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July's topic:
„The Fed reaches its limits"

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The Fed reaches its limits

- The global economy remains resilient and continues to benefit from the shift of liquidity into the real economy.
- The Fed under Kevin Warsh has taken a surprisingly hawkish stance, as a solid labour market and increasingly supply-driven inflation increase the pressure for restrictive monetary policy.
- We remain neutral to slightly positive on risk exposure; corporate bonds are benefiting from the robust economic backdrop, while convertibles offer attractive asymmetry.

Overall economic situation

The global economy remains resilient and continues to benefit from a shift in financial-market liquidity into the real economy, driven by the AI investment boom and high fiscal deficits. Recent economic data have therefore come in better than expected, and the energy-price shock has so far been well absorbed. The interim agreement between the US and Iran is also providing relief, with the oil price falling back to pre-war levels as a result. The downside of this environment remains persistent inflation and increasingly restrictive central banks.

Recent developments: Hawkish Fed, tight liquidity

- The Federal Reserve under its new Chair, Kevin Warsh, has taken a surprisingly hawkish stance. Around half of the Fed leadership expects one or two further rate hikes by year-end, thereby confirming the signals from the bond market, where the 2-year US Treasury yield had already anticipated higher policy rates. This reflects a better-than-expected development in the US labour market in the first half of the year and persistent inflation. Warsh also points to a monetary-policy approach with less forward guidance, allowing markets to react more independently to economic data.
- At the same time, the global liquidity cycle has turned and is now in a critical zone. The shift of liquidity out of financial markets and into the real economy is leading to a growing lack of oxygen on the equity markets. This development is being driven by several major trends: high budget deficits, rising defence spending, the diversification of global supply chains and the AI infrastructure boom. The Mag7 are emblematic of this shift: since the end of 2025, they have for the first time raised more net capital through bond and equity issuance than they return to capital markets through share buybacks and dividends.

➲ **On the radar: Kevin Warsh and Greenspan's legacy** (page 6)

Overview & outlook: The Fed reaches its limits

» The Fed is limited in curbing supply-driven inflation

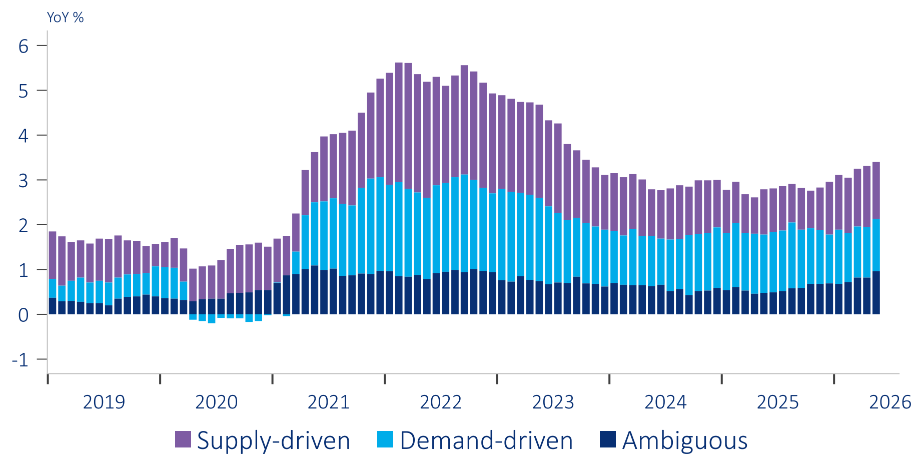
— Even if the Fed were to raise its policy rate once more this year, as priced in by futures markets, this is unlikely to be enough to slow the robust US economy. The Taylor rule, which derives the appropriate policy rate from inflation, the neutral real rate and economic capacity utilisation, would currently point to a significantly higher level. A "run-it-hot" scenario is therefore likely, in which the late-cycle economy continues to benefit from the shift of liquidity into the real economy, while inflation remains persistent.

