

INVESTMENT OUTLOOK

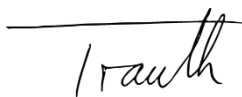
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17 February 2016

The year started with a brutal and lasting sell-off and a flight to safe haven assets. Government bond yields fell and the proportion of bonds with negative yields rose significantly. Equity markets lost between 5% and 20%. It was an uncomfortable reminder of events at the beginning of 2008, which turned into a major meltdown as the year progressed. We suspect that many of our readers will remember it well.

However, fear is usually not a good guide for investment decisions. We should instead carefully assess the situation, consider the existing risks, come to a rational conclusion, and act accordingly. The million-dollar question in this context is: are we heading towards a 2008 meltdown scenario or does our fundamental macro and market assessment still hold in a situation of exaggerated market movements?

In the following, we discuss this question and we hope you will appreciate our analysis.

A handwritten signature in black ink that reads 'Trauth'.

Thomas Trauth
CEO – IMT Asset Management AG

FINANCIAL MELTDOWN OR BUYING OPPORTUNITY?

Financial markets

The year started with a brutal sell-off of risky assets. China, the perceived root cause of the global growth slow-down and financial instability, suffered from the most severe equity sell-off, with the CSI300 falling 21% in January. The Nikkei225 fell 8%, the S&P500 5.1%, and the German Dax 8.8%. Also, credit spreads widened, led by high-yield, and followed by emerging markets and high-grade bonds. The fact that financials underperformed in the sell-off may indicate that markets have been concerned about systemic risks.

Safe-haven assets rallied, government bond yields fell significantly, 10-year German Bunds fell 30 basis points to 0.33% and 10-year US Treasuries fell 35 basis points to 1.92% at the end of January. The Gold price surged by 5.4% in January and rose even further to levels above 1,200 USD/oz.

The EUR and the JPY did not move much in January but strengthened by 2.8% and 6.1%, respectively in the first half of February. Interestingly, the CHF weakened despite its typical safe-haven character.

Central banks

The Bank of Japan surprised us on 29 January when it introduced negative interest rates on bank deposits. The rate was reduced from 0.1% to -0.1%.

Statements put out by both the ECB and the Fed were dovish. The probability of a Fed rate hike fell from almost 50% end of December to almost 0% end of January.

Macroeconomics

Without doubt, the observed market moves reflect rising recession anxieties and increasing fear of another 2008-like financial system collapse. In the following we try to assess whether fundamental data justify this pessimism. However, we are also very cognizant that the mere fact of falling asset prices can have negative repercussions on the economy, and this makes the assessment of the current situation significantly more difficult. Falling asset prices may reflect underlying and not so obvious adverse developments, not yet reflected in the usual leading indicators. Furthermore, falling asset prices have the potential to drag down consumer and investor sentiment and slow down economic activities. In addition, a drop in asset prices has a negative wealth effect, which impairs the ability to spend and invest.

A closer look at January's macro indicators confirms our base-case scenario of a slowly growing global economy. It does not indicate, in our view, elevated recession risks. The US ISM index rose slightly to 48.2 from 48.0, the Chinese PMI increased to 48.4 from 48.2. At the same time we saw the European PMI fall to from 53.2 to 52.3 and the Japanese PMI, drop to 52.3 from 52.6.

Looking at the overall health of the US economy, the Services PMI still remained in expansion territory at 53.2 in January, although it fell from its December level of 53.7. The US economy overall continues to create jobs, with non-farm payrolls at +151,000 and a

further decline in the unemployment rate from 5.0% to 4.9%.

Meltdown or buying opportunity?

The million dollar question currently is whether we are heading towards a 2008-like scenario with a major recession and financial distress, probably triggered by defaults in the commodities sector, or whether the current sell-off will be short lived and sound fundamentals will prevail, convincing market participants that current price levels provide buying opportunities.

As already mentioned above, as an investor you always have to balance different considerations and scenarios. While the recession and bear-market risk has certainly risen, not least due to the potential of self-reinforcing market moves, we need to reassess our fundamental view, critically analyze the underlying hypotheses, and then come to a rational conclusion.

