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6 September 2022

After bond and equity markets rebounded in July, recession and inflation fears, coupled with hawkish central banks and a European energy crisis, sent markets tumbling again.

Meanwhile, geopolitical tensions remained high. China was extremely annoyed by the visit to Taiwan of US House Speaker Nancy Pelosi and reacted with military maneuvers around the island. Just recently the US announced an arms sale to Taiwan to the tune of USD 1.1 bn.

The G7 and Europe are discussing means to cap energy prices, potentially including Russian oil. Meanwhile, Russia decided to shut the North Stream gas pipeline to Europe until Western sanctions against Russia are lifted.

We remain cautious and will take profit if the proportion of risky assets exceeds our tactical targets. We are overweight in defensive stocks – the dividend aristocrats – and underweight in European equities. Furthermore, we have gone underweight in commodities.

Trauth

Thomas Trauth
CEO – IMT Asset Management AG

ENERGY CRISIS

Financial markets

In August the US S&P500 fell by 4.2%, the MSCI Europe by 5.2%, while the MSCI Emerging Markets index was flat. The Brazilian Bovespa index performed especially strongly, rising 6.2%. The Nikkei225 index was up by 1%, helped by a weakening JPY. The Chinese CSI300 index lost 2.2%. The only equity sector which has performed positively this year is the energy sector.

After bond yields dropped in July, a hawkish stance by central banks caused yields to rise strongly in August. European 10-year yields reached almost 1.6% and US 10-year yields 3.3%. In July and August inflation expectations, as measured by 10-year break-even rates, rose again after having fallen in May and June. Long-term inflation expectations, however, remain in a range between 2% and 3%, implying that long-term inflation is expected to revert to more normal levels. The risk-off environment in August drove credit spreads sharply higher

The broad commodity index was about flat in August. While elevated natural gas and electricity prices remain a major concern in Europe, the price of crude oil for example fell by 12% in the month. Prices for industrial metals also declined, due to a weakening demand from China. The price of gold fell 3%, in line with most other precious metals. REITS lost 5.4%. Crypto assets could not sustain their rebound in July and softened in August. Bitcoin lost 15% and Ethereum 6%.

The USD continued to rally, as the US economy looks more robust than those of Europe and China. The USD is further supported by the increasing US yield advantage. After the SNB surprised markets and hiked rates by 50 basis points, the CHF strengthened strongly. The GBP fell 4.5% against the USD, which was the biggest drop since the Brexit referendum. The economic outlook for the UK is dire, with inflation reaching 10.1% in August and most likely rising further. In order to fight CNY weakness, the People's Bank of China (PBOC) cut the forex reserve ratio from 8% to 6% in order to boost the supply of foreign currencies.

Macroeconomics

Most PMIs continued to fall. While the US manufacturing ISM came in unchanged at 52.8, and thus remained above 50, the European PMI fell to 49.6 after 49.8. PMI values below 50 indicate a contracting economy. Eurozone inflation rose to 9.1% and the core CPI went above 4%.

US non-farm payrolls increased by 315,000, slightly above expectations. Nevertheless, the unemployment rate climbed by 0.2%-points to 3.7%. This was due to a rise of the labor force participation rate, which climbed to 62.4% but remained below pre-pandemic levels. The increase of the labor participation rate is good news for the inflation outlook, as it could dent wage growth. This was also confirmed by the slowing momentum of average hourly earnings. In August the increase was only 0.3% after 0.5% in the prior month. The year-on-year increase remained unchanged at 5.2%.

Meanwhile, geopolitical tensions remained high. China was extremely annoyed by the visit to Taiwan of US House Speaker Nancy Pelosi and reacted with military maneuvers around the island. Just recently, the US announced an arms sale to Taiwan to the tune of USD 1.1 bn.

Energy crisis

Putin's decision to indefinitely suspend gas delivery via the Nord Stream pipeline further squeezes Europe's energy supply. The move came hours after the G7 countries announced their intention to cap prices for Russian oil exports. Gas supply shortages will be very inflationary in Europe, will reduce the purchasing power of households, will threaten energy-dependent industries, and will push Europe into a recession. If the situation is well managed politically, a deep recession might be averted.

European gas storage increased in recent months, reaching 82%. Obviously, further attempts need to be made to substitute Russian gas by liquified natural gas (LNG) from other sources, and to increase nuclear- and coal-based energy production. Furthermore, measures to reduce energy consumption are needed.

