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In the third quarter bond yields jumped and equity markets fell. It seems that market participants finally accepted what central banks have been saying for quite a while, that interest rates will be higher for rather a long time.

Meanwhile global growth continued to slow, with the exception of the US economy, which remained very robust. OPEC+ kept oil supply tightly controlled, which led to a strong rally with the oil price reaching almost USD 94. Just as the oil market cooled down a little in the first half of October, Hamas attacked Israel, which triggered another surge in the oil price. As a result of higher energy and housing prices US inflation started to rise again and remains stubbornly above the Fed's target of 2%.

We continue to expect a US recession in the next 12 months. Furthermore, we are concerned about geo-political tensions and a possible US government shut-down. As a result, we remain underweight in equities, REITs, high yield bonds, and commodities. Conversely, we are overweight in government bonds and insurance-linked bonds, as well as liquidity.

Trauth

Thomas Trauth
CEO – IMT Asset Management AG

HIGHER FOR LONGER

Financial markets

In the third quarter bond yields rose significantly. Market participants seem to finally accept that central bankers are serious about keeping interest rates high for quite a long time to come. US 10-year government bond yields, for example, rose from 3.6% to 4.8%. European 10-year yields almost reached 3%. Since break-even inflation rates (inflation expectations) remained almost unchanged, real yields increased as well. The decreasing risk appetite caused high-yield spreads to widen by about 50 basis points in the third quarter.

On the back of weaker economic data, rising energy prices, and a sharp increase of yields, equity markets sold off in the third quarter, especially in August and September. The S&P500 index fell by 3.6%, the MSCI Europe by 2.5%, and the MSCI Emerging Markets by 3.7%. Year-to-date the Japanese Nikkei index outperformed, advancing by almost 22%, driven by a sharp depreciation of the JPY. Equity performance this year has been best in the technology and the consumer discretionary sector.

Despite the risk-off environment in the third quarter, the gold price fell by 3.7%. Meanwhile, the decision of OPEC+ to keep supply restricted led to a surge in oil prices, which climbed from USD 70 to a peak of almost USD 94 by end of September. The global REITS index fell by 3.7% as higher interest rates are weighing on the earnings outlook. Crypto assets had a negative quarter. Bitcoin fell almost 11% and Ether almost 13%.

The USD strengthened in Q3. The EUR-USD exchange rate peaked in early July at about 1.12 and fell thereafter to 1.05. The USD is supported by the yield advantage, relatively stronger economic growth and by its safe-haven characteristic. The CHF also remained on the strong side. The JYP continued to weaken since the Bank of Japan retained its ultra-expansionary monetary policy stance. The Chinese CNY weakened on the back of sluggish economic growth.

Macroeconomics

Leading growth indicators have weakened globally. Most manufacturing PMIs are below 50, indicating an economic contraction. The European service sector has likewise started to contract recently. US leading indicators have held up somewhat better. The recent US labor market report showed continued job growth. US non-farm payrolls were at 336,000 in September. However, interest rates have risen to levels last seen 15 years ago, which eventually will slow US economic activity. US inflation was 3.7% in September, up from 3.0% in June and EMU inflation was still at 4.3% in September.

On October 7, the Palestinian Islamist group Hamas launched a surprise attack on Israel, by far the biggest attack for many years, incurring a vast number of casualties and strong retaliatory measures by Israel. Further intensive use of armed force is to be expected. In our base scenario, we think that the conflict can be contained to Gaza and Israel. At the same time, there is a heightened risk that the conflict may expand to include the Lebanon-based Hezbollah and other militant Syria-based groups. In the worst case, it could come to military operations including Iran or Iraq. The oil price rose after the Hamas attack. Escalating tensions could drive oil prices much higher, which would create strong headwinds for an already weak global economy and drive inflation higher again.

Central banks

The US Fed raised rates by 25 basis points in July, lifting the target policy rate to 5-25-5.5%. At its September meeting the Fed put hikes on pause but indicated that it would be prepared to raise rates again before the end of 2023, if the inflation outlook should warrant it.

