

» *Fisch View*

*May's topic:
„Markets are ignoring risks“*



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Markets are ignoring risks

- Government debt and inflation, particularly in the US, have been moving in a concerning direction for some time.
- As these are long-term structural trends, little improvement is in sight even once the Iran war has ended.
- At present, however, several mitigating factors are helping to prevent an imminent loss of control.
- We therefore keep risk and rate exposure in a neutral range versus our benchmarks, despite rising risks.

Overall economic situation

Global growth continues to benefit from a growing reallocation of financial-market liquidity into the real economy, strong investment in the technology sector and rising public spending that is financed primarily through short-dated instruments and thus effectively monetised. China has also been adding substantial liquidity for some time, again flowing mainly into real investment with global spillovers. Over the longer term, this dynamic is not sustainable and may put upward pressure on inflation and yields.

Recent developments: Adverse feedback loops are building

- Inflation and public debt have been rising for some time, particularly in the US but also globally, driven by structural factors; in the near term these trends are being reinforced by higher energy prices and increased defence spending.
- The structural drivers of rising public spending are both hard-to-reverse social expenditure and rising interest costs. Higher public spending also supports activity, which can translate into higher inflation. This can trigger a dangerous feedback loop and lift inflationary pressure further. These dynamics are unlikely to be meaningfully curtailed even if the Iran war were to end.
- At the same time, the global liquidity that matters for financial markets has been declining for some time. Key reasons include increasingly restrictive central banks (with China the main exception) and a reallocation of liquidity from financial markets into the real economy. This trend is being amplified by heavy refinancing needs in global bond markets in the months ahead.

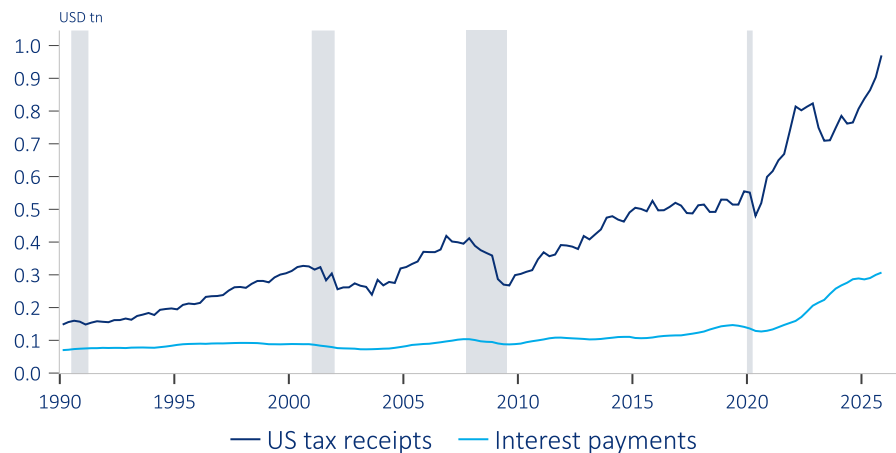
➔ **On the radar: Money supply M2 and inflation (page 6)**

Overview & outlook: The situation remains under control

» **M2 money supply growth dampens inflation**

- The combination of rising public debt, increasing inflation pressure, higher government bond yields and declining financial-market liquidity is a challenging mix for global equities and government bonds. Complicating matters is that the drivers of public debt and inflation are structural, difficult to reverse, and likely to persist even if the Iran war were to end. Global liquidity is also declining for structural reasons, reflecting a recurring seven-year cycle and an upswing in global activity that draws capital away from financial markets. The Magnificent Seven’s outsized capex in the US is a prime example.
- Several potential feedback loops could rapidly amplify problems. Strong growth can lift inflation and rates; higher rates reduce liquidity, which can weigh on equities and subsequently on growth; weaker growth reduces tax revenues and widens the deficit, which can push yields higher again – completing the loop.
- For now, the situation remains under control. Two key positive factors are still damping inflation and the deficit: first, money supply M2 is growing only moderately under restrictive central banks, which is insufficient for a sharp inflation acceleration; second, exceptionally strong US tax receipts (supported by solid growth and rising equity markets) are helping to contain the deficit and thus long-term yields. In addition, inflation around the mid-3% area reduces the real debt burden.

Chart: Rising US tax receipts are damping the fiscal deficit



Sources: Macrobond, Fisch Asset Management

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"> – IT (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, leisure – BBB-rated bonds – Maturities 5-10 years 	<ul style="list-style-type: none"> – Technology, capital goods, transportation – 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 – A- and B-rated bonds – Emerging Markets
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, Brazil), 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, oil & gas 	<ul style="list-style-type: none"> – Asia IG (China, Hongkong) – 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: M2 money supply and inflation

M2 money supply is one of the most reliable leading indicators of inflation. The chart below illustrates this relationship for the US since 1960. Rising money supply tends to lead to higher inflation with a lag of 6 to 18 months – and vice versa.

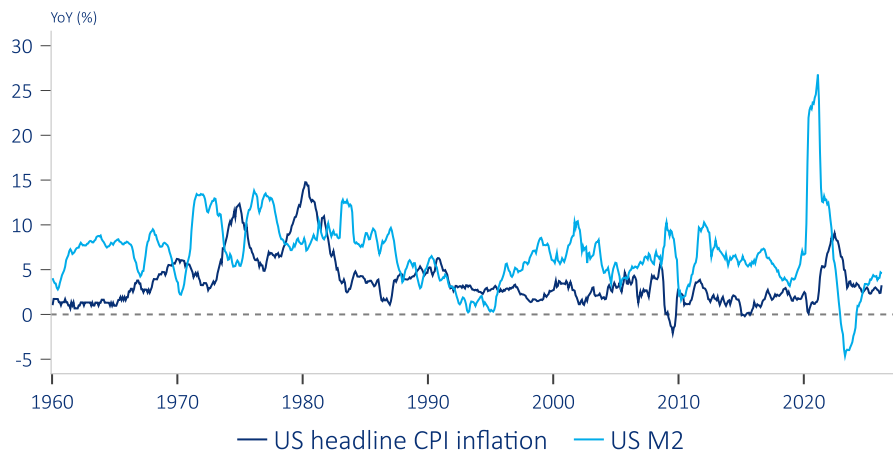
The chart also suggests that money growth in the 8–10% range or more was typically required to generate a significant inflation upswing; the current pace (around 4.9% on an annual basis) is therefore too low for a major inflation wave.

» Many central banks are currently restrictive.

Major central banks (ECB, BoJ, BoE and the Fed) are currently restrictive and are shrinking their balance sheets (QT), withdrawing liquidity from financial markets to fight persistent inflation pressure. This is also damping M2 growth.

Current money growth is not only disinflationary; it is also a headwind for a further strong equity rally and, by extension, for growth. Inflation may therefore continue to rise moderately, but is unlikely to re-accelerate sharply – which could contribute to a potential flattening of yield curves for the time being, particularly if equity markets and growth lose momentum in coming months as a consequence of low money growth. Even so, inflation remains under control for now despite rising oil and petrol prices. However, if growth continues to soften and equity markets weaken, we would expect central banks to respond, with M2 growth re-accelerating over time.

Chart: M2 money supply leads US inflation



Sources: Macrobond, Fisch Asset Management

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