

» *Fisch View*

Monthly Update – February 2023

As at 31 January 2023

Summary: Tensions are increasing

- Central banks remain on a highly restrictive course for the time being. Therefore, global money supply and liquidity continue to decline rapidly.
- At the same time, economic indicators, real estate markets and corporate earnings momentum also continue to weaken.
- However, equity and credit markets currently seem to be ignoring this dangerous combination of simultaneously lower growth and tight monetary policy.
- As a result, increasing tension is building up, which could unwind in the medium term amid high market volatility.
- The slowdown in economic activity and inflation is currently still happening too gradually to allow for a rapid easing of monetary policy. Central banks are thus prepared to accept both a recession and another substantial market correction.
- Overall, we therefore continue to see an asymmetrical risk/reward ratio in financial markets. The risks still predominate in the medium term.
- However, as mentioned above, investors are attributing more weight to positive news than to negative news in the short term, which means that we are currently seeing positive market technicals. However, this does not seem sustainable to us and can change quickly.

Significant changes compared to the previous month

- M1 and M2 money supply growth, which is important for the development of inflation and for financial markets, continues to fall rapidly on a global scale. In the US as well as in the eurozone, there is currently even a significant absolute decline, which has historically been extremely rare. These money supplies are not directly controlled by the central banks, but are an indirect consequence of monetary policy. A decline in the money supply is therefore always a sign of highly effective central bank policy, and thus also a warning signal for financial markets.
- Moreover, the monetary tightening (interest rate hikes and balance sheet reductions) of the central banks continues with unabated vigour. The Bank of Korea raised its key interest rate again at the end of January and now believes that a recession could have begun in the fourth quarter of last year. And in Japan, too, various signs point to an

imminent change in the still very loose monetary policy. Such a decision would also have consequences for global liquidity.

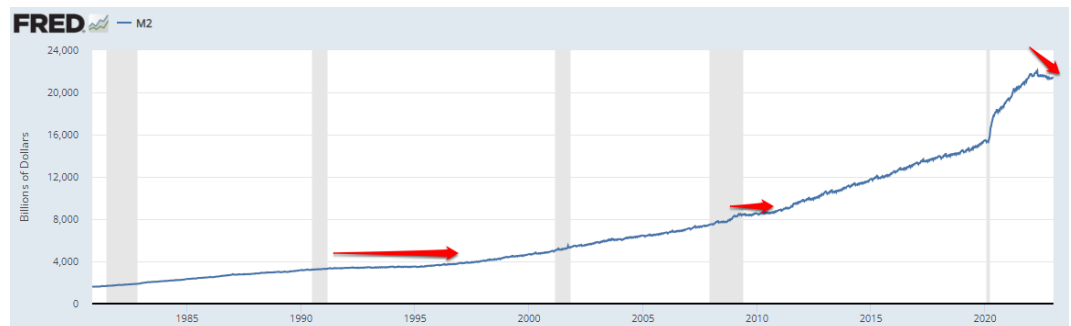
- Conversely, a further steady decline in inflation rates worldwide is a positive factor, both for consumer prices (CPI) and producer prices (PPI). The easing comes on the one hand from the demand side (economic activity) and on the other hand from the supply side (diminishing supply chain problems).
- The decline in inflation as well as in economic momentum is steady, but still too slow to allow for a quick change in monetary policy. Central banks do not want to lose control and are willing to accept a recession and increased market volatility if necessary.
- This creates an increasingly strong divergence between weakening fundamentals and, in overall terms an overly restrictive monetary policy. However, this divergence is currently being ignored by markets. Investor sentiment has brightened considerably and potential dangers are being disregarded.

Current situation and positioning

- In our view, monetary policy will remain too restrictive globally for the foreseeable future, despite cooling economic activity and inflation. An easing is not expected until the second half of the year at the earliest, and thus probably too late to prevent a recession and higher market volatility in time. However, the majority of investors are currently ignoring this, as markets continue to rise.
- Therefore, an imbalance is building up in equity and credit markets between valuations and expectations on the one hand and the supply of liquidity on the other. The development is similar to that of March to October 1987, when the imbalance was unwound abruptly by a severe temporary crash.
- However, a number of very positive factors are currently also at work, which clearly limit the overall correction potential and should provide prospective upward potential in the second half of the year: Inflation expectations are stabilising at a low level. Accordingly, central banks still have the situation completely under control in this regard, which is an important prerequisite for an easing of monetary policy in the future. In addition, the steady decline in inflation is brightening consumer sentiment, which is easing recessionary pressures. At the same time, this latest inflation episode is devaluing real government and consumer debt.
- Moreover, the situation cannot be compared to the inflation environment in the 1970s. Back then, in contrast to today, monetary policy was far too expansionary for a long time, which led to several strong waves of inflation. These then had to be fought with record high interest rates and a severe recession. Today, on the other hand, a large part of the interest rate increases are already behind us, and the economy is still growing slightly.
- All in all, the risks in financial markets dominate in the short term. There is a threat of a market technical and monetary policy induced temporary correction with limited loss potential. We are therefore positioning ourselves cautiously in equities, convertible bonds and the high-yield segment. In the medium term, the sum of the above-mentioned factors will lead to a much more promising environment for financial markets again, and a somewhat looser monetary policy is also approaching.
- Long-term government bonds in US dollars and euros and selected corporate bonds in the investment grade segment as well as in emerging markets already offer initial buying opportunities in this environment, as the further potential for interest rate increases is limited.

