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IMT GROUP

INVESTMENT OUTLOOK 11.2015

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After a brutal third quarter, markets calmed noticeably in October. So far it has paid off to hold on to risky assets or even more to buy on dips. Markets took a certain comfort both from the fact that Chinese officials intervened by implementing monetary and fiscal measures and also from the somewhat better economic data. In addition, the Fed came out with dovish rhetoric and delayed the first rate hike, although in early October the Fed had indicated a rising likelihood of a December hike.

The major concern, a hard landing for the Chinese economy, no longer seemed to be driving the markets. With hindsight, the August and September sell-off looks like an exaggerated market move. However, we think it also shows that the bull market has matured, and many market participants fear we could soon move into a structural bear market. In the following, we discuss the likelihood of this scenario.

We hope you enjoy our analysis.

Thomas Trauth
CEO – IMT Asset Management AG

CHINESE HARD LANDING FEARS BANISHED

Financial markets

In October markets calmed noticeably and risky assets enjoyed a significant rebound. European and Japanese equity markets outperformed with the DAX rising 12.3%, the EuroStoxx50 10.2% and the Nikkei 225 9.7%. The S&P500 rose 8.3%, the Chinese Hang Seng index 8.6% and Emerging markets 7%.

European government bonds rallied on the back of a dovish ECB with 10Y Bund yields declining 7 basis points. Meanwhile US bonds sold off and 10Y Treasury yields rose 11 basis points.

In line with the risk-on environment, credit spreads — especially of high-yield and emerging markets bonds — tightened.

The USD and the GBP strengthened in October, driven by diverging central bank policies. The Chinese CNY strengthened somewhat after the devaluation of recent months. The Swiss franc rose slightly vis-à-vis the EUR.

Gold rose in October by 2.4% compared to end of September, reaching a peak in mid-October at about 1,185 USD/oz, started a marked decent thereafter and currently trades at about 1,090 USD/oz. Oil rose slightly by about 1% in October, while industrial metals fell by about 3%. As discussed previously this is a result of growth concerns but more importantly the outcome of large structural supply surpluses.

Central banks

At its 22 October meeting the ECB left rates unchanged. However, president Draghi's comments that the ECB would re-examine the degree of stimulus in December, were interpreted by many as a possible hint that the ECB could consider accelerating its bond-buying program. As a result, the EUR fell sharply after the announcement.

At its 28 October meeting the Fed unsurprisingly left rates unchanged. In its statement the Fed highlighted soft inflation and slower growth but also said that labor-market slack has diminished since the beginning of the year and that the housing market has improved. As a result, market participants were divided about the odds of a December rate hike. After strong labor-market data in early October, however, the market-implied probability of a rate hike increased significantly.

Meanwhile, at its 7 October meeting the Bank of Japan left the tempo of its quantitative easing program unchanged, thus disappointing 42% of the economists taking part in a Bloomberg survey who had expected additional quantitative easing measures

Macroeconomics

The US ISM manufacturing index fell further to 50.1 from 50.2 in September. Non-farm payrolls rose by 271,000, the strongest increase this year and clearly exceeding expectations. This pushed the unemployment rate down to 5% from 5.1%. Average hourly earnings also increased.

The Markit European composite PMI rose to 52.3 from 52.0 in September and confirmed that European growth dynamics remain intact.

The Japanese PMI also climbed sharply from 51.0 to 52.4, its highest level since October 2014 in its sixth consecutive month of expansion.

The Chinese Caixin manufacturing PMI also rose clearly from 47.3 in September to 48.3, but it remains in the contraction zone below a level of 50.

Is the equity bull market coming to an end?

This is the question investors globally are most concerned about, especially since the current equity bull market, which started in March 2009, is in its seventh year and is thus the third longest on record. Only the bull markets in the 1950s and 1990s lasted longer. This question is, in our view, related to three major equity market drivers, which we think are the following:

1. Earnings growth, which is strongly related to the economic cycle. As a rule, the stronger the overall growth dynamics, the greater the earnings potential for corporates.
2. Central banks' reflationary policy, which is designed to make risky assets more attractive. Central banks provide ample liquidity and push interest rates to zero – and in extremis, as seen in recent months, sometimes even below zero – to encourage corporates and investors to invest and take on more risks, which should boost economic activity.
3. Valuation of equities, which determines returns expectations. Obviously it is harder to gain positive returns when equities are already very expensive. In extreme situations, when valuations are excessively high, we may classify this as a bubble, which can lead to serious losses.

