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»FischView

Monthly Update – March 2023

As at 28 February 2023

Summary: “Anti-Goldilocks” environment

— **For some time now, financial markets have been behaving as if they were in a "Goldilocks environment": They are pricing in moderate economic growth, rapidly falling inflation and an imminent easing of monetary policy.**

— **Yet, exactly the opposite is the case: recession signals are accumulating, inflation remains stubbornly high and monetary policy is extremely restrictive.**

— **The tightening of monetary policy so far has been partially compensated by money creation in the private banking system and liquidity injections by the US Treasury.**

— **However, this compensation is now receding. The tightening of monetary policy is therefore soon likely to have a much stronger impact, with corresponding dangers for the economy and equity markets.**

— **A falling silver/gold ratio and increasingly weakening housing markets point to an economic slowdown and decreasing inflationary pressure. However, this development is moving too slowly for prompt monetary policy easing.**

— **Overall, risks continue to predominate in the equity and high yield markets. Conversely, government bonds and investment grade corporate bonds are benefiting from the moderating upward pressure on interest rates.**

Significant changes compared to the previous month

— The restrictive monetary policy of recent months has been offset by a number of liquidity-enhancing effects in the private banking and credit system: Money creation through credit growth, reduction of excess reserves and, in the US, a reduction of the Treasury General Account (TGA) at the Fed. This explains the very moderate impact of tight monetary policy on equity markets and the economy so far, along with the recent decline in stress signals from the NFCI Stress Index.

— However, these factors have started to weaken globally. Bank reserves, reverse repo volumes and bank deposits are all falling. The TGA balance is also now low and can no longer fully compensate for the balance sheet reduction of the Fed and other central banks. Therefore, the restrictive monetary policy can be expected to make a much stronger impact in the foreseeable future.

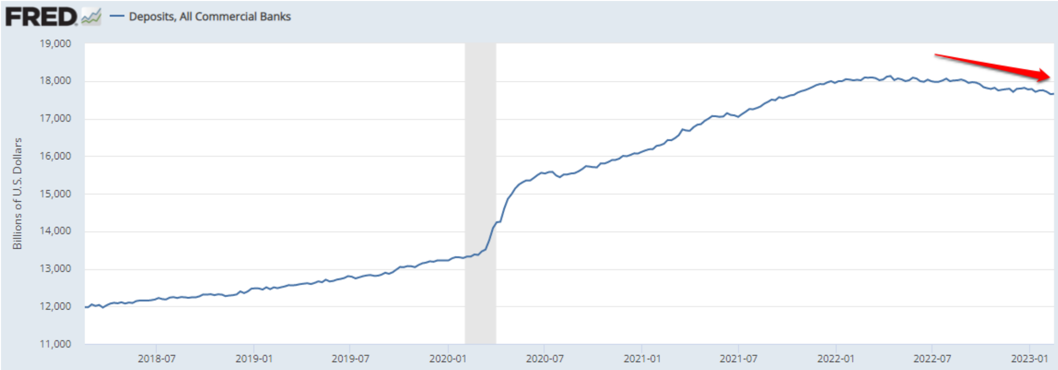
- Also noticeable is the renewed, albeit slight, rise in inflation expectations, both on a one-year and five-year horizon, which is being closely watched by the central banks. This is potentially dangerous, as it means that policymakers will stick to their restrictive course for longer.
- Long-term government bond yields in the US and the eurozone are rising moderately again in response to the aforementioned higher inflation expectations. In contrast, the weakening signals of various economic indicators and the very weak housing market are being ignored. Accordingly, at least for the moment, the normally effective stabilisation of the economy through lower interest rates is not taking place. All in all, this results in a problematic combination of rising interest rates, also at the long end of the curve, and a a simultaneous weakening economy.
- Recently, silver, which is sensitive to economic activity, has been performing relatively weaker than gold. This confirms the recession signals of the important "Conference Board Leading Economic Indicators" for the US, Europe and Asia. However, the deceleration is currently still happening too slowly and inflation is too stubborn to allow for a prompt easing of monetary policy.

