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IMT GROUP

INVESTMENT OUTLOOK 06.2016

11 June 2016

After equities recovered in March and April, developed equity markets consolidated in May, while emerging equity markets lost 3.9%. A number of uncertainties have been weighing on markets. The Brexit vote on 23 June approaches with opinion polls indicating a tight result; market participants have been wondering about the odds of the next Fed rate hike in June; and just recently weak May labor market figures have heightened concerns about the growth outlook.

The European bond market rallied in May with German 10-year bond yields falling 13 basis points. At the same time, 10-year US Treasury yields remained almost unchanged. However, short-term US yields rose in May, which was tantamount to rising Fed rate-hike expectations.

Oil and other commodity prices rose in May, which gave equity markets some support. We remain skeptical with regard to an extended rally in oil and believe that oil prices will at best stabilize around USD 50, and more likely will fall again. Risk-reward for gold remains poor and we recommend selling into strength.

Thomas Trauth
CEO – IMT Asset Management AG

BREXIT AND FED RATE-HIKE EXPECTATIONS WEIGH ON MARKETS

Financial markets

In May developed equity markets consolidated after the recovery in March and April. The US S&P index continued to outperform European equity markets, which in our view at least partly reflects the Brexit risk premium. We continue to believe that UK voters will finally not be ready to take the major risks associated with a Brexit. We also think that bookmakers' odds, which clearly indicate a win for Remain, show a more unbiased picture than the opinion polls, which suggest a 50-50 chance.

If the Brits were to decide to leave the EU, we would expect a sell-off of the GBP, British and more broadly European stock markets. A no-vote, in contrast would lead to a recovery of the GBP and European stocks, which could probably even make up for the underperformance vis-à-vis the US since the beginning of the year.

European government bonds rallied in May, on the back of the ECB's bond-buying program, while US Treasuries at the short end of the yield curve sold off – though then recovered in early June – and longer dated treasuries remained almost unchanged. Break-even inflation represented an increase from very depressed levels, which reflects fading deflation concerns.

The risky part of fixed income has performed very well since mid-February, with a significant spread tightening. However, emerging markets in local currency experienced a sharp correction in recent weeks.

Commodities continued to rally. Oil prices reached 50 USD/bl. In recent months market participants associated rising oil prices with macro normalization, regarding them as a pro-growth indicator, which lifted equity prices. Usually the correlation between equities and oil tends to be negative as higher oil prices are seen as a growth brake.

Gold sold off in May and lost 6% of its value. However, it strongly rebounded in June, probably on the back of heightened macro uncertainties.

Despite Brexit fears the EUR managed to appreciate against the USD by 3.6% year to date. This can be explained by the low valuation of the EUR after the strong depreciation in 2014, disappointing US growth indicators, and a dovish US Fed. Recently, whenever US rate-hike expectations rose, the USD appreciated, and when expectations declined, it fell.

Central banks

On 3 June the ECB unsurprisingly did not change its policy stance. It announced, however, that it would start its corporate bond-buying program on 8 June. The market impact was moderate, especially because credit spreads had already tightened significantly. Furthermore, the ECB said it would start its targeted refinancing program on 22 June, the so-called TLTRO II. As the conditions are very attractive, it will be interesting to observe to what extent banks participate.

On 6 June Fed Chairwoman Janet Yellen, in a speech that gained close attention, pointed out that she would be very mindful of the weak labor market report, watching a potential growth slowdown very carefully. It has become very unlikely that the Fed is going to hike rates at its next meeting on 15 June. The Fed could, however, still raise rates on 27 July, but

this would clearly require a strong June non-farm payroll figure. The market-implied probability of a July hike is currently only 17%.

Macroeconomics

The big macro event in May was the very disappointing US non-farm payroll figure. The US economy created only 38,000 jobs, clearly below expectations. Since this figure tends to be very volatile and is subject to major revisions, we need to wait for the upcoming data points. The US unemployment rate fell to 4.7% from 5%. This drop was primarily due to a decline in the labor-force participation rate, which fell to a 2016 low of 62.6 percent. Meanwhile the University of Michigan consumer sentiment index recovered strongly in recent months, although preliminary estimates for June show some slight softening.

The European manufacturing PMI has been moving sideways for a number of months, remaining in a near stagnation area. The May figure was 51.5 after 51.7.

The Nikkei Japan manufacturing PMI fell to a 40-month low of 47.7 after 48.2. Especially worrying was the rapid drop in the output and new orders sub-indices.

