

» *Outlook 2023* *Global Macro* *Environment*



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Marketing material



Beat Thoma
Chief Investment Officer

Executive Summary

- The past year has been dominated by extremely restrictive global monetary policy designed to tackle high and persistent inflation, rising short- and long-term interest rates, and sharply declining equity and credit markets.
- In light of the increasingly deflationary effect of monetary policy, the mounting risk of recession and the noticeable drop in inflation, we are already anticipating monetary easing in the first half of the coming year.
- Although various indicators currently suggest that the global economy is weakening, a “soft landing” or only a mild recession are still possible due to persistently robust labour markets, low levels of private debt, buoyant consumer sentiment and other positive structural factors.
- As a result of deflationary monetary policy and its dampening effect on the economy, long-term interest rates on government bonds have only limited upside potential and are even expected to decline over the coming year.
- Plenty of negatives have already been priced into equity and credit markets, as pessimistic investors opt to hold large amounts of cash, limiting the additional downside potential in these markets.

Review of 2022

2022 was shaped by the extremely restrictive monetary policy adopted by the US Federal Reserve to tackle persistent and higher-than-expected inflation. The Fed raised key interest rates at a historically unprecedented pace, while at the same time starting to dramatically reduce its balance sheet, thus withdrawing liquidity from financial markets. The strong US dollar also forced various other central banks, particularly the ECB, to tighten the monetary reins significantly. Overall, this resulted in a sharp decline in global money supply, the first inflation-damping effects as well as an economic cooldown. However, this complex mix of factors also led to heavy losses in equity and credit markets. In addition, several stress indicators signalled a growing risk of liquidity problems in the financial system. Despite the economy remaining robust, rising long-term interest rates on government bonds, combined with flattening or even inverting yield curves, stoked fears of recession. And for the first time in a long time, the second half of the year saw sharp declines in real estate markets. Despite this clear overall weakening of the global environment, central banks dashed the hopes of financial markets that they would take action at a slightly slower pace. Due to credibility considerations, monetary authorities have maintained a strict anti-inflation line and even signalled their willingness to tolerate a potential recession.

Outlook 2023

The restrictive monetary policy being adopted by central banks around the world is having an increasingly strong impact, causing the economy to cool markedly and significantly inverting yield curves. The downward trend in real estate and commodity markets, as well as gas prices, is accelerating in some cases. Inflation has passed its peak across the globe and long-term inflation expectations remain low. The reduction in money supply is also accelerating, which in turn is having a direct and pronounced dampening effect on inflation. While several of the deflationary factors outlined above, most notably the fall in property prices and rents, as well as decreasing pressure on wages in the US, will only begin to affect the economy after a time lag of a few months, but their impact will be all the stronger for the delay. However, restrictive monetary policy has also increasingly triggered stress symptoms in financial markets of late. Equity markets are becoming increasingly volatile, the bid-ask spread on US Treasuries is widening to signal a dangerous drop in the supply of liquidity, and there has been some significant upheaval in the UK government bond market.

» Rising prospect that central banks will change course.

