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INVESTMENT OUTLOOK 07.2017

10 July 2017

On 27 June ECB President Mario Draghi said that "deflationary forces have been replaced by reflationary ones", which was interpreted as indicating that the ECB might soon slow down or even reverse its quantitative easing program. The market reaction was pronounced. Especially European bond and equity markets sold off, while the Euro rallied.

We see those concerns as exaggerated for the time being. While many central banks will start to lift their foot from the gas paddle somewhat, the ECB will do so at a measured pace and in combination with soft rhetoric. We think the ECB will follow a similar path to that already taken by the US Fed, which managed to tighten monetary policy with little harm to markets. As long as the global growth recovery remains steady, equity markets are likely to do well, while bond yields are likely to climb.

High inventories and stronger supply from emerging markets caused the oil price to tumble. We believe the oil price has potential to recover from the current very depressed levels.

Thomas Trauth
CEO – IMT Asset Management AG

ECB PRESIDENT DRAGHI AND HIS DIFFICULT EXIT STRATEGY

Financial markets

Equity markets moved sideways in June until on 27 June ECB president Mario Draghi caused a scare by emphasizing reflationary forces. The market reaction was significant since participants took Draghi's statement as a signal that the ECB is preparing an exit from its ultra-expansionary monetary policy. European equities fell by 3.4% (EuroStoxx50) between 26 June and 30 June. At the same time 10-year bond yields almost doubled and rose from 0.25% to 0.47% and the EUR appreciated 2.2% against the USD and many other currencies.

While global equity markets were also hurt, the damage done was far less. Both the US S&P500 as well as the MSCI Emerging Markets index lost 0.6% during the same period but remained positive for the month of June.

The impact of the ECB comments on bond markets has been more uniform internationally and more lasting compared to the effects on equity markets. Global yields rose from then and have not declined much since. The market seems to be in agreement on the subject of reflation. However, break-even inflation rates (compare Fig. 9 on page 5) rose recently, though significantly more gradually. This suggests that the market expects more growth – associated with rising real yields – and is not concerned about rising inflation per se.

The Brent oil price has fallen since February and reached its YTD low in mid-June at USD 42.5. While this looks puzzling on the back of stronger global growth, oil prices are currently clearly driven by the supply side developments. Recently, while OPEC has restricted output, we have seen some countries, like Libya and Nigeria, increasing production. Since demand also fell slightly short of expectations, oil prices fell. In the coming months, we expect the supply- demand balance to shift, which should lead to lower inventories and an oil price recovery. Since rising oil prices will trigger additional US shale production, the upside of oil prices will remain limited.

Higher real rates and the benign risk environment led to a selloff of gold. Gold prices dropped from nearly USD 1,300 per ounce on 6 June to US 1,215 beginning of July. For a EUR investor the sell-off was amplified by the strengthening EUR. The gold price in EUR fell from almost EUR 1,150 to EUR 1,050.

Macro economics

Most growth indicators improved in June. The US ISM index, which was a bit softer in April and May, rebounded in June, rising to a strong 57.8 reading after 54.9. The European manufacturing PMI rose to 57.4 in June after 57.0 in May.

US non-farm payrolls rose by a healthy 222,000 in June vs. 152,000 in May. US average hourly earnings rose 2.5% year-on-year and show a steady growth without rapid pickup.

Headline inflation declined somewhat in the US and in Europe. The base effects from energy are petering out, especially since energy prices have clearly fallen in the last couple of months. Chinese inflation picked up somewhat since base effects from high food prices last year are unwinding.

Central banks

On 27 June ECB President Mario Draghi made a remarkable comment in a speech, to the effect that "deflationary forces have been replaced by reflationary ones". In short, it seems that the ECB has declared victory over deflation, the evil it has been fighting with all means and justified unconventional policy measures, such as negative rates and buying government and corporate bonds to massively inflate money supply. If inflation were back, the ECB would need to first reverse the above-mentioned unconventional policy measures and instead focus on the fight against inflation. The initial market reaction was strong, but the ECB has calmed investors in the aftermath of the statement. While the ECB is very likely to take the first steps towards an exit from its ultra-accommodative policy, it will stay accommodative for the foreseeable future. Therefore, we regard the initial market reaction as exaggerated. Indeed, the markets calmed down shortly after 27 June. We expect the ECB to lower their monthly bond-buying program from currently EUR 60 bn to EUR 40 bn beginning of next year. The open question is whether the reduction will apply to government bonds or rather corporate bonds. If there should be a reduction of corporate bond buying, this may lead to a widening of European corporate spreads.

