IMT Asset Management AG
Austrasse 56 · P.O. Box 452
9490 Vaduz, Liechtenstein
asset@imt.li · www.imt.li

INVESTMENT OUTLOOK 09.2018

17 September 2018

August was a very challenging month. Concerns about a Chinese growth slow-down, not least on the back of additional trade tariffs, together with the crises in Turkey and Argentina, had a large negative impact especially on emerging markets assets. Market participants worried about global contagion spreading from the above-mentioned hot spots.

Meanwhile the US equity market continued to outperform. In Europe Italian government bonds continued to sell-off. The sell-off started in May and pushed 10-year yields above 3.2% in August. This reflects concerns about the sustainability of Italian finances, which also exerted adverse effects on European equities, with a loss of 2.5% in August.

We continue to avoid interest-rate risks, have reduced credit risks and remain overweight in US equities and energy.

Trauth

Thomas Trauth
CEO – IMT Asset Management AG

GLOBAL CONTAGION RISKS?

Financial markets

August was a very volatile month. US and Japanese equities performed positively, up 3.0% and 1.4% respectively. Emerging markets sold off, due to concerns about the impact of the trade dispute on Chinese growth as well as the crises in Turkey and Argentina. Emerging markets equities lost 3.3% and local currency bonds 6.1% in August. In Europe, concerns about Italian finances, banks' exposure to Turkish debt, and the potential impact of US tariffs, weighed on markets. As a result, the equity index, MSCI Europe, fell 3.1% and banks especially came under selling pressure.

The safe-haven environment led to declining government bond yields. European 10-year yields fell 12 basis points and US yields 10 basis points. The yield spread of Italian 10-year bonds over their German equivalents climbed to roughly 2.5%. High-yield and emerging market bond spreads widened in August by 15 and 65 basis points respectively.

REITS had a strong month, the global REITS index rose 1.6%.

The Bloomberg Commodity index fell 1.8% in August, mainly driven by falling prices for agriculture (-6.0%), industrial metals (-4.3%) and precious metals (-3.1%). Only energy prices rose, with an increase of 3.8%.

UCITS hedge funds had another weak month with the broad hedge fund index falling 1.1%.

Emerging markets currencies had a terrible month. The Turkish lira fell about 30% and the Brazilian real 8% against the USD. The USD rose 0.8% against the EUR. The CHF appreciated 2.9% vis-a-vis the EUR.

Macro economics

In Q2 US GDP grew 4.2% QoQ annualized, which is the strongest growth for many years. This compares with growth of 1.6% in the euro area and 1.9% in Japan.

The IMF estimates that tax cuts and fiscal stimulus in the US will add 0.7% to GDP growth this year and 0.8% next year.

There is a big question mark regarding the growth outlook for China. President Xi has recently cut interest rates and brought forward fiscal spending to support the economy. However, it appears unlikely that China will introduce strong stimulus packages similar to those of 2009 and 2015, since the Chinese administration has declared its focus to be on deleveraging and structural reforms.

The US PMI climbed to a very strong 61.3 in August after 58.1. The EMU PMI stagnated and fell slightly to 54.6 after 55.1.

US inflation was at 2.7% in August, slightly down from 2.9% in the prior month. Core inflation also fell to 2.2% after 2.4%. EMU inflation was at 2.0% down from 2.1% and core inflation remained at 1.0%.

US non-farm payrolls rose more strongly than expected. The US economy added 201,000 jobs in August. Average hourly earnings increased 2.9% from a year earlier, the strongest wage growth since 2009.

Central banks

Fed chairman Jerome Powell, speaking at the annual Jackson Hole Economic Symposium, reiterated that "a gradual process of normalization remains appropriate". In our view, this suggests that the Fed will be hiking rates by 25 basis points each quarter going forward. The futures market is still not fully pricing such a hiking path.

On September 13 the ECB kept rates unchanged and clarified its planned tapering measures, which were in line with expectations and did not surprise markets.

Contagion risks?

Market participants were worried that the situation in China, Italy, Turkey and Argentina could become contagious and drag down other markets. Most worrying to us appears the situation in China and Italy. China is a major concern due to its sheer size and since it is very connected economically and financially. The country has become the biggest importer of many commodities. A slowdown could have a large negative impact on many commodity-producing economies. It is also an important market especially for European exporters.

