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INVESTMENT OUTLOOK 02.2017

10 February 2017

Those, including us, who expected that President Trump would act and speak differently from the election campaigner Trump, proved to be wrong. President Trump has started, without any hesitation, to implement his very controversial election promises, which many did not take literally. In doing so, he has caused considerable political shock waves.

Meanwhile, we continue to see solid growth indicators and strong performance of risky assets. The so-called reflation trade continues and the market expects solid global growth and a certain healthy inflation pick-up. The market is – in our view – complacent when it comes to existing geo-political risks and uncertainties about the implications of the Trump policy mix.

We stay constructive for risky assets, in general, but also nervous about political risks related to the new US administration and right-wing populism in Europe.

Thomas Trauth
CEO – IMT Asset Management AG

THE TRUMP ERA HAS STARTED

President Trump has unleashed a series of initiatives which have destroyed our hope that, once in power, he would become tamer and would allow competent people in the administration and in the Republican party to help him run the country prudently and diligently. We now know for a fact that Trump is committed to fulfilling his electoral promises — which seems to includes bringing down the establishment. He acts ruthlessly, without honoring international contracts or the US legal framework. He does not hesitate to blame or threaten individual companies, foreign politicians, judges, and other individuals. What we observed in the last couple of weeks makes us very concerned about the future economic and geopolitical implications of the US presidency.

In our view, Trump, Brexit, and the various European protest parties, are the result of broad-based frustration with encrusted political systems, politicians without vision, a lack of clear decisive decision-making, overregulation, and overly complicated legal and tax systems. Our hope is that the established governments – not least in the EU – will learn the right lessons and start reforming themselves before disruptive forces become too strong and take over.

Financial markets

Equity markets continued to rally. It seems as if president Trump has cleared the view of investors on last year's positive macro fundamentals. Emerging markets gained 5.4% in January and clearly outperformed developed markets. Within developed markets the US S&P500 index gained1.8% and clearly outperformed the European MSCI Europe and the Japanese Nikkei 225 index, both of which fell by 0.4% in January.

While the 10-year Treasury yield stabilized at about 2.4%, the European 10-year yield rose 23 basis points. Yields at the short end of the curve rose only slightly. Consistent with the theme of global reflation, break-even inflation rates continued to rise in Europe as well as in the US. The 2-year interest rate differential has now reached about 2%, which makes it quite expensive to short the USD.

Oil prices gave back some of their previous gains. The price for Brent oil fell 3.4% in January. Meanwhile industrial metals continued their ascent and rose 7.5% in January. Despite the risk-on environment the gold price recovered from the steep sell-off in Q4 and gained 5.5%.

REITS remained under selling pressure, probably because rising yields are seen as negative for real estate investments. However, in our view, REITS may start to look attractive again. Stronger growth and rising inflation should allow many REITS to increase rental fees.

The USD gave back some of its Q4 gains. Probably, the USD was a bit overbought. Also, markets started to worry about the negative impact of US protectionism and a potential trade war with China. The CHF has appreciated since November and the SNB seem somewhat less committed to take measures against CHF strength. Still we would expect the SNB to act again if the EUR-CHF exchange rate were to fall below 1.06.

Macro economics

The European PMI surged to 55.2 after 54.9. Also, the US PMI strongly rose to 56.0 in January after 54.5. The US non-farm payrolls for January rose more strongly than expected, by 227,000 after 157,000. The labor-force participation rate rose to 62,9%, its highest level since September. Interestingly, labor-market tightening came without accelerating wage pressure. Average hourly earnings rose 2.5% year-on-year, and clearly less than the previous reading of 2.8%. As a result, Fed rate-hike expectations fell somewhat after the release of the labor-market statistics.

Inflation rose, not least due to base effects resulting from the sharp drop in oil prices a year ago. US inflation stood at 2.3% in January after 2.1% in December. Likewise, EMU inflation was clearly up to 1.8% in January after 1.1% in December.

