

» *Fisch View*

*Septembers's topic:
„No trend reversal in sight yet“*



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Beat Thoma
Chief Investment Officer



Krishna Tewari
Investment Strategist

No trend reversal in sight yet

- Financial markets are typically driven primarily by liquidity flows. Conversely, economic development typically lags. This is why the current debate – recession ‘yes, or no’? – is actually irrelevant for equity markets.
- The recent signs of weakness in the US labour market were therefore only the superficial trigger for the high market volatility in recent weeks, but not the real underlying cause.
- Much more significant, however, is the decreasing supply of liquidity to stock markets at a global level, which is prompting us to take a cautious stance.

Overall economic situation

The US economy and labour market continue to cool down. At the same time, consumption remains resilient due to the continued solid rise in income and high government spending. A recession is not in sight for the time being. In Europe and China, economic activity is running at a much lower level, but not yet in recessionary territory either. Overall, moderate inflation-dampening forces are therefore at work globally, fuelling hopes of interest rate cuts.

Recent developments: Economy trails stock market

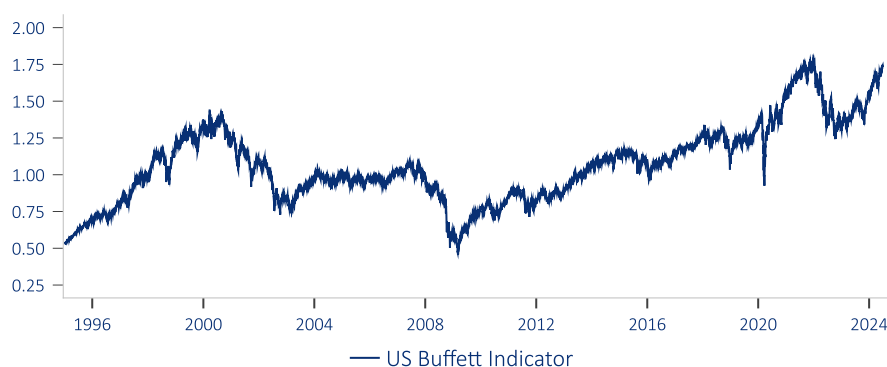
- A weak US labour market and the rise in the unemployment rate to 4.3% triggered a temporary tremor on global equity markets in August. At the same time, a ‘flight to quality’ led to rising government bond prices and thus significantly falling interest rates.
- However, as the economy and the labour markets always lag the stock markets, the weak figures cannot have been the underlying cause of the market slump. Instead, the stock markets are primarily driven by liquidity flows and changes in the money supply. And there have been important changes here in recent weeks and months, which are likely to increasingly weaken the foundations of the highly valued stock markets.
- There are currently three significant factors that are acting simultaneously and strongly reducing liquidity: the drying up of the Fed's overnight reverse repo facility, the unwinding of the yen carry trade (and thus global capital flows back to Japan) and the continuous balance sheet reductions by the Fed and the ECB with a corresponding substantial withdrawal of liquidity from the financial system.

Overview & outlook: Warning but no sell signals

- Due to decreasing liquidity flows into the financial markets, the trend in global equities are increasingly likely to be approaching a reversal.
- This assessment is further confirmed by the behaviour of long-term market cycles: Strong performance in the capital goods and utilities sectors, and rising precious metal prices (especially gold) are typical during peak ('overheat') phases. In addition, valuations, particularly in the US, are extraordinarily high: the meaningful 'Buffet indicator' (value of the stock market in relation to gross domestic product) is close to an all-time high. Warren Buffet himself indirectly confirms this, as evidenced by the record-high level of cash in his fund and the halving of his position in Apple shares. The typical characteristics of a possible market peak are rounded off by a high level of complacency among many investors (the expectation of a 'Goldilocks scenario').
- However, despite declining new liquidity flows, there is still a lot of liquidity in the system in absolute terms (created during the pandemic until April 2023). These enormous sums are likely to provide support for both the equity and credit markets as well as the economy for some time to come. In addition, the Fed has just stopped reducing its balance sheet and has even temporarily increased it slightly. This is likely to have been a temporary measure ('emergency liquidity') to dampen the high market volatility in the first half of August. As a result, there are no signs of a turnaround yet in the financial markets, despite the high volatility.
- Nevertheless, a certain degree of caution is warranted. Regardless of the Fed's temporary emergency liquidity, QT will continue for the foreseeable future. Moreover, the ECB remains on course and is reducing its balance sheet even more than the Fed (EUR 2,400 billion vs. Fed with USD 1,800 billion since the peak in March 2023).
- A cooling economy and decreasing liquidity are having a deflationary effect and thus dampening interest rates. Accordingly, we believe the environment for government bonds remains favourable.

» In the current environment, a certain degree of caution is appropriate.

Chart: Record-high US equity market valuations



Sources: Bloomberg, Fisch Asset Management

Positioning: Neutral to slightly positive positioning

» In the short term, we do not yet see any sell signals.

