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INVESTMENT OUTLOOK 11.2018

11 November 2018

October was a damaging month for multi-asset-class investors. Risky assets sold off, while safe-haven assets like government bonds and gold failed to provide portfolio insurance. In fact, governments bonds and high-grade bonds were marginally down in October and gold gained merely 2%. At the same time, we saw, e.g., Japanese and Emerging markets equities losing roughly 9%.

The major reasons for the October market moves are related to more hawkish comments by Fed chairman Powell, resulting in fears of rising interest rates, concerns about the impact of the trade war, and late-cycle nervousness of investors, who fear the party could end sooner rather than later.

However, fundamentals still indicate a robust growth momentum, despite a certain slowdown in Europe and China.

We remain cautiously positive for equity markets and continue to avoid interest-rate risks. Our portfolios are positioned defensively with a small risk tilt towards US equities and a clear underweight in bonds.

Thomas Trauth
CEO – IMT Asset Management AG

WILL THE FED SPOIL THE PARTY?

Financial markets

Equity markets fell peak-to-trough by about 10% between mid-September and the end of October. The trigger was hawkish comments by US Fed officials. As a result, US 10-year yields rose as high as 3.2%, which, in turn, worried equity investors. As a result, the sell-off of equities accelerated during October, further fueled by trade war concerns, the slowing of the Chinese economy, discussions around the Italian budget, and a more general late-cycle nervousness on the part of investors. At the same time, the traditional safe-haven assets hardly helped, since government bonds were down as well, albeit only marginally, and gold rose only 2% in October.

The big question for investors has been, “Are we in an equity market correction or in a bear market?”. During a correction, equities lose 10-20% and you typically like to hold on to your positions and potentially even buy into the weakness. During a bear market, when equities lose more than 20% you want to sell or reduce your position and wait for a re-entry at a later stage. Usually bear markets occur in the run-up to or during a recession. Since we see no indication of a looming recession, we rather think that what we experienced in October was a correction.

Major victims have been Japanese and emerging markets equities, which lost about 9%. For a change, US equities underperformed Europe, falling 6.9% in October compared to 5.9%. A notable exception from the sell-off of global markets was the Brazilian equity market. In the run-up to the second presidential election round on 26 October the Ibovespa rose about 10%. Market participants seem to have given the likely and actual winner of the elections, the far-right Jair Bolsonaro, a lot of credit for a positive economic reform program.

US yields rose by about 5 basis points in October, while European yields dropped about 10 basis points. Credit spreads widened across the board. Especially high-yield and emerging-markets bonds sold-off, albeit by much less than equities.

REITS proved their defensive nature and lost only 1.4%. Growth-sensitive commodities, energy and industrial metals fell significantly. Oil prices dropped almost 9% and industrial metals 5.5%.

The USD and the JPY gained in October. The USD appreciated 2.5% vis-à-vis the EUR and the JPY even rose 3.2%. The GBP benefited from expectations of a positive Brexit result.

Macro economics

In October most PMIs softened. The US ISM index fell to 57.7 after 59.8, and the EMU PMI fell to 52.0. The Chinese PMI, however, managed to rise slightly to 51.1 after 50.0. However, the China PMI remains very close to the critical level of 50. Levels below 50 indicate declining economic activity.

US non-farm payrolls rose strongly by 250,000 in October, which was above expectations. Average hourly earnings rose by 3.1% YoY, which is the strongest wage growth for many years. It seems that wage pressure is building, which could start pushing headline inflation up. However, US headline inflation for September (the figure for October is not yet available) fell to 2.3% after 2.7%. EMU inflation slightly rose in October to 2.2% after 2.1%.

Central banks

On 7 October the People's Bank of China (PBOC) announced that it would cut the reserve requirement ratio (RRR) for financial institutions by one percentage point, the fourth such move this year. This move frees up banks' liquidity by an estimated USD 109 bn with the objective of expanding bank lending. This measure supposedly comes as a reaction to a slowing Chinese economy and as a measure to counter the negative impact of the trade war with the US. At the same time, the PBOC still regards its policy stance as neutral.

On 3 October Fed chairman Jerome Powell said that the Fed "… may go past neutral, but we are a long way from neutral at this point …". These comments were taken as rather hawkish, sending US bond yields up and equity markets down. At its regular policy meeting on 8 November, the US Fed kept rates unchanged. The Fed said that economic activity has been rising at a vigorous rate and that job gains have been strong. Furthermore, chairman Powell repeated the outlook for further gradual rate increases. The Fed regards risks to its outlook as roughly balanced. It is widely expected that the Fed will raise rates for the fourth time this year at its 19 December meeting.