After doing this exercise in our investment committee, we came to the conclusion that the financial system underwent a major deleveraging after 2008 and looks much healthier and more robust today. Also, while we do see a slow-down in some critical parts of the global economy, most noticeably in the US and Chinese manufacturing sector, we nevertheless see encouraging data from other sectors and a robust development in Europe. The energy price slump certainly hurts the oil producers around the world, but it benefits the majority of the energy consumers. Overall, one would expect a net positive growth impulse from falling oil prices. On top of this, central banks continue to be very accommodative and may even decide on additional monetary stimuli.

As a result, we decided not to reduce our exposure to risky assets. We have rather even increased our equity exposure slightly. We have also added some exposure to high yield bonds, since valuations appear to be attractive to us.

Outlook

As discussed, some major macro indicators have been weak in recent months, especially in China and the US. The outlook for the US is somewhat ambiguous since the weakness in the manufacturing sector is accompanied by a robust services and construction sector as well as healthy job creation overall. In Europe and Japan we observe better growth data. Company earnings, despite an across-the-board decline, still look healthy. We also take some comfort from more attractive valuations after the recent price decline.

As a result, we remain cautiously constructive for equity markets. We also think that especially the high-yield market offers interesting spreads. In our view, the spread levels are consistent with a very high recession risk and an elevated number of expected defaults. Since we think that those spread levels are exaggerated, we have taken an overweight position in high yield bonds.

Bond yields have gone too far and inflation expectations look much too low for us. We therefore remain underweight in bonds overall and especially government bonds.

We think that the recent USD weakness will be short lived and we expect the USD to rebound. The CHF, however, will continue to weaken, in our view.

We are skeptical about the recent gold strength and would, for tactical reasons, take profit on long gold positions.

ECONOMICS

Leading indicators were by and large robust in January. The US and Chinese manufacturing PMIs improved slightly, while the European and the Japanese PMIs fell. US non-farm payrolls remain robust despite a lower increase than in the previous month. US job

creation continues and the unemployment rate fell further to 4.9% after 5.0% in December. Inflation remains subdued in all shown economies. Rising wage costs in the US may signal early signs of rising price pressure.

