



Monthly Update - February 2022

As at 25 January 2022

Summary: Market fears due to monetary policy change

- The economy remains solid, but continues to cool both in the US and globally. Several forces are having a positive impact in the medium-to-long term.
- The economic slowdown is dampening inflationary risks.
- Despite a rise in long-term government bond yields, yield curves are flattening, reflecting expectations that restrictive monetary policy will dampen growth and inflation.
- Central banks are continuing to tighten monetary policy to a possibly greater degree than necessary.
- Financial markets are already reacting unusually strongly to expected interest rate hikes and balance sheet reductions (QT) by central banks. In previous cycles, equity market fell only after several interest rate hikes and more advanced balance sheet reductions.
- From a market technical perspective, this is nevertheless healthy behaviour, as future tensions are already being eased. Investor sentiment is already pessimistic and hedges have been put in place.
- Continued subdued volatility in currency markets and an easing of monetary policy in China are having a stabilising effect globally.

Significant changes compared to the previous month

- Various meaningful economic indicators (consumer sentiment, PMIs, retail sales, real
 estate prices, GDPNow and Fed Weekly Economic Index) are currently weakening
 significantly. However, this trend has already been apparent for some time.
- The reasons for this are base effects, weakening money supply and labour market dynamics, omicron and the prevailing high inflation rate, which are collectively depressing consumer sentiment.
- This economic slowdown is having a dampening effect on inflation and interest rates. In particular, inflation expectations and thus possible second-round effects due to rising wages should also be lower.
- However, several important factors should continue to support growth for some time:
 High household cash balances, high industrial new orders, globally declining supply-

chain problems, low inventories, once again rising US labour force participation rates since early 2021 and strong credit stimulus in the private sector banking system. Thus, the probability of a recession or stagflation scenario remains low, despite the current slowdown.

- Financial markets are currently behaving as if strong monetary tightening has already been implemented and there is a greater risk of recession. This is unusual, because historically negative reactions on equity markets have only occurred after several interest rate hikes.
- Therefore, a divergence is building up between negative markets and, at the same time, a well-balanced, still solid economic and monetary environment. This is positive from a market technical point of view. Markets are letting off steam before monetary policy is really tightened much at all.
- In addition, many analysts expect relatively large interest rate hikes and an imminent and significant reduction in the Fed's balance sheet. There is therefore room for positive surprises if inflation should develop less strongly than feared in the coming months.
- However, if inflation remains high or above expectations, there is a risk of an overreaction by the central banks ("policy mistake"), which would unnecessarily reinforce the already visible cooling tendencies of the economy and financial markets.

Current situation and positioning

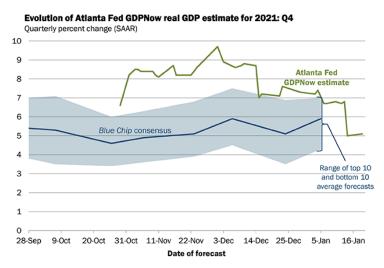
- A comparison of the current situation, with the last monetary tightening cycle of the US Federal Reserve in 2017 to 2019, shows a better starting position for financial markets today than back then: Fed funds rates were raised to 2.25% by mid-2019 and the central bank's balance sheet was reduced by more than USD 400 billion. At the same time, the US yield curve inverted and signalled a recession. Currently, monetary policy is much looser. The private lending system is generating a lot of liquidity and the economy remains solid.
- However, the inflation trend is more problematic today than in 2019, but since it is likely
 to ease in the medium term (due to the economic slowdown, base effects, declining
 supply chain problems), there is justified hope for only limited negative inflationary
 disruptions in the coming months.
- Nevertheless, the 3D factors (deglobalisation, decarbonisation, demographics) continue to push up inflation in the long term. However, this is at least partially priced into current expectations.
- The current baseline scenario therefore remains a combination of an economic slowdown without recession, lower inflation again in the medium term, and therefore only moderately rising long-term interest rates and a flattening yield curve structure. Monetary policy will become tighter globally, but a stalling of the economy and financial markets remains unlikely.
- Worst-case scenarios with a currently low probability are: a) higher-than-expected inflation in the short term coupled with an overreaction by central banks and b) renewed major supply chain problems due to Omicron in China with the associated global surge in inflation and simultaneous sharp economic slowdown. In this scenario, monetary policy cannot make much difference.
- The current monetary easing in China to support the economy and real estate markets is already working, and also contributes globally to a balanced environment for the

economy, foreign exchange markets and stock markets. This increases the likelihood of the above-mentioned baseline scenario.

- The aforementioned overreaction of central banks and an extremely strong reduction of balance sheets (through sales of securities) cannot be ruled out. However, in this case we would expect extreme market distortions that cannot be tolerated by central banks.
- After the strong equity market corrections and the return of higher long-term interest rates, the risk/reward ratio and valuations have improved again. This also applies to credit markets, where market sentiment has similarly fallen extremely quickly and sharply, which we also see as a rather positive sign for future developments. Nevertheless, the current monetary tightening, although only moderate, is likely to lead to high volatility and limited upside potential for some time to come. However, we still consider a prolonged bear market scenario as unlikely. Thus, large corrections can be seen as buying opportunities. Equities, convertible bonds and corporate bonds with somewhat higher credit spreads also offer much better inflation protection than cash or government bonds.

Topics "on the radar"

Chart: US economy cools down noticeably, but remains solid



Source Federal Reserve Bank of Atlanta

The chart shows the Fed's current estimate for economic growth for Q4 2021. Continued high values in the 5% range point to a very solid development. In the medium term, various factors with a sustained positive impact will come into play.

However, a clear slowdown to values even below analysts' estimates is discernible. This cooling, however, has a dampening effect on inflation and interest rates, possibly allowing the Fed to tighten monetary policy at a somewhat lower pace than expected.

Overall, this combination of moderate economic growth, subdued inflation expectations and continued good liquidity supply would also be a favourable environment for the financial markets, which stands in stark contrast to the current negative investor sentiment.

Summary of FischView model outputs

	US	Europe	Japan	Asia ex- Japan	LatAm	CEEMEA	Key:	
Equities	0 ↓	0 ↓	0 ↓	+ ↑	+ ↑	+ ↑	++	Strong positive
Government Bonds	-	-	-				+	Positive
Credit IG	0	- ↓		+ ↑	+ ↑	+ ↑	О	Neutral
Credit HY	0	0 ↓		+	+	+	-	Negative
Convertibles	0	0	0	o 1				Strong negative
Commodities	Energy	+	PrecMet	+ 1	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	 Recovery names Growth at a reasonable price (GAARP) Stocks related to electrification of economy 	 Expensive growth 			
Global IG Corporates	Financials, energyUSD IG"Rising Stars"	Real estateCapital goodsEUR IG			
Global Corporates	Financials, energySpread duration 7-10 years"Rising Stars"	 Real estate Capital goods Spread duration 20-30 yrs. 			
Global High Yield	'B' rating segmentTelecomsBasic industryEnergy	BankingTransportation			
Emerging Market Corporates -Defensive	– Indonesia	SingaporeTaiwan			
Emerging Market Corporates - Opportunistic	High yield commoditiesLatAmSub-Sahara Africa	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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