On 14 June the US Fed raised the Fed funds target by 25 basis points to 1.00-1.25%. This was expected and had very little market impact. The market-implied probability of a further Fed rate hike by December is currently at 50%. Furthermore, the Fed outlined a process to start shrinking its balance sheet. Currently the Fed reinvests principal payments from its bond holdings. At the beginning of next year, the Fed will start to gradually reduce the reinvestment of principal payments and will thereby start to shrink its balance sheet, which currently stands well above USD 2 tn.

Other central banks are contemplating hiking rates sometime soon. On the radar are the Bank of England and the Bank of Canada.

Meanwhile, and in contrast to the above-mentioned central banks, the Bank of Japan confirmed its commitment to yield-curve control in June, i.e. its policy target of holding 10-year government bond yields at close to zero. Furthermore, the BoJ has accelerated its buying of equity ETFs, a program which has been running since 2011. The BoJ holdings of ETF have grown by more than USD 30 bn this year. These measures make Japanese equity attractive and are likely to further weaken the JPY.

Outlook

We see a continued goldilocks environment with better growth and earnings, still accommodative central banks, which will carefully and gently reduce pressure on the gas pedal, and continuing low inflation. Risky assets should do well in such an environment and bond yields will gradually rise.

We took advantage of the recent sell-off of European equities and increased our exposure. We stay overweight in Japanese equities. We also reduced our exposure to UK equities and the GBP.

ECONOMICS

Most growth indicators improved further in June, while inflation data retreated on the back of lower energy prices. US non-farm payrolls remained strong rising by 222,000 in June vs. 152,000 in May. The unemployment rate fell to 4.5%. US average hourly earnings rose by 2.5% year-on-year and remain at a moderate non-accelerating level.