Fig. 1: PMIs

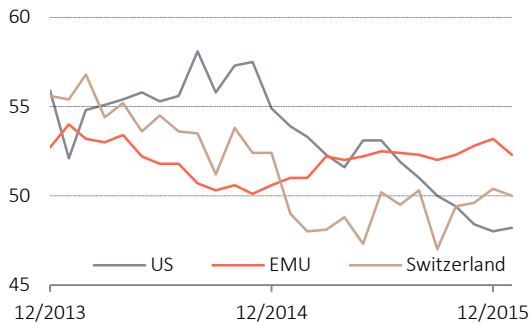


Fig. 2: PMIs

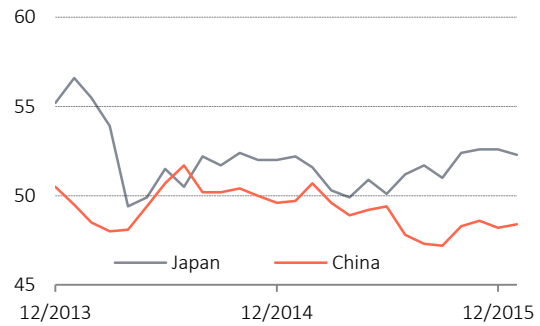


Fig 3: Consumer price inflation, in % YoY

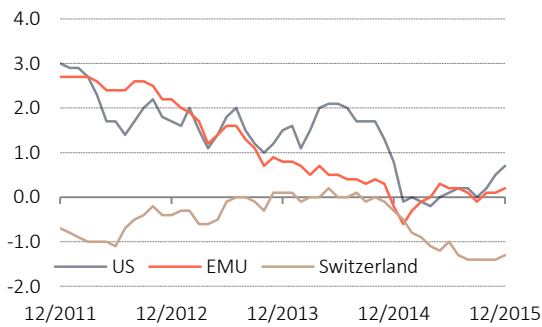


Fig. 4: Consumer price inflation, in % YoY

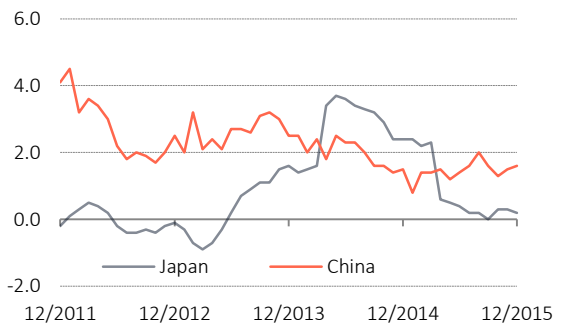


Fig 5: Unemployment rates, in %

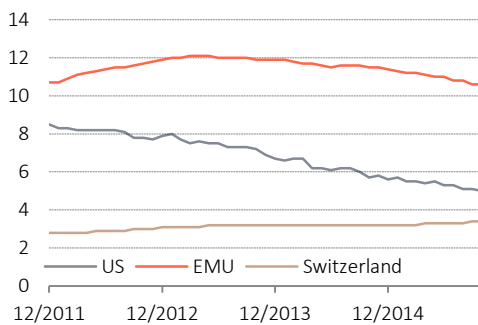
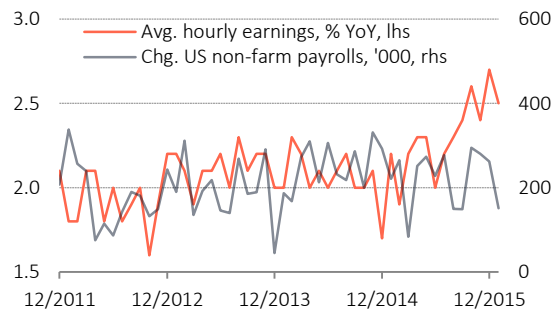


Fig 6: US labor market



FIXED INCOME

In January and early February government yields fell across the board as safe-haven assets have been in high demand. At the same time, credit spreads widened. Rising fixed income volatility signals that the

market is uncertain about the future developments and seeks protection. Fig. 11 illustrates that the money market has reduced Fed rate hike expectations for 2016 significantly.

Fig.7: 2Y government bond yields

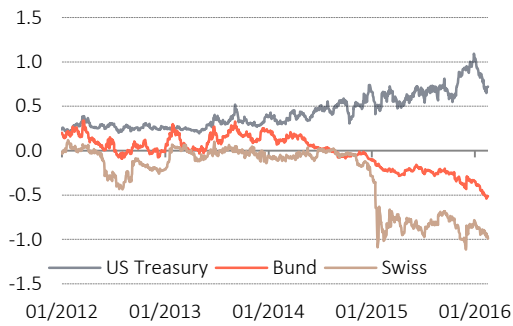


Fig. 8: 10Y government bond yields

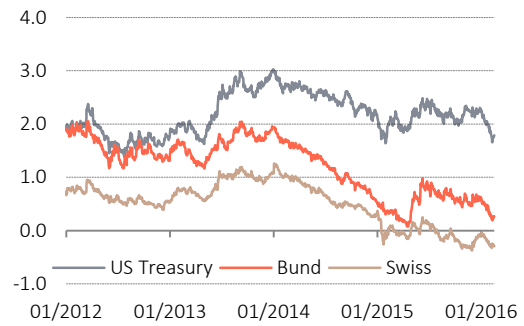


Fig 9: 10Y break-even inflation

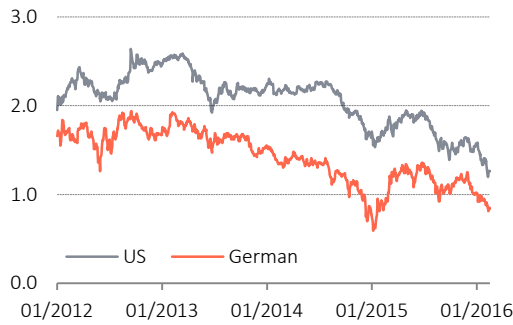


Fig. 10: Credit spreads, 5Y credit default swaps

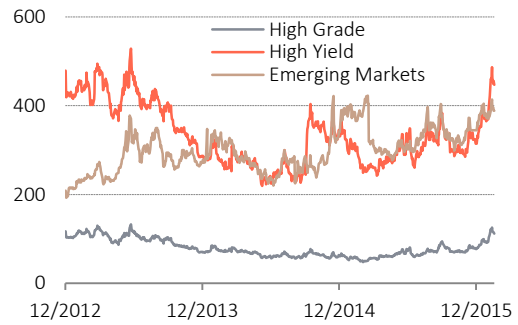


Fig 11: Money market spreads (3M-2Y)

