

# » *Fisch View*

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## Monthly Update – January 2021

As at 5 January 2021

### Summary

- The positive drivers of the global economy and financial markets continue to work as they have before. They constitute a combination of extremely loose monetary policy, government stimulus packages and more dynamic economic development.
- For financial markets, this environment is leading to a weakening US dollar, while commodity prices, inflation expectations and long-term interest rates are all rising. This means that the "reflation" of the economy and financial markets, which central banks are striving for, is proceeding according to plan and is additionally supporting global growth. This reflationary trend is progressing in a very moderate and controlled manner. Thus, there is currently no danger of an imminent change in monetary policy that would be forced by market dynamics.
- However, the global financial system is becoming increasingly dependent on the historically unprecedented high levels of liquidity injections by central banks. Thus, even the smallest weakening of monetary dynamics is likely to spur a strong negative reaction. This massively increased sensitivity of the markets to minimal disruptions is currently the greatest danger for the coming months and makes market timing increasingly difficult.
- Additional factors of uncertainty are rising gold and bitcoin prices, which could constitute the first precursors of a loss of confidence in global monetary policy. Moreover, swelling Covid-19 case numbers and potential problems with vaccine distribution or efficacy could cause turbulence in financial markets at any time.
- Accordingly, we continue to position ourselves with slightly increased risk exposure, but will react quickly to early warning signals.

### Highlights and key changes

- The current main risk for the further advancement of financial markets is the great dependence of the system on monetary impulses, and thus the high sensitivity to the smallest changes in liquidity supply or monetary (e.g. velocity and multiplier) dynamics.
- Changes in monetary dynamics are not necessarily triggered by central banks. Shifts can also occur within the system (M1 money supply declines, velocity of money changes,

money multipliers fall) that are not directly controlled by the central banks. This makes market timing even more difficult, since, in the current environment, investors anticipate future changes in monetary policy well in advance, and can therefore react strongly to such system-endogenous monetary fluctuations.

- The reasons for the current high sensitivity of the system with regard to monetary impulses are, on the one hand, based on the falling US dollar and the associated steady rise in inflation expectations in the US. This development shows that more and more newly printed central bank money is spilling over from stock markets and the economy to foreign exchange markets, triggering concerns about monetary stability in this sphere. This is further confirmed by the recent sharp rises in gold and bitcoin prices. On the other hand, the increasing government deficits are also being increasingly financed by the printing press, which further increases the system's dependence on monetary factors. Currently, the financial system is crumbling on all fronts, so to speak. The situation is thus very different from the crisis year 2009, when the US dollar appreciated, deficits were smaller and monetary policy still had several years of large quantitative easing programmes ahead of it. The central banks had so much more room for manoeuvre.
- In the current environment, therefore, not only monetary fluctuations but also further falling dollar exchange rates or changes in inflation expectations could potentially lead to turbulence on the markets. There is an extremely high consensus among investors that inflation and accordingly long-term interest rates will rise in the coming months – although the effect is expected to be only temporary and limited. There is therefore a certain potential for disappointment in this respect.
- Despite the dangers mentioned above and the high vulnerability of the system to small disturbances, the fundamental drivers remain clearly positive at the moment: monetary policy is very loose, the government stimulus programmes are working and the global economy is on the path of recovery. Reflation is proceeding as desired and a moderately lower US dollar is even positive in the short term. It allows many emerging markets to loosen their own monetary policy and increase government deficits. Higher long-term interest rates mean steeper yield curves and constitute a favourable signal for the economy. Historically, such an environment has always led to gains in equity and credit markets. Only when the reflationary trend accelerates too much does it become dangerous. We are therefore watching developments closely, but do not believe it is appropriate to reduce risk prematurely.
- Equity market valuations are currently at historically high levels in absolute terms, but relative to the low interest rates, the current valuation level is still justified. But here, too, even a small rise in interest rates would lead to a clear overvaluation of the market.
- Credit markets are currently fairly valued. In the high yield segment, defaults are expected to decline. Government and monetary aid packages are helping even barely survivable companies to make ends meet, especially in Europe. In the investment grade segment, a moderate rise in interest rates (due to higher economic growth and somewhat higher inflation) should be compensated by lower credit spreads. Emerging markets are benefiting from the weaker US dollar and most of them are favourably valued. We find many interesting opportunities there.
- The various trade conflicts (USA-China, USA-Europe, Brexit) keep making negative headlines. However, according to historical experience, these should have only a very limited impact on financial markets.
- We see a somewhat greater risk due to the very strong second Covid-19 wave worldwide, which is exacerbated by a more contagious viral mutation. However, the risks for financial

