Global Financial Markets

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Tighter monetary conditions should limit growth

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The clever research concept for time-pressed decision makers

Executive summary

- Economic growth rates in the US in particular, but in Europe as well, are too high to depress inflation permanently to 2% or slightly lower.

- A complicating factor is that inflation is currently subject to upward forces, while the 2008-2020 period saw a variety of downward forces on inflation. The main factors to consider are the presence of ample liquidity, large public deficits and deglobalisation.

- It is basically surprising that economic growth in the West has not declined further as a result of sharply higher interest rates. This is mainly due to fiscal stimulus and persistent loose monetary conditions (the level of asset prices, credit spreads, the dollar exchange rate, real interest rates et cetera).

- In addition, there are other forces that have boosted growth, but these have reversed or are in the process of reversing.

- It is becoming increasingly difficult for the US to contain China and Russia. In fact, this costs so much money that it comes at the expense of the prosperity of its own people. More and more Americans are therefore turning it around, putting themselves first and then the rest of the world. In the long run, however, this is also going to cost vast amounts of money.

- Europe can only avoid being crushed between China and the US if it forms a large economic and military bloc. This is very difficult and costly.

- Chances are high that excessive, persistent public deficits will be evident in the US and Europe, which will (have to) be increasingly financed by central banks. In other words, inflation will rise to ever higher levels.

- Many hopes are pinned on Artificial Intelligence. However, we fear that economic policies in the West are not sufficiently geared towards productivity growth to make AI a game changer - at least not in the reasonably short term.

- If we are proved right, then the economic outlook will be fairly poor, as there is little scope for further monetary and/or fiscal stimulus.

- Moreover, ageing populations will depress growth, and the rise of all sorts of populist parties is also unhelpful.

- Monetary conditions will have to be tightened in order to lower growth in the period ahead, to the point where inflation permanently declines to 2%. This means lower share prices, higher (real) long-term interest rates and credit spreads and a strong dollar. However, the question is whether even higher interest rates will be required for this, or whether interest rates should be kept at current levels for now. We believe the latter should be opted for. Incidentally, this applies more to the US than to Europe.

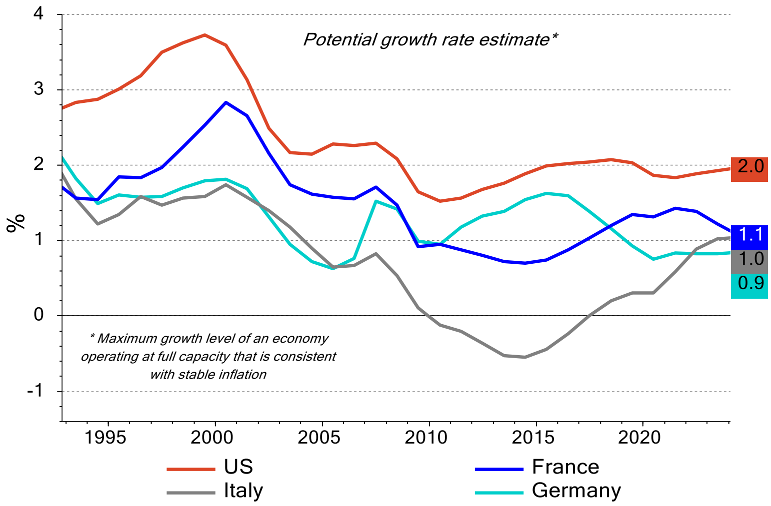
- If US interest rates are indeed to be kept high for the time being and the dollar remains strong as a result, this will produce a risky situation for the global economy. Indeed, it means that interest rates will also have to remain high in many other territories where interest rates should actually decline.
- Once the situation becomes more serious, it is very likely that parties will increasingly resort to the monetary financing of deficits, i.e. inflation.
- The US and European economies will only gradually weaken for the time being. The same applies to inflation.
- We see the Fed lowering its rates by 0.25 percentage points by the end of this year and lowering its rates further every three to four months through 2025 (until recently, we assumed a sharper decline in 2025).
- The ECB will likely begin cutting its rates in June and continue to do so every three to four months thereafter.
- 10-year US and German government bond yields will initially move sideways before a new uptrend begins.
- Conditions for shares in the US and Europe will gradually deteriorate (shares in most emerging markets will be affected even more).
- The S&P 500 is unlikely to far exceed 5,300 and, on balance, the index will be in a downtrend for the time being.
- EUR/USD will likely slide down to around 1.00 over the next few months or quarters (any interim rallies are unlikely to far exceed 1.10).
- USD/CNH will continue to hover near 7.25 for a while. Before too long, however, we expect a rise to 7.50-7.60. EUR/CNH will likely fluctuate between roughly 7.50 and 7.80.
- The gold price is still in a correction phase, but will subsequently rise further to around $3,000.

Immune to higher interest rates?

Earlier this year, there was a general assumption that economic growth in the West would soon decline due to far higher interest rates. In the US, however, (underlying) growth is still around 2.5% and the European economy is clawing its way back from a mild recession. In parallel, inflation remains stuck at levels that are (slightly) too high.

This is why growth should end up well below potential growth (see also our recent GFM reports about this). For the US, this means growth of about 1.75%, compared with roughly 0.5% for Europe. This can be achieved through substantial fiscal policy tightening and/or high interest rates. However, a tighter fiscal policy is hardly possible in the current climate, so it mainly concerns the level of interest rates, but these have already gone up quite a bit. Under normal circumstances, they would have risen enough to tip the economy into recession. To understand why this has not happened now, we must take a leap back in time.

Western countries are dealing with low potential growth



Source: LSEG Datastream / ECR Research

Starting in the 1950s, Keynes' and Friedman's theories were mostly misused. They were no longer used to flatten the business cycle, but to make an economy that was already growing grow even faster. The result was ever-increasing inflation and a rapid rise in the total debt/GDP ratio. In the early 1980s, however, Fed Chair Paul Volcker put an end to high inflation by raising interest rates until the economy and inflation collapsed.

