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The FischView

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Preface

Dear Readers,

In the *FischView* we provide you with the views of our investment experts on the financial markets. In particular, we focus on the asset classes most closely associated with Fisch Asset Management, namely credit and trend.

Each month, this publication is created by members of our Investment Office, and summarises the perspectives of our Investment Committee. In it, we pay special attention to the outputs of our various models, which provide us with valuable signals in our core disciplines of economics, trends and valuations.

The *FischView* is based on the monthly Asset Allocation Meeting, in which our specialists in each individual asset class, many of whom have decades of experience, present their analysis and voice their opinions. The presentations of all members are subsequently debated and scrutinised to ensure that the Investment Office is best placed to formulate the top-down investment strategy.

Thus, the *FischView* firstly documents the latest perspectives and the investment strategies of all the investment teams in a manner that is clear and accessible to our employees. It also enables us to share this information directly with a large circle of interested parties. One of the aims of the *FischView* is to make the rationale for our investment decisions open and transparent. Second, the *FischView* contains a list of the current most preferred (and least preferred) country and/or sector allocations by asset class.

We hope the *FischView* offers you in-depth insights and we welcome any comments or critiques you may have.

Kind regards,

Beat Thoma
Chief Investment Officer

Market Outlook – Summary

The market outlook summarises our positioning for a medium-term time horizon of 3 to 6 months. It is based on the three components of economics, trends and valuations, which are each discussed separately on the following pages. Likewise, the table below summarises the outputs of the individual models.

Equity market signals now negative in all regions, but valuations are attractive; temporary recovery is likely

- **Equity markets:** Equity markets have now priced in many negatives. Valuations are attractive. We are already seeing positive countereffects via lower interest rates and a more accommodative Federal Reserve. China is also ramping up monetary stimulus. The extremely negative investor sentiment is a further factor increasing the likelihood of an upward correction. In the medium term, however, the global trend is still negative.
- **Credit markets:** Credit markets too are now valued more cheaply. The global economy is still growing, and continues to lend support, although this trend is somewhat on the decline.
- **Interest rates:** Weakening global economic growth, paired with lower inflation expectations, have resulted in a temporary fall in long-term interest rates. When financial markets settle, however, the moderate upward trend should resume.
- **Currencies:** The US dollar has begun to show a weakening trend, while the Chinese yuan is very stable, despite looser monetary policy. This has had a calming effect on financial markets.
- **Convertible bonds:** The trend remains negative for equities and credit, but there is potential for a temporary rally, including in convertible bonds. In addition, convertibles valuations are currently cheap from a technical perspective.

Summary of the three underlying model outputs

	US	Europe	Japan	Asia ex-Japan	LatAm	CEEMEA
Equities	- ↓	-	-	- ↓	O	+ ↑
Government Bonds	O ↑	O ↑	O			
Credit IG	O	O		O	O	+
Credit HY	- ↓	- ↓		O	O	+
Convertibles	- ↓	-	-	- ↓		
Commodities	Energy:	O	Prec. Met:	O ↑	Indu. Met:	-

Key:

++	Strong positive
+	Positive
O	Neutral
-	Negative
--	Strong negative

Notes regarding the table: Changes from prior month are indicated with ↓ or ↑. i.e. "O ↓" means that the output has weakened from a prior value of + or ++.
The methodology for calculating model outputs, and how the various pieces fit together to form the big picture, is explained in the appendix.
Within government bonds, we consider the most important bonds for each region, e.g. German Bunds in Europe, and a representative group of countries for Latin America, Asia ex-Japan and CEEMEA (Central and Eastern Europe, Middle East and Africa).

Economics

Our macro analysis is based on an in-house model with fundamental and quantitative parameters as input factors. These include our cycle model, monetary conditions, yield curves and leading indicators.

Cycle model for the US now also negative; early warning indicators neutral; interest rates, inflation and oil all lower, providing economic stimulus

