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INVESTMENT OUTLOOK 05.2018

18 May 2018

In April, despite elevated geopolitical risks, most notably the looming US decision to exit the Iran deal and the US-China trade war fears, equity markets stabilized in the US and emerging markets, and rebounded strongly in Europe and Japan.

While leading indicators are rolling over and US GDP growth slowed to 2.3% in Q1 after 2.9% in Q4, fundamentals still look very healthy. US inflation picked up markedly, which led to higher inflation expectations and a rise in US 10-year yields to about 3%.

For the time being we remain cautious, especially in view of concerns about disruptions to world trade. These concerns are focused mainly on US-China but, following the US decision to exit the Iran nuclear deal, they are also fueled by the possibility of disruption between the US and Europe.

As a result, we remain underweight in interest rate risks, neutral regarding equity risks, and overweight for commodities.

Trauth

Thomas Trauth
CEO – IMT Asset Management AG

APRIL RECOVERY DESPITE GEOPOLITICS

Financial markets

In April, despite the unclear situation regarding US-Chinese trade relations and the future of the Joint Comprehensive Plan of Action (Iran unclear deal), equity markets rebounded noticeably. However, we observed diverging equity market movements. Emerging markets equities fell 0.6% in April, driven by Chinese equities, which sold-off by 3.5%. The US S&P500 index was about flat, ending the month 0.3% higher. Meanwhile, the EuroStoxx50 surged 5.2% and the Japanese Nikkei225 4.7%. European and Japanese equities were supported by weakening currencies, the EUR fell 2% vis-à-vis the USD and the JPY almost 3%.

The sudden rise in USD strength, which started mid-April, was remarkable. Convincing explanations for the sudden USD bounce are lacking. The USD is certainly supported by stronger US growth, compared to most other regions, and a clear yield advantage. In recent weeks the yield differential widened even further, to more than 300 basis points based on 2-year yields. However, both of these factors had been present for some time, during which the USD weakened month after month. Some analysts argue that markets have started to re-focus on fundamentals, which will lead to a much stronger USD over the coming months.

For fixed income markets the major development was the strong rise in US yields, especially after the Fed rate hike on 21 March.

Higher US yields and a stronger USD generated strong headwinds for emerging market assets. Local currency bonds lost 3% in April and hard currency bonds 1.5%. In contrast, high-yield bonds gained moderately, by 0.2%. Energy-related companies are an important part of the high-yield index. Therefore, higher oil prices have certainly helped the overall performance.

Global REITS recovered strongly, gaining 3.5% in April. European and Asian REITS outperformed. In our view, REITS have suffered too much from rising yields in recent months, since in the current environment REITS should be able to profit from rising rental income.

Commodities surged in April. The broad Bloomberg commodity index climbed 2.6%, driven by oil, up 7%, and metals, up 3.5%. Gold fell 0.8% and was unable to benefit from either geopolitical tensions or from rising inflation.

Macro economics

In Q1 global growth slowed. US GDP growth fell to 2.3% after 2.9% in Q4. EMU growth also fell to 1.6% after 2.8% in Q4. This is consistent with falling PMIs, after a peak in late 2017 (EMU) and early 2018 (US).

US non-farm payrolls rose to 164,000 in April and the unemployment rate fell below 4% for the first time since 2000. The US economy continues to create jobs at a strong pace.

US inflation accelerated in recent months, reaching 2.5% in April. Most notably the personal consumption expenditure core price index (PCE) rose to 1.9% in March, after 1.6% in February. This is an important indicator since it excludes volatile seasonal food and energy prices and is closely monitored by the US Fed. Average hourly earnings, however, rose only slightly to 2.6% yoy, suggesting there is still no significant wage pressure building.

Central banks

On 26 April the ECB kept rates unchanged and did not alter its wording. It will maintain its asset purchase program at the current pace of EUR 30 bn per month until at least September. It is widely expected that the ECB will reduce its asset purchase after September. More guidance on the further tapering measures are expected at the ECB's policy meeting on 26 July.

On 2 May the US Fed kept rates unchanged. It confirmed that inflation has risen to almost its 2% target. That would mean, in our view, that the Fed is likely to accept a certain overshoot of inflation above the 2% target. The market fully prices another rate hike at the Fed's next meeting on 13 June.