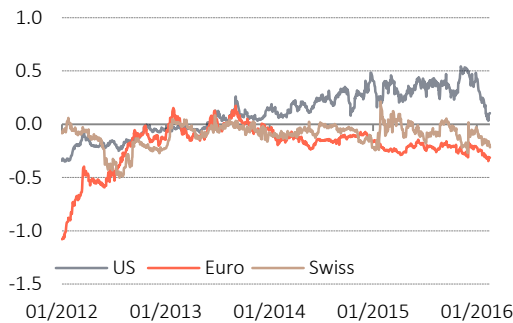
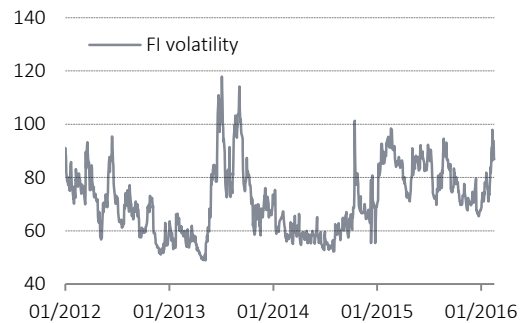


Fig 12: Merrill Lynch volatility index



EQUITIES

The year 2016 started with a massive sell-off in all major equity markets. Interestingly, emerging markets started to outperform developed markets in February. Fig. 16 shows that this time financials underperformed, which could indicate rising fear of a systemic

crisis. Since the start of the year the S&P500 index outperformed other developed markets and the Nikkei225 underperformed. Within emerging markets, China underperformed, highlighting the weakness of the Chinese growth prospects and financial system.

