

»FischView

Monthly Update – March 2021

As at 23 February 2021

Summary

- The positive global drivers for the economy, in addition to robust equity and credit markets, continue to be extremely loose monetary policy in combination with extensive government aid packages.
- However, the effect of monetary and fiscal policy is gradually being dampened by rising long-term interest rates. Investors are increasingly asking themselves whether the degree of stimuli constitutes too much of a good thing.
- There is an increasing danger that the positive trends in the economy – including the labour market and surging commodity prices – will reinforce each other, triggering feedback loops with undesirable acceleration effects.
- Such non-linear implications could also have an accelerating impact on the long-term interest rate level and inflation expectations.
- A resulting risk is a price decline in the expensively valued equity market if long-term interest rates continue to rise from their prevailing low levels.
- Overall, in the current increasingly sensitive market environment, the implementation of monetary policy by central banks is becoming more difficult. There is a risk of undesirable interest rate or inflation movements or changing market expectations putting pressure on central banks to act.
- However, as the positive forces currently outweigh the potential dangers, we remain positioned with slightly increased risk exposure and neutral on interest rate duration. An adjustment of risk premiums in the equity market and falling prices due to rising long-term interest rates is possible, but would only be temporary in nature as long as the central banks do not fundamentally change their monetary policy.

Highlights and key changes

- A number of factors continue to have a very positive effect on the global economy and on equity and credit markets:
 - a) An expansion of government stimulus in the US. In addition to the Biden administration's very extensive new aid package (American Rescue Package [ARP] totalling USD 1.9 trillion), further infrastructure programmes are planned for the rest of the year. Massive fiscal stimulus also in the EU's individual states equates to 24%

of GDP so far on top of a EUR 1.75 trillion package from the EU. The EU's government aid is relatively larger than that of the USA.

- b) Monetary policy remains enormously expansionary. Currently, the Fed and the ECB are buying USD 120 billion and EUR 90 billion of securities respectively on the market every month (QE), thereby further increasing their bloated balance sheets. The M1 and M2 money supply, which are important for economic growth, are rising accordingly, proving that monetary policy is still effective at present.
 - c) Household and corporate cash balances are at record highs in both the US and Europe. Together with a solid housing market, strong positive wealth and asset effects are currently at work and should remain so over the coming months, which is having, and will likely continue to have, a positive impact on goods consumption for the time being.
 - d) A slight improvement in the labour market, despite a strong second Covid-19 wave, provides an additional boost to consumption. This gives rise to positive feedback effects, which, in our view, are not sufficiently taken into account in the consensus expectations.
 - e) Vaccination of broad sections of the population is underway, albeit with slight delays. Nevertheless, a positive effect should become visible in the foreseeable future. In addition, there is the immunity of all those people who have already suffered from Covid-19. Here, a global population share of more than 20% is estimated. In addition, modified vaccines against the latest Covid-19 mutations are already being developed.
 - f) There are positive feedback effects from the global economic development (also between individual countries) and the extremely loose monetary policy. In particular, export-driven EU industries are receiving strong impulses from abroad. Europe is benefiting particularly strongly from the economic recovery in Asia, especially in China. Various shipping indicators (Baltic Dry, RWI container throughput, Harpex Index) confirm the stabilisation of international trade.
- However, there are still a number of risks to economic development and to financial markets that could strongly affect the positive environment:
 - g) Falling consumer confidence due to vaccination issues (double-dip recession).
 - h) Economic overheating and/or strong rally in equity markets
 - i) Temporary fluctuations in monetary aggregates or tapering discussions
 - j) Pronounced US dollar weakness or a higher-than-expected escalation in inflation and long-term interest rates (US dollar index DXY below 85, inflation expectations above 2.8%, yield on 10-year US government bonds above 2%)
 - k) High valuation of equity markets and correspondingly greater sensitivity to negative news
 - l) Regulatory interventions at large corporations or tax increases
 - m) Increasing government debt leading to stronger than expected upward pressure on interest rates
 - However, we do not consider these risks to be acute at the moment. The positive drivers still dominate. Nevertheless, a combination of several of the above factors can quickly lead to an accelerated negative development due to feedback effects.
 - A relatively new problem is the increased vulnerability of markets to small disturbances (e.g. an increase in long-term interest rates or higher inflation rates). There is a risk of sudden high volatility due to feedback effects, even with small changes in interest rates, and of non-linear amplification mechanisms in general. The stock markets also tend to build up risk premiums relatively quickly (i.e. falling share prices) when interest rates rise

from a low level. However, these would only be temporary corrections as long as the central banks do not change their monetary policy.

- Moreover, in this environment, the implementation of monetary policy becomes more difficult for central banks. The danger of policy mistakes or pressure on central bank policy due to shifting market expectations increases.
- Nevertheless, the positive drivers still predominate at present. The potentially dangerous trends in the US dollar, inflation and long-term interest rates are still very moderate and even desirable for central banks. We are therefore keeping the risk exposure in our strategies slightly above benchmark. The duration is in a neutral range.

Topics “on the radar”

The following chart impressively demonstrates the current dependence of the economy and financial markets on monetary policy. The blue bars are the quantitative easing (QE) programmes of the Fed compared to the global stock market – the influence of monetary policy on equity markets has never been greater.

Chart: Development of the global equity market relative to the US Federal Reserve's quantitative easing programmes



Source LongView Economic Research

Summary of *FischView* model outputs

	US	Europe	Japan	Asia ex-Japan	LatAm	CEEMEA	Key:
Equities	+	+	+	+	+	+	++ Strong positive
Government Bonds	- ↓	- ↓	- ↓				+ 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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