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IMT GROUP

INVESTMENT OUTLOOK 01.2019

29 January 2019

In our first Investment Outlook of the year, we usually assess our last year's predictions and formulate our predictions for the current year.

As you will see, 2018 was exceptional and financial markets surprised us in different ways and led to disappointing portfolio results. We will discuss the causes and the performance results in more detail below.

As always, we hope you enjoy reading this issue and welcome any comments you may want to share with us.

We wish you and your families a very successful, happy, and fulfilling 2019.

Thomas Trauth
CEO – IMT Asset Management AG

REVIEW AND LAST YEAR'S PREDICTIONS

What happened in 2018?

For investors 2018 was a very demanding year that presented several tough challenges:

1. US policy was erratic and unpredictable to a completely unprecedented degree. The US administration's aggressive approach to trade policy exerted a particularly unsettling influence on investors.
2. Both the US Federal Reserve and the European Central Bank made major changes to monetary policy and announced other such changes.
3. There was a distinct slow-down in the pace of growth in Europe. In addition, political imponderables related to Brexit, the formation of a new government in Germany, Italian fiscal policy, and the protest rallies in France ("Gilets Jaunes") all led to feelings of uncertainty among financial market participants.
4. The crises in Turkey and Argentina triggered severe exchange losses in the emerging economies.
5. The trade dispute between China and the USA and the slow-down in China's economy resulted in corrections on the Chinese stock market and negative impacts on the whole complex of emerging economies.

The above-mentioned factors, especially the political uncertainties arising in 2018, caused a sharp increase in market volatility and produced atypical results in the global financial markets. For instance, some higher-risk categories of investment underwent very marked corrections despite overall economic development, which remained solid in Europe and was strong in the USA, and despite a background of continuing low inflation. Furthermore, almost all asset classes declined in value, with the exception of European government bonds and insurance-linked securities, both of which went up slightly. Therefore, the natural diversification effects failed to materialize, and the outcome was unusually high portfolio losses.

In addition, one result of the unforeseeable political influences was that asset prices were far less driven by fundamental factors than would normally be the case. Consequently, many active funds managers who rely on fundamental data were not able to do better than their benchmark indices.

Lasts year's prediction

In the following, we critically review our forecasts for last year. For the details, we refer to our Investment Outlook 01.2018. We changed the format to allow you a faster overview of the predictions and the actual results.

Last year's prediction	Actual outcome	
1. Growth (real GDP)		
US: 2.2%	2.9%	☹
Eurozone: 2.1%	1.8%	(✓)
Japan: 1.5%	0.8%	☹
China:6.5%	6.6%	✓
	Note that GDP growth for 2018 is based on the latest estimates since official 2018 figures are not yet available.	
2. Inflation		
US: 2.5%	2.2%	(✓)
Eurozone: 1.5%	1.9%	(✓)
Japan: 1.0%	0.9%	✓
Overall mild pick-up with upside for US inflation.	Outcome in line with expectations, while volatile oil prices led to a peak of inflation in Q3 and clear moderation thereafter.	
3. Central Banks		
Fed: 3-4 hikes	4 hikes	✓
ECB: Reducing its asset purchase program (risk of more hawkishness)	Ended asset purchase program on 31 December	✓
Bank of Japan: Remain dovish and potentially lift 10-year yield target	Very expansive, but no End of 10-year yield targeting	(✓)
4. Rates (10-year yields)		
US: 2.8%	2.68%	✓
Eurozone: 0.9%	0.24%	☹
Inflation-linkers will outperform nominal bonds.	Inflation-linkers underperformed since inflation expectations fell.	☹

Last year's prediction	Actual outcome	
5. Credit		
Positive outlook for US corporates and high-yield	US corporates and high-yield performed negatively	☹
Spread widening in Europe	European high-yield spreads widened significantly, from 280 to 506 basis points.	✓
6. Equities		
Positive outlook in general with preference for Europe, Japan and emerging markets.	Overall equity markets were clearly down. The US outperformed, followed by Europe and very poor results for Japan and the emerging markets.	☹
7. Emerging markets		
Positive outlook, but downside risks, if USD strengthened, US yields rose strongly, China slowed down.	Unfortunately, all the risks we identified kicked in and made emerging markets one of the worst performing asset classes.	☹
8. Commodities		
Moderately positive on oil	-19.5% (positive until end of September)	☹
Negative on industrial metals	-19.5%	✓
Negative on gold	-1.56%	✓
9. Alternatives		
REITS to recover somewhat	-3.74% (positive until end of November, good relative performance)	(✓)
Absolute-return strategies to benefit from rising volatility and dispersion.	Overall disappointing results, driven by erratic politics and sharp trend reversals	☹
10. Currencies		
USD to rebound in first half of 2018	The USD appreciated strongly in first half of 2018 and mildly in the second half.	✓
GBP on the weak side	GBP clearly depreciated in 2018.	✓
CHF to weaken	The CHF weakened vis-à-vis the EUR until April, but strengthened thereafter and ended the year stronger.	☹