Outlook

We reduced portfolio risks at our last Investment Committee meeting, due to heightened geopolitical risks, especially a potential trade war between the US and China. We lowered our equity exposure to neutral and slightly reduced credit risks. We remained positive on the outlook for commodities, especially energy, due to robust growth, rising inflation and geopolitical tensions.

So far markets have remained relatively calm after the US decision to exit the Iran contract. However, we remain cautious regarding the long-term implications and especially the impact on the US-European relationship. In addition, it is very possible that US President Trump will decide to take a tough stance and introduce massive tariffs on Chinese export goods.

ECONOMICS

In Q1 global growth slowed. US GDP growth fell to 2.3% after 2.9% in Q4 and EMU growth fell to 1.6% after 2.8% in Q4. This is consistent with falling PMIs, after a peak in late 2017 (EMU) and early 2018 (US). US inflation accelerated in recent months, reaching 2.5% in April. US non-farm payrolls rose to 164,000 in April and the unemployment rate fell below 4% for the first time since 2000. Average hourly earnings, however, rose only slightly to 2.6% yoy, suggesting there is still no significant wage pressure building.

Fig. 1: PMIs

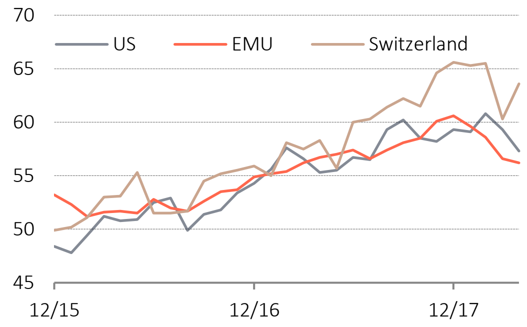


Fig. 2: PMIs

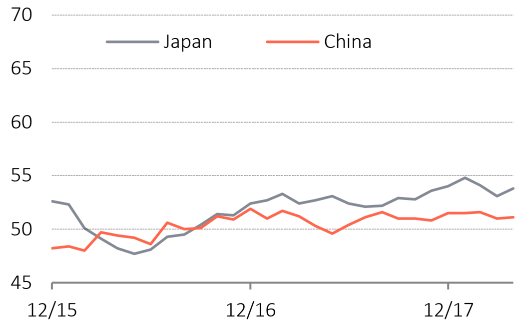


Fig 3: Consumer price inflation, in % YoY

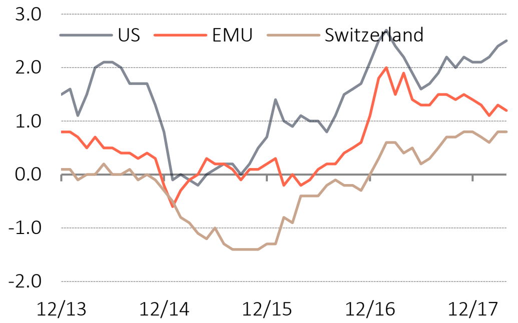


Fig. 4: Consumer price inflation, in % YoY

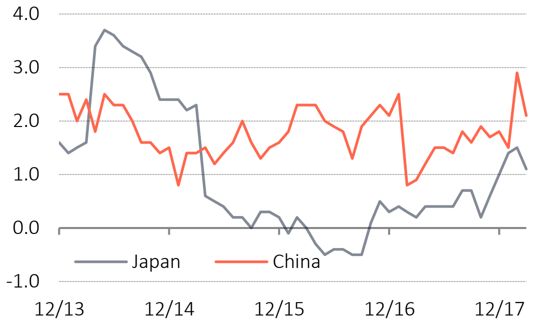


Fig 5: Unemployment rates, in %

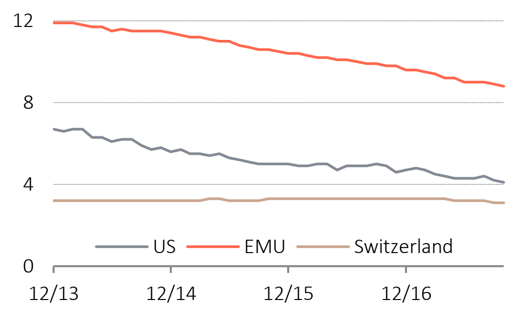
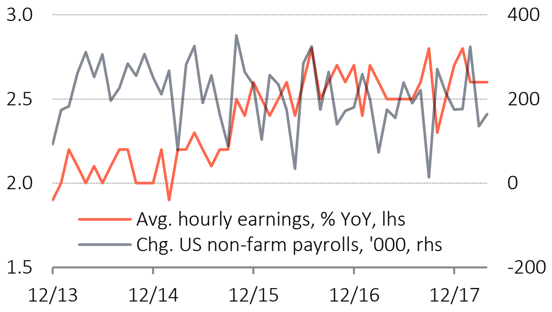