- **Economic situation:** The US has now also slid into negative territory in our cycle model. That puts all regions in the negative (US, Europe, China and Japan), constituting a warning signal. Still, the various key leading indicators have yet to follow suit (yield curve, credit signals, copper price, planned job cuts; see Chart 2 in the appendix). Yet positive counterpressures have been active for some time: the lower oil price and falling interest rates are helping consumers and investors, while China is increasing its economic and monetary stimulus.
- **Inflation:** Inflation-linked swaps show expectations to be falling steadily. This is dampening real inflation. Overall, a moderate trend, which is ideal.
- **Monetary policy:** Lower inflation expectations are increasing central banks' room for manoeuvre to allow for less swift interest rate hikes. In addition, the Fed's ongoing balance sheet unwinding (= removal of liquidity) may be brought to a halt. However, global monetary policy is already at a healthy equilibrium. Monetary multipliers are stable to slightly up (see Chart 1 in the appendix), indicating the suitability of current monetary policy.
- **Interest rates:** A substantial slowdown in growth has been priced into the current decline in long-term interest rates, which have been further depressed by the volume of short positions on Treasuries. Barring a recession, interest rates are likely to rise again.
- **Outlook:** We don't anticipate a true recession, but an earnings recession is possible.

Economics – model output

	US	Europe	Japan	Asia ex-Japan	LatAm	CEEMEA
Equities	- ↓	-	-	- ↓	o	o ↓
Government Bonds	-	-	-	-	+ ↑	o
Credit IG	- ↓	-		- ↓	o	o
Credit HY	- ↓	-		- ↓	o	o
Convertibles	- ↓	-	-	- ↓		

Commodities	Energy:	o	Prec. Met:	- ↓	Indu. Met:	- ↓

Key:

++	Strong positive market
+	Positive market
o	Neutral
-	Negative market
--	Strong negative market

Notes regarding the table: Changes from prior month are indicated with ↓ or ↑. i.e. "O ↓" means that the output has weakened from a prior value of + or ++.
The methodology for calculating the model outputs is explained in the appendix.
Within government bonds, we consider the most important bonds for each region, e.g. German Bunds in Europe, and a representative group of countries for Latin America, Asia ex-Japan and CEEMEA (Central and Eastern Europe, Middle East and Africa).

Trends

Our trend analysis uses medium-term trend indicators for a number of markets. These identify patterns in momentum, relative strength and trends. The signals are described in the appendix.

Trends strongly negative at year-end

Equities

– Downward trends have strengthened in equity markets in recent weeks. Markets in the US and Japan were particularly shaky. Trend signals are also negative in all other regions, with the exception of Latin America, which continues to show positive momentum.

Sovereign bonds

– In recent weeks, the divergent performance typical of sovereign bonds in times of crisis was once again observable. In all regions, these bonds gained momentum and now show clear positive trend signals.

Convertible bonds

– Caught in the wake of equity markets, convertible bonds worsened in performance. Trend signals are negative in all regions, and especially in Europe.

Credit

– Credit market performance is less homogeneous than with other asset classes. High yield markets in the US and Europe have lost significant momentum. For other regions and credit qualities, however, trend signals are improving.

Commodities

– Prices in the energy and industrial metals sectors are still caught in a downward spiral, with clear negative trend signals. In precious metals, by contrast, a considerable rally has taken place for several weeks. The trend signal for this sector is now positive again.

Trends – model outputs

	US	Europe	Japan	Asia ex-Japan	LatAm	CEEMEA
Equities	- ↓	-- ↓	- ↓	-	+	O ↑
Government Bonds	++ ↑	++ ↑	++ ↑			
Credit IG	+ ↑	+ ↑		++ ↑	O ↑	+ ↑
Credit HY	O ↓	--		++ ↑	O ↑	+ ↑
Convertibles	-	--	-	-		

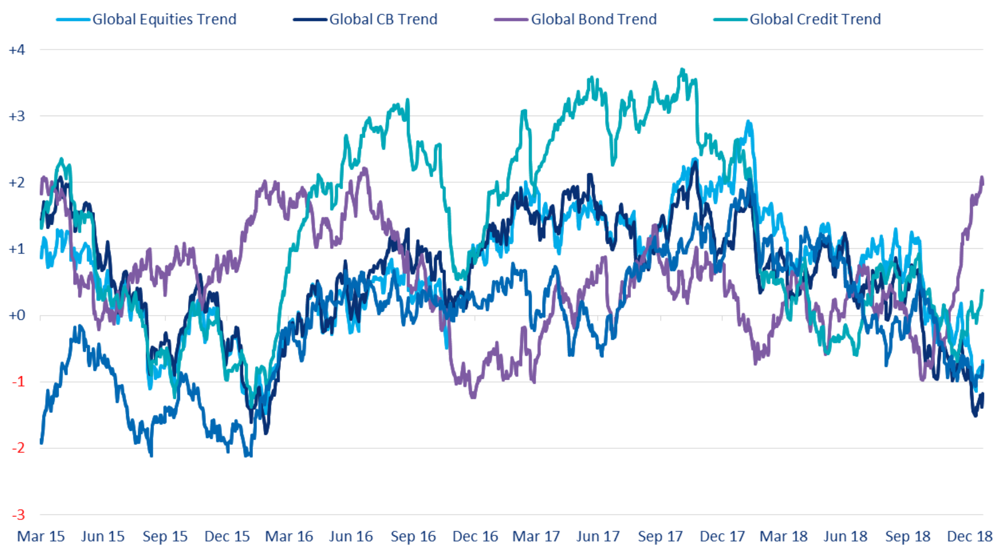
Commodities	Energy:	-	Prec. Met:	+ ↑	Indu. Met:	-- ↓