In his fight against inflation, Volcker was helped by two important developments:

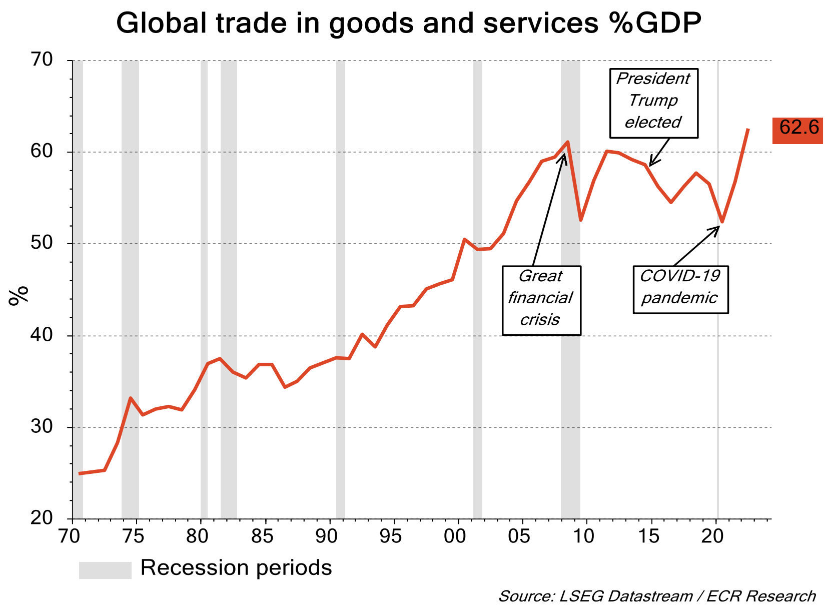
- A revolution in electronics, causing productivity to increase rapidly.
- The collapse of communism, followed by globalisation.

The collapse of communism and globalisation

The latter phenomenon deserves further explanation. When communism fell and the Chinese economy opened up far more, the West had a fairly disparaging view of emerging markets. Indeed, they lagged far behind the West in terms of the productivity of their people, modern products, infrastructure et cetera. This especially applied to China. China could only somewhat imitate simple Western products, whose quality was very mediocre as well.

At the time, therefore, hardly anyone saw China as a serious competitor to the West, neither economically, nor militarily, nor geopolitically. The West did see a great opportunity, namely sending modern technology and Western management to the formerly communist countries and China and combining these factors with very cheap, but mostly reasonably well-skilled labour. This had two major advantages:

- For example, production in China and Eastern Europe was far cheaper than in the West.
- By exporting these far cheaper products to the West, China and the formerly communist countries made vast amounts of money. As a result, their domestic economies would also grow substantially. Thus, Western companies could subsequently export a great deal to emerging markets. The West still manufactured many products that could not be made in emerging markets. In other words, there would be a win-win situation.



For Western central banks that had to fight inflation, this meant two important things:

- Cheaper imports from emerging markets helped to significantly depress inflation.
- Hundreds of millions of people were suddenly added to the workforce by globalisation. These were all low-wage workers. Understandably, this put downward pressure on wage increases in the West. This pushed inflation down.

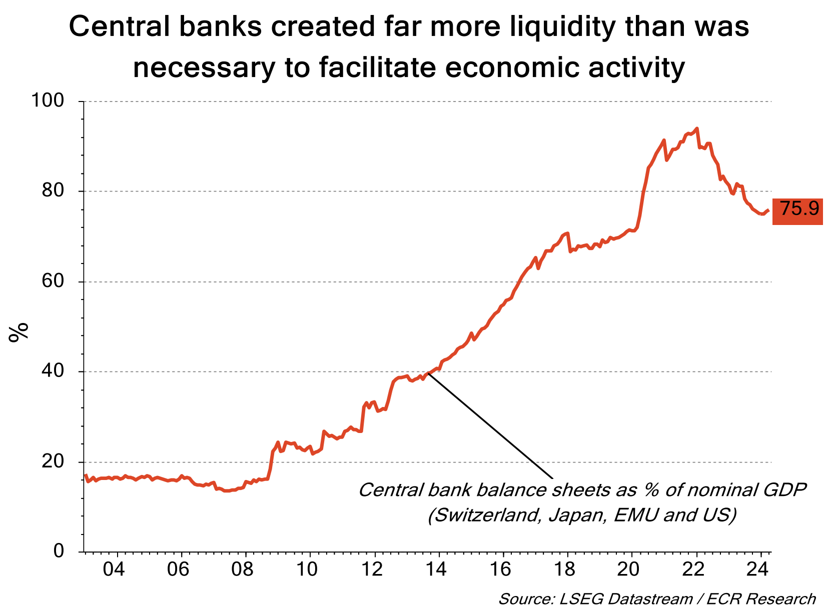
The result was that from the late 1990s - the Asia crisis - the risk of inflation turned into the risk of deflation.

Three drastic consequences

However, the above developments triggered all sorts of effects.

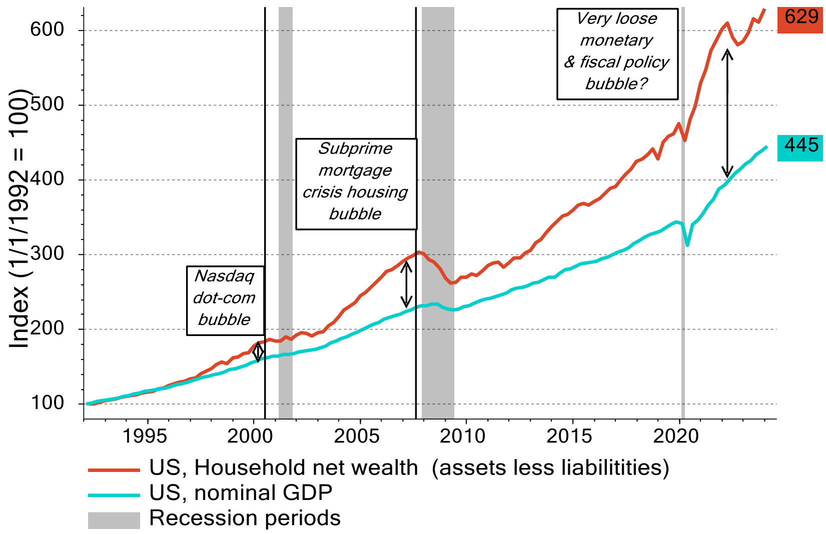
The money press had to run faster and faster.

Inflation came under considerable downward pressure, to the point where this triggered the risk of deflation. However, the combination of deflation and high debt is very risky for an economy. Hence, Western central banks turned the money tap wide open and cut their rates enormously. Such a policy is geared towards lower savings and higher borrowing. In this case, spending increases to the point where it dispels deflation.



However, particularly after the 2008 credit crisis, it became increasingly difficult to boost credit activity and reduce the savings rate. Hence, central banks created vast amounts of surplus money, to the point where a large proportion of this money could not be absorbed by the real economy. As a result, more and more money flowed into the so-called asset markets - shares, bonds, property et cetera, driving asset prices ever higher (so-called asset inflation), meaning that the old debts were offset by ever higher asset values. Balance sheets improved so much as a result, that borrowing ultimately went up and savings declined. However, it became apparent that ever higher asset price increases were required to maintain credit supply, and more and more money had to be created to drive asset prices higher. This is understandable, as they became increasingly overvalued relative to their real underlying value.

