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INVESTMENT OUTLOOK 09.2017

5 September 2017

End of August leading central bankers and economists gathered in Jackson Hole to discuss the world economy and monetary policy issues. Janet Yellen and Mario Draghi gave no additional guidance on their next monetary policy decisions, but they have clearly chosen to focus on the merits of financial regulation and free trade.

Meanwhile geo-politics took center-stage, especially the situation in North Korea. President Trump did his bit to heighten tensions. Other US-related policy issues were the discussion following the terrible events in Charlottesville, the staff turnover in the White House, and the looming debt ceiling.

As a result, equity markets fell, albeit relatively moderately, and demand for safe haven assets, like government bonds and gold, rose. Overall, however, financial markets remained quiet calm, which in our view rightly indicates that the North Korea situation will not escalate to a military conflict.

We kept our moderate risk-on bias and think that the very positive macro-environment will further boost corporate earnings and equity markets.

Thomas Trauth
CEO – IMT Asset Management AG

WILL GEO-POLITICS DERAIL THE BULL MARKET?

Financial markets

Worries about North Korea, coupled with uncertainties regarding the future course of the US administration, had an impact on financial markets in August. Developed markets equities were slightly down, by 0.1%, with the S&P500 index up by 0.1% and the MSCI Europe index down by 1.1%. In Asia it was interesting to observe that while the Nikkei 225 fell by 1.4%, the other equity markets in Asia Pacific fell only moderately by 0.5% and the Chinese Hang Seng index even rose strongly by 2.4%. It seems that market participants took the positive Chinese growth figures more seriously than they took the saber-rattling of the neighbors in North Korea.

Emerging equity markets had a good month, the MSCI Emerging Markets index was up 2%. Best performing equity markets were Brazil, up 7.5%, and Russia, up 5.3%.

Despite an increase in break-even inflation rates, European and US 10-year yields fell by 18 basis points. This was driven not least by safe-haven flows. As a result, real yields fell even further, translating into a very strong performance of inflation-linked bonds in August. Emerging markets bonds continued to perform very well, rising 1.8% in August.

Industrial metals were up 9.6% in August, driven by stronger demand from China. Copper prices, e.g., rose even 13%. Gold as a safe haven asset gained 4.0% on the back of geo-political concerns. Oil prices declined by 6.0% in August, but recovered recently not least due to supply disruptions after Hurricane Harvey hit the Texas coast and disrupted US east coast oil supply.

Macro economics

August delivered another data set confirming steady and synchronized global growth coupled with subdued inflation. The OECD reported that it expects each of the 45 economies it tracks to grow this year. This would be the first time this has happened since 2007.

Figures 1 and 2 show that all displayed PMIs improved in August. The US ISM rose to 58.8 after 56.3, the European Markit PMI climbed to 57.4 after 56.6, and the Chinese PMI also improved to 51.6 after 51.1. Japanese Q2 growth delivered a surprise on the upside. The economy grew 4% QoQ annualized. Both consumer spending and capital expenditures contributed to the growth surprise.

Inflation figures remained subdued. US core inflation for July fell to 1.4% from 1.5%, while Eurozone's core inflation remained at 1.2% in August unchanged vs July.

Central banks

Between 24 and 26 August the Federal Reserve Bank in Kansas City hosted its famous annual conference at Jackson Hole, where major central bankers, policy-makers, academics, and economists gather to discuss the global economy and economic policy issues. Janet Yellen, Mario Draghi, Haruhiko Kuroda and other major central bankers attended the meeting. While the global crisis dominated the agenda in recent years, this year's gathering took place in a more relaxed atmosphere. Obviously, market participants were eager to hear details about the Fed's and the ECB's next steps regarding the exit from ultra-loose monetary policy. Instead, Yellen as well as Draghi emphasized the importance of financial regulation and free trade — the opposite of what has been high on the agenda of the Trump administration.

Nevertheless, after the speeches the EUR-USD exchange rate rallied, confirming the market expectations of decisive ECB steps to normalize its monetary policy.

