





Monthly Update - November 2022

As at 31 October 2022

FISCH » Asset Management

Summary: Stress indicators are giving warning signals

- Monetary policy remains extraordinarily restrictive globally. We therefore see increasing recession risks.
- However, the rise in interest rates on long-term government bonds is likely to be increasingly curbed by a number of deflationary factors, especially in the US. In the eurozone, there is still somewhat more upward pressure on interest rates due to high government debt levels.
- Various stress and liquidity indicators are currently deteriorating and signal increasing dangers.
- Yield curves continue to flatten worldwide and money supplies are falling fast. While this clearly has a deflationary effect, it is problematic for financial markets and a warning signal for the economy.
- Inflation expectations, which are important for monetary policy, still remain at a low level overall, but have recently started to rise again moderately. Here we see a potentially dangerous development.
- Despite clear signs of financial market stress, central banks are forced to remain restrictive for reasons of credibility.
- Many negativities are currently priced in by markets and investor sentiment is extremely pessimistic. A gradual build-up of risk in the portfolio can therefore be considered now. However, we do not expect a sustained recovery in financial markets until there is a shift in monetary policy or positive surprises in the inflation trend.

Significant changes compared to the previous month

- Various stress indicators, including the comprehensive "National Financial Conditions Index" (NFCI) in the US, are increasingly rising, providing clear warning signals for the financial system. There is an increasing danger of "monetary air holes", i.e. temporary liquidity shortages in the financial system. This can lead to severe market turbulence, which could even require central bank intervention. A first example was recently observed in British Gilt markets.
- Various leading economic indicators, such as the important "Conference Board Leading Economic Indices", also signal increasing risks of recession. The flattening of the yield curves both in the US (and here recently also in the previously steep 3-month versus 10-

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year) and in Europe confirm growing economic headwinds. Rapidly falling money supply and real estate prices as well as declining commodity prices have an additional deflationary effect. This development is a consequence of the Fed's extremely restrictive monetary policy, whereby it is also increasingly forcing other central banks to tighten their own monetary policy as a consequence of the strong US dollar.

- The aforementioned flattening of the yield curve structure is a serious warning, but there
 is no actual recession signal (inversion) yet.
- Inflation dynamics continue to decline slightly, but less rapidly than hoped. Various current deflationary developments (real estate markets) are only reflected in the statistics with a time lag (especially in the core rates). Nevertheless, a significant decline on an annual basis is already possible in November due to very strong base effects.
- Inflation expectations, crucial for central banks, remain at a low level, but have recently risen slightly again. This could lead to a loss of confidence among market participants in monetary stability and force the central banks to adopt an even more restrictive course. This development must therefore be closely monitored.

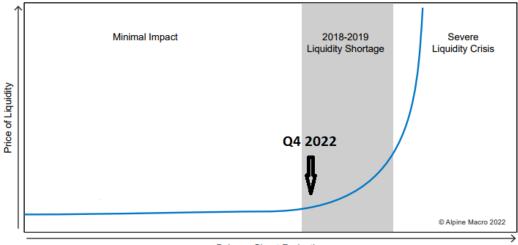
Current situation and positioning

- Due to the prevailing strongly bent and steep Phillips curve (ratio of unemployment to inflation), even a moderate increase in unemployment in the US should lead to rapidly decreasing inflationary pressure. Therefore, a severe recession is not a necessary condition for the Fed to achieve its inflation targets.
- Corporate profits and labour markets remain very solid in both the US and Europe. This
 also dampens recessionary tendencies, at least to some extent. A soft landing in the US
 and only a mild recession in Europe therefore remain high-probability scenarios.
- The deflationary factors mentioned would argue overall for a somewhat less restrictive monetary policy by central banks. They are at least dampening long-term interest rates, and an end to the cycle of increases is therefore on the horizon. For credibility reasons, however, the Fed and ECB will remain on a strongly restrictive course for the time being. This continues to be a burden on financial markets and the economy, which is also confirmed by the leading indicators.
- There is therefore still a tug-of-war between declining inflation dynamics, which allow an easing of monetary policy, and overly restrictive central banks, which tend to encourage a recession and monetary air holes. A glimmer of hope emerged a few days ago here when various Fed officials expressed concern about interest rates being raised too quickly.
- A temporary relief rally is therefore possible at any time in equity and credit markets. Market sentiment is extremely negative and many adverse factors are priced in. However, an official shift in monetary policy or clear positive surprises on the inflation front must first be forthcoming for a sustained turnaround. Long-term opportunities are becoming increasingly apparent, however. Nevertheless, we remain defensively positioned.

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Topics "on the radar"

Chart: There is a threat of liquidity shortages in the financial system



Balance Sheet Reduction

Source Alpine Macro / Fisch Asset Management

The chart schematically shows the non-linear relationship between the reduction of the Fed's balance sheet and the price of liquidity (= stress) in the financial system. The progression is based on the experiences of 2018 and 2019 with the reduction of the balance sheet at that time.

Fundamentally, a reduction in a central bank's balance sheet corresponds to the sale of government bonds (or other securities on the balance sheet) on the market, which leads to a withdrawal of liquidity: This is because the government bonds sold are paid for with cash, which flows back to the central bank in this process and is no longer available to markets.

A balance sheet reduction is also called quantitative tightening (QT) and is the reverse of liquidity injections via quantitative easing (QE), which has been carried out on an extreme scale by the Fed and other central banks for well over a decade.

It is easy to see in the chart that at the beginning of the balance sheet reduction (left part in the chart) there is initially no significant increase in market stress. The withdrawal of liquidity is still compensated for in this phase by private money creation in the banking system or a reduction in reserves. After a certain point, however, there is a rapid and strong (non-linear) surge in stress.

The recent increase in various stress indicators (e.g. NFCI in the US) is suggesting that due to the Fed's balance sheet reduction, which has been ongoing since April this year, the financial system is now approaching this critical phase. Entering this phase would significantly increase volatility in markets, but may also prompt the Fed to ease monetary policy.

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Summary of FischView model outputs

	US	Europe	Japan	Asia ex- Japan	LatAm	CEEMEA	Кеу:	
Equities	-	-	0	- ↓	+ ↑	0	++	Strong positive
Government Bonds	-		-				+	Positive
Credit IG	0	-		0	0	О	О	Neutral
Credit HY	- ↓	- ↓		0	+	0	-	Negative
Convertibles	-	- 1	-	- ↓				Strong negative
Commodities	Energy	О	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 segmentFinancials, energy5-10 year maturities	'BBB' rating segmentIndustrialsMaturities >10 years
Global Corporates	Financials, energyInvestment gradeDeveloped markets	IndustrialsHigh yieldEmerging markets
Global High Yield	Telecoms, energyBasic industry	RetailTechnology'CCC' rating segment
Emerging Markets - Defensive	Korea, Indonesia3-5 year maturities	Taiwan, MexicoMaturities >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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