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IMT
GROUP

INVESTMENT OUTLOOK 08.2017

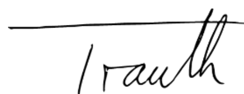
4 August 2017

The most important debates currently center on the sustainability of the equity bull market and the question of when central banks will withdraw monetary stimulus more aggressively.

We expect the equity bull market to continue. Two factors will support equities in the coming months. Firstly, earnings growth continues to be strong. Secondly, the Trump administration is committed – and very much under pressure – to introduce significant tax cuts. Unlike with other policy initiatives, we expect President Trump to have the support of the Republican party for cutting taxes.

We think that most major central banks – except for the Bank of Japan – will start or continue to withdraw monetary stimulus in the coming months. However, as recent central bank communications show, this will be a very gradual and gentle process, which will be unlikely to unnerve financial markets.

We think that the recent move of EUR-USD is exaggerated, anticipating too much ECB hawkishness and too little Fed hawkishness. We would not be surprised to see the USD recovering soon.



Thomas Trauth
CEO – IMT Asset Management AG

WHAT'S NEXT FOR CENTRAL BANKS?

Financial markets

Equity markets performed well in July. Emerging markets equities clearly outperformed, rising by 5.5%, while developed markets rose 2.3%. The performance of emerging markets was driven by China, up 6.1%, India up 5.8%, and Brazil up 4.8%. Asia Pacific, excepting Japan, performed strongly, up 4.3% in July and 16.5% year-to-date. Among developed markets the US S&P500 and the Swiss SMI outperformed in July, gaining 1.9% and 1.7%, respectively. Both markets were supported by depreciating currencies. The EuroStoxx50 index rose 0.2%, while the Nikkei225 fell 0.5% in July.

The European yield curve steepened. Short-term yields fell 11 basis points while 10-year yields rose 8 basis points. Meanwhile, the US yield curve remained almost unchanged month-over-month.

Despite softer headline inflation in major economies, break-inflation inflation rates rose somewhat after falling since the end of February.

Emerging markets bonds outperformed within fixed income. Local currency bonds were up by 2.07% in July. Also, high-yield bonds performed very well, up by 1.66%. Inflation-linked bonds fell by 0.23% in July and underperformed nominal bonds, which were slightly up.

Commodities rebounded in July. Energy prices were up 4.6%, industrial metals by 4.1% and gold by 2.2%. Oil markets were driven by falling inventories, disciplined OPEC producers and falling US shale production.

REITS had a bad month falling 1.6%. Investors seem to be concerned about rising discount factors more than they appreciate the potential for rising leases in a better economic environment.

Macro economics

The macro environment looks almost too good to be true. We recently read the headline "better than goldilocks" written by a leading bank analyst, who described the very favorable macro environment we are currently enjoying: a period of steady economic growth coupled with low inflation.

Having said this, both the US and the European PMI weakened somewhat, though remaining very solidly in the growth area above 50. The US ISM index fell to 56.3 in July after 57.8 and the EMU manufacturing PMI fell to 56.6 after 57.4. In contrast, the Chinese Caixin manufacturing PMI rose to 51.1 in July from 50.4. This was helped by a solid increase in new business, with growing numbers of new orders and rising export demand.

Inflation figures fell across the board, driven by falling energy prices in recent months. Fed chairwoman Janet Yellen recently stated quite emphatically that softness of inflation will be only transitory. Markets seem to be confirming this view, since break-even inflation rates, as a measure of expected inflation, have recently risen.

Central banks

On 20 July, the ECB kept key interest rates unchanged and maintained its net asset purchase program unchanged at EUR 60 bn per month until at least the end of December 2017. ECB chairman

Mario Draghi was very dovish saying that "… inflation is not where we want it to be and where it should be …" and "… that interest rates will remain unchanged for an extended period of time and well past the horizon of our net asset purchases." Despite the soft rhetoric the EUR continued to strengthen, which was a surprise to us. We expect that at its policy meeting on 7 September the ECB will announce a reduction of its bond-buying program to EUR 40 bn per month starting in January 2018.