Fig. 13: MSCI equity indices – major regions

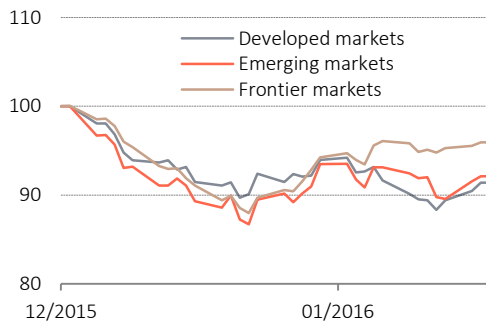


Fig.14: Equity indices – major developed markets

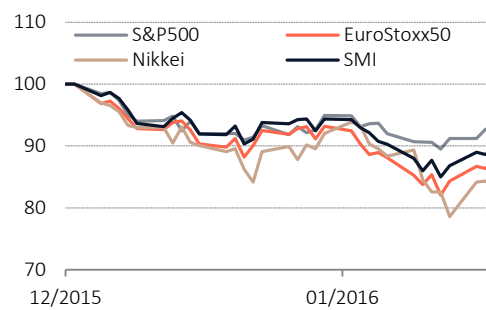


Fig 15: Equity indices – major emerging markets

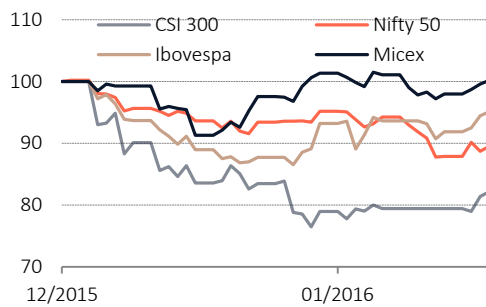


Fig. 16: Sector performance, MSCI Europe, 2015

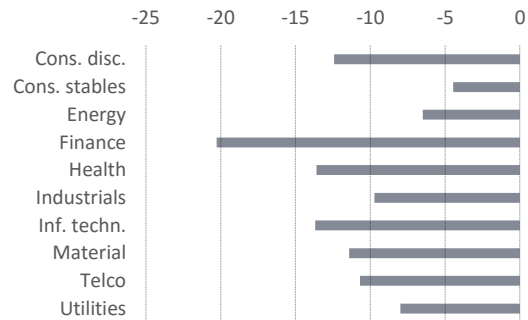


Fig 17: Price-earnings ratios

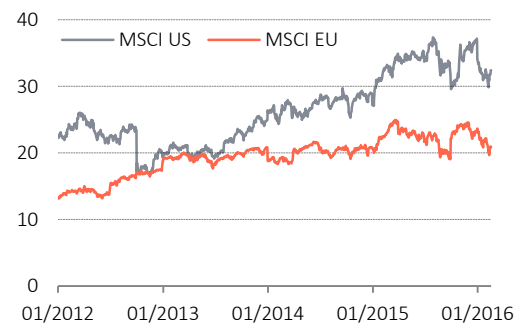
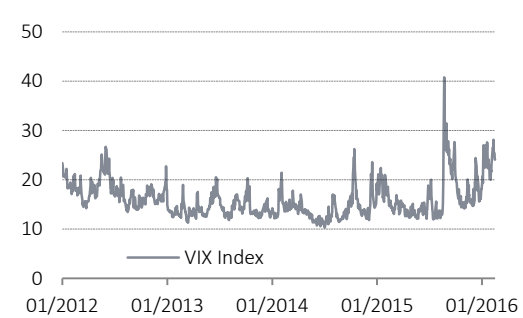


Fig 18: Equity volatility – S&P500 VIX index



ALTERNATIVE INVESTMENTS

In the current risk-off environment, the gold price climbed from a level of USD 1,061 to above USD 1,200. Meanwhile most other commodities prices

fell, especially oil prices. REITS and listed private equity sold-off. Also hedge funds in general had a difficult time coping with the choppy market environment.

Fig. 19: Gold price, USD/oz



Fig.20: Oil price, USD/bl

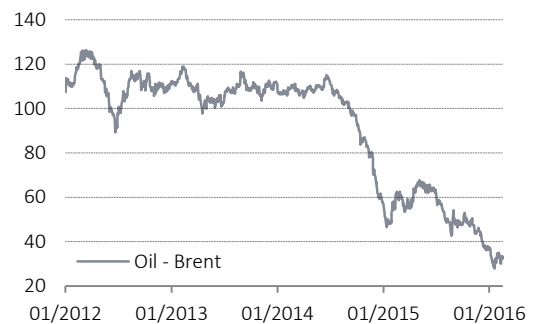


Fig 21: Bloomberg commodity indices

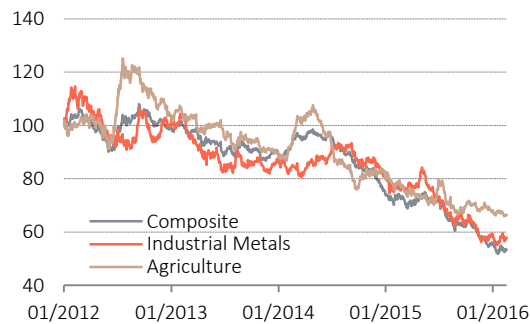


Fig. 22: HFRI hedge fund indices

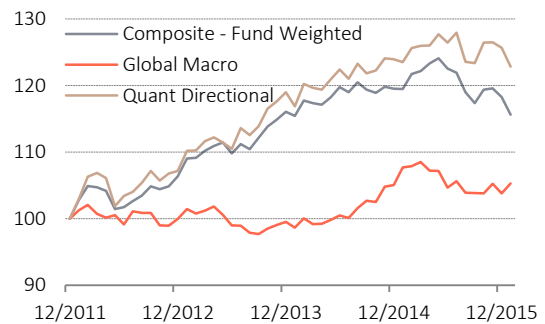


Fig 23: FTSE EPRA/NAREIT global index

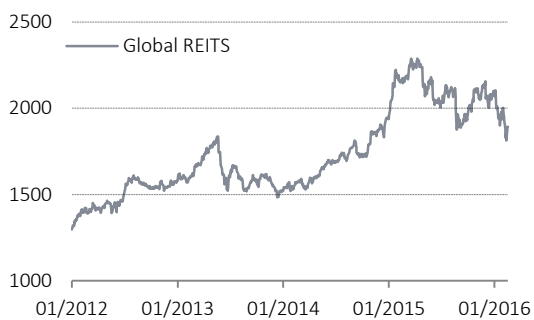
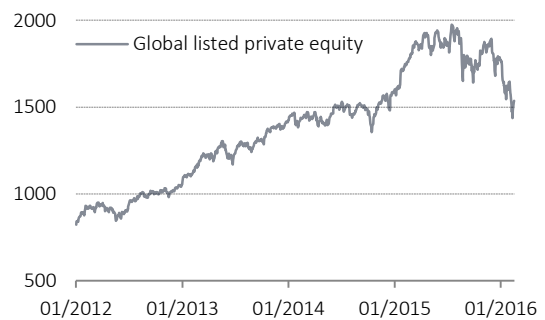