OUTLOOK 2019 – TEN PREDICTIONS

1. Growth

Leading growth indicators weakened in 2018. The European PMI, for example, fell from 60.6 to 51.5 in 2018. The US ISM index, which remained at very strong levels for most of 2018, fell markedly in December to 54.3 from 58.8. China's economy slowed in 2018, because of the effect of structural reforms and US trade restrictions.

While growth dynamic certainly slowed on a global basis and is much less synchronized than in 2017, most economists do not expect a US recession in 2019. There is, however, the risk that the German economy, plagued by falling export demand and problems in the auto sector, could dip into temporary contraction in 2019.

We see, however, potential for positive surprises in 2019. It is entirely possible that president Trump will come to an agreement with China on revised trade terms. In addition, we consider it quite likely that the Chinese government will decide on a more meaningful stimulus package to revive the Chinese economy during the first half of 2019.

Overall, we expect US real GDP growth of 2.3%, Euro area growth of 1.4%, Japanese growth of 0.9% and Chinese growth of 6.1%.

2. Inflation

Inflation has remained surprisingly low. We saw some pick-up of headline inflation in the second half of 2018, but this was mostly driven by rising energy prices and reversed towards the end of the year, when oil prices collapsed. Core inflation remained very stable around 1.0% in the Eurozone and rose from about 1.7% to 2.2% in the US.

We do not see a risk of accelerating inflation in Europe, next year. However, US inflation should pick up somewhat, since wage growth recently rose above 3.0% (see figure 6). This wage pressure should eventually feed through to goods prices. We see a risk that US inflation could overshoot.

Overall, we expect US inflation around 2.5% and European inflation around 1.0%.

3. Central Banks

Most likely, the Fed will reduce the pace of monetary tightening in 2019, on the back of softer growth data. Since real interest rates remain at about zero – so monetary policy cannot be seen as outright restrictive – and US growth remains strong with accelerating inflation, we expect 2-3 rate hikes in 2019. This is clearly above market expectations. The futures markets prices only imply a 20% probability of one more rate hike in 2019.

The ECB stopped its asset purchase program in December 2018. However, it will reinvest maturing bonds to keep its balance sheet constant for the foreseeable future and possibly well past the first hike. In the past the ECB indicated that it would raise rates for the first time in 2019, but it sounded more dovish in its recent policy meeting, when president Draghi made ECB's first rate hike data-dependent. We still believe there is a fair chance of a first hike this year, but this has become a close call.

Mario Draghi will depart at the end of October. His successor has not yet been determined. Mr. Erkki

Liikanen, the former Bank of Finland governor, is currently the most likely candidate to succeed president Draghi.

4. Rates

Further Fed rate hikes in 2019 together with rising inflation and stronger debt issuance by the US treasury should drive US 10-year rates higher. We expect 10-year yields to rise towards 3.5% in 2019, and European yields to climb towards 0.75%.

We also expect US inflation expectations to rise from the surprisingly low current levels.

5. Credits

Despite last year's spread widening, credits, including high-grade and high-yield bonds, do not offer value in our view. While we do not expect default rates to increase meaningfully in 2019, corporates increased leverage. We expect credit spreads to move sideways or to rise from current levels. As a result, we remain underweight credits.

6. Equities

The Q4 sell-off in combination with continuously rising corporate earnings led to a clear decline in forward price-earnings ratios, suggesting that equities are no longer expensive, measured against historic averages. US growth remains probably above trend. European growth softened but remains positive.

However, we continue to see heightened political risks. The biggest risk is certainly an extended escalating trade war. This would dampen global trade and growth and would be an increasing drag on corporate earnings, as exemplified by recent profit warnings regarding Apple.

