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IMT GROUP

INVESTMENT OUTLOOK 12.2015

5 December 2015

The shocking events in November were a sharp reminder of the ever-present geo-political risks. Markets remained very calm though, despite the terrorist attacks in Paris and Mali, Turkey's downing of a Russian jet fighter on its border with Syria, and Belgium's four-day shut-down of Brussels because of terror fears. In the following, we discuss why this time the impact on financial markets has been limited.

Overall, November was a good month for developed equity markets. Fed rate-hike expectations rose. The market-implied probability of a Fed rate hike on 16 December climbed to about 75%, pushing US bond yields up. In anticipation of further ECB quantitative-easing measures European yields fell. On December 3, however, the ECB disappointed market expectations, which led to sharp corrections, especially in equity markets and the EUR-USD exchange rate.

In November, commodities continued to sell off and the gold price fell to its lowest level since 2009, confirming that the Gold bubble is still deflating.

Thomas Trauth
CEO – IMT Asset Management AG

GEO-POLITICAL RISKS ARE BACK ON THE AGENDA

Financial markets

While we were all deeply shocked by the sudden terrorist attacks, financial markets remained well behaved. Developed market equities performed well, with the DAX rising 4.9% in November, followed by the Nikkei up by 3.5% and the EuroStoxx50 up by 2.6%. The S&P500 remained about flat, +0.1%, while the MSCI Emerging Markets index lost 4%.

In line with rising Fed rate-hike expectations, US yields rose. At the same time, European yields fell in anticipation of further ECB easing measures, resulting in a further widening of the US-European yield spread.

Divergence of monetary policies led – not surprisingly – to further USD strengthening against most major currencies. The EUR-USD exchange rate fell by 4% in November and traded around 1.06 at the end of the month. The Swiss franc remained almost unchanged vis-à-vis the Euro.

Commodity prices continued their decline. Despite rising geo-political uncertainties, prices for Brent oil fell 11.3% and gold prices fell 6.8%.

Central banks

At its 3 December meeting the ECB decided to cut its deposit rate by 10 basis points to minus 0.30%, also extending its asset purchase program by six months to at least the end of March 2017. Although the ECB decided on additional easing measures, market participants were clearly disappointed and the market reaction was drastic. The same day, after the ECB meeting, the EUR strengthened by more than 3% via-a-vis the USD, 10-year Bund yields rose 20 basis points and European stock markets dropped about 3%.

During the course of November, comments by Fed officials became more hawkish, which led to rising market expectations of a Fed rate hike in December. Strong labor-market data in November also suggest that such a Fed rate hike has become very likely.

On 30 November the International Monetary Fund's (IMF) Executive Board decided to add the Chinese yuan to the IMF's Special Drawing Rights (SDR) basket. This change will take effect as of 1 October 2016. The SDR basket currently consists of the US-Dollar, the Euro, the Yen and the Pound Sterling only. This decision highlights the importance of the Chinese economy for world trade and for the world economy in general. It is also an important step towards the general acceptance of the yuan as a global reserve currency.

Macroeconomics

The November US ISM manufacturing index disappointed, falling to 48.6 from 50.1, which signals a contraction of the US manufacturing sector. While this reading by itself does not bode well for the US growth outlook, there are a number of encouraging positive indicators. Construction spending is increasing solidly and the US services sector, which accounts for 85% of the US economy, is expanding healthily. Also non-farm payrolls rose by 211,000 leaving the unemployment rate unchanged at 5%.

Meanwhile, the European Markit PMI rose again to reach 52.8 after 52.3. Also, the Chinese and the Japanese PMI rose to 48.6 from 48.3 and 52.6 from 52.4

respectively. The Swiss PMI, however, fell, to 49.7 from 50.7.

Geo-political risks

We are faced with numerous geo-political risks. Besides local and global threats resulting from so-called "IS" or "ISIS", there is the conflict between Russia and the Ukraine, tensions between China and Taiwan, the unstable situation in Iraq, the tensions around Iran's atomic weapons program, and numerous more local conflicts and civil wars in the Middle East and Africa.

While in no way forgetting the associated human misery and tragedy, we will focus in the following on spillover effects such geo-political events may have on financial markets.

