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IMT GROUP

INVESTMENT OUTLOOK 10.2017

6 October 2017

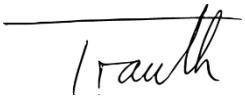
Despite devastating storms and earthquakes as well as major geopolitical tensions, especially relating to North Korea, financial markets remained calm; in fact risky assets delivered strong performances in September.

The US administration unveiled its long-awaited tax reform plan, which would include a significant drop in corporate tax rates and a more moderate decrease in personal tax rates.

The FOMC announced that the balance sheet unwind would start in October and it published its so-called "dot plot" projection, which revealed that the median FOMC member expects another rate hike in 2017 and three more hikes in 2018. Market expectations had been much lower.

Both pieces of news led to rising rates, a steepening US yield curve, and a stronger USD. Equities, especially in Europe and Japan, performed very well.

The hurricane season led to a significant sell-off of insurance-linked bonds, which we used to add to our insurance-linked bond allocation. In addition, we increased our Japan overweight somewhat.



Thomas Trauth
CEO – IMT Asset Management AG

IS INFLATION BACK?

Financial markets

Developed equity markets rebounded in September as geopolitical worries started to abate. The Trump administration revealed its long-awaited tax reform plan, which includes significant tax cuts for corporates and more moderate personal tax cuts. This has led to a rally of tax-sensitive US stocks and could be a positive growth driver for the US and the global economy.

A more hawkish Fed pushed rate-hike expectations, global rates, and the USD up. The USD strengthened clearly against most major currencies. This helped European equities to outperform in September. The EuroStoxx50 rose by 5.1% in September, followed by the Japanese Nikkei225, which rose 3.6%, and the US S&P500, which was up by 1.9%. Meanwhile, the stronger USD was less welcome among investors in emerging markets equities, which had a difficult month with the MSCI Emerging Markets index and fell 0.5%.

US government bonds sold off. 2-year yields rose 16 basis points and 10-year yields 22 basis points. US break-even inflation – the difference between nominal and real 10-year rates – rose 8 basis points to 1.85%. The steepening of the yield curve and rising break-even rates clearly indicate that the market expects inflation to pick up, albeit rather moderately. European bonds also sold off, but to a much lesser extent.

High-yield bonds outperformed other fixed-income markets in September. The high-yield index was up by 0.85%. Emerging market bonds suffered from a correction after very strong gains in previous months and fell by 0.3%.

The hurricane season caused significant damage on the east coast of the US. A large portion of insurance-linked, i.e., catastrophe bonds, are exposed to insurance losses in relation to US wind. The market for insurance-linked bonds therefore sold-off significantly. The Swiss Re cat bond index lost 6.5% in September. It is very likely that some cat bonds will be affected and investors will have to forego coupon payments. We assume that the mark-to-market losses exceed the expected event-related losses and we are taking the opportunity to increase our cat bonds allocation.

Gold continued to sell off on the back of the benign risk environment. The Gold price fell from USD 1,350 beginning of September to USD 1,280 end of September. Industrial metals retreated in September and fell 3.8%. The price for Brent oil rose by 7.7% and passed the USD 50 mark.

Macro economics

The general macro situation we have depicted remains valid. Growth indicators clearly indicate that the economy is moving on a very robust globally synchronized growth path.

Most manufacturing PMIs we observe in this publication increased, with the notable exception of the Chinese PMI, which fell slightly but remained above the crucial 50 mark, indicating that the Chinese economy is still growing.

US non-farm payrolls fell into negative territory. The US labor market slashed 33,000 jobs in September.

This can, however, be explained by weather-related disruptions and does not change the robust labor-market picture overall. The unemployment rate, for example, fell to 4.2% from 4.4%.

Average hourly earnings rose 2.9% year-on-year, the strongest increase since 2009. We monitor this indicator closely as a measure of potential wage pressure, which would translate into higher consumer price inflation. The September figure is, however, distorted to the upside due to bad weather conditions. Utility workers' overtime pay was boosted while lower paid workers, for example in leisure and hospitality, have been more vulnerable to weather-related disruptions. It is still reasonable to assume that wage pressure will start to accelerate, since earnings growth figures were revised upwards in the previous two months.