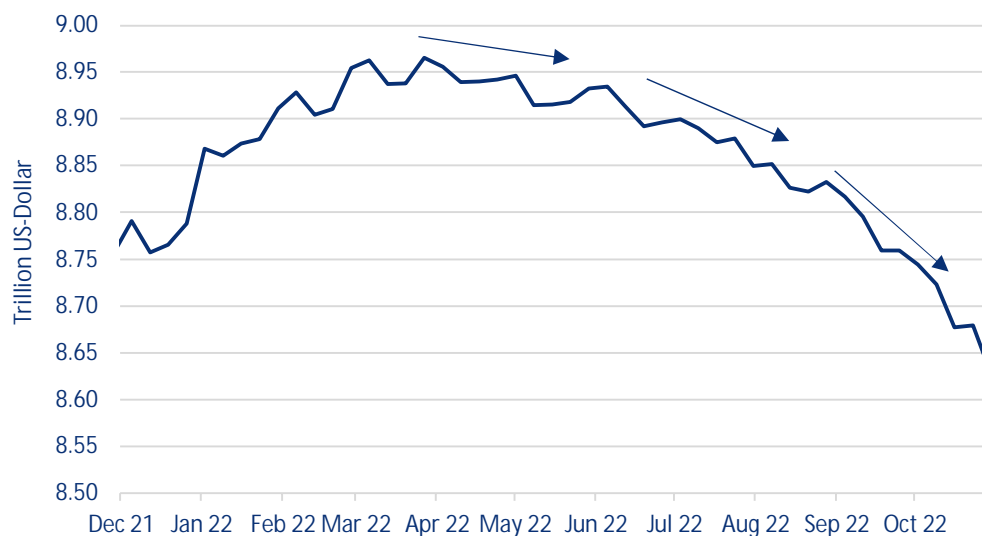
The deflationary impact of this restrictive monetary policy on the global economic and financial system is increasingly raising the prospect that central banks will change course as early as the first half of 2023. Nevertheless, the risk of recession remains high. Any easing of monetary policy may come too late to counter a further cooling of the global economy. Nevertheless, robust labour markets, low levels of household and corporate debt, high cash holdings and buoyant consumer sentiment mean that a recession is only likely to be mild. Declining inflation over the next few months will also boost purchasing power and consumer confidence to lessen any recessionary tendencies. The current extreme steepness of the Phillips curve (correlation between unemployment and inflation) also suggests that a small rise in unemployment is already easing inflationary pressure considerably. This means that a deep recession is not necessary to restore price stability.

This environment of faltering inflation, less restrictive global monetary policy and a moderate risk of recession that looks likely to prevail over the next few months is confirmed by the current flat or inverted yield curve structure, and is fundamentally positive for long-term government bond markets. Historically speaking, government bond interest rates in the US and Europe have always trended downwards before short-term central bank interest rates reach their peak.

Although plenty of negatives have already been priced into equity and credit markets this year in the form of heavy losses, and valuations are therefore now much more attractive, the mood among investors remains pessimistic, dampening further downside risk. This means it is time to begin looking out for buying opportunities.

However, global monetary policy is still too restrictive for a sustained reversal in fortunes. As most equity and credit markets have historically bottomed out at the same time as key interest rates peaked, they have yet to anticipate a turnaround in monetary policy. In this respect, the Fed's decision to reduce its balance sheet and the associated liquidity withdrawal constitute a stress factor that cannot be underestimated (see chart).

Chart: Accelerated reduction of Fed balance sheet triggers withdrawal of liquidity



Source: Federal Reserve Bank of St. Louis

With this in mind, any switch in monetary policy may also be accompanied by a downturn in the US dollar, which in turn would enable other central banks to loosen their monetary policy. A weakening US dollar would also reduce monetary stress levels considerably in many emerging markets in particular.

» For China, the focus remains on controlling inflation.

Specifically, a renewed depreciation of the dollar would also favour a further stabilisation of the situation in China, which would feedback positively into the global economy and financial markets. Apart from that, we expect the party congress and the strengthening of President Xi Jinping's position to consolidate long-running trends in China, namely a moderate easing of monetary policy and increased total social financing (the aggregate volume of funds provided by China's domestic financial system to the private sector of the real economy) to stabilise property markets and support economic growth. At the same time, however, there will continue to be a focus on inflation trends. Beijing is also likely to strive for stable global trading relationships and will be keen to avoid escalating tensions with Taiwan as far as possible.

The war in Ukraine generally continues to drive oil and gas prices. However, China has recently begun to publicly criticise developments in this conflict and the possible risk of escalation more openly. This suggests a change of position regarding their support for Russia. At the same time, a reduction in US military aid over the coming year cannot be ruled out. Overall, these developments would help to facilitate a diplomatic resolution to the conflict. However, an unpredictable overreaction on the part of Russia cannot be ruled out in the event of further major territorial gains by the Ukrainian army.

Conclusion

Overall, it appears that the environment in financial markets will improve significantly during 2023 compared to the previous year. The system is generally moving away from a stagflation scenario towards a balanced and normalised “Goldilocks-like” environment. There are also hopes that the geopolitical situation will ease to some extent.

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