In our base-case scenario, we expect positive returns from equity markets, with the US continuing to outperform. However, the variability of possible outcomes has increased in our view. While in a late cycle, equity markets tend to perform very well and can deliver double-digit returns, last year reminds us that the sentiment can turn sour very quickly, because investors fear that the party could be over rather sooner than later.

7. Emerging markets

After the hefty correction of emerging-markets bonds and equities in 2018, we see many value opportunities. A more meaningful China stimulus package and a further increase of oil prices would serve as further catalysts for positive returns.

However, a stronger rebound of the USD and rising US yields may provide further headwind for emerging markets. Overall, we are currently constructive and expect moderately positive returns.

8. Commodities

We are moderately positive on oil prices for 2019, since some supply disruptions, e.g., in Venezuela and Iran, and a disciplined OPEC will support oil prices. However, oil prices are capped. US oil producers usually increase production when oil prices rise above USD/bl 50-55. This level represents average production costs of US shale oil producers.

The outlook for industrial metals is bleak, since supply looks healthy and global demand will not rise much as global growth rolls over.

We continue to be skeptical about the outlook for gold prices, since real rates are likely to rise in 2019. Gold's recent rebound may run out of steam sometime soon.

9. Alternatives

REITS are exposed to rising interest rates. However, REITS are often undervalued against the intrinsic value of their property portfolios. Therefore, selective REITS can be seen as a good value play. As long as house prices do not collapse, REITS should also trade more stable than the brought market when equity markets correct.

Absolute-return strategies had a disappointing year as markets were driven by politics rather than fundamentals. In addition, some trend-following strategies suffered from frequent and sudden reversals. Furthermore, certain risk factors, like value and small caps, underperformed significantly.

If markets were to behave more normally, i.e., pay more attention to fundamentals, absolute-return strategies should find many ways to perform well, especially since volatility and dispersion have increased.

10. Currencies

The USD is well supported in our view. The US yield advantage vis-à-vis the EUR is very high historically, and the US growth outlook is much brighter compared to Europe's. These factors should continue to support the USD and keep downside pressure on the EUR-USD exchange rate. If the ECB, for example, in the second half of 2019, became more hawkish and indicated a first rate-hike, the sentiment would most likely shift in favor of the EUR. This is especially so since the US is running large twin deficits (budget and current account deficits), which are a net negative for the USD.

If the ECB turned more hawkish, we would expect the CHF to weaken more meaningfully.

Outlook for 2019 / new strategic asset allocation

We are facing an investment year, which will continue to be challenging. The global economy will lose some of its momentum. Nevertheless, we do not assume that any of the leading economic regions will fall into recession in the next 12 to 18 months. The political environment will remain demanding and unpredictable. Moreover, we are in a late-cycle economic phase and a period of monetary policy normalization. In this sort of environment, heightened volatility on the financial markets is to be expected. Such phases, however, definitely hold out prospects of good stock market returns.

As at the end of every year, we reviewed our strategic asset allocation in December, and we decided to adopt a somewhat more defensive investment strategy. The reason for doing so was to be in line with the market environment described above. The following outlines our balanced strategy.

- The proportion of government bonds was increased from 2.5% to 8.0%.
- The proportion of high-yield bonds was reduced from 5.0% to 4.0%.
- The proportion of convertible bonds was likewise reduced from 5.0% to 4.0%.
- The overall proportion of shares remained unchanged, but the proportion of US equities was increased from 13% to 20%. The other regions, namely Europe, Asia und emerging markets, were subject to individual reductions. This shift brings our share exposure closer to the market capitalization of the world's equity markets. Furthermore, the US equity market shows a more interesting mix of sectors than the European equity market in the medium term, with a higher proportion of technology stocks and a lower proportion of financial securities. In addition, the US equity market is rather more defensive than the share markets in Europe and the emerging economies.
- The proportion of absolute-return strategies was reduced from 12.5% to 10.0%.

Current tactical positioning

We still see upside potential for bond yields, and thus stay underweight in government bonds. However, since government bonds are the best portfolio hedge against a return of a risk-off environment, we recently reduced our underweight.

Credits, in our view, are priced to perfection, which warrants a cautious stance and an underweight position for corporate and high-yield bonds.

