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IMT GROUP

INVESTMENT OUTLOOK 03.2022

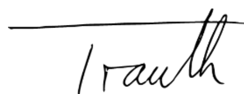
11 March 2022

The war in Ukraine has dominated the news flow and market movements in recent weeks. We are very concerned and deeply saddened by the suffering that has befallen the people of Ukraine.

The West has responded with unprecedented sanctions on Russia, its companies and political and economic elite. The impact on global growth could, however, remain limited as long as, first, the military conflict continues to be contained within Ukraine's borders and, second, Europe maintains its access to Russian gas. Central banks seem to share this view, as many of them have confirmed that they will continue to normalize monetary policy.

Naturally, since the outlook is clouded with uncertainties about how the war will evolve and how the various scenarios will impact the global economy, financial markets have become very volatile in recent weeks.

Overall, we take the view, that the military conflict will not escalate internationally and that the impact on global growth will be limited. As a result, we are largely maintaining our neutral allocation.



Thomas Trauth
CEO – IMT Asset Management AG

THE WAR AND THE WORLD ECONOMY

Financial markets

Global stock markets sold off sharply. In February, after the Russian invasion of Ukraine, European equity markets underperformed, but recently caught up somewhat. Emerging markets outperformed developed markets until the end of February. However, the massive sell-off and the removal of Russia from the emerging-market indices, took its toll. The only equity sector which has performed positively in 2022 so far is energy. Consumer discretionary and technology stocks underperformed.

Rising inflation and central banks, which remained committed to normalizing monetary policy, drove bond yields higher. Since inflation expectations rose more strongly than nominal yields in February, real yields dropped. This came after a strong rise of real yields in January. The risk-off mood resulted in a broad-based credit-spread widening. High-yield bond spreads widened by as much as 140 basis points year-to-date. Fixed-income volatility rose sharply, highlighting the unusual degree of uncertainty in the markets.

Gold as a safe haven asset rallied sharply. In addition, concerns about supply shortages due to the war in Ukraine and international sanctions on Russia resulted in prices for energy, industrial metals, and agricultural commodities going up strongly. Year-to-date prices for energy rose by 44%, for industrial metals by 33% and for agriculture by 23%. Global REITS fell until 23 February and have recovered since then. Listed private equity stocks have fallen by 15% since the beginning of the year.

Safe-haven and commodity currencies rallied. The USD appreciated 4% against the EUR and the EUR-CHF exchange rate fell to parity temporarily. At the same time commodity currencies like the AUD and the NOK strengthened. The Chinese CNY stayed on the strong side and strengthened further against the USD.

The war and the world economy

Many political analysts, and we too, were expecting that Russia would, if it invaded at all, occupy the Eastern provinces of Ukraine. We were surprised and shocked that Russia did not stop in the East but immediately advanced all the way to the capital Kyiv. It seems clear by now that president Putin wants to overthrow the Ukrainian government and to occupy a much larger portion of the Ukraine. The targeted area probably includes all land east of the river Dnepr, including Kyiv.

So far, despite threats by Putin to use nuclear weapons or to attack convoys transporting weapons into Ukraine, there is little evidence that the war will spread beyond Ukraine's borders.

The draconian sanctions imposed by all major Western countries on Russia will have detrimental and lasting effects on the Russian economy.

At the same time the direct effects on the other economies are relatively mild, since exports to Russia, from Europe for example, are not that high as a percentage of GDP. However, certain industries and companies will clearly suffer more than others.

Since buying Russian debt was recently prohibited and Russia is almost certain to default on its debt anyway, European banks as holders of such instruments will have to write down those positions. The ECB has recently conducted stress tests on this. It seems that the risks for the European banking system as a whole are manageable. The banks with the largest Russian risks seem to be Société Générale, UniCredit and Raiffeisen Bank International.

