

» *Fisch View*

Monthly Update – May 2021

As at 27 April 2021

Summary

- Rising money supply is leading to more economic growth, but also increasing inflation potential
- Fiscal stimuli and easing of lockdown restrictions provide additional growth momentum
- Potential upward pressure on long-term interest rates is rising
- Feedback between economic activity, labour market and monetary stimuli is reinforcing market trends in the medium term
- Markets, some of which are richly valued, are increasingly vulnerable to rising interest rates
- Normalisation of monetary policy by central banks is not yet underway, with the exception of China
- Monetary impulses on financial markets are still very strong
- Trends in equities, credit, inflation and interest rates are still moderate and controlled – the "Goldilocks" environment remains intact for the time being
- Central banks are still facing a difficult communication challenge – market reactions are becoming unpredictable and market timing more difficult

Significant changes compared to the previous month

- Due to the continuing high level of securities purchase programmes (quantitative easing (QE)), money supply continues to rise strongly worldwide. In particular, the monetary aggregate M2 (demand deposits and money market balances) shows an accelerating trend in various countries.
- M2 has historically been a reliable indicator of economic growth and inflation trends. The current acceleration therefore points to a medium-term trend of higher growth worldwide, and increasing upward pressure on inflation and long-term interest rates.
- The current increase in money supply differs from the development during the financial crisis of 2008/09. The QE programmes at that time disappeared in the banking system and did not lead to a strong expansion of the money supply as they do today. Monetary policy is now therefore much more effective and the monetary impulse is correspondingly stronger. This effect is further supported by increasing money creation

within the private banking system, historically unprecedented large fiscal stimuli and the beginning of loosening of the lockdown measures.

- This development is currently still favouring equity and corporate bond markets. However, valuations have risen further in recent weeks, making markets more vulnerable to potential disruptions in the form of rising long-term interest rates or inflation.
- Central banks, with the exception of China, are maintaining their very loose monetary policies at the moment, which should provide a solid foundation for financial markets for the time being. However, the communication challenge for central banks continues to increase. Trends are becoming more unpredictable and market timing more difficult.
- Furthermore, interest rate-sensitive growth and technology companies are facing more trouble in such an environment than cyclical industrial and value stocks.

Current situation and positioning

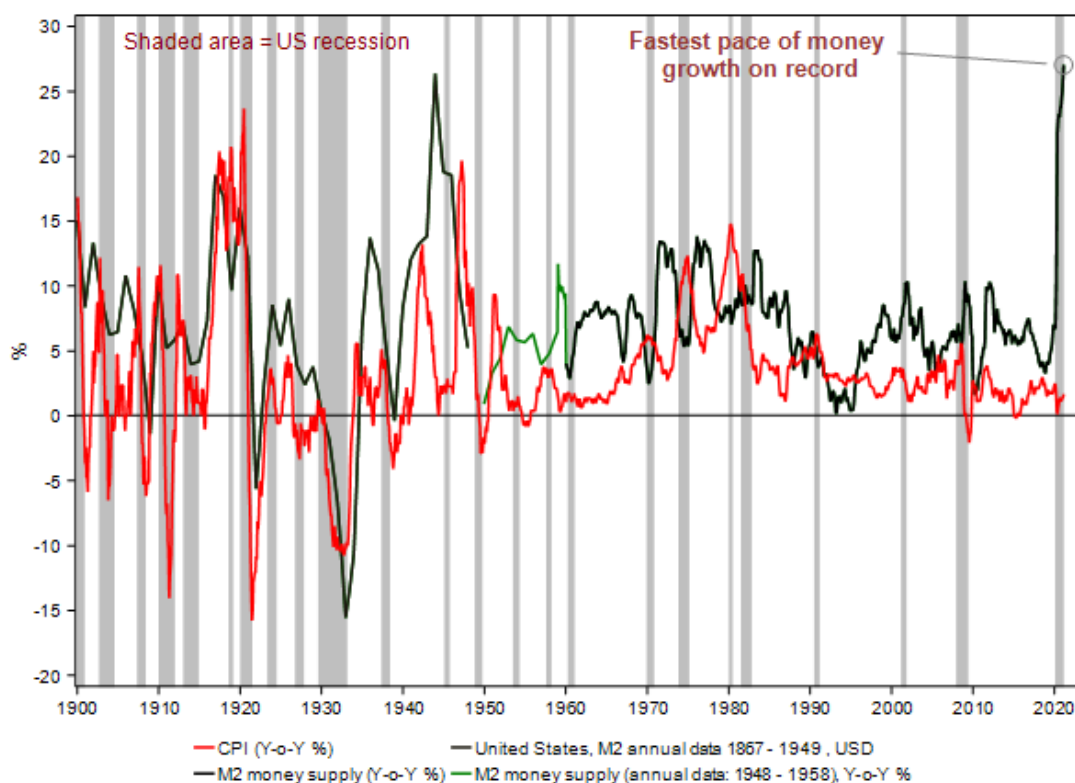
- Due to the strong global money supply growth in combination with fiscal policy impulses and gradual openings of the economy, the foundation has been laid for global growth to pick up significantly, for higher inflation and for rising long-term interest rates. However, the resulting steepening of the yield curve structure is still a positive signal for the equity and credit markets for the time being.
- In the medium term, however, there is likely to be a fundamental paradigm shift. Rising interest rates will become an increasing burden for the richly valued financial markets. The positive correlation between interest rate movements and the stock markets that has existed for about 30 years is thus reversing, which is likely to cause turmoil on stock markets in the foreseeable future.
- These potential disruptive effects will be intensified in the longer term by the so-called "QE trap" ("quantitative easing trap") for central banks. Since 2008, QE has artificially pushed the interest rate level below the normal level in recessions. But this generates a much stronger recovery impulse than in previous recessions for the economy, inflation and interest rates. And this will lead to higher interest rates in the long run, i.e. an overshooting from the low level, in the coming normalisation of monetary policy. This makes the effective management of monetary policy more difficult and can lead to undesirable side effects in long-term interest rates. The central banks are therefore firmly in the grip of the QE trap.
- The central banks do have effective means of action to combat a possible rise in inflation and interest rates. The main tool is quantitative tightening (QT), i.e. selling securities and reducing their balance sheets. However, due to the prevailing very inflated valuations in combination with the aforementioned market paradigm shift, as well as the QE trap, an increased vulnerability of the system to a change of monetary policy course must be considered.
- Additional problems are to be expected in the medium term from acceleration effects due to positive feedbacks between the economy, the labour market, wages and goods consumption. Controlling such strongly non-linear developments is difficult.
- Currently, the environment for equity and credit markets (especially high yield) is still very good. The trends in economic activity, inflation and long-term interest rates are moderate and under control by the central banks. The strongly rising money supply is an extremely good support. And the more restrictive monetary policy of the Chinese