The US Fed held its policy meeting on 24-25 July and left rates unchanged. The Fed believes that the current inflation weakness is only transitory. Chairwoman Janet Yellen said the Fed would start reducing its bond holdings "relatively soon". Despite the more hawkish Fed statements, the market currently prices only a 6% probability for a rate hike at the next policy meeting on 20 September and a 42% probability for a rate hike by December. We think that the market is currently underpricing the Fed's willingness to hike further. Firstly, the real effective Fed Funds Rate is still negative at -0.3%, while the Fed's neutral rate, given current conditions, should rather be at 0.3%. Secondly, the weaker USD has loosened monetary conditions in the US, which may warrant the Fed hiking sooner to prevent the economy from overheating.

While Bank of England's (BoE) Monetary Policy Committee members Ian McCafferty and Michael Sanders have been in favor of a rate hike to address rising UK inflation, the Bank of England decided on 3 August to keep rates and the asset-purchase program unchanged. The vote came in at 6-2, with the above-mentioned members voting for a rate hike. The BoE lowered its forecasts for economic growth and wages. The weakening GBP is driving inflation, which is outpacing wage growth and, in turn, lowering real wages and purchasing power. The BoE continues to assume a smooth Brexit scenario and said that the benchmark interest rate may need to rise somewhat more than the market currently anticipates. The market has fully priced a rate hike by the third quarter of 2018. The GBP dropped further after the policy announcement.

Meanwhile, the Bank of Canada raised its benchmark rate to 0.75%, its first rate hike in almost seven years.

The most dovish central bank remains the Bank of Japan, which revised down its inflation forecast and put forward its expectations for inflation to reach its 2% target to 2019. However, it did not decide on new or changed policy measures.

Outlook

We stay positive for equity markets in general and for Japanese and European equities, in particular. US earnings growth and a high likelihood for US tax cuts will support US equities. While the rotation into European equities, which we discussed back in April, has lost momentum in recent months, we remain overweight in European equities. This thinking is based on solid European growth, a softer ECB than many anticipated, and relatively attractive valuations.

Japanese equities are supported by Bank of Japan's policy measures, including direct buying of domestic equities.

Depressed commodities prices, especially energy prices, have some upside from current levels. We remain overweight in energy but are prepared to take profit when oil prices move towards USD 55, since higher levels may trigger additional production, most noticeably in the US.

We have been caught off guard by the strong rally of EUR-USD. We think the move is exaggerated and not sustainable. It seems to us that the market expects more aggressive tapering than the ECB is prepared to deliver and underestimates the Fed's willingness to hike rates and reduce its balance sheet. The recent USD weakness by itself has softened monetary conditions in the US and gives the Fed more leeway to move.

ECONOMICS

Growth data remained very robust in July. The US and the European PMI retreated somewhat, but remained very solidly in the growth area above 50. Inflation figures did not show any signs of accelerating despite very robust growth momentum. The Chinese Caixin manufacturing PMI rose to 51.1 in July from 50.4. This was helped by a solid increase in new business, growing numbers of new orders and rising export demand.

