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IMT GROUP

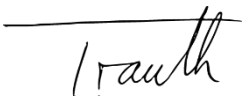
INVESTMENT OUTLOOK 07.2016

20 July 2016

The month of June was dominated by the wait for the Brexit vote and then – after the surprising outcome – by the shock waves rolling over financial markets. The jolts were manifest in a major sell-off of risky assets, like equity and credit, and a rally of perceived safe haven assets, like government bonds, and gold. The GBP was – not surprisingly – the major loser, followed by the EUR, while the USD, the JPY and CHF strengthened. The initial market moves lasted about two weeks and reversed, sometimes sharply, thereafter.

The uncertainties in the market are – in our view – driven by the dispute between euro-sceptics and those who see the European Union as a sustainable institution. While we take a critical view of some institutional deficiencies of the EU, which need to be addressed urgently, we do believe that the Union is a stable institution and a reversal of the European idea is highly unlikely.

Nevertheless, we expect the debate to go on, resulting in continued uncertainties and heightened market risks.



Thomas Trauth
CEO – IMT Asset Management AG

THE WORLD AFTER BREXIT

The Political risk landscape after Brexit

We already commented on the Brexit vote in a special edition of this publication on 29 June. We continue to think that the implications for the UK economy will be severe, leading to a recession and potentially to major business relocations, depending on the outcome of the negotiations. Economic contagion effects on the rest of the world will be minor, however. In its July World Economic Outlook Update the IMF estimates that Brexit-related uncertainties will lower global growth by 0.1 percentage points in 2016 and 2017.

The political implications are, however, more severe and could impact financial markets materially. First, euro-sceptics feel encouraged by the Brexit vote and will raise their voices and concerns over the long-term stability of the European Union. Second, populists in France, Italy, the Netherlands and other EU member countries have been encouraged to initiate more exit referendums. Political uncertainty in relation to the above-mentioned issues clearly has the potential to put a damper on consumer and investor sentiment. We regard this as the major risk factor stemming from the Brexit vote.

We assume that the EU is more likely to take a tough stance vis-à-vis the UK in the upcoming negotiations in order to discourage further initiatives to emulate the UK's decision to leave the EU. This will make the negotiations between the EU and the UK difficult, so that we expect them to drag on for a long time, which will also prolong the phase of uncertainties.

The Brexit vote was – not least – a protest against migration, reflecting deep-rooted and broad-based xenophobia. This has been a common theme not only within various European countries.

It has also been a serious topic of the US election. Donald trump, for example, said about Mexican immigrants that they are "bringing drugs, bringing crime, they are rapists,". On top of this, recent terrorist attacks fuel mistrust and fear of people from Arabic countries.

Groups on the right of the political spectrum in particular take advantage of the xenophobic and populist sentiments. One of the problems with this is that while free commerce of goods, services, and ideas is clearly value and growth enhancing, xenophobia rather leads to isolation and foreclosure.

Financial markets

In June, developed equity markets were flat in the US and clearly negative in Europe and Japan. Meanwhile emerging markets were up 3.3%.

We – like many others – were surprised to see that the UK equity index FTSE 100 managed to gain 2% in the two weeks following the Brexit vote, while at the same time the EuroStoxx50 lost 9.2% and the FTSE 250 lost 9.6%. For a EUR investor losses were even higher since during the same period the GBP lost 13%. The FTSE 100 comprises many large international groups while the FTSE 250 consists of more local and medium-sized companies. The larger international groups are also perceived to be less impacted by the Brexit because they usually already have a presence in various countries and can move business easily across borders. In fact, among the FTSE 100 companies only 20 stocks gained after the Brexit, while the stock of 80 companies fell. The 20

gaining stocks account for the largest index weights and have dominated the index move.

Gold continued to rally after the Brexit and gained 8.5% to reach USD/oz 1,367. In recent weeks gold prices fell back to 1,316. Oil prices fell by 5.3% after Brexit and have not recovered since.

The GBP fell dramatically after Brexit, losing about 13% of its value. The GBP was at around 1.45 to the USD before the Brexit vote and currently trades around 1.32. The EUR-USD exchange rate fell 2.5% in the two weeks after Brexit but overall remained almost unchanged during June. The JPY appreciated after Brexit but reversed sharply in July when Upper House elections in Japan led to expectations of further stimulus measures by the Bank of Japan.

