IMT Asset Management AG
Austrasse 56 · P.O. Box 452
9490 Vaduz, Liechtenstein
asset@imt.li · www.imt.li

IMT GROUP

INVESTMENT OUTLOOK 01.2016

12 January 2016

First we hope that all of you had a good start to the new year — despite the disruptive market movements during the first trading days of 2016, which left many of us worried about the future course of financial markets.

The beginning of a new year is always a good opportunity to step back from current events and to reflect on the past year and on what is to be expected in the year to come. This helps us to adopt a more strategic point of view, and so we would like to devote the current issue of our Investment Outlook to discussing last year's events, with a special focus on the things which came as a surprise to us. We will then make ten predictions for what we think are the most likely macro-economic and financial-market developments in 2016. These glimpses into the future will be useful for formulating our strategic asset allocation for 2016.

We hope you like what we come up with and find it at least thought provoking.

Thomas Trauth
CEO – IMT Asset Management AG

OUTLOOK FOR 2016 – TEN PREDICTIONS

Our predictions for last year

Before we turn to our predictions for 2016 we will briefly review the major developments during 2015 and consider how the author's forecasts for last year matched up with reality. The author's thoughts of one year ago can be found in the Blue Horizon Wealth Partners' "Wealth Management Review" of December 2014.

We correctly forecast that the gradual recovery of the US and European economies would continue, though we were a bit too optimistic about the growth rates. We saw US growth at 3%, while it turned out to be only 2.5%.

We rightly saw inflation remaining subdued.

We foresaw three rate hikes for the US Fed, with the first hike in June. In reality the Fed decided to hike only once, and in Mid-December. But we were right about additional quantitative easing measures by the ECB and the Bank of Japan.

We also rightly predicted further divergence between US monetary policy and the monetary policies of Europe and Japan. We were right too about the EUR-USD movement and the widening yield spread resulting from the divergence factor. The yield differential of 2-year government bonds widened by 63 basis points. The USD-JPY exchange rate, however, remained almost unchanged in 2015.

We had a moderately positive outlook for equities, with single-digit returns, and we expected Europe as well as Japan to outperform. The only caveat to this prediction was that the US stock market actually ended up with a negative calendar year performance. The S&P500 declined by 0.7%. The EuroStoxx50 index rose by 3.8% and the Japanese Nikkei225 index by 9.1%.

With regard to emerging markets we rightly warned about commodity producers but wrongly favored the Asian region, especially India, Indonesia and Thailand, which in fact suffered from Chinese contagion effects.

We rightly foresaw continued low and even falling yields in Europe but incorrectly forecast that the US 10-year Treasury yields would rise towards 3%. In fact, US Treasury yields only rose 10 basis points to end the year at 2.3%.

We anticipated tightening credit spreads for high-grade as well as high-yield bonds, which especially for the latter proved to be too optimistic, since credit spreads widened.

With regard to commodities we were right about gold falling further, but we wrongly predicted a bottoming out of oil and industrial metals prices in the second half of 2015.

We were correct about the EUR-USD falling below 1.10 but we also saw USD-JPY trending towards 130, though this in fact remained almost flat at 120.

We were right about Greece staying in the Eurozone and we correctly forecast that negotiations would finally lead to a solution for that country.

2015 – A year of surprises

The accuracy of our predictions was a little mixed in the end but we believe we got the broad macro picture about right.

Still, 2015 provided a number of major surprises for us, which had significant and lasting effects on financial markets and our portfolio performance. The four major surprises of 2015 were related to the SNB, the US economy, oil prices and China.

Firstly, as early as January 15 the SNB decided to abandon its EUR-CHF floor, which resulted in disruptive market movements for EUR-CHF and Swiss equities. We considered the SNB's repeated firm statements on defending the currency floor to be more credible than they turned out to be.

Secondly, major US leading indicators came in softer than anticipated, while labor-market figures strengthened continuously. Nevertheless, those uncertainties around the growth prospects led the Fed to delay its first rate hike. In addition, this may partly explain why long-dated Treasury yields remained relatively low.

Thirdly, while oversupply in major commodity markets, especially in the oil market, was apparent one year ago, we assumed that accelerating growth would lead to a bottoming of markets for oil and industrial metals. However, this did not happen; especially oil prices fell off the cliff and lost 44% in 2015.

Fourthly, while there were already concerns about the health of the Chinese economy last year, due to overinvestments, high leverage, and a housing bubble, we took the benign view that the Chinese authorities together with sufficient consumer demand and the rising services sector would be able to offset the problems mentioned. While we still think that a hard landing scenario is rather unlikely, markets have repeatedly reacted nervously to negative news from China. However, especially the pronounced sell-offs in August and in recent days highlight the fact that market participants fear major contagion effects.