— In addition, inflation is increasingly supply-driven. The AI investment boom in data centres, memory chips, power grids and power plants is supporting the economy, but it is also meeting scarce resources and limited capacity. The reshoring and reconfiguration of global supply chains is inflationary as well. Yet this is precisely the part of inflation that the Fed can control only to a limited extent. It follows that fighting inflation cannot rely solely on moderate rate hikes; other factors such as supply capacity and fiscal policy play a far more important role.

— At the same time, US demand also remains resilient thanks to the "K-shaped economy": higher-income groups benefit disproportionately from rising equity markets and, through positive wealth effects, account for a large share of private spending. This is reflected in particularly persistent services inflation. As long as equity markets remain at elevated levels and the AI-driven investment cycle continues, sustainable disinflation will be difficult to achieve.

— The US labour market is not yet generating pronounced inflationary pressure. Despite the recent upturn, it is not tight enough to drive wages sharply higher; we are still far from a wage-price spiral. Wage growth has normalised and stands at around 3.5%, leaving little in real terms for the average US consumer. The quits rate remains an important leading indicator: a renewed rise would point to stronger demand for labour and potentially higher wage pressure.

Chart: US core inflation (PCE) is increasingly supply-driven



Sources: Macrobond, Fisch Asset Management

Positioning: Corporate bonds have the advantage

» **Corporate bonds remain attractive fundamentally**

- The uptrends in equity markets remain intact. Larger risk reductions are therefore only warranted once key technical support levels are broken. At the same time, shifting direct equity exposure into convertible bonds already appears attractive, as convertibles offer an appealing asymmetric risk-return profile.
- A cautious stance is warranted on government bonds. The yield curve is flattening because robust economic data, persistent core inflation and a more hawkish Fed are driving up short-dated yields in particular. At the same time, the declining term premium for longer-dated government bonds signals a more defensive positioning among investors: falling liquidity is weighing on equity markets, while demand for long-dated government bonds is rising in this environment.
- Overall, corporate bonds remain more attractive than government bonds. In High Yield, solid fundamentals, high current yields and short duration support the investment case. Emerging-market bonds are also benefiting from the resilient real economy and the commodity cycle: commodity-exporting countries generate more export revenues when prices are higher, strengthening their trade balances and public finances. In addition, global investment needs in energy, infrastructure, mining and agricultural production are increasing financing requirements in these areas, creating additional opportunities for bond investors.
- On gold, we remain tactically neutral but constructive over the long term. In the short term, higher real yields, a stronger dollar and increased liquidity needs are weighing on the metal; the latter has recently dampened demand in key buying regions such as the Middle East and India. Structurally, however, the environment remains supportive: China continues to build its gold reserves in order to strengthen confidence in the yuan, while many emerging-market central banks are seeking to reduce their dependence on the US dollar. The key question now is whether PBoC liquidity increases again, which could be an important signal for a renewed upward move in the gold price.

Return drivers	US	Europe	Japan	Asia ex-Japan	LatAm	CEEMEA
Equities	o	o	o	o	+	o
Gov. Bonds	o ↑	o ↑	o ↑			
Credit IG *(Spreads)*	o	o		o	+	o
Credit HY *(Spreads)*	+	+		-	+	o
Total return						
Convertibles	o	o	- ↓	+		
Credit IG	o	o		+	+	+
Credit HY	+	+		o	+	+