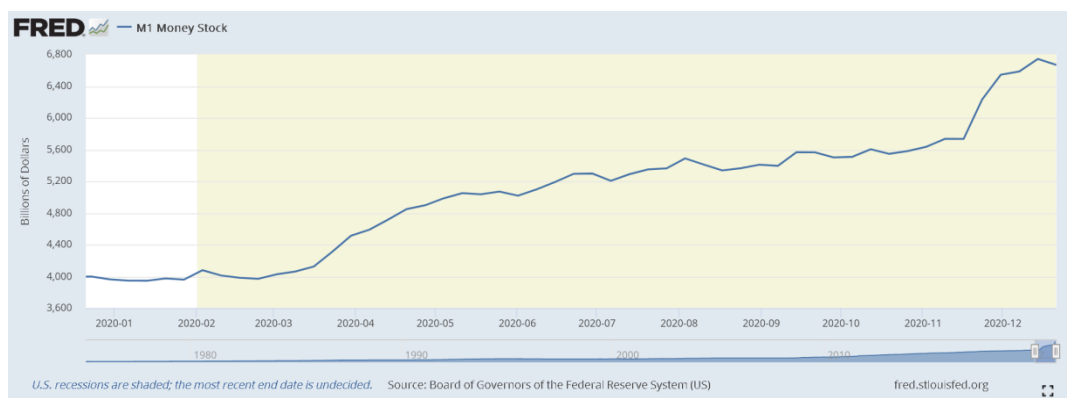
markets should remain limited as long as vaccine production and vaccination capacities can be ramped up at the current pace. Major problems will only arise if the vaccines are no longer effective against the virus mutation. But that does not seem to be the case at the moment.

- We remain positioned with neutral-to-slightly higher risk exposure. Duration is somewhat shorter. However, due to the very high sensitivity of markets to small disturbances, as mentioned above, we continue to pay close attention to possible early warning signals (changes in money supply, market breadth, dollar exchange rates, etc.) on a daily basis and will reduce risk exposure accordingly.

## Topics “on the radar”

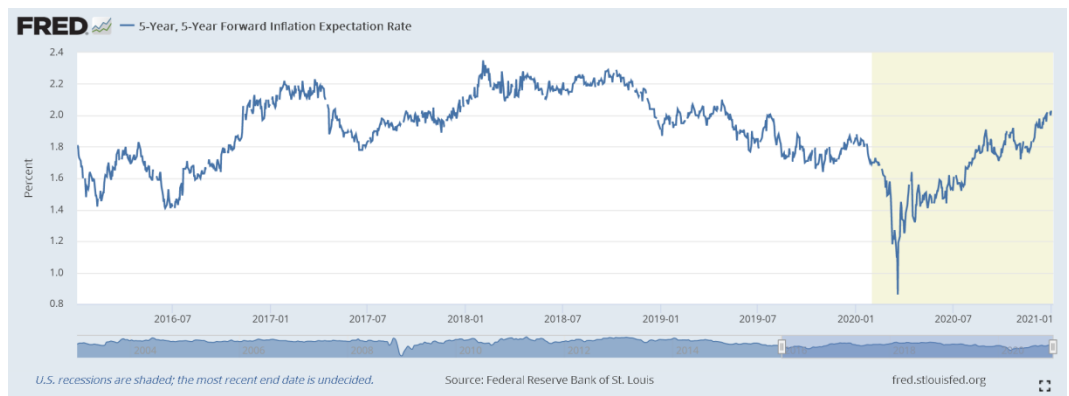
In the US, but also in other countries, the M1 money supply continues to rise very rapidly. M1 is a reliable indicator for goods consumption and the stock market, and shows where the money created by the central bank is flowing in the short term. Currently, this indicator thus provides a positive signal for the stock market. However, increased money supply growth also means potential inflation risks and pressure on the currency. That is why inflation expectations in the US have been rising significantly since the pandemic low in April, and have just reached their highest level since the middle of last year. This development is welcomed by the Fed and is therefore not yet an immediate problem for financial markets. Nevertheless, this dynamic must be watched closely. At a certain point, markets might understandably start to anticipate a shift in monetary policy.

**Chart 1: US money supply M1**



Source Federal Reserve Bank of St. Louis

Chart 2: US inflation expectations



Source: Federal Reserve Bank of St. Louis

## Summary of *FischView* model outputs

	US	Europe	Japan	Asia ex-Japan	LatAm	CEEMEA	Key:
Equities	+	+	+	+	++ ↑	+	++ Strong positive
Government Bonds	o	o	o				+ Positive
Credit IG	+	+		+	+	+	o Neutral
Credit HY	+	+		+	+	+	- Negative
Convertibles	+	+	+	+			-- Strong negative
Commodities	Energy:	+	↑	Prec. Met:	+	Indu. Met:	++

**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 [here](#).

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).

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