Let's have a look at the current situation regarding all three of the above-mentioned factors. Global growth, after the depression in 2008, has been slow to pick-up. Excess capacity and huge leverage had to be reduced and many would argue that the process is still ongoing. As part of the de-leveraging operation, governments took on a lot of bank and other debt, which resulted in the sovereign debt crisis of 2012 and 2013. However, the combination of ultra-expansive monetary policy and slow economic growth has prevented overheating and led to a steady development in most equity sectors, with by and large healthy corporate balance sheets. This environment is especially friendly for corporate credit but also for equity markets in general. As a result, earnings growth is steady but not stellar, which provides the ground-base for a longer lasting expansion.

Despite the fact that the Fed is starting to reduce its monetary support, central banks globally remain very expansive and we do not see signs of economic overheating. As a result, it is possible and likely in our view that the current benign market environment is here to stay. Down-side risks clearly remain and need to be watched. A hard landing in China is certainly one of them.

As mentioned above, we think that monetary expansion will continue for the next couple of years. While there is a certain risk that markets will be disrupted by the start of the Fed hiking cycle, history shows that a hiking cycle is usually a positive environment for equity markets. Also, it is very likely that the Fed is moving very gradually to prevent the USD from rising too strongly. Low and negative bond returns make equities very attractive, especially on the basis of relative valuations. Very often dividend yields exceed equivalent bond returns.

With regard to absolute valuations, equity markets do not look overly expensive historically. Admittedly, though, they do not look cheap either. There are, however, regional differences, which we would recommend taking into consideration. European, Japanese and most emerging markets look more attractive than US equities, as far as valuations are concerned. We certainly do not see bubble-like valuations at present.

Outlook

As a result, we are still cautiously optimistic for equity markets but remain mindful of risks related to the

start of the US hiking cycle and of growth risks, e.g. in China. Ultra-low interest rates and continued reflationary policy will, in our view, support equity markets. Based on valuations we continue to favor European and Japanese equity and certain parts of the emerging markets.

We also continue to see value in credit, especially in high-yield and emerging markets. Break-even inflation has fallen to very low levels, which we think are unsustainable. As a result, we prefer inflation-linked bonds over nominal government bonds.

Given October's upbeat labor market data and recent Fed statements, we expect the Fed to hike rates in December. Market-implied probability has gone up to 75% without disrupting equity markets, while Treasuries have sold off. This may be seen as an indication that markets are well prepared for the first Fed hike.

At the same time, the ECB and the Bank of Japan could accelerate their bond-buying programs. We see a higher probability for the Bank of Japan and a somewhat lower probability for the ECB.

The diverging monetary policies will favor the USD over the EUR and JPY, and we see further downside potential for the EUR-USD exchange rate.

US Treasury yields will gradually move towards 3% in our view, and the Gold price is likely to fall below 1,000 USD/oz when real rates start to rise in the US.

ECONOMICS

Most leading indicators improved in October, especially in China and Japan. The Chinese PMI rose to 48.3 from 47.2 and the Japanese PMI to 52.4 from 51. The US ISM index, however, declined, albeit slightly, falling to 50.1 from 50.2. US labor-market data improved ,noticeably however.