Regarding equities we currently see balanced downside and upside risks. We see upside for equities due to a sharp fall of equity valuations in late 2018 and a still positive economic outlook with moderate inflation. Downside risks relate to politics and especially

an escalating trade war. As a result, we stay neutral on equities.

We currently run an overweight in energy, since we see potential for a further recovery of oil and energy prices after the dramatic slump in Q4 2018.

ECONOMICS

PMI data for December were weaker. The US ISM index clearly fell to 54.3 after 58.8. The EMU PMI fell slightly to 51.4 after 51.8. The China PMI even dropped below 50 to 49.7 after 50.2. In contrast, the US non-farm payrolls rose to a very strong 312,000. Average hourly earnings rose 3.2% YoY and remained above 3% for the third consecutive month.

Fig. 1: PMIs

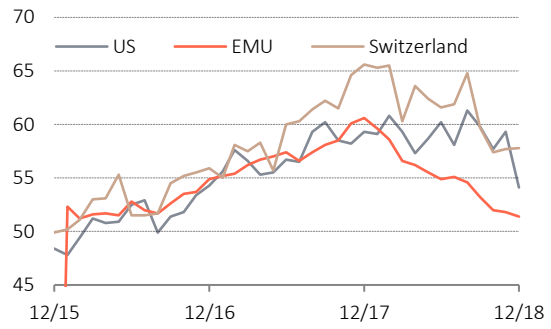


Fig. 2: PMIs

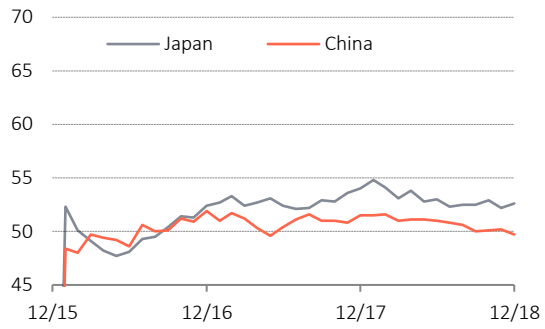


Fig 3: Consumer price inflation, in % YoY

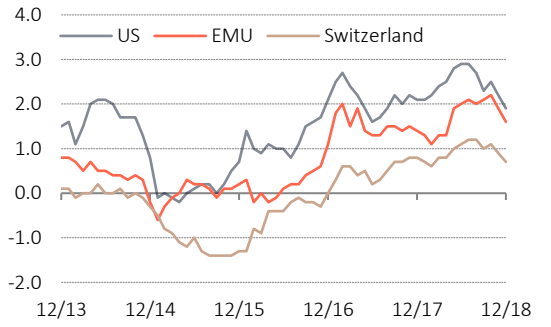


Fig. 4: Consumer price inflation, in % YoY

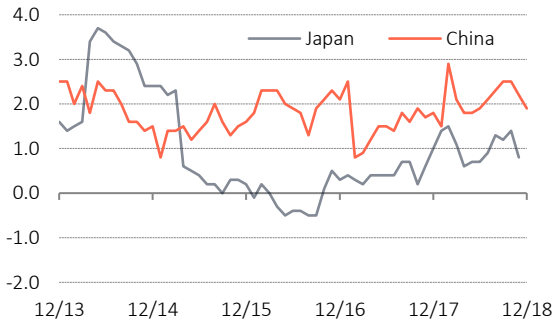


Fig 5: Unemployment rates, in %

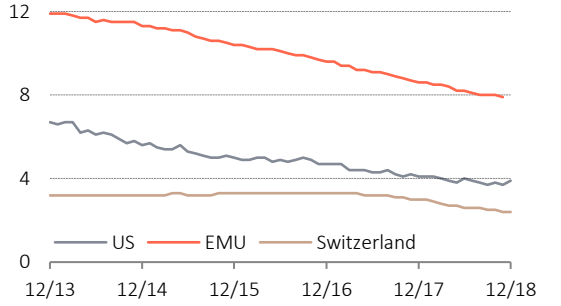
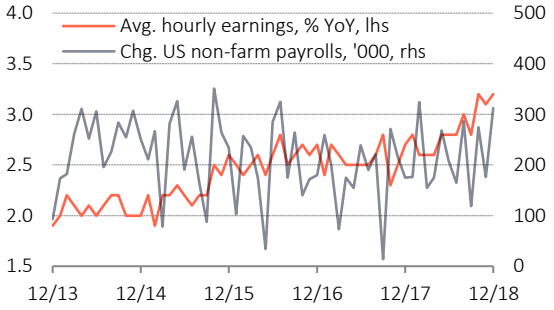


Fig 6: US labor market



FIXED INCOME

In December bond markets rallied strongly. Implied Fed rate-hike expectations for 2019 fell to zero. US 10-year yields have fallen 70 basis points since mid-November to below 2.7%. In addition, break-even inflation and, thus inflation expectations, fell significantly, implying inflation clearly below 2%. Credits sold off, while emerging markets bonds held up well.

