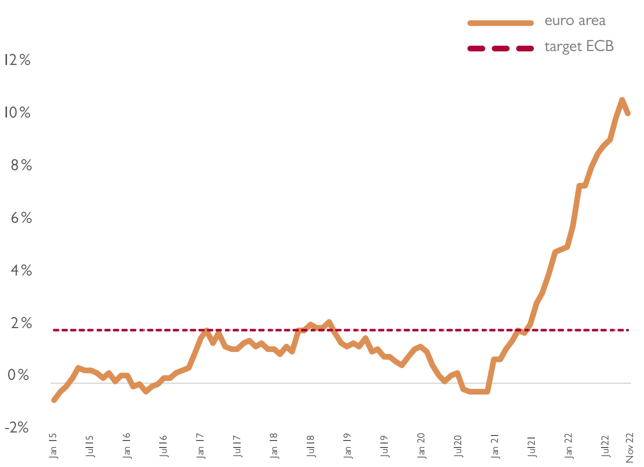
Catella Finance Focus

#01/23

TURNAROUND ON THE CAPITAL MARKETS

In retrospect, 2022 was a turbulent year. Russia's war against Ukraine has produced a humanitarian disaster that is unlikely to end soon. Moreover, this war has contributed to a significant deterioration of the European economy's macro-economic framework. Turbulences on European energy markets and disruptions to global supply chains caused by the COVID-19 pandemic, which continued into 2022, led to historically high inflation rates in Europe. In our latest Catella Finance Focus we want to once again take stock of the monetary policy year 2022 and to provide an outlook for 2023. Despite this polycrisis situation, we would therefore like to offer you a forecast for the coming months. First of all: The economic indicators are very robust and we do not expect any sharp economic downturn over the coming months. For example, one should note that, according to initial figures from the German Federal Statistical Office, Germany's price-adjusted gross domestic product grew by 1.9 per cent in 2022 despite the economic turmoil and showed no signs of a decline. The situation on the German energy market has also improved. So, in all probability, there will be no shortage of gas this winter. Nevertheless, the capital market environment remains volatile.

FIG. 1: Development of the Harmonised Index of Consumer Prices – annual rate of change



Source: Eurostat, Catella

REVIEW

Due to the economic developments of 2022 inflation rates in the euro zone significantly exceeded the European Central Bank's (ECB) target. For example, in November 2022 the annual rate of change of the Harmonised Index of Consumer Prices (HICP) for the euro area was 10.1 per cent. These high inflation rates have a strong potential to cause socio-political tension, as especially low-income private households with no or few savings will face major economic problems due to surging prices.

In order to fulfil its main task - ensuring price stability (target inflation rate: 2.0 per cent) - the ECB had to react to the euro's strong loss of purchasing power. After initial hesitation, the ECB Council decided to change its strategy at its meeting of 21 July 2022, ushering in a monetary policy turnaround- from expansive to restrictive. Consequently, in the course of 2022, the euro zone saw a surge in interest rates of an unprecedented velocity that was not expected by many market players. In four interest rate hikes, the central bank for the euro zone raised key interest rates by a total of 250 basis points.

For example, the interest rate for main refinancing operations rose from 0 per cent to 2.50 per cent during 2022 (interest rate on the marginal lending facility from 0.25 per cent to 2.75 per cent; interest rate on the deposit facility from - 0.5 per cent to 2.00 per cent).

But not only the euro zone's central bank faced inflation rates that far exceeded the target due to economic developments in 2022. Prices also surged in the United Kingdom, with the annual rate of change of the HICP at 10.7 per cent in November 2022.[1] In response, the Bank of England (BoE) carried out a major interest rate adjustment. The BoE raised the key interest rate from 0.25 per cent to 3.5 per cent in several stages across 2022.[2] Alongside the British pound and the euro, other currencies (such as DKK, SEK, NOK, CHF) in the European member states also lost purchasing power due to rampant inflation, forcing their central banks to intervene with interest rate hikes.

[1] Source: Office for National Statistics
[2] Source: Bank of England

However, it was not only Europe that posted high inflation rates in 2022. The U.S. dollar also saw a significant loss of purchasing power due to a strong, consumption-driven economic upturn. Still at 9.1 per cent in June 2022, the U.S. inflation rate fell by two percentage points to 7.1 per cent in November 2022.

December brought a further slowing of inflation in the United States. On 12 January 2023, the U.S. Department of Labor reported price growth of 6.5 per cent for December 2022.

This development would suggest that the U.S. Federal Reserve Board's (Fed) interest rate hikes are working and have produced a deflationary trend. In the course of the year, the Fed raised its key interest rate in seven (!) hikes by a total of 400 basis points. Thus, the interest rate spread climbed from 0.25 - 0.50 per cent to 4.25 - 4.50 per cent. [3] Hence, the Fed responded earlier to high inflation rates and with a much more restrictive interest rate policy than the ECB or other European central banks. In addition to the Fed's strong interest rate hikes, the U.S. government adopted the so-called "Inflation Reduction Act of 2022". The aim of this programme is to curb major inflationary developments in the United States. Furthermore, it is intended to help make the U.S. economy more climate-friendly, placing a strong focus on investments in low-carbon technologies, seeking to promote electric vehicles as well as solar and wind power.

