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IMT GROUP

INVESTMENT OUTLOOK 10.2016

10 October 2016

September was a mixed month for equities. Major equity indices, like the S&P500, the EuroStoxx50 and the Nikkei225 were down by 0.1%, 0.7% and 2.6%, respectively. Emerging equity markets outperformed developed markets. The MSCI Emerging Markets index rose 1.1% in September. Bond yields fell across the board. The GBP continued to weaken. In early October the sell-off accelerated and drove the GBP down by about 4% vis-à-vis EUR and USD, driven by Brexit-related concerns about the UK economy.

Overall macro indicators for September improved, partly even considerably, which confirms our base case scenario of slow but steady growth.

The OPEC finally agreed to introduce production ceilings for oil, which should stabilize oil markets.

In the following we introduce our IMT Risk Monitor, which we have developed to assess macro risks.

We see no reason to change our overall market outlook or positioning.

Thomas Trauth
CEO – IMT Asset Management AG

WILL OPEC BE ABLE TO END THE OIL BEAR MARKET?

Financial markets

As forecast in our last issue of the Investment Outlook, the broad-based sell-off after the ECB meeting was short-lived and markets rebounded during September. Still, September turned out to be a mixed month for equity markets, which were impacted by a number of developments. The central banks' decision not to ease monetary policy further, concerns about the health of Deutsche Bank's balance sheet, as well as the surprise result of the OPEC meeting had varying and offsetting effects on investors' sentiment.

Overall, emerging markets equities outperformed. The MSCI Emerging Markets index rose 1.1% in September, while the MSCI Developed Markets index rose only 0.4%. Major country indices were weaker in September. The EuroStoxx50 index fell 0.7%, the S&P500 index 0.1%, and the Japanese Nikkei 225 index even 2.4%. Among the emerging markets the Brazilian Bovespa index continued to outperform and was up 0.8% in September, followed by a strong rally in early October.

The sell-off of Deutsche Bank shares, resulting from concerns about the health of its balance sheet, had very little contagion effect on other European banks.

The extraordinary meeting of the OPEC conference in Algiers on 28 September led to an unexpected decision to cap oil production at between 32.5-33.0 mbd (million barrels per day). This is OPEC's first production cut since 2008. The result of the decision will only slowly translate into a real impact on oil market supply. At its November meeting OPEC will need to decide how the productions cuts are to be distributed amongst the fourteen member countries. Only thereafter, in December, can oil producers start discussions with oil consumers. And the real impact on volumes will only be felt at the end of Q1 in 2017.

There are justified doubts as to whether the OPEC decision will have a lasting impact on oil prices. First, there are significant tensions and conflicts of interest between OPEC members, which raise doubts about whether the decision will be implemented. In addition, the cuts are relatively modest, i.e. between 0.7% and 2.2% below current output. Furthermore, large oil producers, like the US and Russia, are not OPEC members and act independently. There is even a risk that oil prices could plunge back below USD 40, if the OPEC should fail to implement its decision.

On the back of the above-mentioned considerations and the still very generous supply conditions, we see only limited upside potential for oil prices in the coming year. However, we do think that the OPEC decision is likely to limit the downside potential for oil prices, and thus could help to stabilize global financial markets.

Immediately after the meeting oil prices surged 4%. Other markets also reacted positively, e.g. energy-related high-yield credit spreads tightened by about 40 bps.

In a speech in early October Theresa May announced she would already invoke Article 50 of the EU treaty, the legal route to Brexit, before the end of March 2017. Furthermore, she made clear that she would not accept certain single-market obligations like

limitations on border controls, which make a so-called hard Brexit more likely. The EU will not be willing and able to give Britain access to the European single market if Britain does not accept the single-market obligations. As a result, the GBP sold-off sharply and fell more than 4% vis-à-vis USD and EUR.

Macroeconomics

We observed a broad-based improvement of growth indicators in September. The US ISM manufacturing index bounced back markedly to 51.5 after 49.4. Also, the European manufacturing PMI rose to 53.2 after 51.7. The US inflation rate ticked up slightly and US labor costs continue to rise by about 2.5% year-on-year. US non-farm payrolls rose by 167,000, which fell short of expectations but is still robust enough to confirm that the US economy is creating new jobs at a healthy pace.

Inflation expectations, as measured by 10-year break-even inflation ratios, continued to grind higher. While the levels are still very low, central banks will appreciate the fact that inflation rates are expected to move back up towards the desired level of 2%.

