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INVESTMENT OUTLOOK 11.2017

04 November 2017

Markets performed very well in October, driven by synchronized global growth, expectations of significant tax reductions in the US, and abating geopolitical tensions – at least as far as recent news headlines are concerned.

The US Fed and the ECB took further steps to normalize monetary policy. In September the Fed announced it would start reducing its balance sheet in October, and the ECB announced in October that it would grow its balance less rapidly, starting in January 2018. These policy shifts had no negative impact on markets of risky assets. But currency markets reacted. The USD strengthened vis-à-vis the EUR and the JPY and the CHF weakened across the board.

For the first time since 2003 the Bank of England hiked rates to fight rising inflation, which – contrary to primary intuition but as a result of a rather dovish rhetoric – sent the GBP lower.

President Trump announced the nomination of Jerome Powell as next chairman of the Fed. This is likely to ensure a smooth leadership transition at the institution.

Trauth

Thomas Trauth
CEO – IMT Asset Management AG

WILL THE FED ACCELERATE THE HIKING CYCLE?

Financial markets

The market's assessment of future US monetary policy has shifted remarkably in recent months. Especially after the Fed's September meeting, when it announced that it would shrink its balance sheet and published its so-called dot-plot projection, markets re-adjusted their expectations of the US hiking cycle. Back in September, markets priced a 20% probability of a December rate hike. This market-implied probability has now risen to almost 90%. This has led to a rise in 10-year Treasury bond yields from about 2% to 2.4% and to a fall in the EUR-USD exchange rate from 1.20 to 1.16. Interestingly, while the Fed itself expects about three further rate hikes in 2018, the market probability is still only at 10%. In fact, the market sees only a 50% chance of one additional rate hike in 2018. We expect that futures markets will adjust more towards the Fed projection. Most likely, this would also result in rising US Treasury yields and a stronger USD.

Rising US rate-hike expectations and a more dovish ECB rhetoric had a strong impact on yields. While US 10-year yields rose by 12 basis points in October, European 10-year yields fell by 10 basis points, leading to a strong widening of the international rates differential.

High-yield bonds and hard-currency emerging market bonds were slightly up, by 0.31% and by 0.37%, respectively. Emerging markets local currency bonds, however, gave back part of their strong year-to-date performance and lost about 2.8% in October.

Meanwhile, the market for insurance-linked bonds enjoyed a recovery. The Swiss Re cat bond index rose 1.8%. However, the index remains clearly below its August level.

Emerging markets equities performed strongly in October. The MSCI Emerging Markets Index rose 3.5%. Developed equity markets were up 1.8%. Clear outperformer among developed markets was the Japanese Nikkei 225 index, gaining 8.1%, followed by the German Dax, gaining 3.1%, the S&P 500 index, rising 2.2% and the MSCI Europe, climbing 1.9%.

The gold price was slightly down in October. Industrial metals prices rose strongly, by 5.8%, and the price for Brent oil by 6.7%. Brent oil is currently trading above USD/bl 60.

Macro economics

The October manufacturing PMIs remained robust. The US ISM index dropped to 58.7 after 60.8, but remained solidly in growth territory. The EMU Markit PMI improved slightly to 58.5 from 58.1.

The weak September non-farm payroll number proved to be temporary and, as expected, mainly due to disruptions caused by the hurricanes. In October the US economy added 261,000 new jobs. In addition, August and September readings were significantly revised upwards and, thus, confirm continued strong job creation. Average hourly earnings corrected down from the hurricane-elevated September value. This indicator still does not suggest that substantial wage pressure will build.

The Republicans revealed a USD 1.5 tn tax plan. The plan is tilted towards businesses, which would receive two-thirds of the benefits. For individuals it would reduce the tax brackets from seven to three. The corporate tax rate would be lowered to 20% from 35%. The plan will be subject to serious debate and it remains to be seen when and how the tax plan will be implemented.

