

# INVESTMENT OUTLOOK

## 03.2018

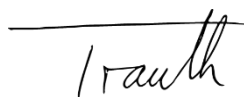
15 March 2018

February was a very difficult month. Inflation fears, concerns about a global trade war, and concerns about more hawkish central banks sent bond and equity markets tumbling. This has been damaging for long-only multi-asset class portfolios, since natural hedges (negative correlation between bonds and equities) did not work. Active managers, including hedge fund managers, often have problems coping with such sudden and disruptive market moves, as was the case this time.

Our assessment that market moves were exaggerated and driven by technical factors – see our Investment Outlook publication of 8 February – seems to be confirmed by the fact that markets calmed down in the second half of that month.

We expect that a severe global trade war can be avoided, and that President Trump will use his strong rhetoric to improve his bargaining position for potential negotiations.

Since the growth and earnings outlook continues to look very healthy, we still prefer equities over bonds.

A handwritten signature in black ink, appearing to read 'Trauth', written over a horizontal line.

**Thomas Trauth**  
CEO – IMT Asset Management AG

# INFLATION FEARS AND TRADE WAR

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## Financial markets

February was a damaging month for multi-asset class portfolios. Government bonds, credits, and equities sold off. Technical factors amplified the sell-off.

Peak-to-trough losses – between 26 January and 9 February – were 10% for emerging markets, roughly 9% for US and European equities, and 9.5% for Japanese equities. In the same period, US 10-year yields rose 20 basis points and European yields 12 basis points. The Brent oil price fell 11% and the price of gold 2.5%.

Such sudden and disruptive market moves usually create challenges for active managers, since investment rationales, established by fundamental relationships, lose relevance. This also holds true for hedge funds and absolute-return strategies. Accordingly, the hedge fund macro index fell 2.6% in February.

Our assessment, as published in our Investment Outlook on 8 February, looks accurate, since markets were quick to recover in the second half of the month. While the recovery was quite strong, the month-on-month performance remained negative for almost all asset classes.

European equities clearly underperformed year-to-date, while US equities and emerging market equities performed positively, 1.5% and 3.2%, respectively.

Insurance-linked bonds proved to be uncorrelated to other asset classes. The Swiss Re Cat Bond index performed positively in January and February.

REITS sold-off significantly in January (-3.7%) and February (-4.9%) but have recovered somewhat in March.

The broad commodity index fell 1.7% in February. All sub-indices but agriculture contributed to the fall. Energy was the largest loser, followed by industrial metals, which came under selling pressure after President Trump's announcement that tariffs were to be imposed on steel and aluminum imports.

The EUR-USD exchange rate remained relatively stable in 2018. The EUR strengthened slightly by about 1.8%. The JPY was very strong and gained 4% against the EUR.

## Macro economics

Almost all leading indicators point to strong and robust growth. Although the European manufacturing PMI fell slightly to 58.6 after 59.6, it remains solidly above the 50 level.

The long-awaited resurfacing of US inflation has been at the core of the recent repricing of macro and especially inflation risks. Those fears calmed down recently, since US headline inflation remained very stable, between 2.0 and 2.2%. In addition, wage inflation, as measured by average hourly earnings (see Fig. 6), declined in February to 2.6%. The January reading was at the core of market nervousness, since it unexpectedly rose to 2.9%. The market seems to confirm the inflation outlook, since break-even inflation rates have stabilized at a level slightly above 2% in recent months.

Nevertheless, we do expect that US inflation is going to rise somewhat in the coming months, albeit not at a worrying pace. Such a slow upward inflationary trend can be seen from the development of US core inflation, which ignores volatile food and energy prices. US core inflation began to go up in Q4 2017, rising gradually from 1.7% in September 2017 to 1.8% in February 2018.

Looking beyond the US, we observed higher inflation in China and Japan. Chinese consumer prices surged to 2.9% in February after 1.5%. While this figure is heavily distorted by seasonal effects, there is evidence that consumer demand remains resilient and food prices are rising. At the same time, producer price inflation is slowing, which is in line with China's policy of decelerating credit growth.

Higher prices for fresh food pushed Japanese inflation up to 1.4% in January, the highest level in three years. However, inflation remains clearly below the Bank of Japan's target of 2%. In addition, there is no evidence that wages in Japan are starting to rise.