In our view, the most important issue to be discussed at Jackson Hole was that the focus of central banks has shifted from price stability and keeping inflation in check to a much-extended mandate, including the maintenance of financial stability. Central banks are being increasingly tasked with macro-prudential oversight, i.e., the task of avoiding financial excesses. While price stability can be measured relatively easily, financial stability is a much fuzzier concept.

Furthermore, additional policy objectives for central banks create additional conflicting objectives. In the past, central bankers have been concerned to weigh their inflation target against cyclical growth. If, in addition, a third target, that of "financial stability" is given high priority on the agenda of central banks, life gets much harder for them, especially since this new policy trade-off is much less easily understood by monetary economists.

The next FOMC meeting takes place on 16 September. It is expected that chairwoman Yellen will announce the beginning of the balance sheet unwind. It is also expected that the Fed will reduce its balance sheet by USD 300 bn per year. At the same time net Treasury issuance is expected to rise by USD 300 bn per year in 2018 and 2019. As a result, the US yield curve could eventually be pushed up. Meanwhile the market-implied probability of a further Fed rate-hike by December came down as low as 30%.

Outlook

We find North Korea's missile and bomb tests and the increasingly aggressive rhetoric of the US administration very worrying. Though North Korea may be regarded as remote and isolated, it is a direct neighbor of Russia and China. Japan is close (about 1,000 km), separated only by the Japanese sea. In recent years North Korea has suffered through tougher sanctions, including further trade restrictions by China, as well as through slower growth in China, and the fall in commodity prices. North Korea's major export goods are coal and iron ore. Weakening economic conditions in connection with heightened internal political tensions have historically coincided with aggressive muscle-flexing by the North Korean leadership.

Taking a more rational look at the situation we think that a nuclear war is highly unlikely. This view seems to be the consensus among most leading political strategists. While we have observed periods of aggressive behavior on the part of the North Korean leadership in the past, the regime has eventually behaved rationally, having used the nuclear threat as a bargaining chip. Also, it is hard to imagine that the US would find it worthwhile to invest time, energy and money in the backyard of China to fight a war with unforeseeable global consequences and little benefit to the US.

As a result, we do not think that financial markets will suffer a lasting negative impact from the tensions around North Korea. The recent market reaction seems to confirm our view. There has been a mild correction of equity markets and rising demand for safe-haven assets, but markets remained relatively calm overall. We also refer to the IMT Risk Monitor (see Figure 32), which shows that typical financial market risk indicators, like hedging costs, remain very relaxed.

We further conclude that healthy growth, low inflation and accommodative central banks continue to provide an environment which should allow equity markets to perform positively.

Although we have been surprised by the strong EUR, we still believe that the EUR strength is exaggerated and that the USD is ripe for a rebound. We also think that the market underprices US inflation risks and the Fed's willingness to normalize rates in the coming quarters. Among equities we still favor Europe and Japan.

ECONOMICS

All PMI figures shown below improved in August, confirming that global growth is broad-based and synchronized. In particular, Chinese growth has accelerated in recent months. While US non-farm payrolls have fallen below 200,000 in recent months, the US economy continues to generate new jobs at a healthy pace. We carefully scrutinize average hourly earnings growth, which has stabilized at 2.5% yoy. We expect wage growth to accelerate on the back of tightening labor market conditions.

