Marketing material



Monthly Update - May 2022

As at 26 April 2022

Summary: Asymmetric opportunities and risks

- The global economy continues to cool down significantly.
- In Europe in particular, the rise in energy prices triggered by the Ukraine war is having a substantial dampening effect on growth. For the time being, however, the risk of a global recession remains low.
- The latest inflation figures from the US point to decreasing momentum. In Europe, too, the trend is approaching its peak.
- However, long-term inflation expectations, which are currently rising for the first time in a long time, are a cause for concern. The development is not yet dramatic, but it points to a possibly fundamental change in perception.
- Labour markets remain very solid in both the US and Europe, and are having a positive effect on consumer spending, while also providing a stabilising influence on economic growth in the medium term.
- The scaling down of its government bond holdings (balance sheet reduction) announced by the Fed from the end of May, as well as the stronger than previously expected interest rate increases, constitute a serious burden on financial markets, despite the economy remaining solid.
- Overall, risks are currently increasing and upside potential is decreasing.

Significant changes compared to the previous month

- The war in Ukraine continues to have only a limited direct impact on financial markets. However, the indirect consequences in the form of higher inflation expectations, a correspondingly more restrictive monetary policy in the US and the eurozone and, at the same time, falling consumer confidence, are becoming more and more pronounced.
- Therefore, the significant cooling of the global economy continues. At the moment, however, various important positive factors (strong labour markets, high credit impulses, plenty of liquidity among consumers and somewhat steeper yield curves again) are still at work, which continue to reduce the medium-term risk of recession.
- At the same time, China and Japan are loosening their monetary policy, and are thus also helping to provide a balancing effect on the global money supply. However, the Chinese and Japanese easing does not fully compensate for the tighter stance in the US and Europe.

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Recently, long-term inflation expectations have started to rise. This is a significant change, and thus something of a warning signal for financial markets. The increase is still moderate so far. Five-year inflation expectations in the US still remain clearly below three per cent. However, significantly higher inflation expectations would put additional pressure on central banks to act, thus causing second-round effects that would be difficult to control.

 Currency markets are also becoming more volatile. In recent weeks, due to diverging monetary policies, the Chinese yuan, the euro and the Japanese yen have tended to weaken against the US dollar after a relatively stable phase. Volatile exchange rates limit the central banks' room for manoeuvre.

Current situation and positioning

- The global economy is slowing down considerably. Nevertheless, various positive factors are at work, especially within the robust labour markets in the US and also in Europe, which should clearly prevent a recession for the time being. Since, at the same time, there are many job vacancies, the labour market will remain very robust for an extended period of time.
- However, the economic slowdown is leading to a calming of the inflation trend, which makes it easier for central banks to fight inflation. It may therefore be possible to tighten monetary policy somewhat less than is currently expected by market participants. Overall, there is thus still a generally balanced environment for economic growth, inflation and monetary policy. The global economy should therefore be able to cope well with the interest rate increases expected in the coming months.
- The structure of the yield curves in the US and Europe is an important leading indicator and currently confirms a low risk of recession (due to a relatively steep yield curve between 1-year and 10-year rates) and, at the same time, only moderate inflation expectations (and a flat yield curve between 10 and 30 years) prevail. Moreover, the Fed's recent announcement to raise interest rates more than previously expected has led to only a moderate increase in interest rates at the long end. This shows that the Fed communicates well, and, by now, much of the future tighter monetary policy is already priced in. Markets expect interest rates in the US for 10-year government bonds to be around 2.8% to 3%, and Fed Funds rates around 2.5% by the end of the year.
- Despite the continuation of a balanced overall environment, there are potential risks in the form of rising inflation expectations and the Fed's "quantitative tightening" (QT/government bond sales) starting in May. Inflation dynamics may have peaked (due to base effects, a global economic slowdown and somewhat more stable energy prices). Nevertheless, the decline could be slower than hoped, leading to higher long-term inflation expectations. This would be a serious problem that could lead to second-round inflation effects. In this context, the probable consequences are even tighter monetary policy and a stronger-than-expected reduction of the central bank balance sheet (government bond sales). If the Fed were to reduce its balance sheet by around USD 100 billion per month from May onwards, strong corrections in the (minus) double-digit range could be expected for equity and credit markets.
- At present, however, global currency and financial markets are still in balance, as mentioned above. Market technicals are neutral. Many negative factors, especially the Fed's more restrictive monetary policy, are priced in. Market expectations are currently realistic and cautious.

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 However, the prevailing risk/reward ratio is strongly asymmetrical. The risks of setbacks outweigh the opportunities for further gains. Even minor disruptions, due to increased volatility on currency markets (for example), could lead to sharp market corrections.

Topics "on the radar"

Chart: US unemployment rate near historic low



Source Trading Economics

The US labour market is currently in exceptionally strong shape. The unemployment rate is close to historic lows (see chart). At the same time, the number of job openings is reaching unprecedented levels. This will continue to have a lasting and positive impact on goods consumption and economic development in general in the US for some time to come. But labour markets in Europe are also performing very well.

At the same time, however, there is a strong tendency for the economy to cool down due to other factors, such as the Ukraine war, high inflation and thus falling consumer confidence, as well as a cooling real estate market due to sharply rising mortgage rates. This has been clearly confirmed by various indicators (purchasing managers and consumer indices) for some time.

Thus, currently very opposing forces are affecting the economic environment, and the longer-term outcome of the race is open. However, at least in the short-to-medium term, the extremely strong labour market impulses should prevent a recession, as well as compensating for the negative effects of rising interest rates and the more restrictive monetary policy.

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Summary of FischView model outputs

	US	Europe	Japan	Asia ex- Japan	LatAm	CEEMEA	Key:	
Equities	0	0	О	0	0 ↓	О	++	Strong positive
Government Bonds	-	-	-				+	Positive
Credit IG	+	+		0	0	О	О	Neutral
Credit HY	0 ↓	0		0	+	0	-	Negative
Convertibles	0	0	0	- ↓				Strong negative
Commodities	Energy	0 ↓	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	 Growth at a reasonable price (GAARP) Stocks related to electrification of economy Cyber security 	 Expensive growth
Global IG Corporates	 Telecom, media USD credit 'A' rating segment, Rising Stars 	 Real estate, capital goods GBP credit 'BBB' rating segment
Global Corporates	Developed marketsTelecom, mediaInvestment Grade, Rising Stars	Real estate, capital goodsEmerging MarketsHigh yield
Global High Yield	'B' rating segmentTelecomsBasic industryEnergy	BankingTransportation
Emerging Market Corporates -Defensive	IndonesiaLatAm	– Qatar – Taiwan
Emerging Market Corporates - Opportunistic	High yield commoditiesLatAmSub-Sahara Africa	Asia IGBahrainQatar

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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