Macroeconomics

Global growth indicators were a bit stronger in June. US non-farm payrolls rose unexpectedly strongly in June to 287,000 after the very disappointing May figure, which was even revised down. The May figures can probably be seen as a one-off. Meanwhile the US unemployment rate rose slightly to 4.9%.

The US ISM index rose to 53.2 after 51.3, and the European manufacturing PMI climbed solidly to 52.8 after 51.5.

The Nikkei Japan manufacturing PMI managed to tick up a bit to 48.1 after 47.7 but remains in the contraction area below 50.

The Chinese manufacturing PMI was again weaker and dropped further to 48.6 after 49.2.

Inflation remained low or negative in most countries. If oil prices remain at least at current levels we expect base effects in the second half of this year, due to oil prices being above their prior year levels.

Outlook

We have positioned our portfolios more or less neutrally to our strategic asset allocation, with the exception that we remain clearly underweight in government bonds and somewhat underweight in commodities. We still see major structural oversupply in many commodities markets, especially in oil. Furthermore, low global economic growth will prevent demand from rising rapidly.

European equities have underperformed US equities by about 15 percentage points since January. We see this primarily as a result of uncertainties regarding the future path of Europe and the Brexit implications. While it is likely that such uncertainties will remain for the coming months, from a valuation perspective European equities appear attractive vis-à-vis US equities. Therefore, we are keeping our positioning in European stocks and may even decide to increase our exposure in the coming months.

Emerging markets bonds and equity outperformed year-to-date and we continue to see value there, since valuations still look attractive.

For the time being we prefer the USD over the EUR, based on the above-mentioned political uncertainties. While the Fed has been very dovish recently, we would not be surprised by a Fed rate-hike in December of this year. Based on this assumption we see a greater likelihood of further USD strength towards the end of the year.

The GBP will probably stay weak since we expect negotiations between the UK and the EU to be difficult and protracted. News about a more positive outcome could however spark a GBP rally.

ECONOMICS

US non-farm payrolls rose unexpectedly strongly in June to 287,000 after the very disappointing May figure, which was even revised down. Meanwhile the US unemployment rate rose slightly to 4.9%. The US ISM index rose to 53.2 after 51.3, and also the EMU PMI rose solidly to 52.8 after 51.5. Inflation remained low or negative in most countries.