Fig 24: LPX global listed private equity



CURRENCIES

The risk-off environment led to a strengthening of the EUR and the JPY. The USD, the GBP, and the CNY sold off. Many commodity currencies initially extended their losses but recovered after Mid-January. The CHF, which is usually recognized as a safe-haven cur-

rency, weakened vis-a-vis the EUR. The EUR-CHF exchange rate climbed to the highest level since the end of the SNB exchange rate floor in January 2015. It briefly traded close to a level of 1.12.

Fig. 25: EUR-USD exchange rate



Fig. 26: GBP-USD exchange rate

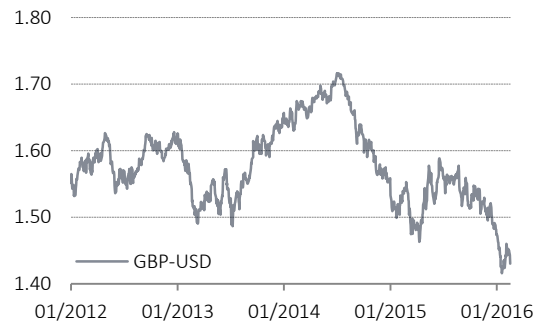


Fig. 27: USD-JPY exchange rate

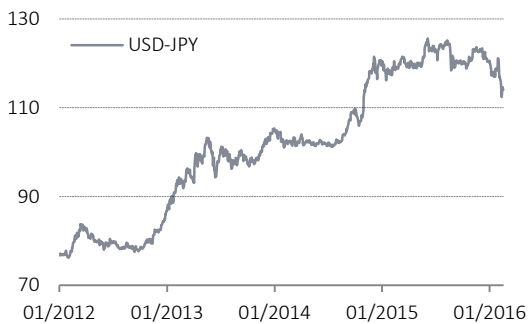


Fig. 28: USD-CNY exchange rate

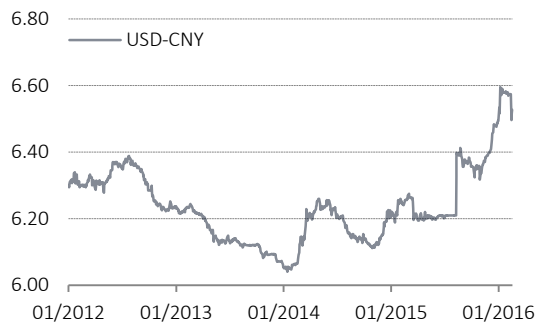


Fig. 29: EUR-CHF exchange rate

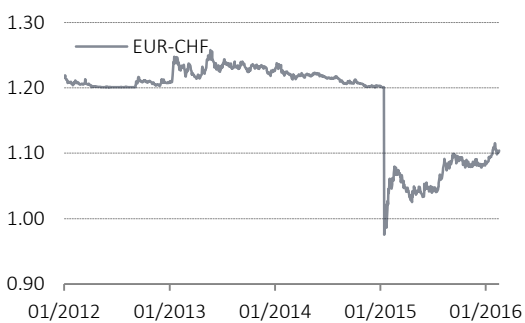
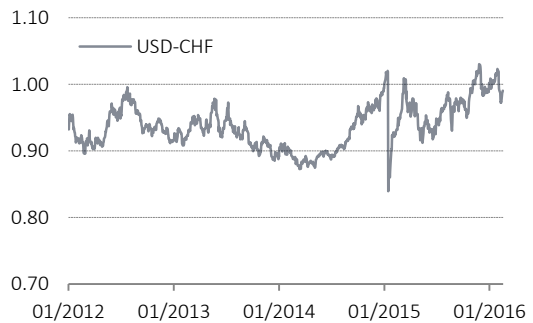