The Chinese manufacturing PMI was also weaker at 49.2 after 49.4, and thus remained at contraction levels (below 50). It is expected that the Chinese authorities will apply further fiscal and monetary expansion measures.

As far as inflation is concerned, US inflation trended upwards in recent months, certainly due in part to rising wage costs. On the one hand this reduces deflation fears, but on the other it may make the Fed more concerned about inflation risks, despite mixed growth indicators. Meanwhile inflation trended lower and into negative territory in the Eurozone as well as in Japan. Swiss consumer prices clearly fell less than in previous months. The consumer price index fell by 0.4% YoY in May, while it had fallen by 1.3% in January. This may reflect the weakening of the currency and rising energy prices.

Outlook

As growth remains subdued, growth indicators are close to stagnation, and at times they can fall into negative territory due to normal fluctuations. While markets may react negatively to such events, it is important to keep an eye on the underlying trends. It is also worth noting that when the US economy approaches full employment, it is very normal for job growth to decline. It will be important to keep an eye on upcoming US hiring intentions for small businesses and the US manpower reports. If those reports should confirm weak US labor-market conditions, we would not exclude more pronounced market reactions.

As discussed previously, anemic growth coupled with high valuations does not bode well for large equity-market returns. On the other hand, positive growth and negative bond yields will continue to pressure investors into equity and riskier credit markets. We continue to be positioned for that. We are neutral in our equity market position and slightly overweight in high-yield bonds.

In our base case, British voters will vote against the Brexit. In that case, we expect the GBP to recover and European equity markets to make up for their significant underperformance in 2016. We therefore remain overweight on European equities.

When it comes to commodities we do not see much upside for oil prices above 50 USD/bl. In recent weeks we have observed some supply disruptions and easing inventory figures. Oil prices above 50 will, however, lead to the buildup of additional supply, most notably in the US but also in Saudi Arabia, and push oil prices lower again.

Big uncertainties are keeping up the demand for safe-haven or portfolio insurance assets, like high-quality government bonds and gold, while the pricing for such assets has become punitively high in our view. Therefore, and since we still believe in a non-catastrophic outcome, we are staying away from the mentioned assets and would rather recommend selling gold and government bonds into strength.

ECONOMICS

The big macro event in May was the very disappointing US non-farm payroll figure. The US economy only created 38,000 jobs, clearly below expectations. Meanwhile the US ISM index improved to 51.3 after 50.8 and the Europe PMI only slightly softened to 51.5 after 51.7. The Japanese and the Chinese PMI both softened in May. US inflation seems to be accelerating somewhat and is at about 1% currently.