The ECB had its meeting on 25 October. It kept rates unchanged and did not change its policy stance or its outlook. The asset-purchase program will most likely end in December. The ECB will reinvest proceeds from maturing securities to keep favorable liquidity conditions thereafter.

On 1 November the Bank of England announced its intention to maintain the bank rate unchanged at 0.75% and to keep the stock of sterling bonds constant.

The Bank of Japan also kept its monetary policy unchanged at its 31 October meeting. The policy balance rate remains at -0.1% and the target for 10-year JGBs remains at about 0%.

Outlook

There is no indication that the US economy will be slowing down significantly in the coming quarters. The impact of the trade war is much harder for China, other emerging markets and Europe, since the countries in those regions have a much larger import and/or expert sector than the US.

As wage pressure is starting to build, US inflation is likely to rise and the Fed will continue to raise rates. The next rate hike is expected for December. In our view, the market is still underestimating the probable future hiking path. Since real short-term interest rates are still negative, we regard the current Fed policy as still accommodative. There is a debate on where the neutral short-term interest rate actually is. It is safe to assume that the neutral rate is above 2.75, possibly above 3.0%.

On the back of stronger US growth and higher interest rates compared to Europe, we regard it as likely that the USD will strengthen further.

Rising rates and a stronger USD will tighten monetary conditions in the US, generating headwinds for US equity markets. However, strong evidence from past cycles suggests that this does not usually derail equity markets. On the other hand, equity-market corrections, as experienced in February and October, certainly become more likely.

As a result, we remain cautiously constructive on equities. Equities are likely to outperform bonds. We express this via a neutral or close-to-neutral equity position (small overweight of US equities) and a clear underweight of bonds. Despite recent credit spread widening, we remain underweight in credit. Overall, this results in a higher cash position, which we see as appropriate for reducing portfolio risks and which could be deployed into equity market weaknesses.

ECONOMICS

PMI data for October came in weaker. The US ISM index fell to 57.7 after 59.8, the EMU PMI fell to 52.0 after 53.2, while the China PMI rose slightly to 50.1 after 50.0. US non-farm payrolls rose to 250,000, above expectations. Average hourly earnings rose 3.1% YoY, which is the strongest increase for many years.

