

» *Fisch View*

*November's topic:
„Credit crunch slows economy“*



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A substantial decline in credit growth

- Liquidity in the banking system in the US and Europe is decreasing and lending is falling fast. At the same time, interest costs are rising.
- This creates an additional headwind for the economy - on top of a prolonged slump in the manufacturing sector.
- We remain cautiously positioned in the equity and credit markets in this environment, but expect interest rates to rise only moderately with potential for lower rates again soon.

Overall economic situation

Rising interest rates on both money markets and long-term bonds are leading to an accelerated outflow of customer funds from banks, and thus to a decline in lending capacity. In addition to the weakness in demand in the manufacturing sector, which has persisted globally for some time, many companies are facing another negative factor: The credit machinery is starting to falter. At the same time, the previously very robust services sector in the US and Europe is beginning to weaken. This has the potential to put the brakes on both labour markets and the economy. Neither of these factors is yet fully priced into financial markets.

Recent developments: Banks fight for customer deposits

- Due to the elevated interest rates on money market investments and long-term government bonds, more and more bank customers in both the US and Europe are swapping their deposits into these alternatives, thereby withdrawing liquidity from the banking system. This is leading to sharply reduced lending and higher underwriting standards.
- Many banks are already losing money in the lending business and are forced to raise deposit rates to attract customer funds. In the US, regional banks are also suffering massive losses of sometimes more than 60 percent on huge government bond positions, further reducing liquidity. A new index developed by the Fed - the "Financial Conditions Impulse" - has already been in the highly restrictive range for some time, confirming the increasing refinancing problems at banks and companies.
- But interest costs are rising rapidly not only for companies, but also for governments and private households. This leads to reduced consumption potential and even lower liquidity in the system.

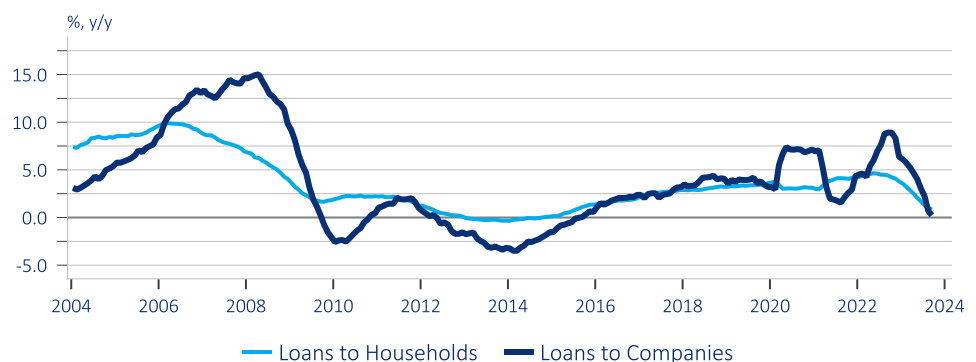
➡ **On the radar:** US reverse repo markets are drying up (page 6)

Overview & outlook: Pressure on the economy increases

» The Swedish Purchasing Managers' Index is a reliable leading indicator.

- The latest quarterly figures for US economic growth, which remain very strong at 4.9% (annualised) are based on exceptional factors, such as an enormous fiscal stimulus by the US government, the unwinding of high surplus savings and a delayed effect of the restrictive monetary policy. However, these factors are now diminishing rapidly. This is leading to an accumulation of dampening forces that should soon translate into significantly lower growth rates. The important Conference Board Economic Leading Indicator continues to fall sharply. Here, nine out of ten sub-indicators are currently negative.
- A slowdown in the US is likely to be felt worldwide. Europe is already close to recession. The Swedish Purchasing Managers' Index (PMI) for the manufacturing sector also confirms an economic slowdown. This index has historically been a good leading indicator for the global economy, due to Sweden's advance role in global supply chains.
- We also have concerns about negative feedback loops given continued tight monetary policy around the world and declining liquidity, falling money supply and bank lending. In addition, spreads of Italian government bonds over German Bunds have risen significantly recently, which is likely to become an additional monetary challenge for the ECB in the foreseeable future.
- At the same time, inflation remains stubborn in all segments (headline, core and services) in the US and Europe. Although the trend is pointing downwards, the decline is likely to slow in the coming months due to the disappearance of positive base effects. Although inflation expectations remain moderate, we do not see the possibility of a rapid easing of monetary policy.

Chart: In the eurozone, credit growth is weakening dangerously fast



Sources: ECB, Macrobond, Fisch Asset Management

Positioning: Caution with equities, but bonds offer opportunities

- Although global equity and corporate bond markets have weakened recently, a sharper slowdown in the economy and lower corporate earnings are in no way priced in. Moreover, markets expect the first interest rate cuts by central banks as early as the first half of next year.
- Overall, we continue to see a certain carefree attitude, which could lead to negative surprises at any time. Moreover, valuations are still relatively high for both equities and credit spreads. Therefore, we remain defensively positioned in our convertible bond strategies and focus on lower equity sensitivity (delta) and higher credit quality relative to the benchmark. In addition, we are concentrating on convex bonds with high asymmetry. In corporate bonds, we are also cautiously positioned in both the investment grade and high yield segments, with underweights in low credit quality.
- Due to the cooling global economy, moderate inflation expectations, strongly deflationary monetary policy and declining inflation rates, the interest rate cycle is likely to peak soon at both the short and long end of the yield curve. And in the event of a more severe recession, falling rates can even be expected again in the foreseeable future. However, the prevailing strong increase in government debt in the US could delay a rapid decline in long-term interest rates. This does not apply to Europe. In any case, less inverse (or even slightly steep) yield curves are to be expected.
- The overall advanced interest rate cycle therefore favours corporate bonds. The currently already attractive yields currently on offer provide a risk buffer.
- In the event of a recession with rising credit spreads, falling interest rates provide a certain amount of diversification. This diversification effect is particularly pronounced in the investment grade segment and in various emerging markets.