On 8 March US President Trump imposed tariffs of 10% and 25% on imports of steel and aluminum. Steel and aluminum account for only 2% of world trade and this move should have only limited impact on global trade and growth. In addition, it seems that Trump is willing to make exceptions. As of now, Canada and Mexico are exempt. We assume that an escalating trade war can be avoided. However, if further tariffs were to be imposed on Chinese exports or European cars, for instance, retaliatory measures by the EU and / or China could lead to more drastic US action. A trade war has the potential to impair global trade, which would lead to lower growth and higher inflation.

### Central banks

Jerome Powell has taken the helm of the US Fed. At his first Congressional testimony on 27 February he was very positive on the growth outlook, which suggests that the Fed is willing to follow its dot-plot

projection and hike rates three to four times this year. The market fully anticipates another 25 basis point rate hike at its next policy meeting on 21 March. The market currently discounts two additional rate hikes in 2018.

At its 8 March meeting the ECB left key interest rates and its asset purchase program unchanged. However, President Draghi dropped a sentence from the communication, which stated willingness to increase bond buying if needed. The market initially reacted with a stronger EUR but retreated thereafter. This change in wording is regarded as another signal that the ECB is moving towards normalization of its monetary policy.

### Outlook

We remain constructive on the equity outlook, since a moderate increase in inflation poses no threat on equities in our view. The major risk, however, is an escalating trade war. We think the chances are very high that such a scenario can be avoided, since there is too much at stake for everybody. President Trump has shown in the past that after vigorous initial rhetoric – most likely to build a strong negotiation position – he softens his position later.

We have shifted from a European and Japanese overweight to a US and emerging markets overweight.

We also reduced our bond positions (interest rate risk) further. Since credits – in our view – are priced to perfection, we started to underweight high-grade and high-yield bonds.

We increased our commodities allocation, since commodities usually benefit in a late-cycle reflationary environment.

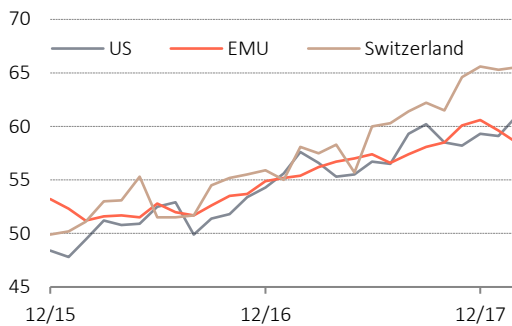
We also became more positive on the EUR vis-à-vis the USD and reduced our USD exposure below our strategic level.

# ECONOMICS

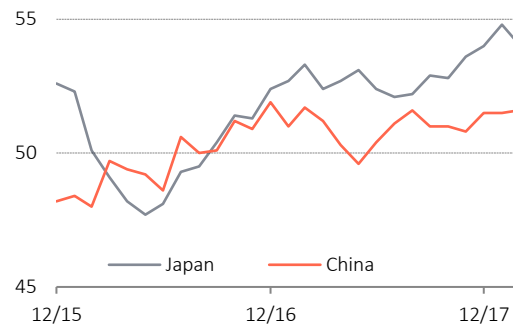
PMIs remained very strong, although the EMU manufacturing PMI declined to 58.6 after 59.6. Headline inflation remained calm in most economies. The exception was China, where consumer price inflation surged to 2.9% after 1.5%. While this figure is

distorted by seasonal effects, there is evidence that consumer demand is resilient and food prices are rising. US wage rises slowed down in February, easing fears of accelerated wage inflation.