The EU is discussing further action to be taken, including a windfall tax on inflated profits of energy companies. The tax revenues are intended help provide financial support for households and those industries which suffer most from rising energy costs.

The EU is also discussing the price-setting mechanism for electricity. The electricity price is set according to the merit order principal, in other words according to the marginal cost of producing energy. Electricity producers are ranked in the order of their marginal cost of producing electricity. As a result of certain supply shortages, elevated gas prices have increasingly determined the price of electricity. The EU is trying to find alternative price-setting rules. However, such interventions in a functioning market may generate other costs and need careful consideration.

The energy crisis may lead the EU to reconsider its energy policy. So far, Europe has been hasty in shutting down traditional energy sources but slow in building the necessary infrastructure to produce renewable energy. It is absolutely necessary to accelerate the expansion of the necessary infrastructure for renewable energies. Furthermore, the EU needs to remove massive bureaucratic obstacles which considerably slow down the energy transition.

European natural gas price, EUR/MWh

Central banks

In his speech on 26 August at the Jackson Hole central bankers conference, Fed Chairman Jay Powell was very explicit about the future path of the Fed's policy. He clearly stated that the Fed's major objective was to fight inflation, and that this would require higher rates, and such higher rates for a long period. He said the Fed was aware that this would bring some pain to households and businesses, but that the Fed would require clear signs to be confident that its job was being done. After the Jackson Hole meeting, equity markets fell further and bond yields continued to climb.

The ECB's next policy meeting is on 8 September. On the back of numerous hawkish comments by ECB board members, it is expected that the ECB will deliver a rate hike of up to 75 basis points. The ECB's rhetoric has clearly shifted from growth concerns towards inflation concerns and the necessity to fight a further acceleration of inflation. The call for a decisive rate hike is also supported by a pronounced EUR weakness, which is inflationary, and a eurozone jobless rate which fell to a new low of 6.6%.

Covid-19

After new Covid cases surged in July, the numbers clearly declined thereafter. Omicron remains the major virus variant and continues to be less harmful than other variants. As a result, most European countries abolished lockdown measures.

The situation in China, however, is very different. Just recently, the city of Shenzhen announced the introduction of stricter lockdown measures and mass testing. It is believed that currently 33 Chinese cities are imposing lockdown measures.

Globally 12.6 bn doses of vaccine have been administered. 5.3 bn people have received at least one dose, and 4.9 bn people – 63% of the global population – are fully vaccinated.

Outlook

We expect further headwinds for financial markets as central banks tighten monetary conditions and stay focused on the fight against inflation. The energy crisis and geopolitical tensions will remain a concern for investors.

However, we also expect inflation to moderate in the coming months since commodity prices may have peaked, transport costs are already falling, and supply- chain constraints are loosening. While the US and Europe are sliding into a recession, it may prove to be mild, at least in the US. Since uncertainties remain very high and equity markets could move in either direction, we remain with a neutral equity allocation. However, we are underweight in European equities since Europe looks most vulnerable and overweight in high-dividend quality stocks.

Interest rates and bond yields may continue to rise. Since we strategically reduced interest-rate risks in our portfolios, we remain overall neutral in bonds.

We entered an underweight position in commodities as we think that commodity prices in general are very elevated. China’s demand for industrial metals remains sluggish and oil prices are currently under pressure as growth slows.