Fig. 1: PMIs

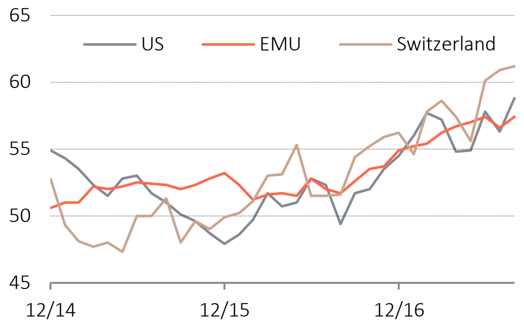


Fig. 2: PMIs

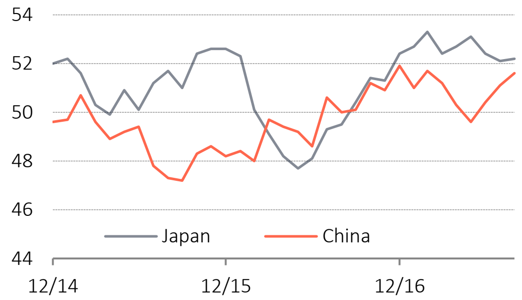


Fig 3: Consumer price inflation, in % YoY

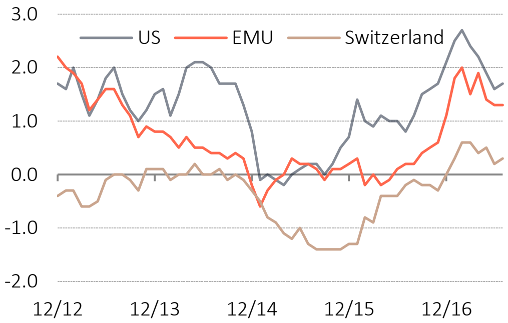


Fig. 4: Consumer price inflation, in % YoY

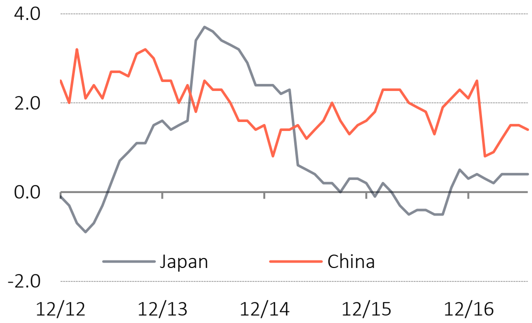


Fig 5: Unemployment rates, in %

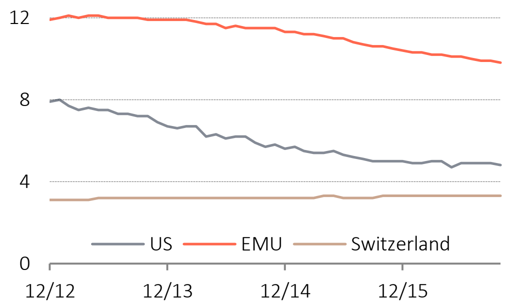
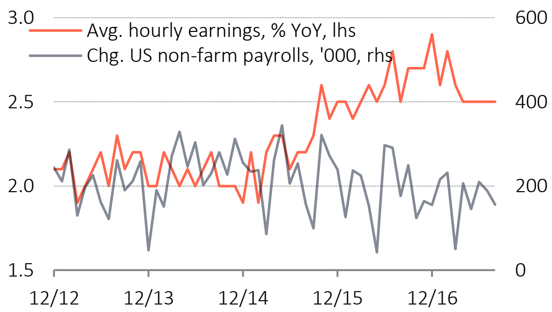


Fig 6: US labor market



FIXED INCOME

Bond yields remained stable or even declined, driven by dovish central banks and safe haven flows in the wake of rising geo-political uncertainties. Despite a slight uptick in inflation expectations, as measured by 10-year break-even rates, yield curves flattened. Credit spreads tightened further and fixed income implied volatility remained very low.