Key:

++	Strong positive momentum
+	Positive momentum
O	Neutral
-	Negative momentum
--	Strong negative momentum

Notes regarding the table: Changes from prior month are indicated with ↓ or ↑. i.e. "O ↓" means that the output has weakened from a prior value of + or ++.
The methodology for calculating the model outputs is explained in the appendix.
Within government bonds, we consider the most important bonds for each region, e.g. German Bunds in Europe.

Trend signals – Aggregates by asset class



Source Fisch Asset Management, December 2018

Valuations

In the valuation section, we give an overview of the current status of valuations in the markets of relevance to us: credit, convertible bonds, equities and government bonds. The input factors are described in the appendix. However, valuations are capable of remaining too high or too low for a prolonged period, meaning they tend not to be an effective short-term signal.

Risk premia on corporate bonds significantly more attractive; convertible bond valuations lower – opportunities exist in the medium term, especially outside the US

Credit

- **Outlook:** By the end of the year, risk premia had reached levels not seen since the 2016 energy crisis. The current risk premia are attractive in view of only a slight global economic slowdown.
- **Investment grade:** The relative attractiveness of emerging market issuers versus developed markets has decreased. Even so, we are still seeing interesting investment opportunities in emerging markets.
- **High yield:** The fall in energy prices and a sharp drop in liquidity have brought the US and European high yield segments back to attractive valuation levels. The 5.4% risk premium over government bonds (for global high yield strategies) represents the market's 30-year average.
- **Risks:** The main sources of uncertainty are the effects of the trade war between the US and the rest of the world, as well as an even more pronounced slowdown in growth worldwide.
- **Opportunities:** Further interest rate rises in the US are unlikely to agitate markets. We see the current valuation as an opportunity for credit investors with a three-year investment horizon.

Convertible bonds

- **Underlying stock volatility:** Market gyrations in December sent several of our metrics for short-dated US volatility to their highest level since the financial crisis in 2008.
- **Implied volatility:** Despite higher short-term stock volatility, CB implied volatility was largely unchanged in December, reflecting both CB cheapening versus their theoretical values and the long-dated nature of the embedded optionality within convertible bonds.
- **Valuations:** Convertible bond valuations have cheapened across all regions during December. This was a function of net selling pressure together with lower risk appetite from brokers approaching year-end.
- **Market commentary:** Primary markets were understandably quiet in December. As such, final full-year issuance fell just short of USD 100 billion, slightly lower than 2017, but with the highest US issuance since 2014.

– **Summary:** Based on our model of mean-reverting CB valuations, we are positive on the potential for medium-term improvements in Europe, Japan and Asia, while remaining neutral for the US. The short-term catalysts are likely to be fund flows and overall market sentiment. We feel the latter may be slightly more positive following a testing December.

Equities

– **Absolute valuation:** Due to December's correction, equity valuations in all regions are more favourable than the previous month, and are now low across the board based on price/earnings ratios.
– **Relative valuation:** Compared with an alternative investment in sovereign bonds (Fed model), equity valuations are attractive. Paired with lower interest rates, lower stock prices have increased their attractiveness versus the previous month.
– **Summary:** On aggregate, absolute and relative valuations result in a low valuation for every region.

Sovereign bonds

– The slope of the yield curve (defined here as the difference between 2-year and 10-year sovereign yields) flattened across regions in December. This has rendered sovereign bonds less attractive than in the previous month.
– At 79 basis points, the slope of the German yield curve is neutral in historical terms.
– We consider US and Japanese sovereigns unattractive due to the low yield curve slopes of only 15 and 13 basis points, respectively.