ECONOMICS

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Fig. 1: PMIs

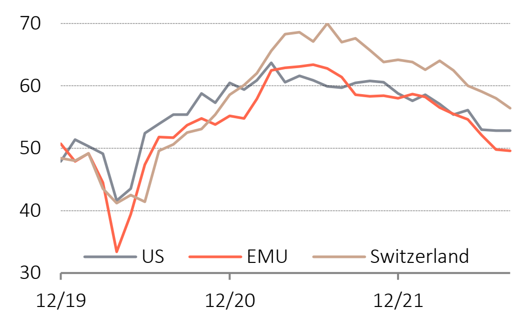


Fig. 2: PMIs

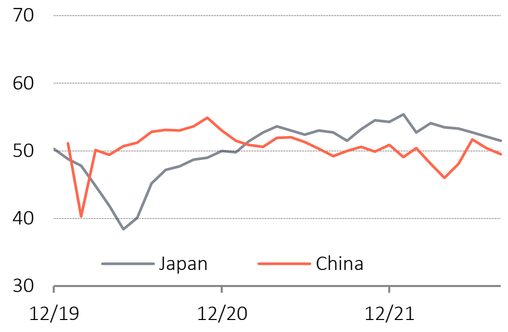


Fig 3: Consumer price inflation, in % YoY

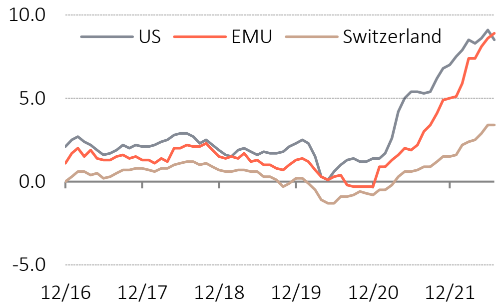


Fig. 4: Consumer price inflation, in % YoY

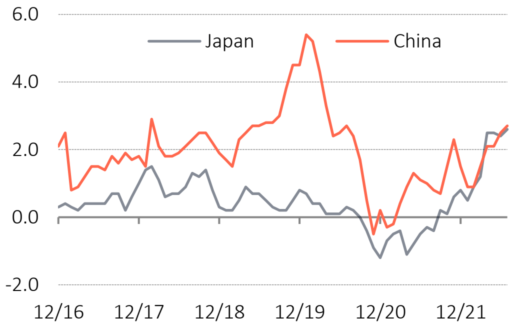


Fig 5: Unemployment rates, in %

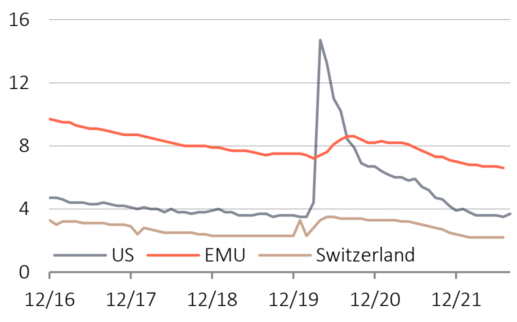
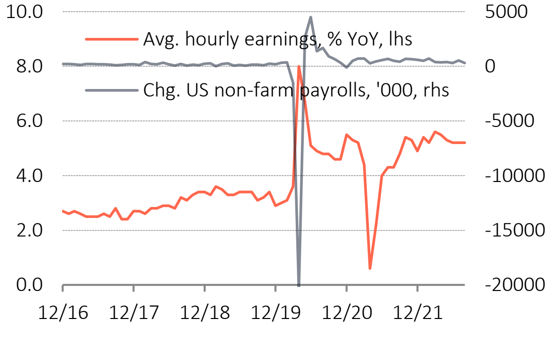


Fig 6: US labor market



FIXED INCOME

After bond yields dropped in July, a hawkish stance by central banks caused yields to rise strongly in August. European 10-year yields reached almost 1.6% and US 10-year yields 3.3%. In July and August inflation expectations, as measured by 10-year break-even rates, rose again, after having fallen in May and June. Long-term inflation expectations, however, remain in a range between 2% and 3%, implying that long-term inflation is expected to revert to more normal levels. The risk-off environment in August drove credit spreads sharply higher.

