

# » *Fisch View*

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## Monthly Update – January 2023

As at 4 January 2023

### Summary: Unprecedented tightening of ECB monetary policy

- At present, historically unprecedented restrictive monetary policies can be observed not only in the US, but worldwide. The number of interest rate hikes and other central bank measures to restrict liquidity is at a record high.
- In December, the ECB stood out in this regard, reducing its balance sheet by an enormous 492 billion euros.
- The restrictive monetary policy is already having a global impact: many economic indicators are now at recession levels, yield curves are inverting more and more, property prices and money supply appear to be falling at accelerated rates.
- The positive news is that inflation has begun to fall, although expectations over the future trajectory are not yet definitive. Inflation expectations currently remain at low levels, despite a small increase.
- Nevertheless, the economy and inflation are currently not slowing down fast enough to allow for the rapid and comprehensive monetary policy change that many had hoped for. However, we expect the first slight easing steps to be taken from the end of the first quarter onwards.
- The high number of analysts who expect a recession is striking. This poses the risk of a self-fulfilling prophecy, which could lead to an increased propensity to save among consumers and further increase the risk of an economic slowdown in the medium term.

### Significant changes compared to the previous month

- Together with the almost 500 billion euros in December, the ECB has reduced its balance sheet by a total of 850 billion euros since September (see also "Topics on the Radar"). This is an unprecedented withdrawal of liquidity, which is likely to have a negative impact on financial markets and also reduces global financial market liquidity. The ECB is thus currently more restrictive than the Fed, which reduced its balance sheet by a further 40 billion US dollars in December.
- This extremely restrictive global monetary policy is leading to increasingly strong recession signals. In particular, the important leading indicators of the US Conference Board for the US and Europe as well as China and Japan have meanwhile fallen to

recession level. These signals are confirmed by strongly inverted global yield curves and the decline in freight volumes in the US (measured by the ATA Truck Tonnage Index).

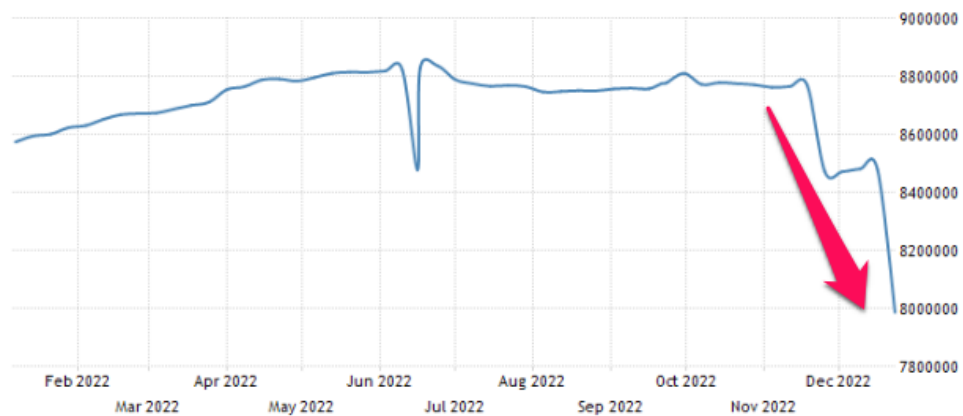
- Conversely, the easing of inflation dynamics worldwide is positive. However, inflation expectations have recently increased again slightly to re-enter the 2.75% range. This is still very low, but is likely to delay the decline in long-term interest rates as well as a change in monetary policy. The Fed has even rejected interest rate cuts until the end of 2023.
- Moreover, the economy and the labour market are currently weakening, but for the time being still too slowly to allow a rapid and comprehensive change in monetary policy. However, initial easing steps at the end of the first quarter are still possible. However, this is probably too late to prevent a recession. The current broad-based recession expectations could also lead to a self-fulfilling prophecy and lower consumer confidence.