Central Banks

In September, attention was focused strongly on the policy meetings of the ECB – on 8 September – and of the BoJ – on 21 September. Neither of the two central banks decided to deliver additional quantitative easing (QE) measures, though markets were expecting such measures. We discussed the implications of the ECB meeting and its communication in our last Investment Outlook. As expected, the drastic market reaction after the ECB meeting was only short lived.

The BoJ likewise decided not to take additional easing measures. Instead the BoJ kept short-term rates unchanged at -0.1%. In addition, the BoJ announced it will stay accommodative for the foreseeable future and allow the inflation rate to overshoot its target of 2%. The BoJ also announced an explicit target for 10-year government bonds yields of about 0%. It remains to be seen whether those measures do provide sufficient stimulus for the Japanese economy.

IMT Risk Monitor

Our general macro and market assessment has always included a strong focus on macro risks. We decided to come up with a simplified illustration of our risk monitoring and make it available to our clients and readers. You will find the summary graph, a cobweb diagram, in our Investment Outlook starting with this issue. We refer to Figure 32 on page 11. The IMT Risk Monitor is based on various risk indicators, most of them derived from tradable market instruments or – in the case of growth risks – from published surveys. We have come up with seven risk categories and condensed the various indicators into one aggregate indicator per risk category. These indicators are normalized. A level of 0 represents a very low risk and a level of 10 a very high risk. The larger the area in the cobweb diagram the higher are the overall macro risks. For comparison, we show the current risk indicators alongside their levels mid-February, when concerns about China led to a major sell-off, and their levels in August 2015, when growth concerns had a major impact on financial markets.

The IMT Risk Monitor is a systematic monitoring tool and helps us keep a close eye on various risk indicators. The tool is not designed to propose trading rules; it needs careful analysis and interpretation. For example, in February of this year the risk indicator showed heightened systemic risks as well as high implied volatility levels. Back then we concluded that the market-implied risk indicators were exaggerated. As a result, we decided not to reduce risk in our portfolios. From today's perspective, the decision looks to be right.

In the coming months we will publish more background information on our risk monitor, and we will – over time – develop the tool further.

Outlook

Rate-hike expectations have risen – as indicated by our latest Risk Monitor, see page 11. In our view, the US Fed will hike rates either in December of this year or in the first quarter of 2017. Neither the ECB nor the BoJ decided on additional QE measures, but clearly stay accommodative for the foreseeable future. Better growth indicators pose a threat to government bond markets but should be supportive for equity markets. The Q3 earnings season is starting and the outlook for earnings is reasonably good.

With the OPEC decision the downside risk for oil prices has been reduced somewhat, which is a positive for the overall stability of financial markets. The OPEC decision is unlikely though to induce a major oil-price rally in the coming quarters. We therefore continue to expect oil prices to stay range bound between 45 and 55 USD/bl.

Overall we continue to favor risky assets and stay away from government bonds. We see major risks for the UK economy, while the GBP will take the main burden of the adjustment process for now. We expect the GBP to stay weak unless the British government changes course and works towards a soft Brexit scenario, which would mean an adoption of single market obligations.

ECONOMICS

We observed a broad-based improvement of growth indicators in September. The US ISM manufacturing index bounced back markedly to 51.5 after 49.4. Also, the European manufacturing PMI rose to 53.2 after 51.7. The US inflation rate ticked up slightly and US labor costs continue to rise by about 2.5% year-on-year. US non-farm payrolls rose by 167,000, which fell short of expectations but is still robust enough to confirm that the US economy is creating new jobs at a healthy pace.