Fig 6: US labor market



FIXED INCOME

Rising US inflation pushed US yields higher, driven partly by growing inflation expectations. US 10-year yields rose 22 basis points, climbing as high as 3%. German 10-year yields rose moderately, by 6 basis points. High-yield bonds were flat in April, whereas emerging markets bonds sold off. Insurance-linked bonds continued to perform steadily and once more proved to be uncorrelated to other asset classes.

Fig.7: 2Y government bond yields

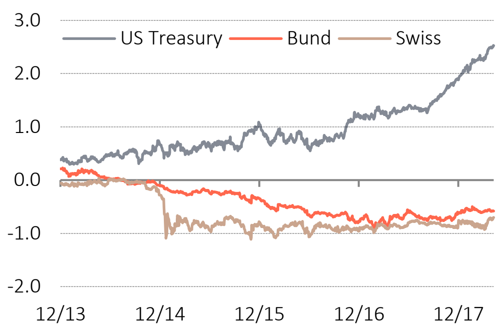


Fig. 8: 10Y government bond yields

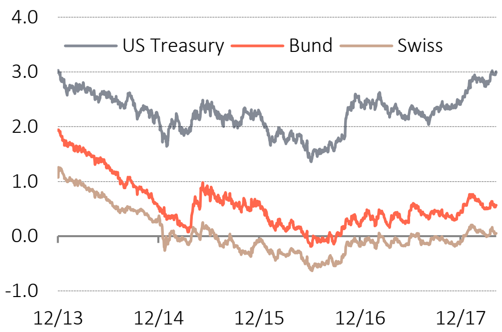


Fig 9: 10Y break-even inflation

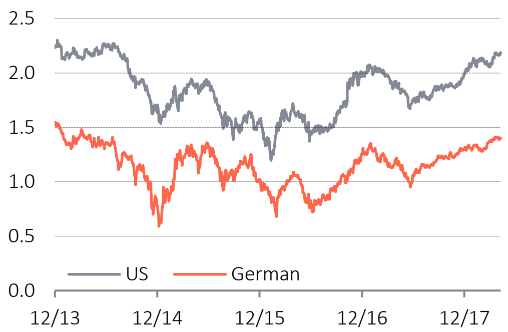


Fig. 10: Credit spreads, 5Y credit default swaps

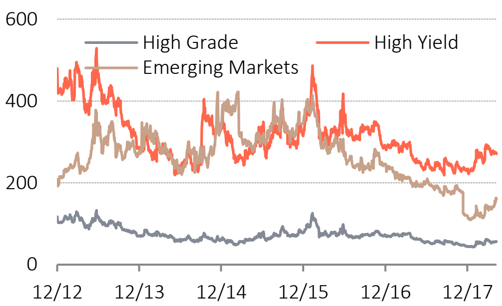


Fig 11: Money market spreads (3M-2Y)

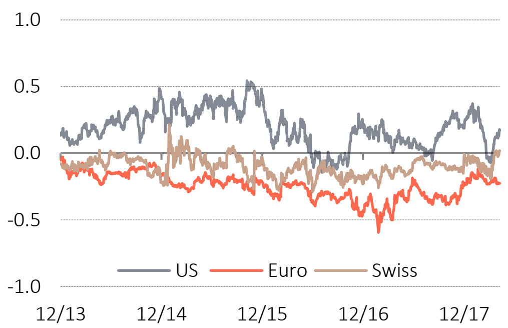
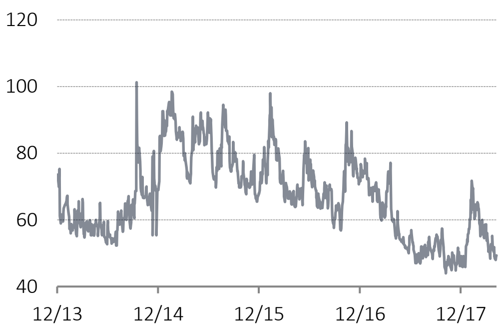


Fig 12: Merrill Lynch volatility index (MOVE)



EQUITIES

In April, most equity markets rebounded. The exception was the Chinese market, which suffered from trade war fears. The S&P500 index was slightly up, whereas the EuroStoxx50 and the Nikkei 225 rebounded strongly, climbing 5.2% and 4.7%, respectively. The volatility, as measured by the VIX index, clearly fell.

