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Marketing material

» FischView

Monthly Update – June 2022

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Summary: Calm before the storm?

— **The economy is beginning to stabilise again after a slowdown in recent months in both the US and Europe. We still consider the risk of recession as being low for this year.**

— **Inflation expectations are again falling sharply after a temporary increase. This means there is little pressure on central banks to tighten monetary policy further.**

— **The yield curve structure currently confirms this balanced environment. Inflation rates themselves have also peaked globally.**

— **The labour market and real estate markets in the US are beginning to cool slightly, and are thus contributing to easing inflationary pressures.**

— **Nevertheless, monetary policy in the US and Europe is becoming more restrictive in line with expectations. This is being achieved through interest rate hikes and direct money supply control via central bank balance sheets.**

— **The temporary recovery potential due to the current negative market sentiment could only be a "calm before a storm" in autumn. The high risks for the financial system therefore make the opportunity/risk ratio appear decidedly asymmetrical.**

Significant changes compared to the previous month

— The Ukraine war continued to fade into the background in terms of its direct significance for global financial markets. However, the risks here are likely to be significantly underestimated. The danger of a renewed escalation remains high as Russia is increasingly cornered and has clearly missed its initial objectives. This could lead to military actions that are difficult to assess, with strongly negative consequences for global markets.

— Current economic indicators in the US and the eurozone are stabilising after a prolonged decline. China is slowly opening up its economy after the recent pandemic lockdown and, like Japan, continues to loosen its monetary policy. Overall, the global economic and financial market system thus remains balanced.

— However, the Fed has recently tightened its rhetoric, accelerating the rise in US Treasury yields. It has also confirmed a sharp reduction of its balance sheet in the range of 60 to 95 billion US dollars per month starting in June. The ECB is also stepping on the brakes in monetary terms: it is ending its bond-buying programme and announcing forthcoming interest rate hikes.

— The Fed's balance sheet reduction has a much stronger effect than interest rate hikes, but is likely to lead to problems in financial markets and could jeopardise the prevailing economic growth trajectory within a matter of months (allowing for the usual time lag).

— In addition, the falling inflation expectations, after a brief interim rise, have a threefold positive effect: first, central banks do not have to tighten their monetary policy any further, second, consumer sentiment is being stabilised, and third, dangerous wage-price spirals are being dampened.

— At the same time, the labour market and real estate markets in the US are cooling moderately. This does not yet have a strong negative impact on the economy, but it does provide additional relief in the inflation trend.

— The structure of the yield curve in both the US and Europe confirms that central banks still have the situation under control. The short end (3 months / 10 years) is steep and thus signals a stable economy. The long end (10 years / 30 years) is flat and confirms low inflation expectations.

Current situation and positioning

— Various economic indicators in the US and Europe signal a stabilisation, and thus a very low risk of recession. This is confirmed by the relatively steep yield curves in the range between 3 months and 10 years. Historically, a recession has always been preceded by a complete flattening or even an inversion of the yield curve.

— However, the Fed and the ECB are becoming much more restrictive in their monetary policy. In particular, a massive balance sheet reduction by the Fed (through sales of government bonds) is imminent from June. The resulting direct reduction in the money supply is likely to have a strong negative impact on both the economy and stock markets, because changes in the money supply have a much greater impact than interest rate hikes. However, experience from previous cycles shows that the effect only occurs with a time lag of three to six months.