Fig. 1: PMIs

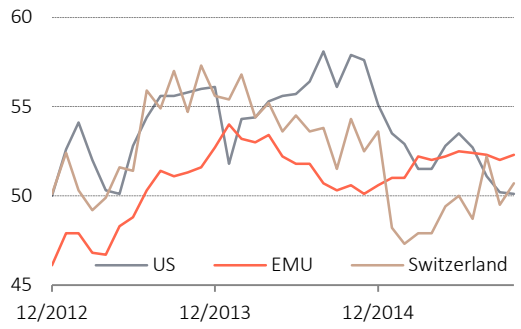


Fig. 2: PMIs

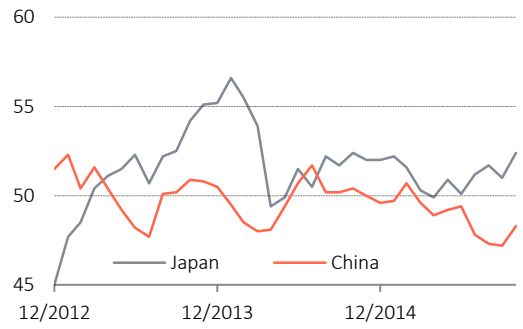


Fig 3: Consumer price inflation, in % YoY

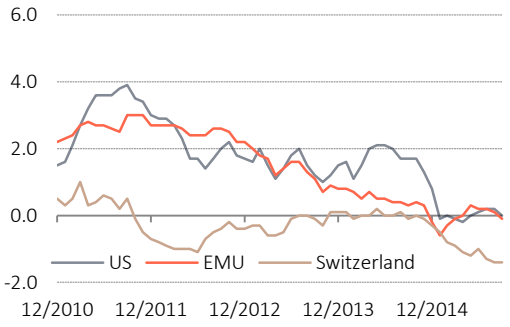


Fig. 4: Consumer price inflation, in % YoY

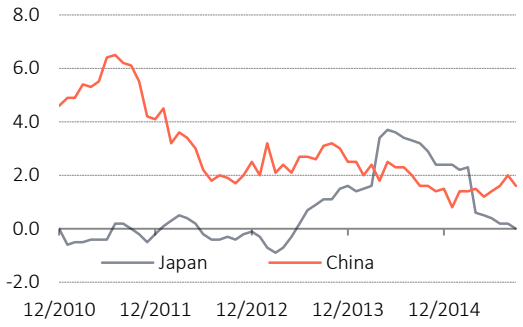


Fig 5: Unemployment rates, in %

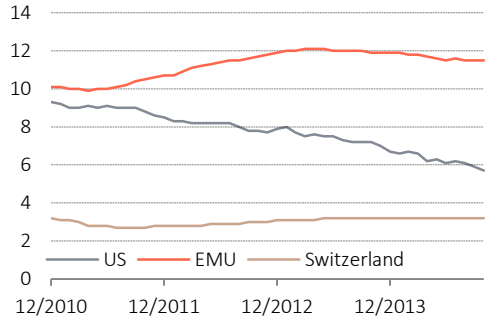
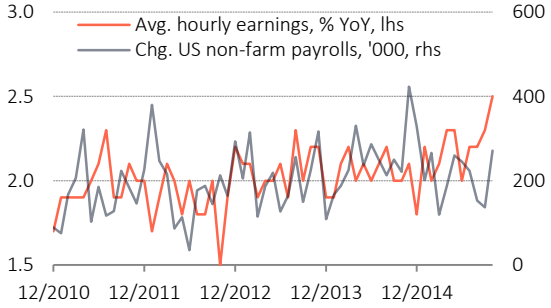


Fig 6: US labor market



FIXED INCOME

Government bond yields in Europe fell while US yields rose in October. German 10Y bunds declined by 7 basis points and US 10Y treasury yields rose by 11 basis points. Inflation expectations as measured by 10Y break-even spreads remain depressed. Rising demand for risky assets led to declining credit spreads, especially of high-yield and emerging markets bonds.

Fig.7: 2Y government bond yields

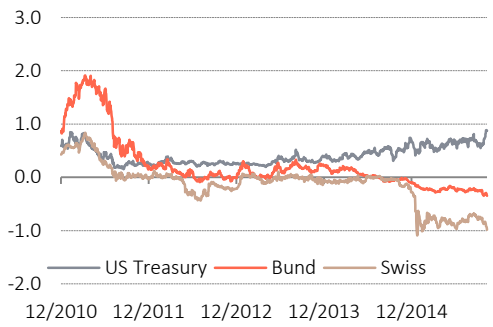


Fig. 8: 10Y government bond yields

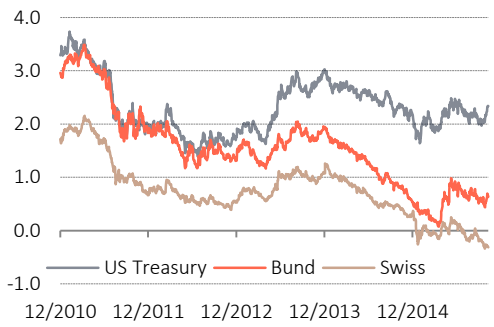


Fig 9: 10Y break-even inflation

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

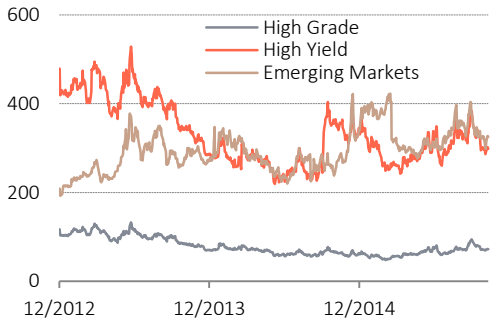


Fig 11: Money market spreads (3M-2Y)