Russian is the third largest oil producer in the world and the second largest oil exporter. It produces 10.5 million barrels per day. The US already banned imports of Russian oil, gas, and coal. The UK decided to phase out its imports from Russia by the end of 2022 and is considering a ban of Russian gas. We expect Saudi Arabia, the UAE and Kuwait to significantly increase their daily oil production volumes in order to curb the sharp rise in oil prices. U.S. President Biden has already held talks with Saudi Arabia's King Salman in this regard. In addition, U.S. shale oil producers could increase their production capacities. In total, these additional oil production volumes would compensate for a part of the Russian shortfalls. Nevertheless, crude oil prices will likely remain above USD 90 per barrel for some time.

The wheat market is also hugely disrupted by the war. Russia is the third and Ukraine the seventh largest wheat producer in the world. As a result, wheat prices rose sharply from USD 800 to USD 1,400, but have fallen back to about ISD 1,090 currently.

The biggest concern, especially for Europe is the market for natural gas. The dependency on Russian gas is very high in Europe and cannot easily be reduced. Europe gets 40% of its gas from Russia. However, import quotas vary widely within the EU, from almost 100% in Bulgaria, 55% in Germany to 0% in Spain and Portugal. Currently, gas storage facilities are sufficient to meet demand through the winter months. A complete stop of gas supply from Russia, would, however, have severe consequences for Europe and most likely send it into a recession.

In the medium-term Europe will increase its use of alternative gas suppliers, especially buying liquefied natural gas from the USA and Qatar. Germany stopped the Nordstream 2 project immediately after the invasion.

In addition, many investors are directly or indirectly invested in Russian assets. Russian stocks and bonds are part of various emerging markets indices, which are replicated by index funds and ETFs. As trading of Russian assets was suspended, all major index providers excluded Russian assets from their indices. We estimate that typical multi-asset class portfolios had Russian exposure in the amount of 0.3-0.5% of the portfolio value.

Macroeconomics

Growth indicators remained very robust in February. Covid-related supply-side restrictions seem to have eased. The US ISM manufacturing index rose to 58.6 after 57.6 and the European PMI fell slightly to 58.2 after 58.7.

At the same time, inflation further accelerated as commodity prices surged. US inflation reached 7.9%, the highest reading since 1982, and Eurozone inflation 5.8%. It is to be expected that the war in the Ukraine will push inflation even higher in the coming months, while the inflation rate is likely to fall thereafter.

US non-farm payrolls rose by 678,000 in February, clearly stronger than expected. At the same time, wages growth was unchanged at 5.1%.

Central banks

At its policy meeting on 10 March, the ECB stated that it regards inflation risks as being higher than growth risks. As a result, but by far not unanimously the ECB communicated its plan to stop net bond purchases in the third quarter. A complete cut-off of the supply of Russian energy to Europe would, however, in all likelihood, make the ECB change its mind. The ECB's current stance makes a rate hike before the end of the year highly likely.

The US Fed is meeting this week on 15-16 March and is widely expected to raise rates by 25 basis points. Furthermore, markets believe that it will follow through with five to six more rate hikes by the end of the year.

The Bank of England raised rates at its last two meeting and is expected to hike rates again at its next policy meeting this week, on 17 March.

Covid-19

The Omicron wave seems to be dying down in many countries. A lot of countries have started to relax their lockdown measures. The speed of the vaccination roll-out increased during the Omicron outbreak but has recently been slowing down. Nevertheless, immunization is clearly increasing, which gives cause for hope that the worst is over and Covid will become less harmful though endemic. However, since the virus readily mutates, the risk remains that new variants will evolve, which may be vaccine evasive or more harmful.

At the same time, China has just recently locked down various cities, including Shenzhen, which is a technology hub. The lockdown is scheduled for six days and could disrupt global supply chains. Among others, Foxconn, a major supplier for Apple, had to stop production.

Outlook

The world has clearly become a more uncertain place. Nevertheless, we think that a very robust economy can withstand the impacts from the current geopolitical crisis.