We all remember the terrorist attacks on 11 September 2001 when Al-Qaida terrorists devastated the World Trade Center in New York, the world's financial-markets capital. When the terrorists struck, the S&P500 index had already been selling off for a couple of days due to worsening economic conditions. After the attack the S&P500 fell sharply. In a couple of days it lost 12%, to reach its low on September 21. The attacks caused major disruptions on the East coast of the US but also on the trading infrastructure. One month after the attack the S&P500 index had already recovered its losses and was trading above the 11 September index levels. Financial markets, however, remained choppy and trended down until March 2003. The reasons for the bear market were not only geo-political, most notably related to the discussion in the US on whether to go to war with Iraq or not, but also related to macro-economics. The US economy had gone into a recession earlier in 2001, and the Enron scandal later in 2001 cast serious doubts on the reliability of corporate accounting data.

In brief, September 11 and the resulting war on terror were certainly significant for financial markets, but it remains unclear whether the effect was really lasting since other important factors were weighing on investor sentiment.

Analysis of other geo-political events suggest that as a rule they tend to have a rather moderate and short-lived impact on markets.

Another example is the Russian annexation of Crimea in March 2014. Although Europe's gas supply was potentially at risk, financial markets were not disrupted for long. At the same time, of course, the impact on the Russian ruble and the Russian equity market was very significant.

In what cases would geo-political risks disrupt markets more significantly? In our view, the geo-political event would need to impair growth of a major region or economy or at least lead to significantly higher risks to global growth. In the past, such events were usually related to disruptions of oil supply in the Middle-East and major spikes in oil prices. While we think that such events are still a risk to global growth, dependency on Arab oil sources has greatly diminished. Firstly, most major economies have become less dependent on oil generally, and secondly, in recent years the US has become a major oil producer itself by exploiting its shale gas reservoirs.

To summarize, effective risk management certainly entails monitoring geo-political risks, but experience of geo-political events in the past shows that in most cases they had a much lower and less lasting impact on global financial markets than many people anticipated. It is nevertheless clear that such events occurring in the future could have more severe impacts on global markets. Furthermore we should not underestimate the potential for local market disruptions.

Outlook

November did not change our general macro-economic and financial market outlook. Growth is accelerating, despite the current weakness in the US manufacturing sector. Monetary policy divergence is here to stay with further widening of international yield spreads and a strong USD.

The disappointment about the ECB decision will not overshadow the outlook for long. Still, the extent of the market reaction highlights the fact that market

participants are nervous and volatility is going to rise, especially since a better growth outlook will lead to less aggressive monetary easing and less dovish central-bank rhetoric during 2016. This, together with quite rich valuations across major asset classes, has reduced expected returns. In other words, we are entering a period with lower financial returns and higher risks. As a result, investment skills like selecting the right investment themes or making the right tactical decisions are likely to result in higher rewards going forward. Also, risk management will become increasingly important.

We still favor European and Japanese equities. In addition, since we still regard Chinese hard-landing concerns as exaggerated, we see interesting opportunities in other Asian equity markets. Those markets suffered significantly during the sell-off in August and have not yet fully recovered.

Despite the weak ISM reading for November, we think it likely that the Fed will hike rates on 16 December. However, we expect that the hiking path will be gradual to protect economic growth and to avoid excessive USD strength. As a result we remain bearish for US government bonds and bullish for the USD.

ECONOMICS

Most leading indicators continued to improve in November, especially in Europe and Asia. The clear decline of the November ISM index, however, highlights the current weakness of the US manufacturing sector. Other US economic indicators, e.g. non-farm payrolls and construction data, point to robust US growth. Inflation remains low, which could encourage central banks to accelerate monetary expansion, most notably in Europe, Japan and Switzerland.