In Japan, Mr. Shinzo Abe handsomely won a snap election on 22 October and, together with his coalition partner, retained a two-thirds majority in the lower house. This victory was all the more remarkable since according to opinion polls Mr. Abe is very unpopular. The election result may partly be explained by voters looking for reassurance due to the economic crisis and a hostile North Korea.

It is expected that Abe will continue his expansionary policy mix. Mr. Abe will nominate the next leadership of the Bank of Japan sometime soon. The election result sent the JPY lower and the Nikkei 225 stock index higher, accelerating the rally which started in early September.

China's National Party Congress ended as expected with a strengthened President Xi Jinping, who reiterated that he plans to implement structural supply-side reforms, to reduce overcapacity, and to deleverage the economy. As discussed in our Investment Outlook 10.2017, this will prove to be very positive for a long-term and sustainable growth path. But it is also very likely that such reform plans will reduce growth in the short-term as the economy adjusts to the new policy measures.

The question may arise, why President Jinping did not implement such reforms during his first five-year tenure. Marko Papic, Chief Geopolitical Strategist of BCA, points out that Xi Jinping has faced a number of domestic political constraints, which have become less stringent after the Congress. It became very clear that Jinping was able to strengthen his position considerably.

Central banks

On 26 October the ECB decided to leave rates unchanged. Until the end of December the ECB will continue to run its asset purchase program at the current rate of EUR 60 bn per month. Thereafter, it will reduce asset purchases to EUR 30 bn per month until at least September 2018. The market interpreted this as a slow, dovish start to the tapering, which produced a fall in the EUR after the press conference.

At its meeting on 31 October and 1 November the US Fed kept the Fed funds rate at 1.25% and indicated it would like to see inflation closer to its 2% target. It is widely expected that the Fed will raise its Fed fund target by 25 basis points to 1.25-1.50 at its next meeting on 12-13 December.

More importantly, on 2 November president Trump announced that he will nominate Jerome Powell as next chairman of the Fed. Jerome Powell, a former investment banker and currently Federal Reserve governor, is believed to have very similar views to Janet Yellen's. Powell's background is a bit unusual for a Fed chairman since he is not an economist by training but a lawyer. He has expressed very liberal views regarding financial regulation, which may have been appealing for Mr. Trump.

On 2 November the Bank of England's (BoE) Monetary Policy Committee (MPC) decided to raise the base rate from 0.25% to 0.5%. The base rate was cut to 0.5% after the financial crisis and cut again to 0.25% after the Brexit vote last year. This is the first rate hike since 2003. The decision was not unanimous, with two out of nine MPC members advocating keeping rates unchanged.

There is much more trouble ahead for the UK economy, in our view. In the UK there is not much of an industrial export industry which could benefit from the weaker GBP. The UK financial industry, which is very strong and could benefit from the weaker GBP, will – depending on the negotiations – suffer from limited market access to the EMU and because of companies moving employees into the Eurozone.

The weaker GBP reduces the purchasing power of British consumers, and rising interest rates will increase borrowing costs, since 40% of UK mortgages have variable rates. This, in turn, will lead to lower real-estate prices outside London, where prices remained relatively stable after the Brexit vote. In London, real estate prices already fell by 7% in the last seven months.

Outlook

The Fed is likely to raise interest rates at its 12-13 December meeting. We expect a further repricing of the US money market curve to reflect a higher probability of additional interest-rate hikes in 2018. This should not only drive short-term rates but also long-term rates further up. Furthermore, this should strengthen the USD.

We remain positive on equities in general and European as well as Japanese equities in particular.

A stronger USD could provide some headwind for emerging markets assets. We are therefore becoming a little more cautious and are considering reducing our emerging-market bonds overweight. A further risk to emerging-markets assets is the high likelihood of structural reforms in China. This will dampen Chinese growth immediately, with negative spill-over effects to other emerging markets.

High-yield markets are priced to perfection, in our view. The worsening risk-reward may not justify keeping an overweight position.

