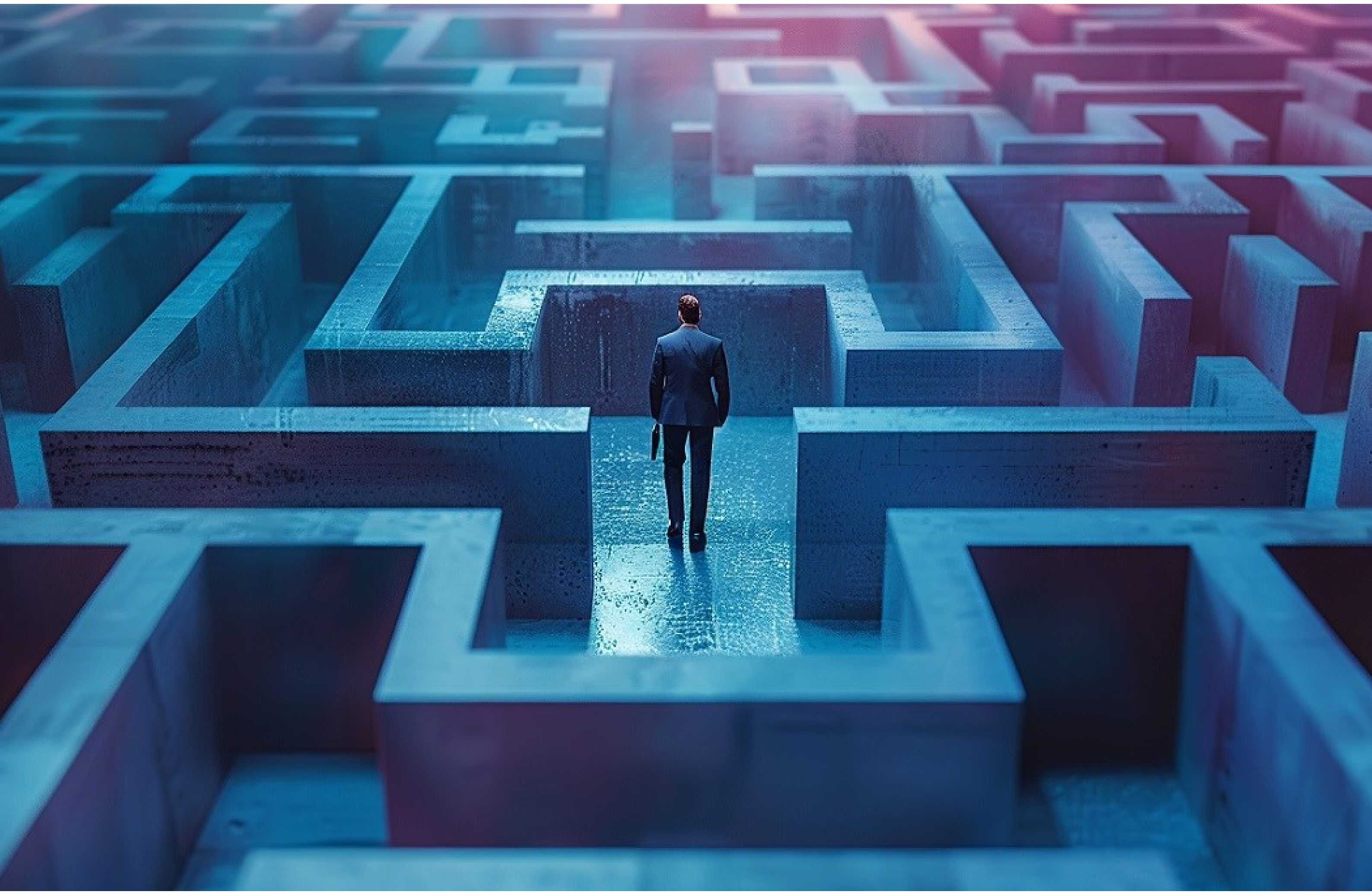
FISCH »Asset Management
Bellerive 241 | P.O. Box
CH-8034 Zurich
info@fam.ch | www.fam.ch
P +41 44 284 24 24

»FischView

February's topic: „Central banks face challenges"



31/01/2025

Beat Thoma
Chief Investment Officer

Krishna Tewari
Investment Strategist

Central banks face challenges

- High government spending in the US is fuelling the economy, but also inflation expectations and thus long-term interest rates.
- The Fed is therefore finding it increasingly difficult to control the long end of the US yield curve – yields on 10-year US Treasury bonds are rising despite a reduction in Fed Funds rates. A similar trend can also be observed in Europe.
- This is a warning signal for equity and credit markets. However, liquidity in the system is currently still high and we remain neutral to slightly overweight in terms of risk exposure.