The Italian government is a major debtor and Italian government bonds sit in large amounts on European banks' and insurers' balance sheets. Distress in Italy would certainly also lead to serious concerns about the sustainability of the European union.

In contrast, we regard the situation in Turkey and Argentina as less contagious for global finances. While there are sizeable amounts of Turkish debt on balance sheets of European banks, overall it does not look too worrying. The stark depreciation of the Turkish lira had a short-lived effect on financial markets

The Argentinian economy is relatively small and far less connected to the rest of the world. Therefore, we see only moderate contagion risks there.

However, we continue to monitor the situation in China and Italy. Currently we see only a slight chance that the situation could trigger a strong and lasting market correction in the next couple of weeks.

Outlook

We still see an escalating trade war as the major risk, followed by an overheating US economy, which could scare the Fed policy committee and lead to aggressive monetary tightening. It seems, however, that markets have recently become more sanguine regarding the potential impact of additional tariffs.

While the US economy is clearly firing on all cylinders, the inflationary impact has so far been limited. However, we continue to monitor US inflation risk, since this is the single most important variable which could make the Fed more hawkish.

We reduced interest-rate risks in the portfolios and have lowered our exposure to credit risks, since credit risks are priced to perfection in our view. We maintain a slight overweight of US equities and energy.

ECONOMICS

Global growth has become desynchronized. While the US economy is growing very strongly, potentially even overheating, European growth has slowed somewhat, and many emerging economies have slowed more significantly. Inflation, especially in the US, has picked up but so far does not look dangerously high. In August, wage growth reached 2.9%, the highest reading since 2009.