Fig. 1: PMIs

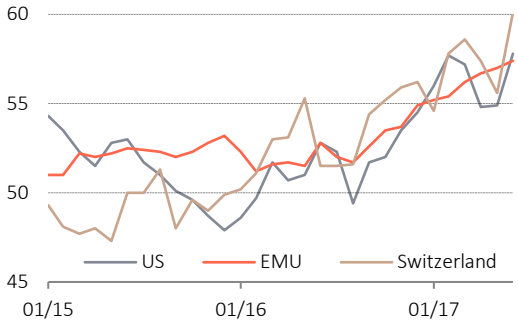


Fig. 2: PMIs

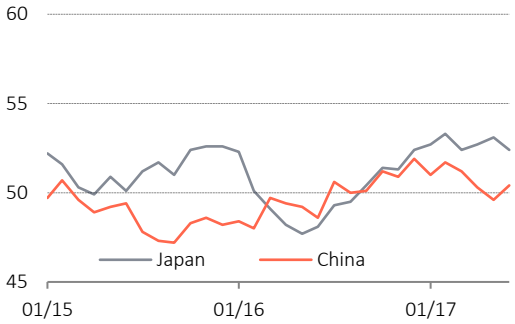


Fig 3: Consumer price inflation, in % YoY

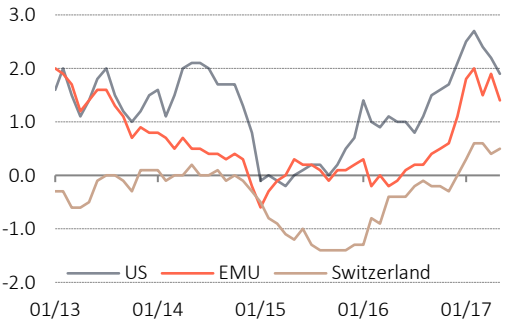


Fig. 4: Consumer price inflation, in % YoY

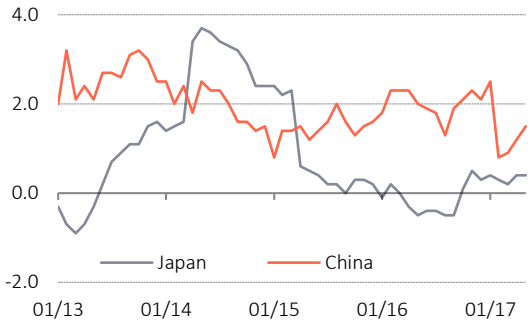


Fig 5: Unemployment rates, in %

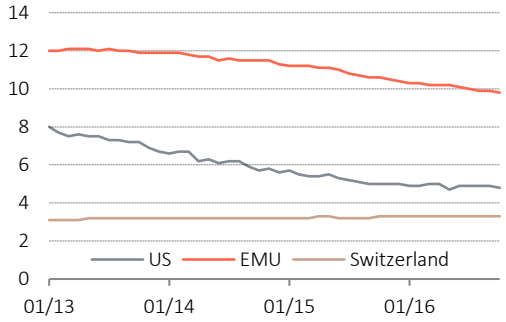
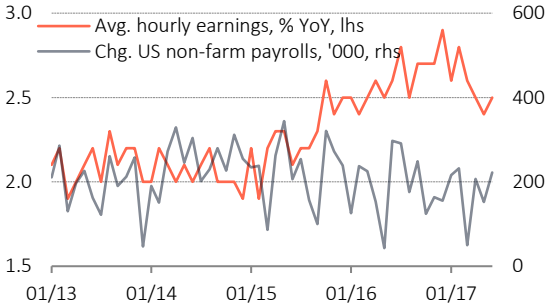


Fig 6: US labor market



FIXED INCOME

Draghi's comments had a pronounced impact on the yield curve. 10-year Bund yields rose from 0.25% before the Draghi speech to about 0.55%, while the 2-year yields have remained almost unchanged since then. 10-year US yields also rose during the same time period from 2.14% to 2.38%. European break-even inflation rose by about 10 basis points, while US break-even rates remained unchanged. Credit spreads widened somewhat.

Fig.7: 2Y government bond yields

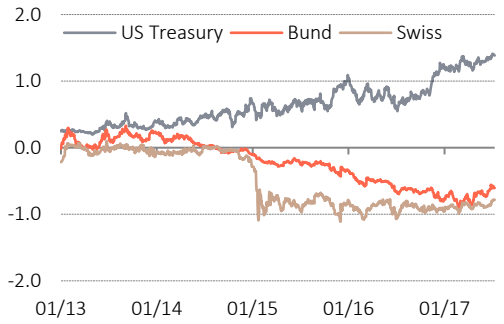


Fig. 8: 10Y government bond yields

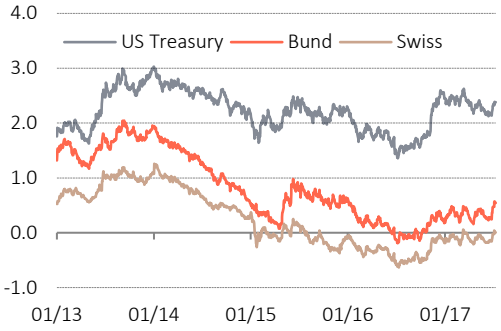


Fig 9: 10Y break-even inflation

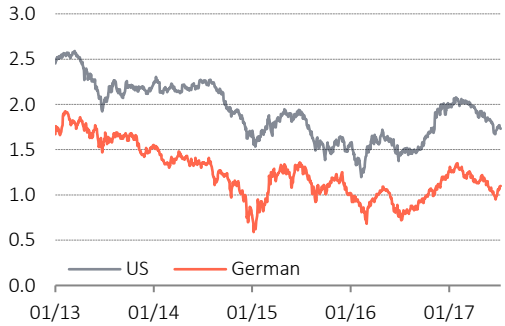


Fig. 10: Credit spreads, 5Y credit default swaps

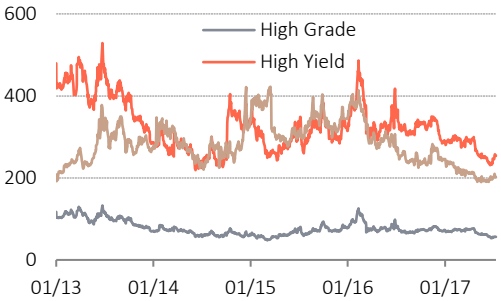


Fig 11: Money market spreads (3M-2Y)

