

# » *Fisch View*

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## Monthly Update – December 2022

As at 1 December 2022

### Summary: Yield curves are inverting – recession signals

- The yield curves in the US and Europe are inverting more and more, sending increasing signals of recession. A "soft landing" of the economy is thus becoming less likely.
- Structural reasons, such as low debt ratios, solid labour markets and high consumption potential, however, point to only a mild recession. In any case, a further decline in corporate profits is on the horizon.
- The main driver of the economic slowdown is the persisting extremely restrictive global monetary policy with increasingly undesirable side effects, which are also evident in financial markets.
- Monetary policy is having an increasingly dampening effect on the development of inflation and indirectly reinforcing deflationary factors.
- Inflation expectations also remain low, giving central banks greater room for manoeuvre.
- A change in monetary policy is therefore becoming increasingly apparent for the first quarter of 2023. However, it will be too late to prevent a recession.
- In this environment, long-term government bond interest rates will decline again in the medium term. In the short term, however, a rise is still conceivable.
- There is still a lot of negativity priced into equity and credit markets. However, after the recent price rallies, the short-term risk/reward ratio has deteriorated again.

### Significant changes compared to the previous month

- The latest figures on consumer price inflation (CPI) in the US were a mildly positive surprise, although the current significant fall in real estate prices is continuing to make inflationary contributions to the statistics due to lag effects. The inflation trend in Europe is likely to follow the US in the coming months, as the recently lower energy prices will soon have an effect here.
- The trend towards a significant easing in inflation is additionally supported by a number of factors that are increasingly deflationary: The economy is weakening globally, money supply and commodity prices are falling, and rent and wage dynamics are also weakening.

As a result, an increasingly deflationary trend can also be deduced for the coming months worldwide.

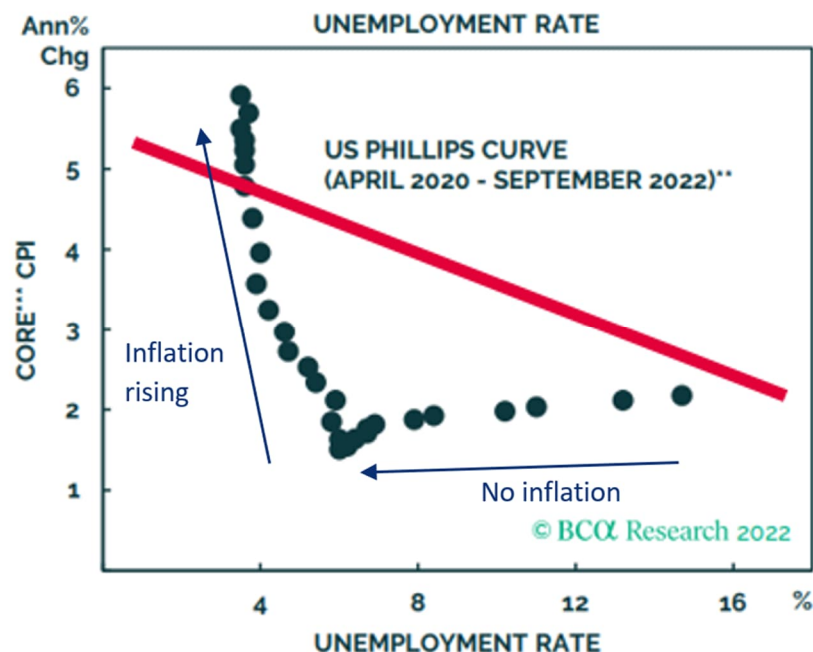
- In this environment, monetary policy remains too restrictive globally and is even being tightened further by various central banks. In addition, the reduction of the Fed's balance sheet continues at an increasing pace, leading to an ever greater withdrawal of liquidity from financial markets.
- Various reliable stress, liquidity and leading indicators (yield curves, labour markets, spreads in the US Treasury market, Conference Board LEI) have been sending warning signals for some time and recently with increasing intensity. Some of these indicators develop very sluggishly and change direction only slowly. In the short term, this makes a positive change of direction and a soft landing of the economy increasingly unlikely. The current development is thus becoming increasingly dangerous.
- The recent weakening of the US dollar, on the other hand, is having a positive effect on the global financial system. It reduces stress, especially in many emerging markets, and allows a somewhat more independent monetary policy outside the US again. The dollar's weakness was induced by hopes of a loosening of the monetary reins by the Fed in the near future due to the aforementioned lower consumer price inflation.