Fig. 1: PMIs

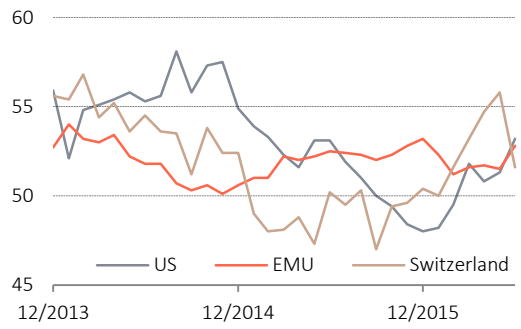


Fig. 2: PMIs

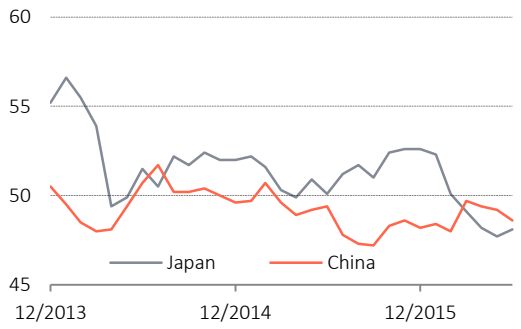


Fig 3: Consumer price inflation, in % YoY

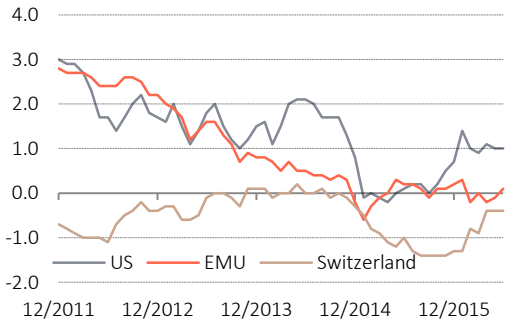


Fig. 4: Consumer price inflation, in % YoY

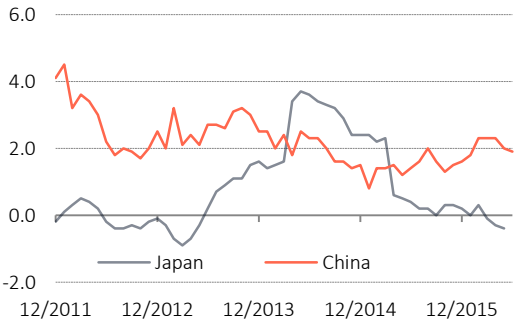


Fig 5: Unemployment rates, in %

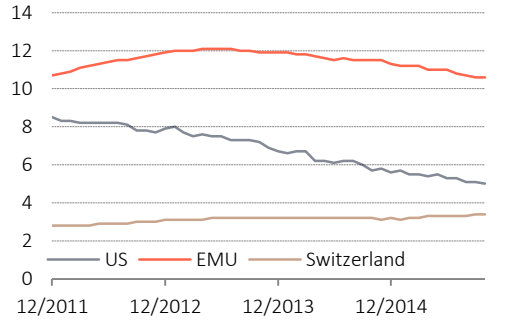
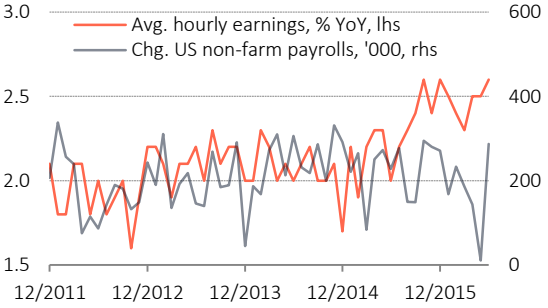


Fig 6: US labor market



FIXED INCOME

After the Brexit vote, government bonds rallied across the board, while credit spreads widened significantly and implied volatility spiked. During the first half of July those moves reversed. Fed rate-hike expectations were pushed further into the future especially after comments by Fed chairwoman Yellen that a hike will be considered only after there is more clarity with regard to the implications of Brexit.

Fig.7: 2Y government bond yields

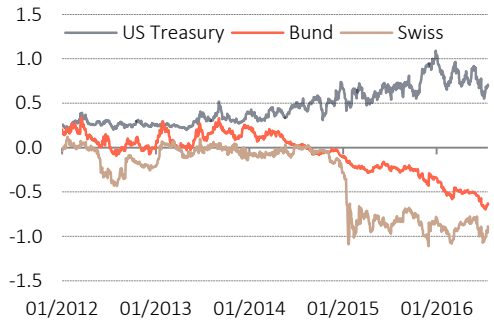


Fig. 8: 10Y government bond yields

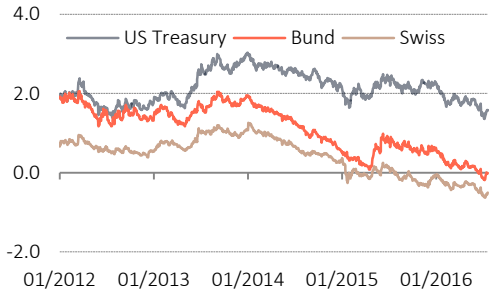


Fig 9: 10Y break-even inflation

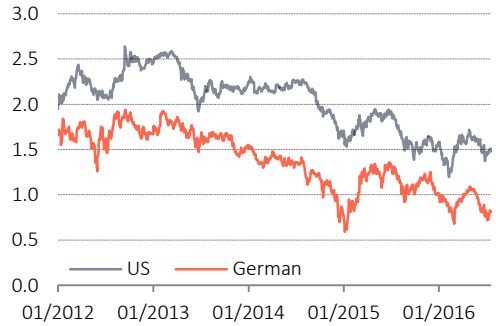


Fig. 10: Credit spreads, 5Y credit default swaps

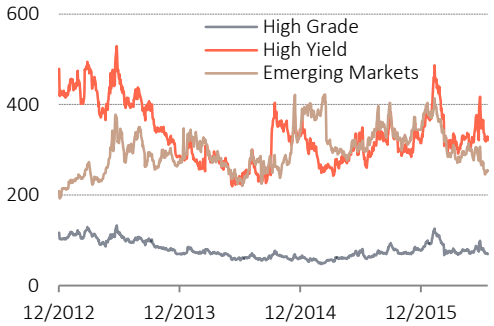


Fig 11: Money market spreads (3M-2Y)

