

» *Fisch View*

Monthly Update – April 2023

As at 28 March 2023

Summary: Central banks are walking a monetary policy tightrope

- The US banking system is currently experiencing massive liquidity stress, which is progressively spreading globally. Markets are increasingly questioning the stability of the system.
- However, the main reason for the turmoil is the excessively restrictive monetary policy, rather than the robustness of bank balance sheets.
- The banking crisis is leading to sharply declining private money creation, and thus reinforcing the negative effect of the restrictive central bank policy.
- There is a threat of a downward spiral with mutually reinforcing negative feedback on the supply of liquidity and the economy.
- The Fed and the ECB are forced to continue their restrictive monetary policy despite the banking crisis owing to persistently high inflation.
- The enormous amounts of emergency liquidity are helping in the short term, but this is also leading to rising inflation expectations.
- The central banks' room for manoeuvre is thus decreasing. The risks prevailing on financial markets continue to outweigh the benefits. A liquidity-driven interim rally is possible.

Significant changes compared to the previous month

- Despite rapid, comprehensive and effective stabilisation measures by the central banks in the case of the ailing Silicon Valley Bank and Credit Suisse, the current crises of confidence and liquidity are spreading to other banks. For example, various US regional banks, but also individual banks in Europe, are coming under increasing pressure.
- The reason for the banking crisis and the general liquidity stress is the commitment to extremely restrictive global monetary policy. In contrast, the majority of banks' balance sheets and their capital resources are extremely solid. The situation here is in no way comparable to the financial crisis of 2008. Nevertheless, a liquidity shortage induced by monetary policy may at any time lead to a "bank run", and thus rapid deposit outflows, even at healthy financial institutions. The risk of contagion affecting the entire system is considerable.

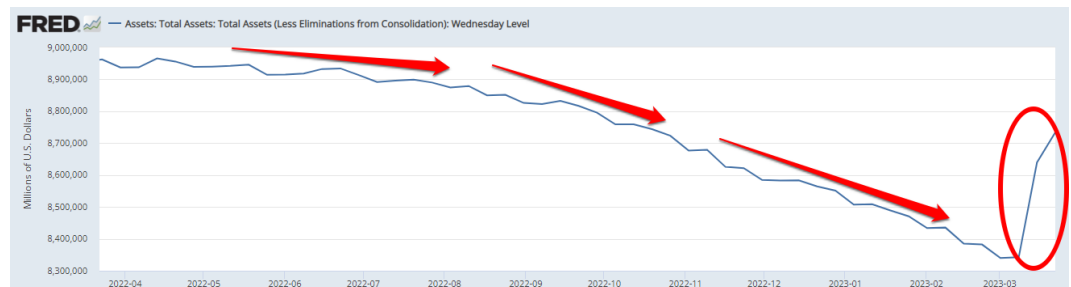
- In this environment, there is also the danger of an accelerated liquidity crisis due to feedback loops: The outflow of funds at the banks leads to a decline in lending, and thus to an additional drop in liquidity as well as a dampening of the economy. Central banks cannot directly influence this destruction of private money supply, which makes the situation potentially dangerous.
- So far, central banks have successfully stabilised the system with massive emergency liquidity and prevented feedback and a further spread of the crisis. However, this simultaneously stimulates economic growth, inflationary pressures and especially inflation expectations. This results in an extremely difficult balancing act for monetary policy. As a result, the stability of the system and the value of money is increasingly being called into question, which is also indicated by significantly rising gold and bitcoin prices.

Current situation and positioning

- Various important leading economic indicators (Conference Board Economic Leading Indicators, yield curves) have already weakened significantly for some time and are likely to fall even further soon owing to the current banking crisis. The US labour market is also showing the first signs of weakness. This is also likely to accelerate the so far relatively moderate decline in inflation.
- Nevertheless, the current pace of cooling is still too slow to allow monetary policy easing, let alone interest rate cuts. In particular, as already mentioned, central banks' emergency liquidity has an inflationary and economically supportive effect here, which paradoxically further delays monetary easing.
- Thus, the restrictive monetary policy is likely to lead to a further decline in the money supply, with a simultaneous decline in private money creation. And as soon as the banking system has stabilised significantly, emergency liquidity and central bank balance sheets will also be reduced again (see also "Topics on the radar").
- Thus, a difficult combination of cooling economic momentum and declining corporate profits, combined with restrictive monetary policy and decreasing liquidity, continues to prevail for equity and credit markets. The risks thus outweigh the opportunities. However, there is no 'quick rescue' in sight, as central banks' room for manoeuvre is severely limited. In addition, a loosening of monetary policy in the near future is currently priced in, which can also lead to disappointment.
- In this environment, there is only very moderate upward pressure on long-term government bond yields, as the deflationary monetary policy, the danger of a renewed flare-up of the banking crisis and a weaker economy dampen any rise in interest rates and may even lead to lower rates again in the medium term via a flight to quality.
- We therefore remain cautious on convertible bonds, equities and high-yield bonds from developed countries. A short-term interim rally, on the other hand, is very possible due to the now very pessimistic investor sentiment and the central banks' injection of emergency liquidity.
- In the investment grade segment and also in emerging markets, the environment is, in contrast, slightly friendlier due to the economic stabilisation in China and the limited potential for interest rate increases at the long end of yield curves.

Topics “on the radar”

Chart: Plenty of emergency liquidity to contain the banking crisis



Source: Federal Reserve Bank of St. Louis

The Fed has had to interrupt the ongoing reduction of its balance sheet that it had initiated in April 2022 (to normalise the very loose monetary policy prevailing at the time) due to the collapse of Silicon Valley Bank (SVB) and the subsequently rapidly spreading banking crisis. In the process, more than half of the previously reduced money was injected back into the banking system as on-balance sheet emergency liquidity. It is very likely that the reduction of the Fed's balance sheet was the real reason for the liquidity stress in the system.

However, it should be noted that the Fed's sale of US government bonds, and thus quantitative tightening (QT), continues unabated. The resulting continuous balance sheet reduction of USD 95 billion per month is now only temporarily eclipsed by the purchase of short-term securities as a liquidity injection.

As soon as the banking system sustainably stabilises once more, this emergency liquidity will be withdrawn from the system once more, thus further reducing the balance sheet as planned. And here is the Fed's real dilemma: the balance sheet reduction is necessary to keep inflation, and especially inflation expectations, under control. At the same time, however, the associated withdrawal of liquidity leads to massive problems in the global banking system. Therefore, both monetary easing and continued tightening can lead to unwanted market reactions.

The recent sharp rises in the price of gold and bitcoin are therefore an indication of declining confidence in systemic and monetary stability due to excessive emergency liquidity. Conversely, the banking crisis itself is a signal of too little liquidity. This is why the Fed (and other central banks) are walking an extremely fine monetary tightrope.

Summary of *FischView* model outputs

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

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 Retail
Global IG Corporates	<ul style="list-style-type: none"> Energy, healthcare 5-10 year maturities 	<ul style="list-style-type: none"> Financials, real estate Maturities >10 years
Global Corporates	<ul style="list-style-type: none"> Energy, healthcare Investment grade Developed markets 	<ul style="list-style-type: none"> Real estate, transport 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, Indonesia, Malaysia 'A' rating segment 	<ul style="list-style-type: none"> Taiwan, Mexcio 'BBB' rating segment
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.

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