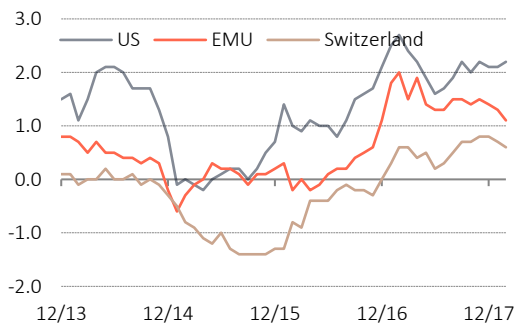
**Fig. 1: PMIs**



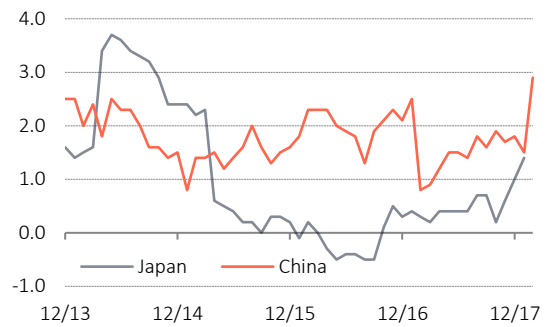
**Fig. 2: PMIs**



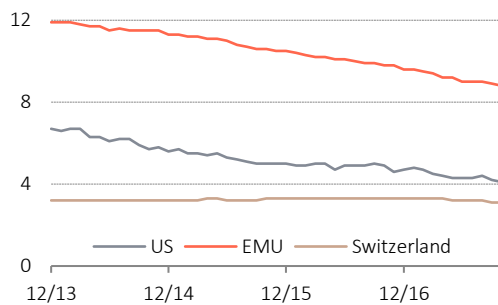
**Fig 3: Consumer price inflation, in % YoY**



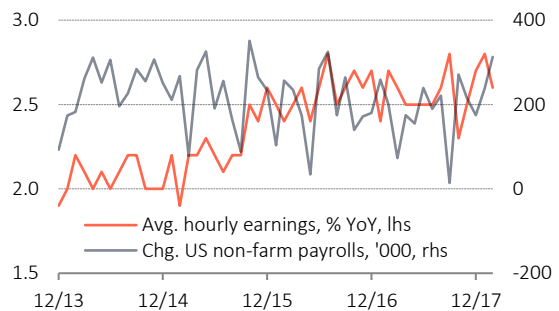
**Fig. 4: Consumer price inflation, in % YoY**



**Fig 5: Unemployment rates, in %**



**Fig 6: US labor market**

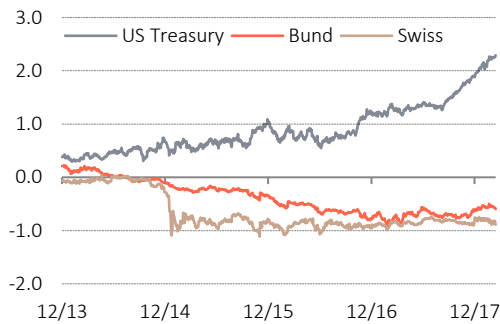


# FIXED INCOME

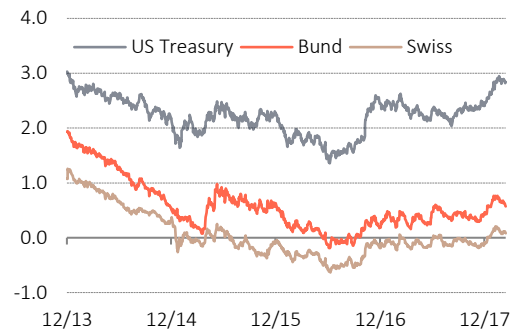
US yields rose significantly from the beginning of the year on, but have recently stabilized. Break-even inflation rates rose since last December. The rise was clearly stronger in the US as compared to Europe, which reflects the tighter labor market conditions in

the US. Credit spreads widened early February in sympathy with equities but tightened thereafter. The fixed-income volatility spike was not as pronounced as in equity markets and retreated when markets calmed.