Central bank policy has created a lot of paper wealth



Source: LSEG Datastream / ECR Research

The Chinese advance

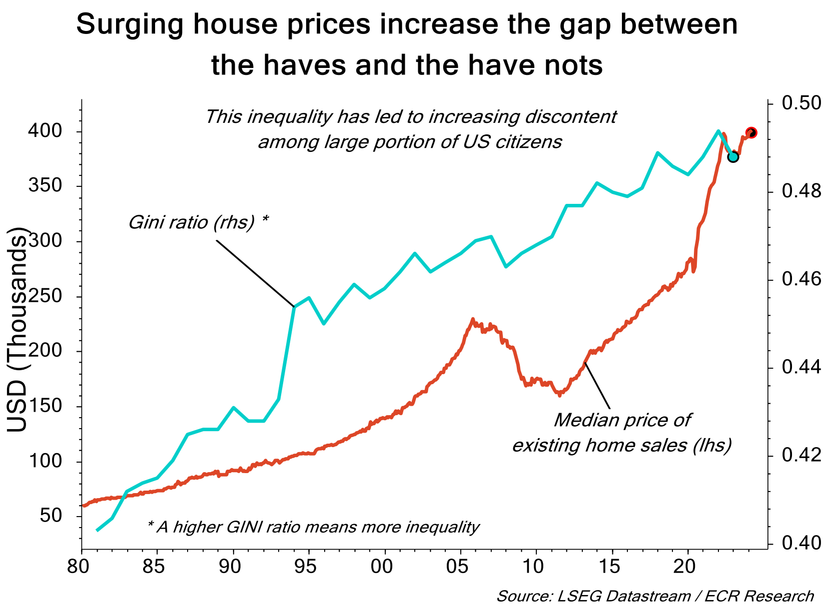
Despite initial expectations, China in particular managed to catch up with the West at lightning speed. China could jump ahead due to a great entrepreneurial instinct, technology imported from the West and greatly improved training of the workforce. China has now become a formidable competitor to the West in quite a few areas, not only economically, but also geopolitically.

As a result, China is claiming an ever greater role on the world stage. Another important factor here is that China remained a dictatorship of the Communist Party and, within it, of Xi Jinping and his confidants. Xi and associates are terrified of Western democracy, which explains the continuous need to demonstrate that authoritarian regimes can help the people far better than the West can. The West is sinking further and further in their eyes, and should therefore be kept at bay as far as possible.

The social divide and populism

Competition from emerging markets and China has not only pushed up inflation in the West, but has also contributed to a divide in Western society. The people who were involved in setting up and regulating globalisation - mostly the higher educated - have continuously gained in purchasing power. However, this did not apply to the people in the West who had to compete with cheap labour in emerging markets. For decades, this group has made little or no progress in real terms.

Moreover, the first group has the money to buy shares, bonds, property and so on, while the second group does not, and has therefore not been able to benefit, or has benefited only slightly, from higher asset prices.



Partly because of this, we are seeing a huge rise of all manner of populist parties across the West. Their main point is that far less care should be taken of people in or coming from other countries. Indeed, their own people - especially the disadvantaged part - should come first. These populists find a willing ear with the group that has been financially stagnant for many years and feels abandoned by the governments of the past years/decades.

Rising and waning influence

The US was the only remaining superpower following the Cold War. By offering military and economic protection, the US was able to form all sorts of alliances that kept China and Russia under control. In doing so, the US acted as the world's policeman.

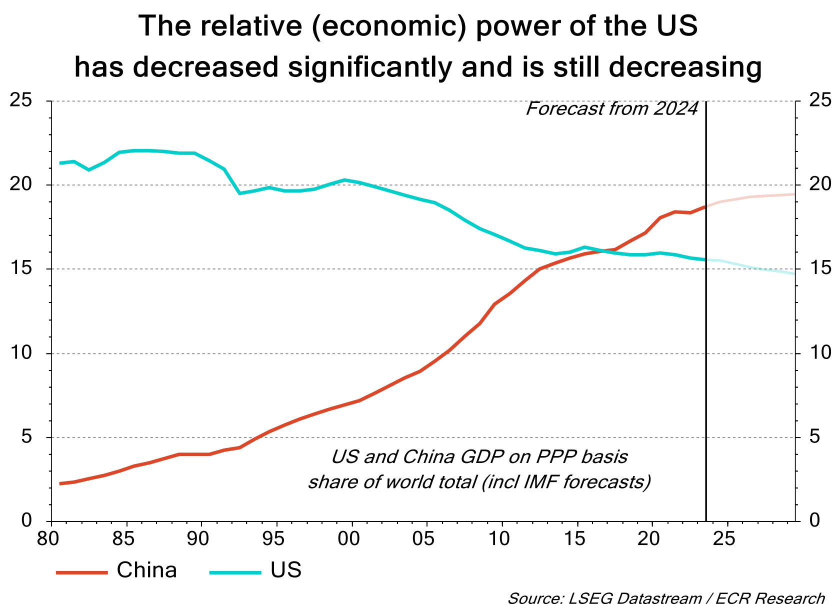
However, the relative power of the US has declined significantly and continues to decline. In contrast, countries such as China and India are gaining influence. Russia also jumped into the resulting vacuum. This has important implications:

» China and Russia can keep expanding their influence, and it is becoming progressively difficult for the US to hold together the alliances it has entered into. This is evident against a backdrop where China and Russia want to reduce the influence of democratic countries as far as possible.

» This movement is reinforced by the rise of populism. For the US to retain as much of its influence as possible, stupendous amounts of money will have to be available. However, the US is lacking in funds due to soaring debts and decreased competitiveness. The populists quickly respond to this by arguing that choices must be made between preserving the old world order or supporting people in the US.

» This choice is not that easy. For example, Russia has started a war in the Ukraine, which, if given the chance, it will expand further into the rest of Europe. China and Russia are also major forces behind Iran, and Tehran is a major force behind Hamas and Hezbollah. If these developments continue, the US economy is going to feel this in the form of far fewer export opportunities than would otherwise have been the case. Washington is also aware of this. Hence, vast amounts of money are spent on repatriating all manner of production processes that are currently overseas, on the domestic production of rare minerals and products that would otherwise have to be imported, as well as on the military.

» This spending drives up the public deficit. Especially when this is added to the necessary spending to address climate change. However, policy should move in exactly the opposite direction because of the exceedingly high total debt/GDP ratio. If the item of interest payable alone is to be kept from spinning out of control - thereby driving interest rates ever higher - public deficits should actually be reduced. In other words, politicians face enormously difficult choices.