Fig. 1: PMIs

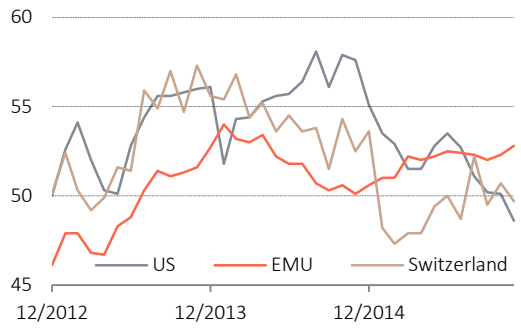


Fig. 2: PMIs

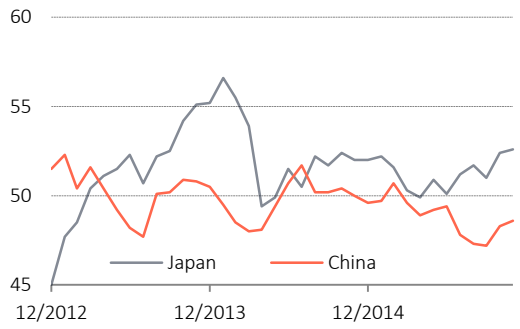


Fig 3: Consumer price inflation, in % YoY

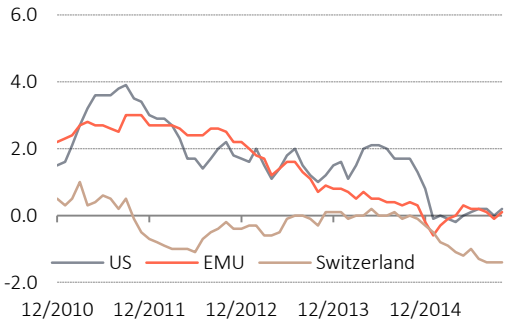


Fig. 4: Consumer price inflation, in % YoY

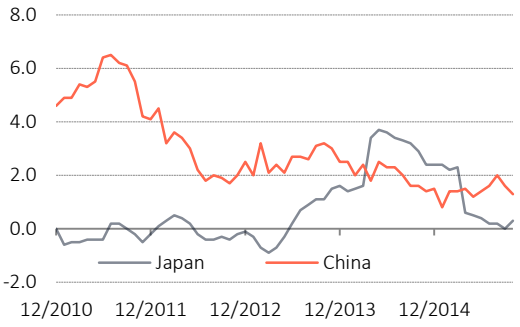


Fig 5: Unemployment rates, in %

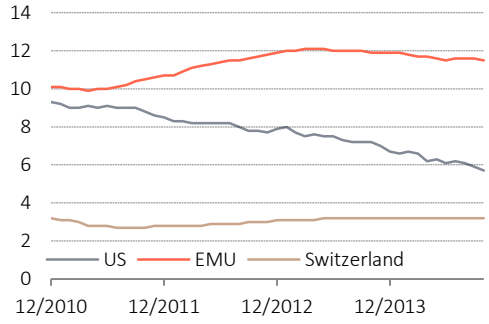
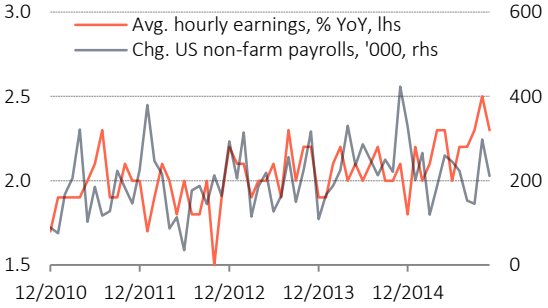


Fig 6: US labor market



FIXED INCOME

The rising probability of a Fed rate hike in combination with expectations that the ECB may decide on further QE measures drove a wedge between European and US yields. While European yields fell, US yields rose. At the same time inflation expectations increased somewhat from very depressed levels. Better growth data helped credit spreads to tighten.

