FISCH » Asset Management

Bellerive 241 | P.O. Box
CH-8034 Zurich

info@fam.ch | www.fam.ch
P +41 44 284 24 24

» Fisch View

June's topic: „Global balancing forces“

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Beat Thoma
Chief Investment Officer

Krishna Tewari
Investment Strategist

Global balancing forces

– The current economic slowdown, despite the environment in the US remaining favourable, is unusual.
– In particular, the previously robust consumer spending is beginning to weaken, although the US labour market remains robust. Historically, the latter has always been the main driver of consumer behaviour.
– However, the development in the US is being offset by a stabilisation of the economy in Europe and China. We therefore remain neutral in terms of risk exposure and duration overall.

Overall economic situation

More and more indicators are confirming an incipient economic slowdown in the US. However, this slowdown is unusual as the main drivers of the economy to date are still positive: These include the high level of government spending and the abundant supply of liquidity. The labour market also remains solid for the time being. Nevertheless, retail sales and consumer sentiment are weakening. However, economic development in Europe, China and some other emerging markets has recently stabilised, at least partially offsetting developments in the US.

Recent developments: Liquidity supply at risk

— The previously abundant supply of liquidity in the US financial system is likely to weaken significantly in the coming months. The main reason for this is the stagnating flow of capital from the overnight reverse repo facility (excess reserves of US banks and money market funds) into the US government bond markets. The flow of these funds, totalling USD 2,000 billion over the past 12 months or so, has clearly overcompensated for the Fed's restrictive monetary policy.
— Despite the ongoing flow of liquidity and continued more than ample US government spending (the most important pillar of the economy), the consumption of goods and services, is beginning to weaken. There is therefore a risk of a rapid slowdown in the US economy, which is already based on an unbalanced, purely consumption-driven foundation.
— However, the economies in Europe and China are stabilising, while inflationary pressure is decreasing. At the global level, the economic environment therefore still appears balanced overall.

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Overview & outlook: Effect of the stimuli becomes weaker

» Consumption is the mainstay of the US economy.

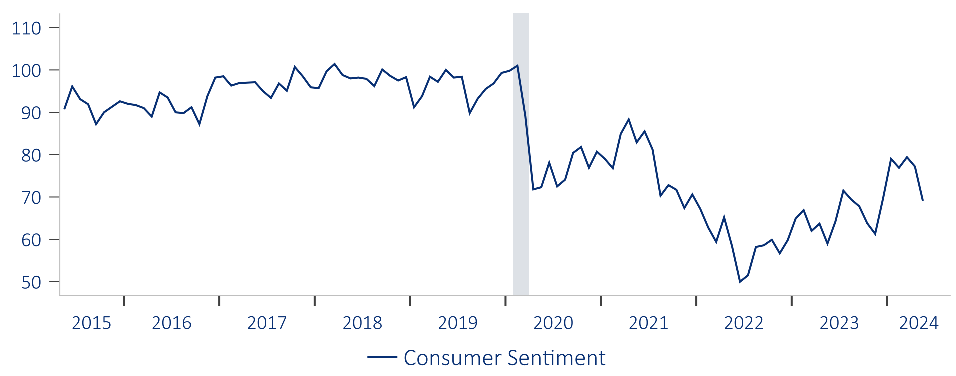
— Historically, the consumption of goods and services in the US has only weakened after a significant slowdown in the labour market and the economy. And the labour market, for its part, has always reacted negatively to rising interest rates, restrictive monetary policy and falling money supply with a certain time lag. At present, this sequence seems to be unusually reversed. Consumption is slowing, while the US economy is being kept going by high government spending and the abundant liquidity that is still circulating in the system. The US consumer therefore appears to be responding less and less to the various monetary and government stimuli.

— We are, in the prevailing scenario, monitoring this development closely, as the consumption of goods and services is the only, albeit robust, pillar of the US economy. Conversely, the manufacturing industry, and small and medium-sized enterprises, have been struggling for some time. Overall, there are therefore imbalances in the US that could disrupt financial markets in the medium term.

— The current uncertainties are exacerbated by the aforementioned decline in the supply of liquidity from the overnight reverse repo facility. However, the Fed is closely monitoring the risks in this regard and has already responded by announcing a scaling back of the balance sheet reduction (QT) from June this year. The slowdown in QT has come as a surprise and is intended to counteract an excessive squeeze on liquidity. In the event of major turbulence, balance sheet expansion and other monetary support measures could even be expected again, which should limit an escalation of the situation.

— However, persistently stubborn inflation is making the Fed's work more difficult. In recent years, problems with economic growth and in the financial markets have always been solved with the printing press without triggering negative side effects on inflation. This is becoming increasingly difficult in the current reflationary environment. An excessively loose monetary policy could lead to higher long-term interest rates and a weaker US dollar at any time.

Chart: US consumer sentiment is weakening



Sources: University of Michigan, Fisch Asset Management

Positioning: Still no clear sell signals

» Significantly lower long-term interest rates are unlikely to materialise.

— As mentioned, balancing forces are at work on a global level. Together with the continuing ample supply of liquidity and the further massive increase in government spending until at least the US presidential elections, it is therefore still too early to significantly reduce risk exposure (equities and credit). In addition, our market and valuation indicators continue to provide warning signals, but not, as yet, sell signals. We therefore remain neutrally positioned despite high valuations and low risk premiums.