Outlook for 2016 – Ten predictions

1. Growth outlook

We continue to see a sustained growth recovery in major developed markets. Despite gradual Fed tightening, monetary policy remains supportive or very supportive in Europe and Japan. Low commodity prices are another positive factor for all non-commodity-producing economies. Some weakness in the US manufacturing sector will be more than offset by expanding services and construction sectors. US growth is expected to slightly exceed 2%, while the Eurozone is likely to grow by about 1.7%. Also, Japan might reach 1% growth in 2016.

2. Inflation outlook

While we are not surprised by the low inflation rates generally observed, since there is still considerable slack in most major economies, we are surprised about the ultralow market-implied inflation rates (see Fig. 9). We find those expectations exaggerated. While we do not foresee a strong increase in inflation in 2016, we do anticipate a mild inflation pick-up especially in the US. Also, inflation expectations should start rising somewhat in 2016, in our view.

3. Central Banks

The Fed will continue its hiking path. Once started, a logical continuation could be four hikes (one hike per quarter), each by 25 basis points. Due to recent weakness in the manufacturing sector and the strong USD, we rather expect two to three hikes in 2016. The ECB will keep its policy stance and is unlikely to accelerate its QE program, while the Bank of Japan, in our view, is likely to add further easing measures.

4. Rates

We expect yields to grind higher in Europe due to a slight pick-up of inflation and the continued recovery. The US short-end of the curve is likely to underperform, driven by Fed rate hikes, and 10-year US Treas-

ury yields will eventually move higher – most likely towards 2.5-2.6. Overall we expect negative returns from holding government bonds.

5. Credit

Credit spreads are relatively tight, in line with historically low default rates. It is very likely that default rates will start rising somewhat – but will remain low compared to the historical average – and high-grade credit spreads will widen in tandem. This will most likely lead to negative returns in 2016. In the high-yield segment, given last year's spread widening, the carry from credit spreads may suffice to compensate for rising benchmark yields, resulting in positive overall returns.

6. Equities

Overall, we expect (single-digit) positive returns for developed equity markets, though accompanied by higher volatility. On the basis of diverging monetary policies and differences in valuations we continue to favor Europe and Japan over the US. Depending on the development in the commodities space, there may be interesting opportunities in the energy and materials sectors. Other than that we prefer technology and consumer stocks.

7. Emerging Markets

The situation for emerging countries remains difficult. Commodity-producing countries are under pressure and are suffering from falling revenues. Growth in most emerging countries is slowing and capital is flowing out. Therefore, it is advisable to take a very cautious stance. Still, valuations have already corrected to a large extent and opportunities certainly exist. However, we advise waiting for a catalyst which is strong enough to unfold the potential.

8. Commodities

The fall in major commodity prices is due to oversupply rather than lack of demand. As a result, it will take some time until supply conditions adjust, especially since exit costs for commodity producers are often punitively high. As a result, we do not expect a sharp reversal in commodities prices in the coming months. However, there are first signs of supply conditions adjusting, which may lead to a bottoming of commodities prices. This should prove especially true for oil prices and happen in the second or third quarter of 2016. Thereafter prices should grind higher. Such a turn of the price cycle will be very relevant for a number of asset classes, e.g. inflation-linked bonds, commodities-related high-yield bonds and equities, and commodity currencies.

9. Alternatives

Since we foresee lower expected returns coupled with rising draw-down risks, we look for less correlated trading strategies among so-called liquid alternatives. Such strategies had a difficult year in 2015. The broad hedge fund index was down 0.8%. Since rising volatility and probably also rising dispersion may offer opportunities for such strategies, we look for opportunities in this sector.

10.Currencies

In our view, further divergence of monetary policies between the US on the one hand and Europe as well as Japan on the other hand, suggest to us that the USD will remain on the strong side. EUR-USD has potential to fall further and USD-JPY to rise further. However, since the major movements already happened in 2015 for EUR-USD and in 2014 for USD-JPY, we see only moderate potential for further USD appreciation.

For the Swiss Franc, which we consider significantly overvalued, we expect further weakening vis-à-vis the EUR. All the more since economic conditions in Switzerland continue to deteriorate.

Commodity currencies will remain under pressure for now, but may be able to rebound in the second half

of the year, if our assumption regarding rising commodity prices should prove to be correct.