ECONOMICS

October manufacturing PMIs remained robust. While the US ISM index dropped to 58.7 after 60.8, the EMU Markit PMI improved to 58.5 from 58.1. The weak September non-farm payroll number proved to be temporary and due to bad weather conditions. In October the US economy added 261,000 new jobs. Significant upward revisions of August and September readings, confirm strong job creation. Average hourly earnings corrected down from the hurricane-elevated September value.

Fig. 1: PMIs

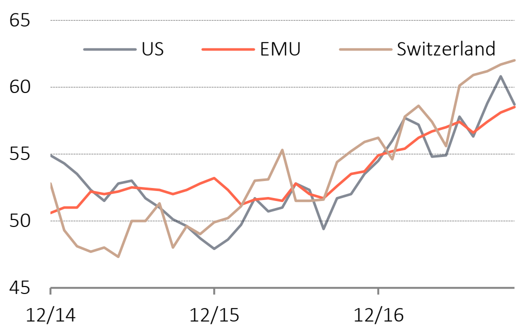


Fig. 2: PMIs

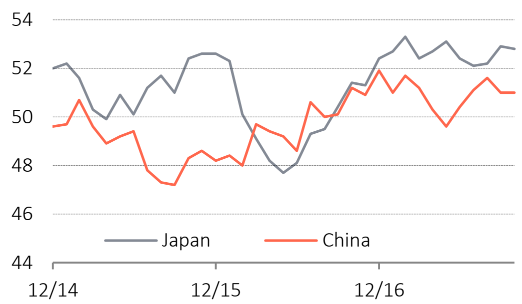


Fig 3: Consumer price inflation, in % YoY

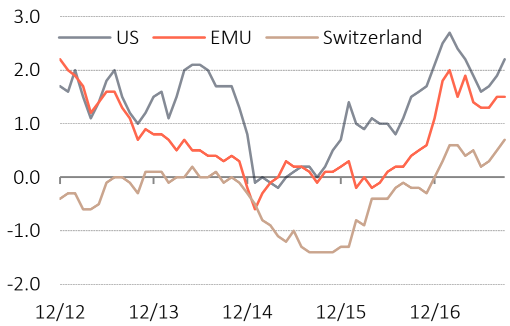


Fig. 4: Consumer price inflation, in % YoY

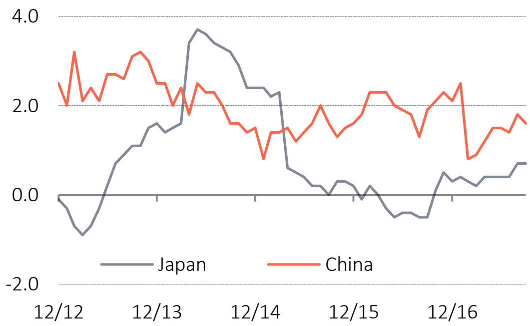


Fig 5: Unemployment rates, in %

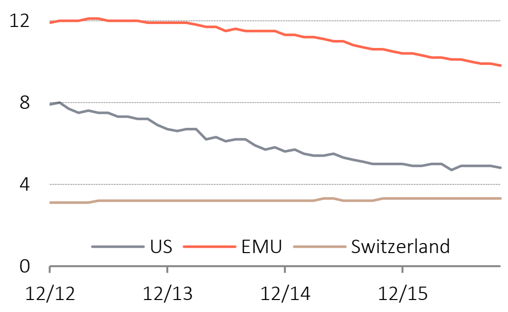
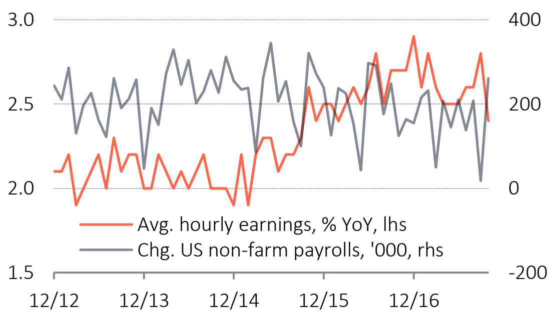


Fig 6: US labor market



FIXED INCOME

US short-term rates rose significantly, as expectations of a Fed rate hike in December rose to almost 90%. Meanwhile inflation expectations (break-even inflation rates) remained firmly anchored. Credit spreads continued to tighten. Emerging markets bonds in local currencies sold off in October.