Fig.7: 2Y government bond yields

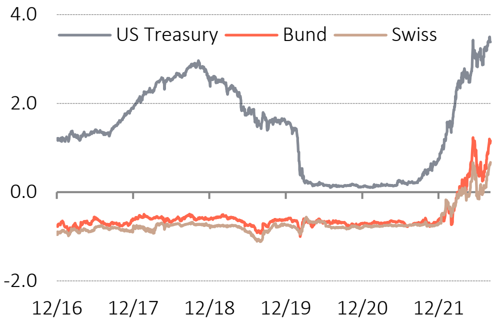


Fig. 8: 10Y government bond yields

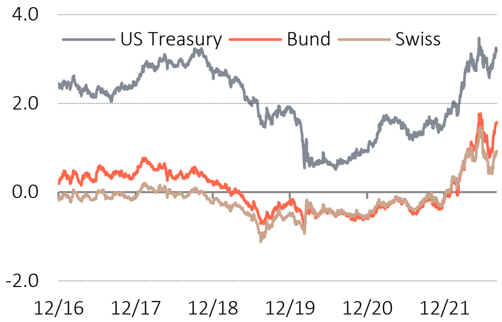


Fig 9: 10Y break-even inflation

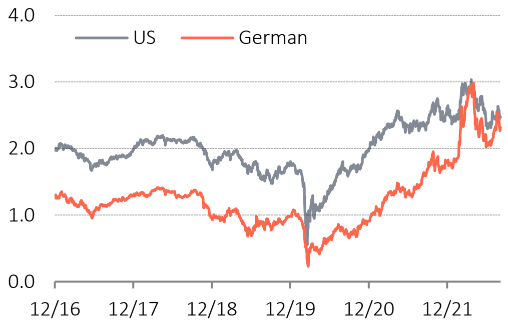


Fig. 10: Credit spreads, 5Y credit default swaps

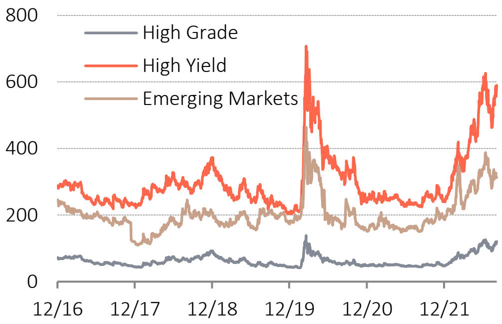


Fig 11: Money market spreads (O/N-2Y)

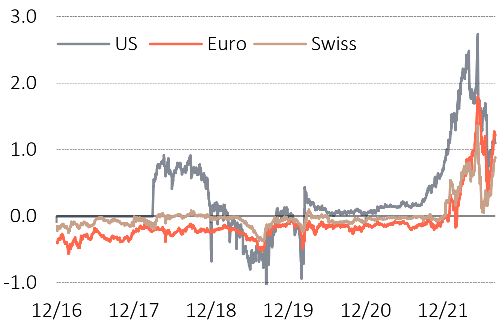
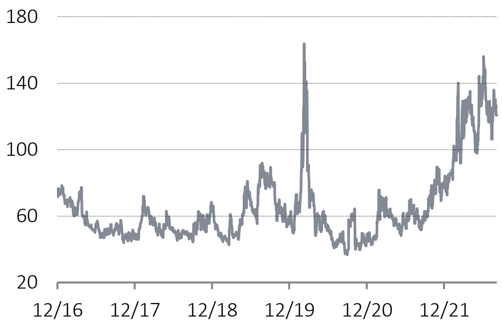


Fig 12: Merrill Lynch volatility index (MOVE)



EQUITIES

In August the US S&P500 fell by 4.2%, the MSCI Europe by 5.2%, while the MSCI Emerging Markets index was flat. The Brazilian Bovespa index performed especially strongly, rising 6.2%. The Nikkei225 index was up by 1%, helped by a weakening JPY. The Chinese CSI300 index lost 2.2%. The only equity sector which has performed positively this year is the energy sector.

