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October's topic:
„The Chinese central bank is forced to act"

26/09/2024

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The Chinese central bank is forced to act

- A further decline in the supply of liquidity to global financial markets may increasingly burden equity and credit markets, but should only have a delayed effect.
- In addition, China is now approaching a dangerous deflationary wage-price spiral, which could also have a negative impact on the global financial system, assuming the Chinese central bank does not intervene decisively.
- By contrast, the global economic slowdown continues to play only a lesser role in the short-term development of equity markets and will only become relevant in the medium term.

Overall economic situation

The US labour market continues to show signs of cooling. In addition, the savings rate is falling and defaults on credit card debt are increasing. Alongside a number of other leading indicators, this points to declining economic momentum and impending problems with consumption in the US, which has remained very robust to date. Overall, however, these factors are leading to an environment that is dampening inflation and thus interest rates, which in turn is stabilising the economy. This means that for the time being, positive and negative forces are still cancelling each other out.

Recent developments: China has become the problem child

- In China, the downward pressure on the economy is intensifying. There is a threat of a negative deflationary spiral that is difficult for the government and central bank to control. As a result, developments in China are likely to increasingly become a global disruptive factor.
- However, equity and credit markets continue to be driven primarily by liquidity flows and not yet by economic factors in the US, Europe and China. Nevertheless, various sources of liquidity that were previously very buoyant are now beginning to dry up.
- Realistically, these decreasing liquidity flows will only take effect with a delay of three to six months. As a result, a trend reversal in the equity and credit markets is not to be expected immediately. The continuing exaggerated liquidity levels should therefore remain supportive in the short term, especially if the latest interest rate cuts by the Fed and ECB lead to a shift from money markets into equity and credit markets.

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Overview & outlook: Inflation-dampening factors at work

— Despite the enduring high levels of liquidity and enormous government spending in the US, the labour market and the economy continue to weaken. This is a cause for concern as an increasing immunity to fundamental and monetary stimuli appears to be developing. In the medium term, this threatens a loss of control by both the Fed and the US Treasury.

— The latest US labour market data shows a rapid decline in job vacancies, with fewer jobs being created at the same time. In addition, medium-sized and smaller companies in the US remain under pressure. It should be borne in mind that these companies represent around 45% of US economic output and have historically been responsible for more than 50% of newly created jobs.

— By contrast, consumer spending, which is still very robust at present, is not a leading indicator but is lagging behind the economic trend. In addition, defaults on credit card debt are currently rising rapidly – a first sign of an imminent slowdown in consumption in the US.

— In addition, as already mentioned, developments in China are increasingly deteriorating. Until recently, China was still a rather stabilising factor globally, but it is increasingly becoming a problem child. In particular, the export-orientated industrial policy and the sharp decline in domestic consumption are threatening to lead to a glut of exports, which is likely to cause problems particularly in the EU and Germany.

— However, the real-time economic indicators in the US (GDPNow and Weekly Economics Index) are not yet signalling an imminent recession. The global economic trend is therefore unlikely to have any negative impact on equity and credit markets for the time being.

» The Chinese economy is dampening global inflation.

— Inflation is already being dampened by the deflationary economic slowdown in the US and especially in China (with pressure on commodity prices), as well as the drying up of liquidity flows. However, a number of counteracting forces are at work: these include the elimination of base effects, seasonality in the fourth quarter, and geopolitical tensions. These are potentially indicative of higher inflation rates once more, which is also confirmed by the rising gold price. Overall, these factors collectively signal a neutral to slightly positive outlook for inflation.

Chart: The "Weekly Economic Index" still signals stable US growth

Sources: Dallas Fed, BEA, Macrobond, Fisch Asset Management

Positioning: Longer duration and neutral risk exposure

» We would recommend switching from equities into convertible bonds.