Major risks to watch out for in 2016

As usual we also discuss major risks to our base-case scenario. We would like to highlight the following four major risks:

1. Fed behind the curve

The Fed has started to raise rates very late in relation to the observed improvements in the labor market. If, for example, wage-induced inflation were to pick up, the Fed could come under pressure to fight upcoming inflation and start raising rates too strongly. This could lead to petering out growth and major sell-offs.

2. Deflation

Since growth dynamics look robust to us, it is still a slow growth scenario, which lags behind potential growth rates. If this dynamics deteriorated, deflation concerns could easily arise and lead to a major sell-off of equity and credit markets. In such a case, central banks would be left with insufficient ammunition to fight the deflationary environment.

3. China

Our base-case scenario for China is a soft landing, with a strong services sector and robust domestic consumption compensating for a softer manufacturing sector. The risks in China, however, are at least three-fold. First, in contrast to our assumption, China could end up with a hard landing. Second, high private-sector leverage and bad bank loans could culminate in a financial crisis. And third, a strong depreciation of the CNY could reduce global risk appetite. While we do not believe that a CNY devaluation would be that bad, recent history demonstrates, how sensitively financial markets react to CNY moves. We believe the risk for a CNY-induced crisis is relatively low, since the Chinese central bank is in possession of large foreign reserves, and thus, sufficient means to manage a CNY depreciation in an orderly manner.

4. Geo-politics

Geo-political factors are always a concern and are almost impossible to predict. Areas to worry about are, for example, terrorists attacking vulnerable financial or political centers in Western countries, the recent tensions between Iran and Saudi Arabia, tensions in relation to North Korea, and intensifying friction between China and the US and Japan related to territories in the South China Sea.

Conclusions for asset allocators

We believe we have arrived at a typical late-cycle market environment, which could last longer than comparable phases in the past. This is due to the fact that central bank policy will stay accommodative for much longer, even though the Fed has started its tightening cycle. In this phase we expect equity-market returns to fall to single digits – possibly low single digits. Government and corporate bond returns could turn out to be negative. High-yield and emerging-market credit spreads could earn enough carry to offset rising benchmark yields.

We therefore still expect equities to be a better place than high-grade and government bonds and we are keeping a neutral and even overweight equity position. We would continue to seek exposure to high-yield and emerging-market bonds. And we would keep emerging-markets equity underweight. We are also preparing ourselves for rising portfolio volatility.

We further see the timing to be right to diversify into less correlated trading strategies, which should help diversification away from the traditional interest-rate, credit, and equity-market risks.

ECONOMICS

While many leading indicators improved in December, the US and Chinese manufacturing PMIs continued to deteriorate. Though the US economy is supported by a strong services sector and continues to generate jobs (as is apparent from strong non-farm payrolls) market participants have focused on the health of the Chinese economy. The Swiss unemployment rate has risen to 3.4%, seasonally adjusted and reflects the cost pressure many Swiss companies face due to the strong Swiss franc.