Fig.7: 2Y government bond yields

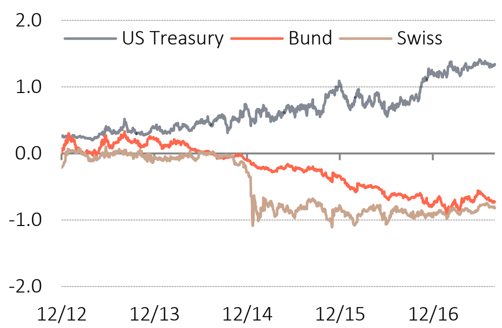


Fig. 8: 10Y government bond yields

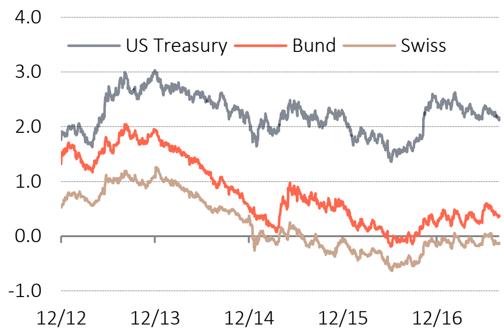


Fig 9: 10Y break-even inflation

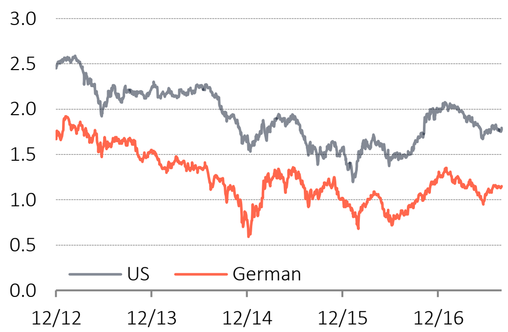


Fig. 10: Credit spreads, 5Y credit default swaps

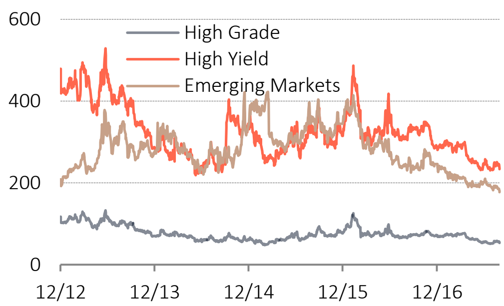


Fig 11: Money market spreads (3M-2Y)

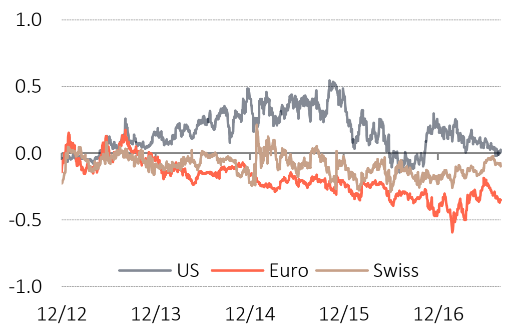
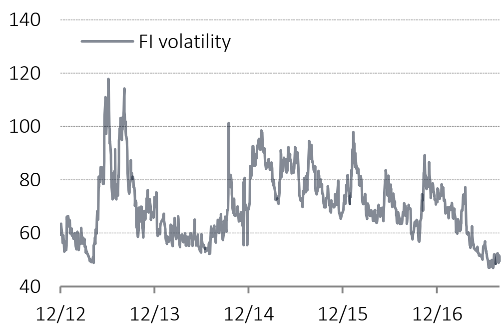


Fig 12: Merrill Lynch volatility index



EQUITIES

Emerging markets were up 2.0% in August, while developed markets fell slightly, by 0.1%. US equities (+0.1%) outperformed European equities (-0.8%), probably also driven by the EUR strength and USD weakness. The Japanese Nikkei 225 index fell 1.4% while the JPY appreciated slightly. The valuation gap between US and European equities continued to widen. The VIX implied volatility index rose to 16 intra-month from 10 End of July, but remained at relatively low levels, despite geo-politic tensions.

