

»Fisch View

Monthly Update – September 2020

As at 25 August 2020

Summary

- The prevailing balance between positive and negative forces in financial markets remains in place for the time being. However, various influencing factors are beginning to deteriorate.
- The economic recovery in the US has accelerated modestly, yet remains relatively slow. China has improved considerably, while Europe is lagging behind. The global recovery is therefore intact, but is increasingly vulnerable to disruptions.
- Although the supply of liquidity from central banks remains generous overall, various types of monetary stimulus are beginning to subside. The US dollar is in decline, central bank balance sheets are no longer expanding and smaller companies are increasingly finding it difficult to refinance. These could be the first signs of a possible monetary policy bottleneck that could appear in the near future.
- Equity market valuations have become ever more expensive following recent gains. In many cases they no longer reflect the fundamental economic reality we are in. Credit markets are also expensive in some areas, but these valuations are less exaggerated in comparison to equity markets. The valuation discrepancy in financial markets has been strongly driven by loose monetary policy.
- Rising national debt and a weaker US dollar both contribute to a bias towards rising US interest rates.
- Technical conditions for stock markets are currently still good, but are beginning to weaken slightly. Owing to the negative factors mentioned above, a break in this trend is possible at any time.

Highlights and key changes

- In the US, the Fed Weekly Economic Index has hardly improved, while unemployment has fallen very slowly. This is likely to have a negative impact on consumption over the medium term. This cannot be fully offset by the government's plans for possible new stimulus programmes. More and more structural problems for economic growth are becoming evident. In contrast, the housing market in the US is very strong and should provide some support for the economy for the time being. In China, the economy has developed much

better in comparison, while Europe continues to struggle. Overall, the global economy remains in a rather subdued upswing and there is a risk of it stalling.

- The monetary situation continues to deteriorate. Central banks continue to supply markets with ample liquidity. But this money is likely to only reach large listed companies and borrowers. Refinancing opportunities for small and medium-sized enterprises (SMEs) have deteriorated significantly. Banks are afraid of payment defaults and are becoming more restrictive in their lending. Various indicators (Senior Loan Officer Survey etc.) show a similarly difficult situation to what was experienced during the Financial Crisis in 2008/09. The risk of a sharp rise in bankruptcies has clearly increased. It is difficult for central banks to bridge this credit crunch. The US dollar, which has been weakening for some time, is also a potentially negative factor for the US money supply. It could lead to a more restrictive policy by the Fed over the medium term.
- The already rising number of defaults and bankruptcies among SMEs will lead to declining consumption, increased unemployment and thus a negative feedback loop for economic growth over the medium term. There is also the threat of permanent job losses. Since the labour market in the US is more dynamic and flexible, Europe is likely to suffer more from this development, especially for those countries that were badly affected by Covid-19. Asia and China by contrast, are recovering much better, but this is unlikely to fully compensate for the problems faced in Europe and the US.
- Equity market valuations are at historic high levels. Studies show that in the past the US stock market has always corrected within 12 months following similar high valuations. Since these current high valuations are very strongly linked to expansionary monetary policy, small and temporary monetary policy air pockets could easily cause turbulence in the market.
- Corporate bond markets meanwhile, are also expensive in the high yield segment. In the investment grade segment, overvaluations remain more moderate, while emerging markets even offer some interesting opportunities. The US dollar, which has been falling for some time now, has enabled many emerging markets to cut interest rates and implement loose monetary policy. This helps both their economy and financial markets.
- US interest rates are likely to rise again at a somewhat more pronounced rate if the weakness in the US dollar continues. Subsequently, this has led to fears of inflation, if government debt continues to rise. For the time being, the Fed is unlikely to seek control over the yield curve, and would rather allow long-term interest rates to rise if market forces or economic developments were to compel it to do so. In Europe, upward pressure on interest rates is somewhat more muted as the falling US dollar has a deflationary effect.
- Equity markets are still in a stable position in terms of market technicals. However, some indicators have weakened recently and need to be monitored closely (market breadth and the number of shares trading above the 200-day average for instance). Due to current high valuations and declining monetary dynamics, the situation may deteriorate rapidly at any time. In addition, market sentiment is beginning to overheat. Other risk factors include the US trade dispute with China (especially in the technology sector), possible delays in US government aid packages and the US dollar exchange rate.
- Progress has been reported in developing Covid-19 drugs and vaccines. Several phase III trials for vaccines are currently underway. The first results on effectiveness and tolerability are expected in October. In the first quarter of next year, vaccines are expected to be widely available worldwide. However, these expectations are at least partially reflected in current stock market prices.