Topics “on the radar”

Chart: M2 money supply in the US is falling – a warning signal for financial markets



Source Federal Reserve Bank of St. Louis

In the US, the M2 money supply, which is decisive for the development of inflation, has been falling at an increasing rate on an absolute basis since the beginning of last year. This is historically extremely rare. Since the Great Depression in the 1930s, there has been zero growth in this monetary aggregate at times, but never an absolute decline on the current scale. The chart shows the development since 1980 with two phases (horizontal arrows) of only very small money supply growth.

The M2 money supply (as well as M1 and M3) is not directly controlled by the central bank, but is an indirect consequence of monetary policy on the one hand and money creation in the private banking system on the other. Accordingly, these money supplies are a meaningful indicator of the effectiveness of central bank policy. The currently very strong decline therefore proves the effectiveness of the Fed's restrictive monetary policy.

The growth of the M2 money supply is an extremely reliable indicator of future inflation trends (with a time lag of six to twelve months), but it also correlates strongly with stock markets. Accordingly, the significant decline in inflation rates and the correction of the US stock market last year are not surprising. The development of the money supply is fundamentally a measure of the liquidity available for the purchase of goods, real estate and stocks.

As the current decline in M2 continues and equity markets and investor sentiment have been positive since the beginning of the year, a potentially dangerous divergence is building up. The situation is reminiscent of a similar development in 1987 with the then historic stock market crash in October ("Black Monday"). Then, as now, it was a purely monetary problem. Fundamental factors (inflation trend, economy, consumer debt), on the other hand, are positive or at least solid. A sharp increase in volatility, if any, can therefore be quickly and effectively dampened by easing monetary policy and injecting liquidity. It therefore does not look like the Fed will lose control.

Summary of *FischView* model outputs

	US	Europe	Japan	Asia ex-Japan	LatAm	CEEMEA	Key:
Equities	-	-	o	o	o	o	++ Strong positive
Government Bonds	o ↑	-	o ↑				+ Positive
Credit IG	o ↑	+ ↑		o	o	o	o Neutral
Credit HY	-	o ↑		o	o	o	- Negative
Convertibles	-	-	o ↑	+			-- Strong negative
Commodities	Energy	-	PrecMet	o	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"> – CBs with positive yield – Stocks with strong secular trends (renewables, healthcare) – China reopening beneficiaries 	<ul style="list-style-type: none"> – Weak credit quality & liquidity – REITS – Semiconductors
Global IG Corporates	<ul style="list-style-type: none"> – 'A' rating segment – Financials, energy – 5-10 year maturities 	<ul style="list-style-type: none"> – 'BBB' rating segment – Industrials – Maturities >10 years
Global Corporates	<ul style="list-style-type: none"> – Financials, energy – Investment grade – Developed markets 	<ul style="list-style-type: none"> – Industrials – High yield – Emerging markets
Global High Yield	<ul style="list-style-type: none"> – Telecoms, energy – Basic industry 	<ul style="list-style-type: none"> – Retail – Technology – 'CCC' rating segment
Emerging Markets - Defensive	<ul style="list-style-type: none"> – Korea, Malaysia – 3-5 year maturities 	<ul style="list-style-type: none"> – Thailand, Mexico – Maturities >10 years
Emerging Markets - Dynamic / Opportunistic	<ul style="list-style-type: none"> – High yield energy & gold miners – 3-5 maturity IG credits – Latam esp. Mexico, Indonesia 	<ul style="list-style-type: none"> – Deeper credit B/CCC segment

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.

Disclaimer

This documentation is intended for professional investors only. The information and opinions contained in this publication are for information purposes only and do not constitute a solicitation, recommendation, an offer to buy or sell investment instruments or other services, or engage in any other kind of transaction. It is not directed to persons in any jurisdiction where the provision of such information would violate local laws and regulation. No liability shall be accepted for the accuracy and completeness of the information. Any opinions and views reflect the current judgment of the authors and may change without notice. PAST PERFORMANCE IS NOT A RELIABLE INDICATOR OF FUTURE RESULTS OR CURRENT OR FUTURE TRENDS. There is no guarantee that forecasts will be realised. Unless otherwise stated, text, images and layout of this publication are the exclusive property of Fisch Asset Management AG and/or its related, affiliated and subsidiary companies. Fisch Asset Management AG has not independently verified the information from other sources and Fisch Asset Management AG gives no assurance, expressed or implied, as to whether such information is accurate, true or complete.

Fisch Asset Management AG accepts no liability for damages arising directly or indirectly as a result of this document.

© Fisch Asset Management 2023