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

»Outlook 2023
Multi Asset Solutions

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Marketing material

Dr. Torsten von Bartenwerffer
Co-Head Multi Asset Solutions

Reto Baumgartner
Co-Head Multi Asset Solutions

Executive Summary

- In 2022, restrictive monetary policy resulted in significant correlation across almost all asset classes with a simultaneous drop in prices. This negatively impacted the returns and diversification characteristics of mixed investments.
- Higher interest rates will benefit multi-asset portfolios in the long term as they improve the potential for both returns and diversification at the same time.
- In particular, the use of convertible bonds within a mixed portfolio should be attractive once more, as the same effects that led these instruments to underperform over the past two years are likely to be reversed.
- We expect the economic and financial market environment to remain turbulent over the next few years due to a variety of developments. This can be effectively addressed with the help of active management and by tactically deploying the right choice of investments.

Review of 2022

While the liquidity created over the past ten years primarily resulted in asset price inflation, it did not lead to traditional inflation in the real economy. This is because financial markets have a disproportionally greater elasticity compared to the real economy.

However, the supply shock triggered by the pandemic brought this regime to an end, with the resulting traditional price inflation prompting central banks around the world to pursue a restrictive monetary policy.

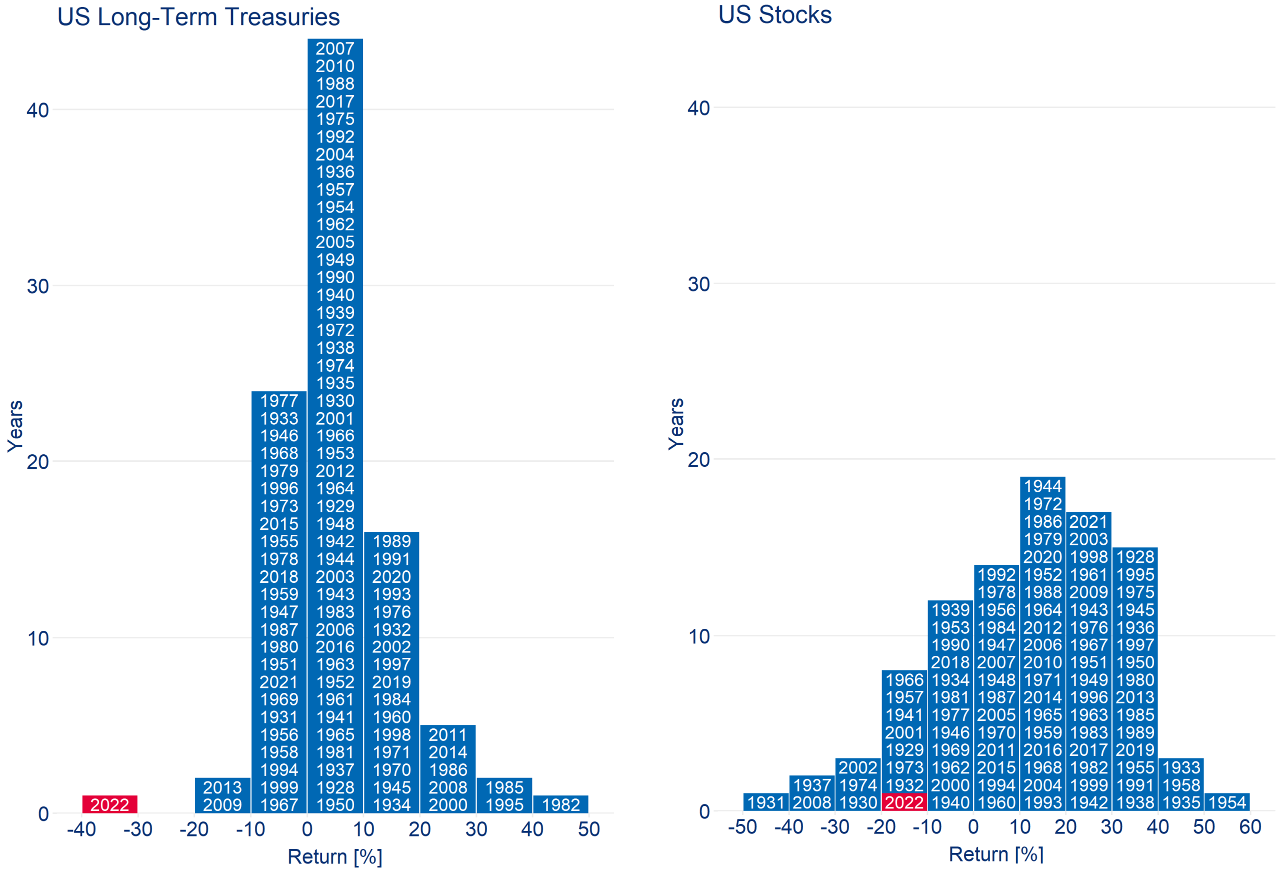
» The withdrawal of liquidity had a major impact on the performance of almost all asset classes.