Fig. 1: PMIs

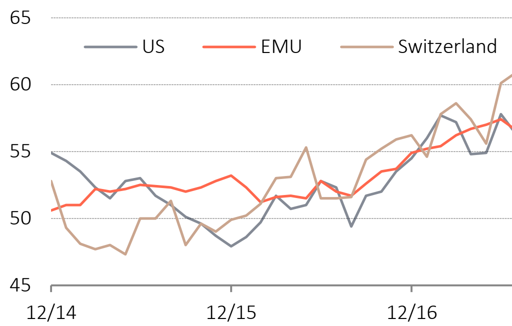


Fig. 2: PMIs

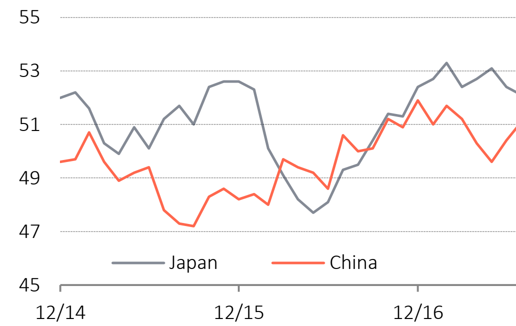


Fig 3: Consumer price inflation, in % YoY

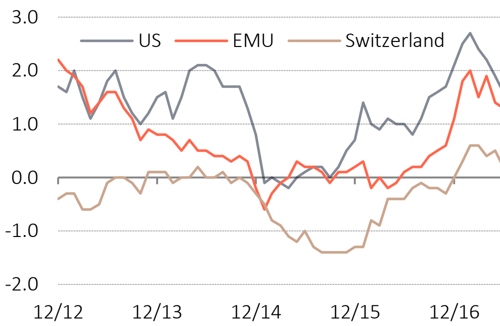


Fig. 4: Consumer price inflation, in % YoY

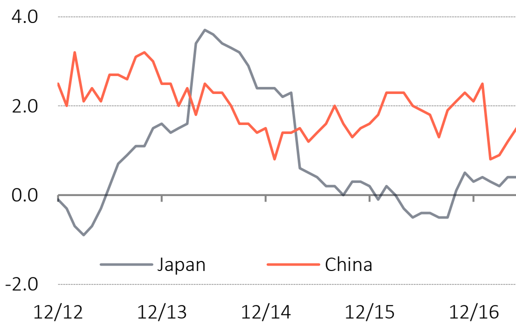


Fig 5: Unemployment rates, in %

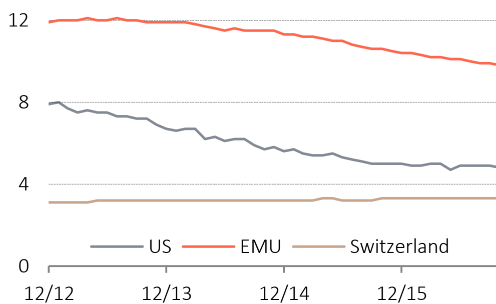
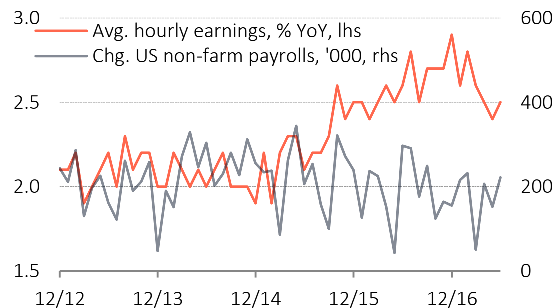


Fig 6: US labor market



FIXED INCOME

The European yield curve clearly steepened in July, driven equally by falling short-term rates, after dovish ECB comments, and rising 10-year yields. The US yield cuve remained almost unchanged month over month. Inflation expectations edged slightly up after the strong drop in recent months. Credit spreads tightened across all major segments. The Fixed Income implied volatility index experienced a remarkable drop, despite rising uncertainties about the future path of central bank policies.

Fig.7: 2Y government bond yields

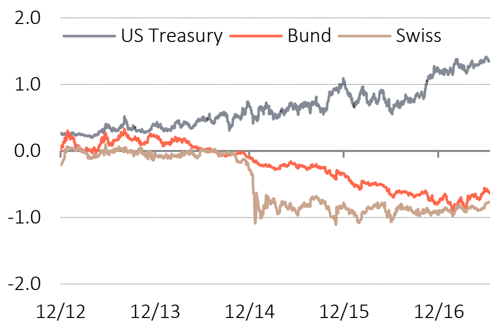


Fig. 8: 10Y government bond yields

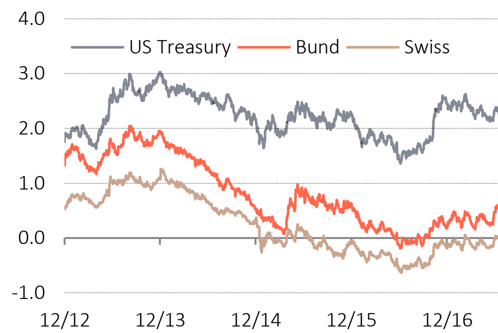


Fig 9: 10Y break-even inflation

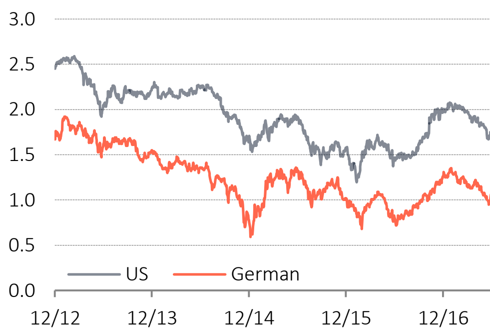


Fig. 10: Credit spreads, 5Y credit default swaps

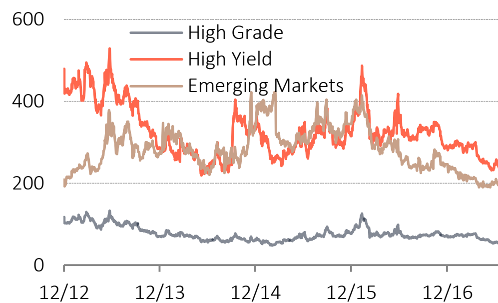


Fig 11: Money market spreads (3M-2Y)

