measures to combat the pandemic will be gradually scaled back after six to eight weeks. But this temporary standstill alone will cause the economies of the major industrialized countries to shrink – even in the US. The US Federal Reserve reacted in an extreme fashion: it lowered its key interest rate by a total of 1.5 percentage points to almost zero and, in addition to numerous liquidity measures, announced a USD 700 billion purchase programme. The ECB, which was initially hesitant, expanded its bond purchases first by 120 billion and then by a further 750 billion euros. The two central bank balance sheets are likely to expand to a similar extent. However, the US yield advantage has declined significantly. Fiscal policy is also in panic mode. While in the euro zone the nation states are putting together large rescue packages, US President Trump plans to spend well over USD 1 trillion. The exploding US budget deficit will cause the "twin deficit" to rise considerably – even if the current account balance should improve somewhat. While the mix of very expansive monetary and fiscal policy is basically valid on both sides of the Atlantic, if the financial markets normalise, this could put more pressure on the US dollar. After all, the US is financing itself more abroad. And above all, the US currency is clearly overvalued against the euro. Even if the euro-dollar exchange rate will not necessarily end its slide in the short term, it should recover over the medium term and could climb in the direction of 1.20.

Ulf Krauss

Bonds: stabilisation in the yields

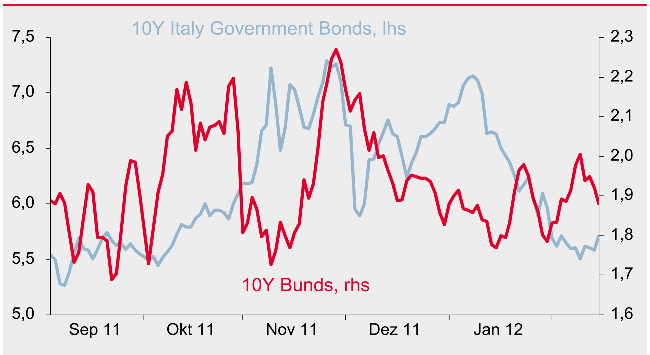
The international bond markets recently saw a significant rise in capital market interest rates. The yield on 10-year US government bonds climbed to 1.25 % at times, after reaching a historic low of 0.4 % on 9 March. The yield on 10-year German government bonds rose temporarily to -0.2 %. This meant price losses of around 6 % within only ten days. This development was due in particular to the rise in the risk premium for government bonds. The cost of the corona pandemic seems to be rising exponentially, parallel to the spread of the virus. The Trump government wants to pump more than USD 1 trillion into the economy through stimulus packages, gift checks and tax breaks. Virtually unlimited guarantees are also being given elsewhere to prevent the worst economic consequences such as insolvencies and unemployment. The national debt in many countries is therefore likely to increase significantly. Germany, too, has set up a guarantee framework of over half a trillion euros – with the option of more. The reaction of investors was not long in coming. The corona crisis has also brought eurobonds back on the agenda, which has caused additional price losses for Bunds. Another reason was the increased need for liquidity during the crisis, which accelerated the temporary sell-off. In addition, the failure of the ECB to cut interest rates caused uncertainty. In contrast to the last crises in 2008/09 and 2011, expectations regarding monetary policy have recently taken a completely different course. Instead of falling further, money market rates on the futures markets have recently actually risen noticeably. This development is unlikely to fit into the ECB's concept, so that in our opinion the topic of interest rate cuts cannot yet be shelved.

Expectations of interest rate cuts have evaporated



Sources: Datastream, Helaba Research

Bunds: confronted with a higher risk premium in 2011



Sources: Datastream, Helaba Research

ECB measures already showing an effect

During the euro debt crisis, as well, when the risk premiums of Italian government bonds rose significantly, the yields of German government bonds were temporarily also pulled upwards. This was, among other things, also due to considerations of introducing euro-denominated collective bonds to secure the financing of the crisis states that were down for the count. However, the situation eased time and again, so that in the end all we saw was a sideways course for German yields subject to considerable fluctuations. Even in the current environment, capital market interest rates on both sides of the Atlantic have recently declined again somewhat. In the coming months, too, we expect a calming down on the interest rate front rather than a further noticeable rise in yields. The powerful purchasing programmes of the central banks, in particular, should contribute to this. The roughly one trillion that the ECB intends to buy by the end of the year represents a strong counterweight to the higher risk premiums. In the case of Italian government bonds, the ECB measures are already having an effect. The spread over 10-year Bunds has recently fallen by almost one percentage point to 2 percentage points compared with the March high. The effects on Greek government bonds, which have now been explicitly included in the ECB's purchasing programme, have been even more marked. Here the spread over Bunds fell by around 1.5 percentage points to 2.7 percentage points. In conjunction with the somewhat more stable stock markets most recently, there is reason to hope that the monetary policy measures will have a positive effect.