Valuations – model outputs

	US	Europe	Japan	Asia ex-Japan	LatAm	CEEMEA
Equities	+ ↑	+ ↑	+	+		+
Government Bonds	-	O	-			
Credit IG	O	+		- ↓	O ↓	O ↓
Credit HY	O	+		- ↓	O	O
CB implied volatility	O	+ ↑	+	+		

Key:

++	Very cheap / strong upside
+	Cheap / upside
O	Neutral
-	Rich / downside
--	Very rich / strong downside

Notes regarding the table: Changes from prior month are indicated with ↓ or ↑. i.e. "O ↓" means that the output has weakened from a prior value of + or ++.
The methodology for calculating the model outputs is explained in the appendix.
Within government bonds, we consider the most important bonds for each region, e.g. German Bunds in Europe.

Cross asset class preferences

This table combines top-down views with bottom-up analysis at the portfolio level.

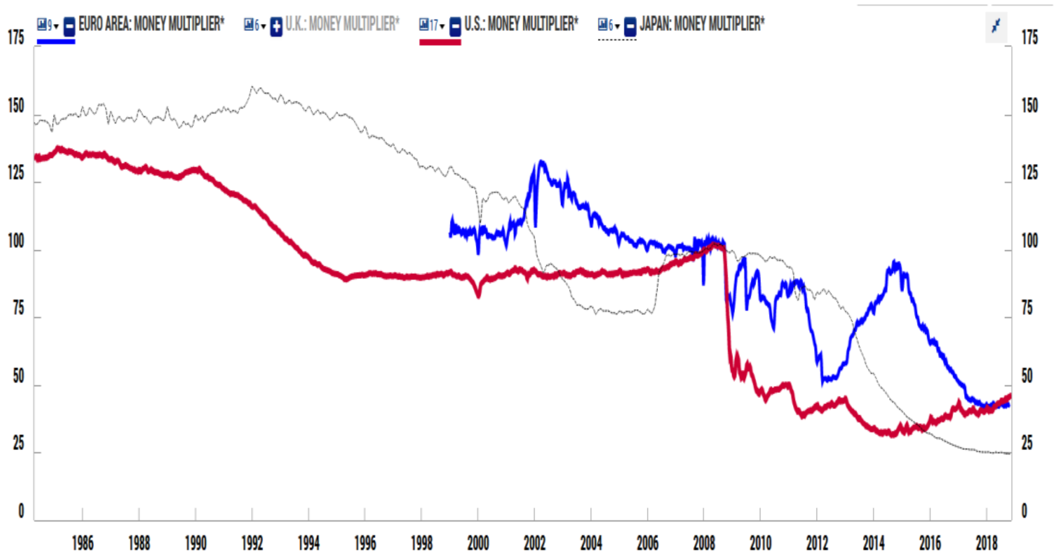
	Most preferred	Least preferred
Convertible bonds	– Materials – Consumer discretionary	– Credit-sensitive CBs – Asia
Global High Yield	– Basic industries – 'BB' rating segment – Telecoms	– 'CCC' rating segment – Asia – Banks/Retail
Emerging Market Corporates	– GCC – China	– South Korea – TMT
Global Corporates	– GCC – Rising stars – 'AAA' and 'AA' rating segments	– 'B' rating segment – Capital goods

Note: Preferred sectors/regions may differ between asset classes owing to respective performance drivers. In particular, equity exposure is the key performance driver for convertible bonds and is not relevant for corporate bonds.