central bank, which has been in place for some time, is dampening signs of overheating in the global context, providing a counterbalancing effect. In addition, a more restrictive monetary policy by the US Federal Reserve at the end of the year is already being discussed. This means that potential damage is priced into current valuations. All in all, there is still a classic goldilocks environment prevailing at present, especially for cyclical industrial stocks and value stocks.

- The situation can, however, deteriorate quickly. We are therefore monitoring our short-to medium-term leading indicators very closely, and are confident that we will receive relevant warning signals in time to reposition our portfolios.
- In the current environment, we also see potential downward pressure for the US dollar, upward potential for commodities (especially industrial metals such as copper as well as energy prices). Overall, this represents a favourable environment for many emerging markets. In addition, the European markets should particularly benefit from an improved global economy due to their high dependence on exports.

Topics “on the radar”

Chart: M2 money supply compared with US consumer price inflation 1900-2021



Source: Longview Economic Research

The above graph amply demonstrates the reliable early warning function of the M2 money supply (black line) on the inflation trend (red line) as well as recessions (grey areas) in the US since 1900. The M2 money supply comprises short-term consumer funds that are available for investment and consumption. Therefore, there is a lead time to the development of the economy and inflation.

The M2 money supply cannot be controlled directly by the central bank, but will change in accordance with the money creation process in the private banking system and fiscal impulses. As such, there was only a moderate increase in M2 in the years of the 2008/09 financial crisis, despite massive liquidity injections by the US Federal Reserve. At that time, a lot of central bank money seeped into the ailing US banking system.

In contrast to then, a much stronger impulse is at work today in the US as well as in many other countries, since central bank liquidity continues to flow through the healthy and strong private banking system without any problems, and is even boosted there through lending. In addition, the money from the gigantic government aid programmes is flowing into M2. The effect on growth and the price level is therefore likely to be correspondingly greater.

Summary of *FischView* model outputs

	US	Europe	Japan	Asia ex-Japan	LatAm	CEEMEA	Key:
Equities	+ ↑	+	+	+ ↑	+ ↑	+ ↑	++ Strong positive
Government Bonds	-	o	-				+ Positive
Credit IG	o	o		o	o	o	o Neutral
Credit HY	o	o		o	o	o	- 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).

Cross asset class preferences

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

	Most preferred	Least preferred
Convertible Bonds	<ul style="list-style-type: none"> – Reopening beneficiaries – Cyclical 	<ul style="list-style-type: none"> – Growth (software/e-commerce) – Covid-19 winners
Global High Yield	<ul style="list-style-type: none"> – 'B' rating segment – Telecoms – Basic industry 	<ul style="list-style-type: none"> – Banking – Transportation
Emerging Market Corporates – Defensive	<ul style="list-style-type: none"> – Colombia – China – United Arab Emirates 	<ul style="list-style-type: none"> – South Korea – Qatar – Russia
Emerging Market Corporates - Opportunistic	<ul style="list-style-type: none"> – Africa – China 	<ul style="list-style-type: none"> – Argentina – Oman
Global Corporates	<ul style="list-style-type: none"> – Investment Grade – Developed markets – TMT – 'BB' rating segment 	<ul style="list-style-type: none"> – Emerging markets – Real estate – Basic industry – 'B' rating segment

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.

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