## Current situation and positioning

- For credibility reasons, monetary policy currently remains too restrictive and close to a so-called "policy mistake", despite deflationary factors. However, a shift in monetary policy is approaching, especially in the US, and possibly faster than officially communicated at present.
- Reasons for a monetary policy shift are positive surprises in the CPI figures, increasingly weaker labour markets with a simultaneously steep Phillips curve (see chapter Topics on the Radar) as well as the currently rapidly deteriorating economic and stress indicators. Furthermore, inflation expectations remain at a low level, which additionally favours a looser monetary policy once more.
- The change in monetary policy is conceivable for Q1 2023 in the US (and somewhat later also in the eurozone), but this is unlikely to be fast enough to prevent a recession. However, only a mild recession is to be expected at the moment, as the following structural factors are dampening recessionary forces: low household and corporate debt ratios, and weaker but still solid corporate profits and labour markets.
- In this environment, a significant decline in long-term interest rates can be expected in the medium term. Although another rise is possible in the short term, an initial extension of the interest rate duration in portfolios seems sensible. Long-term interest rates usually start to fall before the end of the monetary tightening cycle.
- Much negativity is priced into equity and credit markets. However, the recent rally has worsened the risk/reward ratio again. Moreover, the stress and liquidity indicators are a warning signal. In particular, the recent sharp drop in overnight reverse repo transactions points to a sharp decline in excess liquidity in the US. The risks therefore still clearly outweigh the opportunities at present and we consider a defensive positioning to be appropriate. However, as soon as the increasingly likely shift in monetary policy becomes concrete in the coming months, this will lead to considerable upside potential in the further course of the year.

## Topics “on the radar”

Chart: Phillips curve strongly kinked



Source: Alpine Macro / Fisch Asset Management

The so-called Phillips curve shows the relationship between unemployment and inflation. The historically normal course is represented by the red line in the graph: rising unemployment leads to linearly falling inflation rates (and vice versa). This means that for inflation to fall significantly, unemployment must also rise significantly.

Currently, however, the Phillips curve in the US is heavily bent (black dotted line). Accordingly, unemployment, which has fallen sharply in recent years for structural reasons, initially had no inflationary effect. Inflation even fell slightly.

However, there was a sudden regime change here in the past 12 months: unemployment, which continued to fall slightly, now suddenly led to a strong and rapid rise in inflation.

This leads to an interesting conclusion: in the coming weeks and months, even a small rise in US unemployment will be enough to dampen inflation significantly. That is, due to the currently very steep Phillips curve, a recession with high unemployment rates is not necessary to curb inflation.

And since the labour market in the US has already been weakening recently, a strong deflationary impulse can be expected here very soon. This would allow the Fed to loosen monetary policy again more quickly than previously expected. There is no need to wait for a major recession.

## Summary of *FischView* model outputs

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

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	<ul style="list-style-type: none"> <li>– CBs with positive yield</li> <li>– Stocks with strong secular trends (renewables, cyber security)</li> </ul>	<ul style="list-style-type: none"> <li>– Weak credit quality &amp; liquidity</li> <li>– REITS</li> </ul>
Global IG Corporates	<ul style="list-style-type: none"> <li>– 'A' rating segment</li> <li>– Financials, energy</li> <li>– 5-10 year maturities</li> </ul>	<ul style="list-style-type: none"> <li>– 'BBB' rating segment</li> <li>– Industrials</li> <li>– Maturities &gt;10 years</li> </ul>
Global Corporates	<ul style="list-style-type: none"> <li>– Financials, energy</li> <li>– Investment grade</li> <li>– Developed markets</li> </ul>	<ul style="list-style-type: none"> <li>– Industrials</li> <li>– High yield</li> <li>– Emerging markets</li> </ul>
Global High Yield	<ul style="list-style-type: none"> <li>– Telecoms, energy</li> <li>– Basic industry</li> </ul>	<ul style="list-style-type: none"> <li>– Retail</li> <li>– Technology</li> <li>– 'CCC' rating segment</li> </ul>
Emerging Markets - Defensive	<ul style="list-style-type: none"> <li>– Korea, Indonesia</li> <li>– 3-5 year maturities</li> </ul>	<ul style="list-style-type: none"> <li>– Thailand, Mexico</li> <li>– Maturities &gt;10 years</li> </ul>
Emerging Markets - Dynamic / Opportunistic	<ul style="list-style-type: none"> <li>– High yield commodities</li> <li>– LatAm</li> </ul>	<ul style="list-style-type: none"> <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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