Fig. 30: USD-CHF exchange rate

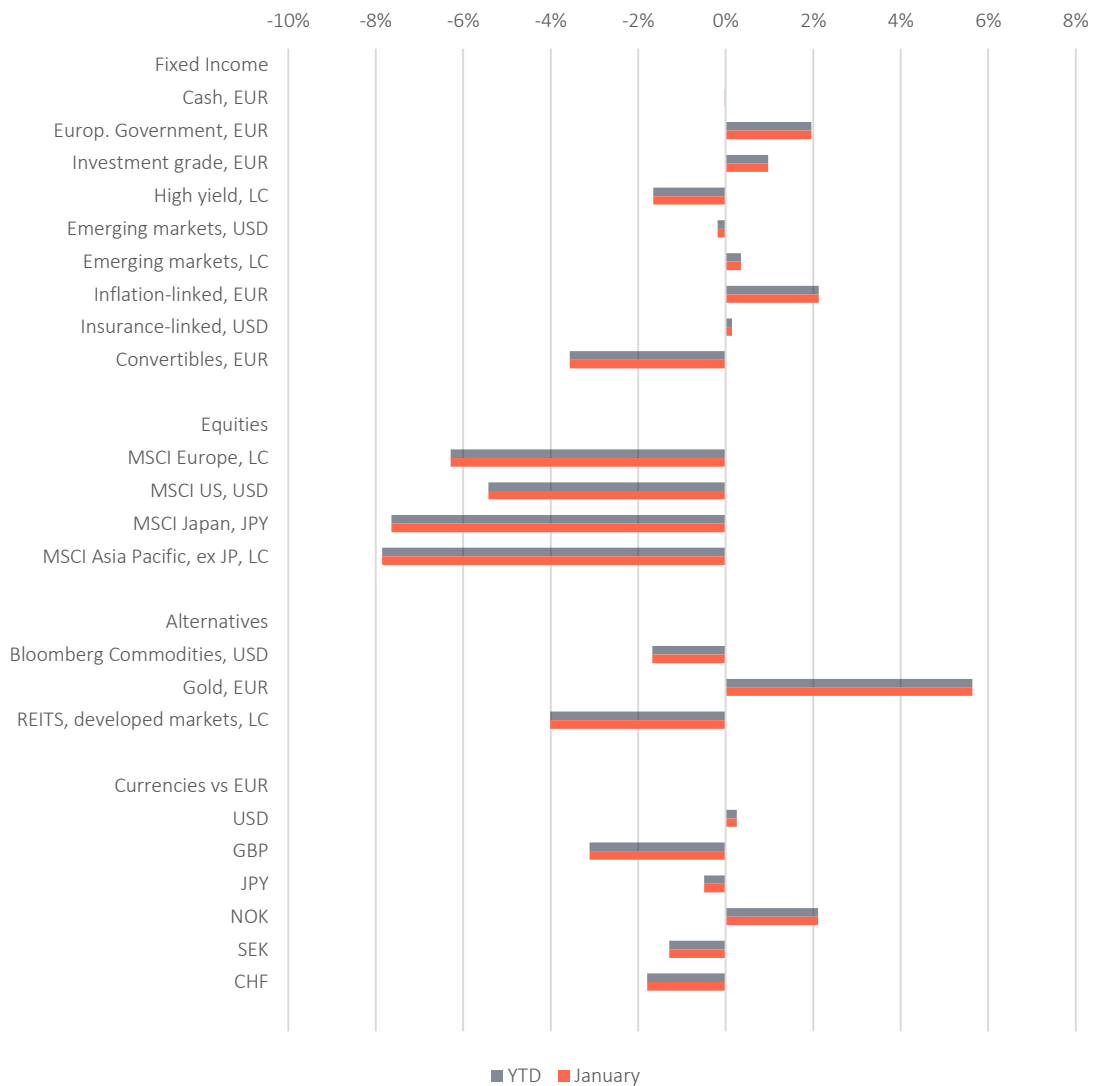


ASSET ALLOCATION

Reviewing major benchmark indices relevant for our asset allocation, government and investment-grade bonds, and inflation-linked bonds performed positively. Gold in EUR rose about 5.5%. Equity

markets, in general, were major negative contributors to the overall portfolio performance. Since the EUR strengthened, foreign currency exposure also contributed negatively to the performance.

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



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