Fig. 1: PMIs

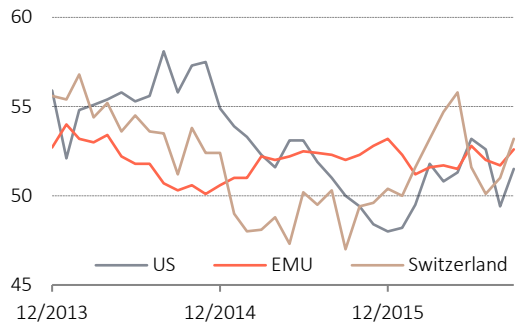


Fig. 2: PMIs

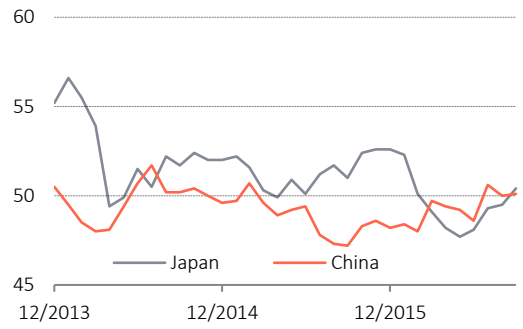


Fig 3: Consumer price inflation, in % YoY

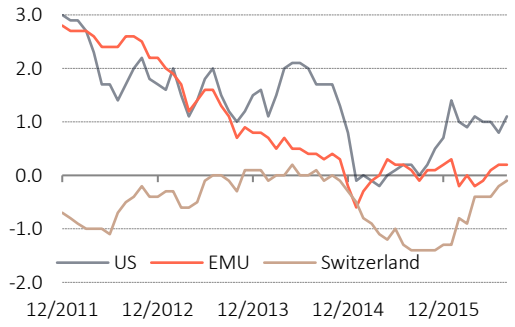


Fig. 4: Consumer price inflation, in % YoY

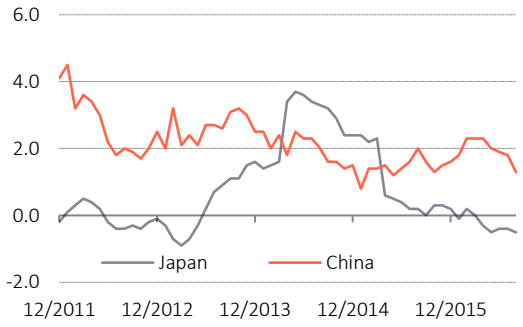


Fig 5: Unemployment rates, in %

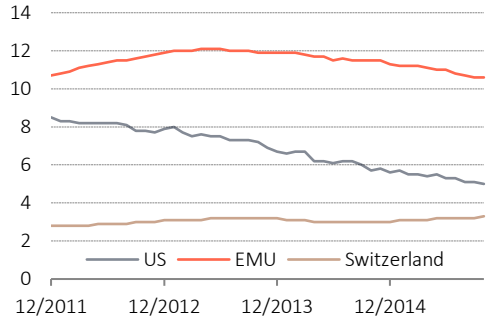
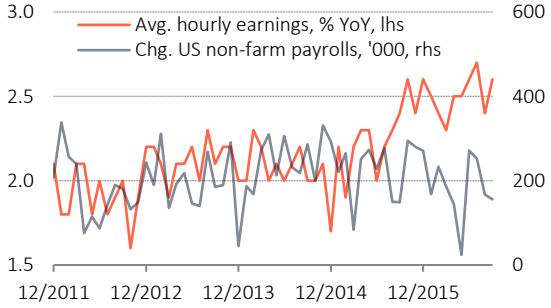


Fig 6: US labor market



FIXED INCOME

In September bond markets rallied. German government bond yields fell by about 5 bps across the yield curve. The US 2-year yield fell by about 5 bps as well, while the 10-year yield remained almost unchanged. 10-year break-even inflation rates in the US as well as in Europe continued to rise, which should give central banks some comfort, suggesting that inflation expectations are moving towards more normal levels. Credit spreads remained quite stable, while high-yield spreads widened somewhat.