Fig. 1: PMIs

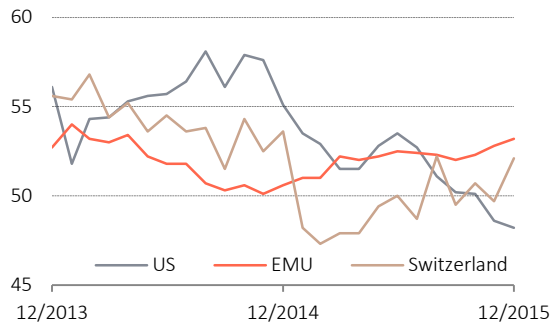


Fig. 2: PMIs

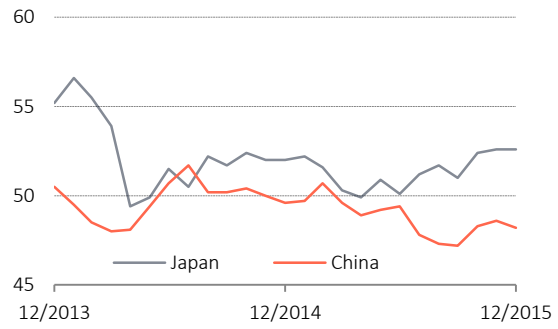


Fig 3: Consumer price inflation, in % YoY

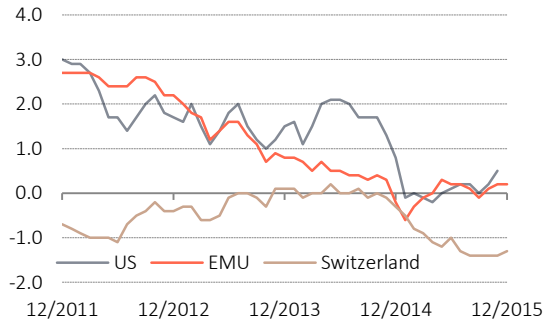


Fig. 4: Consumer price inflation, in % YoY

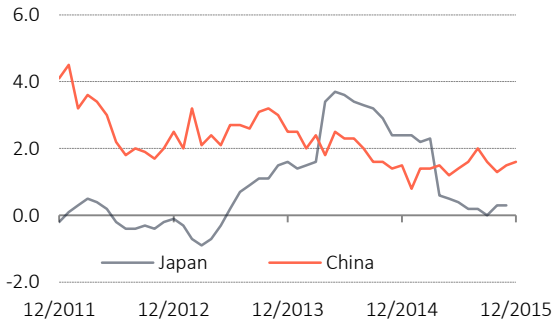


Fig 5: Unemployment rates, in %

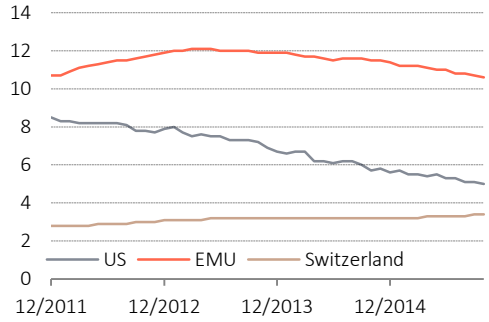
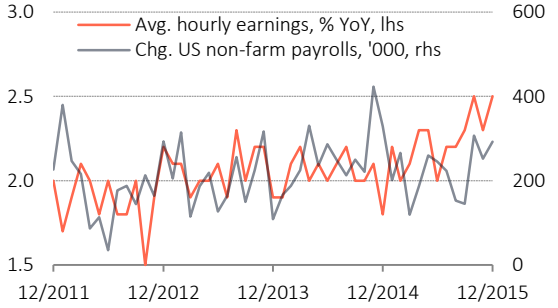


Fig 6: US labor market



FIXED INCOME

The long-awaited first Fed rate hike in December had an impact only on the short end of the US yield curve. 10Y US treasuries remained unimpressed. Inflation expectations remained very low and even fell strongly. High-yield and emerging-markets credit spreads widened further on the back of rising risk aversion in December.

Fig.7: 2Y government bond yields

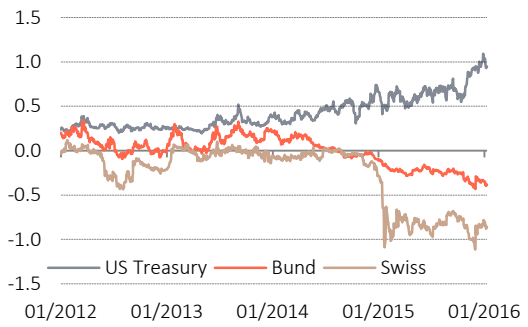


Fig. 8: 10Y government bond yields

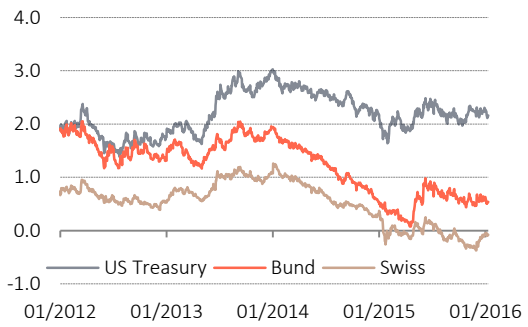


Fig 9: 10Y break-even inflation

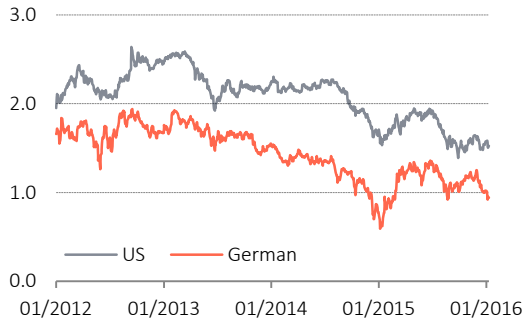


Fig. 10: Credit spreads, 5Y credit default swaps

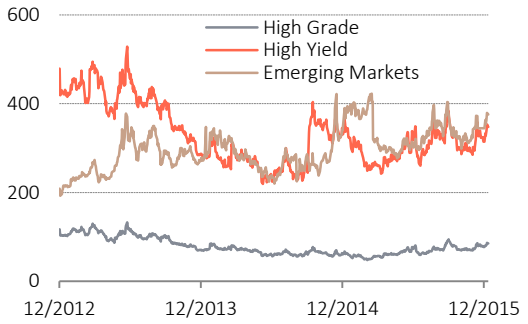


Fig 11: Money market spreads (3M-2Y)