Fig.7: 2Y government bond yields

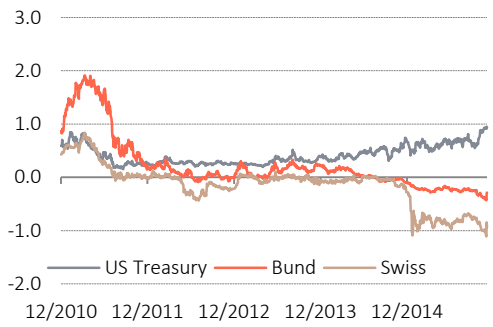


Fig. 8: 10Y government bond yields

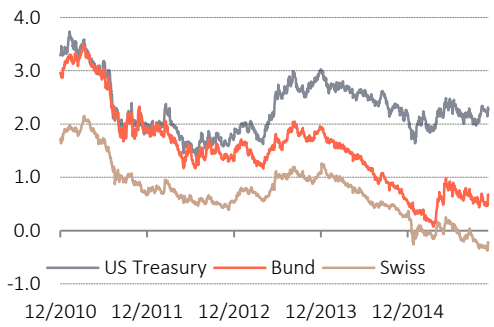


Fig 9: 10Y break-even inflation

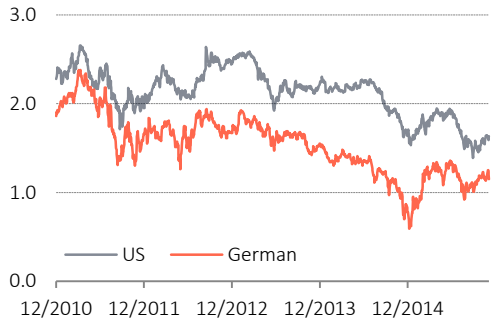


Fig. 10: Credit spreads, 5Y credit default swaps

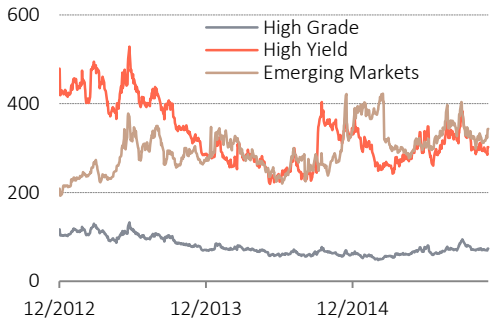


Fig 11: Money market spreads (3M-2Y)

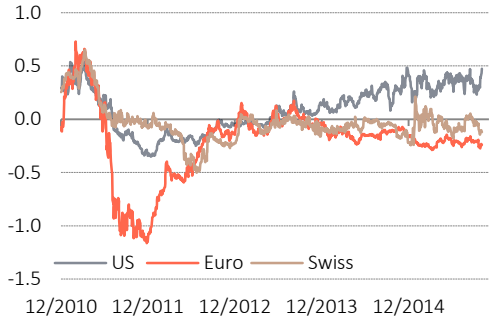
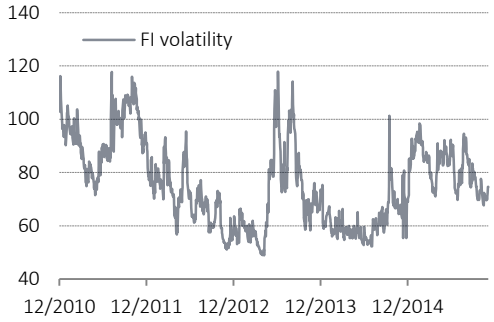


Fig 12: Merrill Lynch volatility index



EQUITIES

European and Japanese equity markets outperformed in November. The German DAX even rose 5.1%. Meanwhile the MSCI emerging markets index lost about 2.5%. Implied volatility declined, signaling that investors require less insurance against adverse market moves.