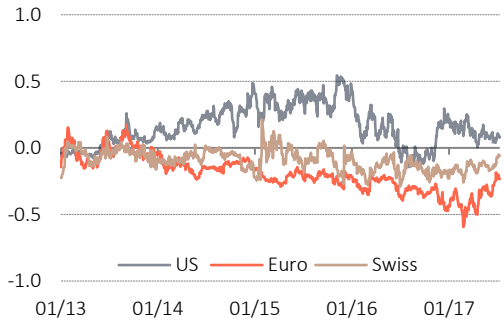
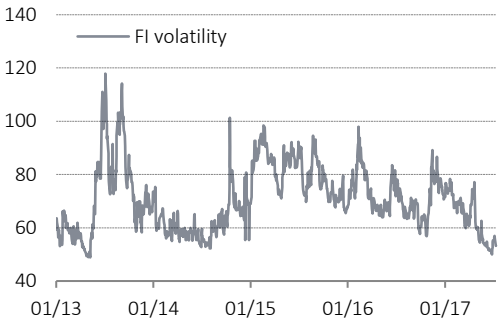


Fig 12: Merrill Lynch volatility index



EQUITIES

In June emerging market equities continued to outperform developed markets, rising 0.5% vs 0.2%. Draghi's comments led to a clear underperformance of European equities (-2.7%) vis-à-vis the US (+0.5%) and Japan (1.9%). Falling energy prices kept the energy sector under pressure, while technology, industrials and financials performed well.

Fig. 13: MSCI equity indices – major regions

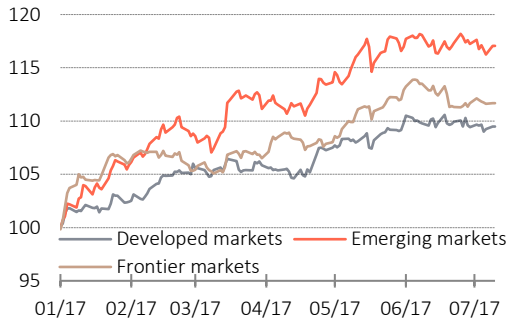


Fig.14: Equity indices – major developed markets

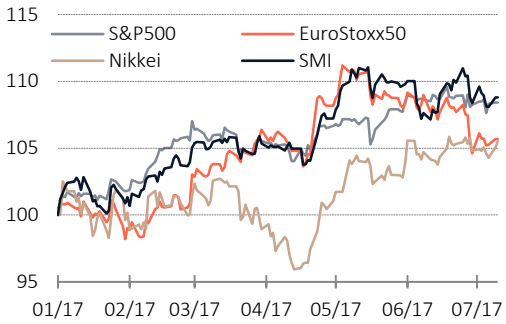


Fig 15: Equity indices – major emerging markets

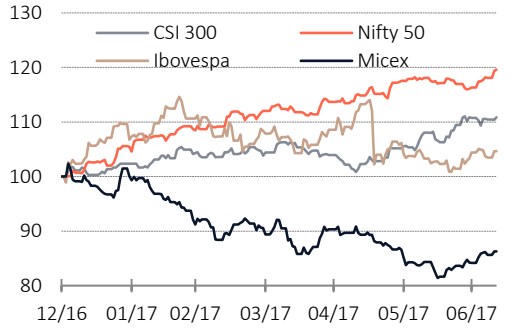


Fig. 16: Sector performance, MSCI Europe, 2017

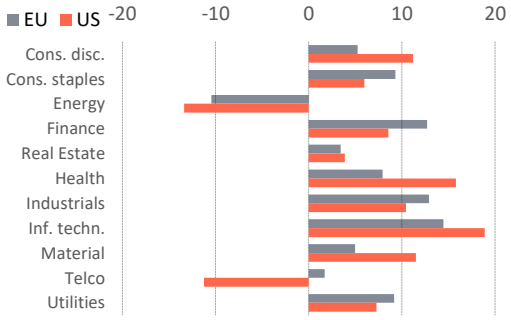


Fig 17: Price-earnings ratios

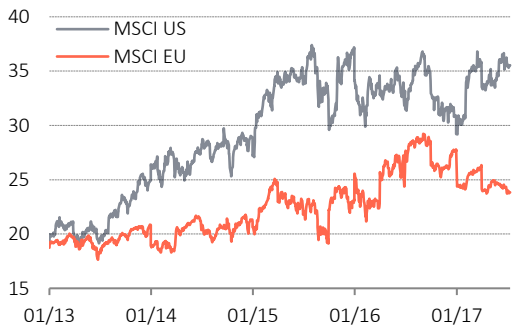
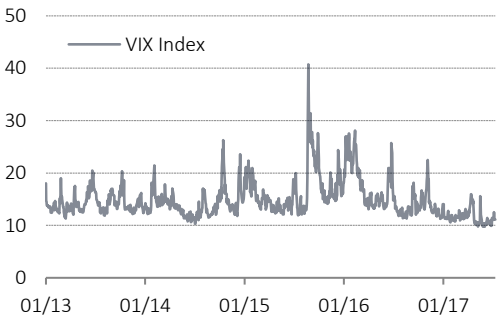