Fig. 13: MSCI equity indices – major regions

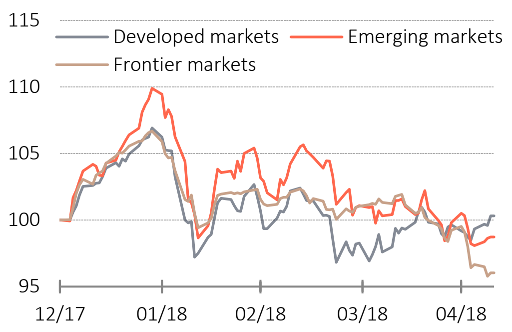


Fig.14: Equity indices – major developed markets

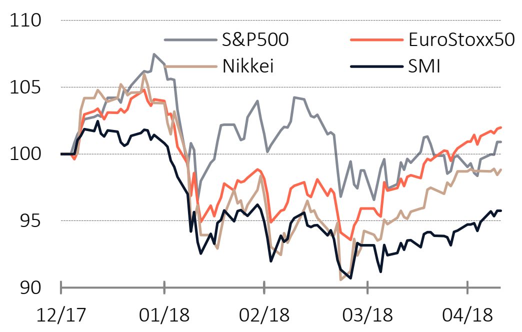


Fig 15: Equity indices – major emerging markets

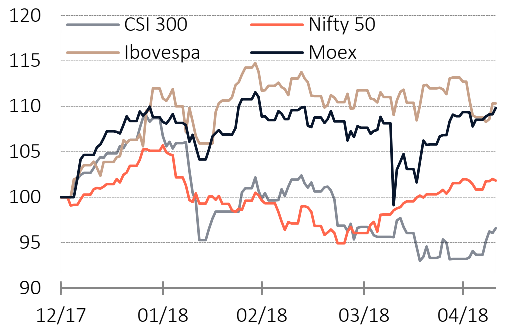


Fig. 16: Sector performance, MSCI Europe, 2017

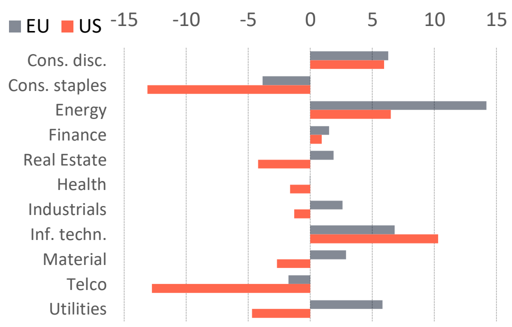


Fig 17: Price-earnings ratios

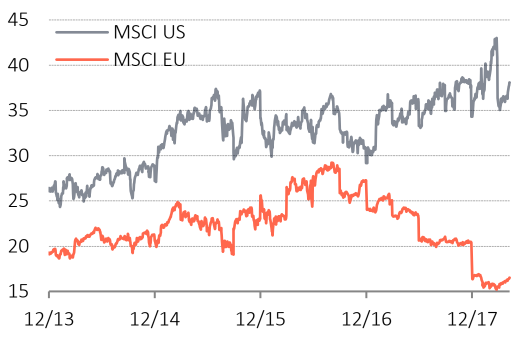
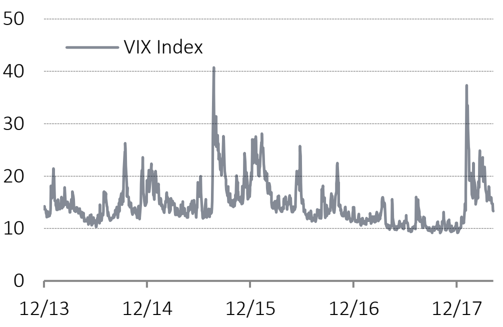


Fig 18: Equity volatility – S&P500 VIX index



ALTERNATIVE INVESTMENTS

Oil prices rallied, driven in part by geopolitical tensions in the Middle East, most notably regarding US policy towards Iran. Despite geopolitics, gold prices fell by 0.8%. Global REITS strongly rebounded in April, rising 3.5%.