The ECB raised rates by 25 basis points at each of its meetings in July and September. In turn, the policy rate reached 4%, the highest level since the introduction of the EUR in 1999. The ECB made it clear that though inflation is falling, it remains much too high and that the ECB is prepared to keep rates at restrictive levels for as long as necessary.

As mentioned above it seems that finally markets accepted the US Fed's statements to the effect that rates are likely to stay high for quite a long time. US 2-year yields, which reflect expected Fed rate hikes and cuts, surged from 3.8% in May to 5.1% by end of September.

Outlook

Inflation is likely to persist above the central banks' targets for a significant period. In line with this view US inflation went up again between June and September, from 2.9% to 3.7%. The central banks have made it abundantly clear that they are giving top priority to the fight against inflation. From our point of view, therefore, no interest rate reductions can be expected before the end of 2024. In fact, we would not exclude the possibility of the Fed or the ECB deciding to raise interest rates further.

While European economic growth has distinctly slowed down, the US economy has remained very stable. We assume, however, that the sharply increased interest rates will sooner or later also constrain US economic growth.

Moreover, we are of the opinion that the political risks have once again increased. A government funding shutdown currently threatens the USA. Republicans and Democrats were able to reach a short-term compromise on raising the debt ceiling. But the fact that Kevin McArthy was voted out as Speaker of the House of Representatives shows how bitterly the debt dispute is being waged and how difficult it will be to reach a lasting agreement. Furthermore, the recent attacks by Hamas have created a highly explosive situation in the Middle East.

Because of the high macro-economic and geopolitical risks we are maintaining our defensive position. We are remaining underweight in equities, REITs and raw materials. In the third quarter we decided on a reduction in the relatively highly priced high-yielding bonds. Conversely, we have gone overweight in government bonds, insurance-linked bonds and liquidity.