Fig. 1: PMIs

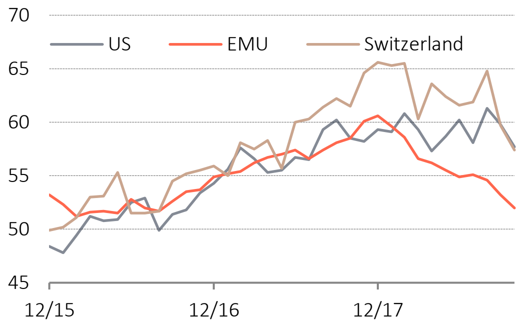


Fig. 2: PMIs

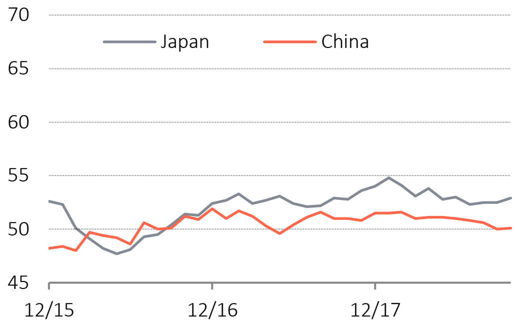


Fig 3: Consumer price inflation, in % YoY

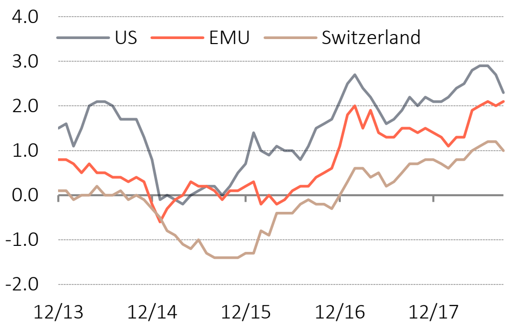


Fig. 4: Consumer price inflation, in % YoY

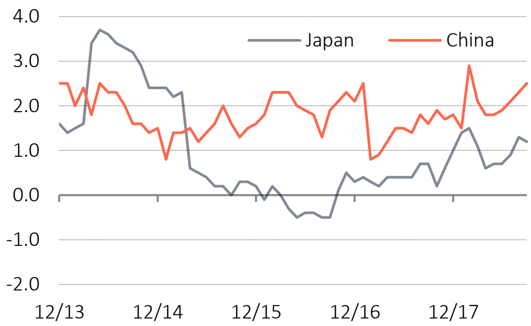


Fig 5: Unemployment rates, in %

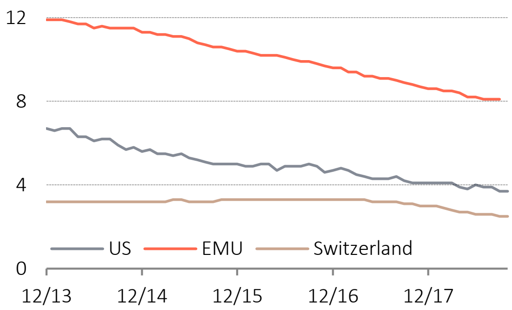
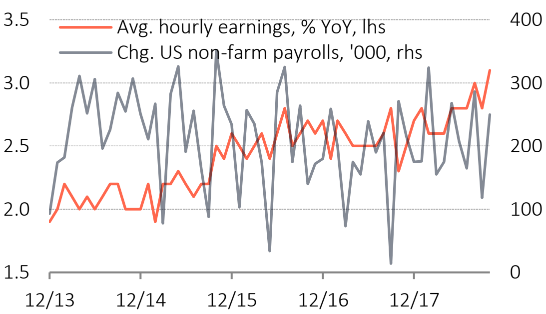


Fig 6: US labor market



FIXED INCOME

A more hawkish Fed pushed US yields up. 2-year treasury yields rose 5 basis points and 10-year yields 8 basis points. In contrast, German 2-year yields fell 10 basis points and 10-year yields 9 basis points. It is interesting that although many strategists expect rising inflation, 10-year break-even inflation rates remained more or less constant. Credits lost in October, especially high-yield and emerging market bonds, were under selling pressure.

Fig.7: 2Y government bond yields

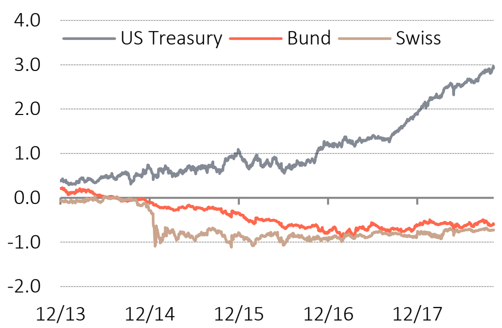


Fig. 8: 10Y government bond yields

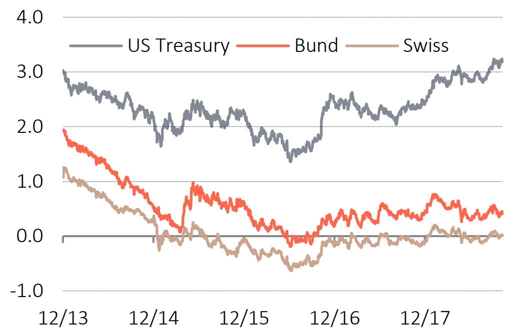


Fig 9: 10Y break-even inflation

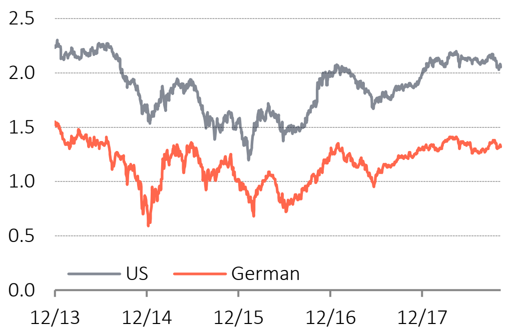


Fig. 10: Credit spreads, 5Y credit default swaps

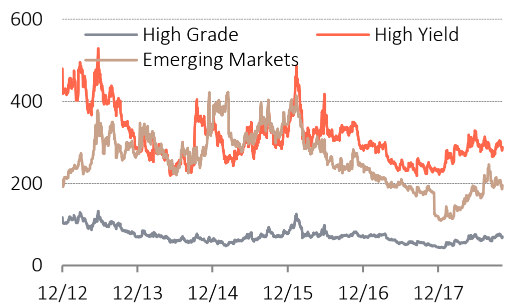


Fig 11: Money market spreads (3M-2Y)