Fig. 1: PMIs

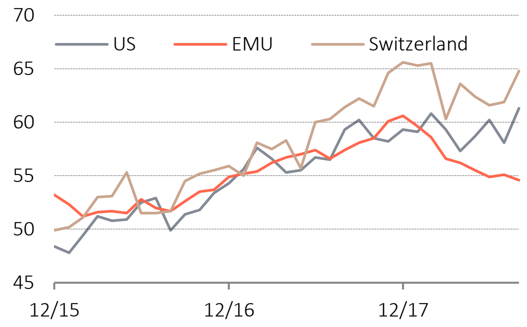


Fig. 2: PMIs

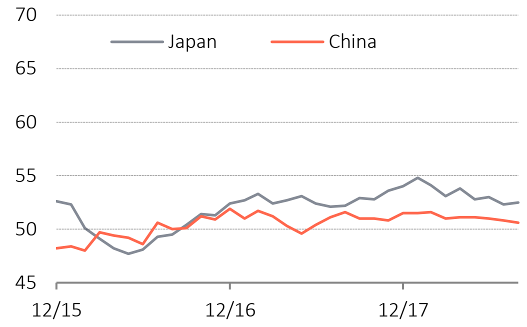


Fig 3: Consumer price inflation, in % YoY

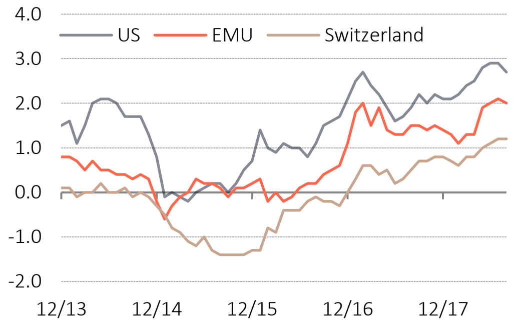


Fig. 4: Consumer price inflation, in % YoY

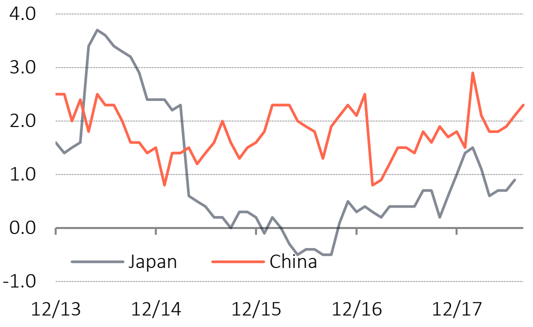


Fig 5: Unemployment rates, in %

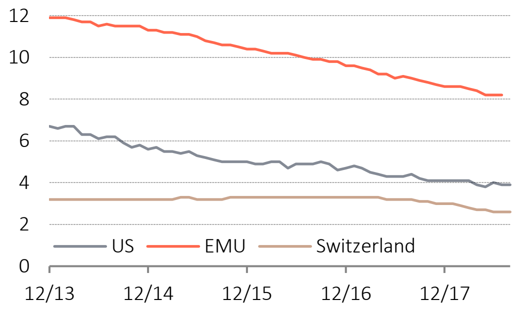
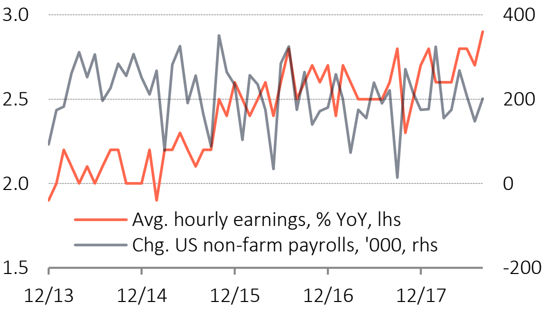


Fig 6: US labor market



FIXED INCOME

In August, interest rates fell as the market was looking for safe-haven assets. European 10-year bond yields dropped 12 basis points and US yields 10 basis points. Break-even inflation rates remained stable (Europe) or even declined somewhat (US). Credit spreads widened, especially for emerging markets (by 65 basis points) and for high-yield bonds (by 15 basis points).

Fig.7: 2Y government bond yields

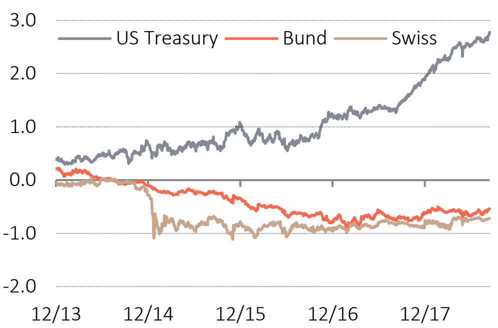


Fig. 8: 10Y government bond yields

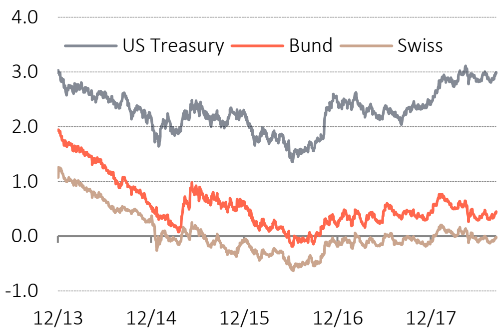


Fig 9: 10Y break-even inflation

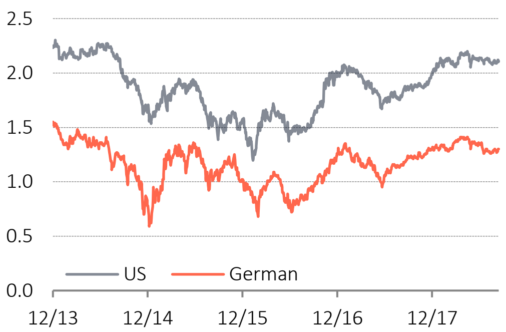


Fig. 10: Credit spreads, 5Y credit default swaps

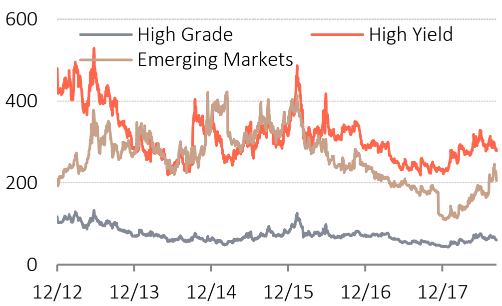


Fig 11: Money market spreads (3M-2Y)

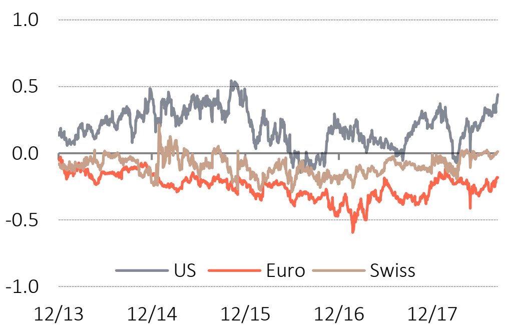
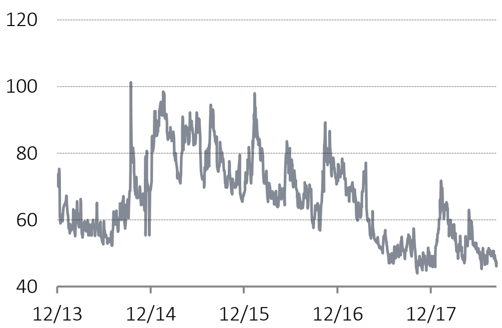