ECONOMICS

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Fig. 1: Manufacturing PMIs

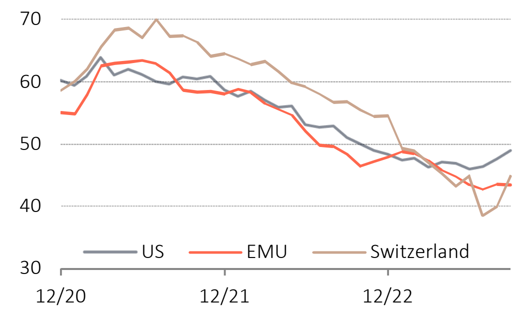


Fig. 2: Manufacturing PMIs

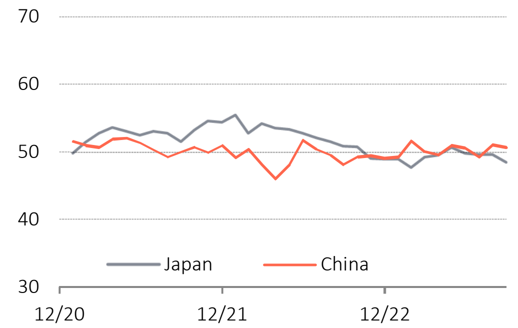


Fig 3: Consumer price inflation, in % YoY

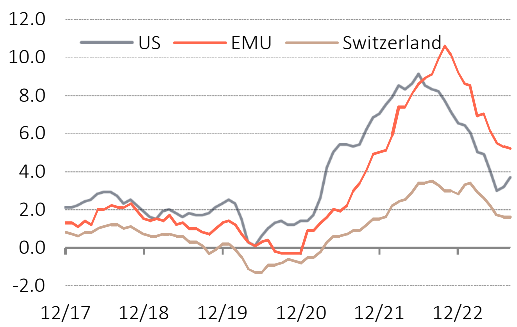


Fig. 4: Consumer price inflation, in % YoY

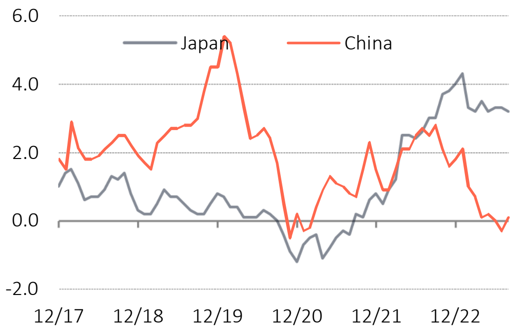


Fig 5: Unemployment rates, in %

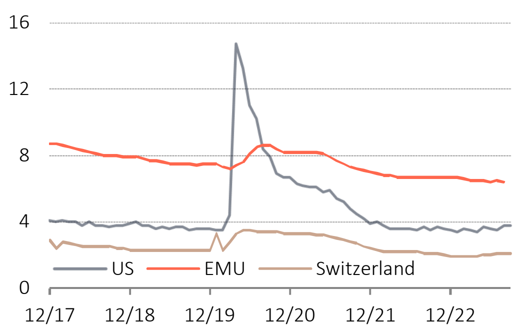
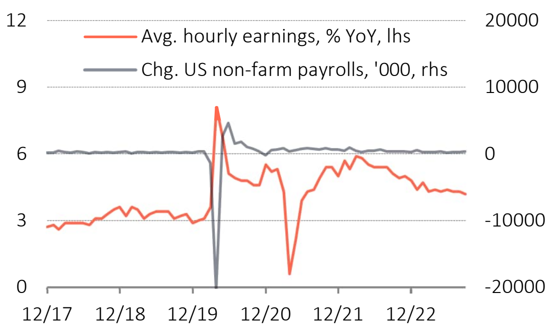


Fig 6: US labor market



FIXED INCOME

In the third quarter bond yields rose significantly. Market participants seem to finally accept that central bankers are serious about keeping interest rates high for quite a long time. US 10-year government bond yields, for example, rose from 3.6% to 4.8%. Since break-even inflation rates (inflation expectations) remained almost unchanged, real yields also increased. The decreasing risk appetite caused high-yield spreads to widen by about 50 basis points in the third quarter.

Fig.7: 2Y government bond yields

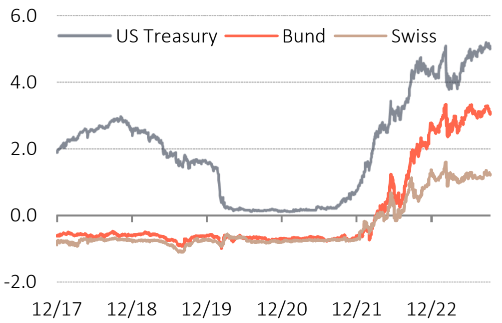


Fig. 8: 10Y government bond yields

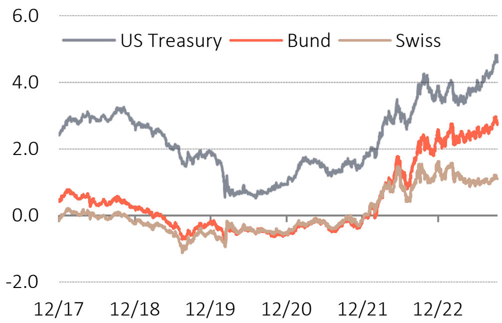


Fig 9: 10Y break-even inflation

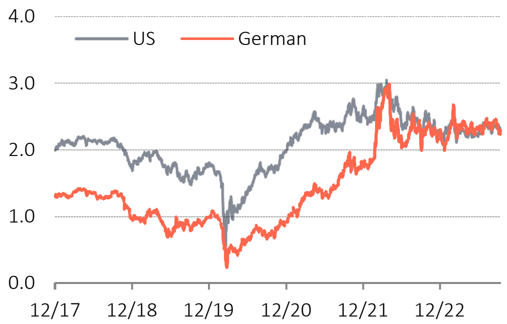


Fig. 10: Credit spreads, 5Y credit default swaps

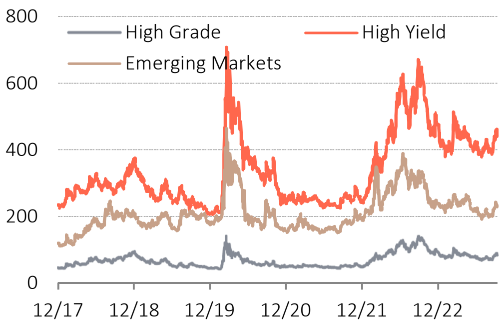


Fig 11: Money market spreads (O/N-2Y)