As many commodity markets are disrupted and commodity prices are likely to stay high, stagflation and recession risks have risen. However, we do not expect a recession to strike in the next 12-18 months. We think that for this to happen, gas supply from Russia would need to stop altogether.

Higher commodity prices are clearly inflationary and will continue to be so for the coming months. However, the major underlying factors for the surge of inflation in 2021 were strong pent-up demand for manufactured goods and certain Covid-related supply side disruptions. This has led to a sharp rise in prices for cars and semiconductors, for example. Some of those effects are still expected to fade out in the coming months.

In our view, oil prices will not stay at the current elevated panic levels. We rather think that finally Saudi Arabia and other oil producers will increase production to make up for the lost Russian oil supply.

The market is anticipating that the Fed will hike rates five to six times this year. We however, think that the slowing of growth, the tightening of monetary conditions, from much wider credit spreads, and subsiding inflation pressure makes it unlikely that the Fed will hike rates so aggressively this year.

So far, we have handled the crisis with a steady hand. We have only slightly reduced our equity exposure in Europe but stayed with a largely neutral equity allocation. Our commodities exposure and our trend-following strategy have performed very strongly and clearly limited the portfolio losses.

ECONOMICS

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Fig. 1: PMIs

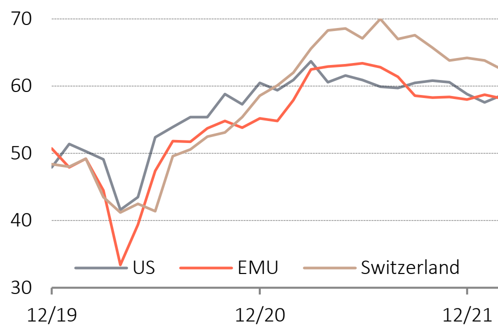


Fig. 2: PMIs

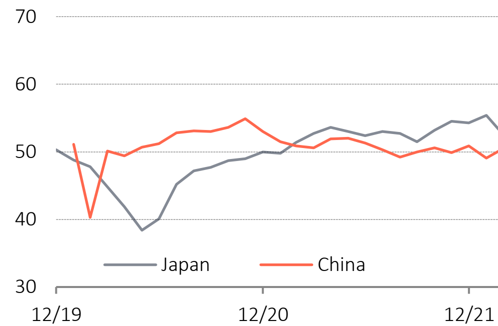


Fig 3: Consumer price inflation, in % YoY

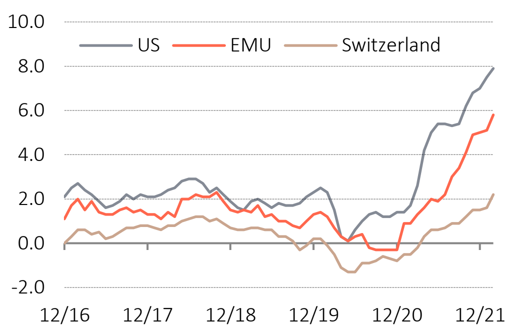


Fig. 4: Consumer price inflation, in % YoY

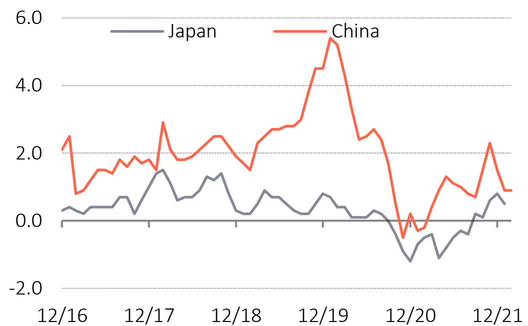


Fig 5: Unemployment rates, in %

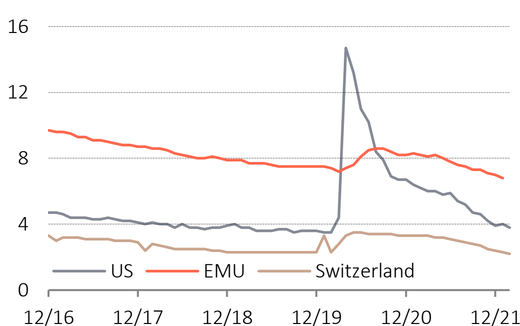
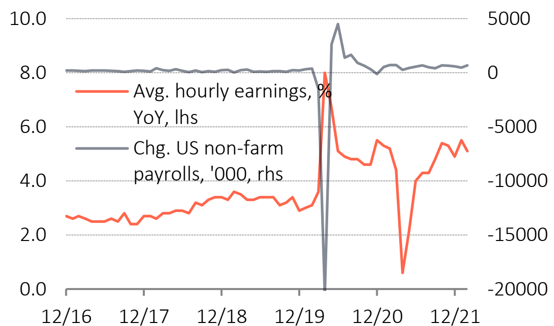


Fig 6: US labor market



FIXED INCOME

Rising inflation and central banks remaining committed to normalizing monetary policy drove bond yields higher. Since inflation expectations rose more sharply than nominal yields in February, real yields dropped. This came after a strong rise of real yields in January.

The risk-off mood resulted in a broad-based credit-spread widening. High-yield bond spreads widened by as much as 140 basis points year-to-date. Fixed-income volatility rose sharply, highlighting the unusual degree of uncertainty in the markets.

Fig.7: 2Y government bond yields

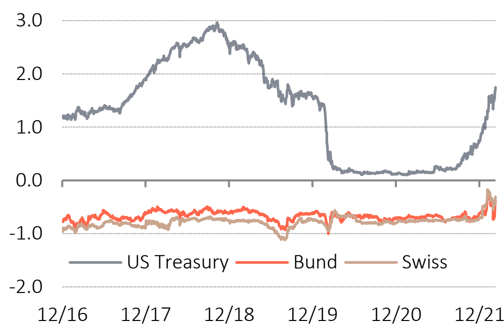


Fig. 8: 10Y government bond yields

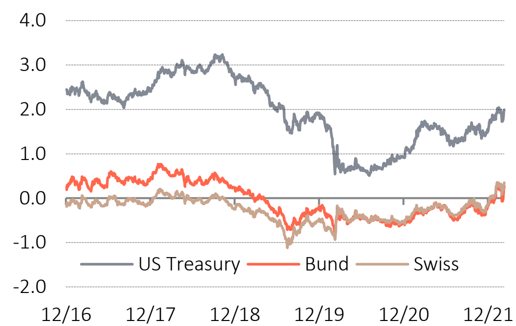


Fig 9: 10Y break-even inflation

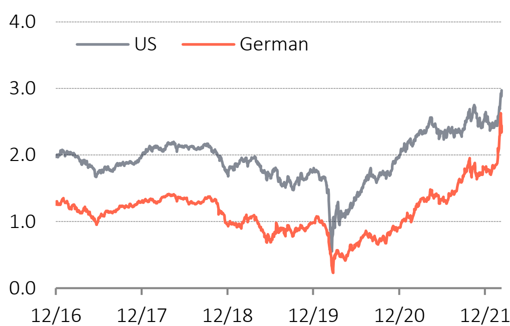


Fig. 10: Credit spreads, 5Y credit default swaps

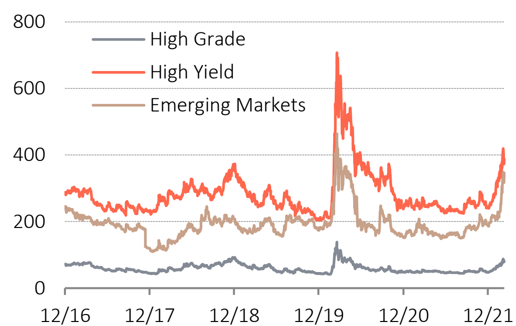


Fig 11: Money market spreads (3M-2Y)