Inflation in most major economies remains moderate. But we see early signs of US inflation picking up. Firstly, the economy has approached full capacity, and wage pressure – as mentioned above – has started to increase. Secondly, if the US tax-reform package were to be implemented, the US economy would receive an additional fiscal stimulus when it is already running close to full capacity.

Central banks

The ECB left rates unchanged at its 7 September meeting. It further confirmed that it will keep its monthly asset purchases unchanged at EUR 60 bn, at least until the end of December 2017 and longer if warranted.

The FOMC had its meeting on 19-20 September. It announced a reduction in the size of its balance sheet, which currently stands at USD 4.5 tn, starting in October. It will reduce its bond holdings by USD 10 bn each month through December. This will comprise USD 6 bn of treasuries and USD 4 bn of mortgage-backed securities. These amounts will rise every three months until they reach USD 30 bn and USD 20 bn respectively.

While the Fed kept rates unchanged, chairwoman Janet Yellen said that "…we continue to expect that the ongoing strength of the economy will warrant gradual increases in that rate to sustain a healthy labor market and stabilize inflation around our 2 percent longer-run objective …".

The Fed published its so-called dot plot projection, in which Fed members indicate their expectation of how Fed fund rates are likely to develop over the next couple of years. This projection revealed that the median Fed member expects another rate hike this year and three more rate hikes in 2018. Last month market expectations were for only a 30% chance of another rate hike in 2017. After the meeting the market-implied expectations for a December hike rose as high as 80%. Interestingly, the market is currently hardly pricing for another rate hike in 2018.

China's National Party Congress

China's 19th National Party Congress, which takes place every five years, will be held 18-25 October. The major purpose is to rotate the leadership. President Xi Jinping will receive a second term but is likely to reshuffle his leadership team. Very often, after the party congress, the new leadership will focus on structural reforms, which can potentially have far-reaching consequences for the domestic economy but also internationally. Comments by key policy makers close to president Xi suggest that major areas of concern are shadow banking, property bubbles, high leverage in state-owned enterprises (SOEs), and elevated local-government debt.

This suggests that the new leadership may focus on de-leveraging the economy. Most likely, this is associated with cutting back on aggressive infrastructure investments, a shift towards more domestic consumption and internal growth instead of export-led growth. In addition, private entrepreneurship may be encouraged more and state-owned enterprises may be rather cut back.

These reform plans are likely to reduce credit growth and slow the economy, before leading to a more sustainable growth path. In addition, Chinese demand for commodities, especially industrial metals, is likely to fall. This may also reduce growth in other emerging economies.

Outlook

We try to take advantage of mark-to-market losses in the insurance-linked securities sector and tactically increase our allocation to this asset class.

Finally, and as we expected, the USD rebounded, when the market readjusted its Fed rate-hike expectations. The GBP, which recovered strongly in September, weakened again in early October after May's speech regarding her Brexit strategy and doubts about the stability of the UK government. We remain USD overweight and GBP underweight.

We also remain slightly overweight in equities in general, and Europe as well as Japan in particular. We increased our Japan overweight and are now underweight in developed equity markets in the Asia Pacific region.

What are the major risks we see? Firstly, the US Fed could fall behind the curve. This could especially be the case if president Trump were to elect very dovish and possibly inexperienced central bankers, who would remain accommodative for too long. A too loose monetary policy in combination with a tax-cut-induced fiscal stimulus could lead to an overheating economy with accelerating inflation. History shows that when central banks react too late, interest rates need to rise above the equilibrium level, which usually triggers a recession.

Secondly, as mentioned above, after the Chinese National Congress there is the possibility of structural reforms in China, including measures to deleverage the economy. While this would move China to a more sustainable growth path in the long run, it could slow Chinese growth in the short-term, with negative spillover effects especially to emerging markets.

ECONOMICS

Most September manufacturing PMIs improved, except for the Chinese PMI, which retreated slightly. Due to hurricanes Harvey and Irma, US non-farm payrolls fell into negative territory. In September the number of workers declined by 33,000, the first decline since 2010. Average hourly earnings rose 2.9% yoy. Since the data are heavily distorted due to the impact of bad weather conditions, we would not overemphasize these latest numbers.