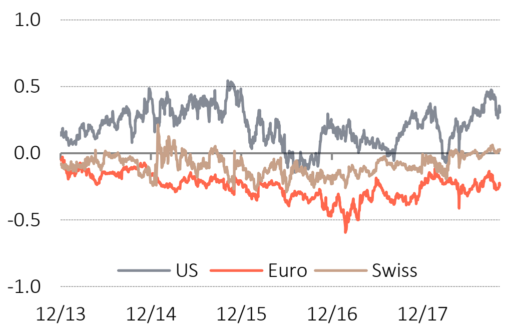
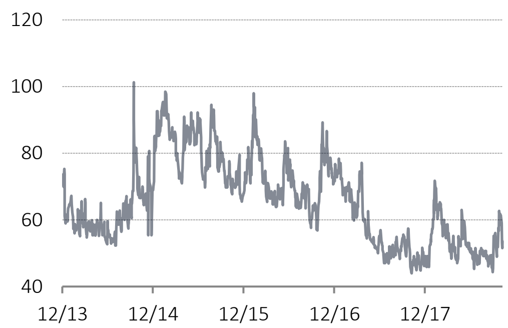


Fig 12: Merrill Lynch volatility index (MOVE)



EQUITIES

Emerging markets continued to underperform and lost another 8.8% in October. Japanese equities, which had a strong run in July, August and September, lost 9%. The US S&P500 index underperformed the MSCI Europe and lost 6.9%, compared to 5.9% (MSCI Europe). A notable exception was the Brazilian Ibovepsa index, which gained 10% in October during the run-up to the second presidential election round, which resulted in a win for the far-right Bolsonaro on 28 October.

