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»FischView

Monthly Update – October 2021

As at 28 September 2021

Summary: Global monetary policy too expansionary

- **Economic growth remains solid globally with the exception of China**
- **Ultra-loose monetary policy across geographies no longer fits the fundamental environment**
- **Strong labour markets, wage pressure and rising real estate prices are the obvious consequences of overly accommodative monetary policy**
- **Consumer inflation expectations are rising and increased US government bond issuance is anticipated**
- **Upward pressure on long-term interest rates and headwinds for the US dollar are gaining traction**
- **Equities continue to be supported by high liquidity, but negative factors are increasing, including high valuations with deteriorating market technicals**
- **No global spillover of China's real estate crisis is yet evident**

Significant changes compared to the previous month

- Current indicators in the US, Europe, Japan and various emerging markets point to very solid, slightly accelerated economic growth.
- In China, the crisis triggered by the Evergrande real estate group is having a strong dampening effect. However, the Chinese central bank is loosening its monetary policy considerably and should thus prevent out-of-control consequences.
- Overall, global monetary policy is becoming less appropriate against the backdrop of an increasingly positive and successfully reflated environment. Negative consequences are becoming more evident: dried-up labour markets and increasing wage pressure, strongly rising real estate prices, in addition to increasing inflation expectations on the part of consumers. These developments are likely to keep inflation rates at elevated levels worldwide for longer than central banks have assumed so far.
- The inflation scenario is further aggravated by persistent global supply chain problems that can probably only be resolved in the medium-to-longer term.
- In addition, economic growth in the US is beginning to outpace money supply growth, while the US Treasury is again announcing significantly higher money borrowing for the coming quarters. These two factors further contribute to the overall imbalance of monetary conditions within the financial system.

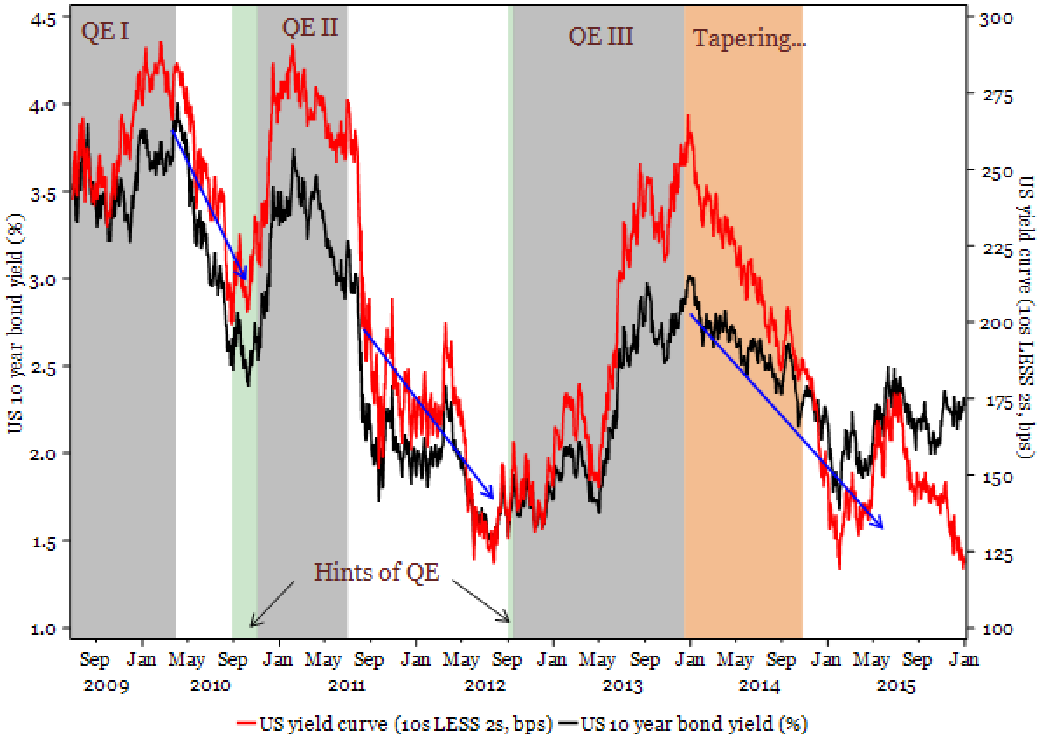
- In contrast, the reaction of the Chinese authorities to the Evergrande real estate crisis is fundamentally positive. Liquidity injections and an easing of monetary policy are preventing the problems from spilling over to other sectors and abroad.