While price indices for goods and services remained high throughout the year, it was a different story in capital markets, where prices fell sharply due to the withdrawal of liquidity. The contraction of liquidity aggregates had an impact across all major asset classes. As a result, multi-asset portfolios lacked their usual diversification effects, which would ordinarily have had a smoothing effect on returns.

The extent of the crisis becomes apparent when looking at the US as an example. While equities only had a ‘poor’ year, the movement in bonds was brutal, with long-dated US government bonds (10 years or longer) recording historic losses.

Generally speaking, market corrections primarily have a deflationary effect, which explains the monetary policy path that central banks have chosen. Their stated objective was and is to create a deflationary impact; after all, the Fed Futures Implied Rate for early 2023 was just under 1% as recently as the start of 2022 but climbed to around 5% by the end of November.

Chart 1: Return of US long-term Treasuries vs. US stocks



Source Bloomberg, Ibbotson

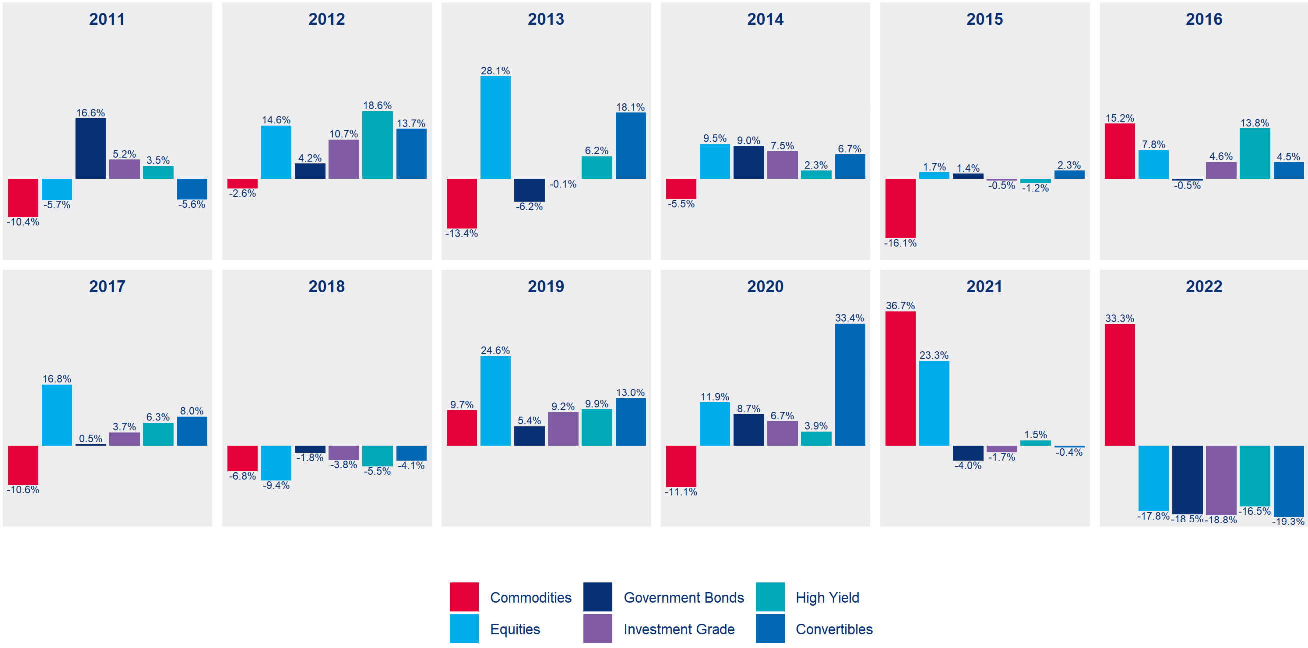
We reduced risk across all asset classes in our multi-asset portfolios over the course of the year, which was the only realistic option in this situation. While this benefited us tactically, we were nonetheless unable to escape the downward trend. In particular, the relatively strong weighting of convertible bonds, which are defensive in principle, offered little protection in this extraordinary environment, as prices for both bond and equity components fell in tandem.

Although prices rallied temporarily, the principle of “don’t fight the Fed” applies not just when the markets are moving upwards, but when they trend downwards too. As a result, relying on these rallies without the underpinning of a supportive macroeconomic backdrop is purely speculative.

Outlook 2023

The calendar year of 2022 proved exceptional in many respects. The extent and size of the losses in capital markets were unlike anything else seen in the recent past. While equities got off lightly in global terms, repricing on the bond side reached historic levels. In fact, total equity and bond losses worldwide measured in USD were significantly larger at the point of maximum drawdown in 2022 than they were in 2008. The effects of this immense destruction of value will be felt for quite some time.

Chart 2: Returns by asset class and year



Source Bloomberg

In light of the deteriorating economic situation and numerous lagging interest and dampening effects, however, the upheaval on the bond side may have reached a level from which a rebound can be expected in the medium term. In keeping with our CIO's macroeconomic outlook (see separate document) that interest rates can be expected to ease once more in the first half of 2023, the Fed Funds Futures are currently pricing in exactly such a movement from mid-2023 onwards.

» In the US, various circumstances should lead to a reversal in interest rates.