Fig.7: 2Y government bond yields

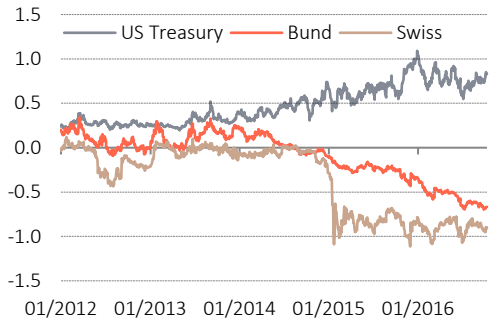


Fig. 8: 10Y government bond yields

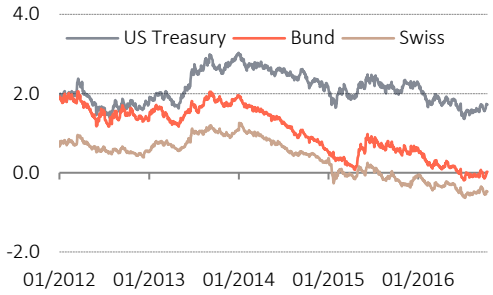


Fig 9: 10Y break-even inflation

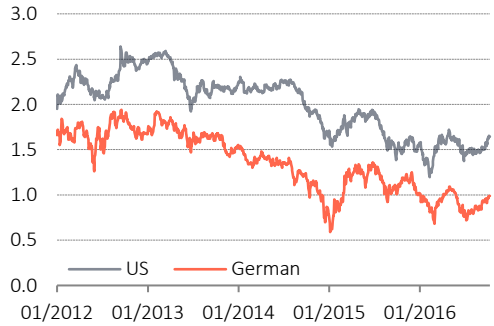


Fig. 10: Credit spreads, 5Y credit default swaps

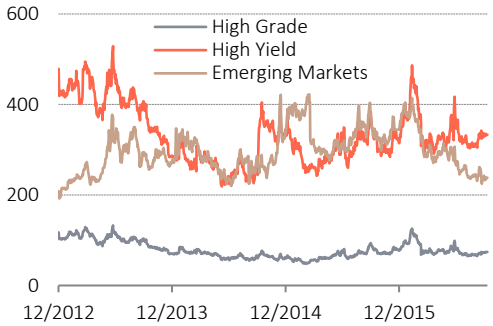


Fig 11: Money market spreads (3M-2Y)

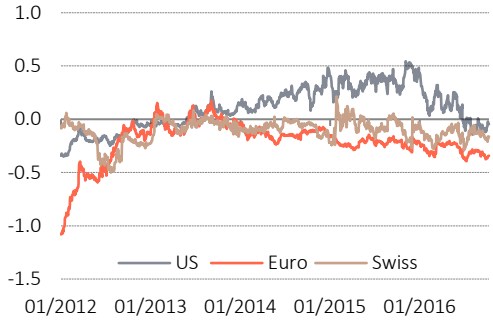
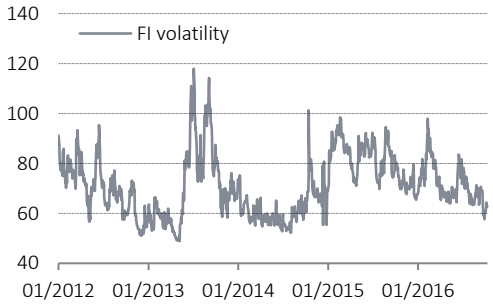


Fig 12: Merrill Lynch volatility index



EQUITIES

In September equity markets were mixed. The EuroStoxx50 index fell 0.7%, while the S&P500 index fell by 0.1%. The Japanese Nikkei 225 index continued to underperform and fell 2.4%. The MSCI Emerging Markets index rose 1.1% in September. The Brazilian Bovespa index continued to outperform and was up 0.8% in September, followed by a strong rally in early October. The fall of Deutsche Bank shares, on the back of concerns about the health of its balance sheet, had very little or no contagion effect on other European banks.

