

»» *Fisch View*

*April's topic:
„Headwinds in financial markets“*



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Headwinds in financial markets

- Global financial-market liquidity is continuing to lose momentum and is even declining in absolute terms. This is creating headwinds and higher volatility in equity and government bond markets.
- This trend is being amplified by heightened uncertainty in the Middle East and elevated energy prices. However, we believe these are likely to prove a temporary disturbance, whereas the decline in liquidity is structural.
- We are therefore reducing risk exposure only moderately for now.

Overall economic situation

Sharply rising government spending – particularly in the US, but also in Europe and Japan – is providing a strong impulse to global growth. This is reinforced by a continued reallocation of financial-market liquidity towards the real economy, as well as sizeable investment by the Magnificent 7 – around two percent of US GDP – into data centres and AI infrastructure. China is also expanding money supply to support activity. Taken together, this is putting upward pressure on commodity prices, inflation and yields, while draining liquidity from global financial markets.

Recent developments: Many central banks remain restrictive

- The main driver of declining liquidity is the stance of several major central banks (the Fed, the ECB, the Bank of Japan, the Bank of England and others), which remain relatively restrictive and are shrinking their balance sheets in order to counter renewed inflation pressures. The Fed’s QE/RMP programme running since December does not materially change this picture. China is the exception, but its additional liquidity is flowing primarily into the real economy.
- This liquidity outflow is creating stress in US money markets. SOFR–Fed Funds spreads are widening intermittently. Volatility in government bond markets is also rising, including in Europe. This, in turn, is putting the “basis trade” under pressure. A disorderly unwinding of very large hedge-fund long positions in US Treasuries would add volatility and could trigger a dangerous feedback loop, with renewed upward pressure at the long end of the interest rate curve.
- Rapidly rising government debt and government spending in the US – and also in Europe – are adding to rate and inflation pressure. The Fed is attempting to counter this by injecting liquidity via its QE/RMP programme and by easing bank capital requirements. It remains unclear whether this will stabilise bond markets, or simply fuel inflation.

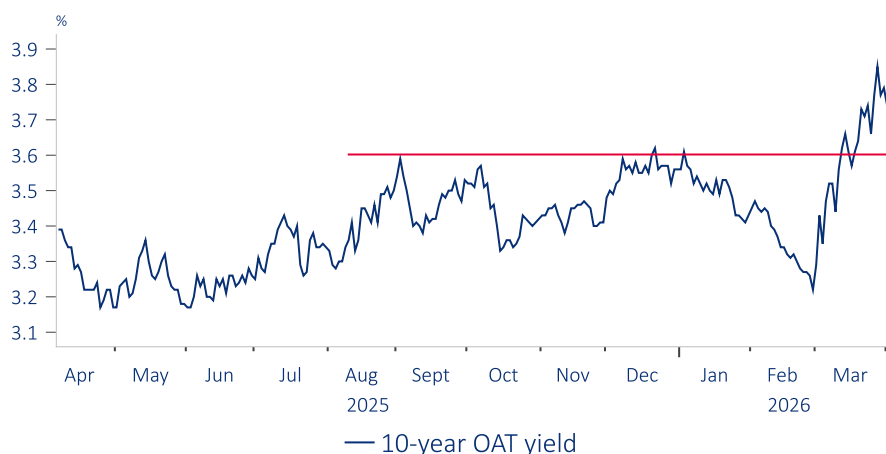
➔ **On the radar: The Fed could lose control** (page 6)

Overview & outlook: The Fed will soon open the money taps

» Rising public debt is driving inflation and yields.

- The global upward pressure on long-dated government bond yields is being reinforced by the recent rise in energy prices. Notably, yields have risen sharply in recent weeks in France, Italy and, in particular, Germany. However, energy prices and geopolitical tensions are only temporary drivers. The rise in yields has independent, structural causes.
- The underlying drivers are rapidly rising public debt globally – especially in the US – and correspondingly high government spending. The surge in new bond issuance pushes yields higher directly, while fiscal stimulus increases money demand and inflation, thereby indirectly reinforcing upward pressure on rates.
- Additional interest rate-driving factors include the ongoing shift of liquidity from financial markets into the real economy. In the US, this is occurring through increased issuance of T-bills (instead of longer-dated bonds). This funding mix protects the long end of the curve and allows a seemingly “frictionless” near-term expansion of debt and spending. However, the cyclical impulse adds to inflation pressure and thus, indirectly, to higher yields. Moreover, this monetisation of public debt via T-bills (which are money-like) is not sustainable and becomes a refinancing time-bomb over the longer term. China is also contributing to the global impulse through large liquidity injections, thereby reinforcing global rate and inflation pressure.
- In addition, as noted, the Fed appears poised to open the money taps – and with them, the door to inflation: first through the QE/RMP programme already in place, and second through the easing of bank capital rules (Supplementary Leverage Ratio (SLR) and other capital requirements). In the near term, a release of USD 200 billion is expected, with substantially more over the longer run.