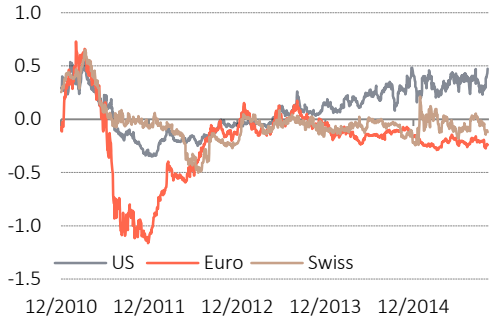
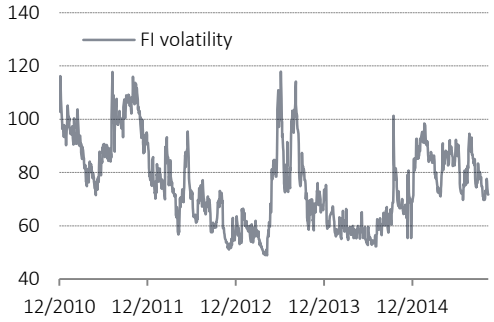


Fig 12: Merrill Lynch volatility index



EQUITIES

Most major equity markets enjoyed a relief rally in October. Lower market fear also translated into lower implied volatility levels. Also Chinese equity (CSI 300) recovered markedly. Among MSCI Europe sectors consumer stables, consumer discretionary, information technology, and health have outperformed since the beginning of the year. Utilities and basic materials continue to struggle.