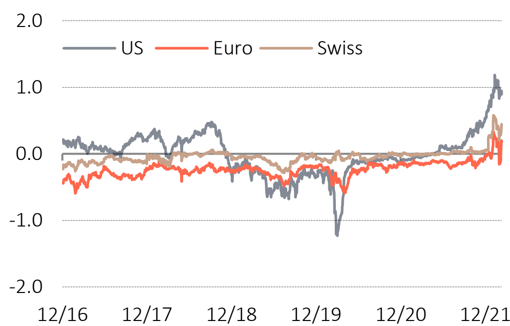
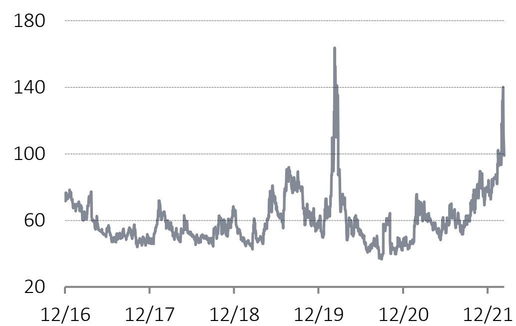


Fig 12: Merrill Lynch volatility index (MOVE)



EQUITIES

Global stock markets sold off sharply. In February, after the Russian invasion of Ukraine, European equity markets underperformed, but recently caught up somewhat. Emerging markets outperformed developed markets until the end of February. However, the massive sell-off and the removal of Russia from the emerging market indices, took its toll. The only equity sector which has performed positively in 2022 so far is energy. Consumer discretionary and technology stocks underperformed.

