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IMT GROUP

INVESTMENT OUTLOOK 04.2018

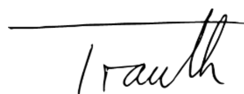
07 April 2018

The first quarter started with a strong equity rally. End of January, however, a major correction began. Developed markets ended the quarter losing 1.7%, whereas emerging markets gained 1.1%. Inflation and trade war fears, coupled with bad news regarding the technology sector, unnerved markets.

We do not expect that these developments will be structurally capable of derailing the equity bull market, since fundamentals remain very strong. It would be very unusual if, despite solid earnings growth, equity and credit markets were to sell-off for longer than one quarter.

However, we remain wary and mindful of some major risks which could override fundamentals and push investors into risk aversion. These risks relate predominantly to US politics. President Trump could force China and/or Europe into an escalating trade war and could take tough measures against North Korea and/or Iran.

We are carefully monitoring the above-mentioned risks, but in our base case we expect a scenario in which equity and credit markets will recover in Q2.



Thomas Trauth
CEO – IMT Asset Management AG

WILL US POLITICS DERAIL MARKETS?

Financial markets

In March risk-takers were punished. Almost all equity markets and high-yielding bonds sold-off. The exceptions were emerging market bonds denominated in local currency, which were able to resist the risk-off mood and gain 1%. Also, REITS, which are considered more defensive, recovered from a major sell-off earlier this year – they lost 8.4% in January and February together – and gained 1% in March. As a result, most multi-asset class portfolios had a second negative month in a row.

Among equities, emerging markets slightly outperformed, losing "only" 2%, whereas the S&P500 lost 2.7% and the MSCI Europe 2.5%. The general market trend, coupled with a stronger JPY, resulted in a loss of 2.8% for the Nikkei 225.

Despite more hawkish ECB and Fed statements in March, 10-year bond yields fell 12 basis points in the US and 16 basis points in Europe, driven by safe haven flows. European break-even inflation rates rose slightly, while US break-even rates remained stable.

The broad commodity index fell 0.6% in March. The development within the commodities complex was, however, very mixed. While industrial metals fell 4.4% on the back of US tariffs on steel and aluminum, Brent oil rose 6.8%. Gold enjoyed a small gain of 0.5% in March.

The EUR continued to be strong in March. It gained 1.1% against the USD, 0.7% against the JPY, and 2.0% against the CHF. The GBP recovered and gained 1.9% against the USD and 0.8% against the EUR.

Macro economics

All major PMIs weakened in March. This can partly be attributed to uncertainties in connection with rising protectionism. We would also expect that growth may have peaked early this year, which would mean we will see falling PMIs in the coming months. However, all major growth indicators suggest that growth dynamics remains very robust, at least for the coming 9-12 months.

While US non-farm payrolls disappointed and fell to 103,000 additional jobs in March, the three months average remains very strong and above the previous year's level. Wage pressure remains muted, with average hourly earnings rising 2.7% after 2.6% in February.

While headline inflation nudged up to 1.4% in March after 1.1% in February, core inflation, which ignores volatile goods, like fuel and food, remained steady at 1.0%. The ECB expects headline inflation to be around 1.5% for the rest of the year. Still, a gradual increase in inflation gives the ECB additional justification to normalize monetary policy.

Trade war

On 23 March the US imposed tariffs on steel and aluminum from some countries, including China. This provoked the first retaliatory measures from China itself. On 3 April President Trump announced an additional list of 1,300 Chinese products, which could be subject to a 25% tariff. Soon after, China published its own list containing 106 categories of US products. US tariffs would hit about USD 50 bn worth of Chinese export goods (9% of total exports to America) and the

Chinese cover USD 50 bn worth of US goods (38% of US exports to China).

The US intends to hurt sectors which benefit from unfair Chinese trade practices. Among other things, China often fails to put protection of international property rights into practice. Furthermore, China has openly communicated its "Made in China 2015" strategy, which aims to redirect production from abroad to China. To achieve this goal China heavily subsidizes often state-owned companies in strategically important sectors. This makes it hard or even impossible for companies in other countries to compete. Such sectors include for example industrial robots, motors for electric vehicles, and semiconductors.