Current situation and positioning

- The above-mentioned side effects of a very strong economy fit less and less with the extremely loose monetary policy worldwide. The increasing "monetary overpressure" is having an impact on long-term interest rates, which are beginning to rise. Moreover, such an environment has often had negative consequences for the US dollar historically.
- The global financial system is thus undergoing a fundamental change: the flood of central bank liquidity, which previously ensured falling long-term interest rates, is now suddenly leading to rising interest rates. This makes the central banks' task of ensuring a stable and balanced system much more difficult (see also " Topics on the radar").
- In addition, the probability of feedback and amplification effects increases: Falling unemployment figures lead to more consumption, which in turn contributes to even lower unemployment. Greater consumption promotes rising demand for goods and higher prices, and this is ultimately reflected in upward pressure on wages (second-round effects) and even more consumption. Such feedback loops make it more difficult for central banks to control the system and further increase upward pressure on interest rates.
- Pandemic-related global supply chain problems are likely to last longer than expected. However, some of the consequences are already included in economic and inflation expectations. Nevertheless, we expect a longer-term and persistent impact on price developments.
- Overall, an environment thus exists globally that is likely to lead to a well-justified rise in long-term interest rates. In the US, this could result in sales of US government bonds by foreign investors and thus to capital outflows, putting added pressure on the US dollar. The greenback is also affected by a negative four-year cycle. A historical analysis shows that the US dollar has endured an equivalent period of weakness very regularly every four years since 1971.
- In the current environment of rather excessive financial market liquidity, equity and credit markets are still well supported. However, high valuations as well as the aforementioned probable rise in long-term interest rates form a negative counterweight. We therefore expect renewed, but only limited upside potential within a larger sideways range in the coming weeks after a potential correction.
- Moreover, central banks can now only intervene in the system under more difficult conditions and will have to curb liquidity supply in the foreseeable future. This would further cloud the outlook for financial markets and increase vulnerability to minor disruptions. Nevertheless, it is likely that major damage to the stock markets can be prevented for the time being. Overall, there is still a balance between positive and negative factors. And in the event of major corrections, counterforces would immediately set in in the form of falling interest rates again.

Topics “on the radar”

Chart: Quantitative Easing (QE) leads to rising interest rates



Source Longview Economic Research

The chart clearly shows that, during the past quantitative easing (QE) phases of the US central bank since the financial crisis of 2009, interest rates have always risen and the yield curve has steepened. At first glance, this is surprising, since the central bank purchases government bonds on a large scale during a QE programme and thus pushes prices up and interest rates down accordingly.

The intuitive explanation is that, although QE represents a massive injection of liquidity (newly created cash is delivered to the market in exchange for government bonds), this stimuli also creates more economic growth, higher inflation expectations and thus also a rise in long-term interest rates. This means that in this environment private investors sell more government bonds into the market on the basis of positive expectations than the central bank buys through its QE. That is why government bond prices fall on a net basis and interest rates rise.

Currently we are also in a very strong QE phase of consolidated central bank intervention (Fed, ECB, BoE, etc.) and, as mentioned, "monetary overpressure" is being built up on the long-term interest rate level. The yield curve is steepening, which is basically a positive signal for the economy and stock markets. However, if interest rates were to rise too sharply, these positive influences would be cancelled out.

Summary of *FischView* model outputs

	US	Europe	Japan	Asia ex-Japan	LatAm	CEEMEA
Equities	o ↓	o ↓	o	o	o	+
Government Bonds	-	-	o ↑			
Credit IG	o	o		o ↓	o ↓	o ↓
Credit HY	o ↓	o ↓		+	+	+
Convertibles	o	o ↓	o	o		

Commodities	Energy	+	PrecMet	o	InduMet	+

Key:

++	Strong positive
+	Positive
o	Neutral
-	Negative
--	Strong negative

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	– Cyclicals (industrials, materials)	– Interest rate sensitives (real estate)
Global IG Corporates	– Banking, energy – Spread duration 5-10 – "Rising Stars"	– Real estate, utility – Spread duration < 3 – 'AA-A' rating segment
Global Corporates	– Technology, retail – Spread duration 5-10 – Crossover rating segment	– Real estate, utility – Spread duration < 3 – 'AA' rating segment
Global High Yield	– 'B' rating segment – Telecoms – Basic industry – Energy	– Banking – Transportation – Real estate, especially China
Emerging Market Corporates - Defensive	– Indonesia – Mexico	– South Korea – Taiwan
Emerging Market Corporates - Opportunistic	– High yield commodities – Mexico – India	– Bahrain – Qatar

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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