Fig 18: Equity volatility – S&P500 VIX index



ALTERNATIVE INVESTMENTS

The Brent oil price fell by 5.2% in June. Industrial metals performed well and rose by 3.4%. Rising real rates and rising risk appetite sent the gold price down: it fell from almost USD 1,300 per ounce in early June to as low as USD 1,210 a month later. The global REITS index lost 1% in June. Listed private equity also lost about 1% in June.

Fig. 19: Gold price, USD/oz

Fig.20: Oil price, USD/bl

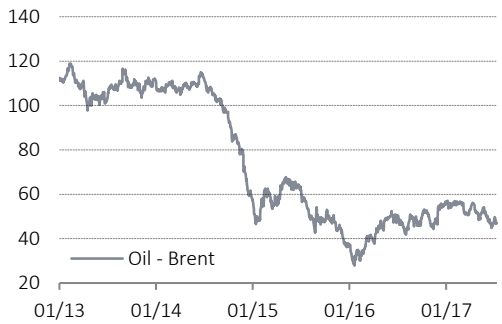


Fig 21: Bloomberg commodity indices

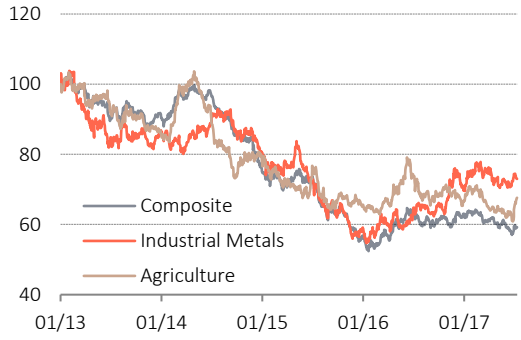


Fig. 22: HFRI hedge fund indices

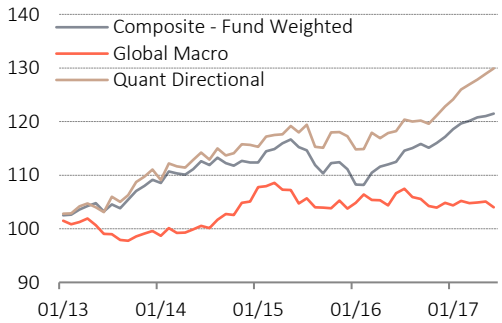


Fig 23: FTSE EPRA/NAREIT global index

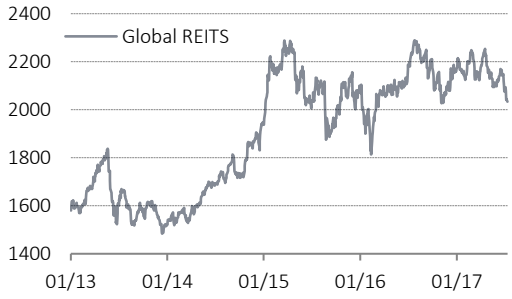
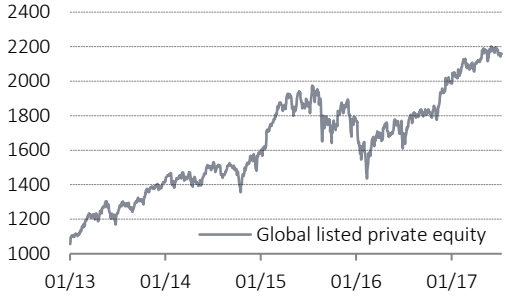


Fig 24: LPX global listed private equity



CURRENCIES

The EUR was the major beneficiary of Draghi's comments. The EUR-USD exchange rate rose immediately after Draghi's speech from about 1.12 to 1.145. The EUR strengthened against most currencies and climbed above 1.10 vis-à-vis the CHF, for example. The GBP remained on the weak side and the JPY weakened clearly.