» The interest rate cycle has probably reached its peak.

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

Key:

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

	PrecMet	InduMet	Energy
Commodities	o ↑	-	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"> – Energy – CBs with high convexity – Short-dated solid CBs with YTM 2% above Swap rate 	<ul style="list-style-type: none"> – REITS – Consumer discretionary – Unprofitable and expensive technology – Weak credit quality and/or liquidity
Global IG Corporates	<ul style="list-style-type: none"> – Healthcare, energy – 5-10 year maturities 	<ul style="list-style-type: none"> – Real estate – Maturities >10 years
Global Corporates	<ul style="list-style-type: none"> – Healthcare, energy – 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"> – Capital goods, energy – Basic industry 	<ul style="list-style-type: none"> – Retail – Technology – ‘CCC’ rating segment
Emerging Markets - Defensive	<ul style="list-style-type: none"> – Indonesia, South Korea, Mexico – A-rated bonds – Maturities <5 year 	<ul style="list-style-type: none"> – China, Hong Kong, Brazil – BBB-rated bonds – Maturities >7 years
Emerging Markets - Dynamic / Opportunistic	<ul style="list-style-type: none"> – High yield energy, gold miners – LatAm (esp. Mexico and Colombia), 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.

On the radar: The reverse repo markets are drying up

We expect an increased decline in financial market liquidity in the coming months with potentially negative effects on stock markets, lending and government bond markets. The reason is the current sharp decline in "overnight reverse repurchase agreements" in the US banking system. These are funds of private banks and money market funds that are deposited with the central bank.

The following chart illustrates this development. During the pandemic, the Fed provided liquidity to the banking system on a historic scale, increasing the money supply to eliminate potential liquidity shortages. Banks then parked excess funds at the Fed using reverse repos.

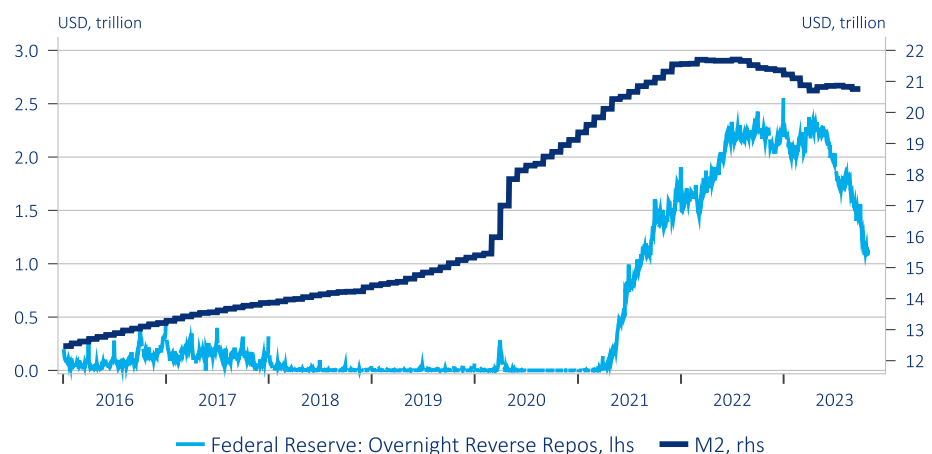
» The reverse repos are being activated in a monetary sense.

However, due to the sharp rise in money market interest rates in recent months, banks and money market funds are now starting to withdraw these funds from the Fed and exchange them for Treasury Bills or short-term notes with slightly higher interest rates. This in turn corresponds to a direct increase in the money supply. The reverse repos are currently being activated in a monetary sense. The decline in the M2 money supply has accordingly been stopped by the decrease in reverse repos since April this year, as can be seen in the chart. And the Fed's quantitative tightening (reduction of the balance sheet) is also partly compensated by the repo money flowing back into the financial system.

However, this source of liquidity will dry up completely within the next three to four months. This will make the restrictive monetary policy massively more effective, the money supply will fall again and an interest rate dampening effect on US government bonds will cease. Negative effects on equity markets are to be expected even before the reverse repos are completely wound down.

Since other central banks are also promoting a similar reduction in the money supply and the Bank of Japan is ending its yield curve control, there is a threat of dangerous global air holes in the supply of liquidity to financial markets in the foreseeable future.

Chart: „Overnight Reverse Repos“ at the Fed are falling sharply



Sources: Federal Reserve Bank of New York, Fed, Macrobond, Fisch Asset Management

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