

» *Fisch View*

*July's topic:
„Confident expectations despite risks“*



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Confident expectations despite risks

- Financial markets are currently characterised by positive expectations regarding economic growth, inflation and interest rate developments. The increasing risks are largely being ignored.
- Various previously positive drivers are weakening, making disappointments more likely as the year progresses.
- However, our risk exposure remains neutral to slightly positive for the time being, as a deterioration in the environment will only have a delayed effect on financial markets.

Overall economic situation

In the US, the slowdown in the services sector that has been evident for some time is intensifying, while the situation in the manufacturing sector, which has been very weak for a long time, is improving. However, the latter is unlikely to prove sufficient to stabilise the service-oriented US economy. In addition, strong monetary and fundamental drivers have been weakening for some time, which is, with a certain delay, further increasing the pressure on the economy. However, as stabilisation can be observed in Europe and China, the global environment should remain solid overall for the time being.

Recent developments: The air is getting thinner

- 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 continuing abundant 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.

Overview & outlook: Accumulation of braking factors

» An economic slowdown has a dampening effect on inflation.

- Due to the aforementioned deterioration in consumer sentiment in the US and the increasing weakening of various factors, there is a risk of negative impulses accumulating. These will feed back into the economy and potentially filter through to equity and credit markets. This affects the US in particular, but also applies worldwide due to global economic interdependencies.
- The inflation-dampening effect of an economic slowdown and a future decline in the supply of liquidity provides a positive counterbalance. However, we do not expect an initial easing of monetary policy in the US until after a sharp increase in market volatility, a significant weakening of the economy and a further rise in unemployment. This delayed reaction time on the part of the central banks is due in particular to persistently stubborn inflation. Base effects are disappearing, the previous goods price deflation appears to have come to an end, and rents, which have a high weighting in the US inflation basket, are only gradually declining.
- In previous downturn cycles, low inflation always made rapid monetary easing possible. This time is different. Easing too early is likely to prove problematic, leading to a rise in interest rates at the long end of the yield curve, exacerbated by exploding government debt (see also "On the radar", page 6), the Fed's quantitative tightening and government bond sales by the Bank of Japan (which is supporting the yen with the help of US Treasury sales).

Chart: Subdued real retail sales



Sources: St. Louis Fed, Fisch Asset Management

Positioning: Delayed sell signals

- Based on our assessment, a cautious positioning in risky assets is appropriate overall. Market breadth remains low for equities in both the US and Europe and sentiment is (overly) optimistic.
- We would wait for a further weakening of the macro environment before making any larger portfolio shifts. There are lag effects here in terms of the impact on financial markets and the generation of sell signals. "The trend is your friend" - and the trend is currently still positive. We therefore remain neutral to slightly positive on equity and credit exposure (investment grade, high yield and emerging markets).
- In the high-yield market, the key balance sheet ratios from a credit perspective, such as net debt, continue to be stable and the continued below-average supply of new issues is having a positive effect on the market as a whole. Our defensive approach should pay off in the event of a weakening of the macro environment.
- We would therefore already be switching from equities to convertible bonds due to the favourable asymmetric risk/reward profile. We are also focusing on corporate bonds with solid issuer ratings (including in the high-yield segment).
- We remain cautious with US government bonds, as long-term rates could rise here despite interest rate cuts. Here too, however, we remain neutrally positioned for the time being. Conversely, German government bonds should benefit from a slowdown in the global economy.
- We are neutral on gold, industrial metals, and the US dollar. The yen remains under pressure due to Japan's excessively loose monetary policy.

» With issuers, solid credit ratings are the key.

	US	Europe	Japan	Asia ex-Japan	LatAm	CEEMEA	Key:
Return drivers							
Equities	o	o	o ↓	o	o	o	++ Strong positive market
Gov. Bonds	o	+ ↑	- ↓				+ Positive market
Credit IG (Spreads)	o	o		-	o	o	o Neutral
Credit HY (Spreads)	o	o		o	o ↓	o	- Negative market
Total return							-- Strong negative market
Convertibles	o	o	o ↓	o			
Credit IG	o	+ ↑		o	o	o	
Credit HY	+	+		+	+	+	
	PrecMet	InduMet	Energy				
Commodities	o ↓	o	o				

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, financials – 5-10 year maturities	– Capitals goods, technology – Maturities >10 years
Global Corporates	– Energy, healthcare, financials – Investment grade – Developed markets	– Capitals goods, technology – High yield – Emerging markets
Global High Yield	– Capital goods, energy – Basic industry – Telecommunications	– Transportation – Financial services – Technology & electronics
Emerging Markets - Defensive	– LatAm, parts of Asia – Brazil, Korea, Indonesia – Maturities <7 years	– Asia, Middle East – Israel, Qatar, Saudi Arabia, China & Taiwan – Maturities >7 years
Emerging Markets - Dynamic / Opportunistic	– LatAm (esp. Brazil) – 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: US government debt explodes

According to an estimate by the Congressional Budget Office, the US government will increase the budget deficit to 7% (in relation to GDP) this year. This means that the national debt will soon reach an all-time high of USD 35 trillion. In 2008, the debt was still at 10 trillion.

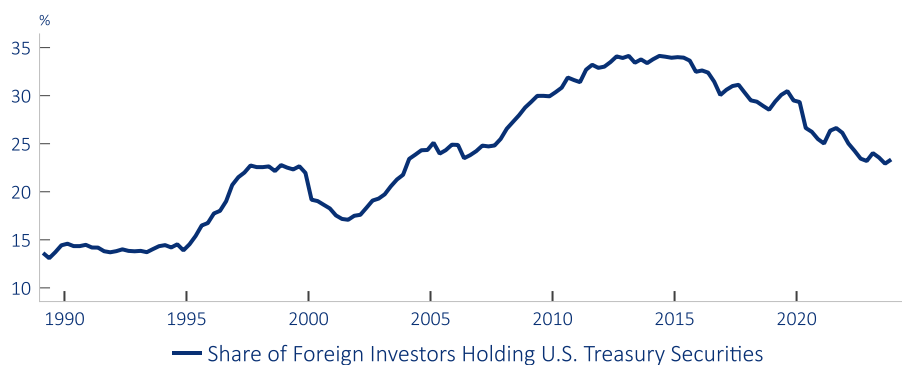
» The US government's interest burden is approaching the record levels of the 1980s.

Together with interest rates, which are also significantly higher than before the pandemic, the proportionate cost of servicing debt is also rising sharply. Around 35% of tax revenue currently has to be spent on interest payments, and the trend is upward. This is the highest figure since 1998 and the ratio is also approaching the historic highs of the 1980s (when US government bond interest rates were at times as high as 15%).

As future interest payments will have to be financed at least in part by new debt, there is a risk of a dangerous acceleration in debt levels. In addition, around USD 9500 billion in US Treasuries are due for refinancing in the next 12 months (at interest rates in the 4.5% to 5.5% range and no longer at 2% to 3% as previously).

As various foreign central banks, as well as the Fed, are also selling US government bonds, a massive increase in supply is to be expected in the coming months, accompanied by a simultaneous decline in demand. Price pressure and thus rising interest rates are becoming increasingly likely, even in the event of interest rate cuts. A structural rise in long-term US interest rates also threatens to have a lasting negative impact on equity markets.

Chart: Foreign investors are selling US government bonds



Sources: U.S. Treasury, Fisch Asset Management

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