Fig. 25: EUR-USD exchange rate

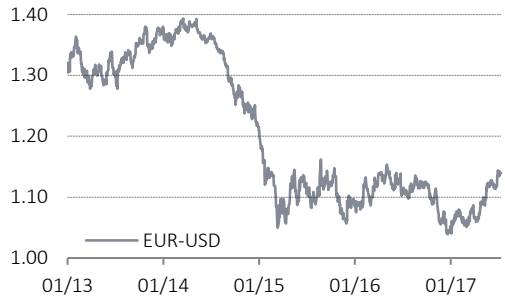


Fig. 26: GBP-USD exchange rate

Fig 27: USD-JPY exchange rate

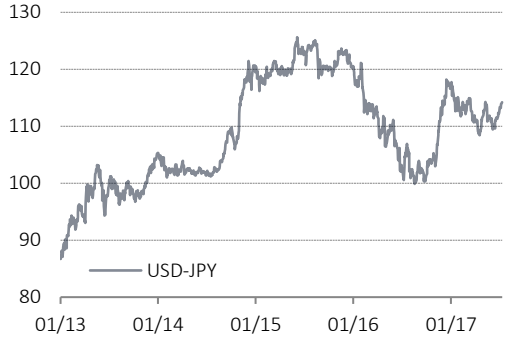


Fig. 28: USD-CNY exchange rate

Fig 29: EUR-CHF exchange rate

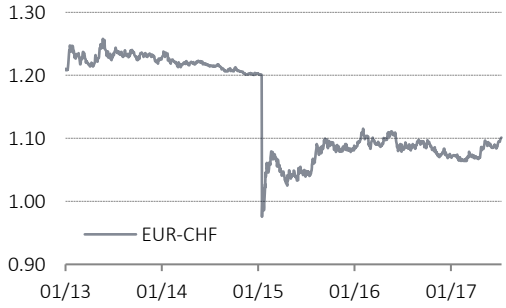
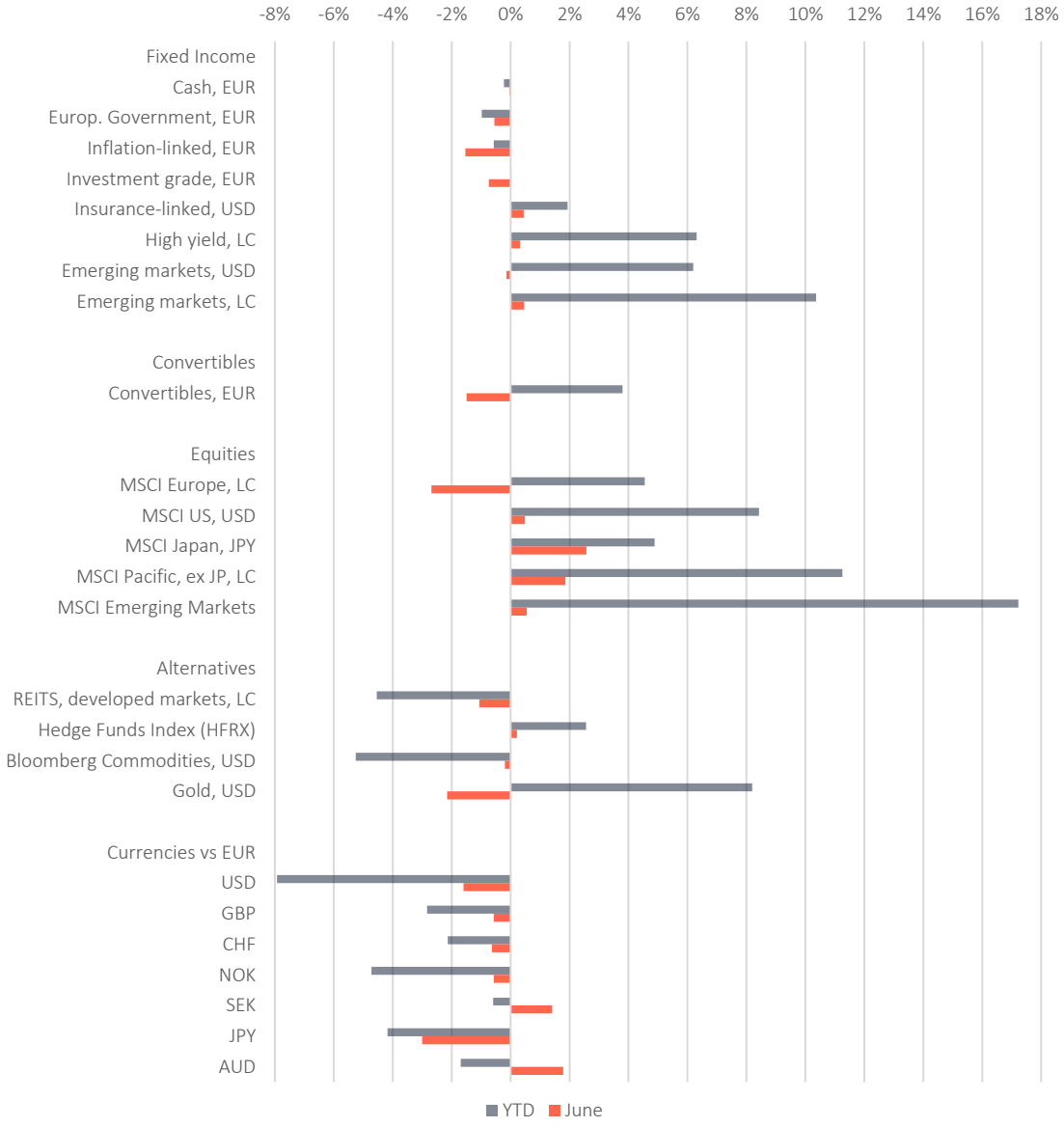