Fig 12: Merrill Lynch volatility index (MOVE)



EQUITIES

Most equity markets sold-off in August, with few exceptions, like the US S&P500, up 3.0%, the Japanese Nikkei 225, up 1.4%, and the Indian Nifty, up 2.9%. The MSCI emerging markets index fell 2.9%.
Year-to-date we continue to see information technology, consumer discretionary, and health outperforming, while telecom, finance and consumer stables are underperforming. Implied volatility has retreated and is back to historically low levels, close to 10.

Fig. 13: MSCI equity indices – major regions

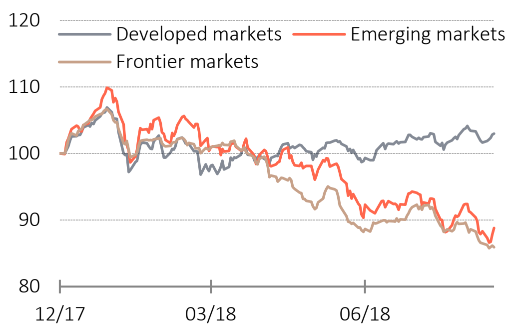


Fig.14: Equity indices – major developed markets

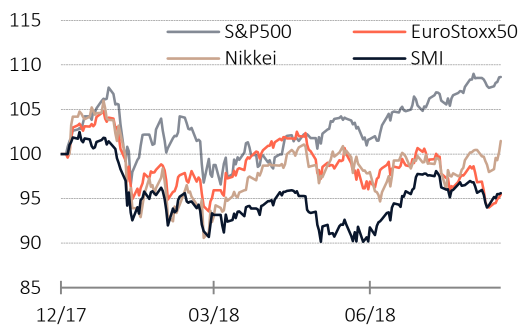


Fig 15: Equity indices – major emerging markets

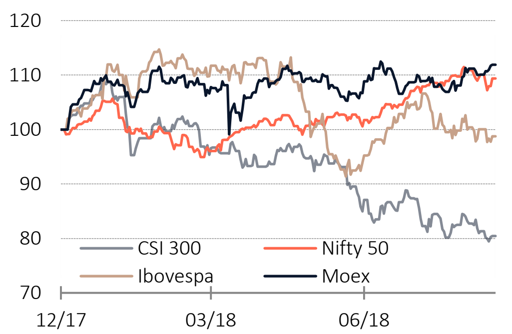


Fig. 16: Sector performance, MSCI Europe, 2017

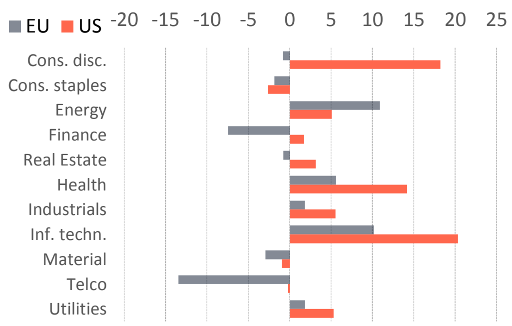


Fig 17: Price-earnings ratios

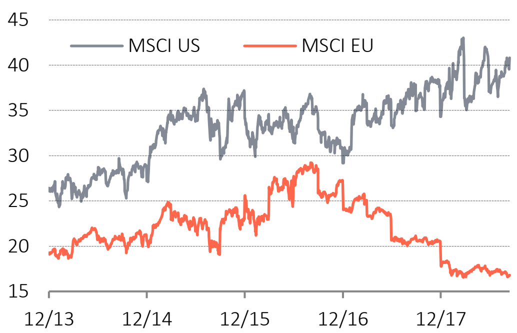
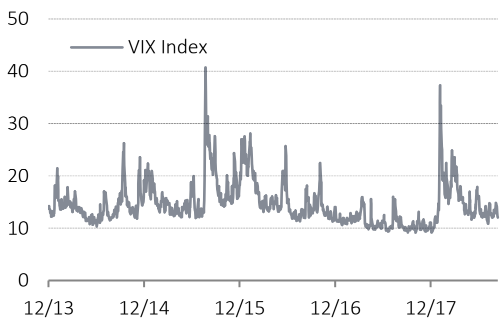