The markets' consensus view is that a normalisation of inflation, potentially combined with a recession, will eventually result in a turnaround in interest rates. Although numerous leading indicators are already pointing to this scenario, we believe there is another reason why this might be the case. The US has taken on USD 8 trillion in debt in the last three years – at an interest rate of 5%, that would mean an interest burden equivalent to more than 30% of all public revenue. Around 30% of government debt will be rolled over in the next 12 months, and approximately 50% in the next three years, with most US sovereign debt financed at the short end of the yield curve. With interest payments set to exceed the US defence budget in this scenario, this item will dominate budgetary discussions and put pressure on the Fed.

What does this backdrop mean for our multi-asset portfolios?

While we believe that all of the above will cause interest rates to fall, they are unlikely to return to pre-crisis levels. Instead, we assume that markets will have to accept an elevated interest rate corridor. This will help to normalise as well as increase the value and diversification potential of our allocation to risk-free government bonds in our portfolio.

Asset classes: return expectations and assessments

Asset class	Expected Return[1] [EUR]	2023 View[2]
Equities	7.3%	→
Convertible Bonds	7.1%	↗
High-Yield Bonds	6.6%	↘
Investment Grade Bonds	4.2%	↗
Government Bonds	2.9%	↑
Commodities	5.1%	→

Source Fisch Multi Asset Solutions

» The environment for technology mid-caps is promising.

These interest rate effects will also have a positive impact on the convertible bond component, which, as bond specialists, is the primary focus of our investments. The earlier precarious interest rate situation meant the bond floor was unable to exert its dampening effect on losses in the options component, which makes a sharp recovery all the more likely in 2023. When one considers that the technology mid-caps that largely comprise the convertible bond universe had already delivered disappointing returns in 2021, it becomes clear that the combination of falling interest rates together with an oversold asset class and an oversold underlying sector is a promising one.

As a result, we believe that not only will the diversification characteristics of multi-asset portfolios return, but also that a reversal of macro parameters will create interesting return potential.

Nevertheless, it is vital to take account of the fact that the investment environment has changed in 2022. Two points are particularly worth noting here. First, we believe that due to the many conflicting macroeconomic currents there will be a much greater emphasis on active management in the future than we have seen in the last ten years. More volatile capital markets, deglobalisation and a generally more turbulent geopolitical environment, together with the additional challenges posted by a politically driven wave of decarbonisation of the economy, will all play a part. As a fixed income specialist, we are exceptionally well positioned here, both at an asset class and allocation level. As a result, it makes sense to broaden our tactical bandwidths.

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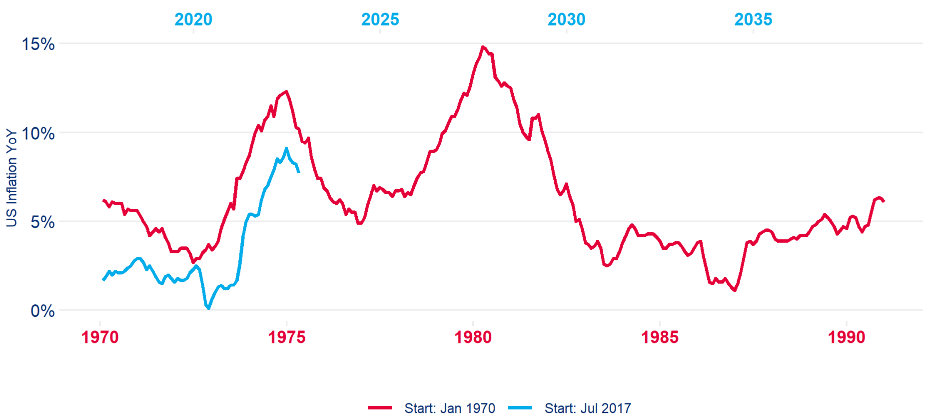
[1] Medium-term, annual return expectation based on current risk premiums of the individual asset classes, currency hedged in EUR
[2] Expected deviation in 2023 from medium-term annual expected return

Second, we assume that the aforementioned circumstances will mean that the future environment is more reminiscent of the 1970s, which implies that we will see successive phases of falling and rising inflation. By way of comparison, we have mapped the current movement in the US inflation rate (CPI) against the post-1970 phase in the chart below. In this context, it is important for us to be able to harness so-called "real assets" at a tactical level in addition to our preferred risk asset class of convertible bonds, where we see considerable value potential. Real assets should offer particularly good protection in the event of a future phase of inflation. As a result, we will increasingly make use of tactical elements, such as inflation-linked bonds, precious metals and dividend-paying stocks.

Chart 3: Comparison of the current inflation with that of the 1970s



Source Bloomberg

Conclusion

For diversified portfolios, 2022 was a poor year. There is a risk that this experience will linger with investors for longer than is reasonable for the purpose of achieving optimum risk-adjusted returns. We see potential both in terms of diversification and in terms of returns. The key to exploiting this potential is a normalisation on the interest rate front. This does not necessarily mean cutting rates, as a less aggressive interest rate trajectory can also help in this regard.

All of this culminates in our view that the three pillars of bonds, convertible bonds and active management should bear fruit once more – in short, it is time for multi-asset portfolios.

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