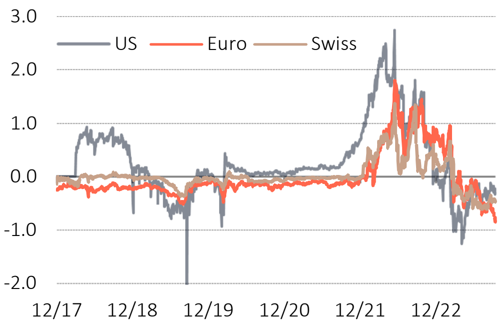
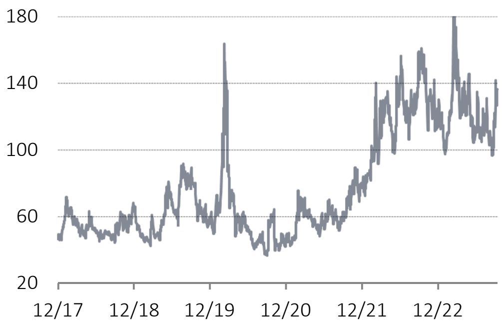


Fig 12: Merrill Lynch volatility index (MOVE)



EQUITIES

On the back of weaker economic data, rising energy prices, and a sharp increase in yields, equity markets sold off in the third quarter, especially in August and September. The S&P500 index fell by 3.6%, the MSCI Europe by 2.5%, and the MSCI Emerging Markets by 3.7%. Year-to-date the Japanese Nikkei index outperformed, advancing by almost 22%, driven by a sharp depreciation of the JPY. Equity performance this year has been best in the technology and the consumer discretionary sector.