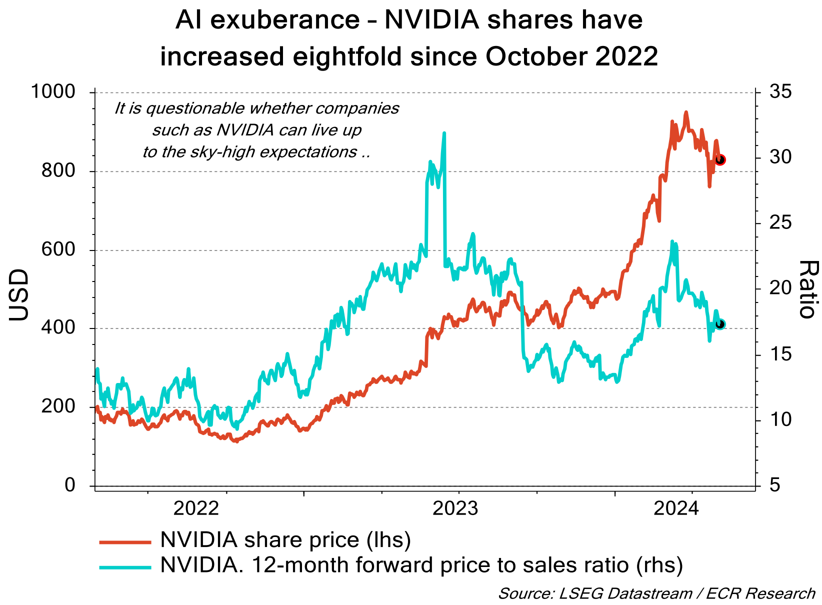


- What is happening in the Ukraine and the Middle East is crucial for Europe. The Ukraine war is important because of the immediate military danger, the second crisis is risky because of oil supply (the US is virtually self-sufficient in terms of oil, Europe is nowhere near self-sufficient). In addition, European exports to China and the Middle East are relatively high, while it imports all sorts of items from China that have long since ceased to be made in Europe itself, but which are essential. It is therefore understandable that Europe takes a less confrontational stance towards China than the US. However, Europe will have to become a powerful economic and military bloc if it is not to be crushed between China and the US in the long run. This is very difficult given the vast internal cultural and economic differences. Again, this situation exists against a backdrop of excessively high debt. So, although the need for Europe to stand united is certainly recognised, it is not easy to achieve this in practice. The US, China and Russia are happy to take advantage of this situation.

Two essential elections

We have pointed out in previous reports that the economy has been driven far too much by fiscal and monetary policy in recent decades. These instruments are fine for absorbing the impact of a recession or overheating, but cannot improve the longer-term earning capacity of an economy. This depends far more on measures that increase productivity: improved training of the workforce, increased spending on infrastructure and research and development, incentives for companies to develop and market new products, a flexible labour market et cetera.

There has not been enough focus on these factors, and the resulting negative impact is increasingly felt. Indeed, the scope for monetary and/or fiscal stimulus is diminishing all the time due to soaring total debt/GDP ratios. Without a drastic change in productivity policies, this will cause Western economies to slow more and more (unless AI comes to the rescue, but this looks unlikely for now); all the more so because workforce growth is declining, if not becoming negative.



European elections

Against this backdrop, two important elections are taking place this year: the European and the US elections. In Europe, it concerns the election of a new parliament (and, by extension, the appointment of a new European Commission). As it looks now, the (extreme) right-wing parties will achieve a significant victory. Not that this will give them power, but it will give them more influence over policy.

The question is how they will implement the principle of 'own people first'. We will likely see a great many internal political struggles. This will not be conducive to co-operation within Europe. It probably also means that countries such as France and Germany will try to limit the influence of the populists as far as possible by imposing limits on the public deficit as far as possible. This is not to say that the deficits will not increase further, but any increases will be limited. In this case, more difficult political choices will have to be made.

However, we doubt that this policy can be sustained for long. If Europe then slips further and further in relative terms, surely the easiest way out is to let the public deficit increase and have the central bank finance it to a greater extent. In other words, an inflationary policy would be pursued in this case.

The American electoral spectacle

Looking at the US elections, Trump's ideas are pretty clear:

- If the US no longer has the financial resources to play the world's policeman, the US must prioritise its own people. The fact that this policy will ultimately harm many of America's interests is seen as the least bad alternative.
- The US will have to ramp up efforts to fend off competition from China and the rest of the world. This could be achieved through high import tariffs or a lower dollar exchange rate.
- If other countries want to retain protection by the US military, they will have to pay for it.
- Helping the poorer part of the US population does not mean that these people will enjoy all manner of tax breaks or subsidies. Tax breaks will mostly benefit the wealthier part of US society and businesses. The assumption is that the latter will hire more people.
- The poorer part of the population - as well as American culture - must be protected by drastically reducing immigration and bringing Christian values to the fore.
- It is unclear what Trump wants to do with the Federal Reserve. Basically, he wants to have more influence over the level of interest rates. This is understandable because his policies also result in a stubbornly large public deficit, which could drive up interest rates, certainly if he is going to pursue a foreign policy that reduces dollar investments of other countries.

If Biden is re-elected, it should, first of all, be feared that Congress retains a Republican majority. In practice, this means that the US largely remains/becomes a rudderless ship. Insofar as Washington manages to pursue any policies, Biden certainly wants to counter the advancing influence of China and Russia, but without the drastic measures advocated by Trump.

In practice, this means that the public deficit will also remain very large under Biden. He wants to offset this by higher taxes on the wealthy and businesses. In the event of a Republican majority, however, he will certainly not get this through Congress. This means that, under Biden too, the deficits will remain so large that this will exert upward pressure on interest rates.

High deficits and monetary financing

So, regardless of who becomes president, public deficits are likely to remain large. In both scenarios, the urge to have the deficits financed monetarily by the Fed will remain/become strong. Indeed, if the central bank did not do this, the very unpleasant choice would have to be made between little/no financial improvement for the American people or allowing the international position of the US to decline at an accelerated pace. At the very least, we expect so much pressure on the Fed that the deficit will be partly financed monetarily.

This means that an essential difference compared to the period 2009-2020 will be evident. At the time, money growth was also high, but the surplus money largely remained in the financial system. At this point, public deficits are getting bigger and bigger, so that more of the (excess) liquidity is entering the economic system via the government. Hence, a far more inflationary situation has emerged, also because globalisation has turned into deglobalisation. This boosts, rather than depresses, wages and inflation. Moreover, there is mounting upward pressure on commodity prices.