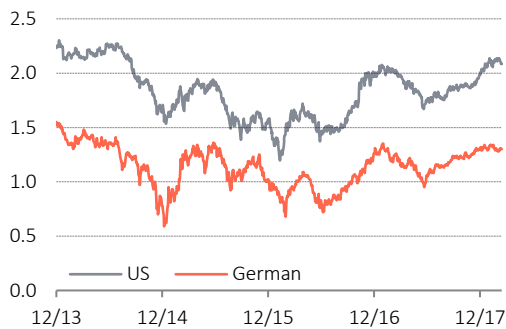
**Fig.7: 2Y government bond yields**



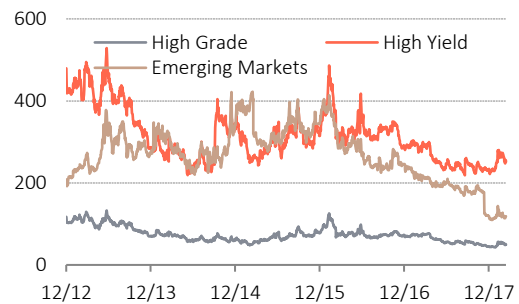
**Fig. 8: 10Y government bond yields**



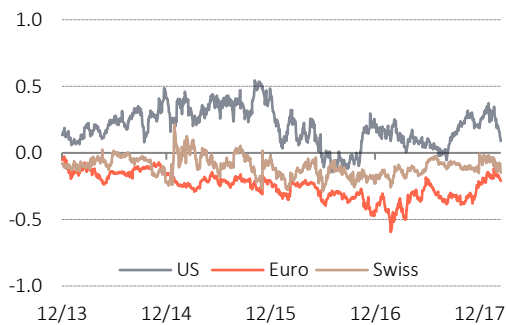
**Fig 9: 10Y break-even inflation**



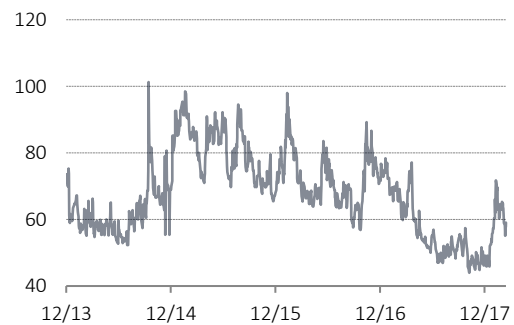
**Fig. 10: Credit spreads, 5Y credit default swaps**



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



**Fig 12: Merrill Lynch volatility index (MOVE)**

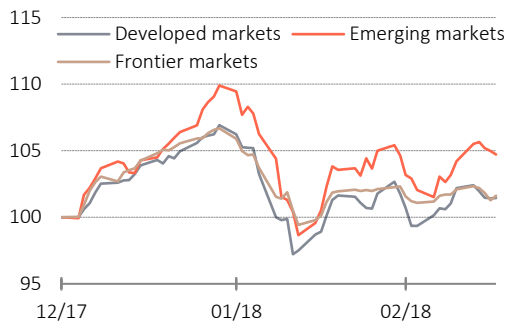


# EQUITIES

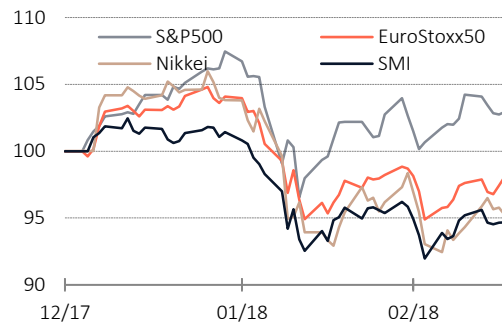
In February we experienced a broad-based equity market sell-off. While markets already recovered in the second half of February, month-on-month performance remained clearly negative. Emerging markets underperformed in February, but clearly

outperformed in January and early March. Europe and Japan clearly underperformed the US. US technology stocks continued to outperform year-to-date. The valuation gap between the US and Europe, as shown in Fig. 17, continued to widen.

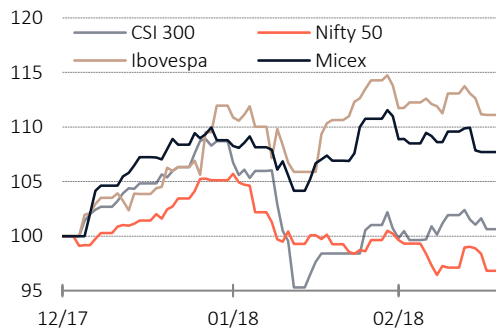
**Fig. 13: MSCI equity indices – major regions**



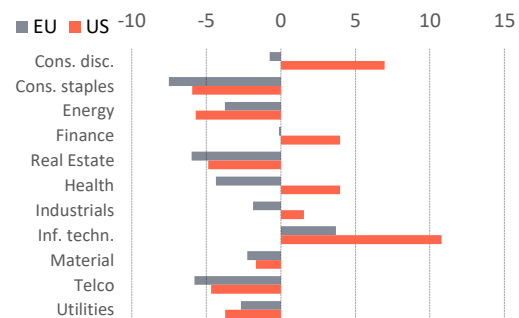
**Fig.14: Equity indices – major developed markets**