Fig. 1: PMIs

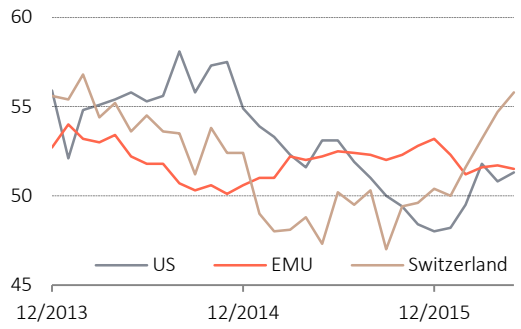


Fig. 2: PMIs

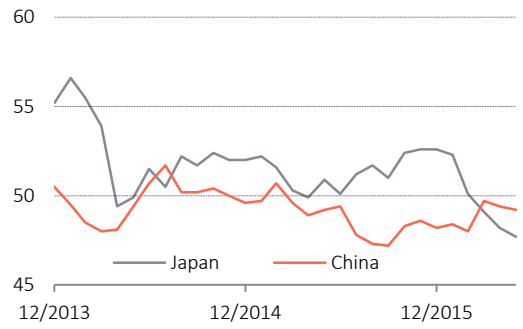


Fig 3: Consumer price inflation, in % YoY

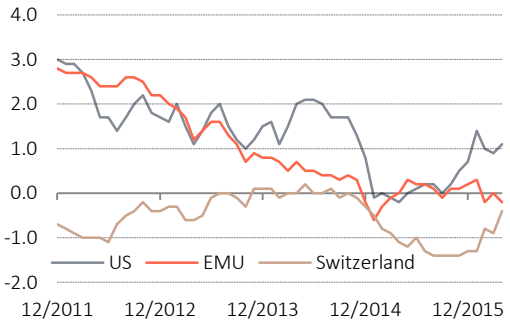


Fig. 4: Consumer price inflation, in % YoY

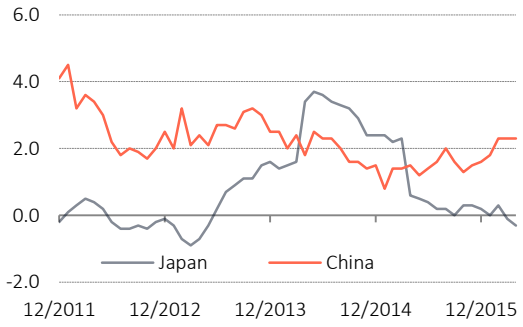


Fig 5: Unemployment rates, in %

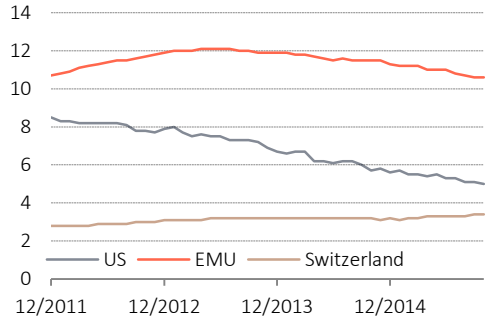
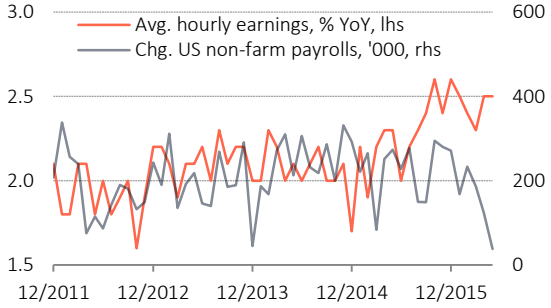


Fig 6: US labor market



FIXED INCOME

Since March the risky part of fixed income has performed very well, while emerging market bonds in local currency sold-off recently. Government bond yields have fallen since the beginning of the year, which can be explained by extended QE in Europe and a rather dovish US Fed. Still, the US money market has been quite volatile recently, as Fed rate-hike expectations fluctuated. The market seems to be less worried about deflation risks since inflation expectations, as measured by break-even inflation rates, rose.

Fig.7: 2Y government bond yields

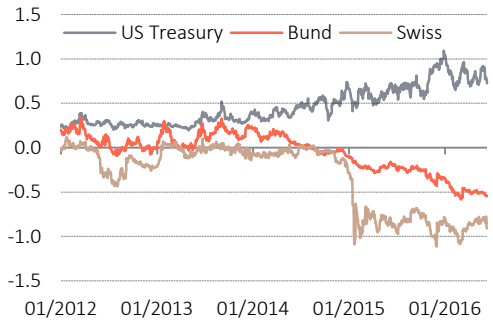


Fig. 8: 10Y government bond yields

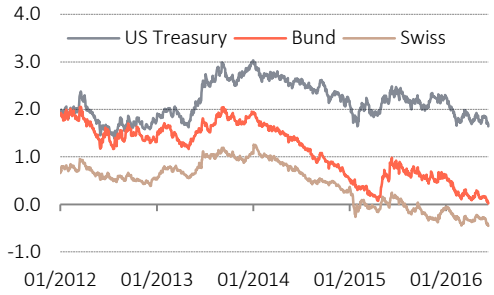


Fig 9: 10Y break-even inflation

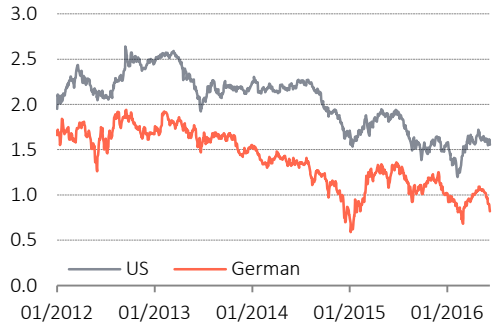


Fig. 10: Credit spreads, 5Y credit default swaps

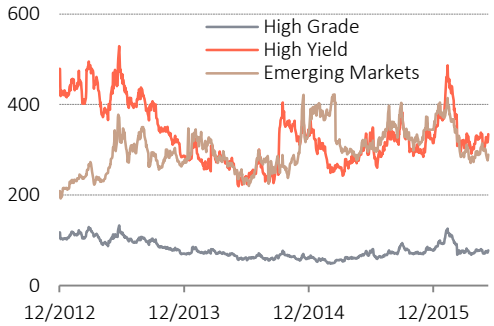


Fig 11: Money market spreads (3M-2Y)