Fig. 1: PMIs

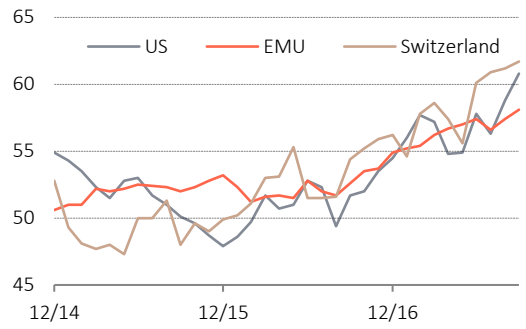


Fig. 2: PMIs

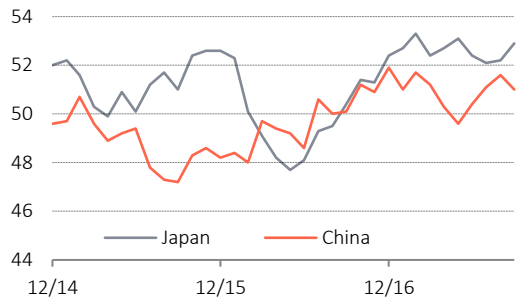


Fig 3: Consumer price inflation, in % YoY

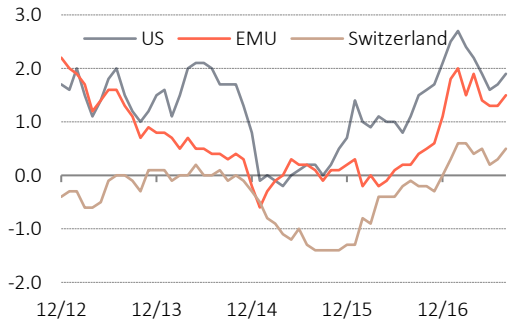


Fig. 4: Consumer price inflation, in % YoY

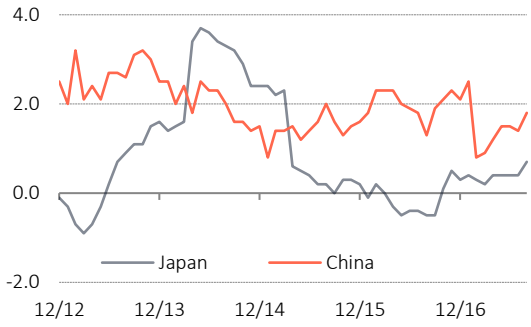


Fig 5: Unemployment rates, in %

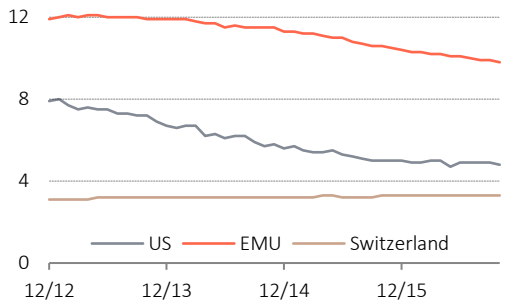
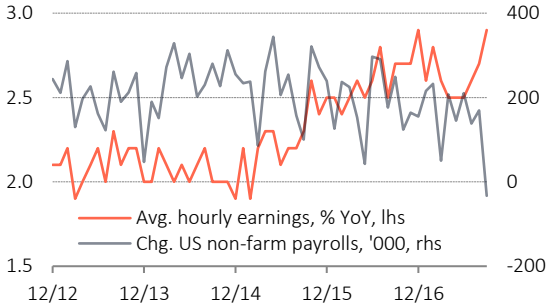


Fig 6: US labor market



FIXED INCOME

Tax cuts and a less accommodative Fed pushed US yields up and led to a steepening of the curve. European yields also rose, though by much less. Inflation expectations continued to rise. Credit spreads remained relatively stable. And fixed-income-implied volatility rose only slightly.