Overall economic situation

The economy in the US, but also in Europe, is currently still being driven by high government spending and strong consumer demand. However, this development is not sustainable and very one-sided. Moreover, there are already imbalances. The first signs of a slowdown are coming from rising defaults on credit card debt and cooling property markets. However, there is no threat of an economic downturn for the time being as long as stock markets remain buoyant.

Recent developments: Government deficits are rising further

- High government spending and the resulting strong economic growth, as well as solid labour markets, are currently driving up US inflation expectations and long-term yields, despite a significant reduction in key interest rates. This also applies to the eurozone and the UK.
- Government bond markets therefore increasingly appear to be interpreting interest rate cuts as inflationary. And sharply rising budget deficits are leading to additional upward pressure on long-dated government bonds. The recent increase in the volatility of government bond yields, for example in France and the UK, is a serious warning signal. The development in France is even more dangerous than in the US and the UK because the ECB is not authorised to buy government bonds. There is therefore a risk that the central banks will lose control of the long end of the yield curve.
- However, the turbulence in government bond markets has not yet spilled over to equity markets. The high level of liquidity in the system is still having a supportive effect here, despite central banks curbing the supply.

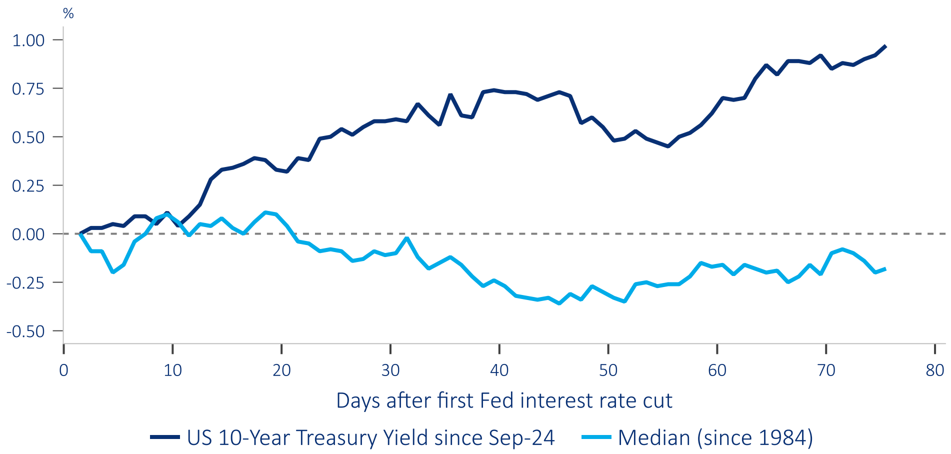
➲ **On the radar: Global liquidity is losing momentum** (page 6)

Overview & outlook: Upward trend still intact

- The continuing robust economic development in the US is primarily leading to upward pressure on inflation expectations and thus on long-term yields, but has no direct influence on equity markets. The economy is lagging behind stock markets. A recession will therefore only occur once equity markets collapse.
- In the event of weaker equity markets, however, the economic downturn would be exacerbated due to structural imbalances in the US (and Europe): the economy is currently driven almost exclusively by high government spending, which cannot be sustained in the longer term. In addition, the US labour market is showing certain signs of cooling (job vacancies are declining, redundancies are increasing) and credit card defaults are rising significantly.
- An additional imbalance has been created over the past 18 months by the US Treasury due to extensive issuance of T-bills. The issuance of short-dated government bonds was intended to depress the long end of the yield curve and indirectly generate liquidity in the system. Although this succeeded temporarily, it is now leading to a huge wave of refinancing of T-bills this year. A portion will also have to be refinanced with longer-dated government bonds, thus cancelling out the previous interest rate dampening at the long end. At the same time, government debt will continue to rise.
- This will make the environment much more difficult for central banks. The upward pressure on long-term yields and inflation would have to be combated with a more restrictive monetary policy, which would stifle the economy. On the other hand, government bond purchases (QE) to dampen the rise in interest rates at the long end would further fuel inflation.

» The environment for central banks is getting more difficult.

Chart: Long-term yields rise despite interest rate cuts



Sources: U.S. Treasury, Fisch Asset Management

Positioning: Risk exposure neutral to slightly overweight

— A sharp slowdown in the global economy is more likely in the second or third quarter of the year due to the aforementioned economic imbalances in the US and the undesirable rise in yields on long-dated government bonds (including in Europe). Additional global pressure is also likely to come from the current excessively restrictive monetary policy in China. However, the braking effect arising there would come far too late to quickly dampen the current relatively strong upward pressure on inflation and long-term interest rates.