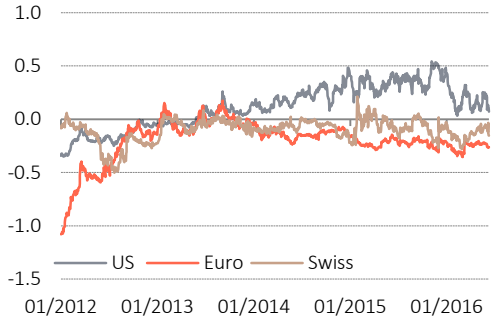
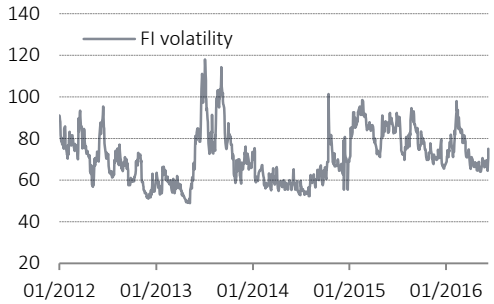


Fig 12: Merrill Lynch volatility index



EQUITIES

Developed equity markets consolidated in May, while emerging markets sold off. Among developed markets the US S&P index outperformed, while Europe suffered from risks associated with Brexit. The Brazilian Ibovespa index reached its peak in April and sold off thereafter. Rising commodities prices helped the energy sector to clearly outperform all other equity sectors, with European financials lagging behind. Despite heightened uncertainties the VIX index, the price for insurance against equity draw-downs, remained at relatively low levels.