Fig 18: Equity volatility – S&P500 VIX index



ALTERNATIVE INVESTMENTS

Oil prices surged another 4.3% (Brent) in August. Meanwhile, due to trade-war concerns, prices for industrial metals fell by 4.3%. The gold price fell 1.9% and has thus dropped more than 8% since last December. It seems that the Turkish central bank, which is known to hold large gold reserves, sold gold to create liquidity. REITS performed well and rose 1.6%. Hedge funds, especially macro funds performed poorly, probably since politics have become a more important market driver than fundamentals.

Fig. 19: Gold price, USD/oz

Fig.20: Brent oil price, USD/bl

Fig 21: Bloomberg commodity indices

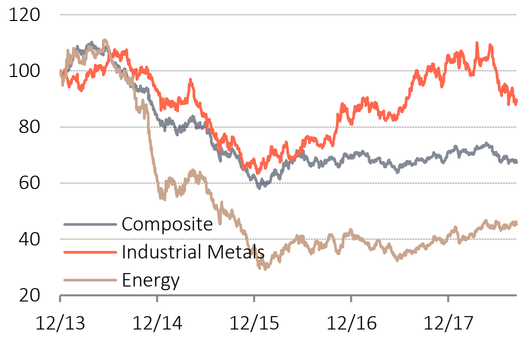


Fig. 22: HFRU hedge fund indices

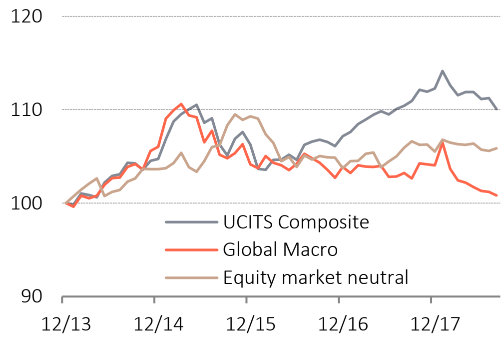


Fig 23: FTSE EPRA/NAREIT global REITS index

Fig 24: LPX global listed private equity

CURRENCIES

In August the EUR-USD exchange rate fell sharply from 1.16 to 1.135 but recovered quickly in the second half of the month. Month on month the USD appreciated only slightly. The GBP weakened, and the CHF strengthened. The CNY continued to depreciate but at a slower pace.