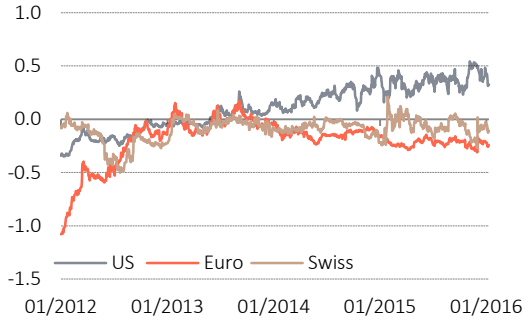
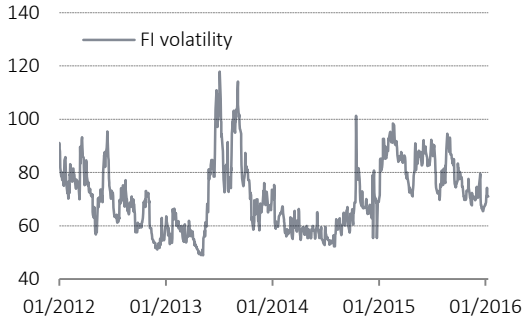


Fig 12: Merrill Lynch volatility index



EQUITIES

In 2015 European and Japanese equity markets outperformed. The S&P500, emerging markets and frontier markets ended the year with negative performances. Within the European sectors, materials, energy and utilities underperformed and ended the year in red figures. The year 2016 started with a strong sell-off, again due to China-related growth concerns.

Fig. 13: MSCI equity indices – major regions

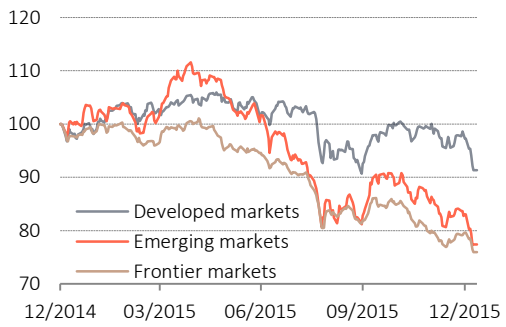


Fig.14: Equity indices – major developed markets

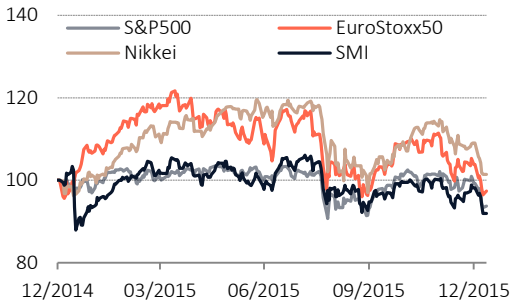


Fig 15: Equity indices – major emerging markets

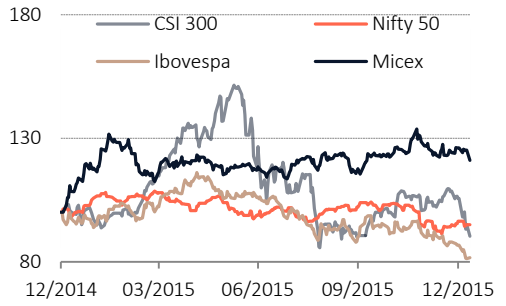


Fig. 16: Sector performance, MSCI Europe, 2015

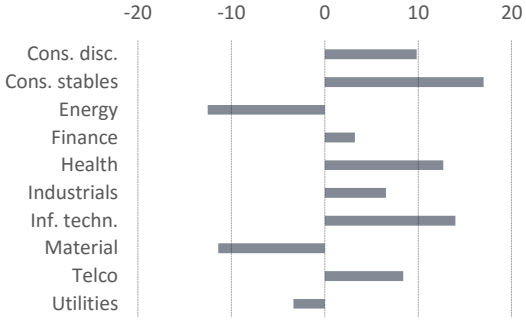


Fig 17: Price-earnings ratios

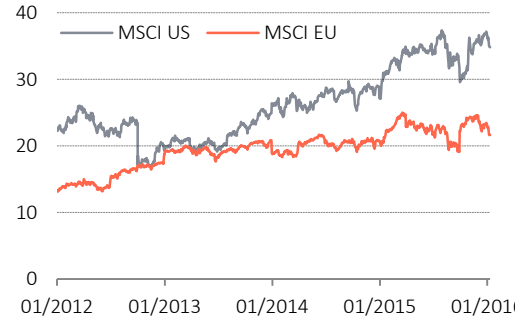
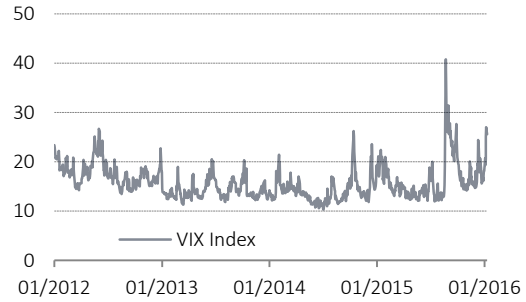