Fig.7: 2Y government bond yields

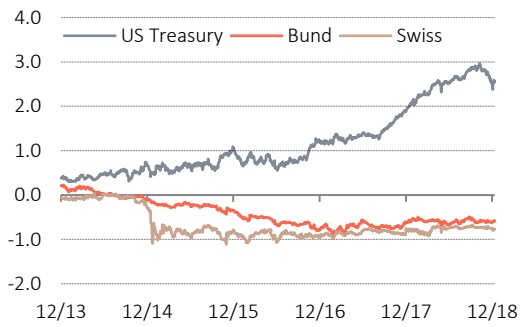


Fig. 8: 10Y government bond yields

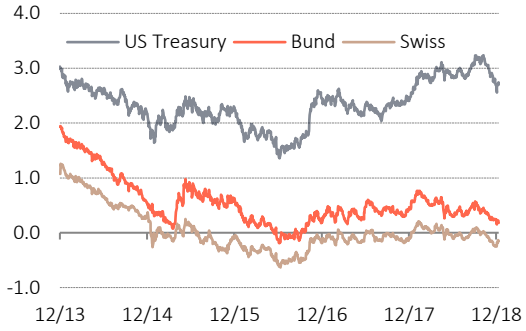


Fig 9: 10Y break-even inflation

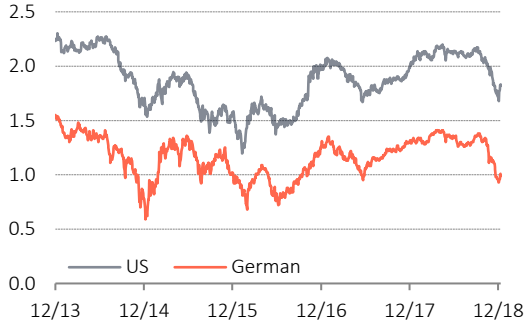


Fig. 10: Credit spreads, 5Y credit default swaps

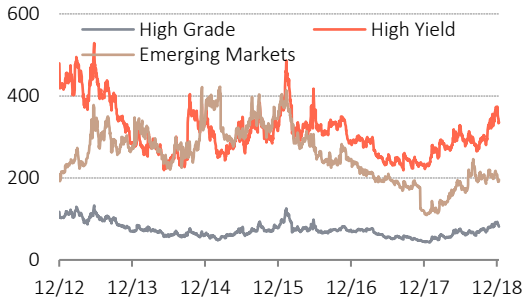


Fig 11: Money market spreads (3M-2Y)

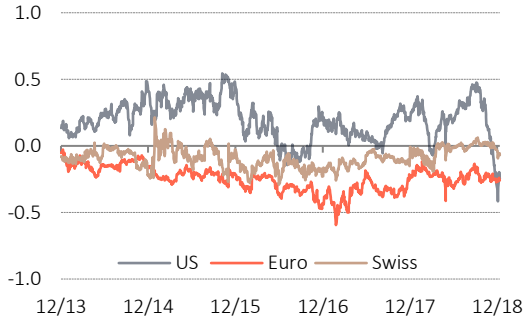
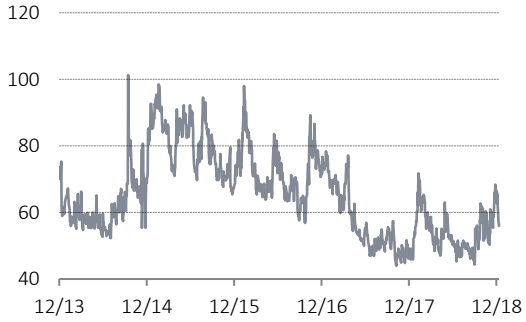


Fig 12: Merrill Lynch volatility index (MOVE)



EQUITIES

The December sell-off was broad-based and very pronounced. The S&P500 index fell 9.2%, the Nikkei225 by 10.5%, the MSCI Europe by 5.6%. Emerging markets fell by 2.9% and held up relatively well. After Christmas, the markets started to rebound strongly. The sectors most hit were energy, material, industrials and financials. Small and mid-caps suffered clearly more than large caps.