Fig 30: USD-CHF exchange rate

ASSET ALLOCATION

During the first half-year, investors were rewarded for taking risks. Equity outperformed bonds and emerging markets outperformed developed markets. Government bonds, REITS and commodities performed negatively. All major foreign currencies weakened vis-à-vis the EUR.

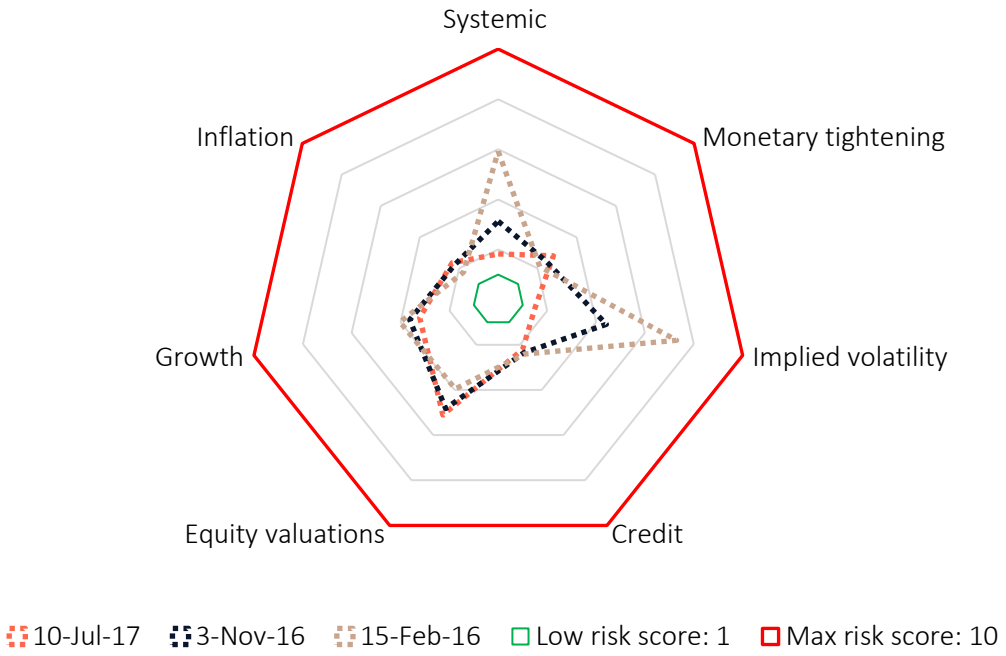
Fig. 31: Performance of major asset classes, based on our EUR portfolio strategy



RISK MONITOR

The risk monitor continues to show a benign risk environment. Implied volatilities fell further to historically low levels. Equity valuations and monetary tightening risks have risen somewhat recently.

Fig. 32: IMT Risk Monitor



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