Fig. 13: MSCI equity indices – major regions

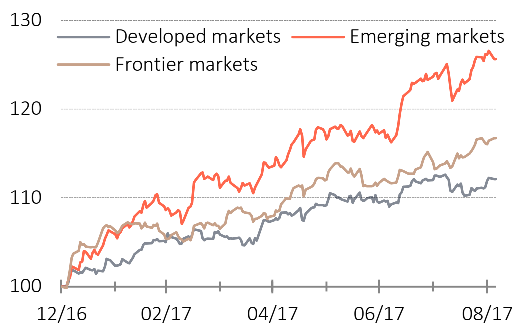


Fig.14: Equity indices – major developed markets

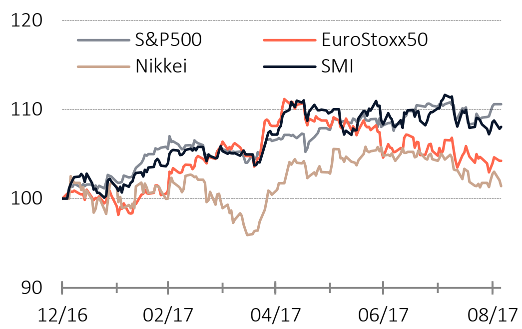


Fig 15: Equity indices – major emerging markets

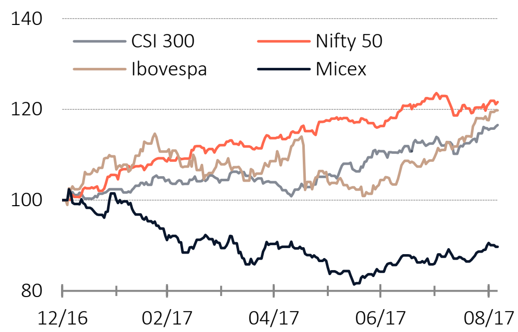


Fig. 16: Sector performance, MSCI Europe, 2017

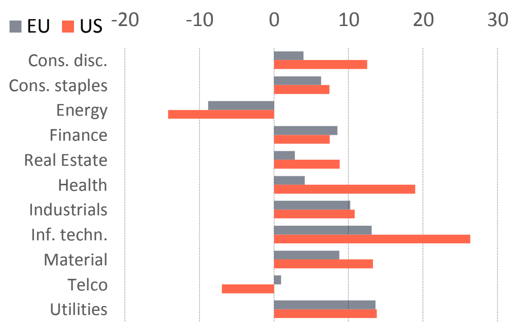


Fig 17: Price-earnings ratios

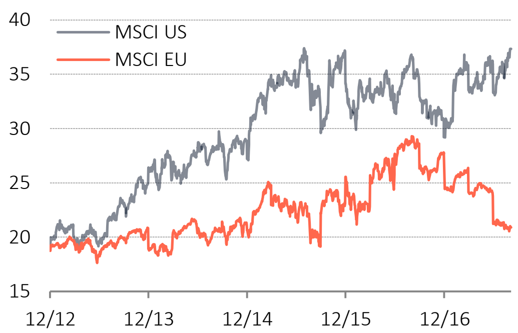
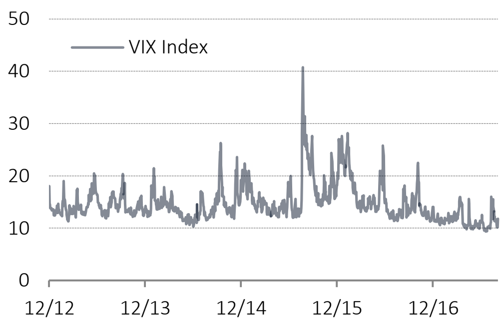


Fig 18: Equity volatility – S&P500 VIX index



ALTERNATIVE INVESTMENTS

In August, the gold price rallied and rose 4.1%. Industrial metals rose even 9.6%. In contrast, the WTI Crude oil future fell 6.0%, but recovered early September. The global REITS index fell 0.9% and the global listed private equity index fell by 1.9%.