Fig.7: 2Y government bond yields

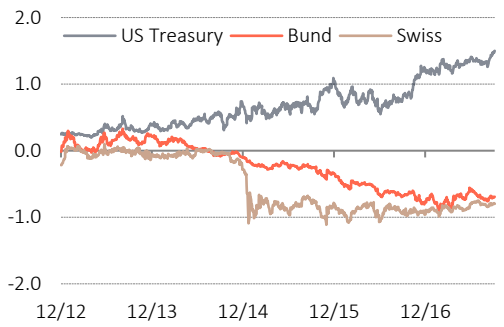


Fig. 8: 10Y government bond yields

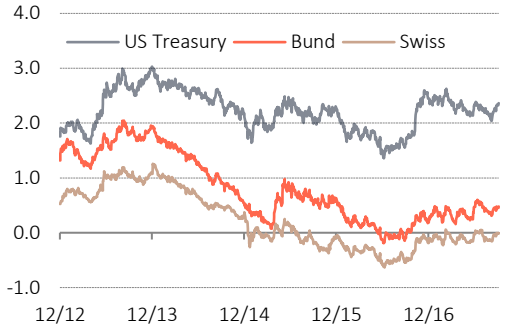


Fig 9: 10Y break-even inflation

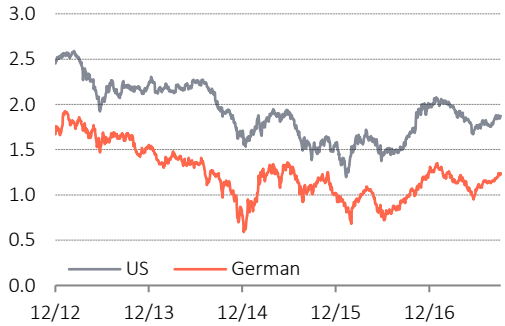


Fig. 10: Credit spreads, 5Y credit default swaps

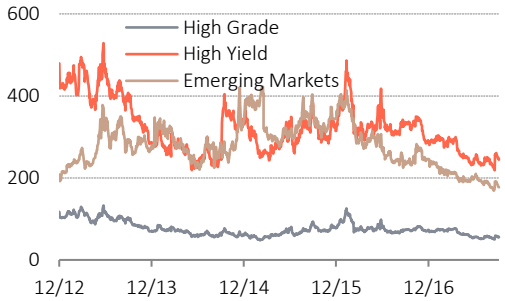


Fig 11: Money market spreads (3M-2Y)

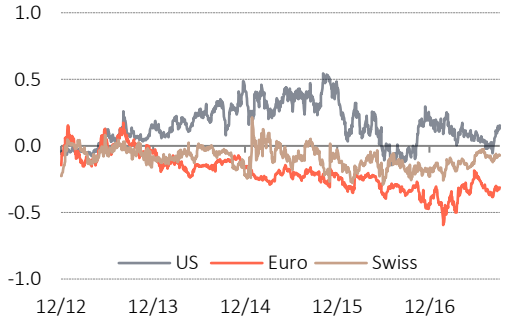
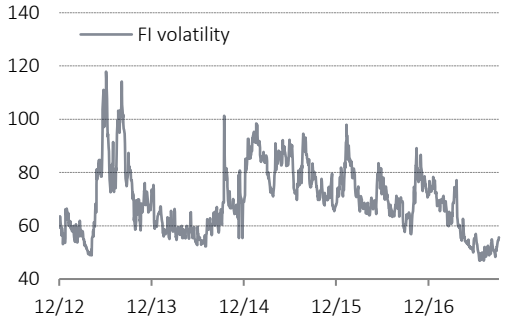


Fig 12: Merrill Lynch volatility index



EQUITIES

Emerging markets were down 0.5% in September, while developed markets performed well. The US S&P500 index performed 1.9%, the European EuroStoxx50 5.1%, and the Japanese Nikkei225 3.6%. Since the beginning of the year, technology, industrials and financial stocks have outperformed. The US tax reform plans have recently boosted those stocks, which would benefit the most from corporate tax cuts.