A gradual decline in growth and inflation

Despite sharply higher interest rates, growth and inflation in the US remain too high. This is also evident in Europe, for that matter, but to a lesser extent. This begs the question, first of all, of why higher interest rates have had so little impact so far. This is probably due to the following factors:

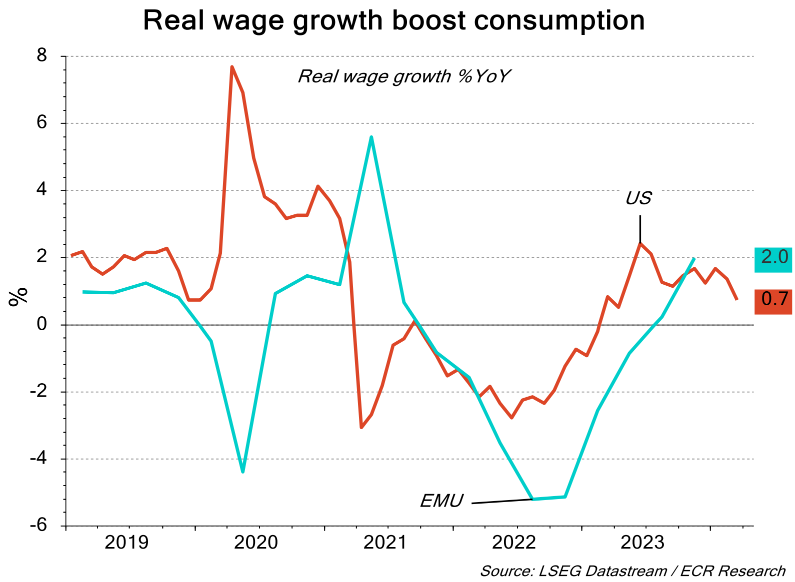
» Fiscal stimulus is still robust, while vast amounts of excess liquidity that were created in the past are still floating around. Via large public deficits, they are currently flowing into the real economy, stimulating growth.

» When interest rates were near 0%, many parties fixed their interest rates for extended periods of time. As a result, high interest rates take a long time to bite in earnest.

» Until recently, many of the additional savings amassed during the corona years were spent. This resulted in additional job growth, thereby increasing the number of income earners. This is currently boosting growth.

» As so much liquidity is still available, property and share prices have remained high. This is reinforced by the (earlier) firm market conviction that growth, wage increases and inflation would soon fall back. This, in turn, would give central banks the opportunity to provide the economy with renewed stimulus even before the occurrence of a recession. This accounts for the expectation that a fairly sharp rate cut would be effected in the US and Europe by the middle of this year.

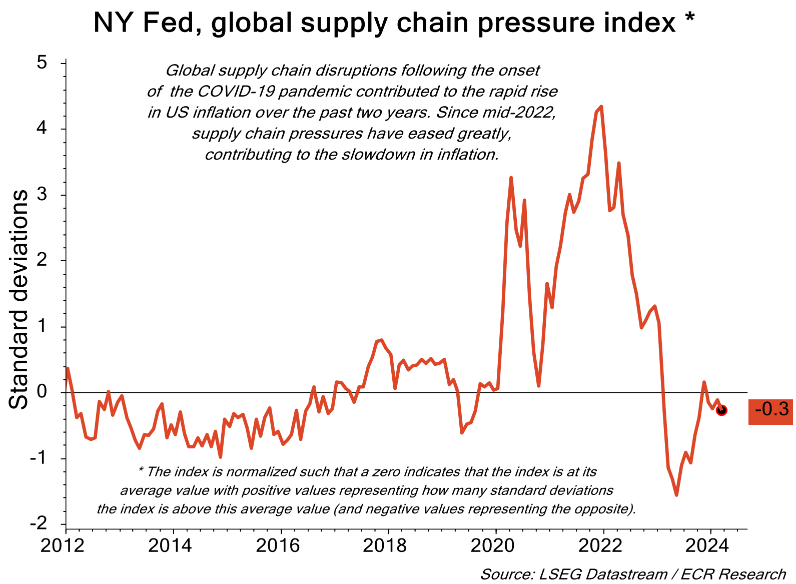
» For a while now, wage increases have exceeded price hikes.



On the other hand, however, deglobalisation and large public deficits make it harder to contain inflation than before. In other words, the brakes will have to be hit even harder to really depress inflation below 2%. In this scenario, growth should be below potential for quite some time. However, this has barely materialised so far because of the reasons mentioned above.

Changing supply and demand forces

The fact that wage increases and inflation have nevertheless fallen considerably is therefore mainly due to the recovery of the supply side of the economy. Supply lines are nowhere near as disrupted as they used to be and labour supply is high due to higher immigration and lower sickness rates.



However, these effects are wearing off rather quickly, which means that a great deal depends on the development of demand now. On the demand side, however, most of the forces that have supported growth are also disappearing. In particular, the time is fast approaching when all sorts of old loans will have to be refinanced, but at far higher interest rates. Incidentally, this is offset by fairly high wage increases and still rapid employment growth as well as persistent high asset prices.

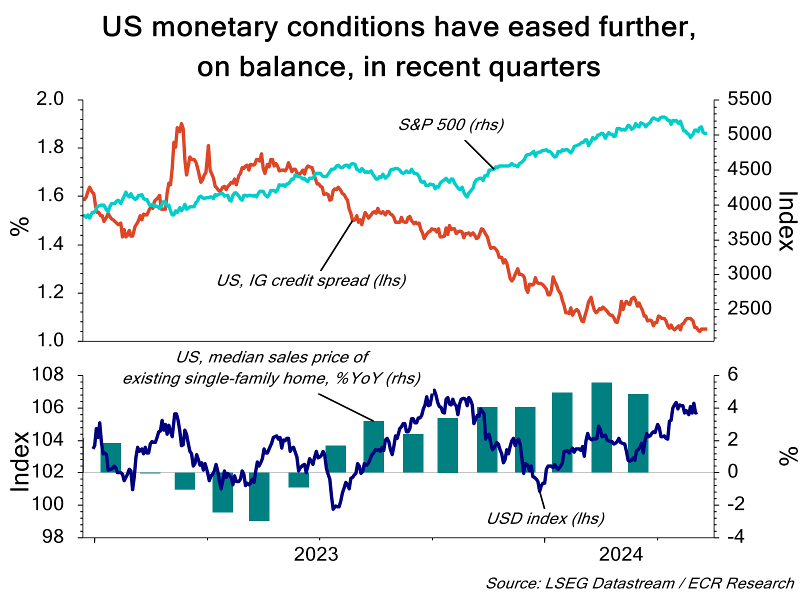
How this plays out for economic growth, on balance, is difficult to predict, but the most likely scenario is one in which growth is slow to fall back. The same applies to inflation. This applies more to the US than to Europe, for that matter. Indeed, the European economy is receiving less fiscal and monetary stimulus.

A struggle with monetary conditions

That said, monetary conditions in the US as well as in Europe must tighten if growth is to be low enough to get inflation permanently at 2% or a little lower. For now, inflation remains stubbornly high (as does economic growth).

Incidentally, the index reflecting US monetary conditions (featuring, for example, asset price levels, real interest rates, credit spreads and the domestic currency exchange rate) is currently lower than it was just before corona broke out. No wonder, then, that - despite sharply higher interest rates - growth remains fairly high.

This also means that if growth is to be depressed to below potential, monetary conditions must tighten. In particular, this means higher real interest rates, lower share prices and widening credit spreads.



So, the task for central banks seems clear. However, the major question is: at what interest rate will monetary conditions start to tighten? Should interest rates be raised further for this, or is it enough to maintain current interest rates for an extended period of time?