Fig. 13: MSCI equity indices – major regions

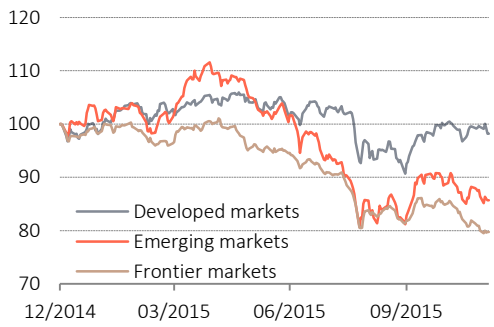


Fig.14: Equity indices – major developed markets

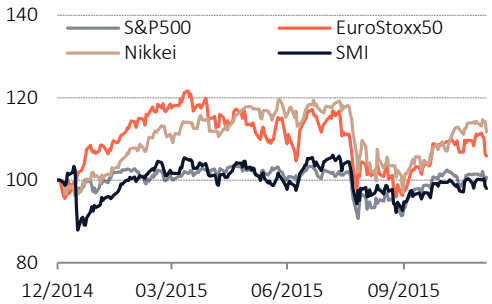


Fig 15: Equity indices – major emerging markets

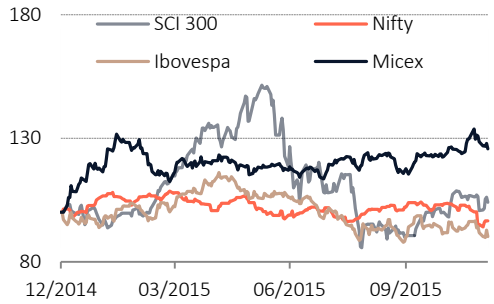


Fig. 16: Sector performance, MSCI Europe, YTD

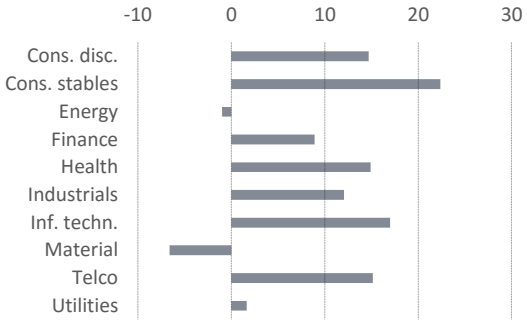


Fig 17: Price-earnings ratios

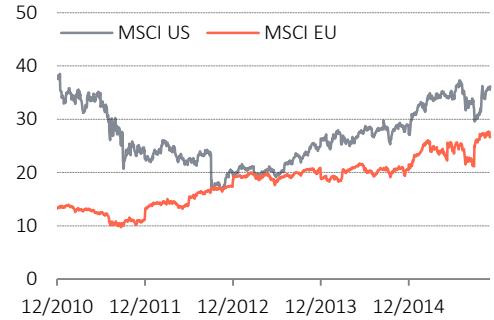
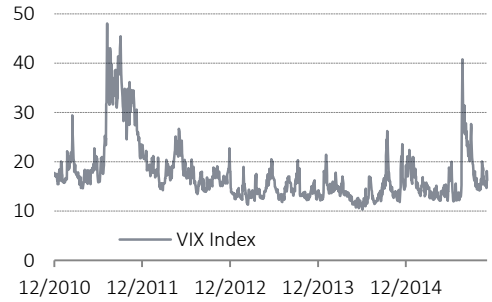


Fig 18: Equity volatility – S&P500 VIX index



ALTERNATIVE INVESTMENTS

Geo-political risks, especially related to the Middle East, often drive oil prices up. This time markets have not been worried about possible disruptions of oil supply. The price for Brent oil fell by 11.3% in November. Also Gold sold off and lost 6.8%, falling to its lowest level since 2009. REITS and listed private equity recovered in November in tandem with other risky assets.