Fig. 19: Gold price, USD/oz

Fig.20: Brent oil price, USD/bl

Fig 21: Bloomberg commodity indices

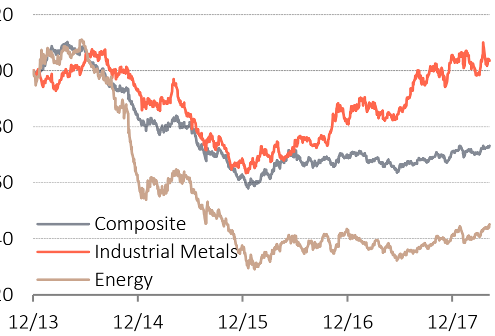


Fig. 22: HFRU hedge fund indices

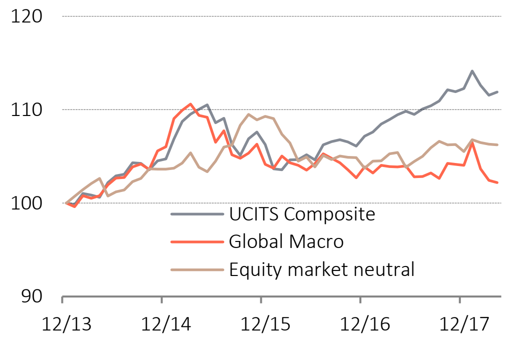
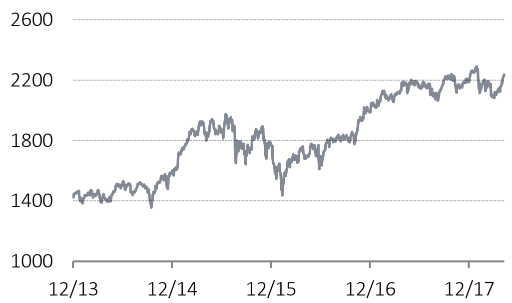


Fig 23: FTSE EPRA/NAREIT global REITS index

Fig 24: LPX global listed private equity



CURRENCIES

The major theme in April was the strong recovery of the USD. This came unexpectedly and there is a lack of convincing explanations for the sudden USD bounce. The abrupt rise in US yields has probably helped, although the yield advantage of the USD has been at historic highs for a long time. The GBP weakened especially after the BoE decided not to raise rates.

Fig. 25: EUR-USD exchange rate

Fig. 26: GBP-USD exchange rate

Fig 27: USD-JPY exchange rate

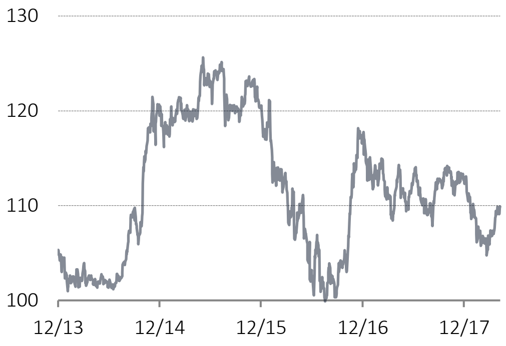


Fig. 28: USD-CNY exchange rate

Fig 29: EUR-CHF exchange rate

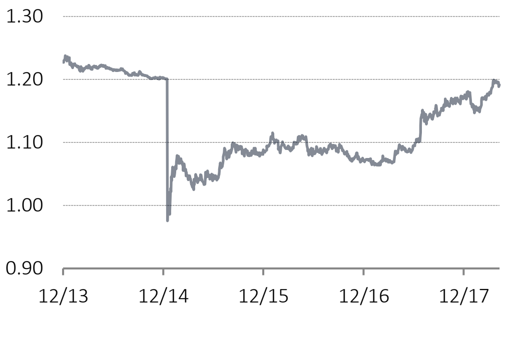
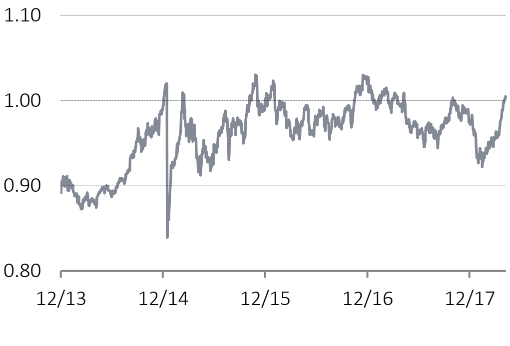