Growth and inflation rates have remained fairly high of late, but there are more and more doubts about this, which may suggest that interest rates are already sufficiently high. Viewed in conjunction with the fact that the Fed does not like to change its rates on the eve of elections, this leads us to believe that the most likely scenario is that the Fed will not raise its rates further, but will keep them constant until the end of this year (which, by the way, may still lead to a limited further rise in long-term interest rates).

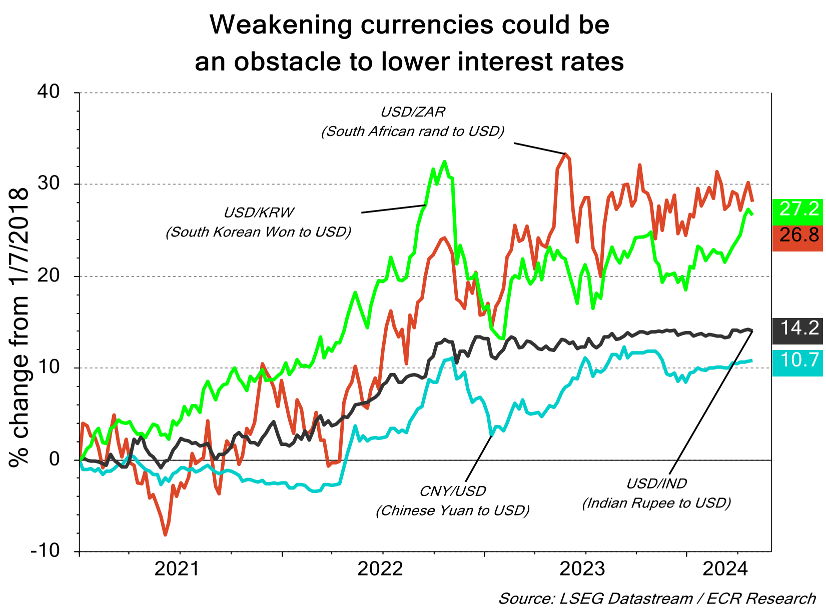
The ECB has already more or less committed to an initial 0.25 percentage-point rate cut in June, but we would not at all be surprised if, for the time being, quarterly rate cuts were to follow in the ensuing period.

For both the Fed and the ECB, faster rate cuts will only be at issue once economic growth has ended up clearly below potential.

Is the dollar's advance unstoppable?

Growth forecasts from the IMF, for example, clearly show that economic growth in Europe, Japan and China will remain low for the time being, while US growth will end up at markedly higher levels. This means that the Fed will have to hit the monetary brakes hardest to curb growth and inflation sufficiently. Higher US growth and interest rates mean that the dollar exchange rate is under upward pressure; against the Japanese yen, to start with. Japan is still not completely finished fighting deflation, meaning that Japanese interest rates are still ultra-low. Moreover, Japan's debts have risen to the point where the country cannot afford far higher interest rates at all. As a result, USD/JPY continues to rise and the yen is now undervalued by about 40% measured on purchasing power parity.

This also places downward pressure on the Chinese yuan. It is already under downward pressure anyway owing to the struggling Chinese economy and problems of overindebtedness that also plague China.



The more undervalued the yen and yuan become, and the longer US interest rates remain high, the more downward pressure will be exerted on the currencies of a variety of emerging markets. Many of these markets desperately need lower interest rates, but this is not possible now. They have generally taken on massive dollar debts. The interest that has to be paid on them is already high in the current scenario in which the US keeps its rates high. If the currencies of these markets decline against the dollar as well, the dollar debts will start to weigh more and more heavily. Many emerging markets cannot sustain this. They will therefore need to keep their own currencies stable, which usually means raising interest rates or at least not lowering them.

Incidentally, Japan is currently trying to keep the yen from declining further through currency interventions. It is likely that other countries will be willing to co-operate here, because of the importance to the global economy. However, experience shows that as long as the fundamentals do not change - in this case, the interest rate differential between the US and Japan - the currency's decline can, on balance, only be slowed. It cannot be prevented. So, the longer US interest rates remain high, the riskier the situation for the global economy.

Consequences for the financial markets

Interest rates

The market's interest rate expectations have been adjusted in recent times; particularly due to stronger data and the fact that wage increases and inflation have struggled to fall back further of late. This particularly applies to the US.

However, the following must be considered:

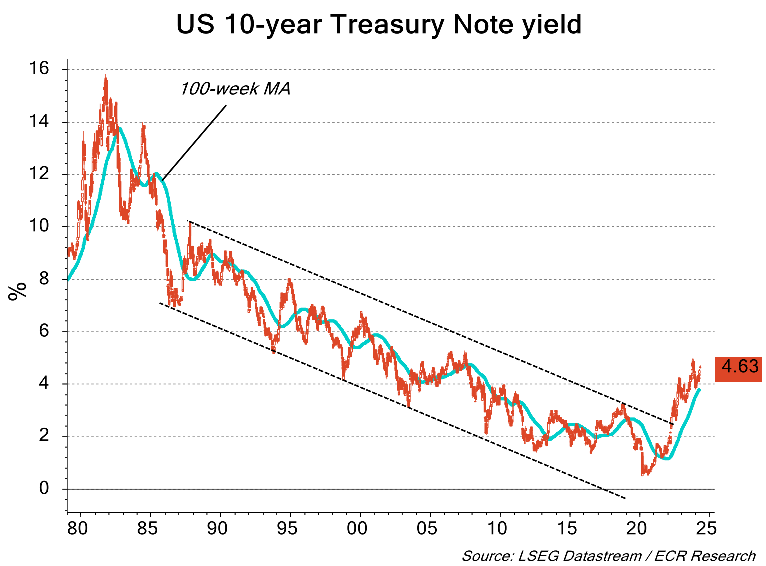
- Further analysis of the data also reveals some weakness.
- Forces that, until recently, stimulated the economy have now reversed or are reversing.
- US workforce growth is still considerable due to high immigration and lower sickness rates. As a result, US potential growth is currently at roughly 2.3% rather than at 1.8%. This is also reflected in the labour market. It is still tight, but not as tight as some time ago.
- It is quite possible that tensions in the Middle East will ease somewhat, and that this will depress oil prices some more, resulting in downward inflationary pressures.
- In any case, monetary conditions are still loose and fiscal stimulus persists. In the US, it will certainly continue until the election.
- Higher US workforce growth is probably only a temporary phenomenon. Both Democrats and Republicans want to quickly curb high immigration.
- The threat of higher import tariffs could drive up inflation.
- It looks as though Beijing wants to step up economic stimulus. This will create upward pressure on commodities.
- US economic growth is still at or just above potential. Even if growth starts to decline from now on, it remains to be seen whether it will decline below potential, as the latter will gradually fall back. Still, growth will have to be below potential for quite a while to get inflation in check properly. In other words, monetary conditions must tighten.