Fig. 13: MSCI equity indices – major regions

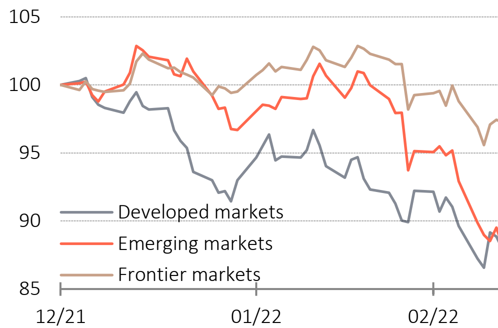


Fig.14: Equity indices – major developed markets

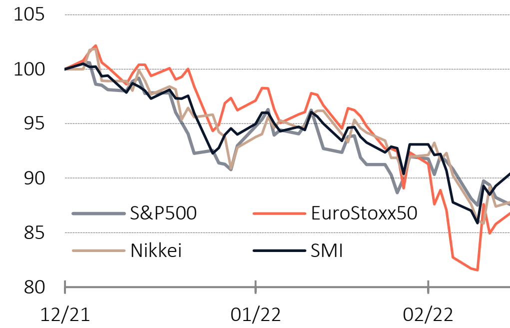


Fig 15: Equity indices – major emerging markets

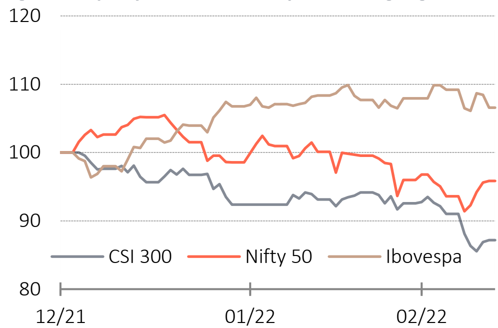


Fig. 16: Sector performance, MSCI Europe, YTD

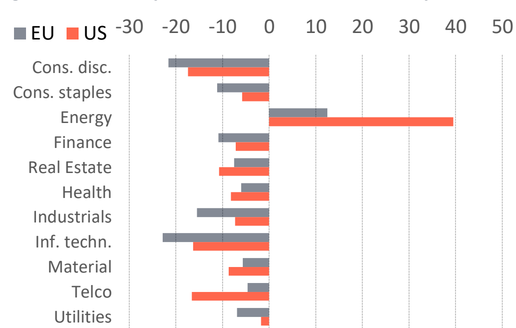


Fig 17: Price-earnings ratios

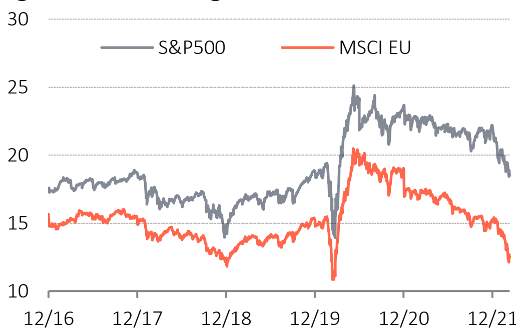
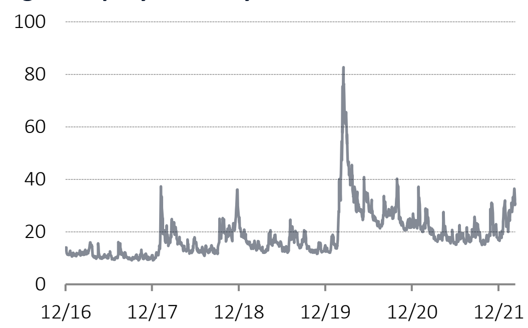


Fig 18: Equity volatility – S&P500 VIX index



ALTERNATIVE INVESTMENTS

Gold as a safe-haven asset rallied sharply. In addition, concerns about supply shortages due to the war in Ukraine and international sanctions on Russia have resulted in prices for energy, industrial metals, and agricultural commodities going up strongly. Year-to-date prices for energy rose by 44%, for industrial metals by 33% and for agriculture by 23%. Global REITS fell until 23 February but have recovered since then. Listed private equity stocks have fallen by 15% since the beginning of the year.

Fig. 19: Gold price, USD/oz

Fig.20: Brent oil price, USD/bl

Fig 21: Bloomberg commodity indices

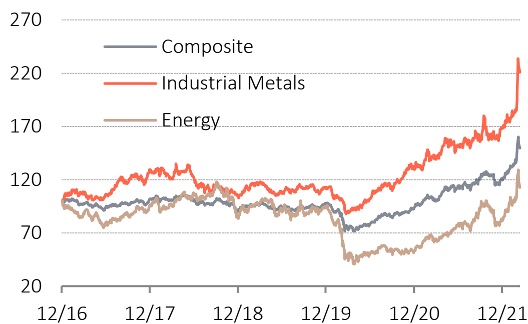


Fig. 22: HFRU hedge fund indices

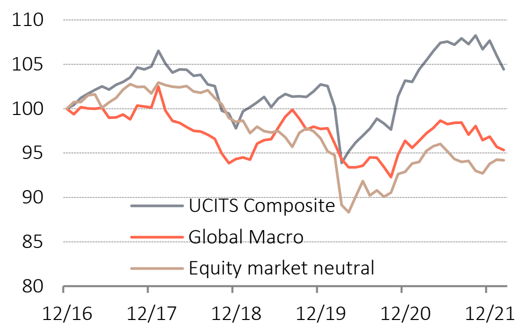


Fig 23: FTSE EPRA/NAREIT global REITS index

Fig 24: LPX global listed private equity

CURRENCIES

Safe-haven and commodity currencies rallied. The USD appreciated 4% against the EUR and the EUR-CHF exchange rate fell to parity temporarily. At the same time commodity currencies, like the AUD and the NOK strengthened. The Chinese CNY stayed on the strong side and strengthened further against 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

COVID-19

The Omicron wave seems to be dying down in many countries. A lot of countries have started to relax their lockdown measures. The speed of the vaccination roll-out increased during the Omicron outbreak but has recently been slowing down. Nevertheless, immunization is clearly increasing, which gives cause for hope that the worst is over and Covid will become less harmful though endemic. Nevertheless, since the virus readily mutates, the risk remains that new variants will evolve, which may be vaccine evasive or more harmful.