From Europe's point of view, however, this U.S. initiative involves economic risks and dependencies. For EU car makers who do not manufacture in the USA, the Inflation Reduction Act of 2022 would therefore have a detrimental effect. [4]

[3] Source: Federal Reserve Board
[4] Source: Bankenverband

OUTLOOK

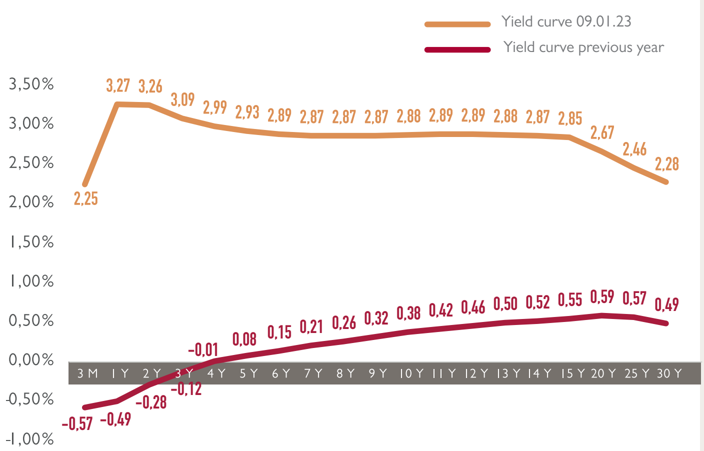
At the press conference following the last ECB Governing Council meeting on 15 December 2022, the monetary watchdogs emphasised that "interest rates [...] will still have to rise **significantly** and **at a steady pace** to reach levels that are sufficiently restrictive to ensure a timely return of inflation to the 2 per cent medium-term target."

This restrictive interest level is intended to dampen macroeconomic demand and the inflation expectations of market players. In its current projections, the ECB expects an average inflation rate of 6.3 per cent in 2023, 3.4 per cent in 2024 and eventually 2.3 per cent in 2025, all of these figures (far) exceeding the 2.0 per cent target. Monetary policy will be further tightened by a reduction of the asset purchase programme (APP) by EUR 15 billion per month, starting in March 2023. Moreover, the ECB projects a short and relatively mild recession for the euro zone over the next few quarters. A first signal of this recession has already appeared on the capital markets now - the inverse yield curve is back! (cf. fig. 2).

Incidentally, this yield curve also reflects expectations of market players that this "high interest period" (compared to the level we have come from) will remain with us for another 2-3 years. In its regular meetings on monetary policy, the ECB Council will make its next (interest rate) measures dependent on further inflation rate developments, inflation expectations and the economic situation. Moreover, the European monetary watchdogs will certainly be observing the Fed's next steps as well as the further development of the U.S. economy and inflation rate and draw conclusions on possible effects on the euro zone from their results. The next ECB meeting in Frankfurt will already take place on 2 February 2023, and we expect the announced interest rate hikes to continue. Against the backdrop of inflation that is likely to continue longer than expected and the ECB's strong commitment to further key interest rate hikes, we have revised our forecasts in the Catella Finance Focus 01/22 of September further upwards (see fig. 3) and expect interest rates to rise even further.

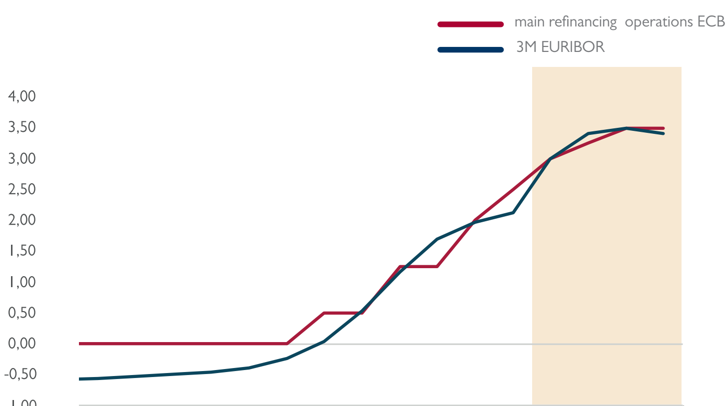
Conditions for real estate financing and property investments will continue to deteriorate over the coming months as long as current property prices remain stagnant. We expect property prices on the supply markets for all asset classes to fall in the coming months. However, potential losses in value will be largely offset by rent increases

FIG. 2: Yield curve



Source: Erste Group, Catella

FIG. 3: Development and forecast of the short-term interest rates



	2022-01	2022-02	2022-03	2022-04	2022-05	2022-06	2022-07	2022-08	2022-09	2022-10	2022-11	2022-12	Q1 2023 e	Q2 2023 e	Q3 2023 e	Q4 2023 e
	0,00	0,00	0,00	0,00	0,00	0,00	0,50	0,50	1,25	1,25	2,00	2,50	3,00	3,25	3,50	3,50
	-0,56	-0,53	-0,50	-0,45	-0,39	-0,24	0,04	0,54	1,17	1,70	1,97	2,13	3,00	3,40	3,50	3,40