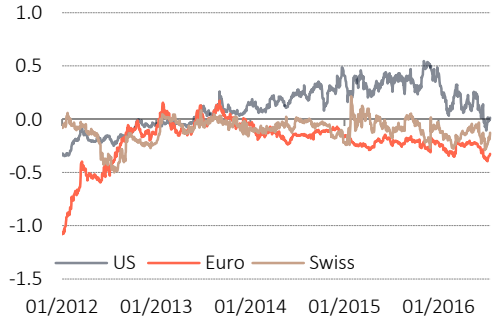
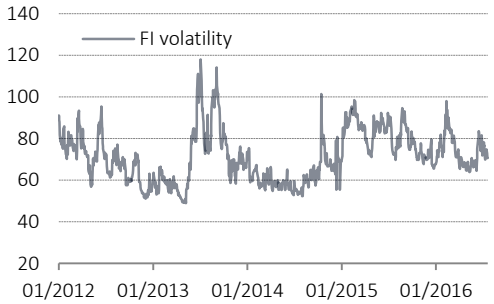


Fig 12: Merrill Lynch volatility index



EQUITIES

The Brexit vote let to a global sell-off of equity markets with European and British small and mid caps clearly underperforming. Between 23 June and 6 July, immediately after Brexit, the EuroStoxx50 lost 9.1% and the FTSE 250 9.6%. Smaller UK companies are more closely linked to the domestic market and suffered most. Meanwhile the FTSE 100 gained 2.0%. This index represents global companies, which are thought to be less impacted by the Brexit and can rather take advantage of a weaker GBP.