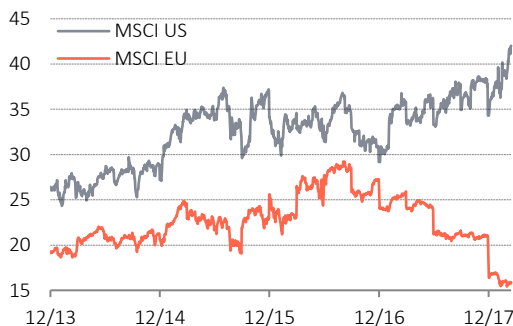
**Fig 15: Equity indices – major emerging markets**



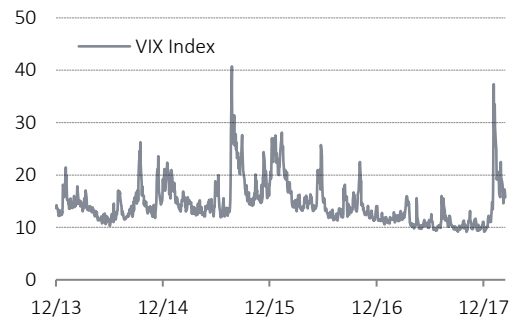
**Fig. 16: Sector performance, MSCI Europe, 2017**



**Fig 17: Price-earnings ratios**



**Fig 18: Equity volatility – S&P500 VIX index**

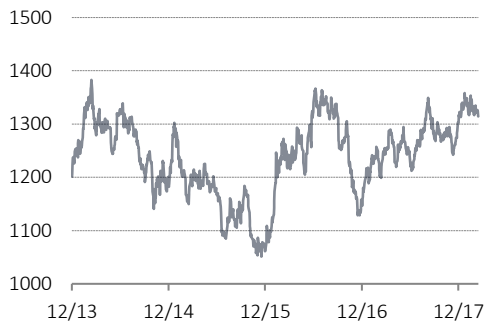


# ALTERNATIVE INVESTMENTS

In February commodity prices fell, driven by falling oil prices, down 4.7%, and industrial metals, down 2.2%. Industrial metals suffered from President Trump’s planned introduction of tariffs on steel and

aluminum. Also, gold fell 2% in February. Marco hedge funds had a difficult month, the respective index fell 2.6%. Global REITS extended their losses and fell 4.9%, but recovered somewhat in March.

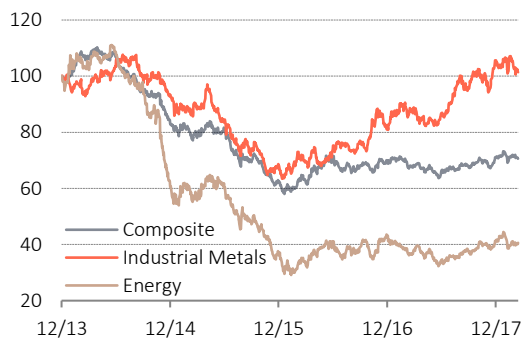
**Fig. 19: Gold price, USD/oz**



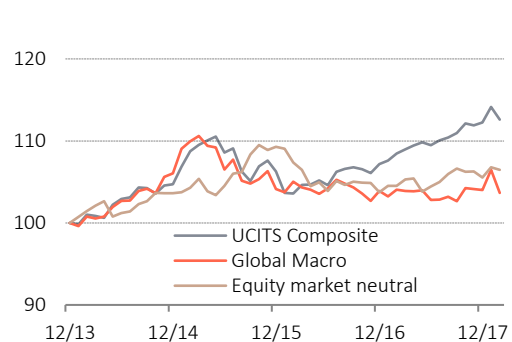
**Fig.20: Brent oil price, USD/bl**



**Fig 21: Bloomberg commodity indices**



**Fig. 22: HFRU hedge fund indices**



**Fig 23: FTSE EPRA/NAREIT global REITS index**



**Fig 24: LPX global listed private equity**



# CURRENCIES

Since the beginning of the year, EUR-USD was basically range bound. Overall the EUR strengthened slightly. The JPY strongly appreciated. The Swiss franc

proved its safe-haven characteristics and temporarily gained during the equity sell-off but gave back its gains after markets calmed.