Current situation and positioning

- In a classic Goldilocks environment, there is a combination of weak but positive economic growth, low inflation and therefore loose monetary policy. This is extremely positive for equity and credit markets, and interest rates are only rising moderately.
- Surprisingly, financial markets have been behaving in Goldilocks-like fashion since the beginning of the year, even though, as mentioned, the current environment is exactly the opposite of Goldilocks: recession signals are accumulating, inflation is stubborn, inflation expectations are rising and monetary policy is historically restrictive. Thus, the tension between fundamental realities and market valuations continues to grow. The aforementioned compensating factors in liquidity generation in the private banking system probably account for market resilience.
- As soon as these factors expire, there is a risk of a renewed impact of monetary policy as well as non-linear feedback loops between economic development, stock markets and rapidly declining liquidity. The persistence of very confident market sentiment could then quickly change, leading to high volatility.
- Corporate profit margins have historically declined in the face of falling inflation. This is due to a combination of stagnating sales prices and high labour costs. Accordingly, lower inflation is paradoxically negative for companies in the coming months. This is another warning signal for equity and credit markets, and we believe a defensive positioning remains appropriate.
- For long-term government bond yields, on the one hand, the strongly deflationary monetary policy and the cooling economy are having a dampening effect on interest rates in both the US and Europe. On the other hand, rising inflation expectations and the central banks' sales of government bonds (QT) have an interest rate-increasing effect. Overall, this results in a neutral environment.
- Furthermore, the current yield level on risk-free government bonds with short to medium maturities in the US of around 5% and Europe of around 3% represents increasing competition for risky investments. The attractiveness of risky investments is therefore decreasing relative to government bonds, which should lead to corresponding asset allocation shifts.

Topics "on the radar"

Chart: Money creation in the US banking system starting to fall – deposits are declining



Source Federal Reserve Bank of St. Louis

The chart above shows a decline in customer bank deposits in the US banking system. This is a consequence of the Fed's restrictive monetary policy: The higher interest rates on short-term government bonds and money market securities lead to a reallocation of customer funds. Bank deposits are being invested into securities with higher yields.

This outflow of customer deposits makes it more difficult for banks to lend and corresponds more generally to reduced money creation by the private banking system and reduced liquidity in the financial markets. There has been no comparable decline in bank deposits for more than 50 years, not even during the financial crisis of 2008/2009.

Other important sources of liquidity (bank reserves at the central bank, TGA, reverse repo investments) are also drying up more and more. Therefore, the money and liquidity creation of the private banking system is less and less able to compensate for the Fed's restrictive monetary policy and balance sheet reduction. Monetary policy is accordingly becoming more effective than in previous months, and is therefore likely to have an increasingly dampening effect on both economic activity and on equity and credit markets. In addition, there may be self-reinforcing feedback effects, and thus an accelerated reduction in liquidity.

The probability of a short-term correction on the stock and credit markets is therefore increasing significantly, but should remain limited for the time being, at least in terms of downward potential. The extremely restrictive monetary policy also has a positive side and will significantly lower inflation in the foreseeable future. This keeps central banks in control (in stark contrast to the 1970s with its escalating inflationary spiral), and it allows for quick, stabilising intervention in the event of overly strong market dislocations.

Summary of *FischView* model outputs

	US	Europe	Japan	Asia ex-Japan	LatAm	CEEMEA
Equities	-- ↓	-	o	+ ↑	o	o
Government Bonds	o	-	- ↓			
Credit IG	o	o ↓		o	o	o
Credit HY	-	- ↓		o	o	o
Convertibles	-	o ↑	- ↓	o ↓		
Commodities	Energy	-	PrecMet	- ↓	InduMet	-- ↓

Key:

++	Strong positive
+	Positive
o	Neutral
-	Negative
--	Strong negative

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	– CBs with positive yield – Stocks with strong secular trends (renewables, healthcare) – China reopening beneficiaries	– Weak credit quality & liquidity – REITS – Semiconductors
Global IG Corporates	– 'A' rating segment – Financials, energy – 5-10 year maturities	– 'BBB' rating segment – Technology, real estate – Maturities >10 years
Global Corporates	– Financials, energy – Investment grade – Developed markets	– Real estate, transport – High yield – Emerging markets
Global High Yield	– Telecoms, energy – Basic industry	– Retail – Technology – 'CCC' rating segment
Emerging Markets - Defensive	– Korea, Indonesia, Malaysia – 'A' rating segment	– Chile, Mexico – 'BBB' rating segment
Emerging Markets - Dynamic / Opportunistic	– High yield energy, gold miners – 3-5 maturity IG credits – LatAm esp. Mexico, Indonesia	– 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.

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