Fig. 13: MSCI equity indices – major regions

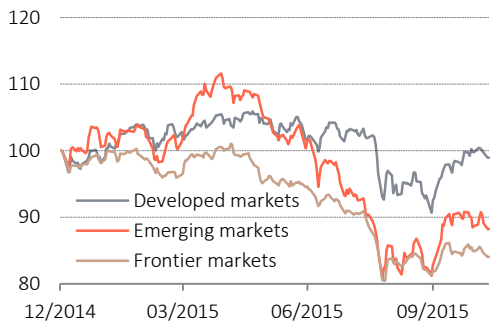


Fig.14: Equity indices – major developed markets

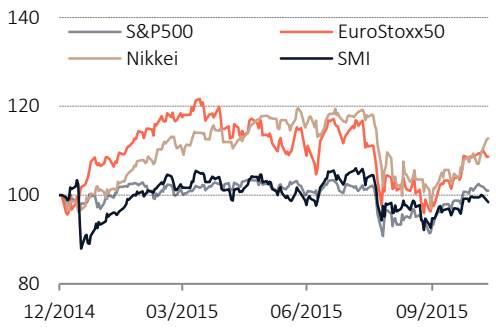


Fig 15: Equity indices – major emerging markets

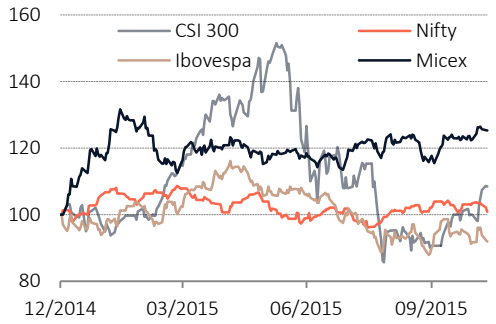


Fig. 16: Sector performance, MSCI Europe, YTD

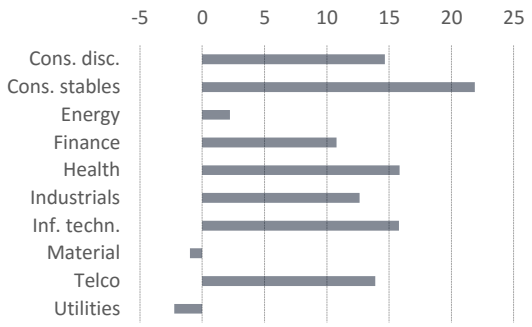


Fig 17: Price-earnings ratios

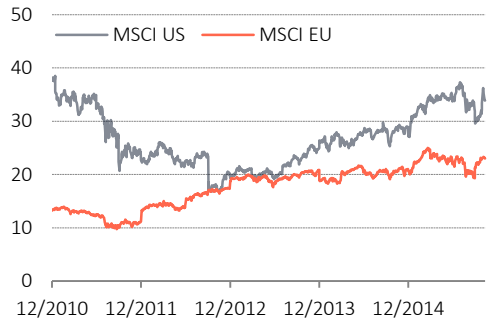
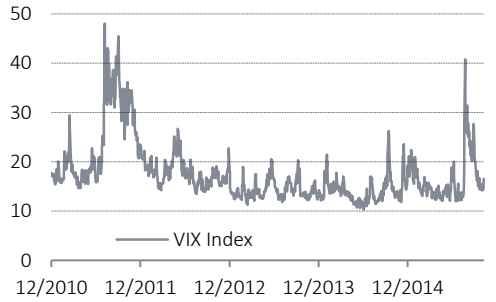


Fig 18: Equity volatility – S&P500 VIX index



ALTERNATIVE INVESTMENTS

REITS, listed private equity, and most hedge fund sectors rebounded in October. Commodities prices, in general, continued to fall. Gold rallied in the first half of October and reached a peak at about USD 1,185. Since then the Gold price has fallen again. Oil prices retreated somewhat and rose by about 1%.

Fig. 19: Gold price, USD/oz

Fig.20: Oil price, USD/bl

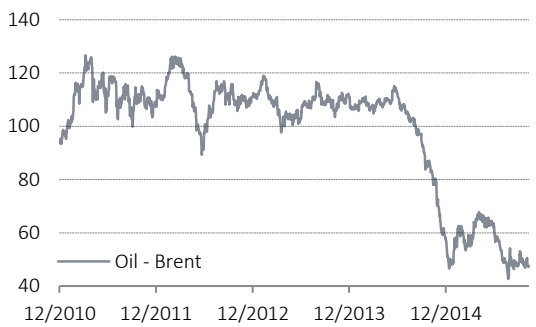


Fig 21: Bloomberg commodity indices

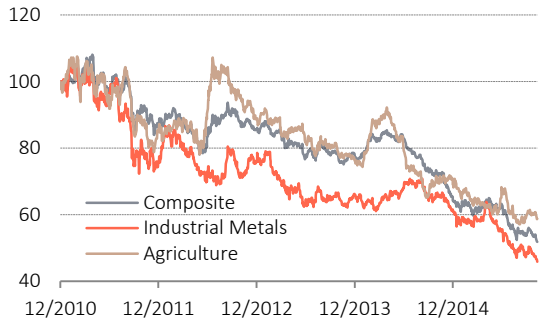


Fig. 22: HFRI hedge fund indices

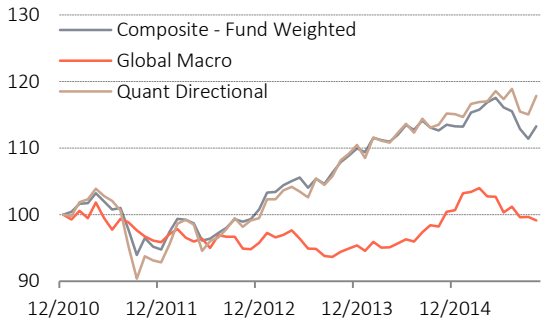


Fig 23: FTSE EPRA/NAREIT global index

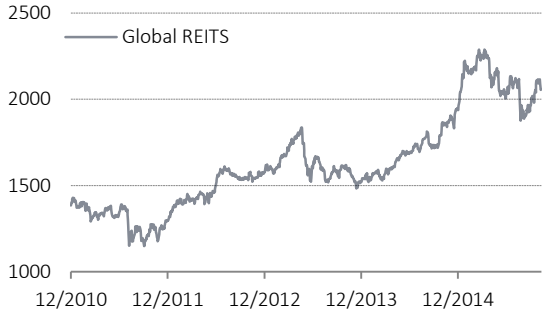
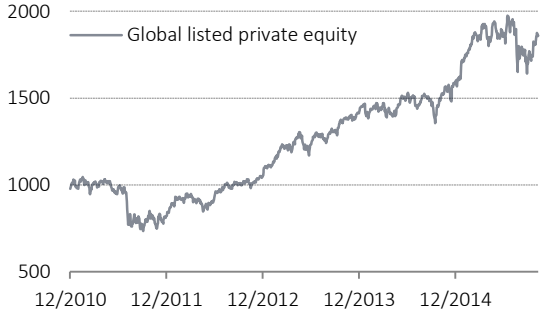