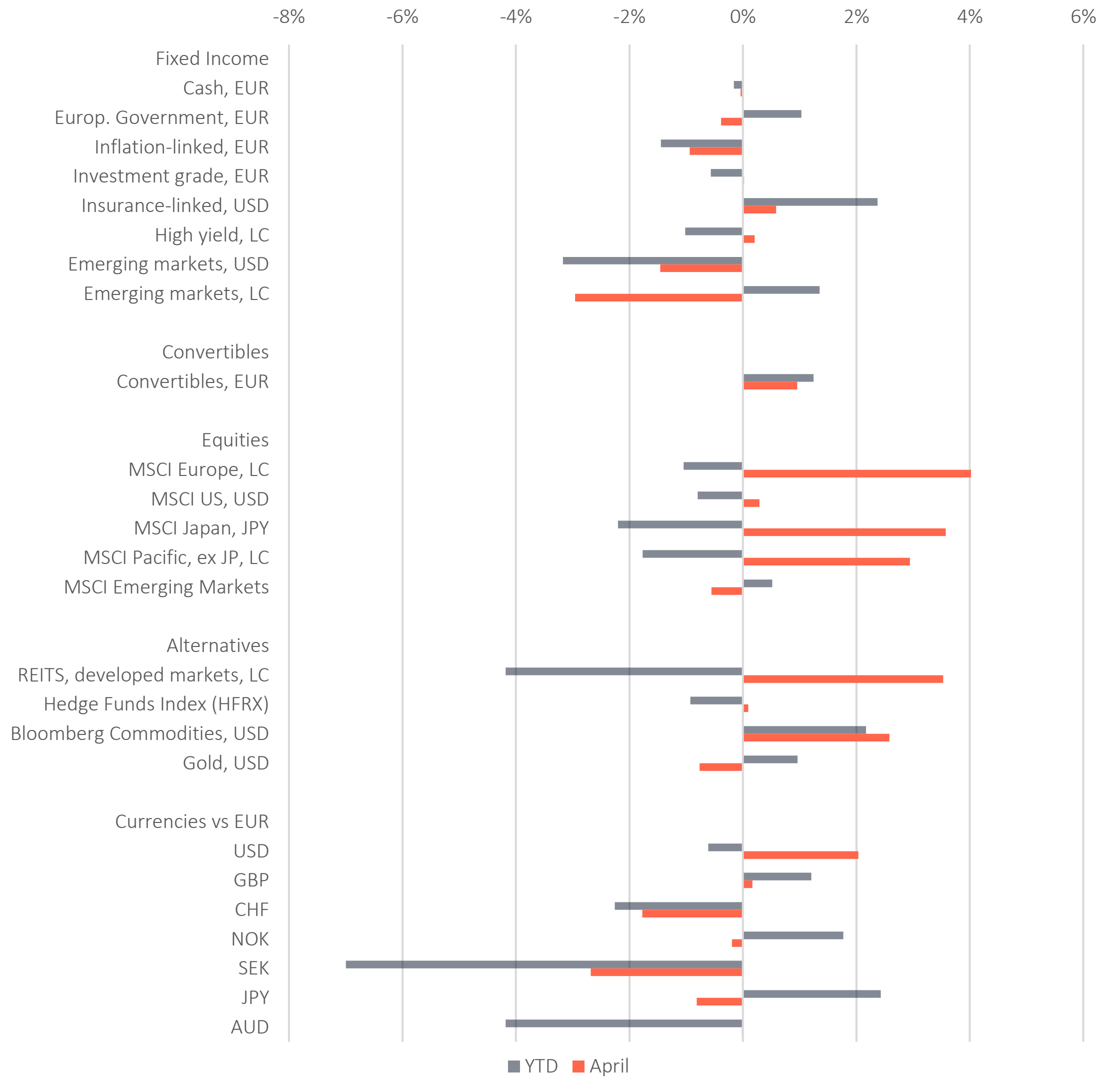
Fig 30: USD-CHF exchange rate



ASSET ALLOCATION

In April, European and Japanese equities as well as REITS, commodities and the USD outperformed. At the same time, emerging markets bonds were performance detractors. Insurance-linkers continued to perform steadily, unimpressed by more general market volatility. Gold did not serve as a hedge for geopolitical uncertainties this month. The CHF continued to weaken, and the JPY gave back some of its year-to-date gains.