» The upward trends are not yet broken.

— The upward trend in stock markets remains intact and is also driving up inflation and interest rates. This is why we are currently running a neutral duration range in the portfolios. In the event of an economic downturn in the second half of the year, there would be a fall in tax revenues, which would further increase the already sharp rise in government debt and push government bond yields even higher.

— The supply of liquidity from central banks is being curbed: Important sources of liquidity (overnight reverse repo facility in the US) have dried up and bank reserves are also falling. However, the M2 money supply relevant for the stock markets is still rising in the US at the moment. The global liquidity indicator (GLI, see section ‘On the radar’) has already turned downwards, but not yet strongly enough to trigger major problems on markets. The M2 money supply is also important for corporate bond credit spreads. This means that a neutral to slightly increased risk exposure can be maintained for the time being.

— The current liquidity trend thus provides warning signals. However, the risk exposure should only be significantly reduced if the M2 money supply in the US falls again or if long-term government bond yields in the US, France and the UK rise by at least 30 basis points from their current level.

Return drivers	US	Europe	Japan	Asia ex-Japan	LatAm	CEEMEA
Equities	o	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	+ ↑	+ ↑	+ ↑	+		
Credit IG	+	+		o	+	+
Credit HY	+	+		+	+	+

	PrecMet	InduMet	Energy
Commodities	+	- ↓	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 – Consumer discretionary – Unprofitable, early stage, expensively valued IT and biotech – Weak credit quality and/or liquidity
Global IG Corporates	– Financials, consumer goods – EUR-denominated issues – BBB-rated bonds	– Transportation, chemicals – USD-denominated issues – AA-rated bonds
Global Corporates	– Healthcare, financials – BBB & BB-rated bonds – Developed markets & emerging markets investment grade	– Transportation, chemicals – AA & B-rated bonds – Emerging markets high yield
Global High Yield	– Capital goods – Basic industry – Telecommunications	– 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: Global liquidity is losing momentum

Global liquidity (measured by the aggregate M2 money supply of major economies) is still on a long-term upward trend, but has begun a significant downward correction in the last four months or so (see chart).

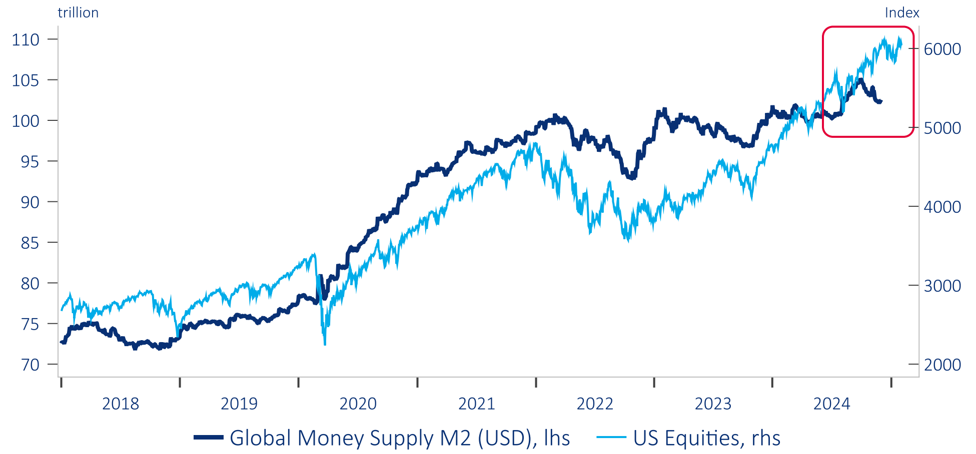
The M2 monetary aggregates are important because they include not only the central bank money supply, but also money creation and bank lending. M2 thus shows the reaction of the banking system to the central bank's monetary policy and is a meaningful indicator of future inflation trends as well as the equity and credit markets.

The aforementioned correction in global liquidity since October of last year contrasts with the continued strength of the equity markets. The current divergence between liquidity and equity market trends is historically rare and provides a clear warning signal. Bitcoin also shows a high correlation to global liquidity. However, this has a lead time of around 12 weeks on Bitcoin prices. There could therefore be a sharp increase in volatility in the foreseeable future.

» Sources of liquidity are drying up.

However, the enormous expansion of the money supply in recent years, particularly in the US, is still having an impact at the moment. These funds were temporarily stored by the banks at the Fed and have only flowed into the financial markets in the last 18 months, with a correspondingly positive effect. The US Treasury also created additional liquidity through the massive issue of T-bills. However, both sources have now dried up.

Chart: Divergence between equity markets and liquidity trends



Sources: Macrobond, Bloomberg, Fisch Asset Management

Disclaimer