Positioning

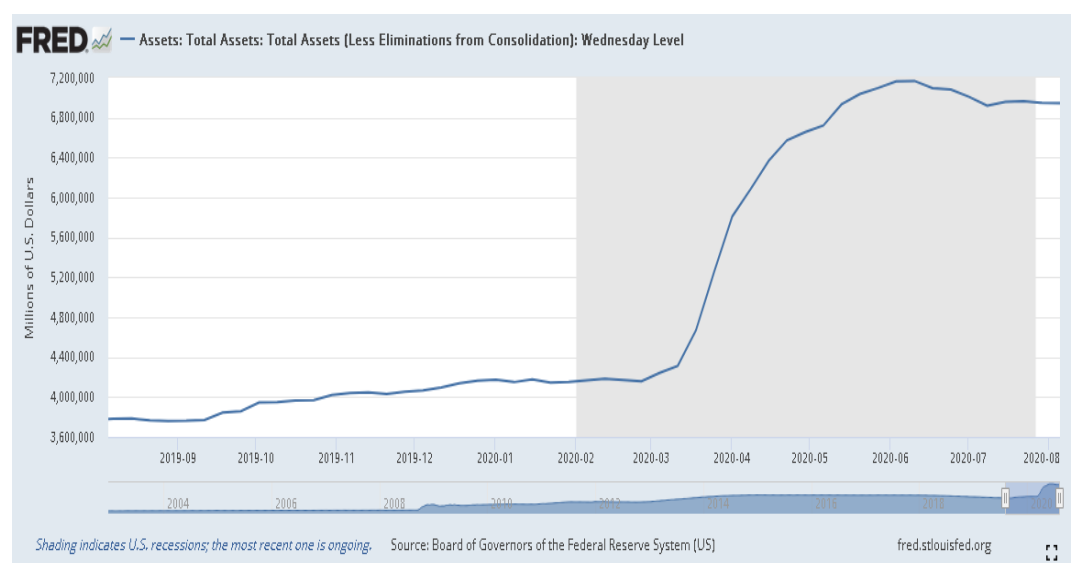
In terms of risk exposure, our strategies continue to be positioned across a neutral to slightly increased bandwidth. However, gains were taken in some areas and risk was slightly reduced. Risks will be reduced further if leading and technical indicators continue to weaken.

Topics on the radar

Various indicators currently point to a slowdown in monetary dynamics. Money supply continues to increase. However, the Fed has not expanded its balance sheet for some time. This points to the purchase of fewer securities (QE). A similar development is also evident at the ECB: The velocity of circulation of money is also falling, which indicates that the effectiveness of monetary policy has been reduced.

These monetary shifts are currently still very moderate and are unlikely to have an immediate negative impact on financial markets. However, they are a first warning signal, as stock markets are strongly dependent on monetary policy.

Chart: The US Federal Reserve balance sheet has stopped expanding



Source Federal Reserve Bank St. Louis

Please note with regards to the table of asset class preferences:

In the current fast-changing environment, we have decided not to present the usual table of country and sector preferences. Relatively static information is of limited use as positioning can change quickly. Our current preference has been on debtors whose credit quality is high enough to survive a prolonged recession. We also prefer securities with good market liquidity. However, due to the stabilisation of the global economy, we are increasingly seeking opportunities in challenging sectors with a high recovery potential.

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