- Owing to the aforementioned record-high liquidity levels (and high bank reserves) in the global financial system, there are still no concrete sell signals for the equity and high-yield markets. However, fresh inflows of liquidity are diminishing and only take effect with a delay of three to six months. We are therefore taking a neutral to slightly overweight position in equity exposure and high-yield credit in the short term. As soon as our liquidity indicators and market technicals provide concrete sell signals, we will reduce our risk exposure again.
- However, due to the nevertheless highly valued equity and high-yield markets (e.g. as measured by the 'Buffet indicator', low credit spreads and positive investor sentiment), we recommend swapping direct equity investments for convertible bonds (with built-in partial capital protection) and focussing on solid borrower qualities.
- In contrast to the equity and high-yield markets, inflation and interest rate trends react very directly to an economic slowdown. We are therefore currently running a slightly longer duration than the benchmark indices. This is due to the continuing global easing of interest rates, while we also expect steeper yield curves globally.
- However, certain risks associated with long-dated US government bonds should be considered. Here, the rapidly rising government debt coupled with the Fed's simultaneous balance sheet reduction (government bond sales) may put upward pressure on interest rates, at least temporarily. In addition, the US Treasury is beginning to reduce its repurchases of long-term government bonds (financed by issuing T-bills), as the optimal ratio of 20% T-bills to the total bond portfolio has been exceeded. This eliminates a factor that has previously dampened interest rates on long-term bonds.

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

	PrecMet	InduMet	Energy
Commodities	+ ↑	o	o

Key:

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

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) – Healthcare – CBs with high convexity – Bond-like CBs with quality credits and attractive yields – Balanced deep investment grade Chinese tech with high convexity	– Utilities, REITS – Consumer discretionary – Unprofitable, early stage, expensively valued IT and biotech – Weak credit quality and/or liquidity
Global IG Corporates	– Healthcare, financials – 5-10 year maturities	– Capitals goods, transportation – Maturities >10 years
Global Corporates	– Healthcare, financials – Investment grade – Developed markets	– Transportation, technology – Emerging markets
Global High Yield	– Capital goods, energy – Basic industry	– Transportation – Financial services – Technology & electronics
Emerging Markets - Defensive	– LatAm, parts of Asia – Chile, Mexico, Korea – Maturities <7 years	– Asia, Middle East – Israel, Qatar, Saudi Arabia, China – Maturities >7 years
Emerging Markets - Dynamic / Opportunistic	– LatAm (Brazil, Colombia, Mexico) – High yield energy – Short-dated high-yield bonds	– 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: Deflationary spiral in China

The Chinese economy has been weakening for some time now. However, the situation seemed to be under control thus far. By virtue of moderate government and monetary policy support, an actual recession has been avoided.

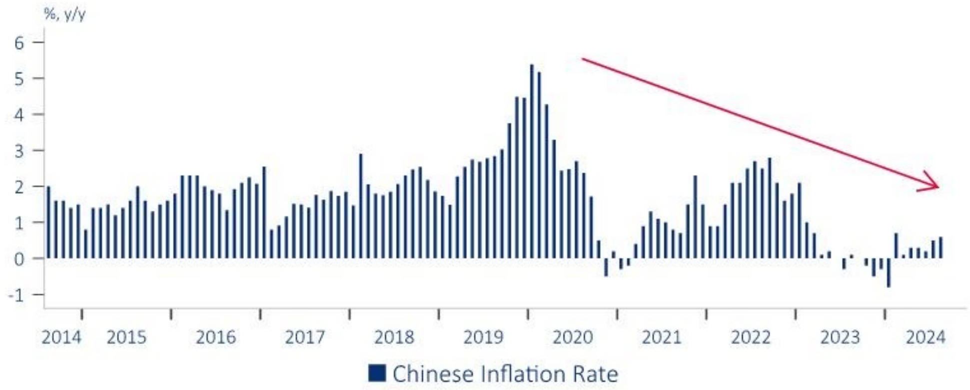
However, there are now increasing signs of an accelerated contraction, particularly in the prevailing extremely weak property market, and a further rise in youth unemployment. Private investment is also falling sharply.

As a result, there is an increasing risk of a deflationary wage/price spiral that is difficult to control, and thus a 'stall' in economic growth. Historical experience from the US and Japan in particular shows that rapid and massive fiscal and monetary policy measures are required in this case. The longer we wait to take relief measures, the more difficult it will be to solve the problem in the future. At least the Chinese central bank has just announced further interest rate cuts and a lower minimum reserve ratio. Overall, however, this still seems too modest to have a lasting positive effect on the economy.

» Developments in China are becoming increasingly relevant globally.

This means that developments in China are also becoming increasingly relevant globally. China's previously neutral to slightly stabilising influence on the global economy threatens to turn into strongly negative impulses. Especially if attempts are made to solve the problems with a wave of exports and a simultaneous drop in private domestic consumption. In this case, the deflationary contraction in China would be exported abroad. Germany would certainly be one of the principal losers here. In addition, commodity prices, especially copper and crude oil, would come under further pressure.

Chart: Deflationary pressure in China



Sources: NBS, Fisch Asset Management

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