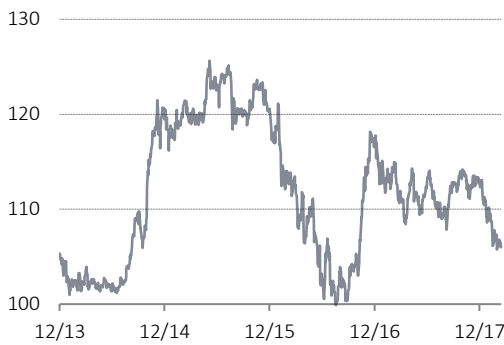
**Fig. 25: EUR-USD exchange rate**



**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**



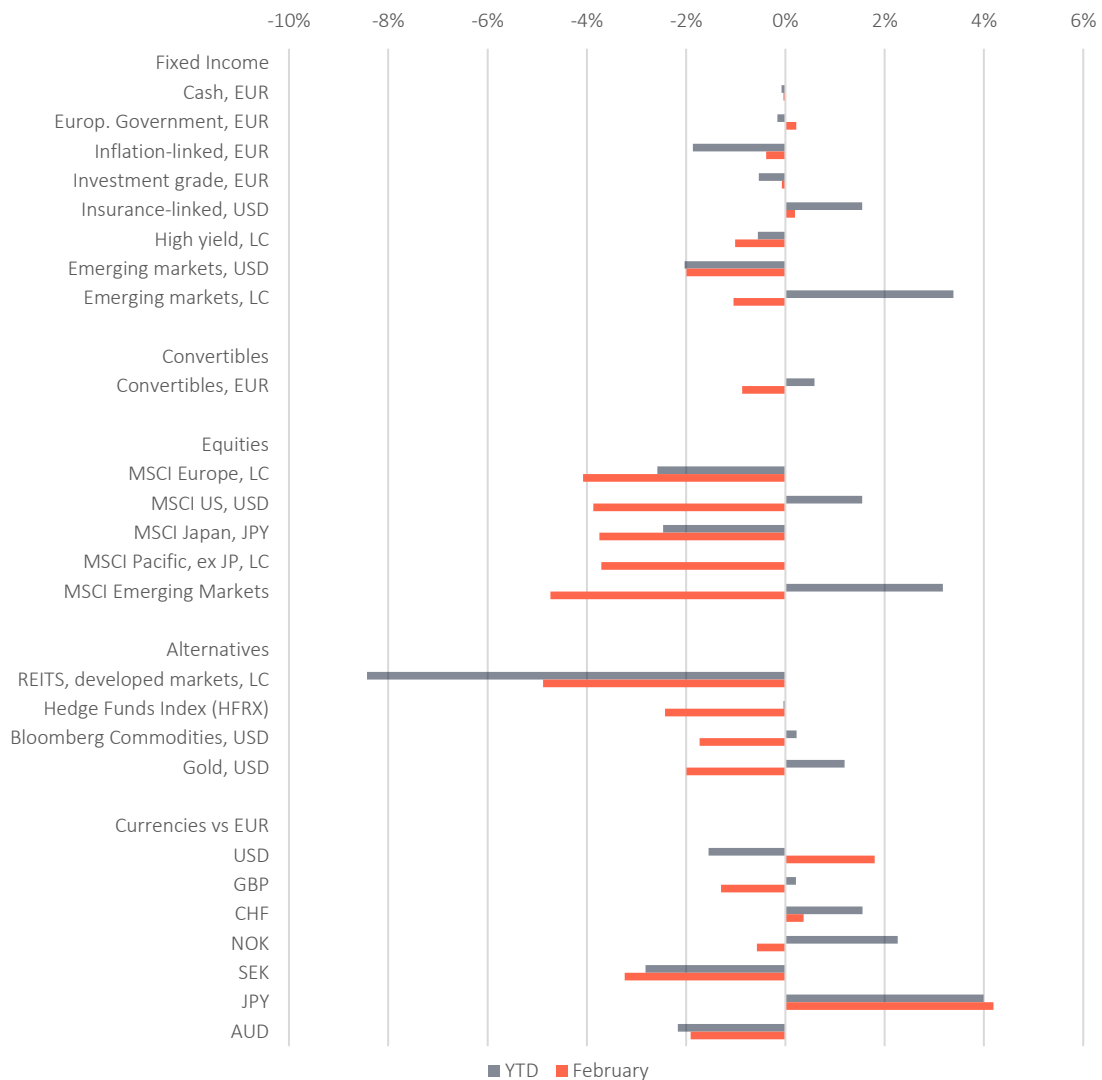


# ASSET ALLOCATION

February performance was negative for most asset classes, and often wiped out the positive January performance. Year-to-date we only see positive performance contributions from insurance-linked

bonds, emerging market bonds in local currencies, convertibles, US equities and emerging market equities, and gold. While the USD lost against the EUR, the JPY appreciated significantly.