Fig. 13: MSCI equity indices – major regions

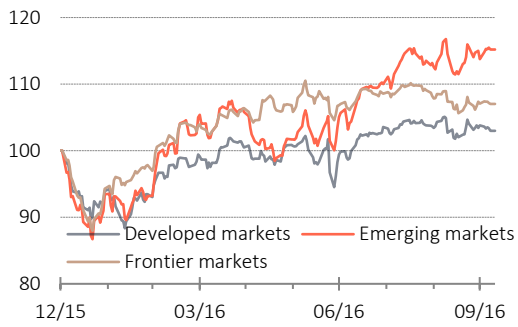


Fig.14: Equity indices – major developed markets

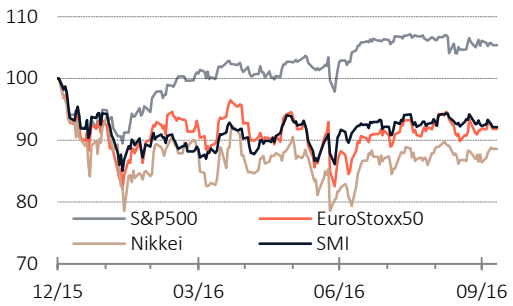


Fig 15: Equity indices – major emerging markets

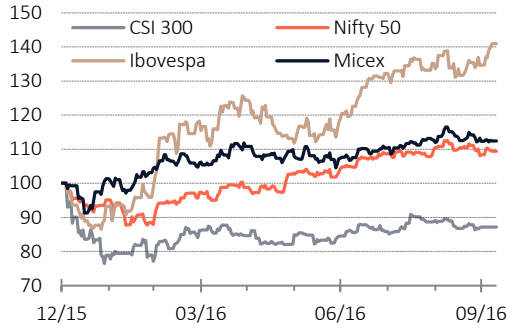


Fig. 16: Sector performance, MSCI Europe, 2016

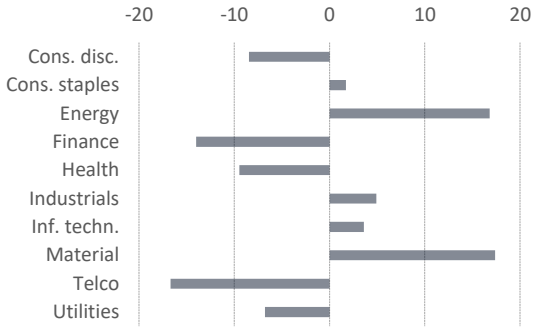


Fig 17: Price-earnings ratios

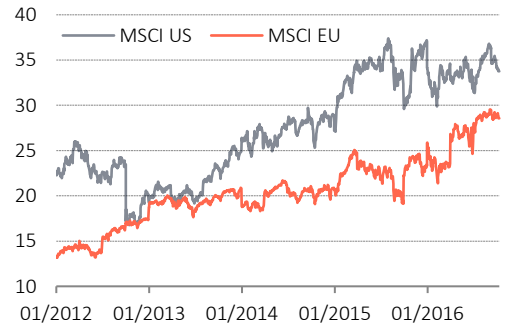
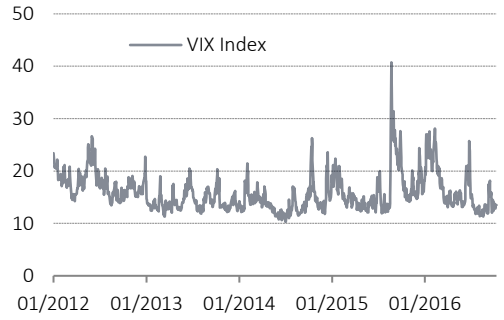


Fig 18: Equity volatility – S&P500 VIX index



ALTERNATIVE INVESTMENTS

The OPEC decision led to a rise in oil prices. Industrial metals also rebounded and rose by about 5% in September. The Gold price rose by about 0.5% in September, but sold off in early October. The Gold price fell by about 4.5% within a few days. Global REITS remained under selling pressure. Listed private equity remained a strong performer.