Central banks

At its 19 January meeting the ECB changed its policy stance. The ECB left key interest rates unchanged and confirmed that it expects rates to remain low or even fall lower for an extended period of time. It also confirmed its plan to reduce its asset purchase program (APP) from EUR 80 bn per month to EUR 60 bn as of April 2017. The APP will continue at least until December 2017.

Likewise, the January US Fed meetings did not surprise markets. There was no change in interest rates and the outlook of the Fed remains balanced. The market currently discounts two rate hikes in 2017.

Outlook

The growth outlook has clearly brightened and additional stimulus from the US government, including tax cuts, fiscal stimulus, and deregulation should further support the economy. The strong USD is supportive for other regions.

Despite the positive outlook, we have decided to maintain our slight portfolio tilt in favor of risky assets, but we are hesitant to move towards more aggressive overweight positons. The reason is that we are becoming increasingly concerned about the growth-unfriendly side of Trump's policy mix, i.e., immigration, protectionism, and arbitrary interference in companies' investment decisions. As a result, the risk of trade wars has risen; especially the US-Chinese relationship is at risk.

Within equities we introduced an underweight position in European equities, since Europe may suffer from US protectionism, and the upcoming European elections in France, the Netherlands, and Germany have the potential to unsettle investors. While Japanese equities had a weak start to the year, we expect that the expansive policy mix in Japan will help equities to perform well in 2017.

In our view, the USD will rather stay on the strong side due to the above-mentioned political risks in Europe, and divergence of monetary policies. The interest rate differential of 200 basis points makes it very expensive to short the USD.

ECONOMICS

PMIs continued to rise in January, confirming the global growth recovery. Also, inflation rates rose, due to strong base effects resulting from commodity prices. US non-farm payrolls rose by 227,000 in January vs. 157,000 in December, confirming continued robust job creation in the US. Average hourly earnings rose 2.5% year-on-year and, therefore, a bit less than in the previous month (2.8%).