Fig. 13: MSCI equity indices – major regions

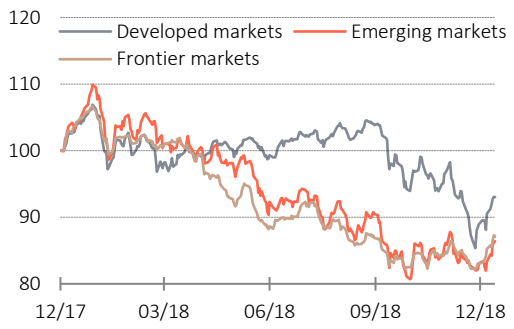


Fig.14: Equity indices – major developed markets

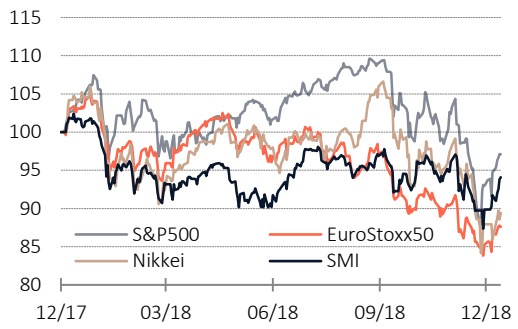


Fig 15: Equity indices – major emerging markets

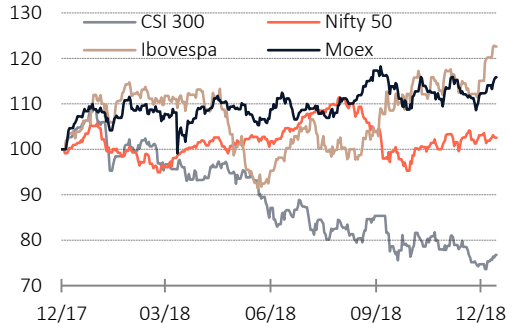


Fig. 16: Sector performance, MSCI Europe, 2018

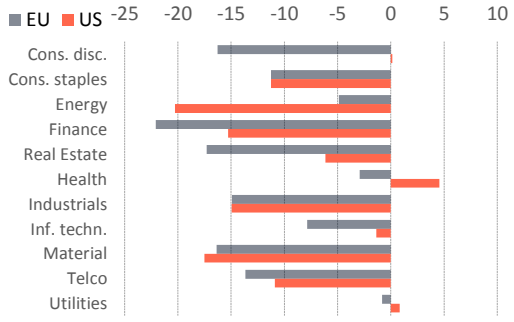


Fig 17: Price-earnings ratios

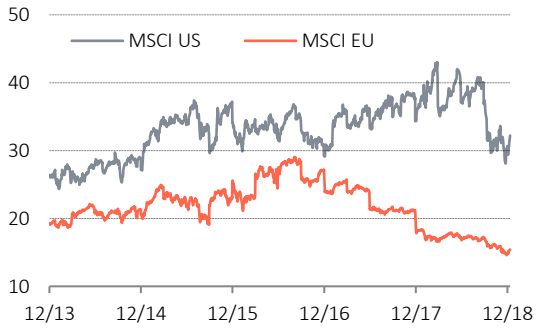
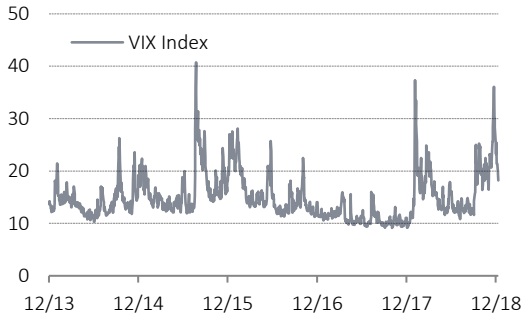


Fig 18: Equity volatility – S&P500 VIX index



ALTERNATIVE INVESTMENTS

Gold bounced back in recent months but remained slightly down compared to the start of 2018. Oil had a terrible month and extended the losses, as the market corrected its assessment regarding scarcer supply. Cyclical commodities, especially industrial metals, came under severe selling pressure and fell 5.1% in December.