Fig.7: 2Y government bond yields

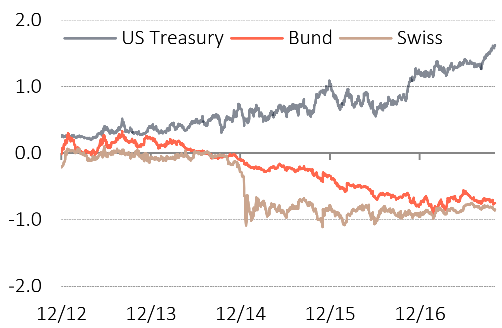


Fig. 8: 10Y government bond yields

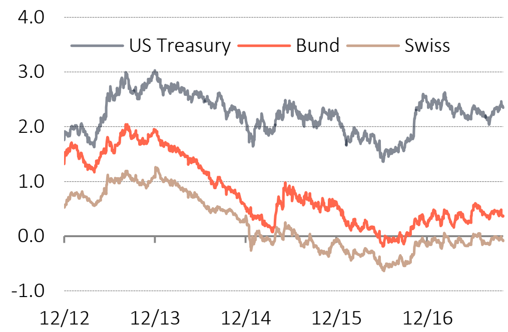


Fig 9: 10Y break-even inflation

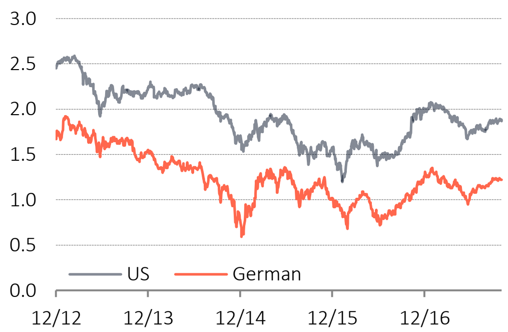


Fig. 10: Credit spreads, 5Y credit default swaps

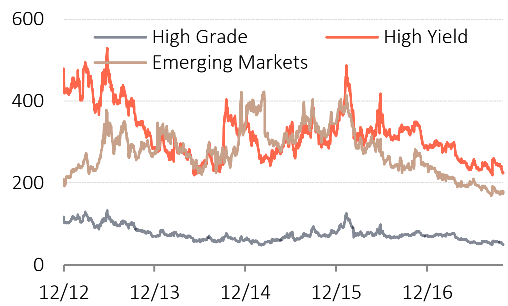


Fig 11: Money market spreads (3M-2Y)

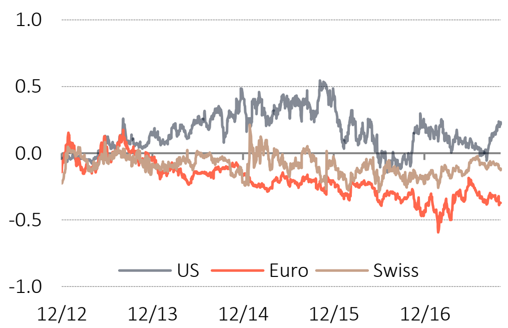
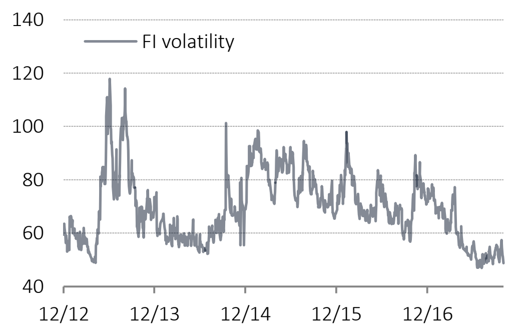


