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»FischView

July's topic: „Money supply in free fall"

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Money supply in free fall

- The current combination of a cooling global economy and restrictive monetary policy is dangerous for equity markets.
- Sharply falling money supply has historically been a reliable indicator of high volatility in financial markets.
- We remain cautious on equity and high yield credit exposure and neutral to slightly positive on investment grade bonds. Falling interest rates in the medium term dampen downward pressure.

Overall economic situation

The extremely restrictive global monetary policy is only now, with the usual delay of at least 12 months, beginning to have a significant impact on the economy and inflation. So far, there has only been a decline in manufacturing investment, but not yet in consumption and labour markets. This is likely to change soon.

Recent developments: Monetary policy has a delayed effect

- The recent development of money supply, bank lending and the reduction of central bank balance sheets point to an accelerated withdrawal of liquidity from the financial system in the US and Europe (and in some other regions). The current issuance of USD 1000 billion in US T-bills is draining additional liquidity from the market. Part of this will be financed by the reduction of banks' excess reserves at the Fed, thus reducing direct market influence. Nevertheless, a net liquidity-reducing influence remains on financial markets. At the same time, key interest rates continue to rise globally.
- The restrictive monetary policy and the falling money supply have historically always had an effect with a delay of at least 12 months. However, since the Fed's first rate hike took place in March 2022, markets have by now, if not slightly earlier, moved into the decisive window of effect.
- The very reliable "Conference Board Economic Leading Indicators" have weakened again globally and signal a recession in the fourth quarter of this year. The Cleveland Fed also calculates a recession probability of 80% for the US for the fourth quarter.
- Equity markets have seen massive covering of short positions in recent weeks. This has had a positive impact on markets and brightened sentiment. From a technical point of view, however, this has led to a deterioration. In addition, large technology companies in the US have continued to be the driving force behind broad market indices.

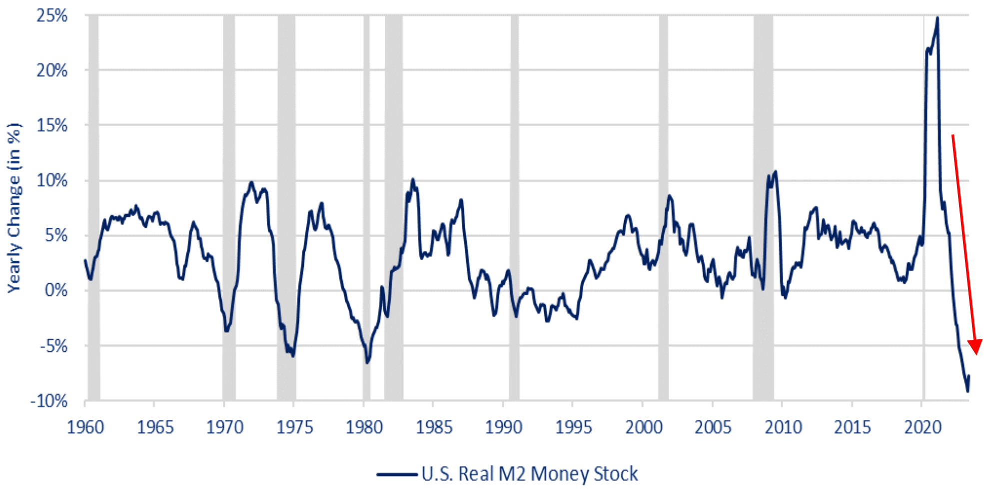
➲ **On the radar:** National debt becomes a problem (page 6)

Overview & outlook: We see no room for looser monetary policy

» We already see warning signals for equities and high yield.

- The US economy is currently still resilient. This is due to the delayed effect of restrictive monetary policy and a robust labour market, which supports consumption as a key driver of growth. Moreover, savings invested in money market funds generate high interest income, which additionally boosts consumption. In addition, the continuing high inflation allows companies to keep their sales prices, and thus profit margins, high. However, the aforementioned leading indicators and strongly inverted yield curves point to declining economic momentum in the near future. Moreover, the eurozone is already in a mild technical recession, while China is struggling with strong headwinds.
- The focus of financial markets is increasingly shifting from positive factors (robust labour markets, etc.) to negative factors (restrictive monetary policy, falling money supply, declining market breadth, high valuations and deteriorating market technicals). Thus, we are already seeing warning signals in equity and high yield credit markets.
- Inflation has peaked globally. Base effects, and lower energy and food prices will lead to a further decline of about one percentage point for the June inflation print. After that, however, a longer period of stagnation is to be expected because service prices are kept high by labour markets remaining strong. This puts upward pressure on core inflation rates in particular.
- Therefore, despite the economic slowdown, we still expect a restrictive monetary policy and thus a withdrawal of liquidity by central banks.
- The following chart shows the dramatic decline in the US M2 money supply and underlines the effect of the restrictive monetary policy. This is dampening both inflation and economic growth, and confirms the warning signals from other indicators for equity and credit markets. A similar situation can be observed in Europe.