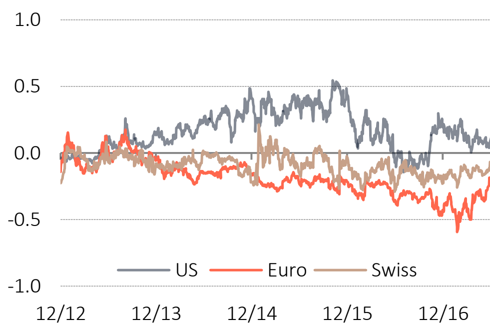
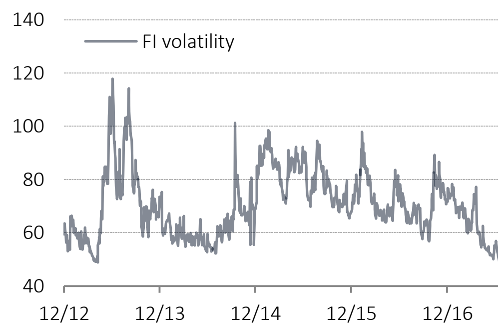


Fig 12: Merrill Lynch volatility index



EQUITIES

Emerging markets solidly outperformed developed markets, driven by strong performance in China, Brazil and India. Among developed markets the US S&P500 and the Swiss SMI outperformed, helped by depreciating currencies. The Japanese Nikkei225 fell by 0.5% and the MSCI Europe by 2.7%. The valuation gap between US and European equities widened significantly. The VIX implied volatility index fell to historic low levels around 10.