Fig. 13: MSCI equity indices – major regions

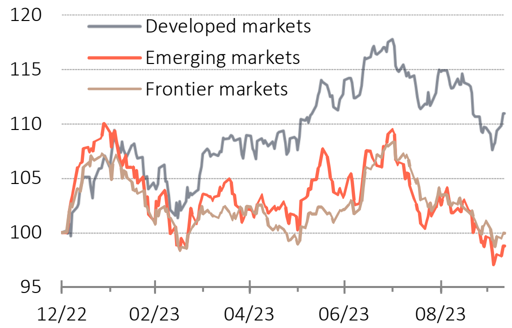


Fig.14: Equity indices – major developed markets

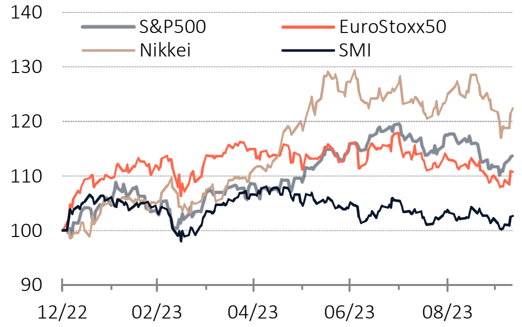


Fig 15: Equity indices – major emerging markets

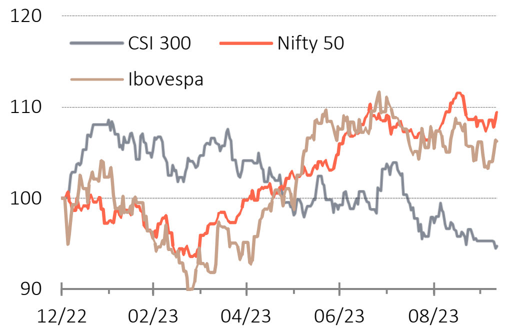


Fig. 16: Sector performance, MSCI Europe, YTD

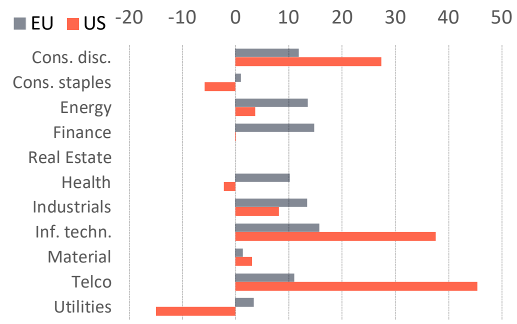


Fig 17: Price-earnings ratios

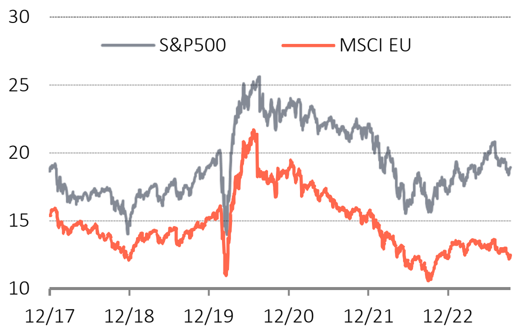
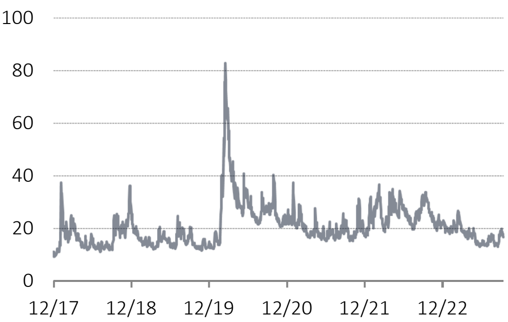


Fig 18: Equity volatility – S&P500 VIX index



ALTERNATIVE INVESTMENTS

Despite the risk-off environment in the third quarter, the gold price fell by 3.7%. Meanwhile, the decision of OPEC+ to keep supply restricted led to a surge in oil prices, which climbed from USD 70 to a peak of almost USD 94 by end of September. The global REITS index fell by 3.7% as higher interest rates are weighing on the earnings outlook. Crypto assets had a negative quarter. Bitcoin fell almost 11% and Ether almost 13%.

Fig. 19: Gold price, USD/oz

Fig.20: Brent oil price, USD/bl

Fig 21: Bloomberg commodity indices

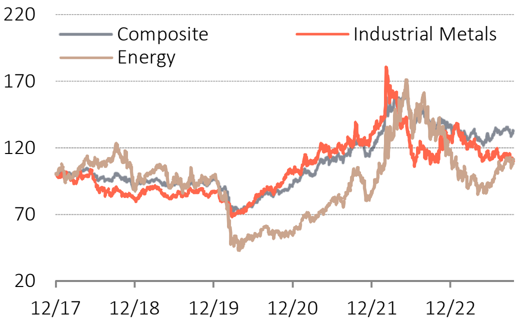
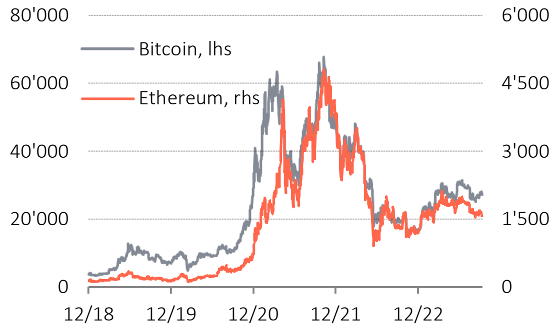


Fig. 22: Global Listed Private Equity

Fig 23: FTSE EPRA/NAREIT global REITS index

Fig 24: Crypto Assets



CURRENCIES

The USD strengthened in Q3. The EUR-USD exchange rate peaked in early July at about 1.12 and fell thereafter to 1.05. The USD is supported by the yield advantage, relatively stronger economic growth and by its safe-haven characteristic. The CHF likewise remained on the strong side. The JYP continued to weaken since the Bank of Japan retained its ultra-expansionary monetary policy stance. The Chinese CNY weakened on the back of sluggish economic growth.