Fig. 13: MSCI equity indices – major regions

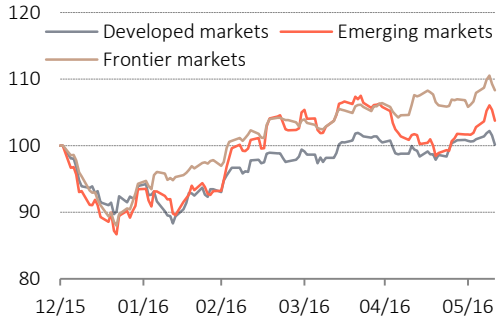


Fig.14: Equity indices – major developed markets

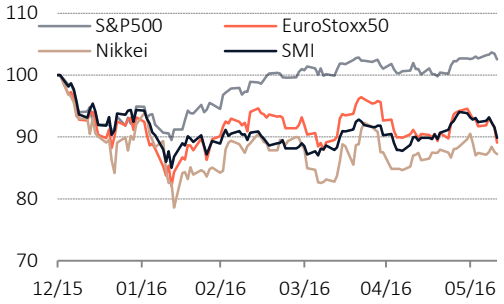


Fig 15: Equity indices – major emerging markets

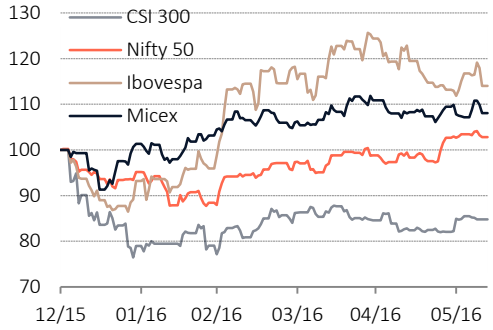


Fig. 16: Sector performance, MSCI Europe, 2016

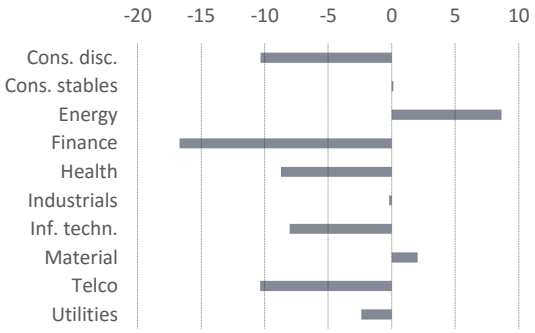


Fig 17: Price-earnings ratios

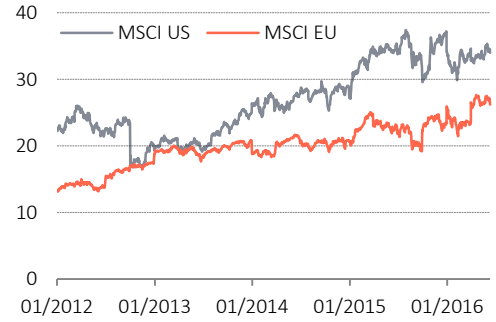
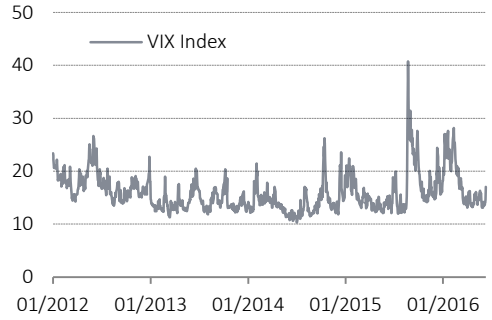


Fig 18: Equity volatility – S&P500 VIX index



ALTERNATIVE INVESTMENTS

Commodities prices recovered strongly in recent months. In the case of oil, markets have been concerned about low oil prices, and recently oil prices often rose in tandem with equities. While rising oil prices can be seen as an indication of more stable growth, it was interesting to see that gold prices rose at the same time. Rising gold usually indicates that investors are seeking insurance against adverse events. REITS and listed private equity performed well year to date.

Fig. 19: Gold price, USD/oz

Fig.20: Oil price, USD/bl

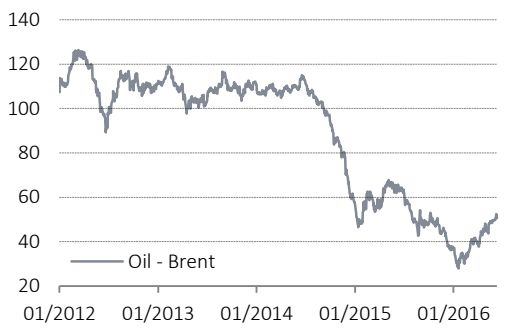


Fig 21: Bloomberg commodity indices

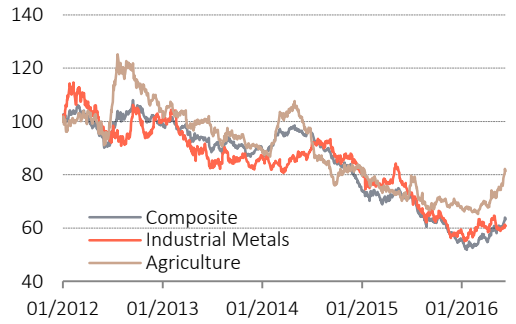


Fig. 22: HFRI hedge fund indices

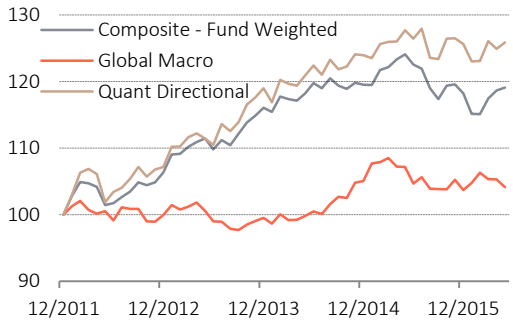


Fig 23: FTSE EPRA/NAREIT global index

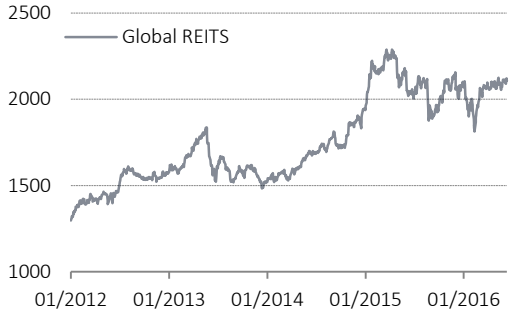
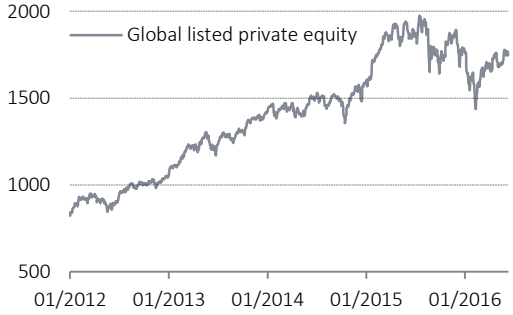