Fig 18: Equity volatility – S&P500 VIX index



ALTERNATIVE INVESTMENTS

2015 was not a good year for Alternative Investments in general. Commodities prices fell by 25%, oil even by 44%. Gold likewise did not benefit from economic and political uncertainties and continued its descent, falling by roughly 10%. Also, the broad HFR hedge fund index lost 0.8% in 2015. REITS and listed private equity, however, performed well and rose by 7.6% and 11.5%, respectively.

Fig. 19: Gold price, USD/oz

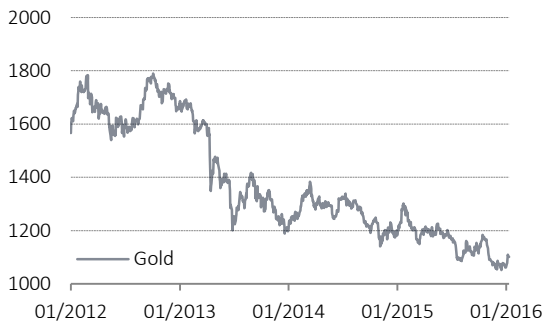


Fig.20: Oil price, USD/bl

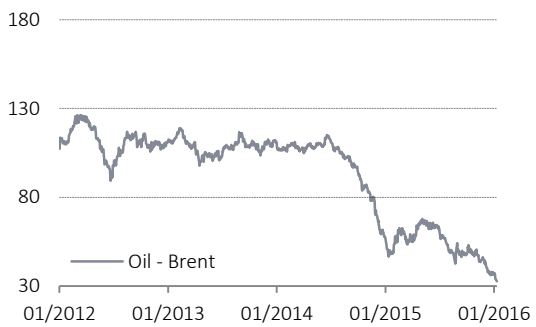


Fig 21: Bloomberg commodity indices

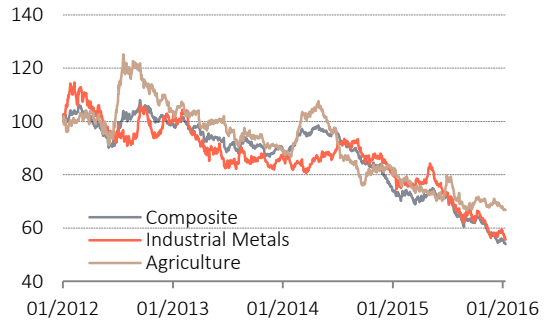


Fig. 22: HFRI hedge fund indices

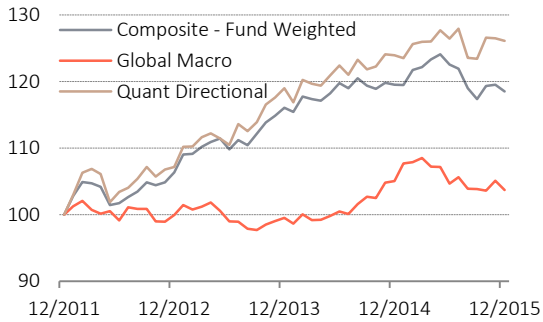


Fig 23: FTSE EPRA/NAREIT global index

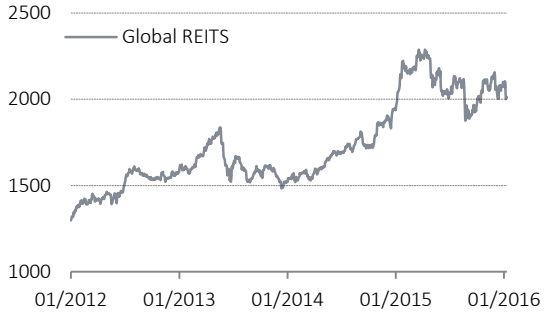
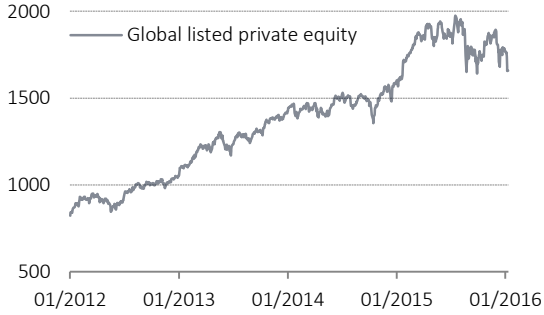