Fig. 19: Gold price, USD/oz

Fig.20: Oil price, USD/bl

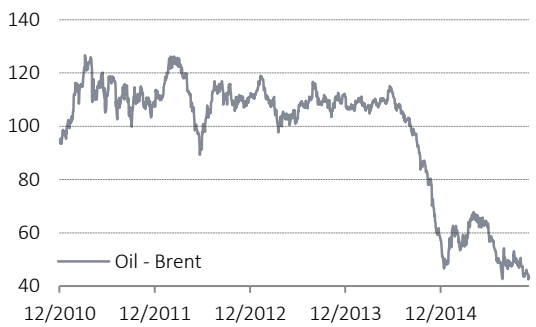


Fig 21: Bloomberg commodity indices

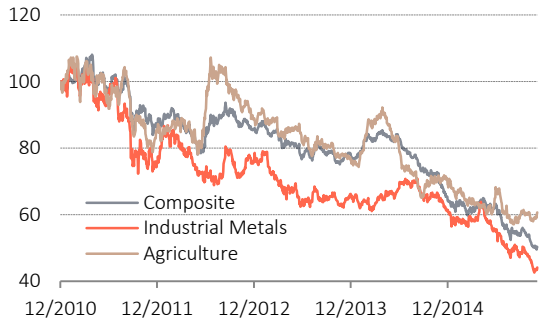


Fig. 22: HFRI hedge fund indices

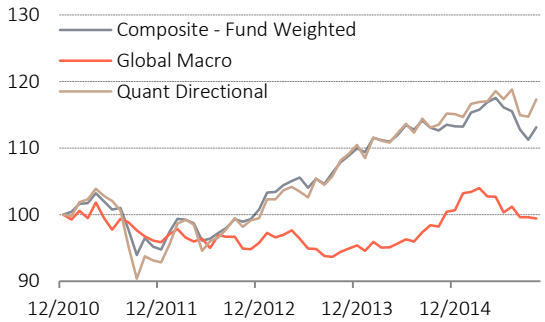


Fig 23: FTSE EPRA/NAREIT global index

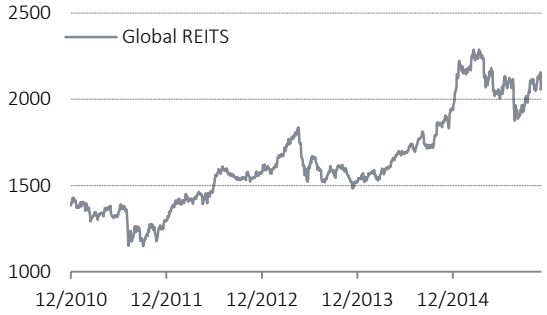
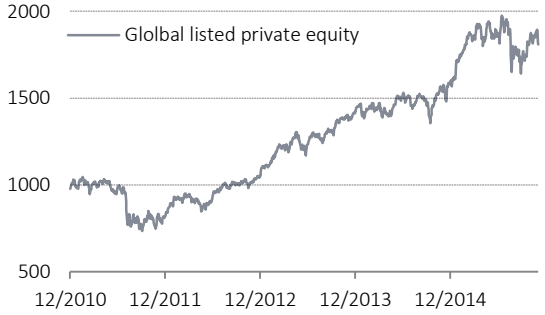


Fig 24: LPX global listed private equity



CURRENCIES

Fed rate-hike expectations lifted the USD against most currencies. The EUR, for example, fell almost 4% vis-a-vis the USD in November. This move was partly reversed after the ECB disappointed market expectations. The CHF remained almost unchanged against the EUR. The GBP weakened in November.

Fig. 25: EUR-USD exchange rate

Fig. 26: GBP-USD exchange rate

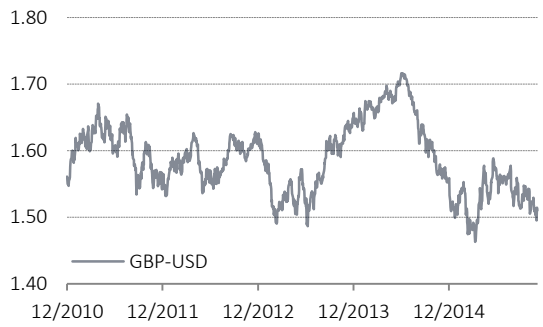


Fig 27: USD-JPY exchange rate

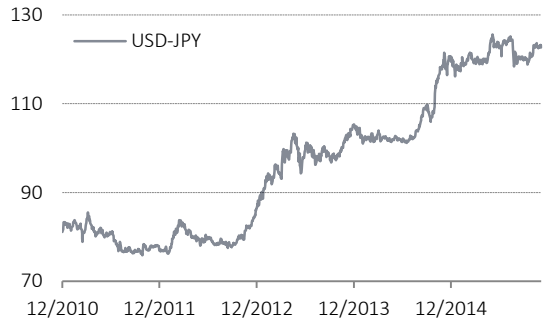


Fig. 28: USD-CNY exchange rate

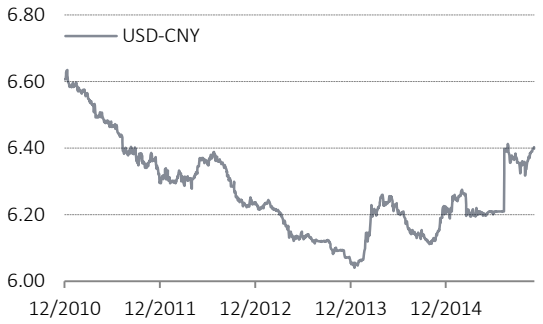


Fig 29: EUR-CHF exchange rate

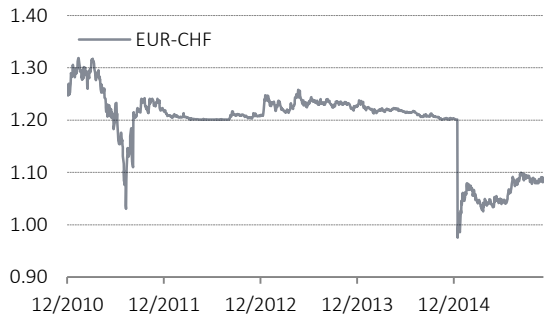
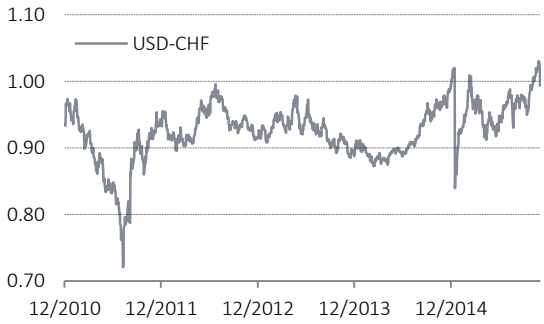