Fig. 19: Gold price, USD/oz

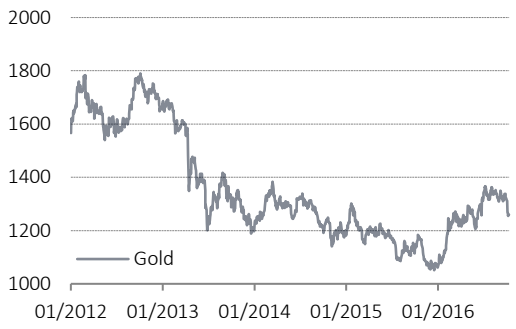


Fig.20: Oil price, USD/bl

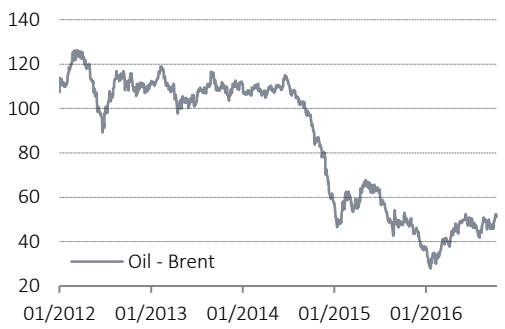


Fig 21: Bloomberg commodity indices

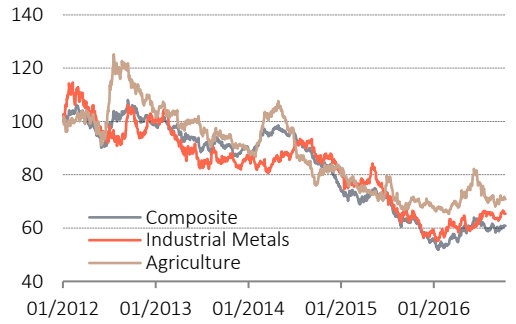


Fig. 22: HFRI hedge fund indices

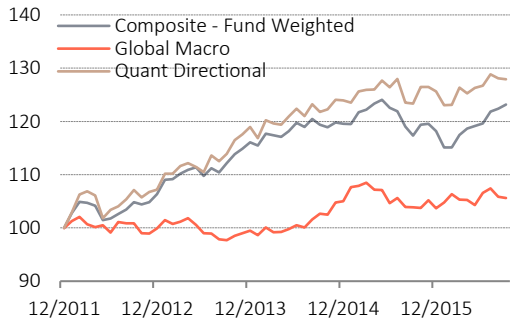


Fig 23: FTSE EPRA/NAREIT global index

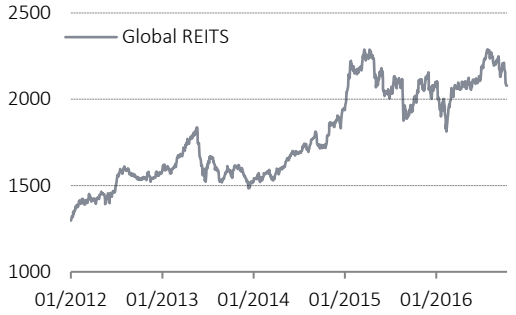
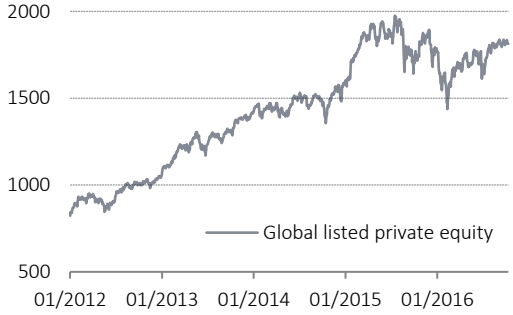


Fig 24: LPX global listed private equity



CURRENCIES

Attention has recently been focused on the GBP. The pound continued on its weakening path and lost 1.3% vis-à-vis the USD in September. In early October additional Brexit-related concerns led to a sell-off, with the GBP losing more than 4% against the USD and the EUR. After the BoJ decision in September the JPY strengthened but gave back most of its gains in early October.