Fig 12: Merrill Lynch volatility index



EQUITIES

Emerging markets outperformed in October, rising by 3.5%. The S&P500 was up 2.2% and the MSCI Europe by 1.9%. The EMU equity markets continued to outperform the non-EMU members. The Japanese Nikkei 225 index performed remarkably strongly, gaining 8.1% in October, supported by the re-election of Prime Minister Shinzo Abe and expectations of continuing strongly accommodative fiscal and monetary policies.

Fig. 13: MSCI equity indices – major regions

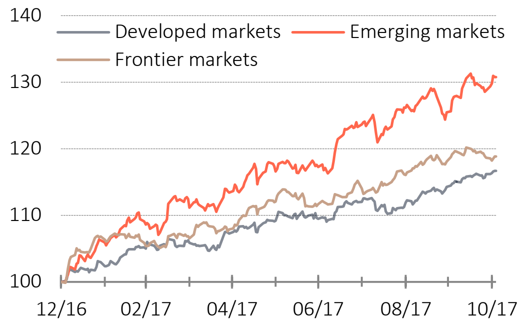


Fig.14: Equity indices – major developed markets

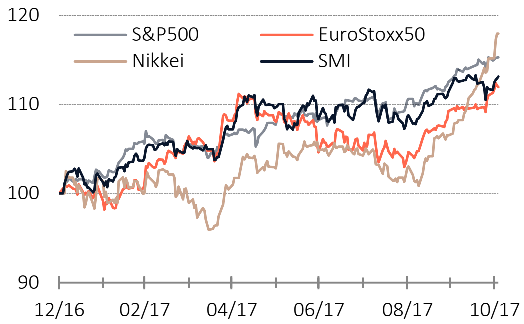


Fig 15: Equity indices – major emerging markets

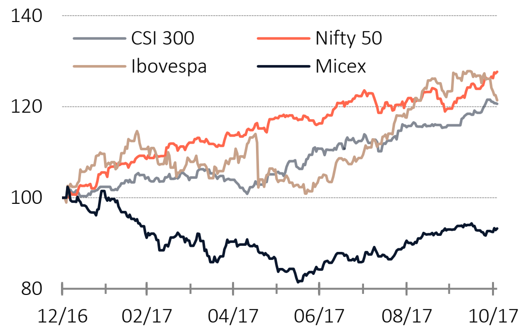


Fig. 16: Sector performance, MSCI Europe, 2017

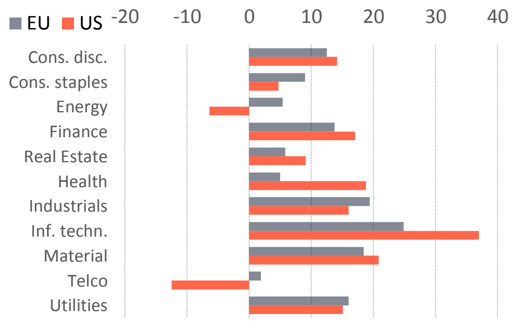


Fig 17: Price-earnings ratios

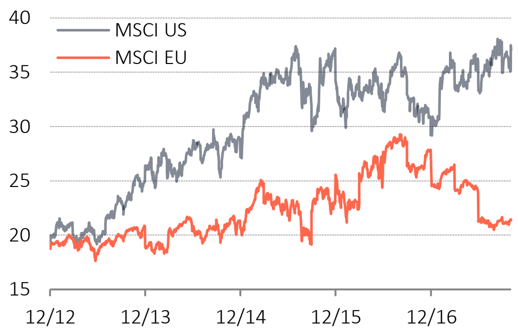
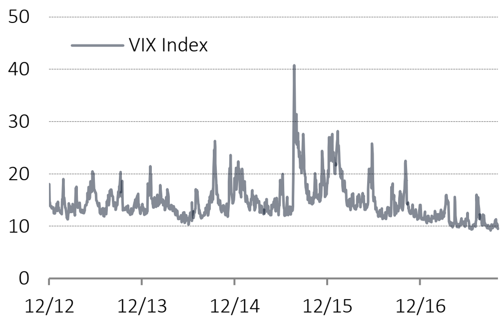