Fig. 1: PMIs

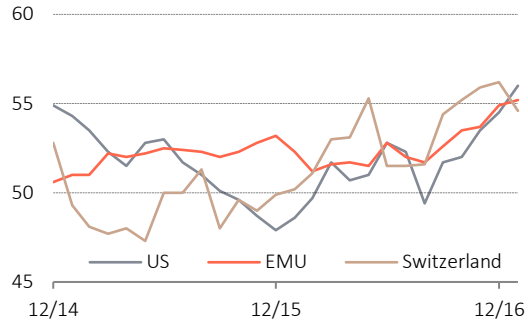


Fig. 2: PMIs

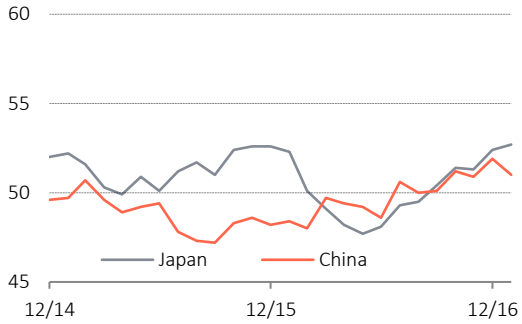


Fig 3: Consumer price inflation, in % YoY

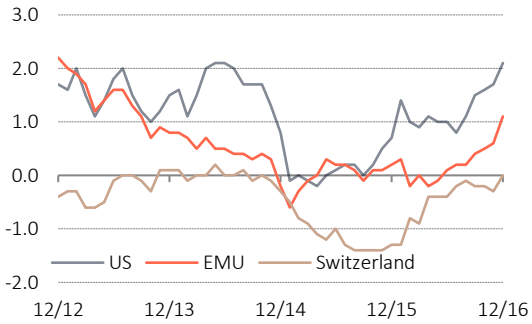


Fig. 4: Consumer price inflation, in % YoY

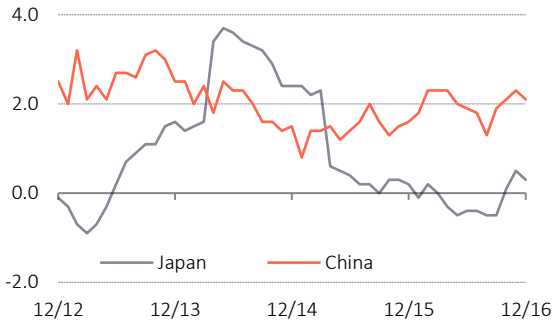


Fig 5: Unemployment rates, in %

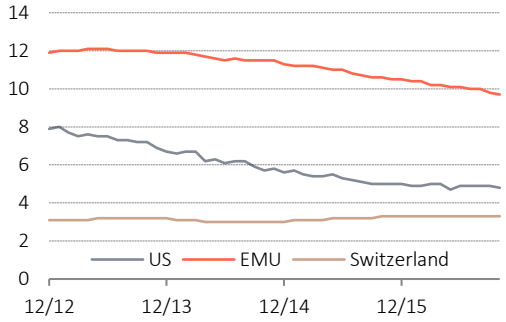
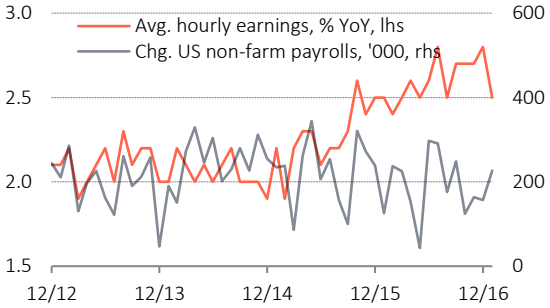


Fig 6: US labor market



FIXED INCOME

US 10-year yields stabilized in January, while European yields rose 23 basis points. Yield differentials at the short end of the curve have widened substantially in recent months. The 2-year yield spread is about 200 basis points. Break-even inflation rates continued to rise, in line with the reflation theme. Credit spreads remained quite stable in January.

Fig.7: 2Y government bond yields

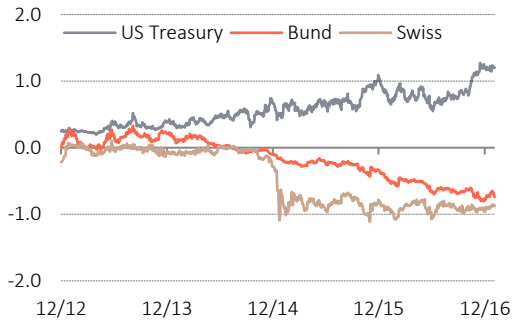


Fig. 8: 10Y government bond yields

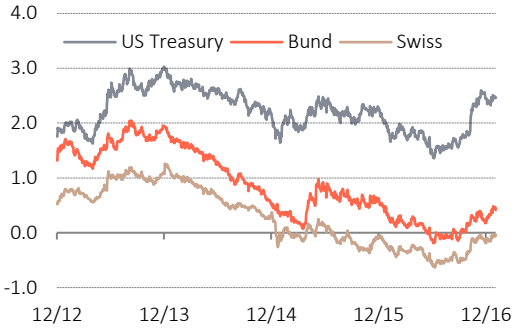


Fig 9: 10Y break-even inflation

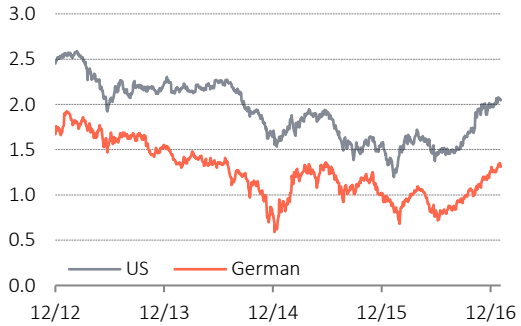


Fig. 10: Credit spreads, 5Y credit default swaps

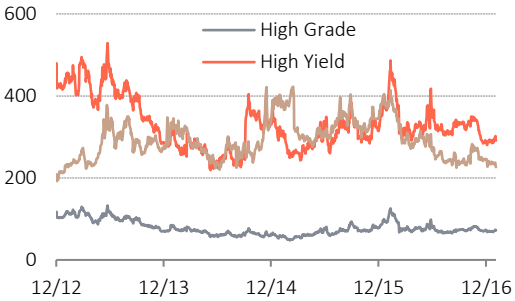


Fig 11: Money market spreads (3M-2Y)