Fig 24: LPX global listed private equity



CURRENCIES

2015 was the year of the USD, which rose against most major currencies. EUR-USD, for instance, fell by roughly 10%. Most emerging and commodity currencies fell even more markedly. The Brazilian Real lost almost 50% against the USD, and the Canadian Dollar lost about 20%. The JPY did not extend its losses from previous years and remained stable vis-à-vis the USD despite further QE by the Bank of Japan.

Fig. 25: EUR-USD exchange rate

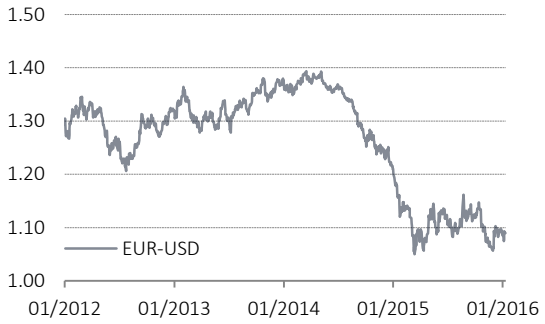


Fig. 26: GBP-USD exchange rate

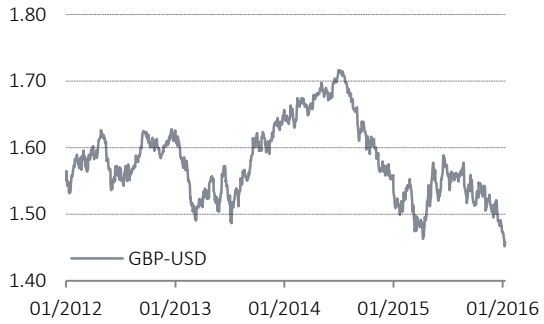


Fig 27: USD-JPY exchange rate

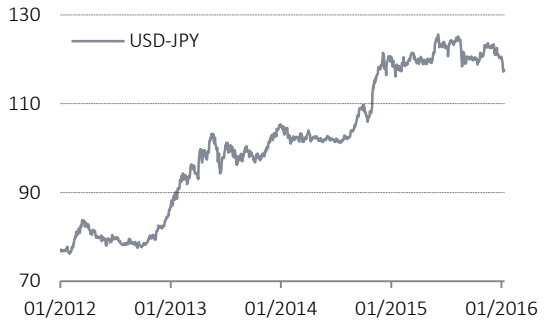


Fig. 28: USD-CNY exchange rate

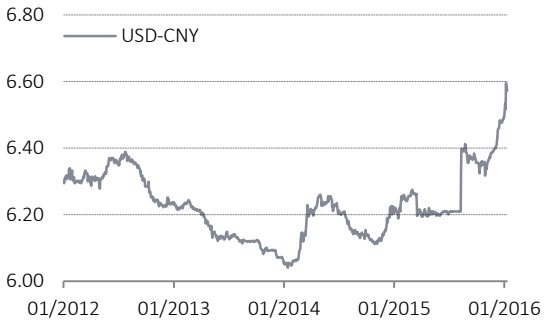


Fig 29: EUR-CHF exchange rate

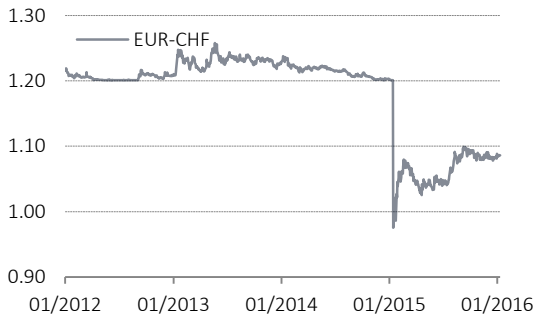
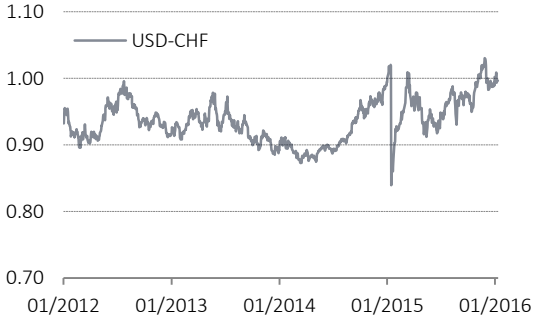