Fig. 25: EUR-USD exchange rate

Fig. 26: GBP-USD exchange rate

Fig 27: USD-JPY exchange rate

Fig. 28: USD-CNY exchange rate

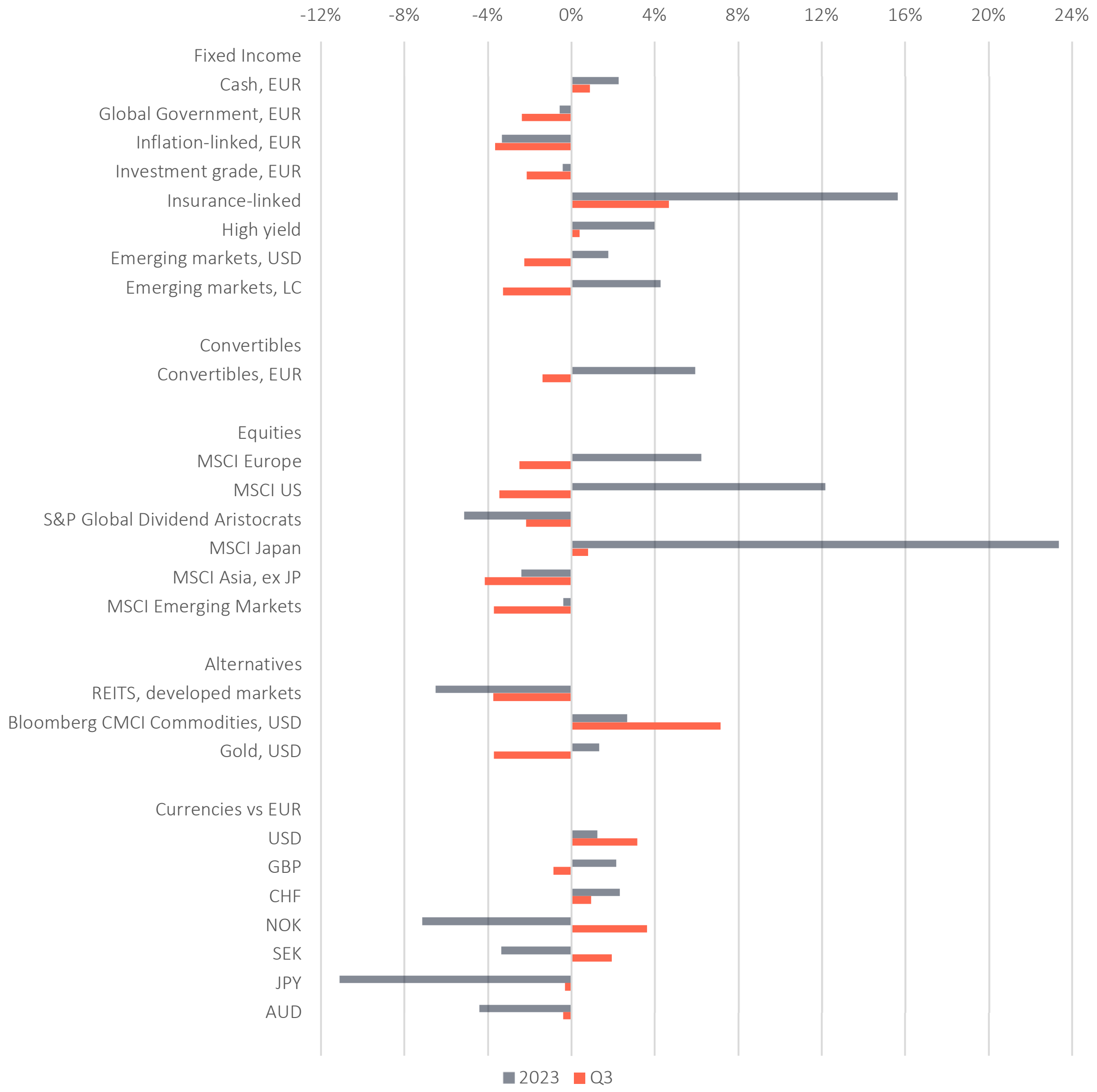
Fig 29: EUR-CHF exchange rate

Fig 30: USD-CHF exchange rate

ASSET ALLOCATION

The third quarter was difficult for multi-asset class portfolios. Equity and bond markets sold off. Exemptions were insurance-linked bonds, which have put in an impressive year-to-date performance of almost 16%, and Japanese equities. The commodity index rose by 7%, driven predominantly