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

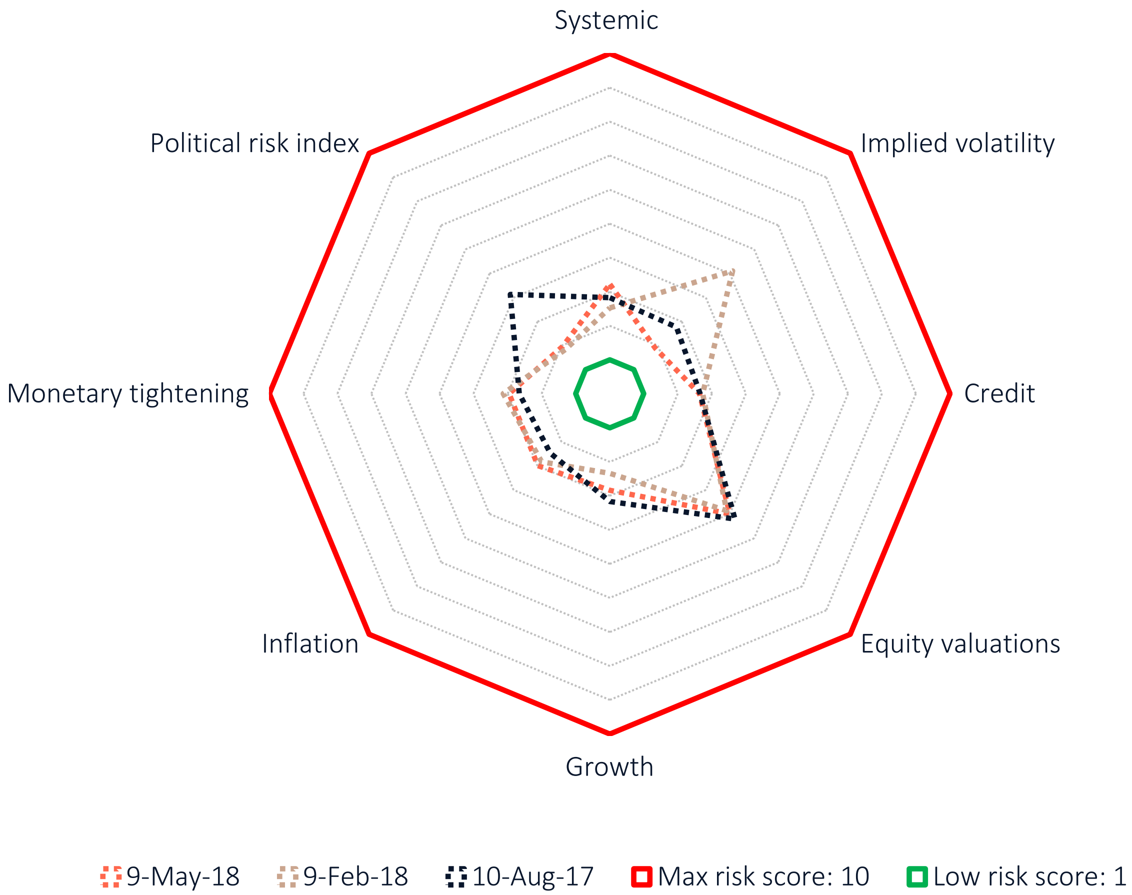


RISK MONITOR

The IMT Risk Monitor remains very calm. As expected, monetary tightening and inflation risks rose somewhat recently. In addition, the banking sector underperformed, which led to a certain but not worrying increase of systemic risk. The political risk index did not capture Trump's wild rhetoric, since the index is based on news headlines mentioning, e.g., terror and/or military conflicts.

Fig. 32: IMT Risk Monitor

09 Feb 2018: Inflation fear and technical correction
10 Aug 2017: North Korea tensions



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