ERSTE Global Strategy

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Interest rate, currency and equity market prospects in the USA, Europe and Japan

U.S. equity market

In conjunction with the economic slowdown in the USA, corporate earnings growth should also begin to decelerate in H2 2006 and throughout the entire year in 2007. While growth rates for corporate earnings should still remain in double-digit territory, the forecasts are gloomier compared to the previous quarters. As the year progresses, this will probably be reflected in share prices. Due to the consistently good valuation of the market and the essentially positive fundamental mood on the market, however, share prices are not expected to decline. For the fourth quarter we expect a modest rise in equity prices at best, due to the mixed overall picture.

USA: Interest rates, bond market and the currency

The first signs of an imminent slowdown in U.S. economic activity are now being seen. Next year, growth in private consumption will likely be quite modest due to the high level of U.S. household debt and the weakening of the real estate market. While inflation remains stubbornly high right now, the impending downturn in economic activity and lower oil prices should dampen increases in prices going forward. Against this backdrop, we expect key interest rates in the USA to remain unchanged through to year-end, and forecast the first cuts in interest rates to come in Q1 2007. With regard to the bond market, we would focus on short to medium-term bonds, as these stand to profit most strongly from the reduction in interest rates. Long-term bonds have already been able to book significant gains in prices and have thus already discounted much of the upcoming development. The USD will suffer from the turnaround in U.S. interest rates, and it is likely that the EUR will break through EUR/USD 1.30 in Q1 2007 as a result.

European equity market

Following assessment and analysis of the fundamental situation of European companies, our conclusion for the fourth quarter of the year is soundly positive. Enterprises in Europe will once again be able to post increases in sales and in net earnings in 2006. And investors should note that valuations are currently at favourable levels in the wake of the summer consolidation that swept the markets. In the eyes of the equity markets, the ECB’s moves to raise interest rates are proceeding at a measured pace, and this factor should not have a negative impact on the exchanges through to the end of the year. On the whole, there are clearly more signs favouring a positive continuation of the good performance of the European equity markets in Q4 2006.

Eurozone: Interest rates and the bond market

The Eurozone has enjoyed a brisk economic recovery in 2006. Unfortunately, the outlook for 2007 is not so rosy, due to the increase in VAT in Germany and the increasingly tangible slowdown in the USA. On the other hand, at least oil prices should not be such a severe problem next year. As this current phase of recovery is borne to a great degree by domestic demand, next year’s weaker export demand should not have too severe an impact on overall growth rates. Despite weak performance in Q1 2007, we expect that the European economy will manage a “soft landing” in 2007. The ECB’s Governing Council will raise key interest rates two more times by the end of this year. Then, when rates have reached 3.5%, the ECB will be able to sit back and assess the further development of economic activity and inflation. On the bond market, worries about a renewed slump in the euro area economy have pushed yields too low. We expect to see a correction from the current yield levels.

Japanese equity market

The main risk factor for the Japanese equity market continues to be decelerating economic growth in the United States. Other risk factors could include a significant increase in energy prices, a substantial appreciation of the yen and the uncertainty surrounding the successor to PM Koizumi. With these risks in mind, and with an eye to the weaker earnings growth and recently disappointing economic data, we do not expect to see the Japanese equity market outperform the USA and Europe in particular.

Japan: Interest rates and the bond market

Following a weak performance in the second quarter, the pace of economic growth in Japan should pick up again. The current level of interest rates is actually more suited for an economy that is in a state of crisis. But the adjustment of interest rates to “normal” levels should continue at a smooth pace, with one hike expected per quarter. As a result, the yen should be able to firm up in the coming months.