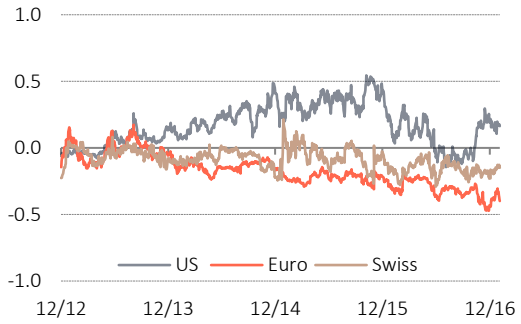
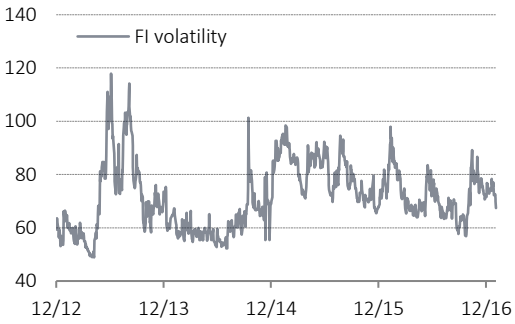


Fig 12: Merrill Lynch volatility index



EQUITIES

Equity markets started the year with good performance. Emerging markets outperformed, followed by the US equity market. European and Japanese equities underperformed and ended the month even with a loss. Energy stocks gave back some of their gains while financials continued to profit from expected US deregulation. Among emerging markets, The Brazilian Ibovespa and the Indian Nifty 50 index outperformed.