Fig 18: Equity volatility – S&P500 VIX index



ALTERNATIVE INVESTMENTS

Oil prices continued to surge. Brent oil reached levels above USD/bl 60. The price for gold declined slightly in October. Industrial metals prices surged. REITS were slightly up. Listed private equity gained 1.5%.

Fig. 19: Gold price, USD/oz

Fig.20: Brent oil price, USD/bl

Fig 21: Bloomberg commodity indices

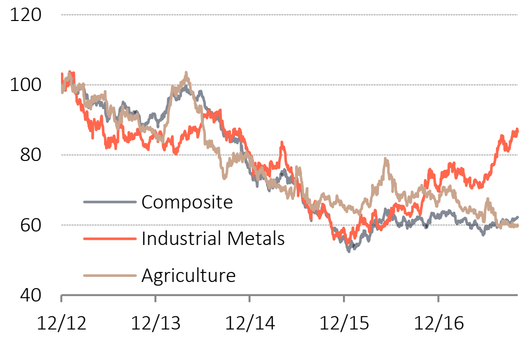


Fig. 22: HFRI hedge fund indices

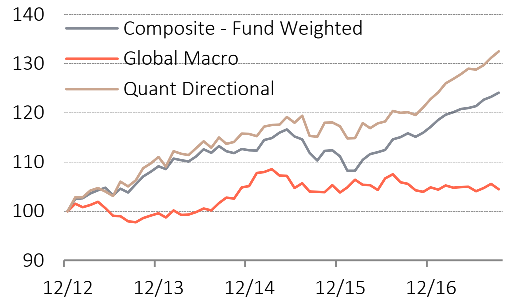


Fig 23: FTSE EPRA/NAREIT global REITS index

Fig 24: LPX global listed private equity

CURRENCIES

In October the USD strengthened, driven by a more dovish ECB and widening interest rate spreads. The GBP was very volatile and strengthened in anticipation of a BoE rate hike. After the delivery of the rate hike, the GBP fell due to a more dovish rhetoric. The JPY and the CHF continued to weaken.