Fig. 19: Gold price, USD/oz

Fig.20: Oil price, USD/bl

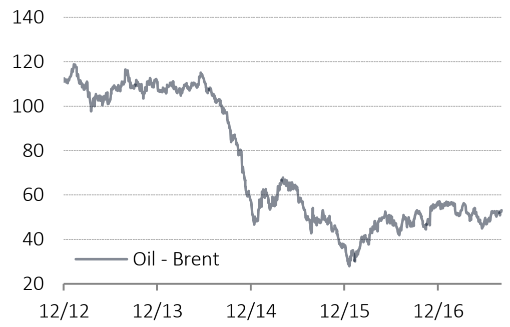


Fig 21: Bloomberg commodity indices

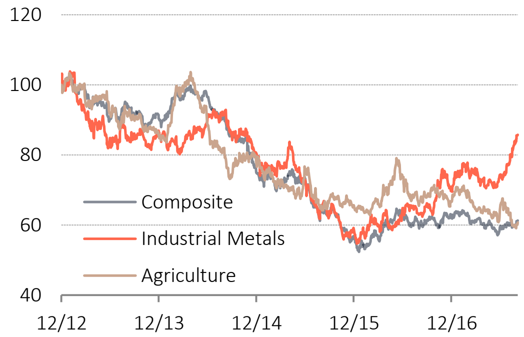


Fig. 22: HFRI hedge fund indices

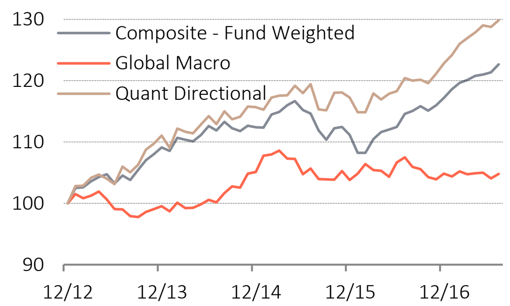
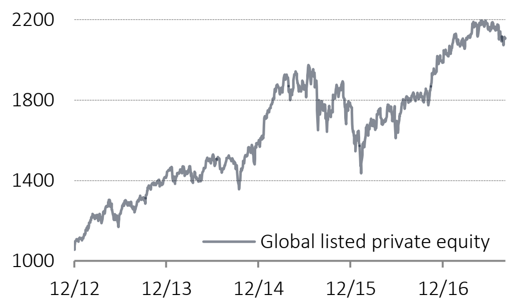


Fig 23: FTSE EPRA/NAREIT global index

Fig 24: LPX global listed private equity



CURRENCIES

The general currency theme, with a stronger EUR and a weaker USD, continued in August. EUR-USD rose as high as 1.20. Brexit uncertainties left the GBP on the weak side. The JPY profited from safe haven flows and also the Chinese CNY remained strong, driven by solid growth figures.