Fig. 13: MSCI equity indices – major regions

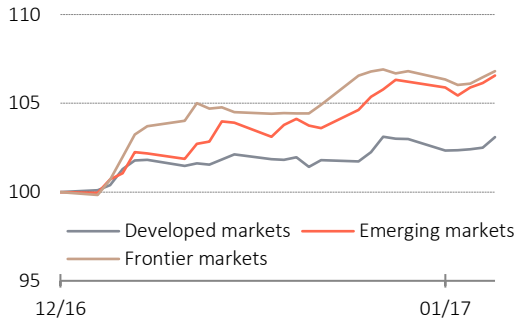


Fig.14: Equity indices – major developed markets

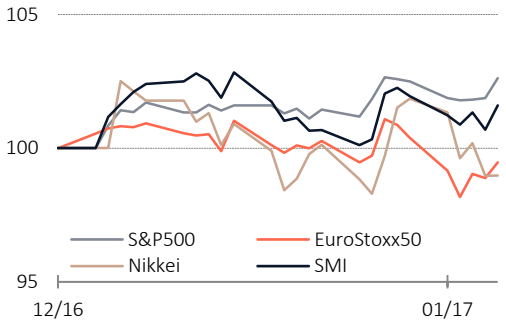


Fig 15: Equity indices – major emerging markets

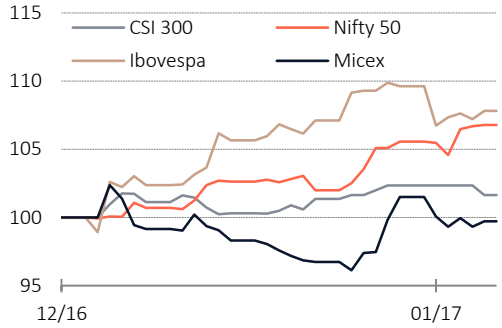


Fig. 16: Sector performance, MSCI Europe, 2017

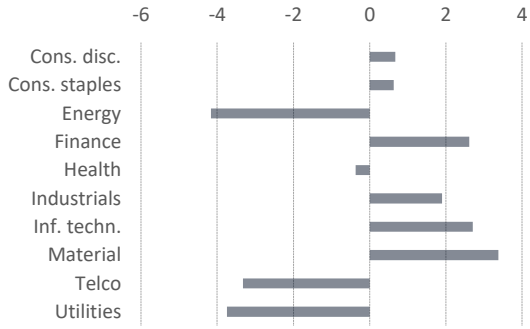


Fig 17: Price-earnings ratios

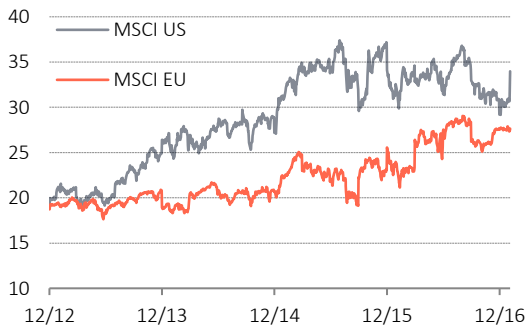
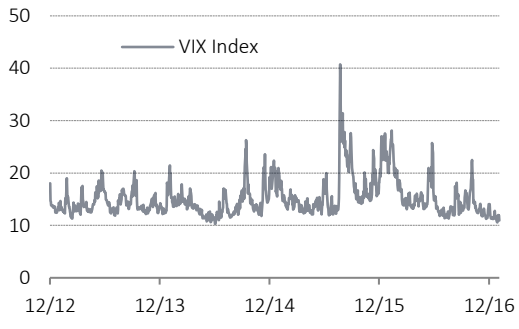


Fig 18: Equity volatility – S&P500 VIX index



ALTERNATIVE INVESTMENTS

Gold and industrial metals rose in January, while oil prices fell slightly. REITS continued to be under selling pressure. Listed private equity continued its strong rally. Also, hedge funds had a good start into 2017. The broad HFR hedge fund index gained 0.5% in January.

