



Monthly Update - July 2021

As at 29 June 2021

Summary

- Solid economic growth and high liquidity ensure favourable global financial market environment
- However, economic momentum, and trend strength on the equity and interest rate markets, are weakening
- China's continued restrictive monetary policy is dampening the global economy
- Higher inflation rates in the US and Europe are, as yet, not impacting on financial markets – expectations of inflation dynamics remain moderate
- The buoyancy of the US labour market is becoming an increasingly decisive factor in Fed monetary-policy deliberations
- Skilful and market-friendly communication by the Fed allows slightly more restrictive monetary policy, which is already priced into markets
- Equity markets now have limited upside potential, despite inflation fears and upward pressure on interest rates remaining moderate
- Timing: US labour market dynamics are strongly influencing financial markets

Significant changes compared to the previous month

- The daily volume on the US repo market (Overnight Reverse Repurchase Agreements) is rising sharply. This is a signal of high excess liquidity in the banking system (see also "Topics on the Radar" below). The money created monthly by the Fed and ECB, totalling USD 200 billion, is finding fewer and fewer takers. Bank lending to private customers is declining due to a slight economic slowdown. However, the high liquidity is not a problem in the short term, and supports the stock and credit markets at elevated levels.
- The global economic slowdown continues. Chinese monetary policy remains on a moderately restrictive course, increasingly dampening the global system and inflationary risks. This is likely to lead to weaker corporate earnings momentum in the foreseeable future.
- Accordingly, we expect some dampening in equity markets, although this will be partially
 offset by the enormously high liquidity within the system.
- Monetary policy in the US will be increasingly influenced by labour market developments,
 while inflation is viewed as merely temporary. A strong increase in new jobs and a

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- significant decline in unemployment could put the Fed under pressure and lead to higher long-term interest rates once more.
- Real estate markets are also accelerating worldwide. The rationale includes the
 expansionary monetary policy, the fiscal stimulus and a trend towards working from
 home. Any overheating would also result in a more restrictive monetary policy.

Current situation and positioning

- The enormously high liquidity, combined with the solid economic development continued to be a positive driver, for equity and credit markets.
- Inflation rates are rising, but remain within expectations. In particular, the "5-Year Forward Inflation Expectation Rate" in the US signals only very moderate risks. Thus, the Fed is keeping the situation completely under control and, from the perspective of market participants, is credible with its expectation of only a temporary rise in inflation.
- Accordingly, there were no further rise in interest rates at the long end in recent weeks
 (also not in Europe), which helps central banks to keep their loose monetary policy
 unchanged for the time being.
- As long as this combination of high liquidity,d economic activity, only moderately rising interest rates and well-controlled inflation expectations continues, the environment for equity and credit markets is ideal ("goldilocks").
- However, potential problems could soon arise from the development of the labour market in the US. The Fed has linked a change in its monetary policy very strongly to the further development of the unemployment dynamic in the coming weeks and months ahead. If there is a stronger-than-expected improvement here in the coming weeks, markets are likely to increasingly question the loose monetary policy. For the time being, the US unemployment rate is therefore the key factor for future monetary policy, and thus also for equity and bond markets.
- An additional problem is the currently ever more strongly rising real estate prices in the US, but also worldwide. A further acceleration will also have to be combated by monetary countermeasures.
- A normalisation of monetary policy is thus becoming increasingly apparent and necessary. At the moment, however, there is still no immediate danger for financial markets. On the one hand, the global economy is cooling slightly, inflation expectations are limited and, despite better labour markets, wage cost increases are still falling at present. In addition, the Fed and also other central banks are currently communicating very skilfully, gently preparing markets for a possible change in monetary policy.
- Thus, the upside potential on equity markets remains intact, but is limited due to historically very high valuations and the current economic slowdown (leading to weaker corporate earnings momentum). Credit markets also offer only low risk premiums, while credit spreads are close to historical lows. The trend in long-term interest rates is likely to point slightly upwards again after the recent consolidation. Overall, markets are in a low-trend phase and are susceptible to disruptions.
- For market timing, the development of the US labour market as well as the money supply development in the coming weeks are crucial. The weekly "Initial Jobless Claims" provide data available at very short notice here.

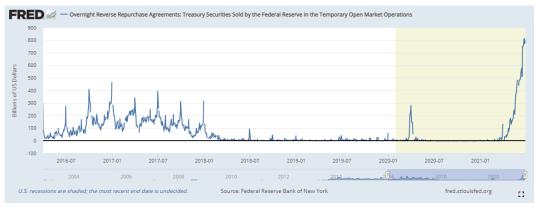
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— Another timing aid is the reaction of the stock markets to unexpected news. Divergences in particular are very revealing here: so far, the US government bond market has reacted positively (falling interest rates) to negative news (i.e. higher inflation, good economic data). This was a divergence and a sign of high market strength. If this reaction pattern changes, a trend change is imminent.

The development of the US dollar can also provide interesting information if there is a resumption of the long-term downtrend and prices drop below 89 (measured by the DXY dollar index). At the moment, the positive and negative forces are neutral to slightly positive. However, if the aforementioned extreme excess liquidity in the US banking system puts pressure on the US dollar, this would be a warning signal for a possible chain reaction: lower dollar, higher imported inflation, rising long-term interest rates and pressure for the Fed to act.

Topics "on the radar"

Chart: Extreme excess liquidity in the US banking system



Source Federal Reserve Bank of New York

US banks have had plenty of liquidity for some time due to the large sums coming from the Fed's quantitative easing (QE) programmes and government stimulus programmes. Since the US economy is cooling slightly at the same time, lending to private customers is also declining and the central bank liquidity is not needed in full.

Therefore, this excess liquidity is parked overnight at the Fed under "reverse repurchase agreements". The chart shows the enormous increase in repo turnover since April.

A further increase is expected in the coming months from the current level of USD 600 billion to USD 1000 billion. However, this is not a fundamental problem for the financial system. On the contrary, this liquidity supports the stability of the markets. But it is a sign that monetary policy is slowly reaching its limits.

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Summary of FischView model outputs

	US	Europe	Japan	Asia ex- Japan	LatAm	CEEMEA	Key:	
Equities	+	+	+	+	+	o ↓	++	Strong positive
Government Bonds	-	-	-				+	Positive
Credit IG	0	0		0	0	0	О	Neutral
Credit HY	0	0		0	0	0	-	Negative
Convertibles	+	+	0 ↓	+				Strong negative
Commodities	Energy	+ ↓	PrecMet	+	InduMet	+ ↓		

Notes regarding the table: Changes from prior month are indicated with \downarrow or \uparrow . i.e. "O \downarrow " 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	 Cyclicals (industrials, materials) 	Interest rate sensitives (real estate)		
Global IG Corporates	EUR IGSpread duration 5-10"Rising Stars"	USD IGSpread duration >10Utility and real estate		
Global Corporates	Developed market HYSpread duration 5-10'BB' rating segment	Emerging market HYSpread duration >10'B' rating segment		
Global High Yield	'B' rating segmentTelecomsBasic industryEnergy	BankingTransportationReal estate		
Emerging Market Corporates - Defensive	ChinaIndonesiaMexico	South KoreaTaiwan		
Emerging Market Corporates - Opportunistic	High yield commoditiesMexico	BahrainQatar		

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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