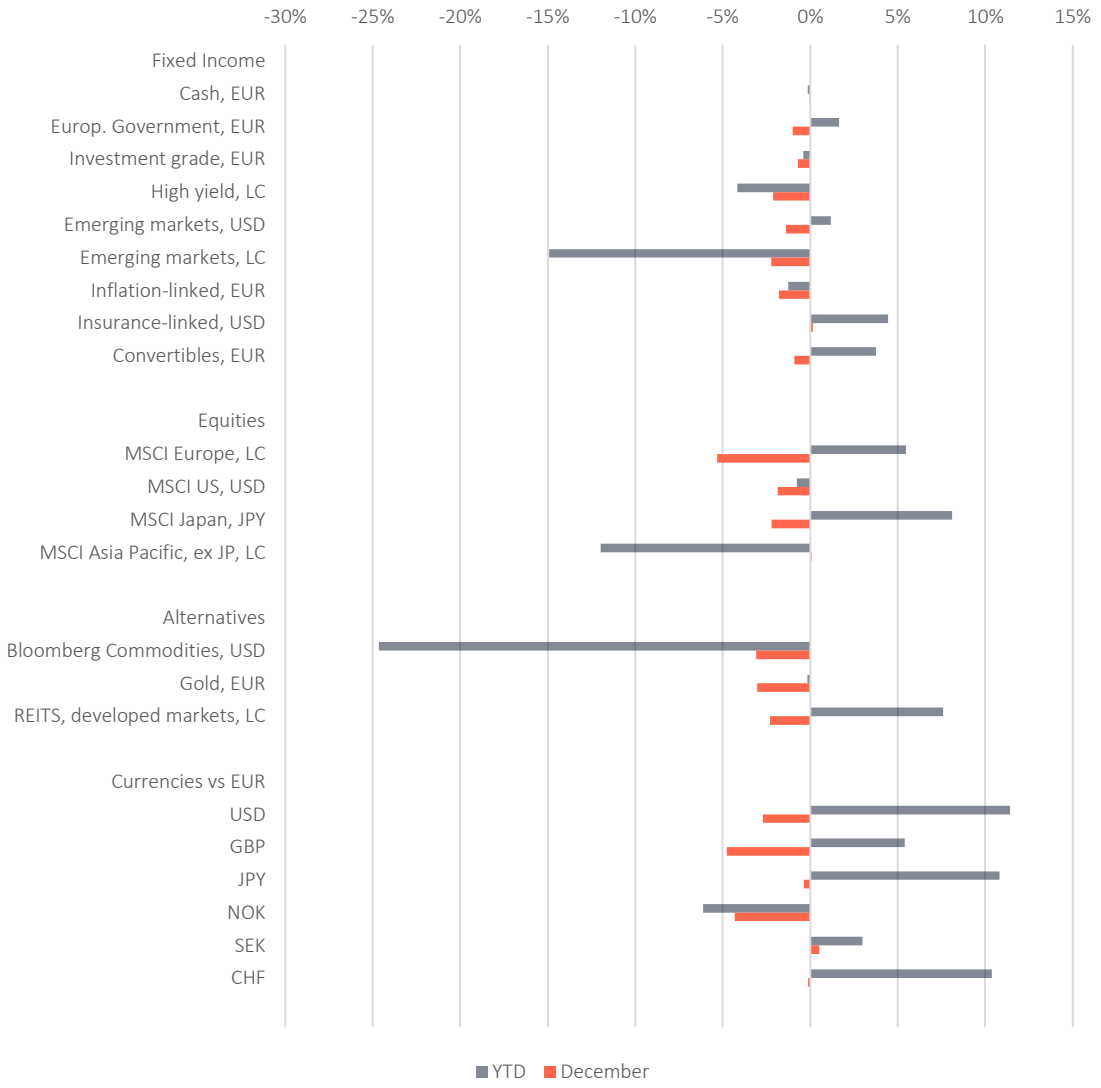
Fig 30: USD-CHF exchange rate



ASSET ALLOCATION

Major performance drivers were European and Japanese equities, as well as insurance-linked bonds and convertibles. Euro-based investors were also able to benefit from a weakening EUR and stronger foreign currencies. Major performance detractors were emerging markets equity and bonds. Our underweight of commodities helped to protect against losses in this asset class.

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



IMT Asset Management AG
Austrasse 56 · P.O. Box 452
9490 Vaduz, Liechtenstein
asset@imt.li · www.imt.li

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