Fig. 25: EUR-USD exchange rate

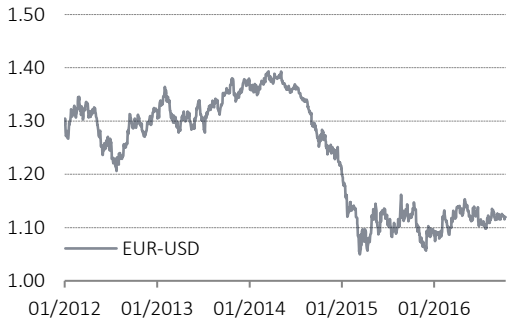


Fig. 26: GBP-USD exchange rate

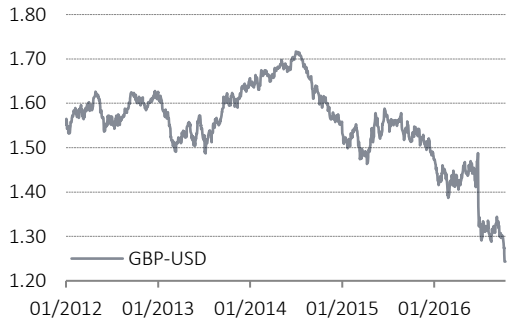


Fig 27: USD-JPY exchange rate

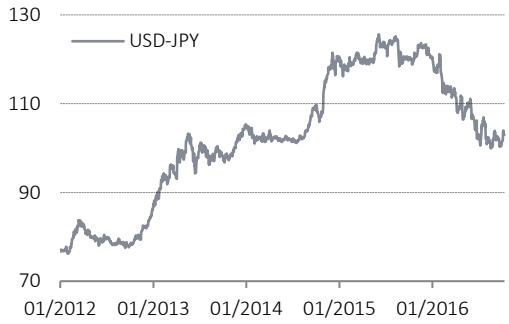


Fig. 28: USD-CNY exchange rate

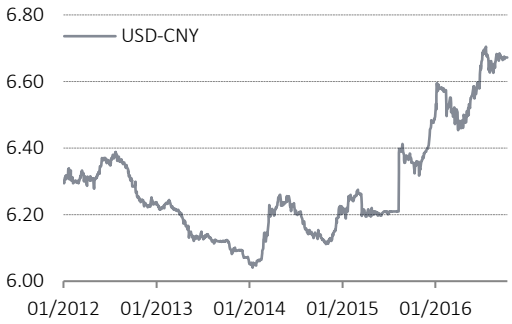


Fig 29: EUR-CHF exchange rate

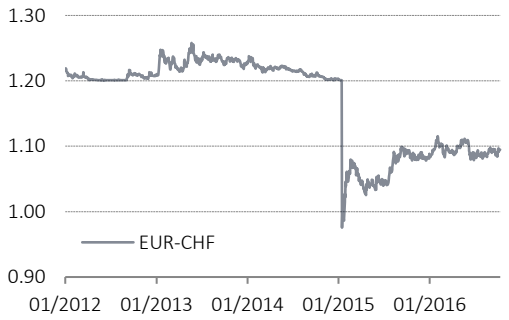
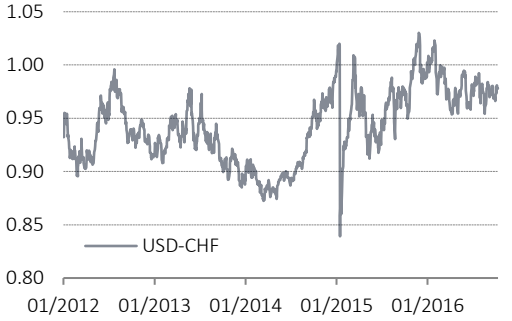