- In terms of equity exposure, we are neutral to slightly positive in the short term due to the continuing high level of liquidity. In the medium term, there are increasing warning signals as liquidity flows are decreasing, valuations are high and the long-term market cycle is very likely in a peak phase.
- We remain neutrally to slightly defensively positioned in investment-grade bonds. Risk premiums are at historically low levels, but momentum remains positive and demand is high. In the case of high-yield bonds, increased quarterly earnings by borrowers (both in the US and Europe), a positive rating trend and rising inflows are currently still offsetting the macroeconomic risks on the horizon, commanding a neutral positioning.
- In the current environment, we would readily suggest switching from equities to convertible bonds due to the attractive asymmetric risk/reward profile. We are also focussing on corporate bonds with solid credit ratings (including in the high-yield segment).
- Due to a cooling global economy, simultaneously declining inflation and thus the potential for interest rate cuts by central banks, the environment for long-term government bonds is favourable. The duration can therefore be neutral to slightly higher. However, the enormous increase in US government debt may hinder or even reverse the decline in long-term US interest rates – especially in the event of a weaker US dollar.

	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	<ul style="list-style-type: none"> – Software (Cybersecurity) – Semiconductor (AI-related) – Healthcare – CBs with high convexity – Bond-like CBs with quality credits and attractive yields – Balanced deep investment grade – Chinese tech with high convexity 	<ul style="list-style-type: none"> – Utilities, REITS – Consumer discretionary – Unprofitable, early stage, expensively valued IT and biotech – Weak credit quality and/or liquidity
Global IG Corporates	<ul style="list-style-type: none"> – Healthcare, financials – 5-10 year maturities 	<ul style="list-style-type: none"> – Capitals goods, transportation – Maturities >10 years
Global Corporates	<ul style="list-style-type: none"> – Healthcare, financials – Investment grade – Developed markets 	<ul style="list-style-type: none"> – Transportation, technology – Emerging markets
Global High Yield	<ul style="list-style-type: none"> – Capital goods, energy – Basic industry 	<ul style="list-style-type: none"> – Transportation – Financial services – Technology & electronics
Emerging Markets - Defensive	<ul style="list-style-type: none"> – LatAm, parts of Asia – Chile, Mexico, Korea – Maturities <7 years 	<ul style="list-style-type: none"> – Asia, Middle East – Israel, Qatar, Saudi Arabia, China – Maturities >7 years
Emerging Markets - Dynamic / Opportunistic	<ul style="list-style-type: none"> – LatAm (Brazil, Colombia, Mexico) – High yield energy – Short-dated high-yield bonds 	<ul style="list-style-type: none"> – Asia, Middle East – 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: The yen carry trade collapses

The Japanese central bank (BoJ) was forced to tighten its ultra-loose monetary policy some time ago due to an increasingly weak yen and rising local inflation. Although the most recent increase in the key interest rate at the end of July was again only marginal at 0.15%, it was still higher than the markets had anticipated.

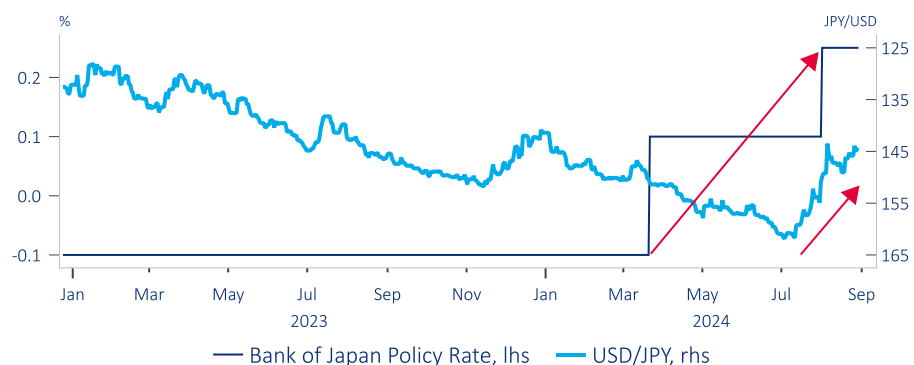
At the same time, however, further interest rate hikes were announced together with the timetable for reducing the massive quantitative easing programme. Despite this dynamic, and only a moderate tightening of monetary policy, the yen appreciated significantly, forcing many investors to unwind the yen carry trade they had been building up for years.

In a yen carry trade, the investor takes out a yen loan at very low (or even negative) interest rates and invests the money in American or European bonds and shares, for example. This allows an interest rate difference of three to five percentage points to be collected. Simultaneously, the gigantic sums of the carry trade transactions lead to a rise in the value of the dollar and euro against the yen, and thus to additional huge currency profits. At the same time, this yen carry trade led to a correspondingly enormous flow of capital from Japan towards the global financial markets. As a result, the money printed by the BoJ spilled over across the world. However, the BoJ's monetary tightening is now making the carry trade less attractive. The interest rate differential is narrowing and there is a risk of losses if the yen rises once more.

» The unwinding of the yen carry trade leads to capital flows back to Japan.

As a result, there was almost inevitably a panic-like unwinding of many of the open positions with huge sales of dollar and euro securities and a dramatic rise in the yen. And the resulting global backflow of capital to Japan also led to the drying up of a huge source of liquidity for the stock markets that had been gushing for years.

Chart: The Bank of Japan hikes interest rates



Sources: BOJ, Fisch Asset Management

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