### Current situation and positioning

- Due to positive structural reasons (low consumer debt, solid labour markets), there should only be a mild recession, despite increasing signs of economic malaise.
- However, this will also tend to delay the decline in inflation and reduce the downward potential for long-term interest rates. However, the restrictive and thus strongly deflationary monetary policy also prevents a further rise in interest rates at the long end. Overall, rates are therefore likely to remain in a relatively narrow range for the time being until the recession signals continue to strengthen significantly.
- Nevertheless, this mixture of economic slowdown and, at the same time, increasingly restrictive monetary policy remains problematic for financial markets. Interestingly, the resulting dangers have been partially ignored by markets so far, despite slightly falling prices.
- An acceleration of the negative economic trend due to feedback loops with negative consumer sentiment cannot be ruled out and is not yet priced in.
- However, since investor sentiment is not euphoric and fears of recession are currently very high, as mentioned above, further downside potential for equity and credit markets is likely to be limited. A part of the possible negative developments is currently already priced in and market technicals are therefore neutral to even slightly positive. Nevertheless, the risk/reward ratio remains clearly asymmetrical and the risks predominate.
- We are therefore maintaining our defensive positioning in equities and high-yield corporate bonds as long as there are no signs of monetary easing by the central banks. Investment-grade bonds as well as government bonds, on the other hand, offer initial buying opportunities due to the increasing potential for interest rate cuts in the medium term. This also applies to emerging market bonds due to the currently favourable valuations and a weakening US dollar.
- The US dollar remains clearly overvalued in terms of its purchasing power parity (PPP). Moreover, monetary policy outside the US is increasingly being tightened, which means additional headwinds for the US dollar.

## Topics “on the radar”

**Chart: The ECB sharply reduced its balance sheet in December**



Source: Trading Economics

As mentioned, the ECB reduced its balance sheet by 492 billion euros in December. This was a continuation of the balance sheet reduction that began last July and has since totalled 850 billion euros. Thus, the ECB has so far reduced its balance sheet by more than double that of the Fed.

This is the repayment of TLTRO-III loans by the European banking system. The extremely cheap TLTRO-III loans were issued by the ECB to banks in recent years with the aim of boosting lending to companies in the eurozone. Despite the official announcement of a gradual withdrawal of these loans as early as last September, the extent and speed is surprising. There is probably a hint of panic in the ECB's leadership because of the current high inflation rates.

The banking system is thus losing enormous amounts of liquidity and, indirectly, money that could be invested in the equity and bond markets. It is possible that the effect of this TLTRO-III reduction has a less direct and strong impact than in the case of sales of government bonds and other securities. Nevertheless, a potential threat to financial markets and the overall liquidity supply arises here. Moreover, the government bond sales start at the end of March.

The effect is likely to be felt globally in the medium term due to the closely linked international stock markets. Interestingly, the majority of financial markets, especially in Europe, have so far ignored this tightening of monetary policy by the ECB. However, this could lead to negative surprises in the foreseeable future.

## Summary of *FischView* model outputs

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

Commodities	Energy	-	PrecMet	o ↑	InduMet	-
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**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
<b>Convertible Bonds</b>	<ul style="list-style-type: none"> <li>– CBs with positive yield</li> <li>– Stocks with strong secular trends (renewables, cyber security, healthcare)</li> </ul>	<ul style="list-style-type: none"> <li>– Weak credit quality &amp; liquidity</li> <li>– REITS</li> </ul>
<b>Global IG Corporates</b>	<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>
<b>Global Corporates</b>	<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>
<b>Global High Yield</b>	<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>
<b>Emerging Markets - Defensive</b>	<ul style="list-style-type: none"> <li>– Korea, Malaysia</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>
<b>Emerging Markets - Dynamic / Opportunistic</b>	<ul style="list-style-type: none"> <li>– High yield energy</li> <li>– LatAm, India, Indonesia</li> <li>– Gold miners</li> </ul>	<ul style="list-style-type: none"> <li>– Deeper credit B/CCC segment</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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