Fig. 25: EUR-USD exchange rate

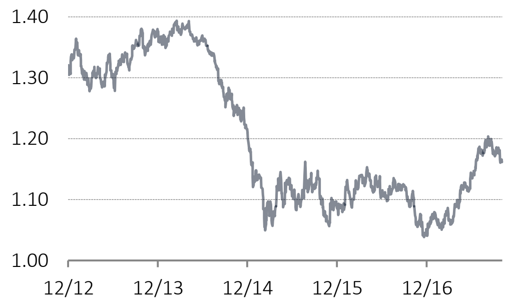


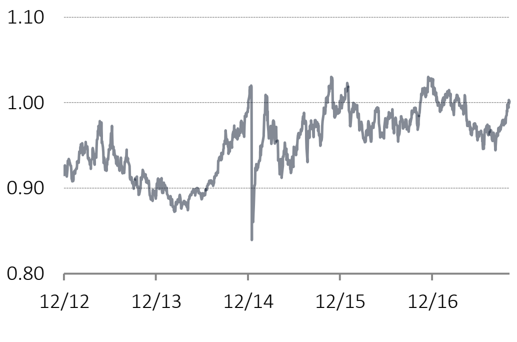
Fig. 26: GBP-USD exchange rate

Fig 27: USD-JPY exchange rate

Fig. 28: USD-CNY exchange rate

Fig 29: EUR-CHF exchange rate

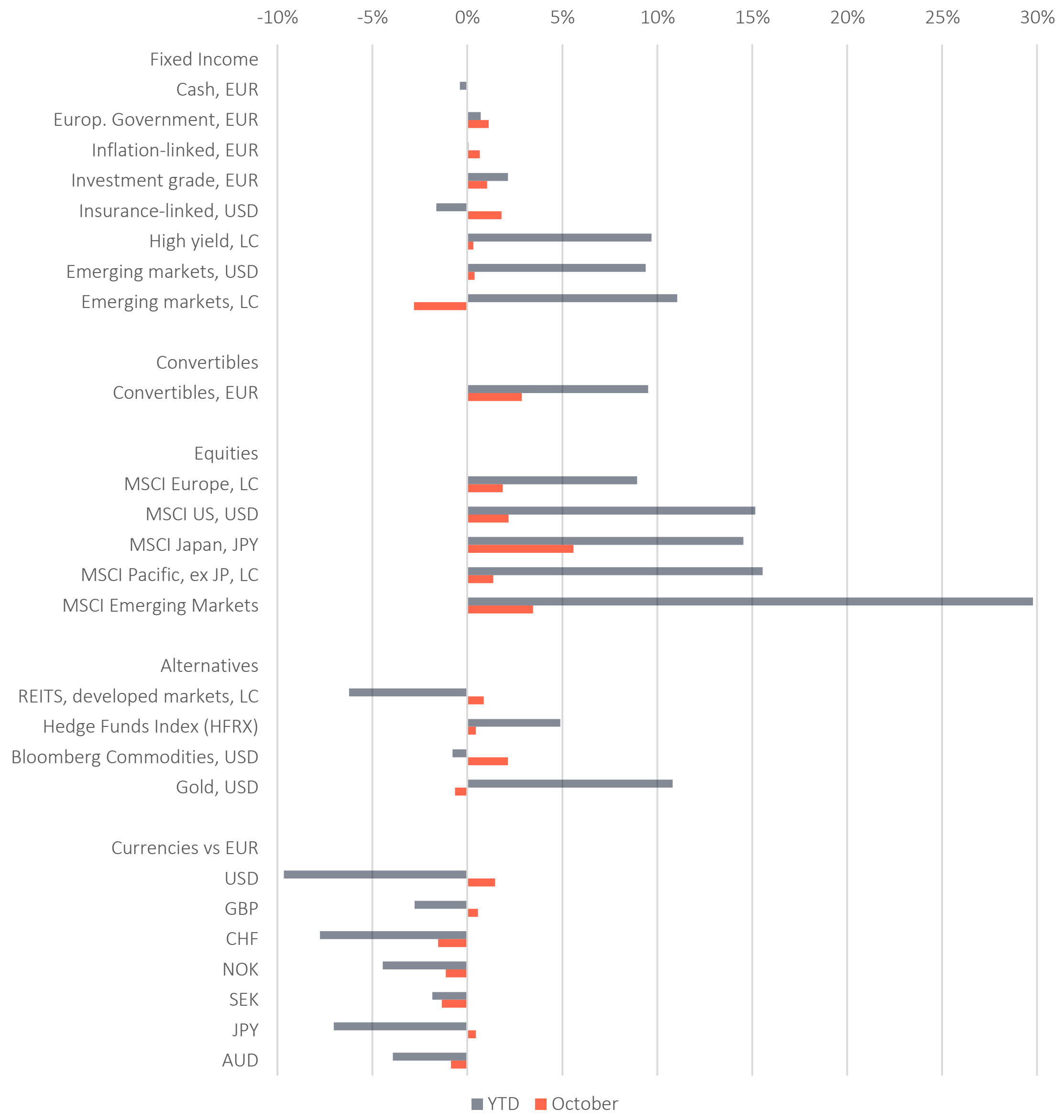
Fig 30: USD-CHF exchange rate



ASSET ALLOCATION

October was a good month for risky assets. Japanese equities outperformed, followed by emerging markets equities. The latter has been the strongest performer by far this year. Overall a European investor should have avoided currency risks in 2017. Emerging markets bonds sold off in October after a very strong rally since January. Insurance-linkers recovered well after natural catastrophes triggered a significant sell-off in September.