Fig. 31: Total Covid-19 cases (x 1000)

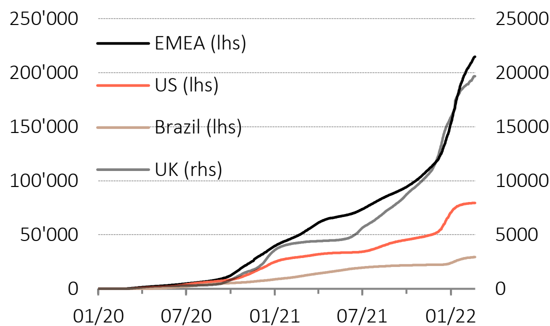


Fig. 32: New cases per day (7-day average)

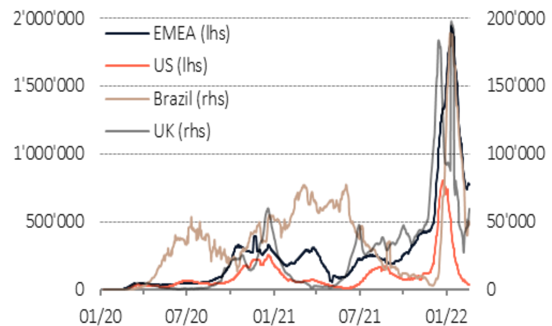


Fig 33: Vaccination rate
(% of the population fully vaccinated)

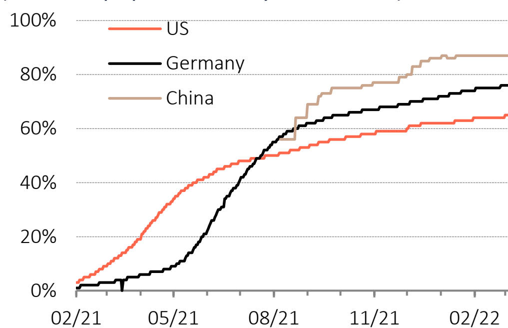


Fig.34: Central bank total assets (indexed)

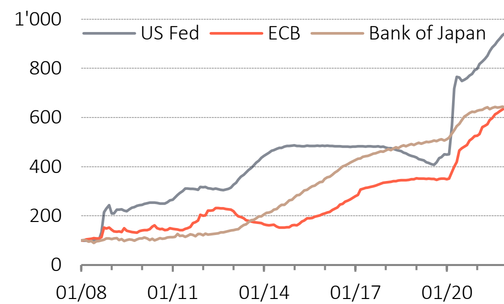
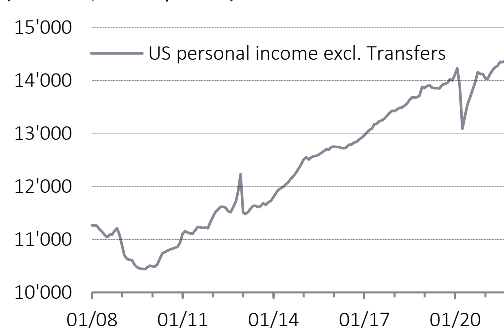


Fig 35: US bankruptcy index

Fig 36: US personal income, excl. transfers
(USD bn, 2012 prices)



ASSET ALLOCATION

The year started with a broad-based sell off. Risky assets fell due to the war in Ukraine and more hawkish central banks. Also government bonds sold off, as the safe-haven aspect of this asset class was more than outweighed by rate-hike expectations and surging inflation. Inflation-linked bonds, however, recovered somewhat after a sharp sell-off in January. The dividend aristocrats' stocks clearly outperformed. Commodity prices sharply rose, driven by obvious supply shortages from Russia and Ukraine. Safe-haven and commodity currencies appreciated.