Fig. 19: Gold price, USD/oz

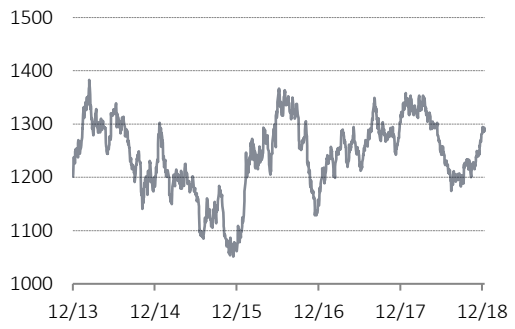


Fig.20: Brent oil price, USD/bl

Fig 21: Bloomberg commodity indices

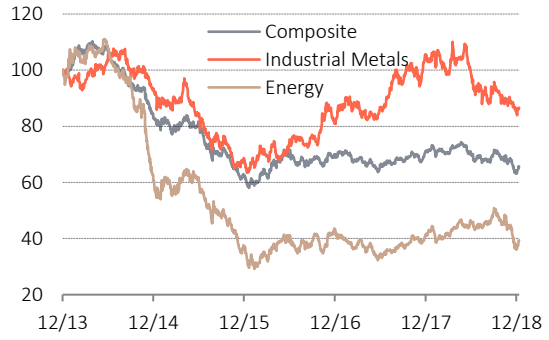


Fig. 22: HFRU hedge fund indices

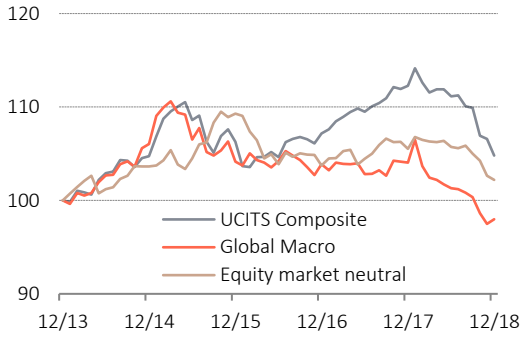
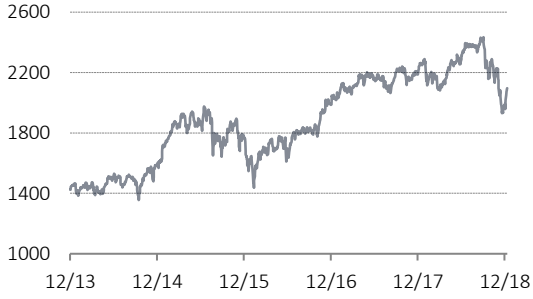


Fig 23: FTSE EPRA/NAREIT global REITS index

Fig 24: LPX global listed private equity



CURRENCIES

The EUR strengthened against the USD in December. Also the CHF appreciated and proved its safe-haven status. Interestingly, many emerging market currencies rose vis-à-vis the USD, e.g., the BRL, MXN, and the CNY. This is inline with the observation that emerging-market assets held up well in December.

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

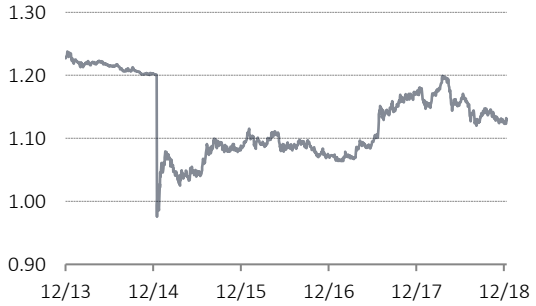
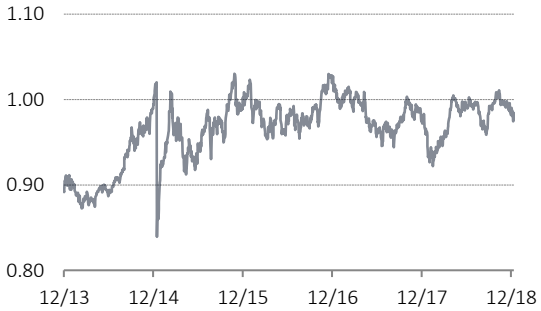


Fig 30: USD-CHF exchange rate



ASSET ALLOCATION

In December risky assets fell significantly. At the same time, safe-haven assets, like government bonds, inflation-linked bonds, investment-grade bonds, and gold, benefited from investors' preference for protection. Emerging market bonds also gained somewhat, despite the described risk-off environment. The EUR gained against the USD and the GBP. Traditional safe-haven currencies, like the JPY and the CHF appreciated vis-à-vis the EUR.