On balance, the above circumstances will not lead to a rapid decline in interest rates, at least not for the time being. In all likelihood, the Fed will cut its rates once by the end of this year in response to somewhat lower economic growth and a slight deceleration in wage increases and inflation. By 2025, interest rates could continue to be cut by 0.25 percentage points every three to four months.

From the perspective of a technical analysis of charts, it is certainly possible that 10-year yields will shortly rise to 5.5-6%. However, this will likely be followed by a move back to around 4% (the US economy will then be hit hard by higher interest rates and tighter monetary conditions).

An alternative scenario is that 10-year yields do not exceed 5% and fall back to approximately 3.5% from roughly the current levels. This will probably happen if growth and inflation decline from now on.

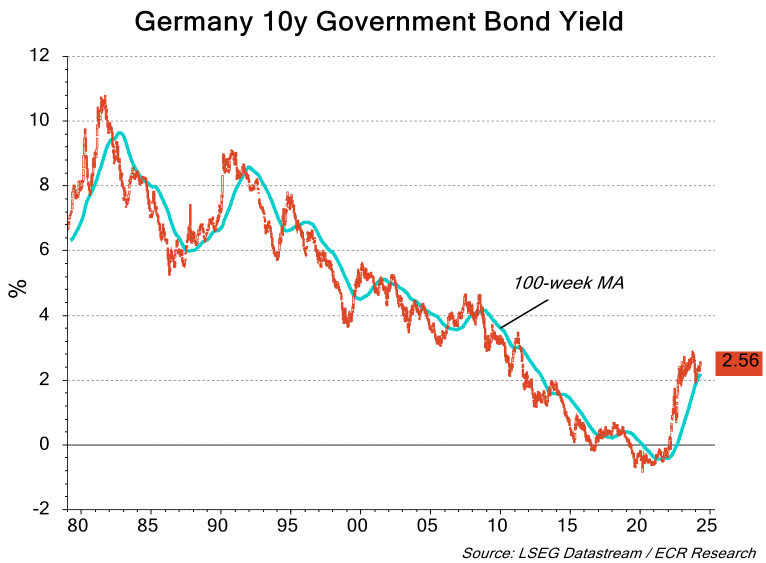
However, we have a different scenario in mind, in which 10-year US yields fluctuate between roughly 4% and 5% over the next few quarters, after which 10-year yields rise further due to persistent excessively high public deficits and rising inflation expectations.



The situation is different in Europe, where economic growth is slower. Growth is also more likely to remain/end up below potential there. That said, fiscal stimulus and ultra-loose monetary conditions can also keep European growth and inflation higher than is generally assumed at this point.

The ECB has already more or less announced an initial rate cut of 0.25 percentage points in June. This intention will not be easily abandoned for prestige reasons. However, the central bank has not committed itself to anything in the ensuing period. At this point, we expect no more than four to six rate cuts of 0.25 percentage points through the end of 2025, with a good chance that interest rates will still be cut less than currently priced in by the markets.

10-year German government bond yields will likely fluctuate between about 2.5% and 2.7% in the coming weeks or months and between roughly 2.4% and 2.7% in the coming quarters. We view this as a run-up to higher levels.



Shares

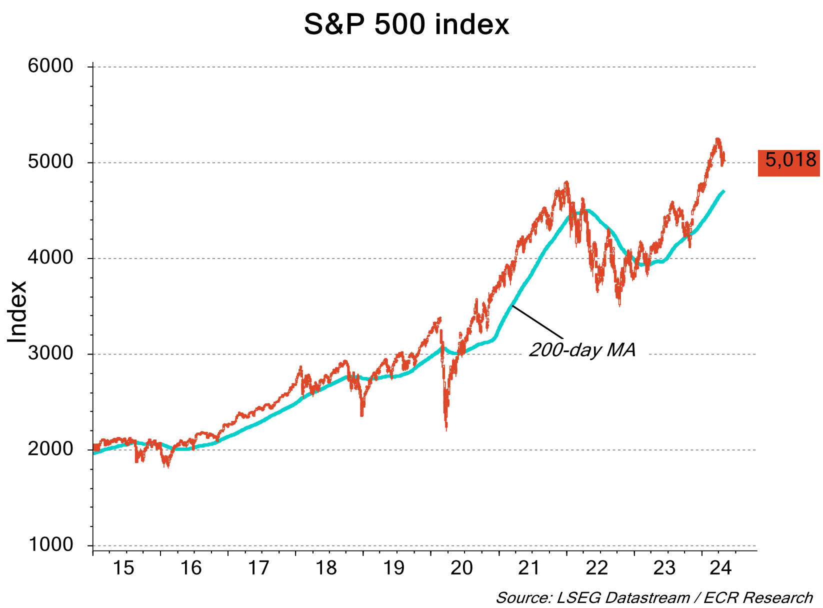
Monetary conditions probably need to tighten if inflation in the West is to be reined in. This will result in lower share prices. However, we believe that share fundamentals will also gradually deteriorate:

- Growth must be below potential for a long time to get inflation in check properly.
- The labour market remains tight, which is likely to produce relatively high levels of wage increases.
- It will become progressively difficult to offset this by raising output prices.
- Commodity prices are likely to rise.
- Interest rates are likely to remain far higher than they were until 2021.

P/E ratios are currently very high, as it was widely assumed that inflation would decline rapidly. This would allow central banks to cut their rates and stimulate the economy. However, it looks as though this was an overly optimistic picture; central banks can only gradually ease off the monetary brakes somewhat.

The only way to quickly return to the positive scenario is via far higher productivity growth. In this context, hopes were high for Artificial Intelligence. However, it looks like this is getting off the ground more slowly than hoped.

The S&P 500 index is unlikely to far exceed 5,300 and the index will gradually decline to around 4,600. In the ensuing period, an upward correction will likely take place, but the main direction will remain downward for quite some time.



European shares will likely follow this pattern. Shares in most emerging markets will probably perform relatively worse for the time being.