Fig. 13: MSCI equity indices – major regions

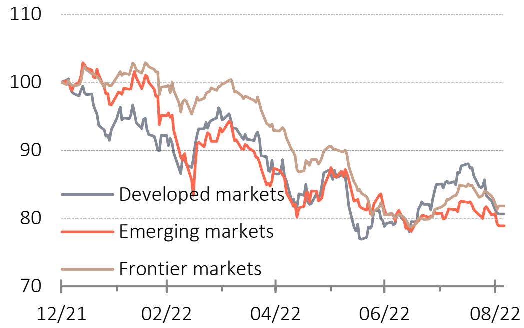


Fig.14: Equity indices – major developed markets

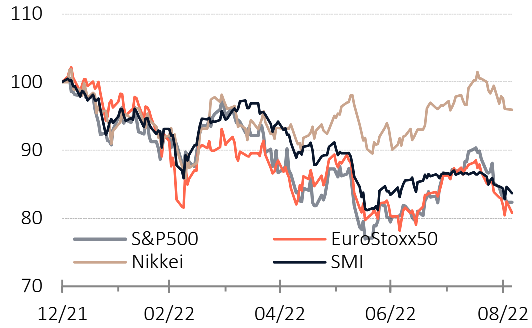


Fig 15: Equity indices – major emerging markets

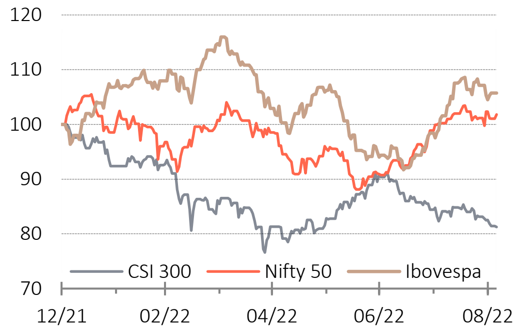


Fig. 16: Sector performance, MSCI Europe, YTD

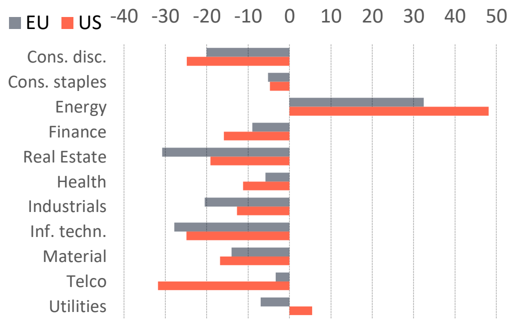


Fig 17: Price-earnings ratios

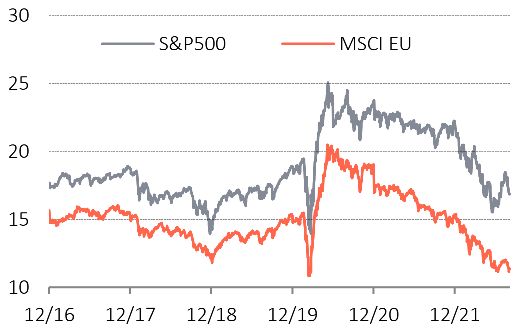
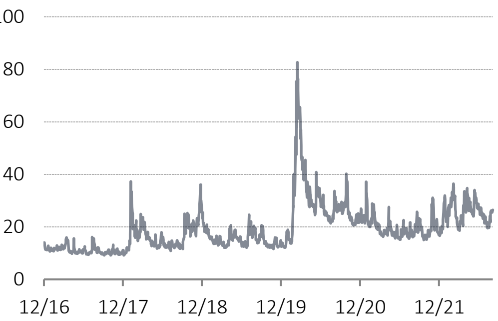


Fig 18: Equity volatility – S&P500 VIX index



ALTERNATIVE INVESTMENTS

The broad commodity index was about flat in August. While elevated natural gas and electricity prices remain a major concern in Europe, the price of crude oil for example fell 12% in August. Prices for industrial metals also declined, due to a weakening demand from China. The price of gold fell 3%, in line with most other precious metals. REITS lost 5.4%. Crypto assets could not sustain their rebound in July and softened in August. Bitcoin lost 15% and Ethereum 6%.

Fig. 19: Gold price, USD/oz

Fig.20: Brent oil price, USD/bl

Fig 21: Bloomberg commodity indices

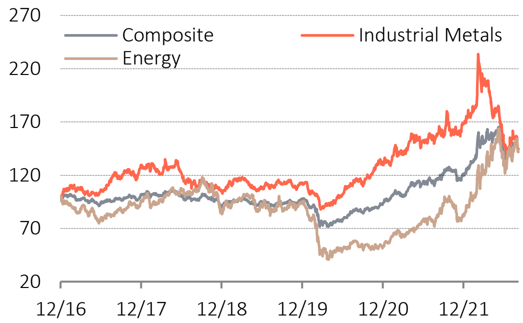


Fig. 22: HFRU hedge fund indices

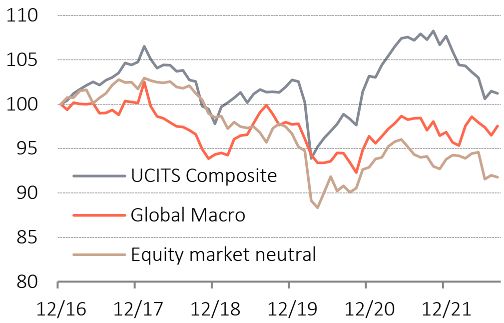
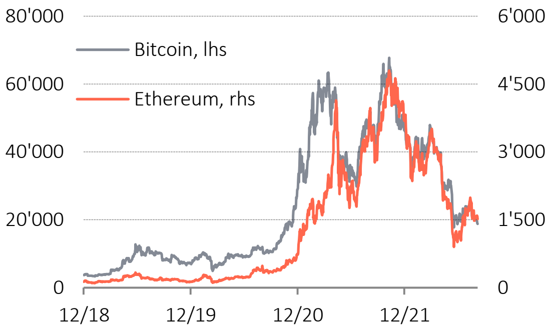