Source: ECB, Catella (e = Forecast)

OVERVIEW OF THE EUROPEAN INTEREST RATE LANDSCAPE 2022/2023

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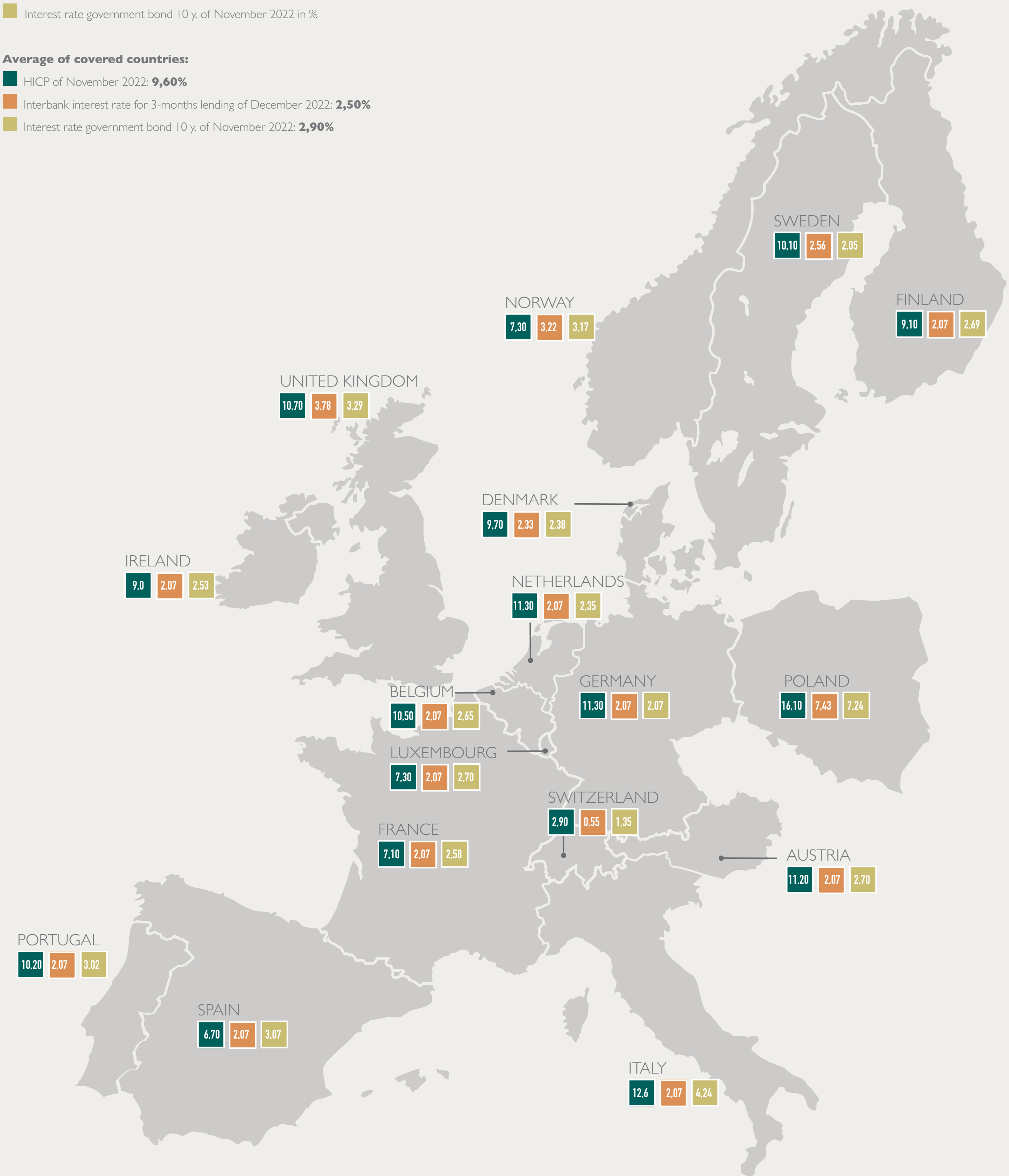
- (HICP) Harmonised Index of Consumer Prices of November 2022
- Interbank interest rate for 3-months lending of December 2022 in %
- Interest rate government bond 10 y. of November 2022 in %

Average of covered countries:

- HICP of November 2022: **9,60%**
- Interbank interest rate for 3-months lending of December 2022: **2,50%**
- Interest rate government bond 10 y. of November 2022: **2,90%**



Sources: Eurostat, ECB, national central banks

About Catella

Catella is a leading specialist in property investments and fund management, with operations in 13 countries. The group has over EUR 13 billion in assets under management. Catella is listed on Nasdaq Stockholm in the Mid Cap segment.

Read more at catella.com

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