Fig. 13: MSCI equity indices – major regions

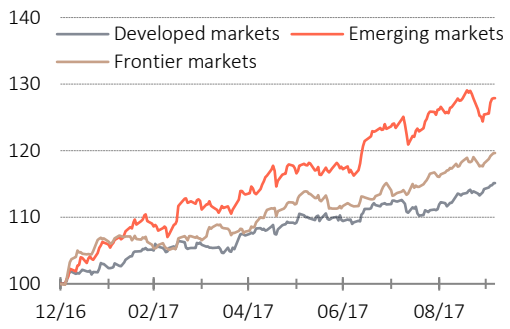


Fig.14: Equity indices – major developed markets

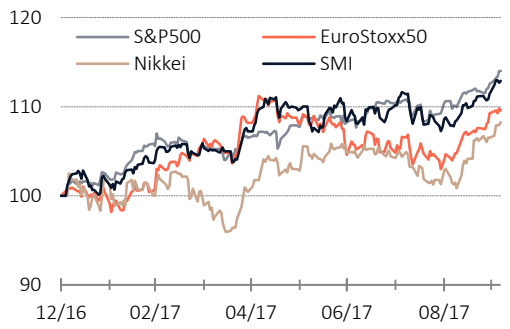


Fig 15: Equity indices – major emerging markets

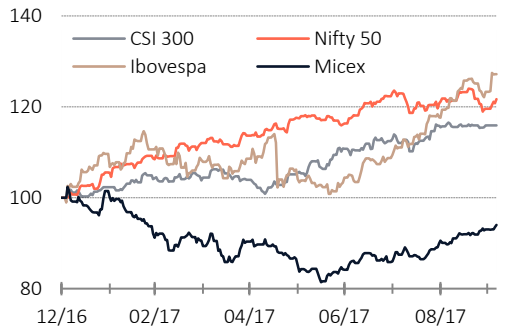


Fig. 16: Sector performance, MSCI Europe, 2017

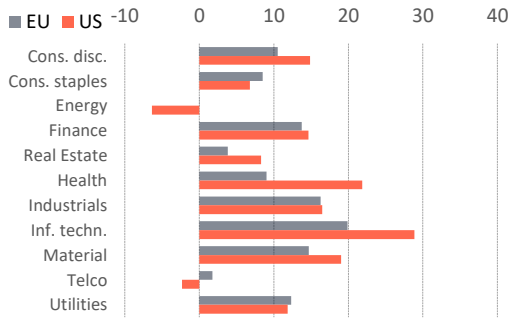


Fig 17: Price-earnings ratios

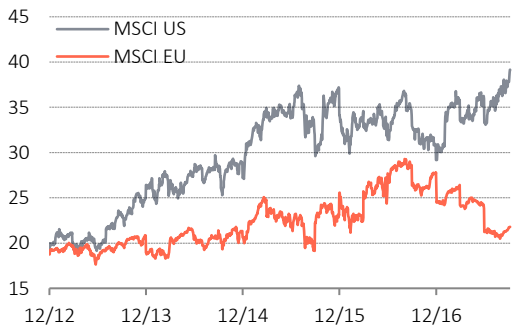
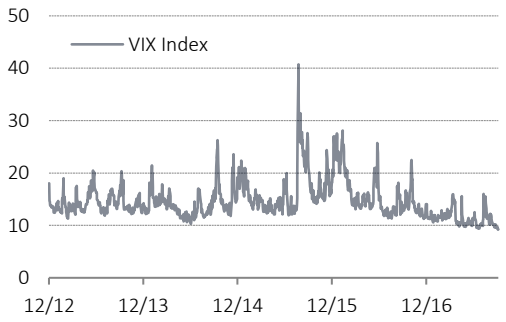


Fig 18: Equity volatility – S&P500 VIX index



ALTERNATIVE INVESTMENTS

Stronger growth and the hurricane season recently supported oil prices. Investors lost interest in gold, as safe-haven assets in general were in low demand. Industrial metals enjoyed a strong rally in recent months. We observed a temporary correction. REITS stabilized somewhat and listed private equity rallied strongly.

