Marketing material



Monthly Update - September 2022

As at 30 August 2022

Summary: Liquidity withdrawal by the Fed continues

- Various leading indicators recently confirmed a fragile stabilisation of the US economy after a marked slowdown in the first half of the year. In Europe, the economy is weakening in the face of high gas and energy prices, but remains resilient for the time being.
- Inflation rates have peaked globally. Inflation expectations remain moderate.
- Deflationary factors are increasingly at work: money supplies are falling, economic development is subdued globally, commodity prices are falling in some cases and real estate markets in the US are progressively weakening.
- The central banks thus remain in control, and so far the ECB has also had a positive influence on the credit spreads across the peripheral countries.
- The US yield curve as an important leading indicator has so far signalled a positive combination of moderate economic growth and simultaneously falling inflation dynamics, while liquidity remains sufficient.
- The financial market environment thus remains neutral in the short term and the upward pressure on long-term interest rates continues to be moderate. However, against the background of the above-mentioned nascent resurgence in deflationary factors, the Fed appears to be too restrictive. In the medium term, it risks a recession and high stock market volatility.

Significant changes compared to the previous month

- Recent economic data and corporate earnings weakened slightly in both the US and Europe, but continue to be reasonably solid. Labour markets and consumption remain a pillar of growth for the time being. However, skyrocketing gas prices are having a dampening effect on Europe. Monetary and fiscal stimuli are also providing positive impulses in Japan and China, although here too a moderate weakening trend continues for the time being.
- Inflation data in the US point to a clear decline in inflation dynamics, which is likely to be carried over into the global trend in the medium term. In Europe, however, this process is being delayed by rising gas prices. Nevertheless, the core rates of inflation are also likely to fall here in the foreseeable future.

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 In addition to the deflationary factors that have been at work for some time (falling money supply and commodity price dynamics, base effects, cooling economy), the real estate markets in the US and Germany are now also showing signs of a progressive weakening.

- All in all, the "triad" of weaker but still positive economic growth, declining inflation dynamics and sufficient liquidity supply is providing some short-term support for global financial markets.
- Measured by falling inflation expectations and the behaviour of the yield curve structure, the central banks have the situation under control for the time being. Confidence in medium- to long-term monetary stability is still in place at present.
- For some time now, the ECB has also been shifting funds maturing from the PEPP bond purchase programme into paper issued by peripheral eurozone countries. As an additional option, there is still the possibility of direct purchases within the framework of the new "Transmission Protection Instrument" (TPI), thus dampening the rise in credit spreads.
- Nevertheless, the Fed currently remains far too restrictive. The reduction of the Fed's balance sheet (i.e. withdrawal of liquidity from financial markets) continues in August as planned and announced, and will be increased in September. This is likely to cause major problems for global financial markets and the global economy in the foreseeable future. The easing by the Bank of Japan (BoJ) and the Chinese central bank is not sufficient to compensate for this.

Current situation and positioning

- The US economy contracted in each of the last two quarters. This formally fulfils the definition of a technical recession. However, the strong US labour market, stable leading indicators and corporate profits have so far not behaved in any way like a classic recession. The contraction is therefore partly due to base effects after last year's explosive growth. And in Europe, too, growth rates stabilised in positive territory in the second quarter.
- This, together with falling inflation expectations and still sufficient liquidity in the system, is a key driver for a continuation of the recovery in equity and credit markets that has been underway for some time. However, further progress now depends heavily on the Fed's monetary policy. The positive factors mentioned are increasingly being undermined by the Fed's withdrawal of liquidity.
- Therefore, a "race between good and evil forces for financial markets" is taking place, which is difficult to assess in terms of timing. From October at the latest, however, the negative forces of monetary policy are likely to gain the upper hand if there is no significant change in the Fed's stance. The risk of recession increases from then on.
- The US yield curve reflects the current environment: the 10-year/3-month spread is still slightly steep and thus points to low recession risks. The 10-year/2-year difference, on the other hand, is inverse and indicates decreasing inflation risks as well as an overly restrictive monetary policy.
- Long-term interest rates should continue to rise moderately for the time being. However, the upward potential is limited due to the deflationary impulse of US monetary policy. In Europe, interest rate pressure is stronger due to higher inflation dynamics. The US dollar has upward momentum.
- We remain neutrally to slightly defensively positioned in equity and credit market exposure as we see the upside potential as being clearly limited. Risks predominate in the medium term. Due to the moderate upward pressure on interest rates, we are also neutral to slightly shorter in duration.

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Topics "on the radar"

Chart: The Fed is too restrictive – liquidity withdrawal via central bank balance sheet reduction



Source Federal Reserve Bank of St. Louis

The chart shows the Fed's balance sheet since its all-time high of 8,965 billion US dollars in April this year. Currently, the value is around 116 billion lower. The Fed is thus relatively well on the target course communicated in June (50 billion in June and then a gradual monthly increase to 95 billion from October). Hopes for a pause in the reduction of the balance sheet (due to the inverting US interest rate curve) have not yet been fulfilled.

This reduction is the result of sales of government bond positions that the Fed had bought up in the context of the quantitative easing programmes and corresponds to a direct withdrawal of the previously injected liquidity into the financial system. At the same time, Fed Funds rates are being raised, which creates additional headwinds for financial markets.

Overall, the Fed is thus being extraordinarily restrictive. The reduction of the balance sheet in the last tightening cycle from 2017 to 2019 was much more moderate (15 to 40 billion per month) and was discontinued after a relatively short period, as the yield curve also inverted at that time. This means that, from October at the latest, major dangers will arise for financial markets, not only in the US. The current generally positive environment may continue for a while, but it will become increasingly threatened. In our opinion, with the impact of the balance sheet reduction being greatly underestimated in the markets.

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Summary of FischView model outputs

	US	Europe	Japan	Asia ex- Japan	LatAm	CEEMEA	Key:	_
Equities	0	0	0	0	+ ↑	0	++	Strong positive
Government Bonds	o 1	-	-				+	Positive
Credit IG	0	0 ↓		0	0	0	О	Neutral
Credit HY	0	0		0	+ ↑	0	-	Negative
Convertibles	0	- ↓	0	0				Strong negative
Commodities	Energy	0	PrecMet	0 1	InduMet	o 1		

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	EnergyStocks with strong secular trends (renewables, cyber security)	Weak credit quality & liquidityREITS
Global IG Corporates	'A' rating segmentFinancials3-7 year maturities	'BBB' rating segmentIndustrialsMaturities >10 years
Global Corporates	FinancialsInvestment gradeDeveloped markets	IndustrialsHigh yieldEmerging markets
Global High Yield	Telecoms, energyBasic industry	BankingTechnology'CCC' rating segment
Emerging Markets - Defensive	Korea, Brasil3-5 year maturities	Taiwan, ChinaMaturities >10 years
Emerging Markets - Dynamic / Opportunistic	High yield commoditiesLatAm	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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