Fig. 13: MSCI equity indices – major regions

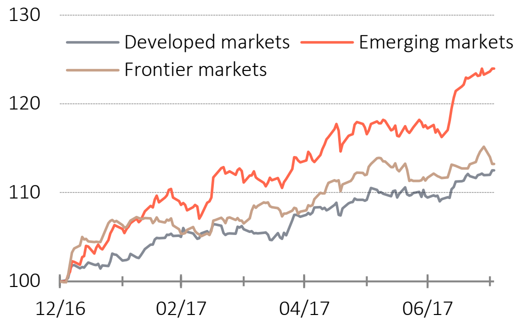


Fig.14: Equity indices – major developed markets

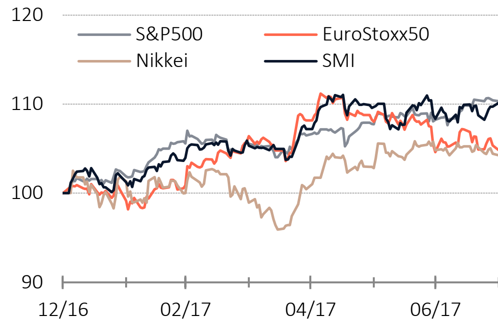


Fig 15: Equity indices – major emerging markets

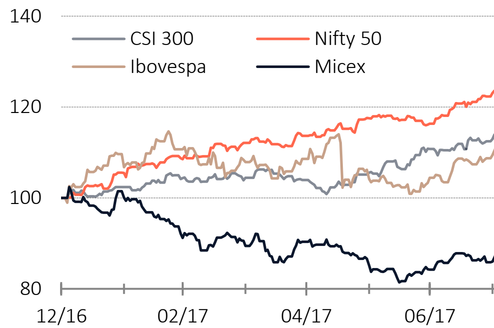


Fig. 16: Sector performance, MSCI Europe, 2017

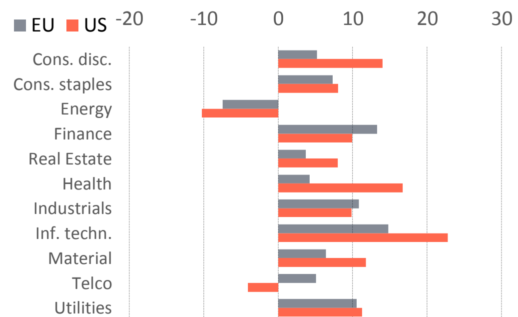


Fig 17: Price-earnings ratios

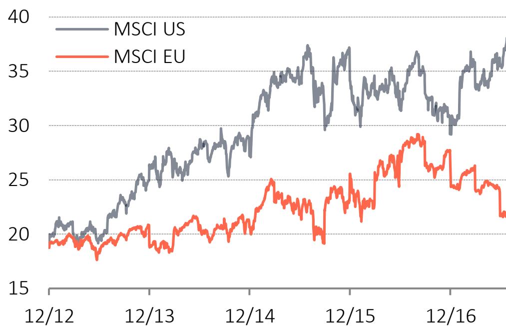
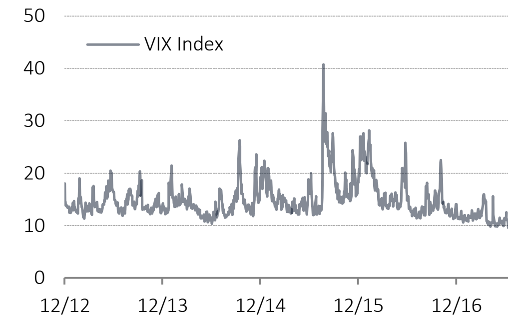


Fig 18: Equity volatility – S&P500 VIX index



ALTERNATIVE INVESTMENTS

Oil (8.4%), industrial metals (4.1%) and gold (2.2%) recovered strongly in July. The broad Bloomberg commodity index rose by 2.3% in July. The global REITS index fell 1.6%, driving the year-to-date performance further into negative territory (-6.5%). US REITS outperformed European and Asian REITS. Listed private equity fell slightly, by 0.2% in July.

Fig. 19: Gold price, USD/oz

Fig.20: Oil price, USD/bl

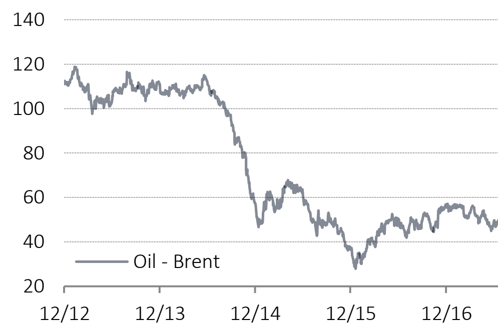


Fig 21: Bloomberg commodity indices

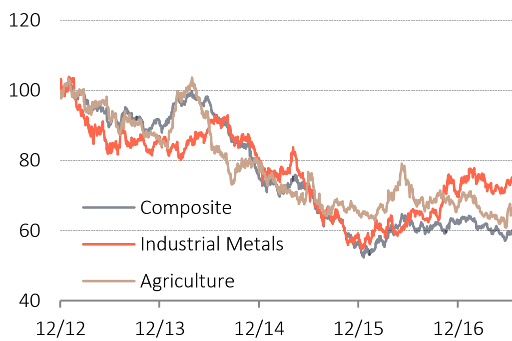


Fig. 22: HFRI hedge fund indices

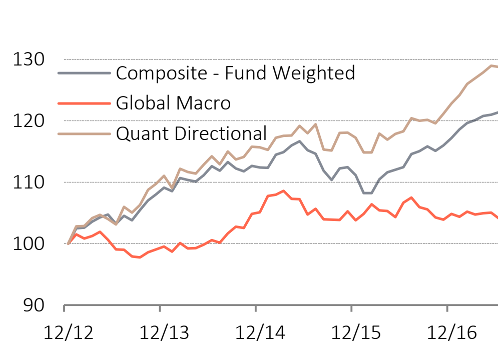


Fig 23: FTSE EPRA/NAREIT global index

Fig 24: LPX global listed private equity

CURRENCIES

The major theme remains the remarkable, broad-based EUR strength. The EUR strengthened versus most major currencies, especially the USD, despite more dovish ECB rhetoric. EUR-USD rose 3.6% in July. EUR-CHF broke above 1.15, the highest level since January 2015 when the SNB abandoned its currency floor at 1.20. The Chinese CNY strengthened on the back of more solid Chinese growth figures.