Fig. 19: Gold price, USD/oz

Fig.20: Oil price, USD/bl

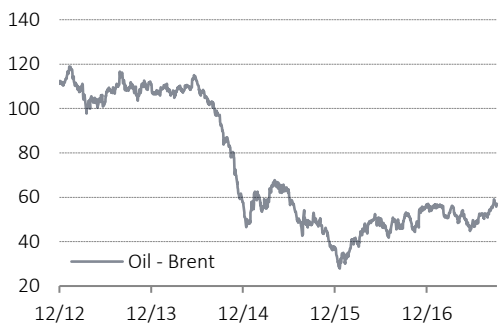


Fig 21: Bloomberg commodity indices

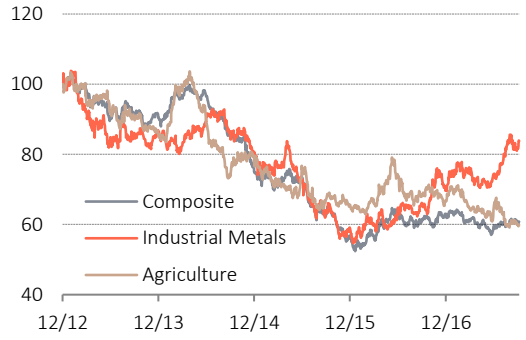


Fig. 22: HFRI hedge fund indices

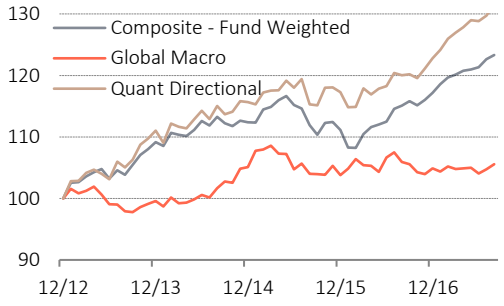


Fig 23: FTSE EPRA/NAREIT global index

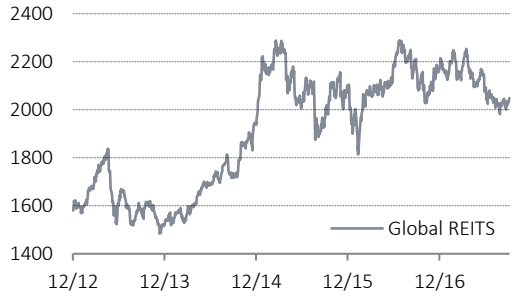
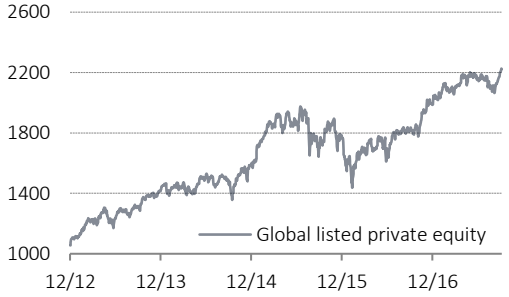


Fig 24: LPX global listed private equity



CURRENCIES

In September the EUR rally came to a halt. A more hawkish Fed together with expected reflation led to a USD rebound. The GBP strengthened on the back of an expected rate hike in the UK, but recent uncertainties regarding Theresa May's Brexit strategy sent the GBP tumbling. The EUR-CHF exchange rate stabilized around 1.15 The JPY and the Chinese CNY weakened vis-à-vis the USD.