Fig 23: FTSE EPRA/NAREIT global REITS index

Fig 24: Crypto Assets



CURRENCIES

The USD continued to rally, as the US economy looks more robust than those of Europe and China. The USD is further supported by the increasing US yield advantage. After the SNB surprised markets and hiked rates by 50 basis points, the CHF strengthened strongly. The GBP fell 4.5% against the USD, which was the biggest drop since the Brexit referendum. The economic outlook for the UK is dire, with inflation reaching 10.1% in August. In order to fight CNY weakness, the PBOC cut the forex reserve ratio from 8% to 6% in order to boost the supply of foreign currencies.

Fig. 25: EUR-USD exchange rate

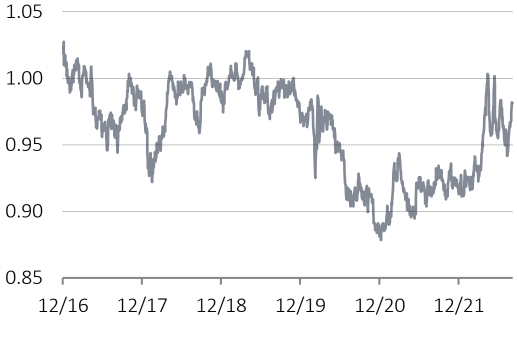
Fig. 26: GBP-USD exchange rate

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

After new Covid cases surged in July, the numbers clearly declined thereafter. Omicron remains the major virus variant and continues to be less harmful than other variants. As a result, most European countries abolished lockdown measures. The situation in China is very different. Just recently, the city of Shenzhen announced the introduction of stricter lockdown measures and mass testing. It is believed that currently 33 Chinese cities are imposing lockdown measures. Globally 12.6 bn doses of vaccine have been administered. 5.3 bn people have received at least one dose.

Fig. 31: Total Covid-19 cases (m)

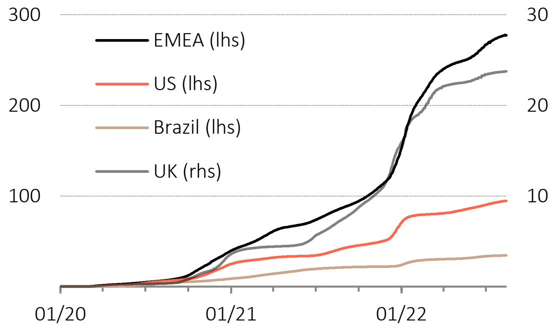


Fig. 32: New cases per day (7-day average x 1’000)

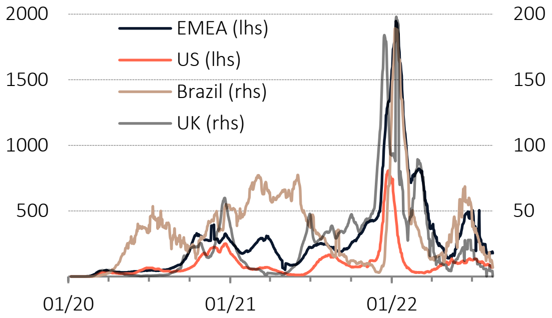


Fig 33: Vaccination rate
(% of the population fully vaccinated)

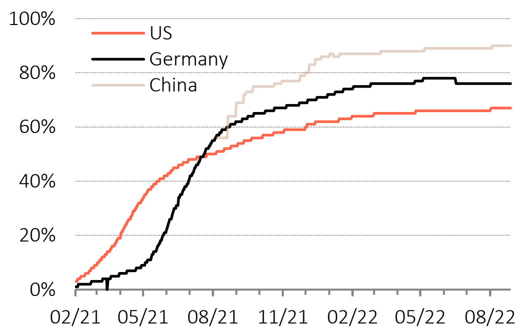


Fig.34: Central bank total assets (indexed)