Fig. 13: MSCI equity indices – major regions

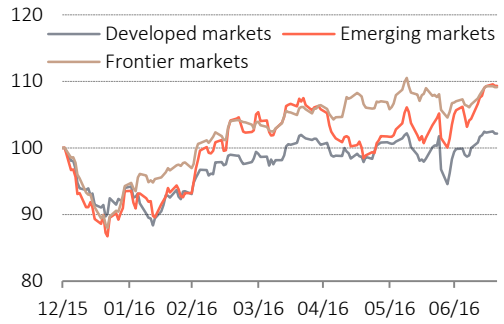


Fig.14: Equity indices – major developed markets

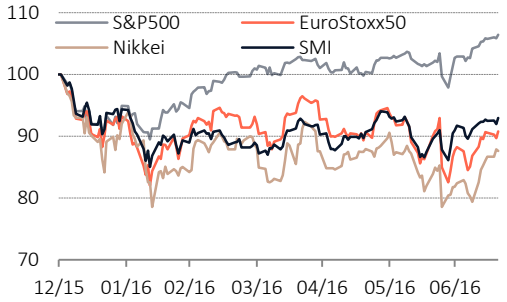


Fig 15: Equity indices – major emerging markets

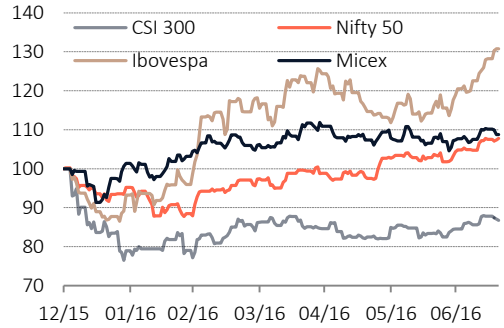


Fig. 16: Sector performance, MSCI Europe, 2016

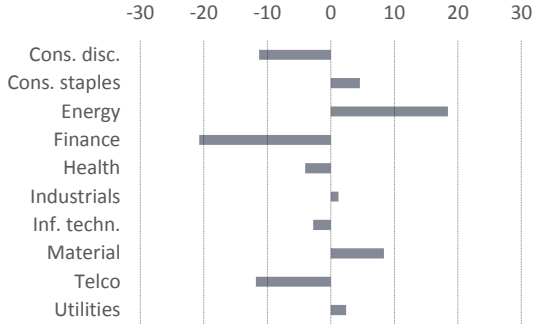


Fig 17: Price-earnings ratios

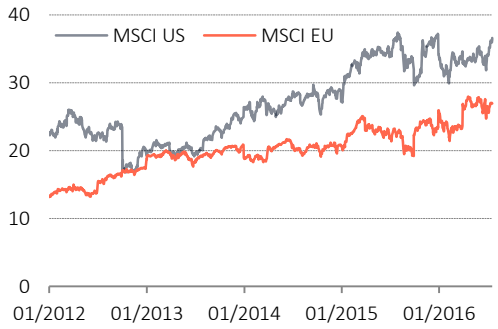
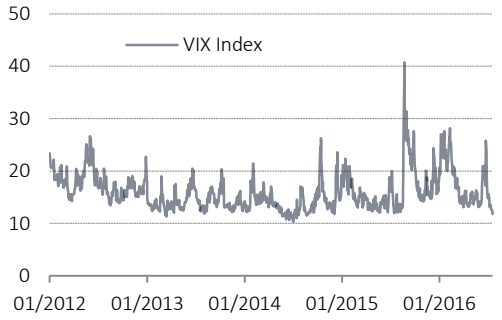


Fig 18: Equity volatility – S&P500 VIX index



ALTERNATIVE INVESTMENTS

Gold rallied before and after the Brexit vote, while oil prices fell about 5% in the two weeks after Brexit. Oil prices seem to be consolidating over USD 45/bl. Hedge funds seem to have managed the Brexit risk well by de-risking their portfolios in advance of the vote. European REITS were hit strongly and sold off 12.7% in the two weeks after Brexit, while REITS in other regions performed positively.

Fig. 19: Gold price, USD/oz

Fig.20: Oil price, USD/bl

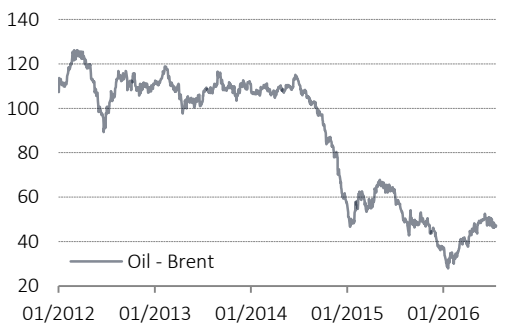


Fig 21: Bloomberg commodity indices

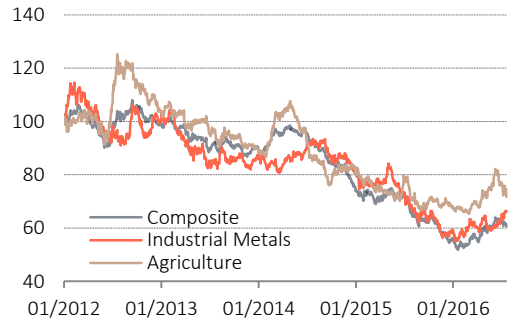


Fig. 22: HFRI hedge fund indices

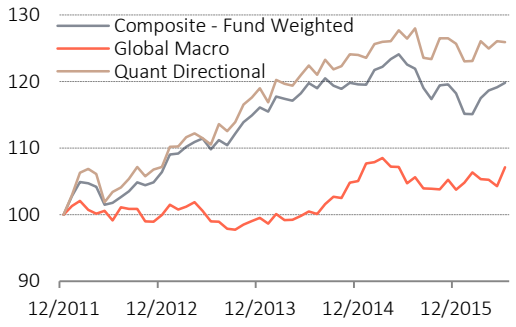


Fig 23: FTSE EPRA/NAREIT global index

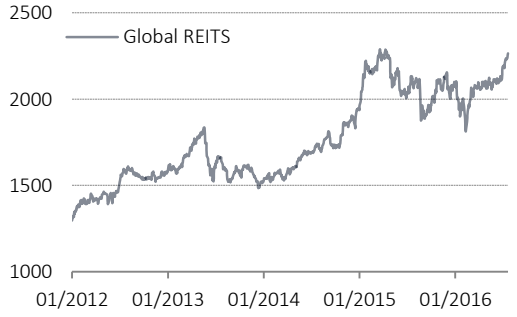
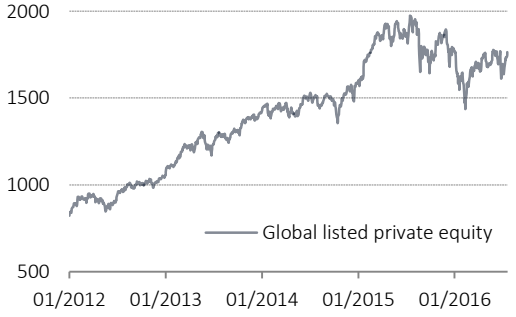


Fig 24: LPX global listed private equity



CURRENCIES

The GBP sold off sharply after the Brexit vote and did not recover in any meaningful way in July. The EUR lost 2.5% vis-à-vis the USD after Brexit and since then trades around 1.10. The JPY remained on the strong side and in June gained 11% vis-à-vis the EUR.