EUR/USD

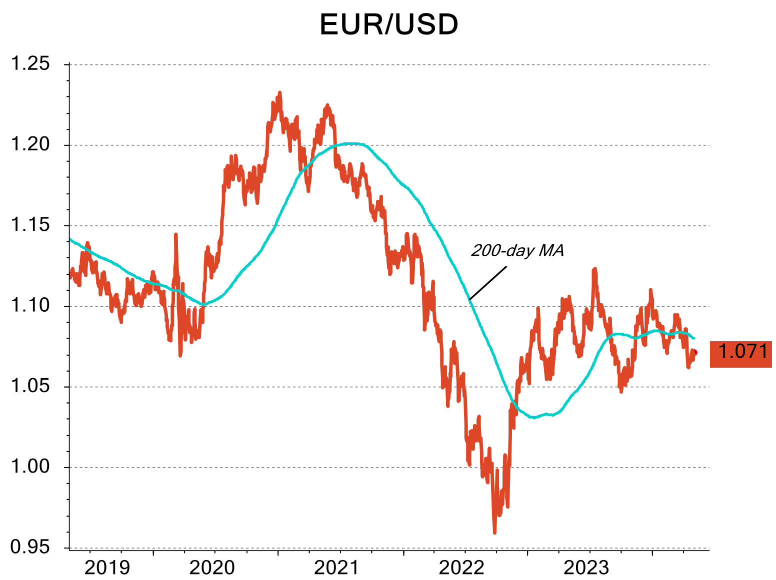
It looks like the ECB will proceed with rate cuts sooner than the Fed, and that the European economy will grow at a far slower pace than the US economy for the time being. In this climate, we expect EUR/USD to slowly decline further. However, this will be evident to a limited extent:

» It is quite possible that the oil price will not rise significantly further in the period ahead. This would be relatively positive for the euro.

» In the US, interest rates are also likely to be cut.

On balance, EUR/USD will likely decline further to around 1.00 in the next few months or quarters. Any interim rallies are unlikely to far exceed 1.10.

It is possible that European economic growth will be very slow by then, to the extent where the ECB will be able to start hitting the monetary gas. In this case, the euro may decline even further. A great deal will also depend on the situation of the US economy by that time. If the Fed keeps hitting the brakes lightly, this will be positive for the dollar, even if interventions are staged to depress the dollar - especially against the yen and yuan. However, if US growth has also declined sharply by then, the dollar will become far weaker.



Source: LSEG Datastream / ECR Research

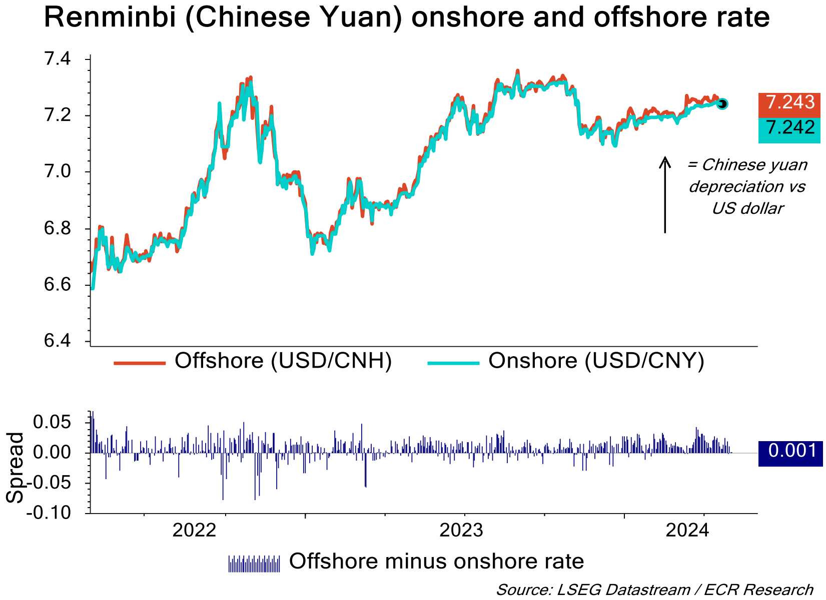
The Chinese yuan

China's economy is struggling with overindebtedness and the property crisis. Until recently, however, Beijing did not want to provide robust monetary and/or fiscal stimulus, fearing that debt levels would rise even more. However, the Chinese government seems to be backtracking on this now.

A weaker yuan would certainly fit in this scenario, but caution is advised here, as this also boosts import prices. However, if the Japanese yen remains as weak as it is now - which we expect despite the interventions - China's sagging competitiveness will plead in favour of initiatives by Beijing to depress the yuan rate.

On balance, USD/CNH will likely keep hovering around 7.25 for a while. Before too long, however, Beijing will likely tolerate a rise to 7.50-7.60, not only because of the Chinese competitive position, but also because otherwise Chinese interest rates must remain too high to defend the currency.

In this scenario, EUR/CNH will likely keep fluctuating between approximately 7.50 and 7.80 for the time being.

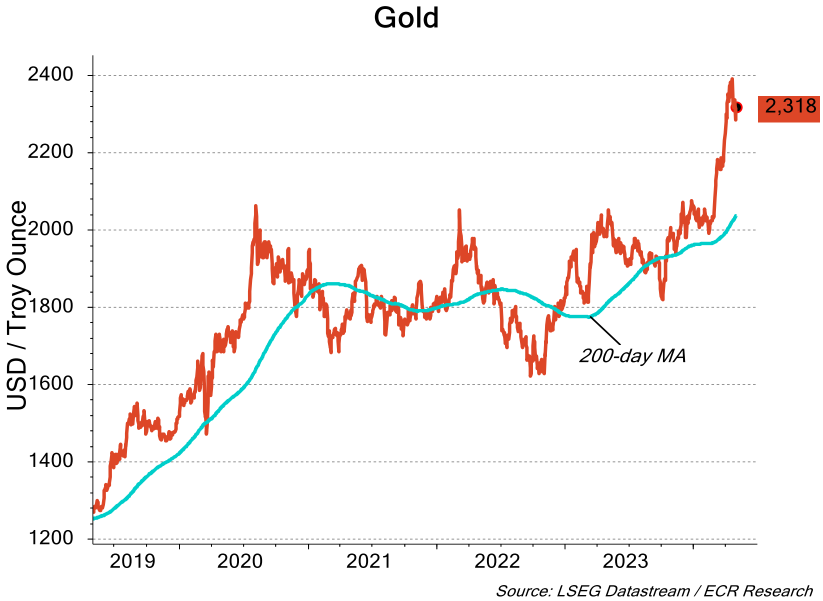


Gold

From a monetary perspective, the gold price looks set to decline rather than rise for the time being. Central banks will have to keep hitting the monetary brakes fairly hard. On the other hand, two groups are enthusiastically buying gold:

- Managers of large reserve funds outside the West. Because of rising geopolitical tensions, they fear blockage or even confiscation of their assets in the West. Gold is an obvious alternative in this case.
- Chinese savers are experiencing difficulties investing abroad, but do not trust their own currency. Gold also represents a sound alternative for this group.

On balance, the gold price will likely decline slightly further for the time being - towards $2,240. In the ensuing period, the uptrend towards $3,000 will continue. In the longer term, the price of gold will rise significantly further due to inflationary policies in the West.



Other inflation hedges

Monetary conditions for inflation hedges - other precious metals, commodities, property et cetera - are basically not very favourable at the moment. However:

- In recent years, there has been underinvestment in production of many commodities. Major shortages therefore exist, particularly of commodities needed for the energy transition.
- Many countries experience severe housing shortages.