Fig. 13: MSCI equity indices – major regions

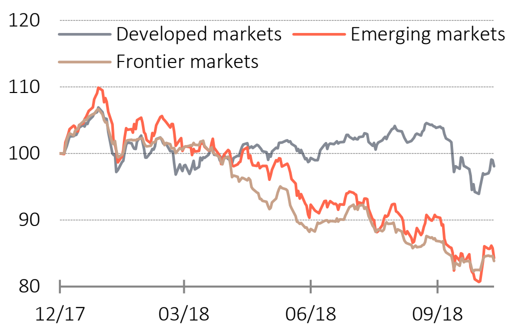


Fig.14: Equity indices – major developed markets

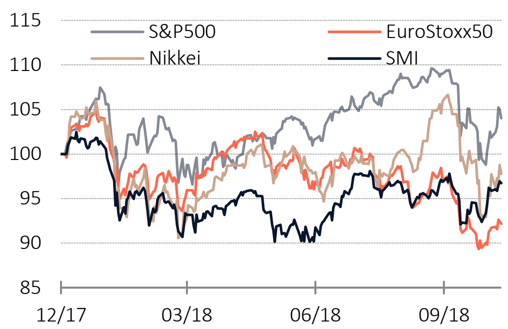


Fig 15: Equity indices – major emerging markets

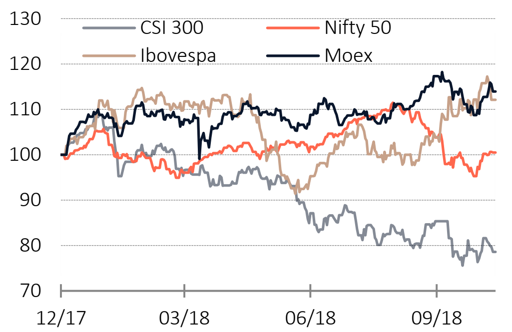


Fig. 16: Sector performance, MSCI Europe, 2018

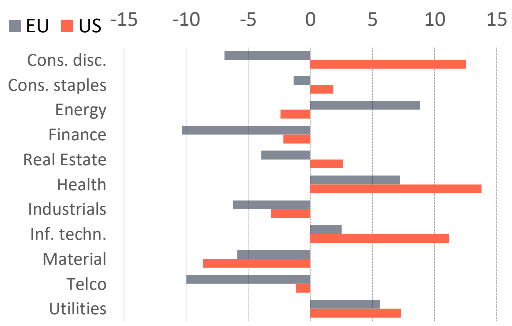


Fig 17: Price-earnings ratios

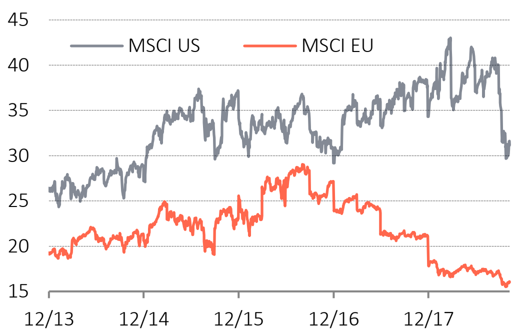
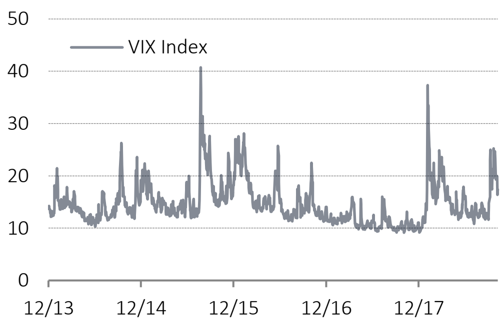


Fig 18: Equity volatility – S&P500 VIX index



ALTERNATIVE INVESTMENTS

Gold retreated in October and gained about 2%. Despite a positive outlook for oil due to looming supply-side restrictions, oil prices fell by 8.8% in October. Industrial metals fell 5.5%. Global REITS fell by 1.4% and were able to hold up much better than many other equity sectors, confirming their defensive nature.

Fig. 19: Gold price, USD/oz

Fig.20: Brent oil price, USD/bl

Fig 21: Bloomberg commodity indices

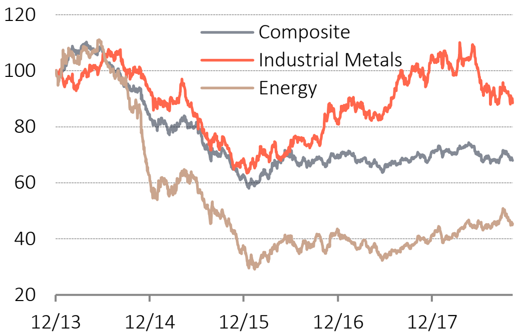


Fig. 22: HFRU hedge fund indices

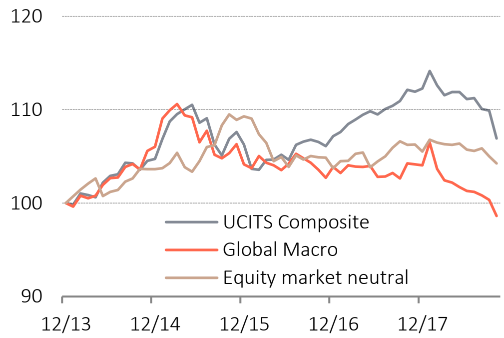


Fig 23: FTSE EPRA/NAREIT global REITS index

Fig 24: LPX global listed private equity

CURRENCIES

During the risk-off environment in October, the USD and the JPY appreciated vis-à-vis the EUR, by 2.5% and 3.2%, respectively. As the chance of a Brexit deal rose, the GBP appreciated in October by roughly 0.5%, and continued to rally in early November. Trade-war concerns and additional monetary easing in China sent the Chinese CNY lower. The CNY lost 1.6% vis-a-vis the USD in October.

Fig. 25: EUR-USD exchange rate

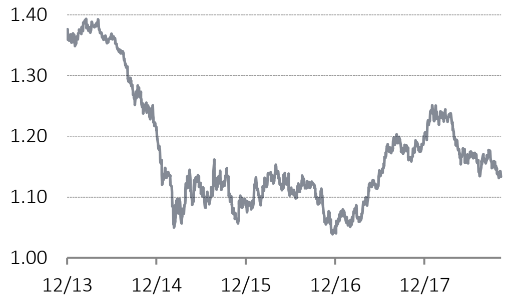


Fig. 26: GBP-USD exchange rate

Fig 27: USD-JPY exchange rate

Fig. 28: USD-CNY exchange rate

Fig 29: EUR-CHF exchange rate

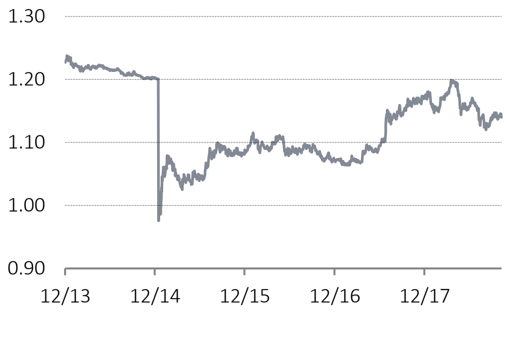


Fig 30: USD-CHF exchange rate

ASSET ALLOCATION

October was a particularly bad month for multi-asset-class investors, since safe-haven assets like government and high-grade bonds gave no protection. The only asset which gained about 2% in October was gold. Equity markets were hit hardest, in particular Japanese and emerging markets, which lost about 9% in October. The USD and the JPY appreciated vis-à-vis the EUR in that month.