Fig 30: USD-CHF exchange rate

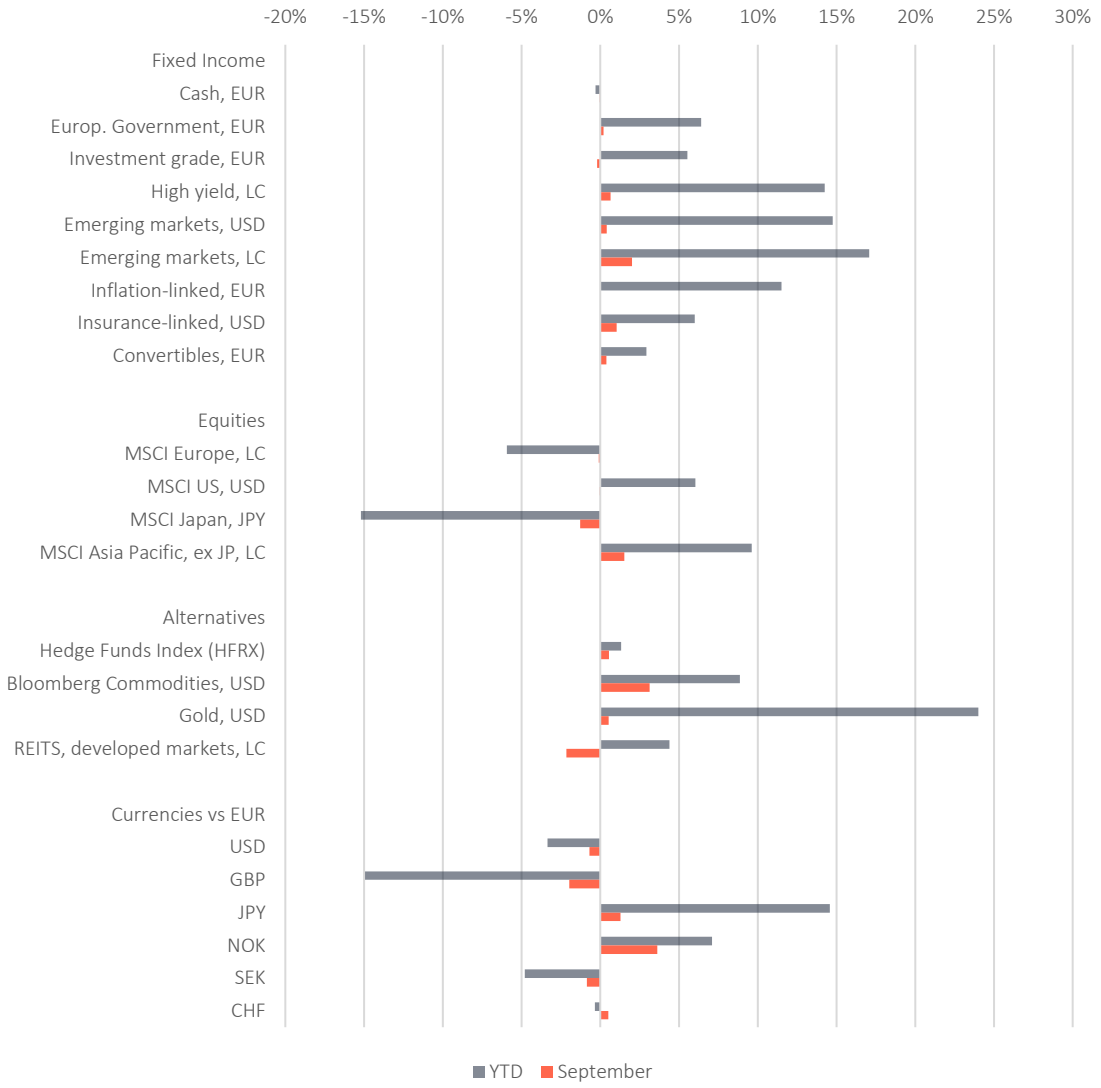


ASSET ALLOCATION

For a EUR investor the best-performing asset classes in September were emerging markets bonds and commodities. For the year-to-date performance, bond markets and especially the risky part, were the major performance drivers.

The European and the Japanese equity markets disappointed, while the US market surprised positively. In September REITS continued to give back part of their strong year-to-date performance.

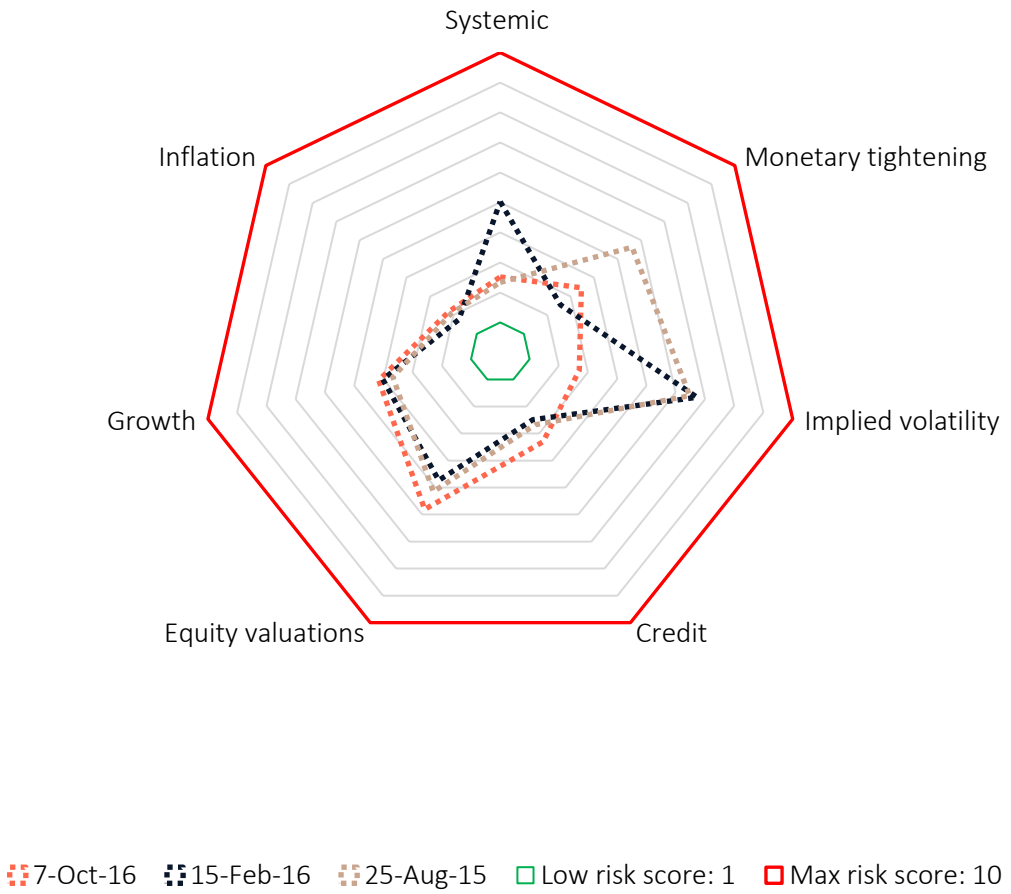
Fig. 31: Performance of major asset classes, based on our EUR portfolio strategy



RISK MONITOR

Our market risk indicators are currently mostly in low-risk territories. The biggest concern for us is the rising equity valuation risk. However, relative valuations, i.e. how equities are priced relative to bonds, do not look worryingly expensive. The IMT Risk Monitor also currently indicates a rising risk of monetary tightening. The concerns about Deutsche Bank did not drive up our systemic risk indicator, which means that Deutsche Bank remains an idiosyncratic risk.

Fig. 32: IMT Risk Monitor



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