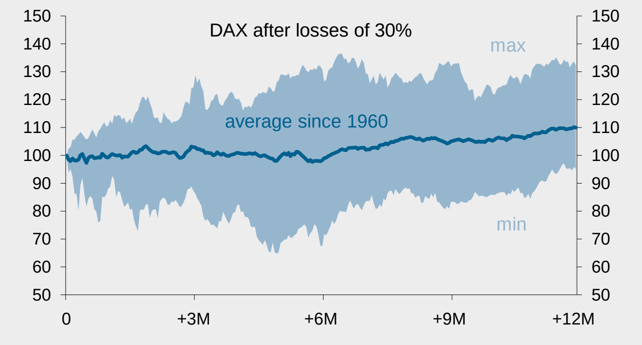
Markus Reinwand, CFA

Stocks: searching for a bottom

Equities around the world continue to fall, even if the decline has slowed somewhat recently. The Chinese equity market has so far come off comparatively lightly. Meanwhile, monetary and fiscal policy is doing everything in its power to cushion the negative economic consequences of the corona pandemic as much as possible. Nevertheless, uncertainty remains extremely high. There are no blueprints for the current crisis. The measures taken to slow the spread of the virus have a massive impact on economic activity and make it necessary to constantly review forecasts. For example, due to the recent massive restrictions on public life and the closure of important production areas, the slump in the first two quarters will be much stronger than initially assumed. We continue to expect a noticeable recovery in the second half of the year. We have therefore again adjusted our equity forecasts accordingly.

Favourable risk-reward ratio over the medium term

Indexed: DAX level after a decline of 30 % = 100



Sources: Bloomberg, Helaba Research

Low valuation argues for bottom-formation

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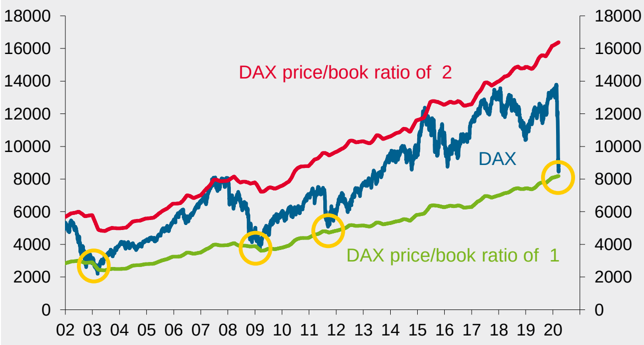

Sources: Bloomberg, Helaba Research

With their rapid correction, equities have already anticipated much of the slump in growth. After all, the DAX has already lost almost 40 % from its high, while the S&P 500 has lost around 30 %. Price declines of more than 20 % are referred to as a bear market. In Germany, there have been 13 such downward cycles since 1960, based on the back-calculated DAX. On average, it took 18 months for shares to reach their low. The mean value of the price declines was 39 %. What took the DAX one and a half years in the past, this time it did within one month. However, to conclude from this that the bottom has already been reached in the current situation would go too far.

Many negative factors anticipated

To gauge the short-term downside risk, we have examined the development of previous cycles in which the DAX had already lost 30 % (left chart). In the bear market from July 2007 to March 2009, there was a further decline of almost 38 % within twelve months, but this was recovered within a few months. Twelve months after a 30 % decline, the DAX gained on average around 10 %, in the best case even 30 %. In the worst case, it fell by a further 5 %. The low valuation gives hope for a gradual bottom formation. In particular, the price-to-book ratio (P/B ratio) has often proved to be a reliable indicator in the past. With a P/B ratio of 1, the DAX gradually found support in earlier price slumps. The DAX's book value currently stands at around 8,200 points, but this number will decline further depending on the subsequent course of the crisis. In the short term, further price declines are therefore possible. For investors with a medium to long-term horizon, however, we believe that the opportunities outweigh the risks. ■