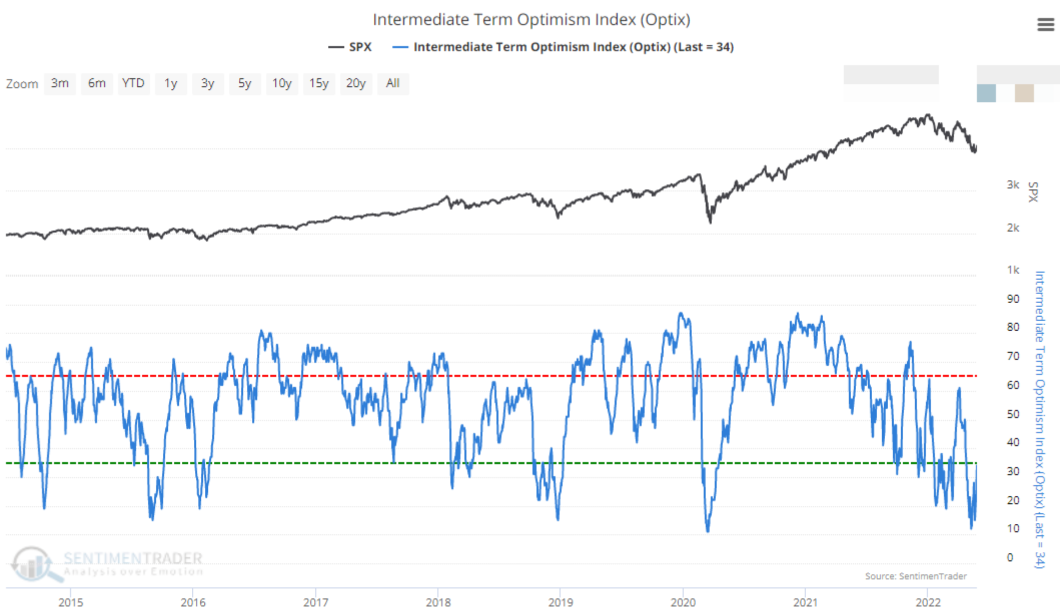
— Moreover, real interest rates (Fed funds rate minus inflation rate) remain low or even negative, which has a strong supportive effect on the economy and stock markets. From September, however, there is a threat of a significant deterioration. Until then, nominal Fed funds rates will be raised further and inflation rates should be significantly lower, resulting in a sharp rise in real interest rates.

— If equity and credit markets perform positively in the environment described above in the coming weeks, but at the same time interest rates rise and liquidity is reduced by central banks (balance sheet reduction), there is a threat of a development comparable to 1987. At that time, dangerous tensions also built up between rising stock market valuations and simultaneous "oxygen withdrawal" through monetary policy. At that time, this divergence led to a severe market correction, albeit very short-lived and without a recession.

— All in all, a number of positive factors are at work in the short term in an environment that is clearly deteriorating in the medium term. In the short term, many negative factors are priced in, while the negative consequences of the Fed's balance sheet reduction are underestimated in our view. Therefore, the current environment can be described as the "calm before a potential storm". The opportunities and risks are thus still very asymmetrical.

Topics "on the radar"

Chart: Market sentiment is extremely negative, leaving room for positive surprises



Source SentimenTrader

Currently, investor sentiment is close to historic lows. Equity and credit markets have globally corrected and valuations are more realistic again. From a market perspective, this means that in the short-to-medium term the signals are more positive than in recent weeks.

Many negative developments have been priced in, especially the current interest rate hikes and potential risks of recession. At the same time, the economy in the US and Europe is stabilising, inflation and inflation expectations are beginning to fall and China and Japan are loosening their monetary policy significantly. Globally, this means a balanced financial market environment again for the time being, which offers room for positive surprises.

However, the effect of the Fed's balance sheet reduction is likely to be underestimated by market participants. The Fed starts with sales of 50 billion US dollars in June and increases to 95 billion monthly from August. This corresponds to a historically unprecedented withdrawal of liquidity. The effects on stock markets and the economy are likely to be clearly felt, with a certain delay, from October at the latest.

Summary of *FischView* model outputs

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

Commodities	Energy	+	PrecMet	o ↓	InduMet	o ↓

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	– Growth at a reasonable price (GAARP) – Stocks related to electrification of economy – Cyber security, energy	– Expensive growth
Global IG Corporates	– Banks, energy – 'A' rating segment – 5-10 year maturities	– Utilities, capital goods – 'BBB' rating segment – Maturities >10 years
Global Corporates	– Developed markets – Media, banks – Investment Grade, Rising Stars	– Automotive, capital goods – Maturities >10 years – High yield
Global High Yield	– 'B' rating segment – Telecoms – Basic industry – Energy	– Banking – Transportation
Emerging Markets - Defensive	– Indonesia – LatAm – 7-10 year maturities	– Qatar – Taiwan – Maturities >10 years
Emerging Markets - Dynamic / Opportunistic	– High yield commodities – LatAm – Sub-Sahara Africa	– Asia IG – 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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