Fig. 25: EUR-USD exchange rate

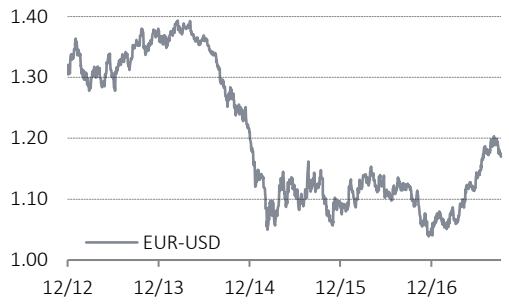


Fig. 26: GBP-USD exchange rate

Fig 27: USD-JPY exchange rate

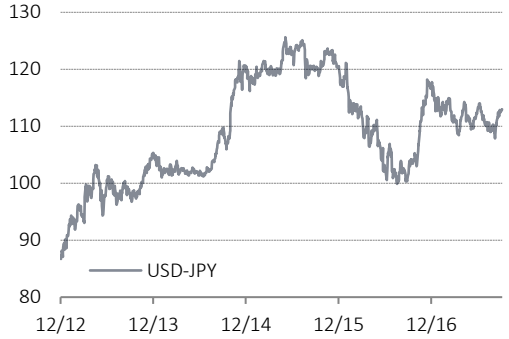


Fig. 28: USD-CNY exchange rate

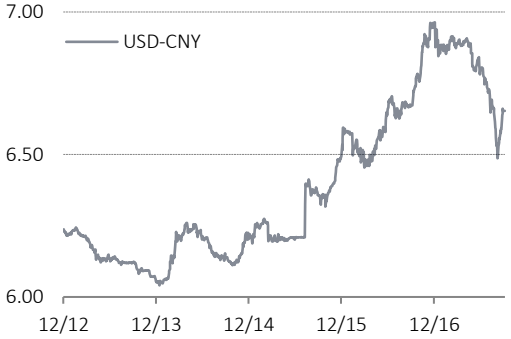


Fig 29: EUR-CHF exchange rate

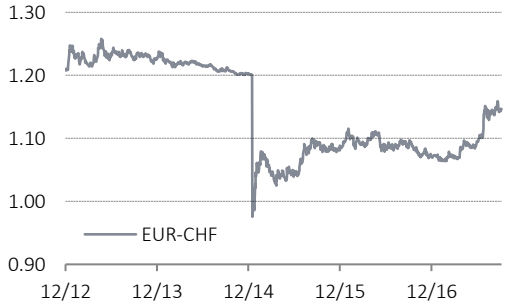
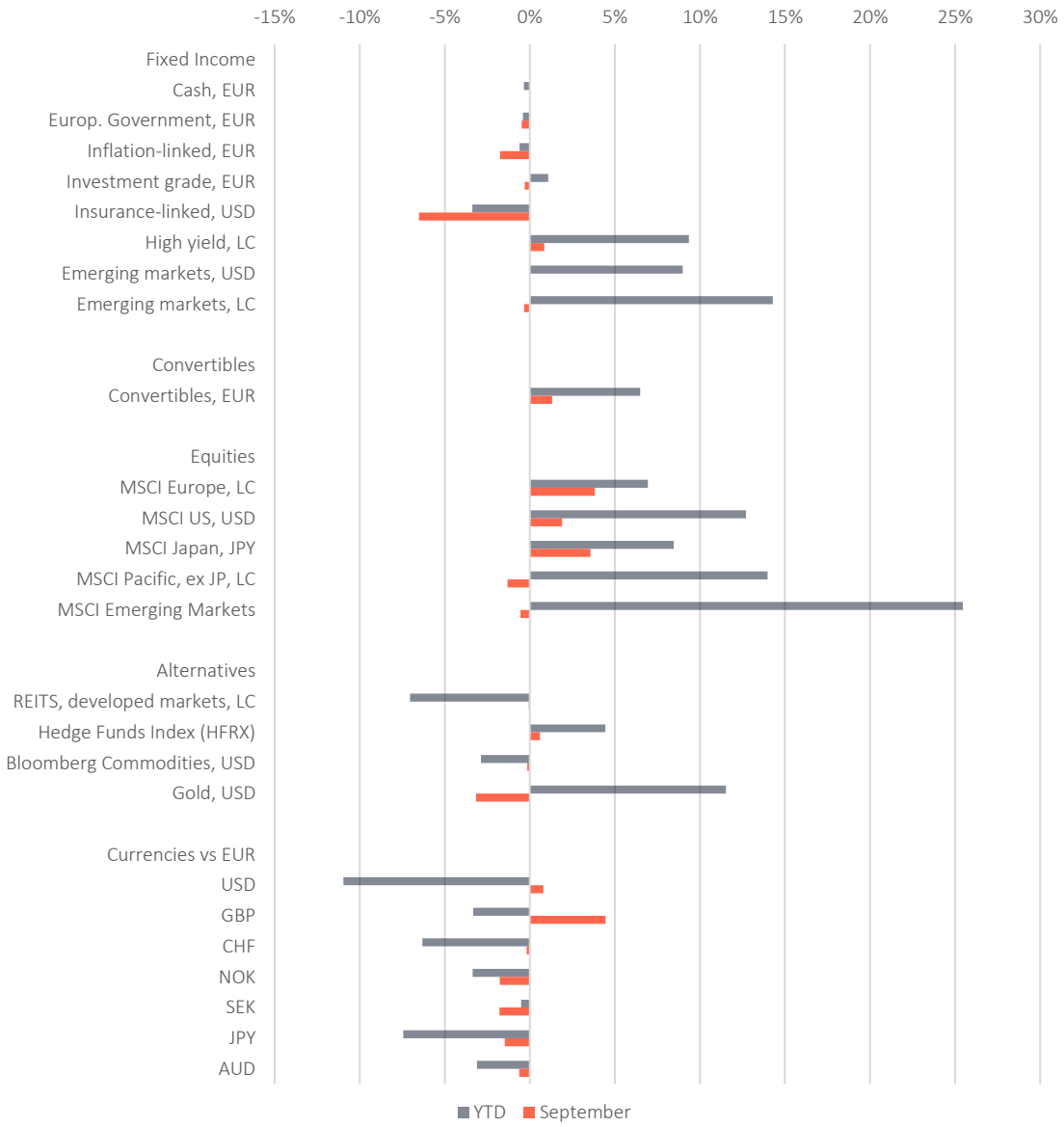