Fig 24: LPX global listed private equity



CURRENCIES

The USD regained strength in October. The EUR-USD exchange rate fell 1.5%. The GBP strengthened even further and rose 2% vis-à-vis the USD. The JPY stabilized around 120 vis-à-vis the USD while the Chinese renminbi strengthened somewhat. The EUR-CHF exchange rate remained relatively stable around 1.08-1.09

Fig. 25: EUR-USD exchange rate

Fig. 26: GBP-USD exchange rate

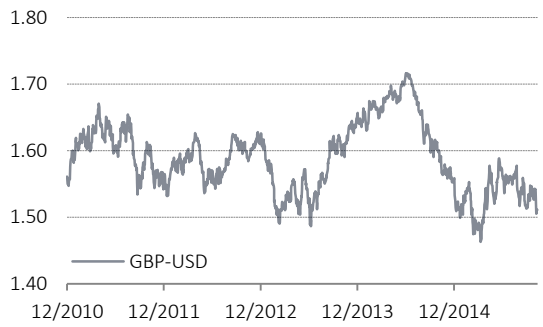


Fig 27: USD-JPY exchange rate

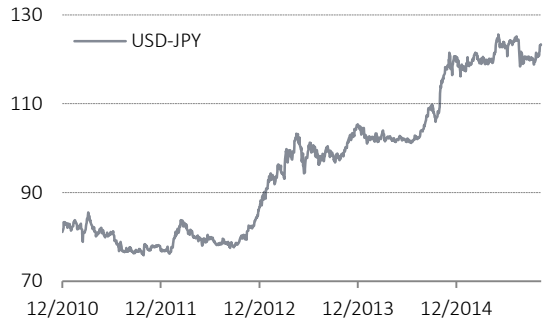


Fig. 28: USD-CNY exchange rate

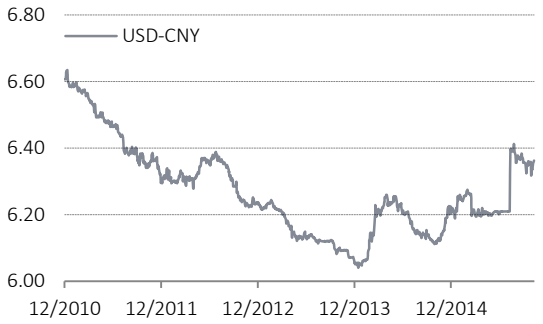


Fig 29: EUR-CHF exchange rate

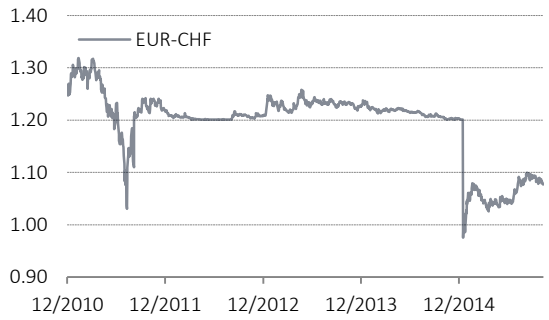
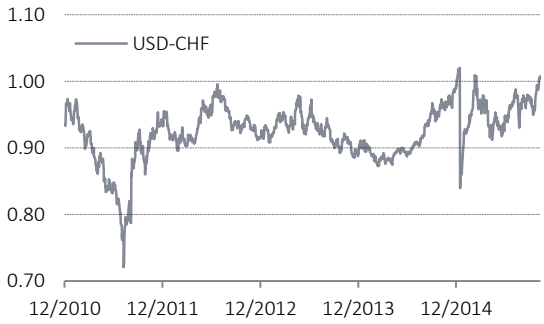