The Swiss Franc strengthened after Brexit but gave back some of its gains thereafter, partly because of SNB's market interventions. The CNY continued to weaken.

Fig. 25: EUR-USD exchange rate

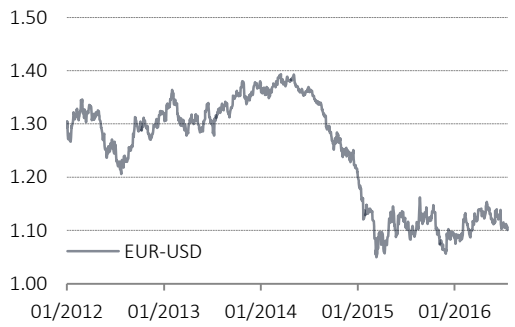


Fig. 26: GBP-USD exchange rate

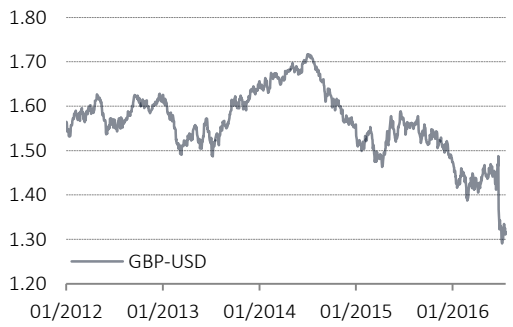


Fig 27: USD-JPY exchange rate

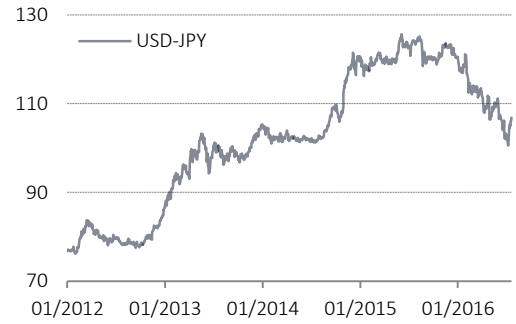


Fig. 28: USD-CNY exchange rate

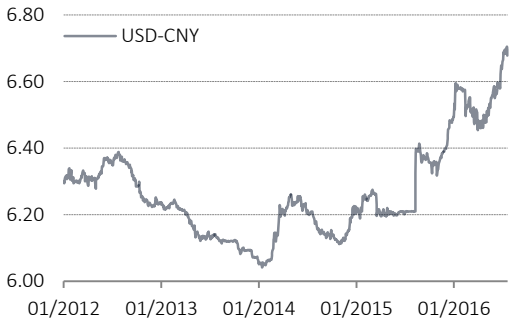


Fig 29: EUR-CHF exchange rate

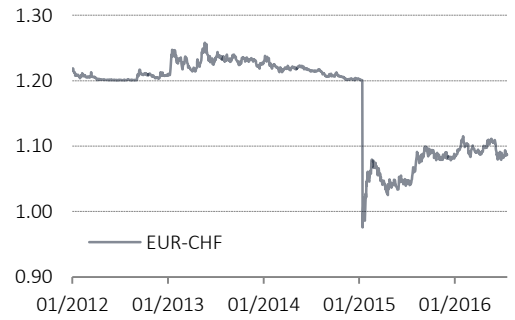
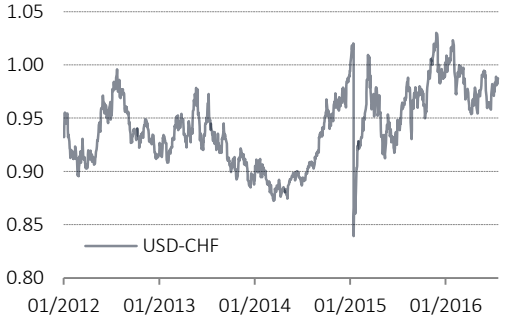