Fig 24: LPX global listed private equity



CURRENCIES

The GBP continued to weaken on the back of Brexit concerns. The USD has weakened since the beginning of the year, with heightened volatility in recent weeks, when the USD traded in tandem with Fed rate-hike expectations. The JPY continued its appreciation path and the Chinese CNY weakened again, giving back its previous gains. The Swiss franc had continuously weakened against the EUR since the beginning of the year, but last week suddenly strengthened.

Fig. 25: EUR-USD exchange rate

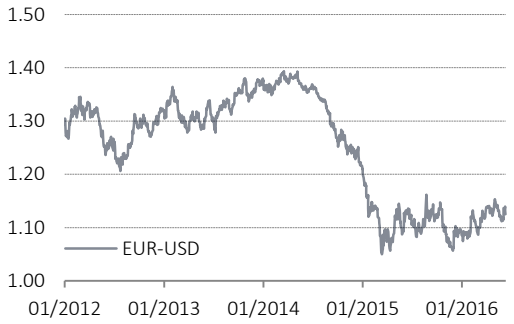


Fig. 26: GBP-USD exchange rate

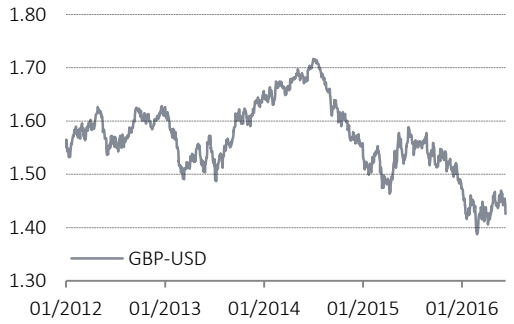


Fig 27: USD-JPY exchange rate

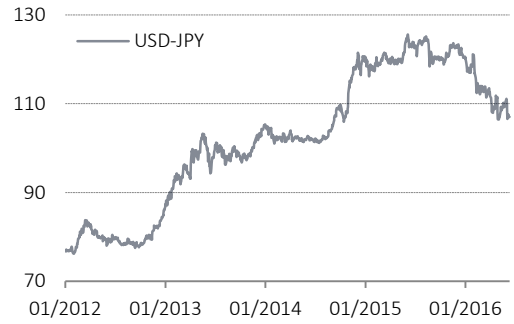


Fig. 28: USD-CNY exchange rate

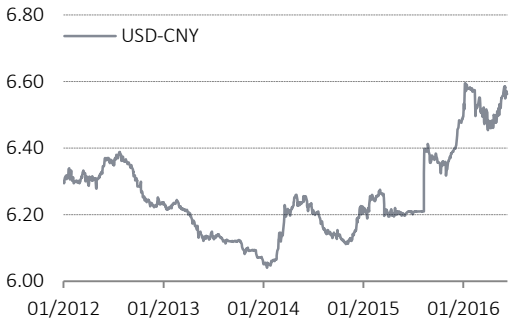


Fig 29: EUR-CHF exchange rate

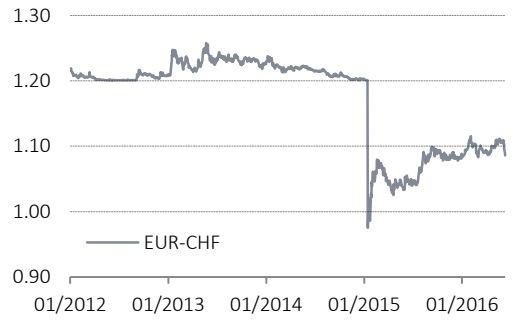
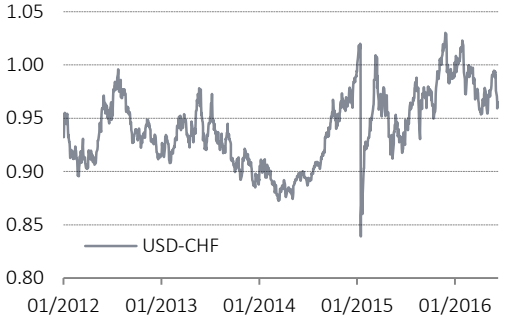