	PrecMet	InduMet	Energy
Commodities	o	+	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 the 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	– 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	– Consumer discretionary – Unprofitable, early stage, expensively valued IT and biotech – Weak credit quality and/or liquidity – Cryptocurrency-related names
Global IG Corporates	– Healthcare, financial services and banking – BBB-rated bonds – EUR-denominated issues	– Technology & electronics, media, basic industry – A-rated bonds
Global Corporates	– Healthcare, financial services, consumer goods – Developed markets – BBB- and BB-rated bonds	– Technology & electronics, basic industry, transportation – Emerging Markets – A-, B- & CCC-rated bonds
Global High Yield	– Telecommunications – Basic industry – Retail	– Financial services – Utilities – Insurance
Emerging Markets – Defensive	– LatAm (Mexico, Brazil), Eastern Europe, Saudi Arabia – Utilities, energy – Maturities 7-10 years	– Asia (Hong Kong) – Industrials
Emerging Markets – Dynamic	– LatAm (Mexico, Brazil, Colombia), Eastern Europe – High-yield bonds – Utilities, consumer goods	– Asia IG (China, Hong Kong) – A-rated bonds – Maturities > 15 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: Kevin Warsh and Greenspan's legacy

Alan Greenspan recently passed away at the remarkable age of 100. Few central bankers shaped modern monetary policy as strongly as he did. Under his leadership, the Fed succeeded in consolidating the progress made under Paul Volcker in the fight against inflation and in establishing the 2% inflation target as the central anchor of monetary policy. His legacy was the conviction that maximum employment can only be achieved over the long term through stable prices.

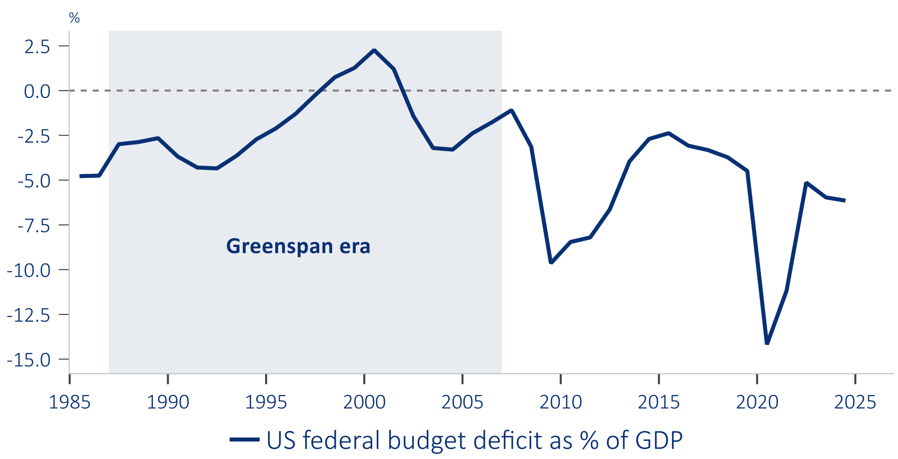
Kevin Warsh is aligned with Greenspan's understanding of monetary policy in several key respects. Like Greenspan, Warsh is critical of forward guidance. Greenspan was known for his deliberately restrained communication; Warsh is now moving in a similar direction. The written statement following the June meeting was already significantly shortened and stripped of forward-looking assessments of the economic outlook and the monetary policy stance. The aim is to give markets fewer reference points for continuously adjusting their expectations of the Fed. Instead, financial markets should once again react more independently to economic and inflation data, while the Fed, in turn, draws additional information from market reactions.

» Less forward guidance can increase rates volatility

This reduces the risk that the Fed loses credibility through incorrect signals. The downside, however, is potentially higher volatility, as rate expectations are less firmly anchored between meetings and Fed policy rate decisions could once again become more market-moving.

There are economic parallels as well: as at the beginning of the Greenspan era, core inflation is currently elevated, and once again we are in a period of profound technological change. Greenspan was right in the 1990s that productivity gains can have a disinflationary effect. Whether AI has a similar impact this time remains an open question. The major difference lies in the fiscal environment: today, public debt and the Fed's balance sheet are significantly larger, which restricts the room for monetary policy more than in Greenspan's time. Warsh's greatest challenge will be to guide monetary policy through an environment shaped both by the opportunities and risks of the AI revolution and by high structural fiscal deficits.

Chart: High US fiscal deficits make the Fed's task harder



Sources: Macrobond, Fisch Asset Management

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