Appendix

Charts

Chart 1: Money multipliers

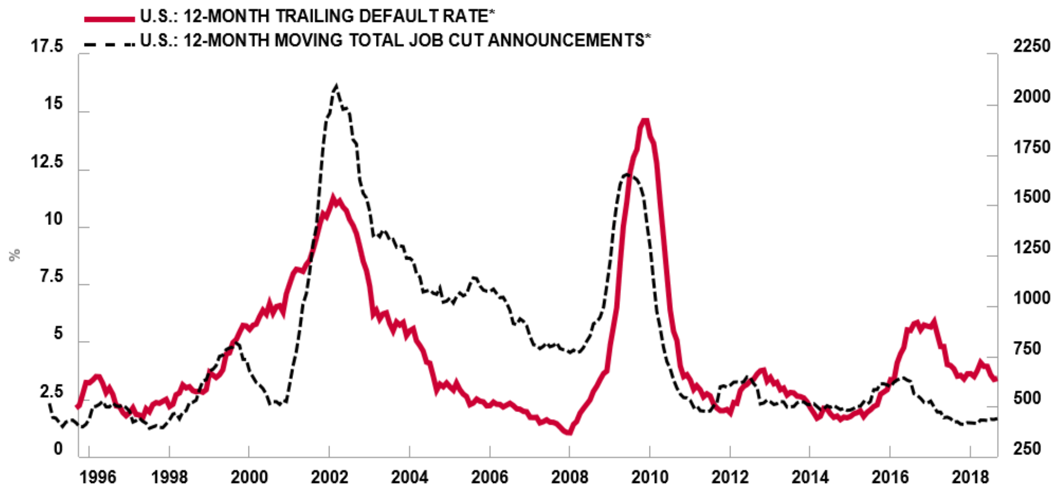


Source BankCreditAnalyst (Analytics)/Fisch Asset Management

The money multiplier in the US is on a steady upward trend, and is stabilising in Europe. Only Japan hangs back. Money multipliers measure the ratio of commercial bank money to central bank money. A rising money multiplier is a sign of increasing money creation by banks, and thus greater lending.

SIGNAL: POSITIVE for economic growth and financial markets

Chart 2: Planned job cuts signal no recession



Source BCA Analytics

Planned job cuts by US corporations are an excellent leading indicator for credit markets and the economy in general. The chart shows that credit market default rates rise sharply once planned job cuts increase. There is no warning signal of this sort for the time being, and the job market is in excellent health.

SIGNAL: STILL POSITIVE

Explanations

Methodology for the top-down investment process

Across all strategies, Fisch Asset Management uses a combined top-down/bottom-up approach for idea generation. In top-down research, the focus is on the continual analysis of the macroeconomic environment and financial markets. We have a structured analytical process in place and apply proprietary models. The result of this process – the *FischView* – becomes our basis for setting out the relevant exposure ranges in all our investment strategies and is also made available to external interested parties each month.

The *FischView* draws on three component models (economics, trends and valuations).

Macro model comprises four input factors
Analysis of the macroeconomic environment is based on our proprietary macro model and has four input factors:
— The Fisch cycle model, which reflects an overall view on the equity and interest rate environment
— Assessments of the liquidity situation and general monetary environment
— An analysis of yield curves
— Key leading indicators with a high predictive value

The macro model produces an economic forecast for the next six to 12 months. In addition, the expected impact on equity, interest rate and credit markets is determined.

Trend model
In our trend model, we calculate various medium-term trend indicators for the equity, interest rate, currency and credit markets. These indicators are based on historical price data and measure how well each of the asset classes has performed in the past. The better/worse an asset class performed in the past, the higher/lower our expectation for the future. A major factor in our analysis is our proprietary trend indicator, which exponentially weights the historical risk-adjusted returns of the various asset classes.

Valuations
In the valuation section we give a detailed overview of current valuations for the markets of relevance to us: credit, convertible bonds, equities and interest rates. For interest-bearing instruments, we use the slope of the yield curve (yield on 10-year minus 2-year sovereigns) as the risk premium for duration risk. To judge valuations in the investment grade and high yield credit markets, Fisch predominantly uses short-term credit market outlook indicators, CDS movement, liquidity patterns and fund flows to indicate market richness or cheapness. The output is overlaid with various external fair value models to determine an overall credit score for various markets and regions.

For convertible bonds, we analyse trends in CB valuation by region. The analysis includes input stock volatility, convertible bond implied volatility and rich/cheap measures based on the difference between trading prices and fair value models. The model outputs are intended to indicate the prevalent direction of risk to convertible bond valuations, which are also influenced by net issuance patterns, fund flows and market-maker risk appetite.

Additional top-down inputs are used across the remaining asset classes. These are based upon a number of different approaches, such as forward equity price/earnings multiples for equities.

Asset Allocation Meeting

The outputs of these three component models are aggregated and discussed by our team of experienced specialists at the Asset Allocation Meeting each month to form the *FischView*. Key topical investment matters and their influence on our products are also discussed at this meeting, while we also set out areas in which we have a particularly high conviction.

Portfolio construction and importance of bottom-up analysis

The *FischView* forms the basis for our top-down-driven overweights and underweights in the portfolio construction of all our strategies. They are also the starting point for the external communication of our market opinion and our key positionings. In conclusion, however, please note that bottom-up analysis (i.e. the analysis of individual securities and the associated sectoral and regional analysis) plays a pivotal role in all our strategies and is typically expected to make a greater alpha contribution than the top-down research.

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