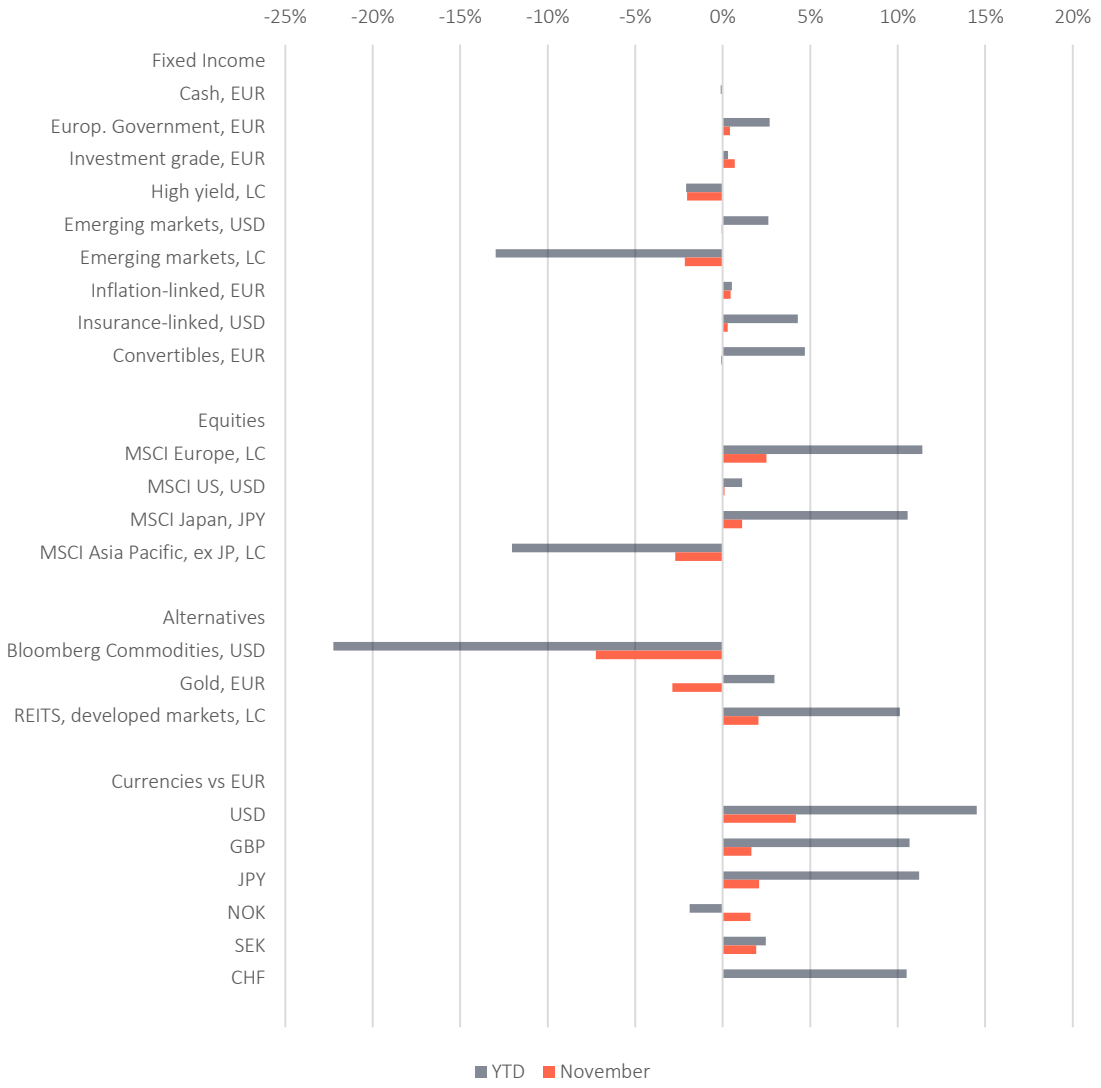
Fig 30: USD-CHF exchange rate



ASSET ALLOCATION

Equity markets, with the exception of Emerging markets and Asia Pacific, contributed positively to the November performance. Also, foreign currencies added positive performance. While European investment grade bonds performed positively, high-yield bonds sold off. Commodities in general and Gold in particular were performance detractors.

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



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