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



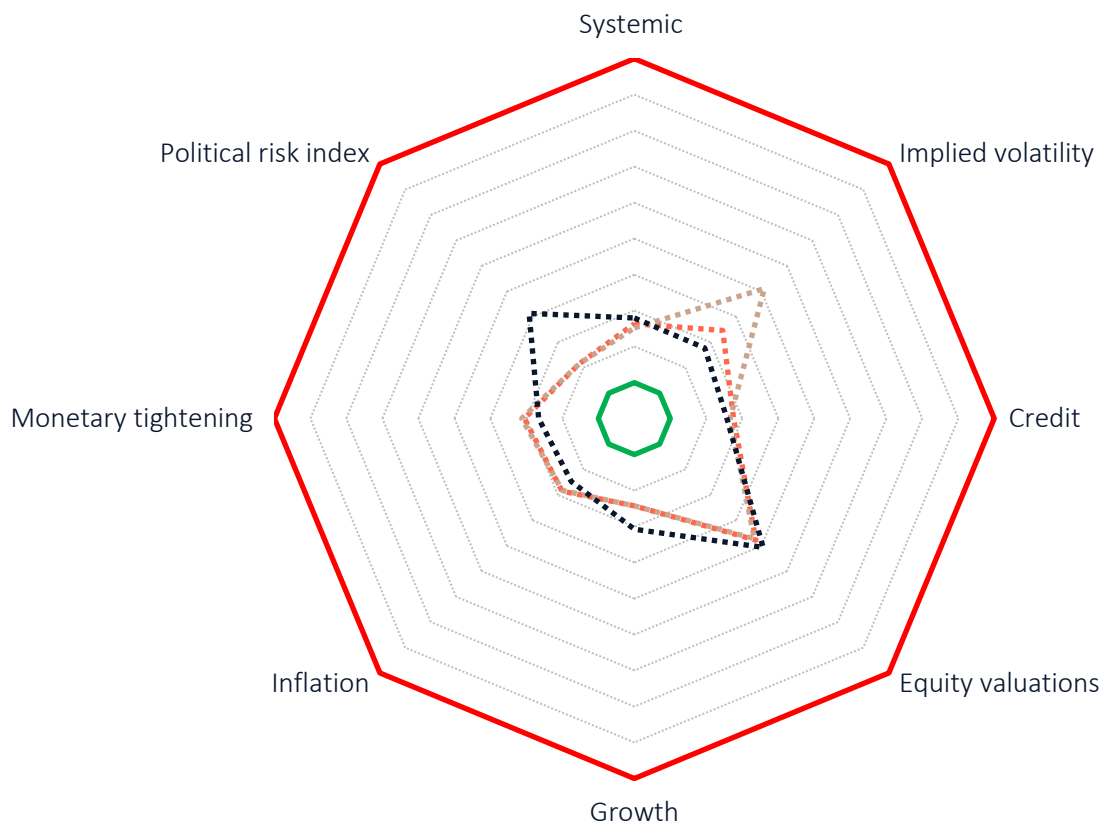
# RISK MONITOR

The IMT Risk Monitor reflects heightened inflation risks and a higher probability of monetary tightening. At the same time, equity valuations fell somewhat after the recent market correction. Implied volatility spiked early February but retreated

thereafter. Other safe-haven assets, like e.g., gold, did not react much during the sell-off in early February, which suggests that the sell-off was not caused by broad-based market fears.

**Fig. 32: IMT Risk Monitor**

09 Feb 2018: Inflation fear and technical correction  
10 Aug 2017: North Korea tensions



⋮ 2-Mar-18   
 ⋮ 9-Feb-18   
 ⋮ 10-Aug-17   
 ■ Max risk score: 10   
 ■ Low risk score: 1

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*Source for all graphs: Bloomberg, IMT Asset Management AG.*