Fig 30: USD-CHF exchange rate

ASSET ALLOCATION

September was a positive month for multi-asset class investors. European and Japanese equities outperformed. Equities in the Pacific region and emerging markets were very slightly down. Insurance-linked bonds suffered from expected losses after severe hurricanes hit the US mainland. Government bonds and inflation-linkers were somewhat negative. The USD and the GBP rebounded and gained vis-à-vis the EUR.

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

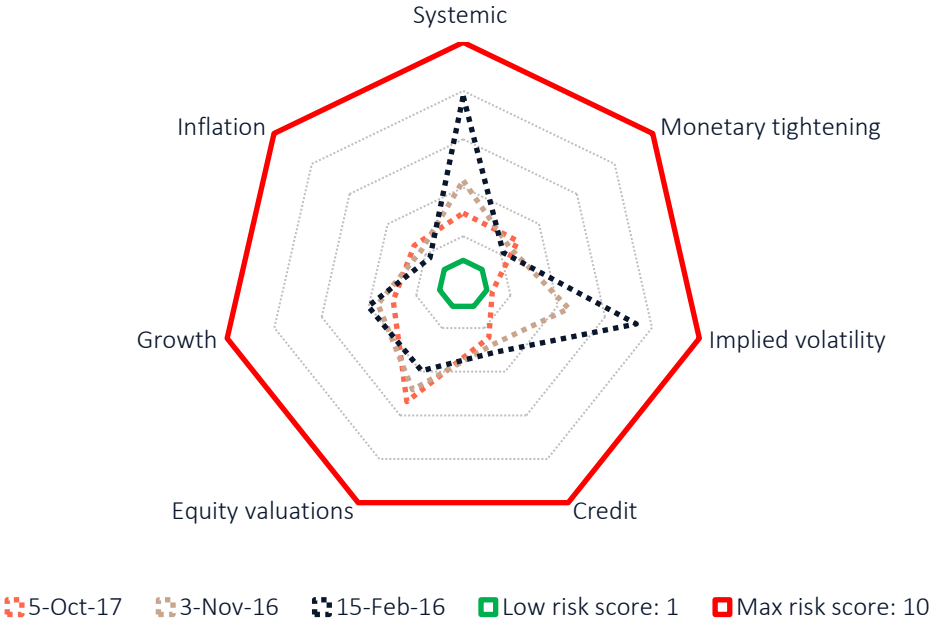


RISK MONITOR

The IMT risk monitor continues to show a very benign risk environment. Our indicators show moderate increases of inflation and equity-valuation risks. Despite this, monetary tightening risks stay very low. Implied volatilities across asset classes remain at historic lows, indicating little appetite for investors to hedge their exposures.

Fig. 32: IMT Risk Monitor

15 Feb 2016: China growth fears, 3 Nov 2016: Pre- US election



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