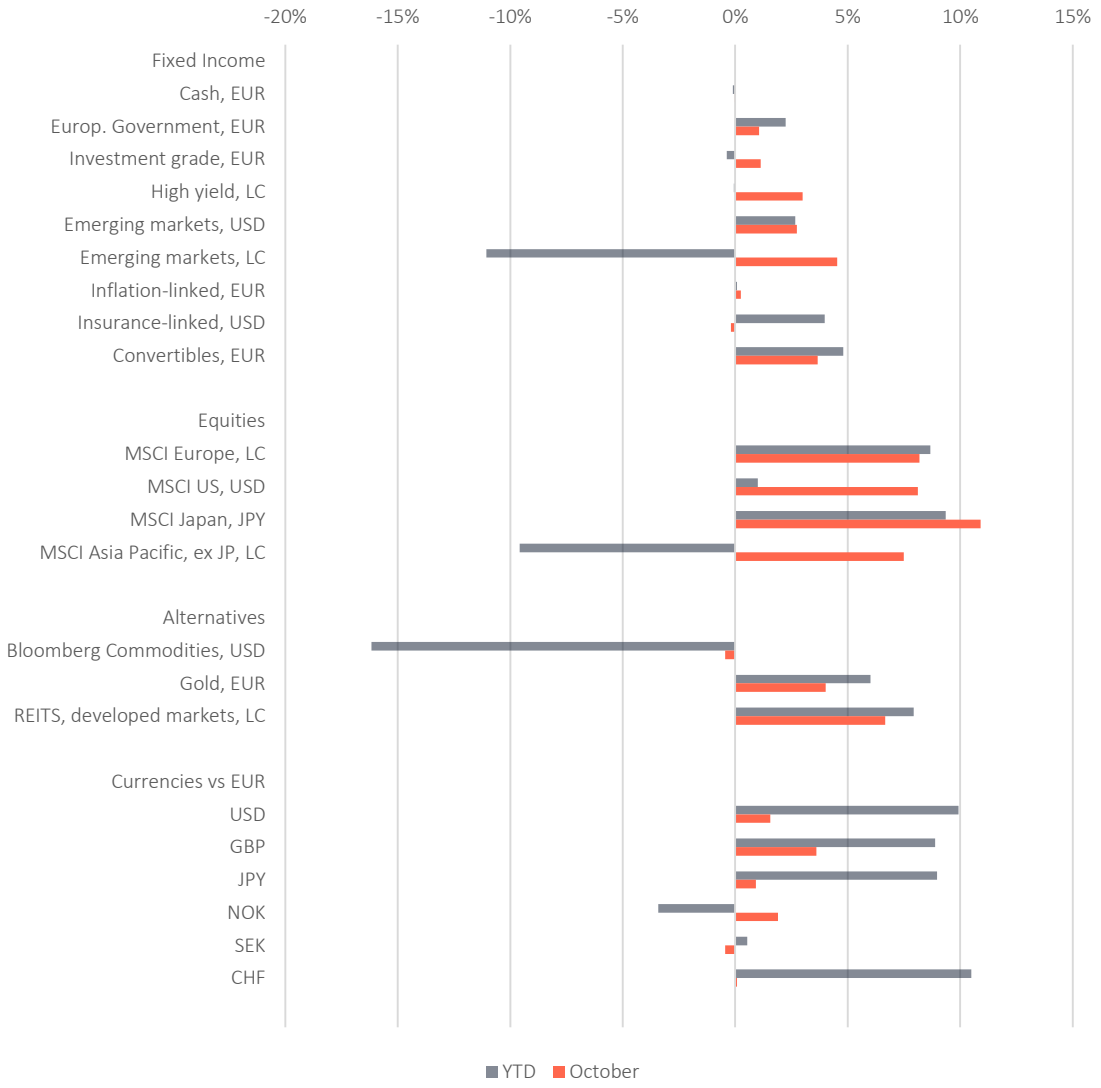
Fig 30: USD-CHF exchange rate



ASSET ALLOCATION

October was a very positive month for our EUR denominated portfolio. Most major asset classes contributed positively to the performance. In general, assets, which suffered most in August and September recovered most in October. Equity markets showed the strongest performance, led by Japanese and Asia Pacific equities. Most major currencies strengthened vis-à-vis the EUR.

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



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