Fig. 25: EUR-USD exchange rate

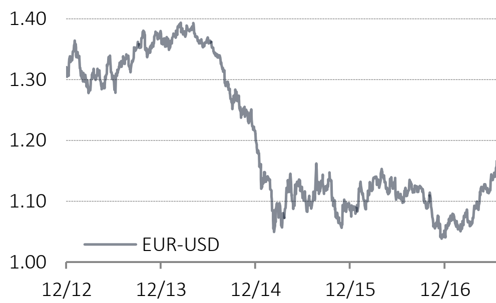


Fig. 26: GBP-USD exchange rate

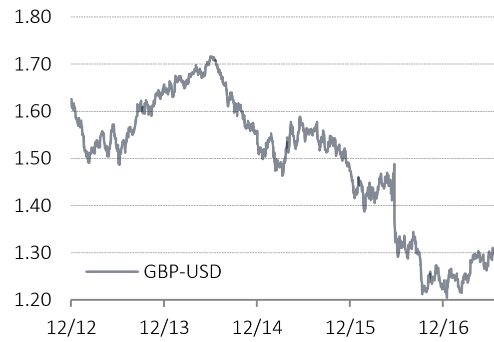


Fig 27: USD-JPY exchange rate

Fig. 28: USD-CNY exchange rate

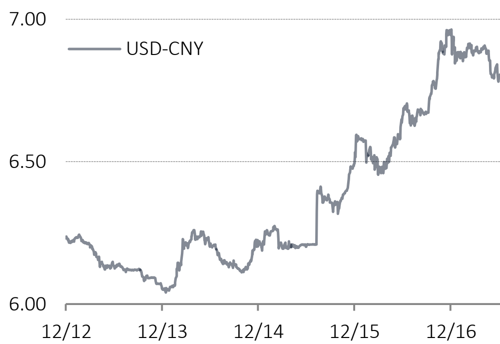


Fig 29: EUR-CHF exchange rate

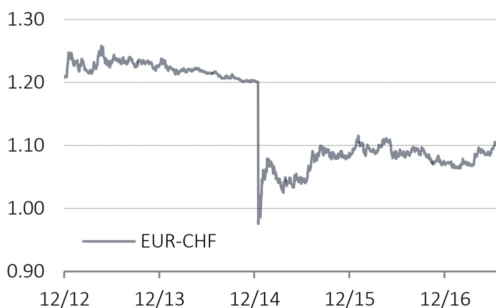
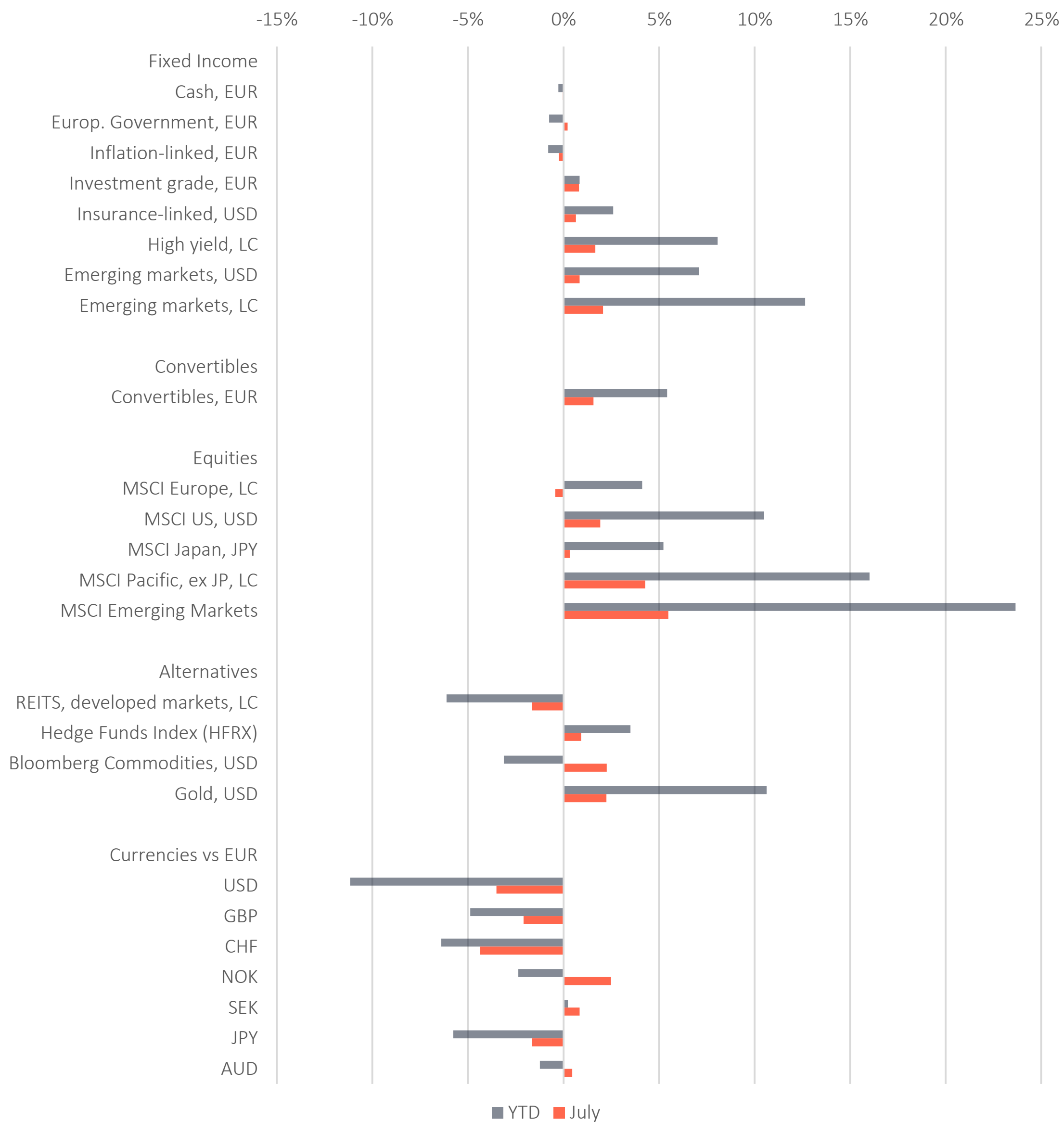