Fig. 25: EUR-USD exchange rate

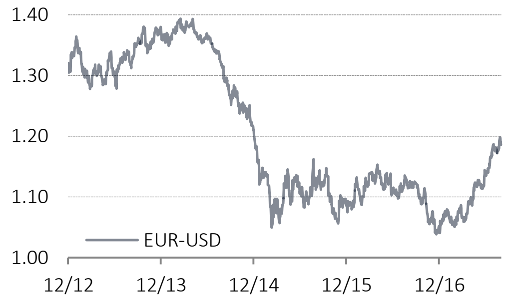


Fig. 26: GBP-USD exchange rate

Fig 27: USD-JPY exchange rate

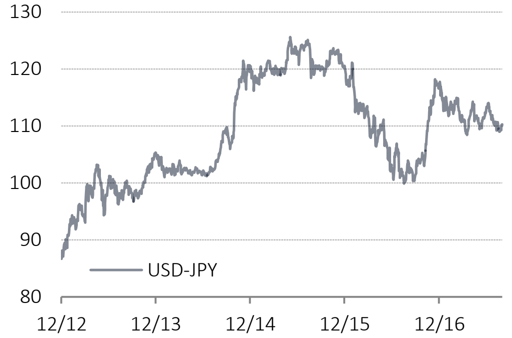


Fig. 28: USD-CNY exchange rate

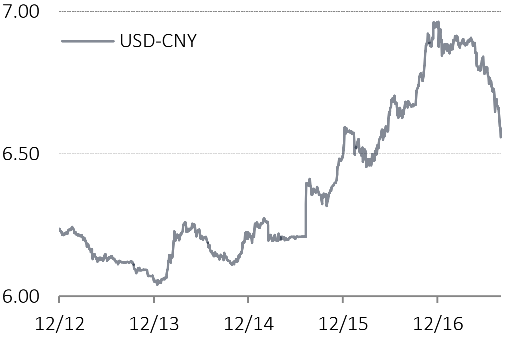


Fig 29: EUR-CHF exchange rate

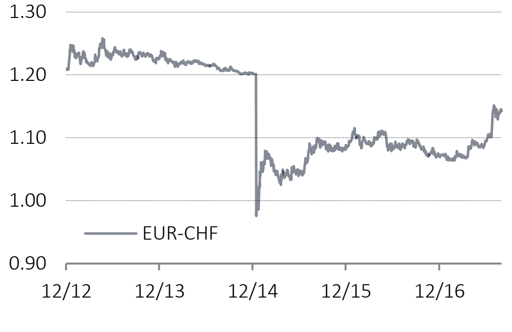
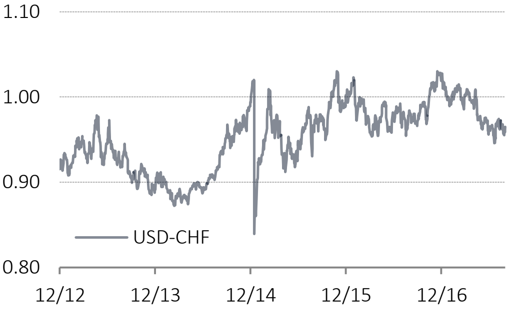