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

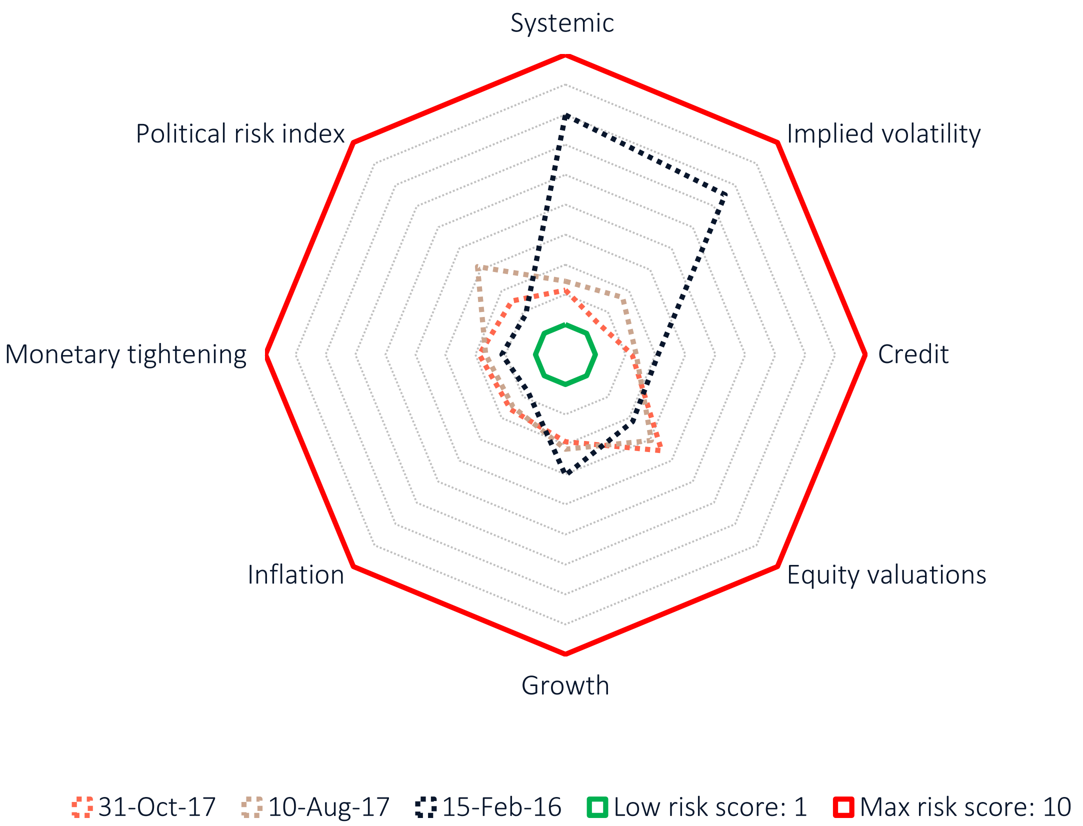


RISK MONITOR

We have modified the IMT Risk Monitor by adding a new dimension. We now include the Political Risk Index of Caldara and Iacoviello, who monitor geopolitical risks using key word searches in leading newspapers. For example, in August the political risk indicator picked-up the North Korea tensions, while our other risk indicators remained relatively benign. This latest addition should help us to paint a more complete risk landscape.

Fig. 32: IMT Risk Monitor

15 Feb 2016: China growth fears
10 Aug 2017: North Korea tensions



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