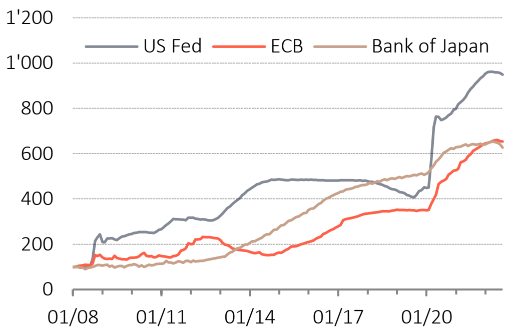
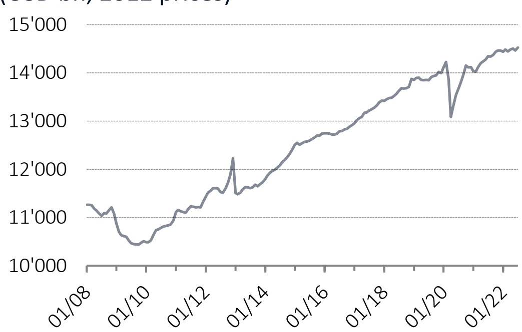


Fig 35: US bankruptcy index

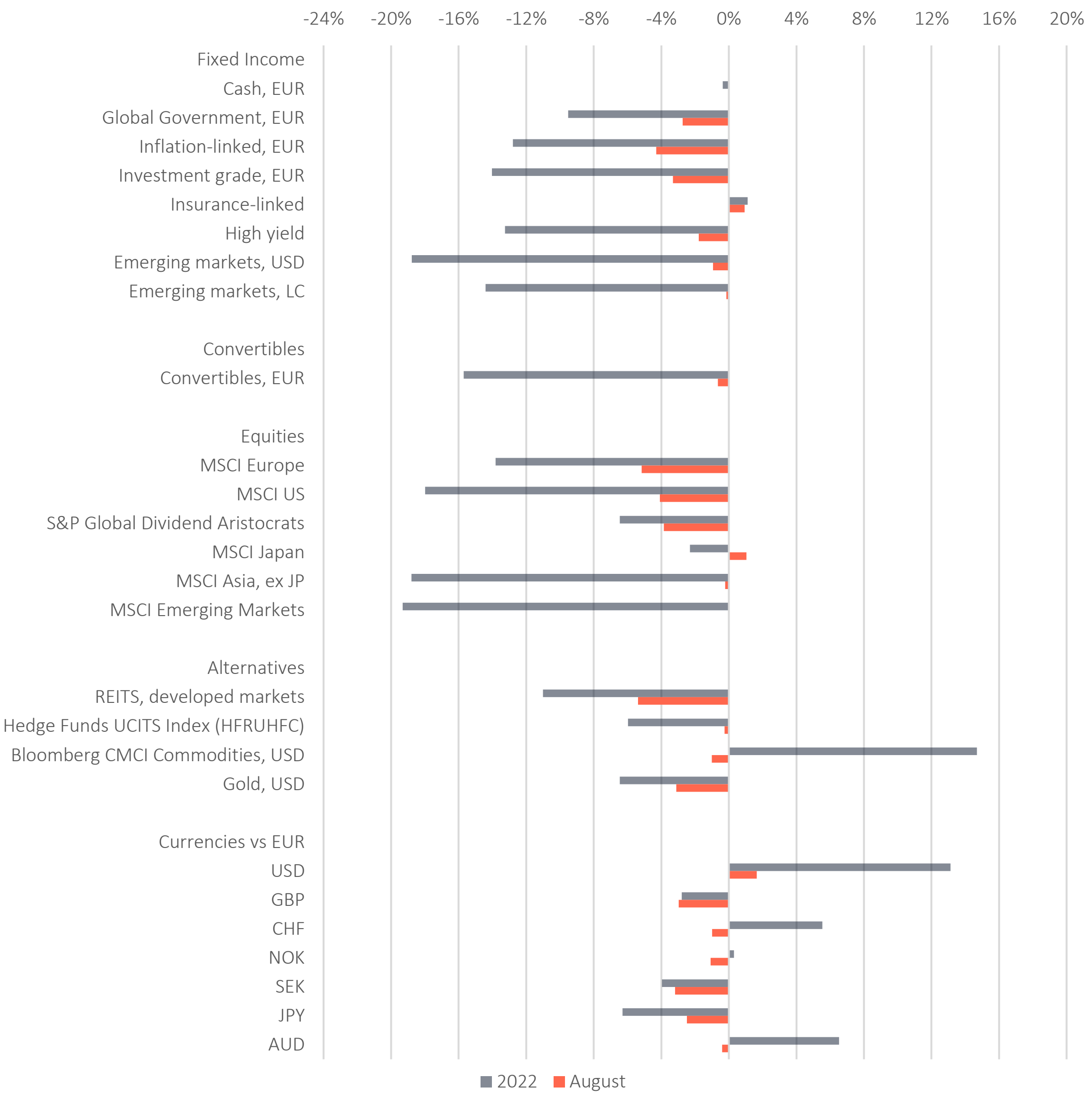
Fig 36: US personal income, excl. transfers
(USD bn, 2012 prices)