by higher energy prices. The USD and the CHF strengthened in the third quarter vis-a-vis the EUR.

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

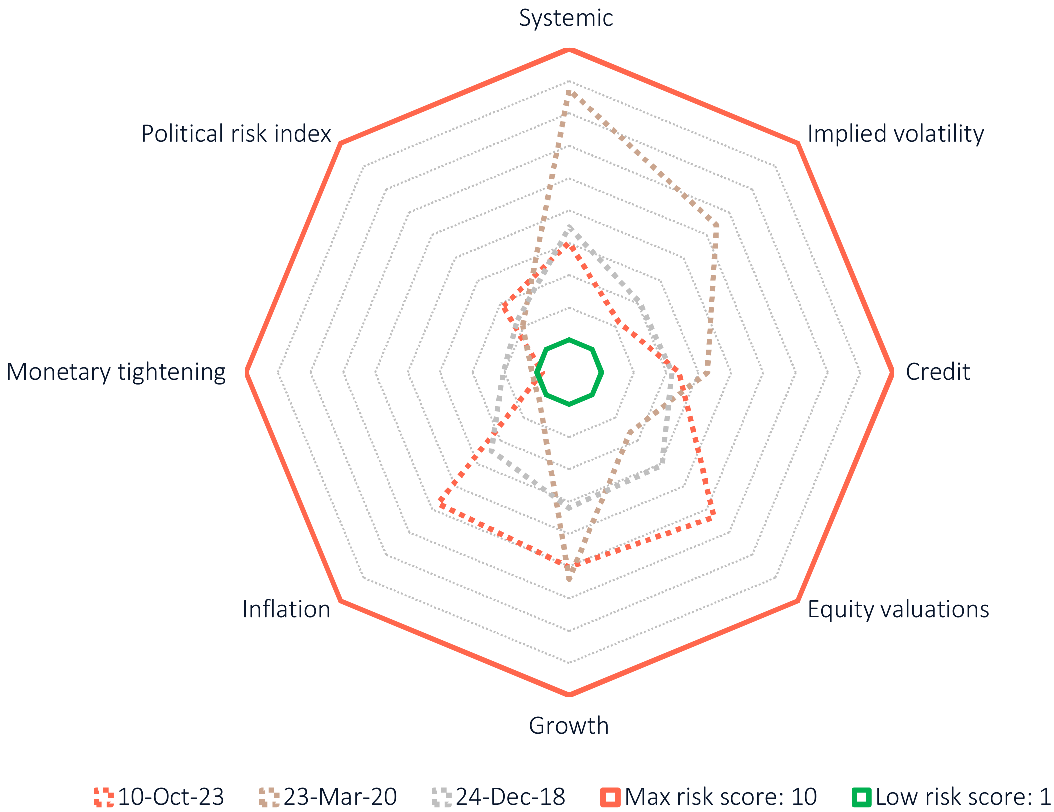


RISK MONITOR

The risk landscape has not changed much. Inflation, growth, and valuation risks are elevated. Implied volatility remains very low, despite heightened macro and geopolitical uncertainties.

Fig. 38: IMT Risk Monitor

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



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