Central Banks Stay on Course

Are they increasing the risk of inducing an economic slump?

On March 16, the European Central Bank raised its key interest rate by 0.5%, despite ongoing fears and uncertainties in the banking sector. Just days ago, the US central bank followed with a hike of 0.25%, the SNB with a surprisingly hawkish move of 0.5%, and finally the Bank of England with 0.25%. Central banks thus suggest that the shockwaves in the banking system are under control and won't transpire into a systemic crisis, thereby allowing them to continue their work on fighting inflation unimpeded.

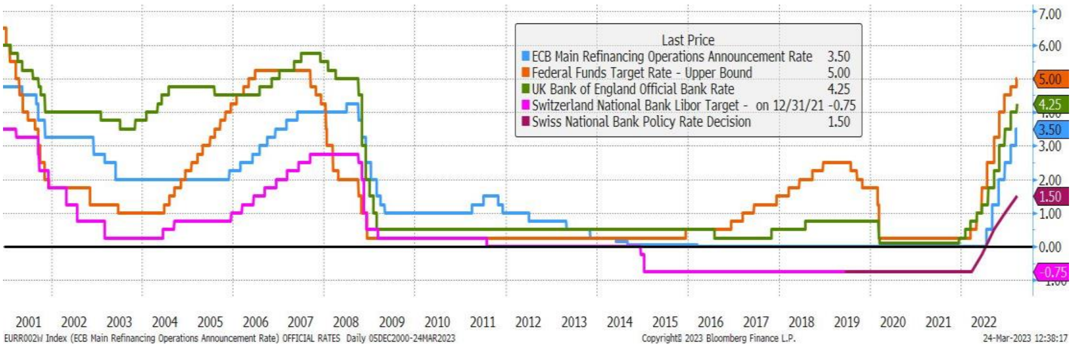

Chart: Key interest rates of central banks (USA, Eurozone, UK, Switzerland). Source: Bloomberg

The effects of higher interest rates are now surfacing, initially at various US regional banks. Further consequences will become apparent in the foreseeable future, as credit conditions have tightened not only because of higher interest rates, but also because of increased risk premiums and more cautious behavior and lending standards by banks. The tightening will rub off on the real economy and induce economic weakness. However, current economic indicators do not point in this direction, and the OECD's latest forecast for the global economy is more optimistic than last November's and predicts encouraging growth for the major economic blocs. Central banks have announced that further rate hikes may follow if deemed necessary.

We believe that with the difficulties in the banking system, the danger of a monetary policy "overkill" has intensified, and the central banks' interest rate cycle has (almost) reached its peak. We are, however, a bit more cautious on the market's expectations of a soon-to-follow turnaround in key interest rates in the U.S. This potential pivot will largely depend on how quickly and severely an economic slowdown progresses.

For financial markets, the implications of the setting outlined above are not clear. Lower interest rates for government bonds, an expression of lower risk appetite and inflation expectations, make the stock markets more interesting. This is especially true for those equities that have been excessively affected by sharply rising interest rates in the past. However, this correlation only works as long as earnings expectations are not severely revised downward by the economic slowdown. In this current situation, we believe that a cautious approach to new investments in equities remains appropriate.

Wangs, 24.3.2023