Fig. 19: Gold price, USD/oz

Fig.20: Oil price, USD/bl

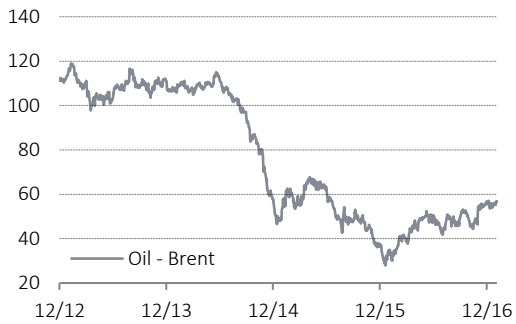


Fig 21: Bloomberg commodity indices

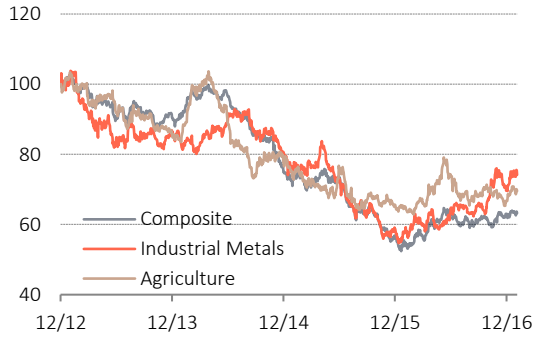


Fig. 22: HFRI hedge fund indices

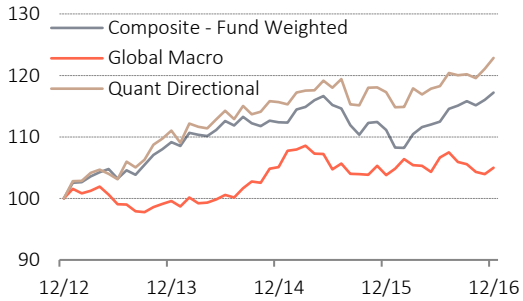


Fig 23: FTSE EPRA/NAREIT global index

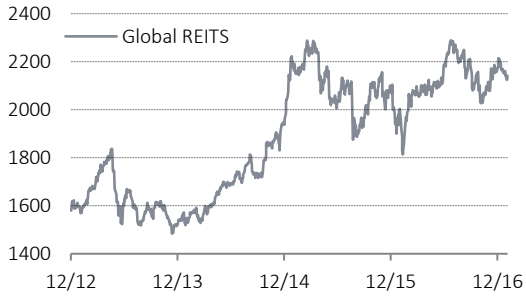
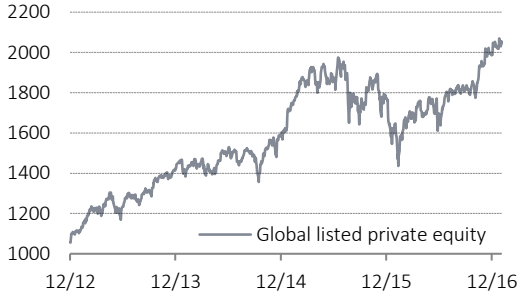


Fig 24: LPX global listed private equity



CURRENCIES

In January, the USD gave back some of its gains from the strong movement in November and December. This describes the USD development versus most major currencies. From end of October, as geo-political uncertainties rose, the CHF appreciated versus the EUR and has remained on the strong side. The SNB is certainly not very happy with this movement but shows little inclination to act against the recent appreciation.