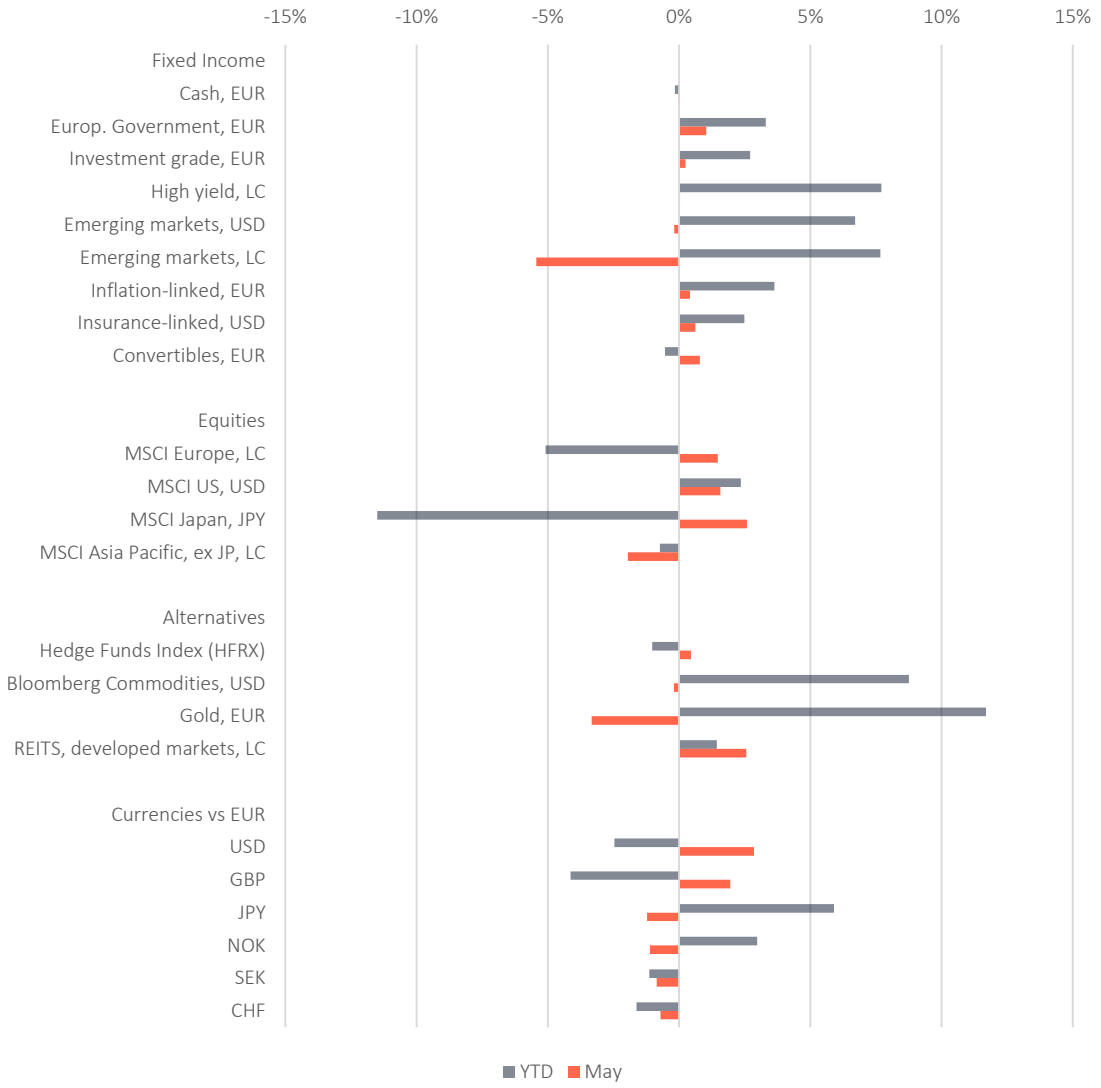
Fig 30: USD-CHF exchange rate



ASSET ALLOCATION

Perhaps surprisingly, commodities and also gold have been the best performing assets since the beginning of the year, followed by the risky part of the fixed-income universe. Equities and especially Europe and Japan have underperformed this year so far. In May we observed some reversals, e.g. bonds of emerging markets in local currency sold off, as well as gold. Meanwhile, European and Japanese equities recovered somewhat.

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



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