Fig. 25: EUR-USD exchange rate

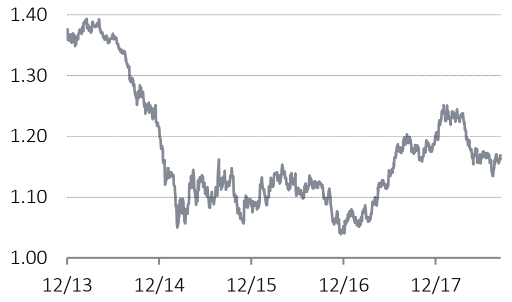


Fig. 26: GBP-USD exchange rate

Fig 27: USD-JPY exchange rate

Fig. 28: USD-CNY exchange rate

Fig 29: EUR-CHF exchange rate

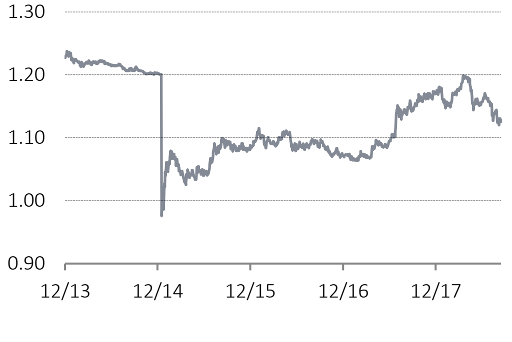
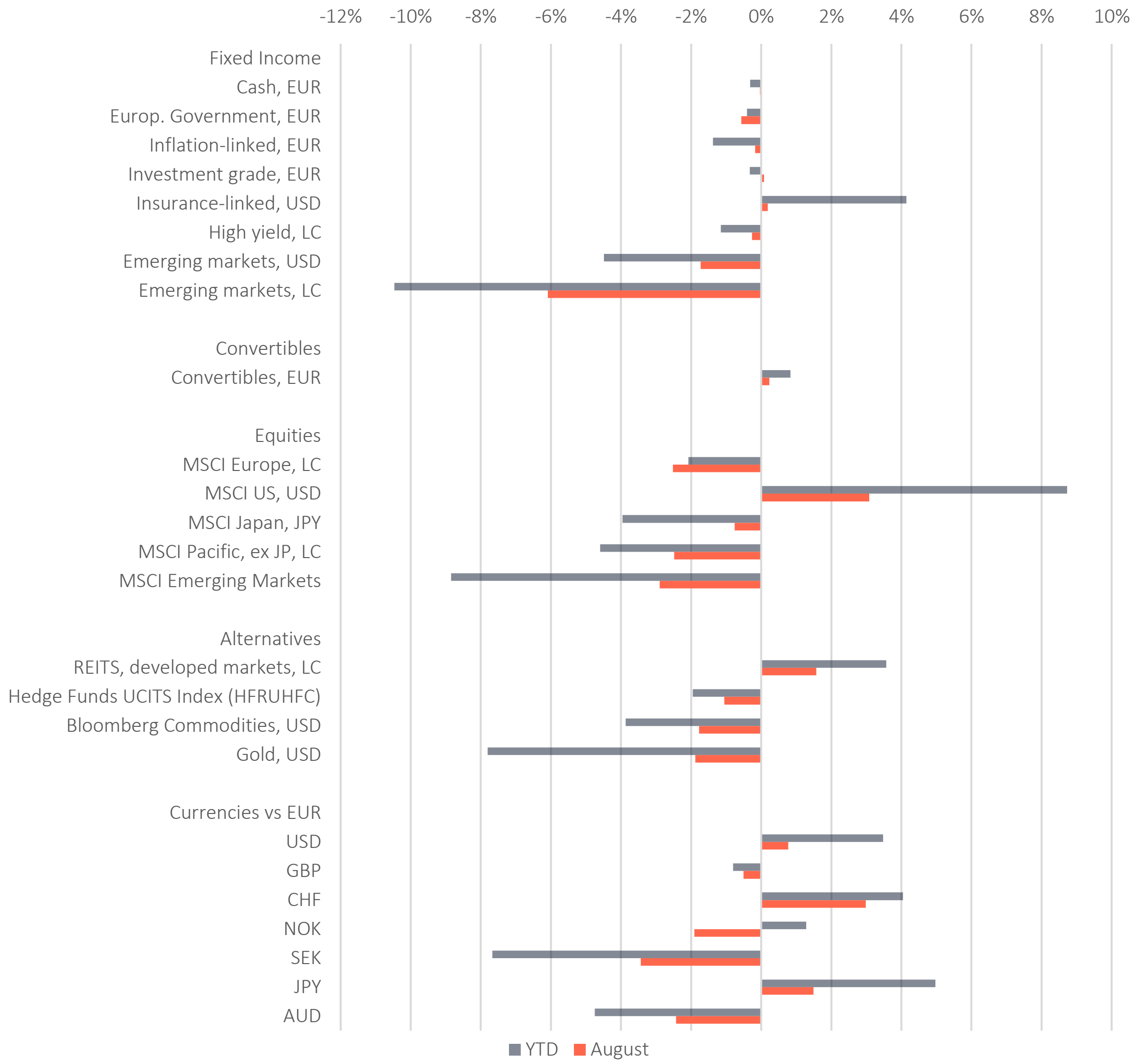


Fig 30: USD-CHF exchange rate

ASSET ALLOCATION

August was a very challenging month, with most equity markets down, except for US and Japanese equities as well as global REITS. The USD remained on the strong side, together with the CHF, the JPY and the NOK. Emerging markets bonds and equities continued to suffer due to trade war fears, strong outflows, and negative news regarding Turkey and Argentina.

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



RISK MONITOR

Overall the risk environment remains benign. Implied volatility and political risks (which do not take into account trade-war-related risks) have fallen to very low levels. At the same time systemic risks (as measured by relative performance of the financial sector) have risen recently. Equity valuation remains relatively high and monetary tightening and inflation risks have risen recently.

Fig. 32: IMT Risk Monitor

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

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