Fig. 25: EUR-USD exchange rate

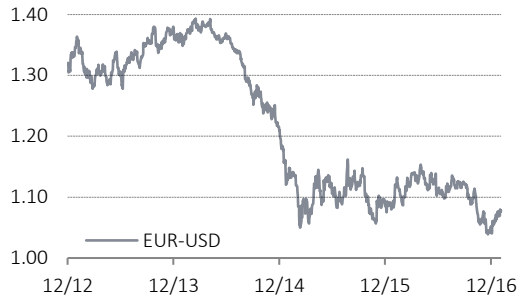


Fig. 26: GBP-USD exchange rate

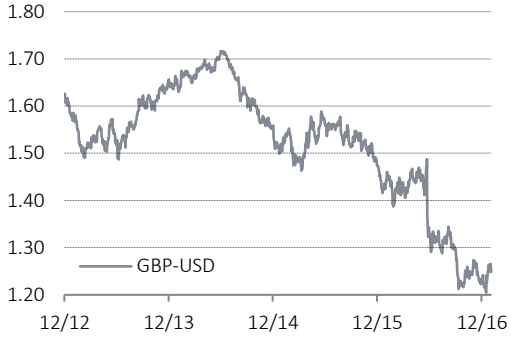


Fig 27: USD-JPY exchange rate

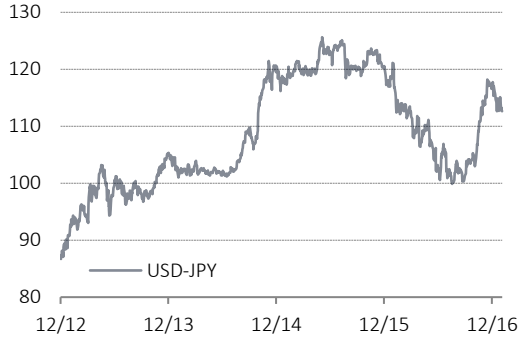


Fig. 28: USD-CNY exchange rate

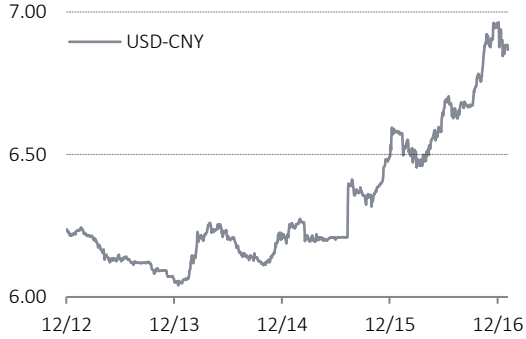


Fig 29: EUR-CHF exchange rate

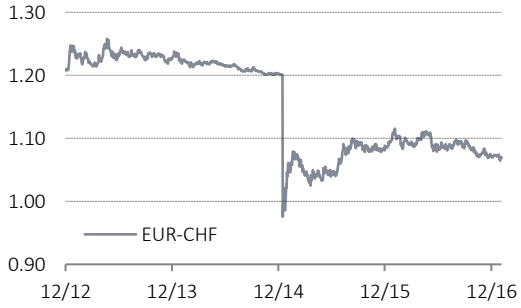
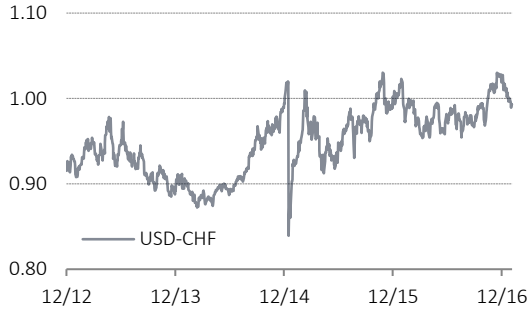