Fig 30: USD-CHF exchange rate

ASSET ALLOCATION

July resembled the broad year-to-date trends. Risky assets, especially emerging market assets, outperformed. Equities outperformed bonds. Commodities, especially energy, had a difficult year, while July saw a strong rebound. REITS have had a difficult year. The market seems to fear rising discount factors more than it appreciates the potential for higher rents as growth picks up. For Euro investors, foreign currency exposures diluted performance.

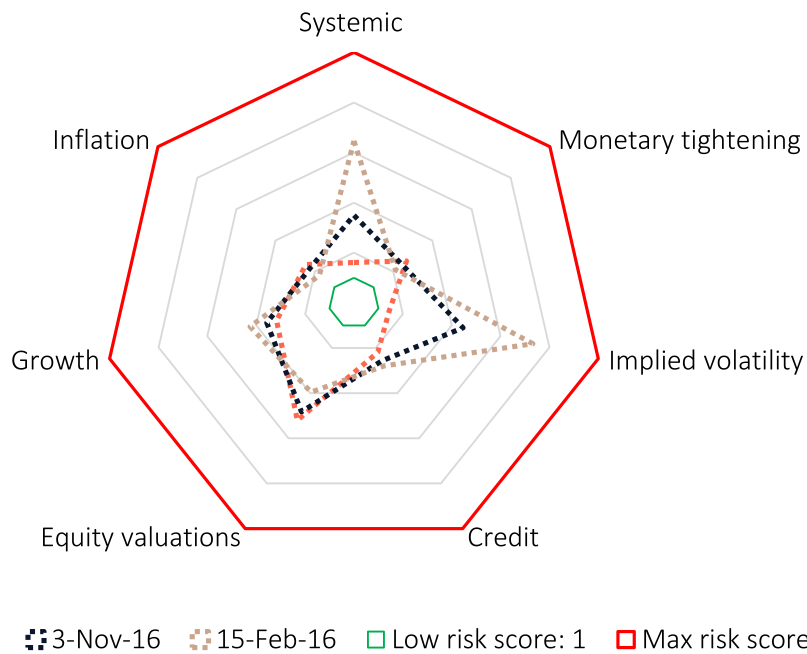
Fig. 31: Performance of major asset classes, based on our EUR portfolio strategy



RISK MONITOR

The risk monitor continues to show a benign risk environment. In recent months, implied volatilities fell to historically low levels. The banking sector performed strongly in recent months, which has lowered our systemic risk indicator further.

Fig. 32: IMT Risk Monitor



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