Chart: Dramatic and historically unprecedented decline in US M2 money supply



Source Federal Reserve Bank of St. Louis, Fisch Asset Management

Positioning: Cautious on equities and high yield – Positive view on investment grade bonds

» In emerging markets, economic weakness could be countered with interest rate cuts.

- Due to the currently dangerous combination of a cooling economy and restrictive monetary policy, we are maintaining our defensive positioning in all our strategies with equity and high-yield exposure in the US and Europe. The current economic big picture is likely to put pressure on corporate earnings in the foreseeable future, and at the same time significantly restrict the refinancing options of debtors with lower credit ratings. This is likely to lead to a widening of credit spreads and also to downward pressure on equity markets. Moreover, a recession is currently not priced in by markets. In this environment, we consider it sensible to swap equity positions for convertible bonds to reduce risk.
- In Japan and the emerging markets, we assess the situation somewhat more positively overall. Japan still has an extremely loose monetary policy with a positive influence on the equity market. The emerging markets are already further advanced in the monetary tightening cycle. An economic slowdown could well be countered with interest rate cuts by the central banks. We are therefore positioning ourselves neutrally and taking advantage of various interesting opportunities in corporate bonds, especially in the investment grade segment.
- In the case of investment-grade corporate bonds, rising credit spreads are likely to be offset by falling long-term interest rates in the event of a recession. In addition, the market currently offers attractive interest rate carry, which leads to a positive total return expectation overall.
- Long-term government bonds are simultaneously influenced by positive (falling inflation, economic slowdown) and negative factors (restrictive monetary policy, high Treasury issuance volumes). We therefore take a neutral position on government bonds and duration.

	US	Europe	Japan	Asia ex-Japan	LatAm	CEEMEA
Equities	-	-	+	o	o	o
Government Bonds	o	o	o			
Credit IG	+	+		o	o	o
Credit HY	-	-		o	o	o
Convertibles	-	-	o			

	PrecMet	InduMet	Energy
Commodities	- ↓	-	-

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) – Defensive sectors (recession resilient) – Artificial intelligence related names	– Weak credit quality and/or liquidity – REITS
Global IG Corporates	– Energy, healthcare – 5-10 year maturities	– Real estate – Maturities >10 years
Global Corporates	– Energy, healthcare – 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	– Indonesia, Malaysia, Middle East, Mexico – Maturities <5 years	– LatAm, Taiwan, Brazil, Hong Kong – Maturities >10 years
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.

On the radar: National debt becomes a problem

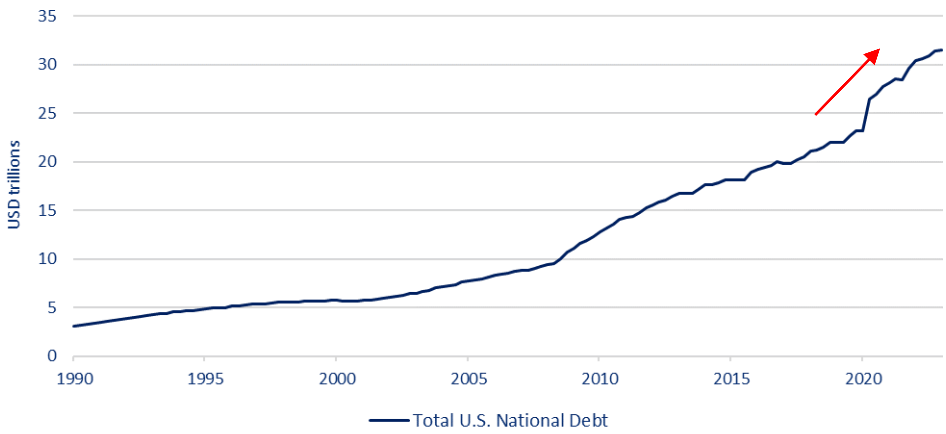
The national debt of the US has already increased enormously during the Covid-19 period due to the various aid programmes, as the chart below shows. After the lifting of the debt ceiling, however, we are now seeing a new wave of debt in the order of 1000 billion US dollars. This means that the total debt of the US has exceeded 32,000 billion (32 trillion). For comparison: after the financial crisis in 2010, the debt was only 12,000 billion.

» National debt explodes in the US and Europe

This enormous increase has so far been partly financed by the central bank and by the reduction of excess reserves of the private banking system, which has limited the negative market impact in the form of rising interest rates. This is now changing, because in the future several negative factors will accumulate: the Fed is selling government bonds as part of its balance sheet reduction (QT), the issuance of US Treasuries is increasing at an accelerated pace while tax revenues are declining, leading to an additional increase in government debt. And foreign investors are increasingly selling US government bonds in order to reduce their dependence on the dollar.

All in all, this could result in a calamitous shift in the supply and demand for US government bonds in just a few months, which could lead to upward pressure on long-term interest rates, an accelerated reduction in liquidity in the financial system and therefore severe turbulence in stock markets. Incidentally, government debt and the consequences for financial markets are developing in a very similar way in Europe.

Chart: US government debt growing unabatedly



Source Federal Reserve Bank of St. Louis, Fisch Asset Management

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