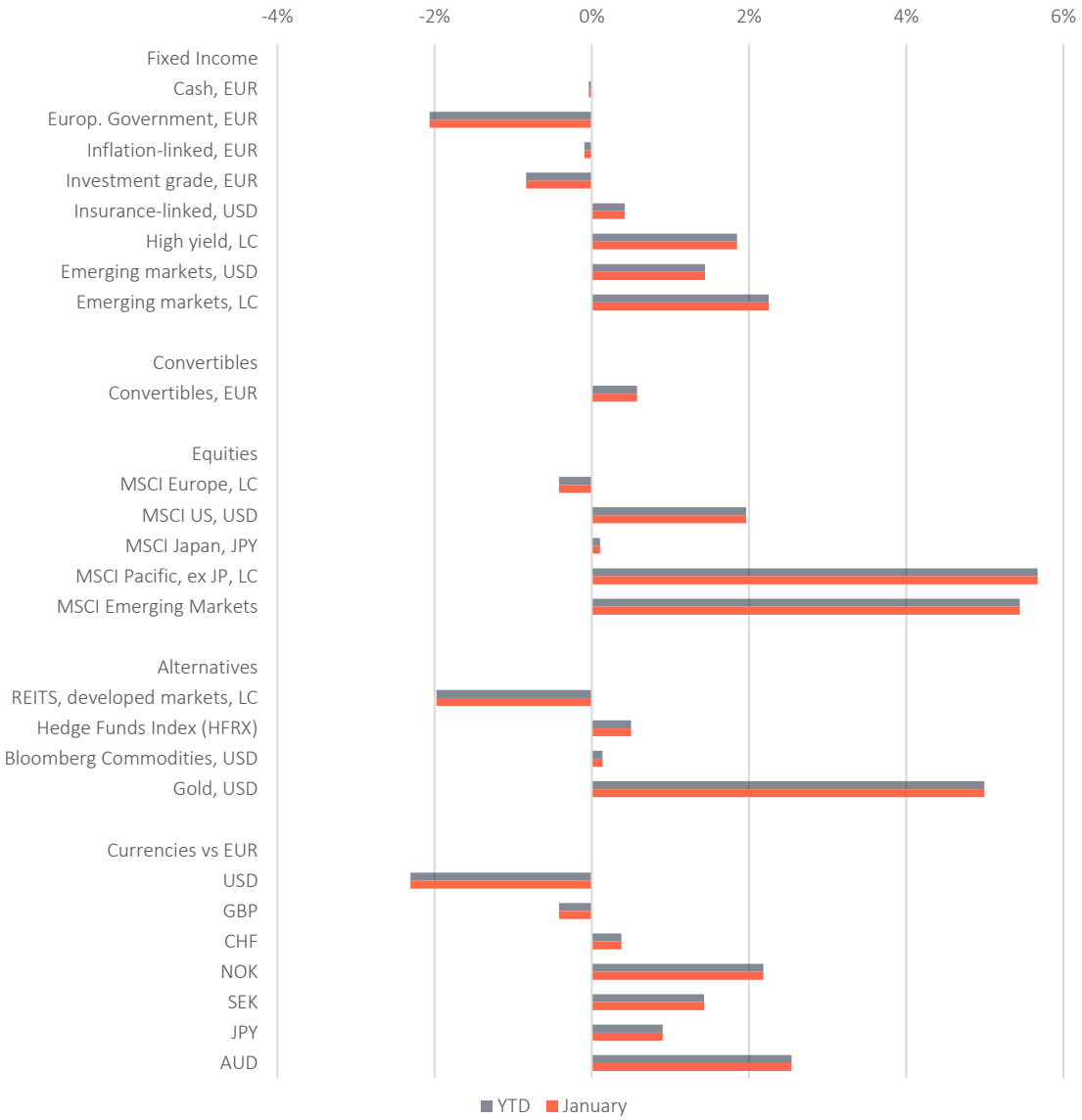
Fig 30: USD-CHF exchange rate



ASSET ALLOCATION

2017 started with a rally of risky assets. Especially emerging markets and the equities in the pacific area performed strongly. Within fixed income, government bonds clearly fell, while high-yield and emerging-market bonds performed well. Interestingly gold performed well despite a risk-on environment. European equities and REITS underperformed. The EUR was rather weak, it appreciated, however, against the USD and the GBP.

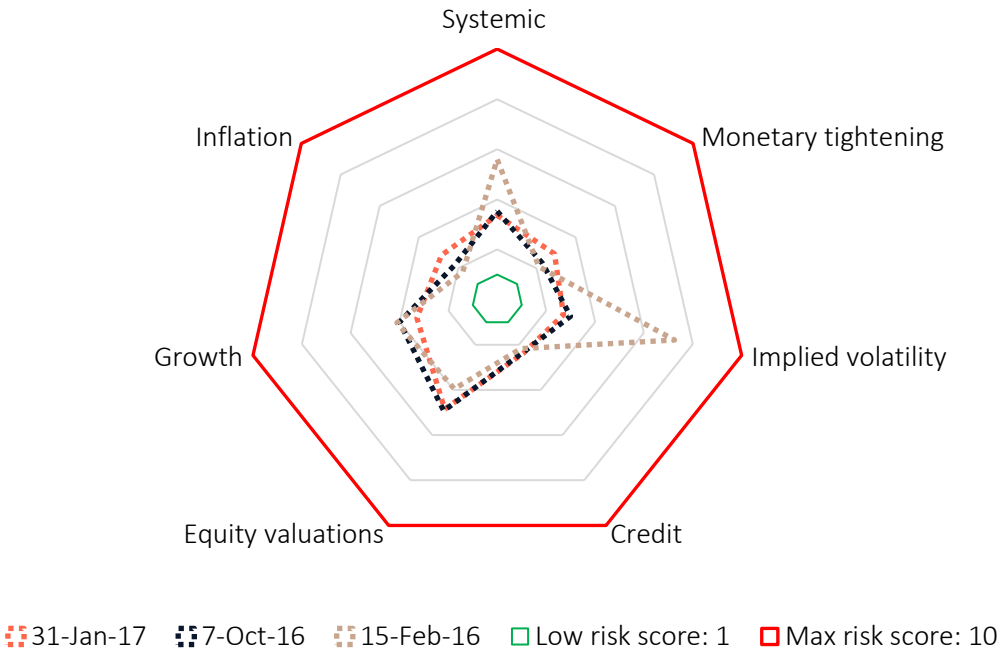
Fig. 31: Performance of major asset classes, based on our EUR portfolio strategy



RISK MONITOR

The risk monitor continues to indicate moderate market risks. Inflation and monetary tightening risks have increased recently. Also equity valuations remain elevated. However, growth risks clearly fell, as global PMIs improved in recent months.

Fig. 32: IMT Risk Monitor



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