Marketing material



Monthly Update – October 2022

As at 27 September 2022

Summary: Monetary overkill by the central banks

- The global economy continues to cool down significantly.
- Inflation dynamics have peaked and real estate markets are weakening further.
- Downside surprises in the inflation trend in the coming months are therefore increasingly likely.
- Long-term inflation expectations continue to fall. Confidence in monetary stability thus remains high.
- Despite these clearly deflationary tendencies, the important central banks are increasingly stepping on the monetary brakes due to credibility considerations. Monetary policy is thus too restrictive and no longer appropriate in this environment. The money supply is falling too fast, not only in the US.
- The US yield curve structure is strongly inverted between two and ten years, confirming an excessively restrictive monetary policy. However, a severe recession in the US is not indicated for the time being. For Europe, on the other hand, we expect a recession due to the impact of high energy prices.
- Overall, therefore, the risks in equity and credit markets continue to predominate. However, the potential for an increase in long-term interest rates is limited globally due to the deflationary monetary policy.

Significant changes compared to the previous month

- The labour markets in the US and the eurozone are still very robust. However, the Fed is aiming for a weakening in the coming months to prevent further wage pressure, unwind imbalances and thus lower inflationary pressures.
- We consider this approach dangerous and it reinforces a significant slowdown in the economy that is already taking place (also in the eurozone). By doing so, the Fed risks a recession and would overshoot its mandate. Other central banks are increasingly being forced, via an excessively strong US dollar, to adopt a monetary policy that is also too restrictive.
- The inverted US yield curve between two and ten years signals an excessively aggressive tightening of monetary policy. However, 10-year rates are currently still above 3-month rates, which historically has always been a sign of an economy that remains resilient (see

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"Topics on the radar"). The same is true for the eurozone. We therefore see the recent rise in interest rates at the long end as a favourable sign for the economic development in the short term. However, the situation could quickly deteriorate here.

- The money supply is declining worldwide and interest rates are being raised to an extent and at a speed never seen before in history. Monetary normalisation is thus already very far advanced. The equity, credit and real estate markets have already reacted strongly as a result. Part of the "monetary damage potential" is thus already priced in.
- In addition, long-term inflation expectations (measured by the USD 5y/5y forward inflation-linked swap) continue to fall very quickly into the 2.5% range, so confidence in monetary stability remains high. However, this is only likely to lead to a change of course in monetary policy in a few months' time and will only have a limited positive impact on financial markets for the time being.

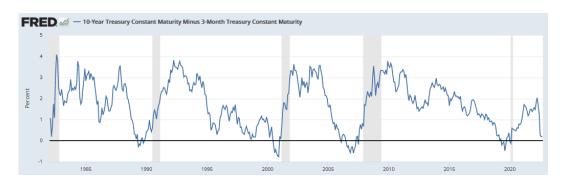
Current situation and positioning

- The Fed cites price stability as an indispensable prerequisite for sustained economic growth. Therefore, fighting inflation is currently an absolute priority, despite the risk of recession. Other central banks are also increasingly following this path. Thus, for the time being, a rather painful extension of the monetary normalisation path is to be expected for equity and credit markets. Although markets have already priced in much negativity and valuations are becoming increasingly compelling, we continue to see defensive positioning as appropriate. The present sharp interest rate hikes by central banks coupled with a weakening economy are a dangerous mix.
- A further yield curve flattening would indicate a worsening of the situation and provide a signal for an even more defensive positioning. At the moment, however, the signals here are not yet extremely negative.
- However, the combination of falling inflation, falling inflation expectations and, at the same time, extremely restrictive monetary policy is favourable for long-term government bonds in the medium term. The potential for interest rates to rise further is therefore diminishing. And the deflationary impulses could even lead to falling rates and correspondingly rising government bond prices once more in the foreseeable future. This also applies, albeit with a time lag, to the eurozone.
- Two scenarios are currently possible regarding credit spreads on corporate bonds. The first is a significant fall in long-term interest rates due to the risk of recession. In this case, credit spreads would rise and compensate for the positive effect of lower interest rates. Secondly, we could expect to see a slight rise in long-term interest rates due to a stable global economy. In this case, credit spreads should fall and also compensate for the rise in interest rates. Thus, on balance, only a small amount of volatility is to be expected in both scenarios due to offsetting factors. Overall, the risks here are also somewhat greater than the opportunities for the time being. Nevertheless, it makes sense to start looking for increasingly interesting opportunities.
- Falling inflation combined with higher interest rates means significantly rising real interest rates. A rise in real interest rates from the currently low levels (by historic standards) is also actively promoted by the Fed, and is part of the normalisation process of monetary policy. As real interest rates are the most important driver of gold, this continues to be a strong dampening factor for the precious metal, and at the same time a supporting force for the US dollar.

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Topics "on the radar"

Chart: The yield curve does not yet signal a recession



Source Federal Reserve Bank of St. Louis

The chart shows the difference between 10-year US government bond yields and 3-month interest rates since the 1980s. Historically, this yield curve structure has always been an excellent indicator of economic trends. Every recession has been preceded by an inversion of the yield curve (i.e. long rates are below short rates). Recessions are shaded grey in the chart and the inversions are represented by a dip below the zero line.

There is currently no inversion, although the yield curve has flattened considerably in recent weeks. This means that we have yet to see a recession signal. At best, a mild recession or anaemic growth would be consistent with the current slope of the yield curve.

However, further interest rate hikes by the Fed at the upcoming policy meetings could quickly lead to an inversion if long-term interest rates do not also rise. Such inversions have repeatedly occurred in previous cycles in times of overly restrictive monetary policy.

Currently, the US yield curve signals only limited downward potential for the economy and stock markets, at least in the short term.

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Summary of FischView model outputs

	US	Europe	Japan	Asia ex- Japan	LatAm	CEEMEA	Key	:
Equities	- ↓	- ↓	0	0	0 ↓	0	++	Strong positive
Government Bonds	- ↓	↓	-				+	Positive
Credit IG	0	- ↓		0	0	0	О	Neutral
Credit HY	0	0		0	+	0	-	Negative
Convertibles	- ↓	↓	- ↓	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	 CBs with positive yield Stocks 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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