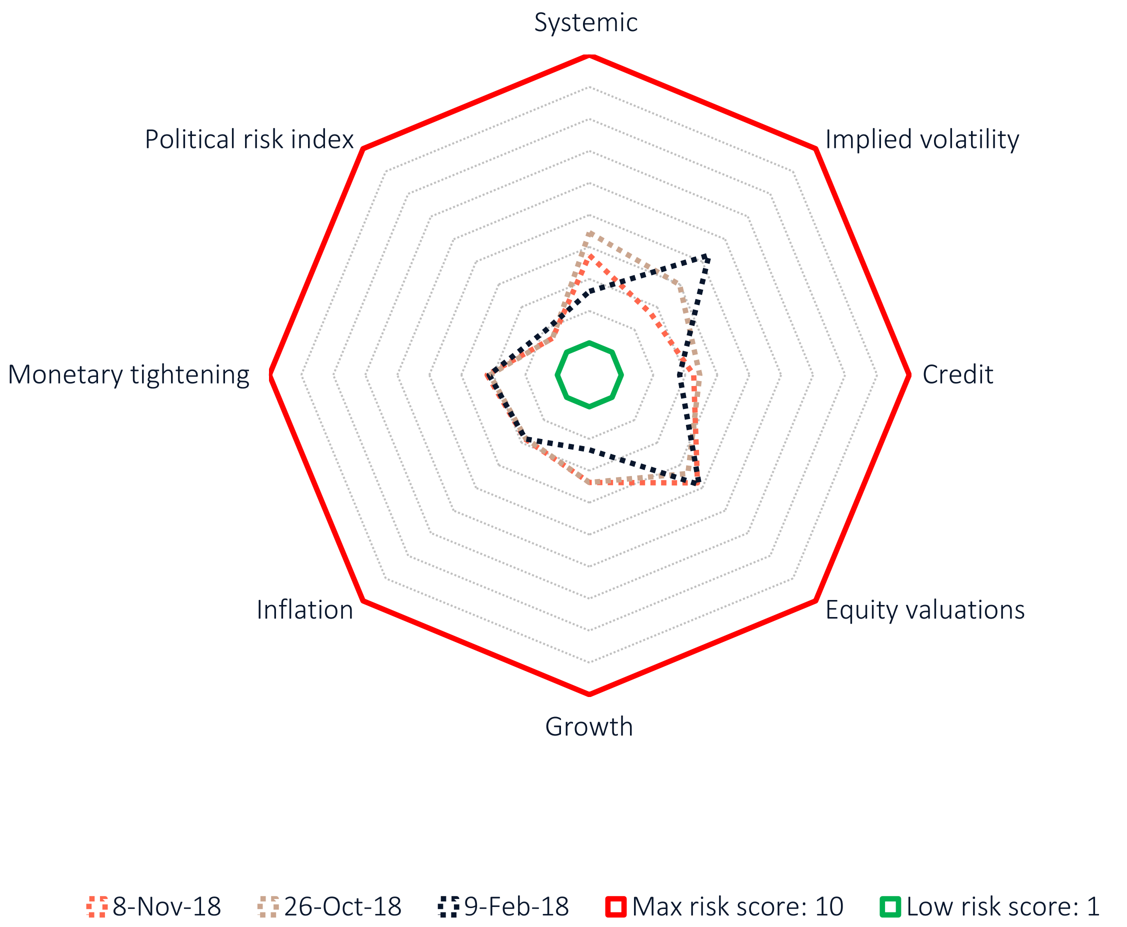
Fig. 31: Performance of major asset classes, based on our EUR portfolio strategy

RISK MONITOR

We compare the risk landscape on 8 November, with that of the end of October, when equity indices reached their low, and with the situation during the February sell-off. During October, there were rises especially in implied volatility and our systemic risk indicator, which reflects the health of the banking system. Since then the systemic risk indicator has fallen, though remaining relatively high, but most other indicators have clearly retreated.

Fig. 32: IMT Risk Monitor

26 Oct 2018: October sell-off
09 Feb 2018: Inflation fear and technical correction



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Source for all graphs: Bloomberg, IMT Asset Management AG.