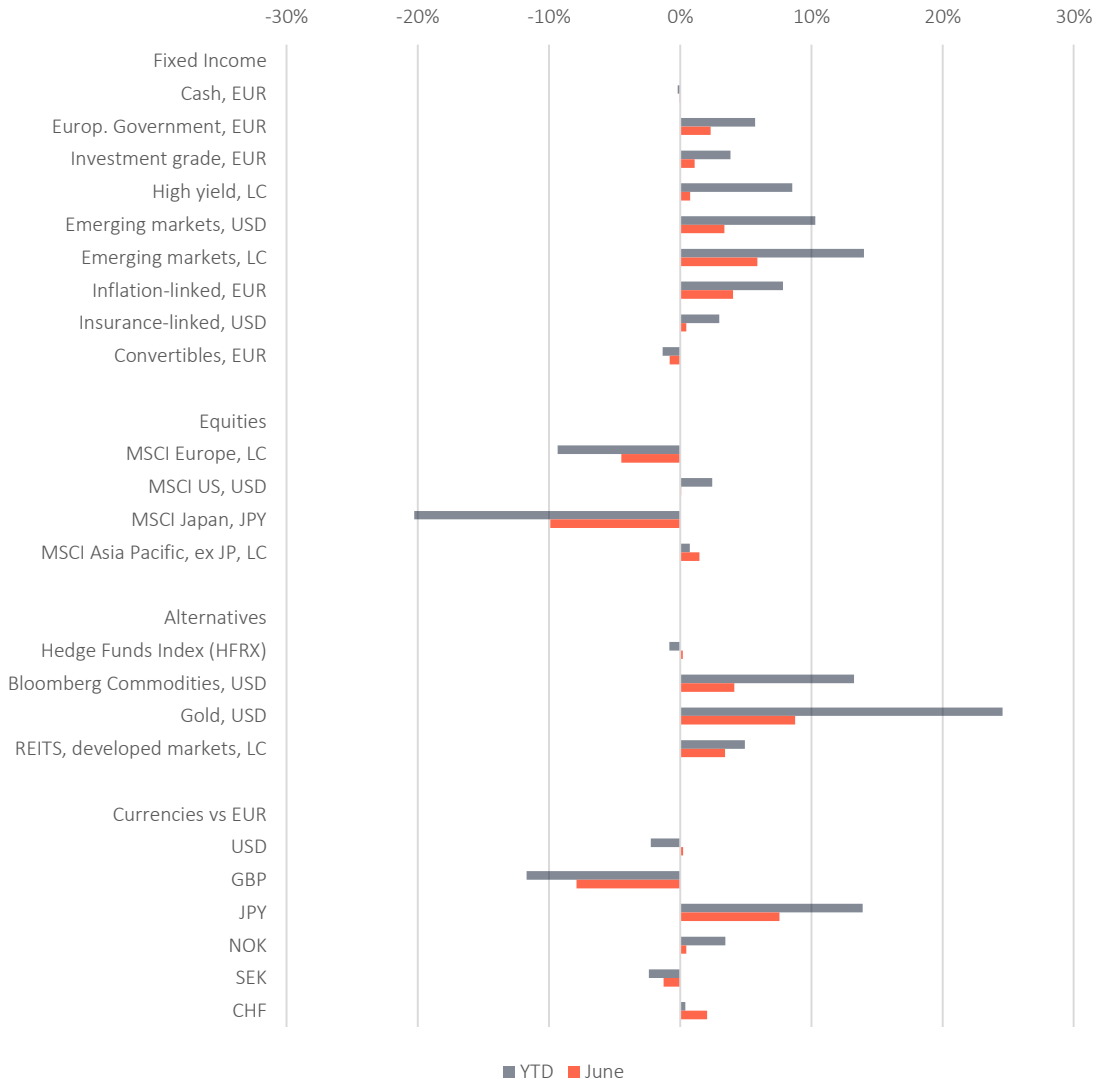
Fig 30: USD-CHF exchange rate



ASSET ALLOCATION

For a EUR investor the best-performing asset classes have been bonds and commodities, especially gold. European and Japanese equities have been the worst performing assets. As far as currencies are concerned, a EUR investor should have taken JPY and NOK exposure and should have avoided GBP and USD so far this year.

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



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Source for all graphs: Bloomberg, IMT Asset Management AG.