MARKET COMMENTARY

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Stock markets will decline further

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Since the turn of the year, main European and American stock indices have come down by about 20%. There are no signs of an imminent and lasting recovery. The likelihood of further declines is greater than of a turn-around.

This is mainly due to the strong increase of energy prices and, caused by them, the risk of a new global recession. Corporate profits will come under pressure, dragging down stock prices. The world has seen eight distinct periods of slow growth since 1960, four of which, the most significant ones, had followed instances of steeply rising oil and gas prices: 1974/75, 1980/82, 2001/02 and 2009. Recently, energy prices have once again increased a lot, especially those of natural gas - its price rose from about 15 dollars per megawatt hour in 2020 to roughly 170 dollars now, a plus of more than 1,000 percent. Producers and exporters of energy have been winning big, but from a global perspective they are a minority. On balance, the world has experienced a huge decline of its purchasing power – which in turn will be the trigger of a global recession.

Since both households and firms are not able to significantly reduce their energy demand in the short term, high world market prices are pushing up the prices paid by end-users. The effect is somewhat milder in countries where taxes and customs duties on energy are high. In general, energy price inflation has knock-on effects across the entire economy. Analysts presently expect that average 2022 consumer price inflation in OECD-countries will be in the order of 8% y/y – which is considerably more than the nominal wage increases workers can hope for. For them, it must be a shock.

Central banks are afraid of a new inflation mentality as labour is beginning to give up its "good" behavior and tries to get a compensation for the drastic reduction of real wages. The negotiating power is quite strong at this point, given the surprisingly strong growth of overall employment and record-low unemployment rates. Empirical studies show that wages or, more precisely, unit labor costs (wages adjusted for productivity) are the most reliable predictor of consumer price inflation. High growth rates of this variable mean there will be significant knock-on effects on most other spending categories. The issue of future inflation would once again become an important, if undesirable factor in resource allocation.

Both the Fed and the ECB are presently between a rock and a hard place: tighter policies, aimed at reducing the growth rate of demand for goods and services, would deepen the recession that has probably already begun, while doing nothing might quickly lead to a widespread inflation mentality and a loss of credibility. The unfolding recession would probably bring down inflation near its 2% target on its own, but who knows. The inflation process is not well understood by economists. As it is, people are quite nervous about inflation and demand action. This is happening now. Monetary policies are getting tighter, interest rates are on the way up.

Market participants expect that the Fed Funds rate, the main American policy rate, will rise from 1.5/1.75% now to 3.25/3.5% by the end of 2022, ie, quite quickly and dramatically. But this would also be the top of the rate raising cycle. The whole US yield curve has shifted up by about 150 basis points since the beginning of the year and is now rather flat beyond durations of 2 years, at around 3%. Savers and borrowers seem to assume that inflation will not get out of control.

The ECB, on the other hand, is in no hurry and accepts that the euro has become a weak currency which contributes to the recent acceleration of inflation. Markets expect, and the ECB confirms, that the main policy rate will rise from zero now to 1.25% in the first quarter of 2023. Even then, it will be negative in real terms. The euro yield curve remains rather steep, a sign that the ECB is focused on growth, not price stability. 10y-Bunds are at 1.35%. The aim seems to be to tighten a little but to avoid an all-out restrictive policy. It is not at all clear how the ECB plans to reach its 2%-inflation target. Are they betting on help from the coming recession?

In any case, with interest rates increasing, the discount rate on future corporate profits in both the US and the euro area is rising which in turn reduces their present value and thus stock prices. This adds to the negative effects of the coming recession on profits themselves.

It's a dangerous mix right now: risk of a global recession, record high debts of households, firms and governments, and still very ambitious valuations of stocks, bonds and real estate. The US is most exposed. If the recessions lead to lower sales while the cost of labour and capital is up, more and more firms will go bankrupt. At the same time, fiscal policies are largely out of ammunition after recent borrowing sprees. Investors will try to take profits before asset markets begin to fall in earnest. At this tipping point, also called Minsky moment, the risk of a panic is quite real, as everybody is heading for the exit. A further decline of stock indices would follow. 50%? Or more, like in 1929 to 1938?

I have to admit that I had expected such a sequence of events before. My age shows. But my worst-case-scenario has not yet materialized. Financial crises are a normal (if underappreciated) feature of the capitalist system, and markets are not necessarily self-equilibrating. Yet, the big sell-out seems to be a very rare event after all. In an aging society where lots of people expect to live on their savings after retirement, there are, at any time, plenty of investible funds which prevent the free fall of markets. Look at the above as a warning, not a forecast!

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About Wermuth Asset Management

Wermuth Asset Management (WAM) is a Family Office which also acts as a BAFIN-regulated investment consultant.

The company specializes in climate impact investments across all asset classes, with a focus on EU "exponential organizations" as defined by Singularity University, i.e., companies which solve a major problem of humanity profitably and can grow exponentially. Through private equity, listed assets, infrastructure and real assets, the company invests through its own funds and third-party funds. WAM adheres to the UN Principles of Responsible Investing (UNPRI) and UN Compact and is a member of the Institutional Investor Group on Climate Change (IIGCC), the Global Impact Investing Network (GIIN) and the Divest-Invest Movement.

Jochen Wermuth founded WAM in 1999. He is a German climate impact investor who served on the steering committee of "Europeans for Divest Invest". As of June 2017, he is also a member of the investment strategy committee for the EUR 24 billion German Sovereign Wealth Fund (KENFO).

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