Marketing material



# Monthly Update - August 2022

As at 2 August 2022

### Summary: US monetary policy is too aggressive

- The US economy continues to decelerate modestly. However, various indicators suggest that a moderation, rather than a recession, remains the most likely outcome.
- Falling commodity prices sharply lower in some cases are dampening global inflationary pressures. Accordingly, long-term inflation expectations are receding significantly.
- The economy in the eurozone is recovering, and the ECB is tightening its monetary policy only moderately (and, in our view, appropriately). The "Transition Protection Tool" is having a positive effect on spreads in the peripheral nations. Interest rates on Italian government bonds have therefore fallen significantly.
- The fundamental environment is positive. However, the Fed is acting too restrictively in our view. Its balance sheet reduction remains a risk factor for markets in the medium term.
- We regard the flattening of the US yield curve as a warning signal for the economy and stock markets.
- We see further potential for the stock market recovery in the short term. However, due to the Fed's monetary policy, the risk/reward ratio remains strongly asymmetrical. The risks clearly outweigh the opportunities, despite the positive fundamental environment.

#### Significant changes compared to the previous month

- Recent economic data and corporate earnings have been surprisingly solid in both the US and Europe. Labour markets and consumption remain pillars of growth.
- US consumer sentiment, which had previously been falling sharply, has begun to stabilise.
- Risk premiums on Italian government bonds have fallen to a multi-month low. Stronger economic growth and the ECB's newly announced "Transition Protection Tool" (TPI) are the main drivers here.
- The US dollar is weakening slightly once more and the euro is recovering. Overall, foreign exchange markets are thus also providing stabilising impulses for the global economy and financial markets.

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 Inflation rates remain high. However, the upward momentum is beginning to weaken significantly. In the eurozone, the monthly increase has fallen from 0.8% to 0.1%.

- In the US, long-term inflation expectations are already falling significantly again. This could be an important signal for the Fed not to overdo the tightening of monetary policy.
- Overall, this results in a solid fundamental environment globally.
- However, the balance sheet reduction (i.e. the selling of US government bonds) is continuing for the time being. The Fed is thus too restrictive overall and is creating a deflationary effect, which is confirmed by a flattening of the yield curve. Long-term interest rates are thus falling faster than short-term rates. Overall, this is a warning signal for financial markets.
- The geopolitical tensions in Ukraine and, since the beginning of August, also in Taiwan pose a continuing potential threat. However, we expect things to calm down again in the foreseeable future after a serious, but temporary, escalation in Taiwan.

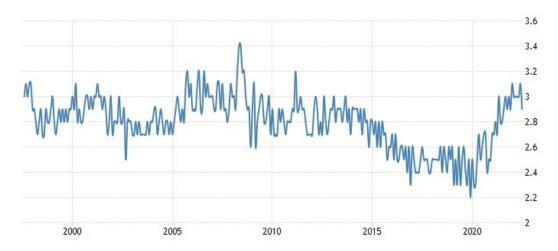
### Current situation and positioning

- The positive news in the US regarding consumer sentiment, the labour market and consumption, as well as corporate profits, are extremely untypical for a recession. The last two quarters of negative growth can therefore be attributed to base effects rather than a weak economy.
- In addition, lower inflation in the near future, due to sharply falling commodity prices and diminishing supply chain problems, should improve consumer sentiment.
- A similar combination of more stable economic growth and declining inflation dynamics can currently be observed in Europe. Furthermore, the ECB's moderate monetary policy and the announced purchase programme for government bonds of peripheral countries (TPI) are very supportive.
- This results in a favourable environment for equity and credit markets in the coming weeks. In addition, interest rates on long-term government bonds are likely to receive only moderate upward pressure. A weaker US dollar will also reduce stress in foreign exchange markets and ease the burden on emerging markets in particular.
- However, the upside potential remains limited globally as long as the Fed continues its
  restrictive monetary policy course. Balance sheet reduction in particular remains an
  underestimated danger. In addition, the M1 and M2 money supplies in the US are falling
  significantly. In such a monetary environment, market rebounds are clearly limited in our
  view. Historical comparisons point to a strongly increased risk of corrections from October
  this year at the latest.
- The US yield curve (Fed funds vs. 10-year) has not yet inverted, but it is now flat. The reason for this could be falling inflation expectations, which would be very positive. But it could also be the harbinger of a recession next year, with corresponding consequences for stock markets after the summer months.
- Investor sentiment is approaching euphoric levels again, which could also be a problem for market technicals in the medium term.
- Despite the positive global environment, we are therefore positioning ourselves neutrally to slightly defensively in our strategies until a change of course by the Fed becomes apparent.

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### Topics "on the radar"

#### Chart: University of Michigan 5-year inflation expectations fall – relief for the Fed



Source Tradingeconomics

Inflation expectations in the US for the next five years have fallen back to the 20-year average. This is remarkable, and it proves that investors continue to have confidence in monetary policy and monetary stability. The current high inflation is seen as being temporary.

This provides direct relief for the Fed. Monetary policy does not need to be tightened further. On the contrary, the Fed could deviate again from the overly restrictive course it is currently pursuing in the foreseeable future.

Indirectly, falling inflation expectations also lead to positive impulses for consumers. Overall, this reduces the risk of recession, which could support the current equity and credit market rally in the coming weeks. In the medium term, however, the risks clearly outweigh the opportunities due to excessively tight US monetary policy.

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## Summary of FischView model outputs

	US	Europe	Japan	Asia ex- Japan	LatAm	CEEMEA	Ke	<i>y</i> :
Equities	0	0	0	0	0	0	++	Strong positive
<b>Government Bonds</b>	-	-	-				+	Positive
Credit IG	0	+		0	0	0	0	Neutral
Credit HY	0	0		0	0	0	-	Negative
Convertibles	0	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	<ul> <li>Cyclicals with reasonable valuation and convex CB structure</li> <li>Stocks with positive long term outlook (renewables, cyber security)</li> </ul>	<ul> <li>Weak credit quality &amp; liquidity</li> </ul>
Global IG Corporates	<ul> <li>'A' rating segment, rising stars</li> <li>Banks, TMT</li> <li>5-10 year maturities</li> </ul>	<ul> <li>'BBB' rating segment</li> <li>Consumer goods, real estate, utilities</li> <li>Maturities &gt;10 years</li> </ul>
<b>Global Corporates</b>	<ul><li>Non-cyclical sectors</li><li>Investment grade</li><li>Developed markets</li></ul>	<ul><li>Cyclical sectors</li><li>High yield</li><li>Emerging markets</li></ul>
Global High Yield	<ul><li>Telecoms, energy</li><li>Basic industry</li></ul>	<ul><li>Banking</li><li>Transportation</li><li>'CCC' rating segment</li></ul>
Emerging Markets - Defensive	<ul><li>Indonesia, Brasil</li><li>Utilities, financials</li><li>3-7 year maturities</li></ul>	<ul><li>Taiwan, China</li><li>Metals &amp; mining, oil &amp; gas</li><li>Maturities &gt;10 years</li></ul>
Emerging Markets - Dynamic / Opportunistic	<ul><li>High yield commodities</li><li>LatAm</li><li>Sub-Sahara Africa</li></ul>	<ul><li>Asia IG</li><li>Bahrain</li><li>Qatar</li></ul>

**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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