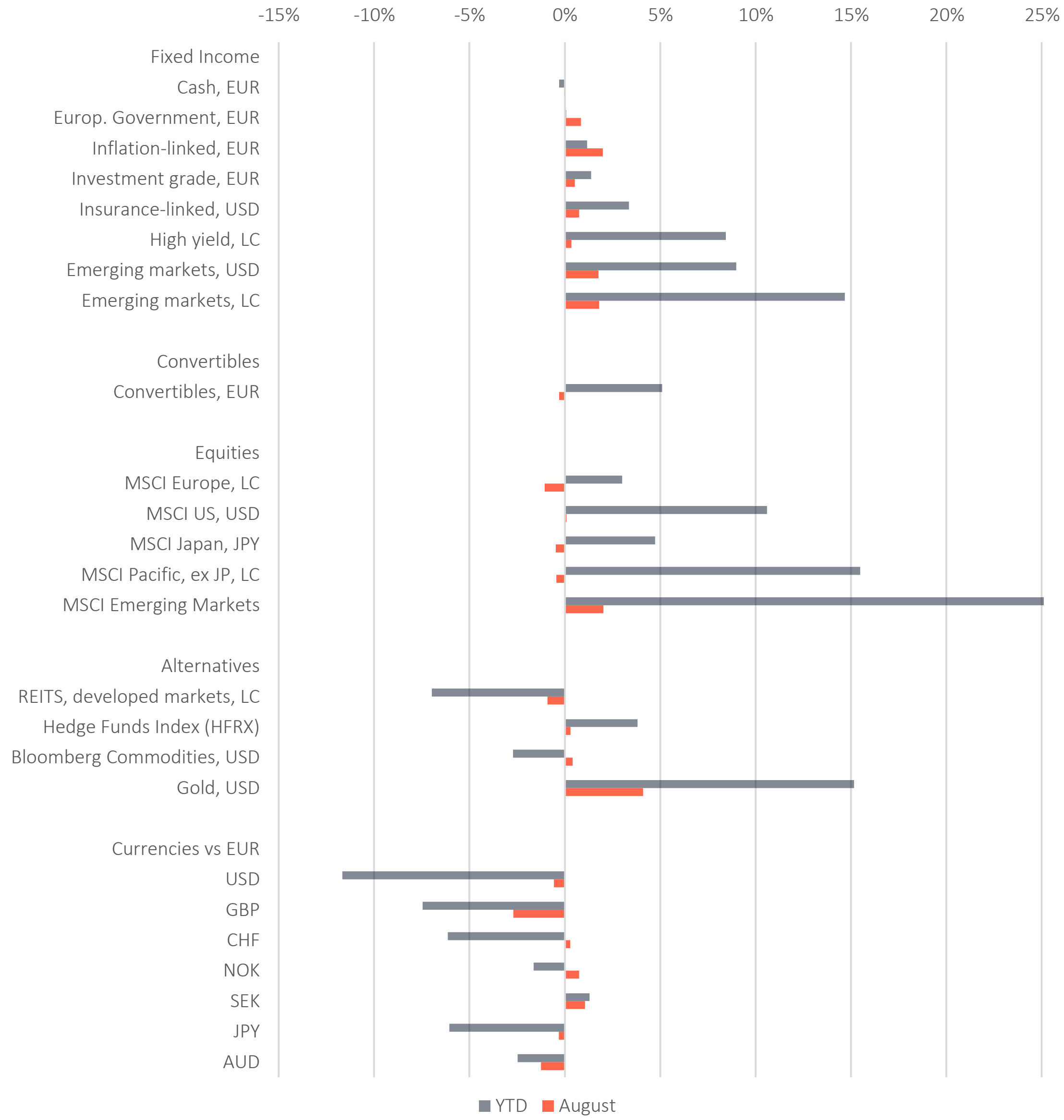
Fig 30: USD-CHF exchange rate



ASSET ALLOCATION

In August, we saw an unusual combination of performing assets: safe-haven assets, especially gold and inflation-linked bonds outperformed, followed by risky emerging market equities and bonds. European and Japanese equities fell in August and lowered performance. Most foreign currencies continued to fall vis-à-vis the EUR, with NOK and SEK being noticeable exceptions.

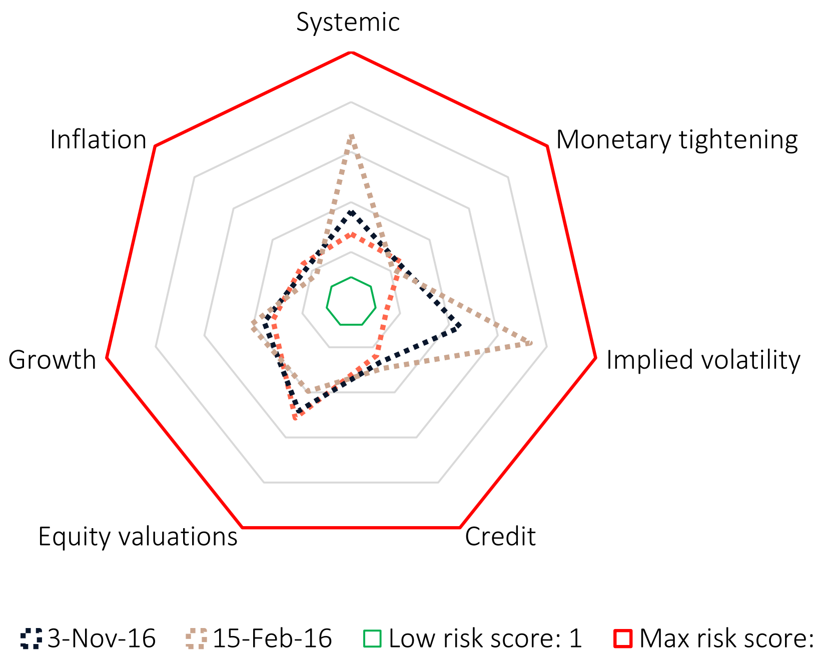
Fig. 31: Performance of major asset classes, based on our EUR portfolio strategy



RISK MONITOR

Despite recent geo-political tensions our IMT risk monitor, which mirrors how financial markets price several risks, did not move much. This seems to confirm that financial markets do not expect the North Korea conflict to escalate. The banking sector continued to perform solidly, driving our systemic risk indicators lower. Geo politics had no significant impact on implied volatilities.

Fig. 32: IMT Risk Monitor



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