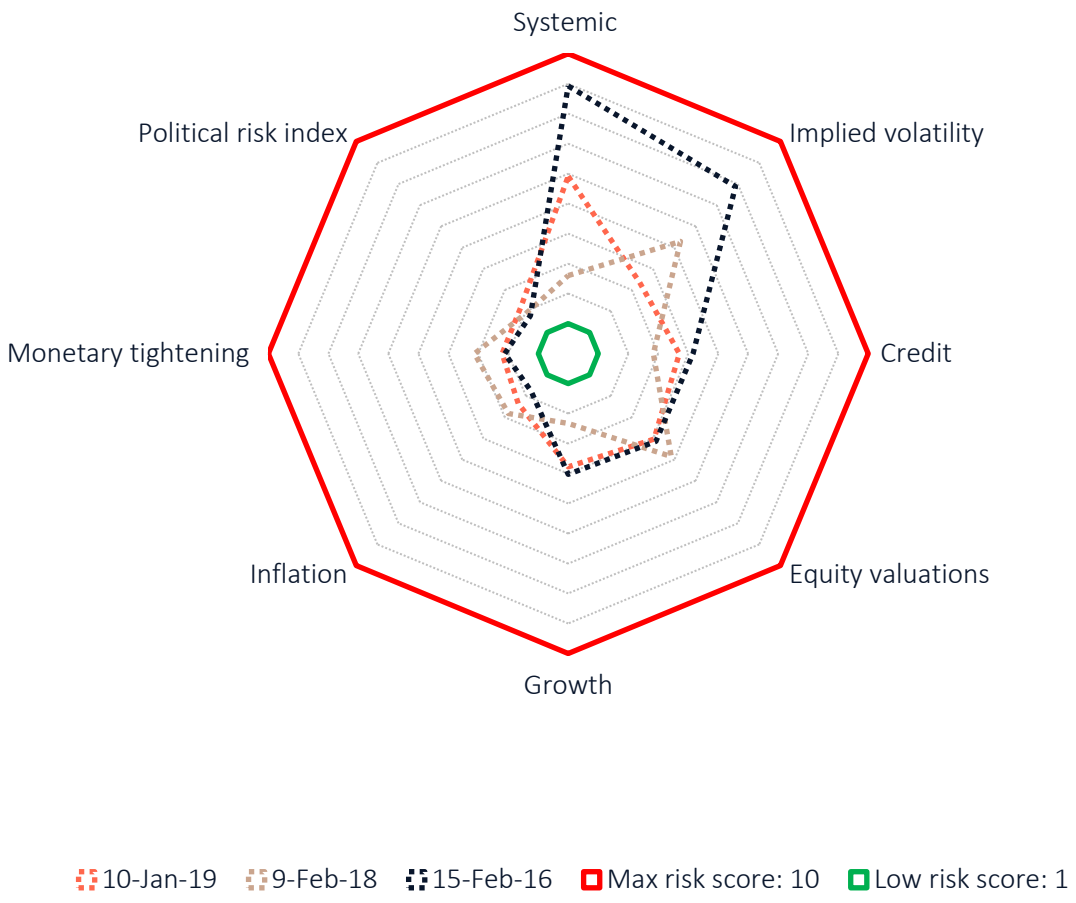
Fig. 31: Performance of major asset classes, based on our EUR portfolio strategy

RISK MONITOR

In December we observed rising risk indicators. In particular, systemic risks (risks related to the stability of the financial sector) rose. In addition, implied volatility and credit risks, i.e., credit spreads, increased. Meanwhile, the market clearly corrected its rate-hike expectations, which lowered monetary tightening risk. Equity valuations fell, driven by lower equity prices and rising corporate earnings.

Fig. 32: IMT Risk Monitor

15 Feb 2016: China growth fears
09 Feb 2018: Inflation fear and technical correction



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