ASSET ALLOCATION

August was a difficult month for most asset classes. In general, bond and equity markets sold off, with the exception of insurance-linked bonds and Japanese equities. Underperforming asset classes were inflation-linked bonds, European and US equities, and REITS. The EUR strengthened against most currencies, with the exception of the USD.

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

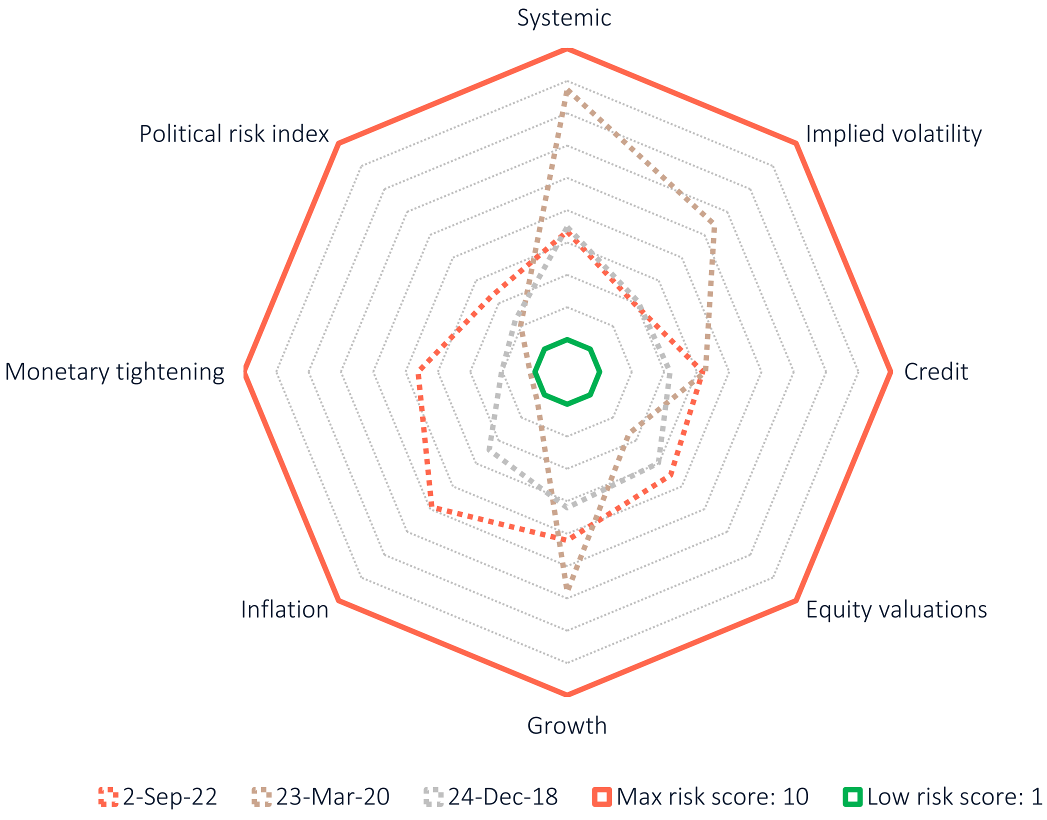


RISK MONITOR

Inflation, growth and monetary tightening risks dominate the risk landscape. Meanwhile, implied volatilities, especially in equity markets, remain relatively muted.

Fig. 38: IMT Risk Monitor

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



DISCLAIMER

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.