— A number of upward forces are acting on long-term government bond yields in the US: These include the persistently high level of government debt, stubborn inflation and government bond sales by various central banks (including the Fed). This means that even in the event of a further economic slowdown and an imminent interest rate cut by the Fed, significantly lower long-term interest rates are not to be expected. We are therefore taking a neutral position in terms of duration. In Europe, the scenario is similar, but much less powerful interest-driving forces are working at the longer end of the curve than in the US. However, as interest rates are already significantly lower here, an ECB rate cut is unlikely to have a major impact at the long end of the yield curve. Here too, we are therefore neutrally positioned in terms of duration.

— A sharp rise in US government debt, a cooling economy and central bank sales of US government bonds are negative factors for the US dollar. A potentially lower dollar and stubborn inflation, on the other hand, are positive for the gold price.

	US	Europe	Japan	Asia ex-Japan	LatAm	CEEMEA
Return drivers						
Equities	o	o	+	o	o	o
Gov. Bonds	o	o	o			
Credit IG *(Spreads)*	o	o		-	o	o
Credit HY *(Spreads)*	o	o		o	+	o
Total return						
Convertibles	o	o	+	o		
Credit IG	o	o		o	o	o
Credit HY	+	+		+	+	+

	PrecMet	InduMet	Energy
Commodities	+	o	o

Key:

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

Notes regarding the table: The table summarises the model results for the total return of convertible bonds and credit investment grade and high yield, which are a function of the listed return drivers. 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 take German Bunds into account for Europe.

Cross asset class preferences

This table combines top-down views with bottom-up analysis at the portfolio level.

	Most preferred	Least preferred
Convertible Bonds	– Software (Cybersecurity) – Semiconductor (AI-related) – CBs with high convexity – Bond-like CBs with quality credits and attractive yields – Balanced deep investment grade Chinese tech with high convexity	– Utilities, REITS – Unprofitable, early stage, expensively valued IT and biotech – Weak credit quality and/or liquidity
Global IG Corporates	– Energy, healthcare, consumer goods – 5-10 year maturities	– Technology & base metals – Maturities >10 years
Global Corporates	– Energy, healthcare – Investment grade – Developed markets	– Technology & base metals – High yield – Emerging markets
Global High Yield	– Capital goods, energy – Basic industry – Leisure	– Transportation – Financial Services – Technology & electronics
Emerging Markets - Defensive	– LatAm, parts of Asia – Colombia, Peru, Korea & Indonesia – Maturities <7 years	– Asia, Middle East – Israel, Qatar, Saudi Arabia, India & Taiwan – Maturities >7 years
Emerging Markets - Dynamic / Opportunistic	– LatAm (esp. Brazil and Mexico) – High yield energy – Short-dated high-yield bonds	– Maturities >10 years – A-rated bonds

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: A source of liquidity dries up

In the US, a source of liquidity that has been bubbling away for a year now appears to be drying up. The 'Overnight Reverse Repo Facility' (excess reserves of banks and money market funds) has been stagnating at around USD 450 billion for several weeks (see chart below) and is no longer falling. This means that liquidity is no longer flowing from these accounts at the Fed into the US government bond markets. The previous decline from more than USD 2,300 billion to the current level has been an important driver of financial market liquidity and the strong equity and credit markets.

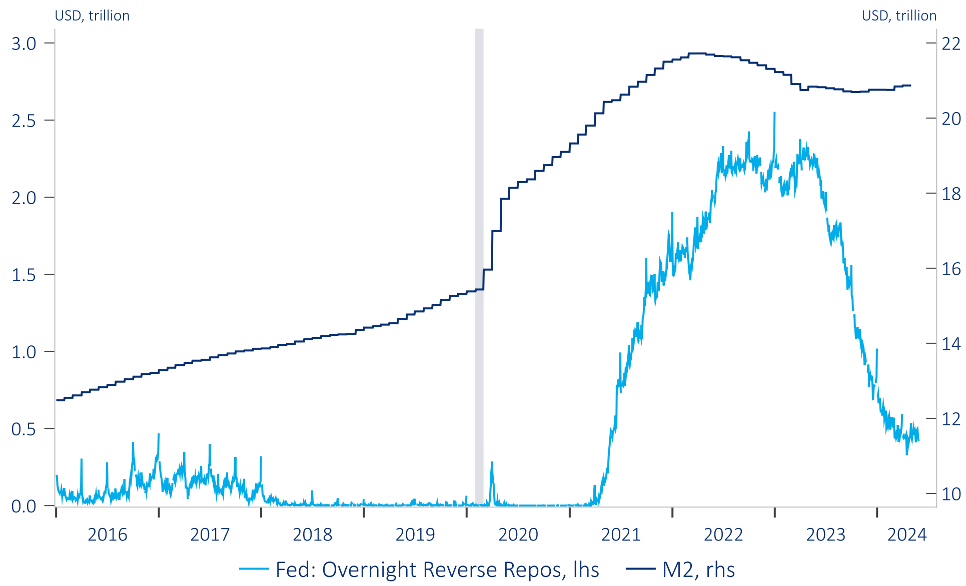
As a result, the M2 money supply is also likely to fall again in the foreseeable future (see chart), which should dampen the economy, equity and credit markets and inflation in the medium term.

However, the Fed has already recognised the associated risks of a liquidity shortage and has announced a monthly reduction in quantitative tightening (QT). System liquidity is also being closely monitored. This is intended to prevent the kind of turmoil seen at the end of 2019 (during the last QT).

» The Fed should prevent greater damage.

Overall, current developments do not yet provide a sell signal for financial markets. Delayed effects in changes to the money supply and careful monitoring by the Fed should prevent greater damage, at least for the time being.

Chart: Reverse repos are no longer declining



Sources: New York Fed, Fed, Macrobond, Fisch Asset Management

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