Chart: Upward pressure on yields, including France



Sources: Macrobond, Fisch Asset Management

Positioning: Reducing risk exposure only moderately

- For now, we keep overall risk exposure (equity risk via convertibles and credit risk via corporate bonds) within a neutral range and reduce exposure only moderately.
- Most market-relevant factors (the reallocation of liquidity into the real economy, public debt, monetisation via T-bills, inflation dynamics and geopolitics) are moving in an unfavourable direction from a market perspective. However, the tipping point for the global financial system has not yet been reached.
- To reach that point, global long-dated government bond yields would need to rise by a further 20 to 30 basis points. Inflation rates (including “Truflation” in the US) would only become dangerous after a further increase of around 50 basis points. And while financial-market liquidity is declining, it has not yet fallen into the acute danger zone.
- As a result, the overall picture for markets and global growth remains only just neutral. However, the margin of safety is shrinking quickly and we are moving closer to the danger zone. The key issue is that the negative drivers – public debt and inflation – are structural and therefore would not improve even if the Iran war were to end.
- Markets are now starting to price these risks in. Notably, 2-year US Treasury yields have risen above the Fed Funds rate. This anticipates rate hikes by the Fed and also puts upward pressure on the long end of the yield curve globally. For now, however, the key variables (long-term rates, inflation, growth and technicals) have not yet fully entered the danger zone.

» **Markets are starting to price in the risks.**

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

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 (AI beneficiaries) – 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"> – Consumer discretionary – Unprofitable, early stage, expensively valued IT and biotech – Weak credit quality and/or liquidity – Cryptocurrency-related names
Global IG Corporates	<ul style="list-style-type: none"> – Healthcare, financials, telecommunications – USD-denominated issues – BBB- and A-rated bonds 	<ul style="list-style-type: none"> – Capital goods, transportation, real estate – GBP- and CAD-denominated issues – Maturities > 15 years
Global Corporates	<ul style="list-style-type: none"> – Healthcare, financials, energy – BBB and BB-rated bonds – North America 	<ul style="list-style-type: none"> – Basic industry, transportation, insurance – AAA-, AA- and B-rated bonds – Asia
Global High Yield	<ul style="list-style-type: none"> – Media – Basic industry – Retail 	<ul style="list-style-type: none"> – Utilities – Financial services – Consumer goods
Emerging Markets - Defensive	<ul style="list-style-type: none"> – LatAm (Mexico, Brasil), Eastern Europe, Saudi Arabia – Utilities, supranationals – Maturities 7-10 years 	<ul style="list-style-type: none"> – Asia (India, Hong Kong) – Industrials
Emerging Markets - Dynamic	<ul style="list-style-type: none"> – LatAm (Mexico, Brazil, Colombia), Eastern Europe – BB-rated bonds – Utilities, supranationals, metals & mining (esp. precious metals) 	<ul style="list-style-type: none"> – Asia, Middle East IG – Investment grade maturities < 3 years

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 Fed could lose control

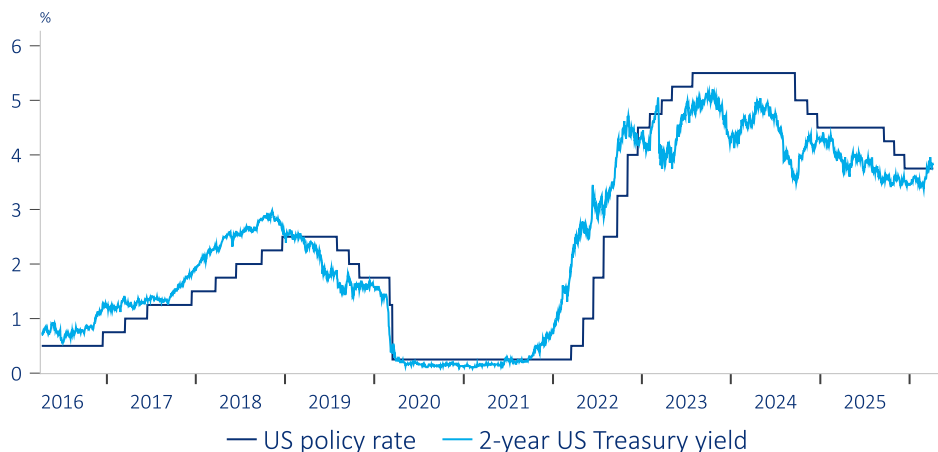
Global financial-market liquidity – essentially central-bank liquidity and repo markets – is currently falling sharply. One reason is that major central banks, notably the Fed, the ECB, the Bank of Japan and the Bank of England, remain relatively restrictive. Despite rate cuts, they are draining liquidity through balance-sheet reduction (QT programmes) in an effort to curb inflation pressures that have been picking up again. In addition, materially higher volatility in government bond markets is itself liquidity-negative. It becomes more difficult for banks to pledge their holdings of government bonds at the central bank as collateral to obtain cash (reserves). A strong dollar and rising oil prices are also currently acting as a drag on global liquidity.

» Higher volatility in US Treasuries is dangerous

The resulting further rise in US Treasury volatility could generate a dangerous feedback loop if the “yen carry trade” and the “basis trade” unwind. In that case, hedge funds could sell large US Treasury positions. At the same time, the US continues to add substantial debt issuance, increasing supply and putting even more upward pressure on yields.

The situation could therefore get out of hand quickly. The rise in 2-year US Treasury yields above the Fed Funds rate already points to a degree of loss of control by the US central bank. Notably, upward pressure on yields is also evident in Europe and even in Germany. For now, however, things remain under control. And if necessary, the Fed will ease again – including by loosening capital rules in the banking system.

Chart: 2-year US Treasury yields rise above Fed Funds



Sources: Macrobond, Fisch Asset Management

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