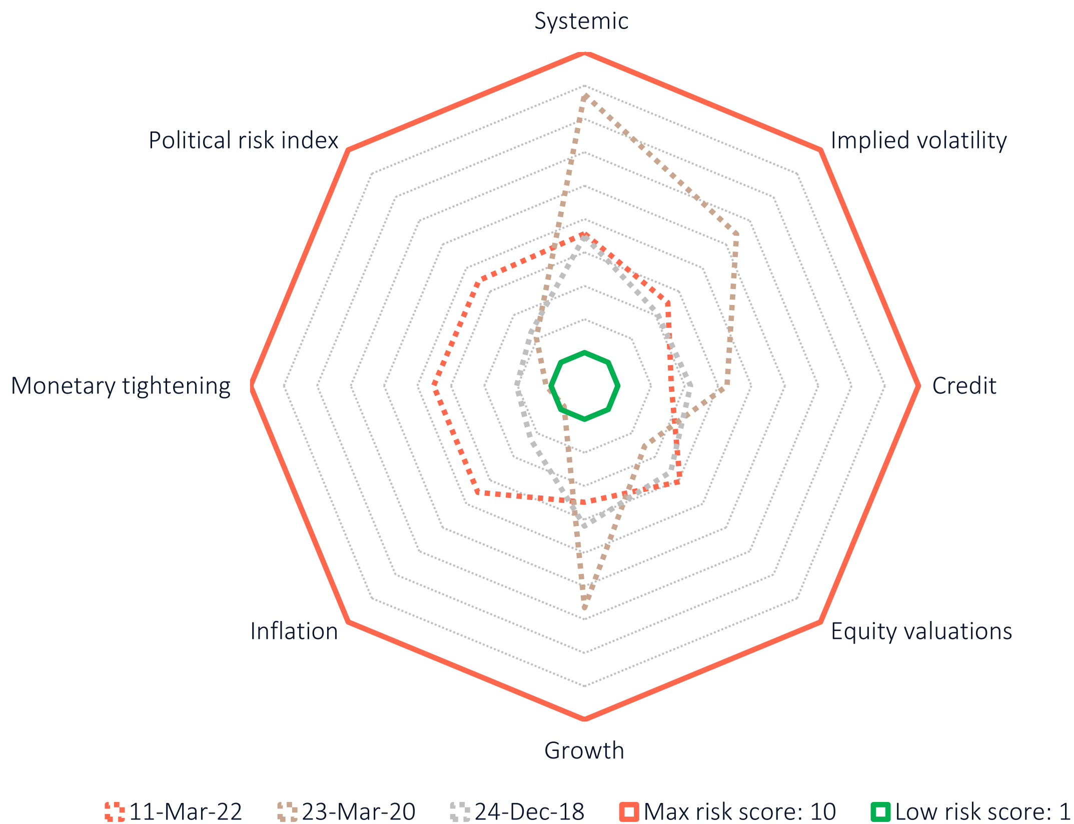
Fig. 37: Performance of major asset classes, based on our EUR portfolio strategy

RISK MONITOR

Geopolitical, monetary tightening and inflation risks took center stage. Also, implied volatility (option prices) increased clearly, though less than in other crises. Equity valuations fell slightly.

Fig. 38: IMT Risk Monitor

23-Mar-2020: Global pandemic
24 Dec 2018: Growth and monetary tightening fears



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Source for all graphs: IMT Asset Management AG, Bloomberg, Real Clear Politics, for Fig 36 Statista (de.statista.com), for Fig. 38, the political risk index: "Measuring Geopolitical Risk" by Dario Caldara and Matteo Iacoviello at https://matteoiacoviello.com/gpr.htm.