China's retaliation measures aim at industries or states with powerful lobbies, which could put pressure on the US administration to moderate its trade policy. Such areas include aircraft and soybeans, among others.

So far, the lists are only threats and there has not been a formal decision to impose tariffs nor on a time line. The US list is open for public consultation until 21 May. China announced it would wait for the next steps by the US administration.

An option for President Trump is to invite Europe also to put pressure on China to comply with international standards. However, since the relationship between the US and Europe has cooled down, it will be much harder for the US to convince Europe to join the campaign.

Central banks

On 8 March the ECB kept rates unchanged. It reiterated its intention to maintain its asset purchase program at EUR 30 bn per month until September. The communication can nevertheless be regarded as more hawkish, since the ECB dropped its so-called "easing bias". For the first time in a very long time, the ECB omitted the sentence stating that it would be prepared to increase the level of bond purchases in the event that the economic outlook were to deteriorate. Furthermore, the ECB increased its growth forecast to 2.4% in 2018, 1.9% in 2019, and 1.7% in 2020. After the announcements, the EUR strengthened distinctly.

On 21 March the US Fed raised its benchmark funds rate by 25 basis points to the new target of 1.50% to 1.75%. This had been widely expected and had no special impact on markets. In fact, 2-year rates even declined after the meeting. It is believed that the Fed will hike rates three more times this year. The Fed increased its projection for future policy rates for 2019 and 2020, based on a positive economic outlook.

Outlook

Fundamentals remain very favorable for equity and credit markets. The recent market correction has improved valuations since earnings growth has remained very strong. Still, valuations remain rich historically. It would be very unusual for equity markets to sell off for more than a quarter in a phase of such strong earnings growth.

The question remains as to whether there are risks which could drive investors into a risk- off mode, despite sound fundamentals. Clearly there are such risks, which we currently see as mostly related to US politics. We think that an escalating trade war and geopolitical tensions between the US and North Korea and the US and Iran are the most imminent risks at present.

While the possibility of a major trade war certainly rose significantly in March, there is still a good chance that negotiations lead to an acceptable solution.

President Trump could certainly also take tough measures on North Korea and/or Iran.

May will be a very decisive month. Firstly, on 21 May the 60-day consultation period for China tariffs ends. Secondly, the Iran sanction waiver expires on 12 May. Since the US is not trading oil with Iran, it cannot embargo it. However, there is a chance that the US will try to put pressure on Europe to tighten sanctions on Iran. This could intensify tensions and push oil prices up.

ECONOMICS

All major PMIs weakened somewhat in March. This can partly be attributed to uncertainties in connection with rising protectionism, but it may also reflect the fact that growth peaked early this year. US non-farm payrolls disappointed and fell to 103,000 additional jobs in March. Nevertheless, the 3 months average remains strong. Average hourly earnings rose 2.7% after 2.6% in February. This suggests that the US labor market remains healthy and wage pressure muted.

Fig. 1: PMIs

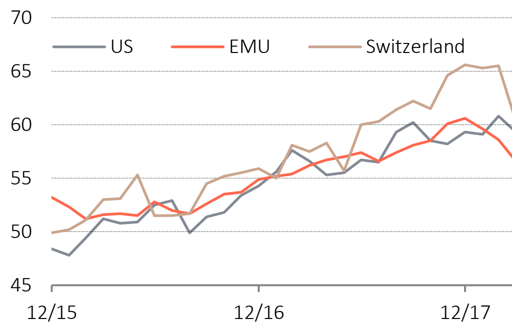


Fig. 2: PMIs

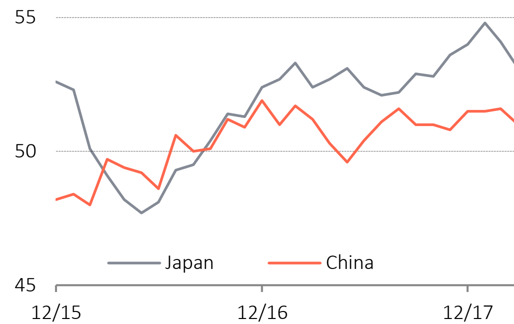


Fig 3: Consumer price inflation, in % YoY

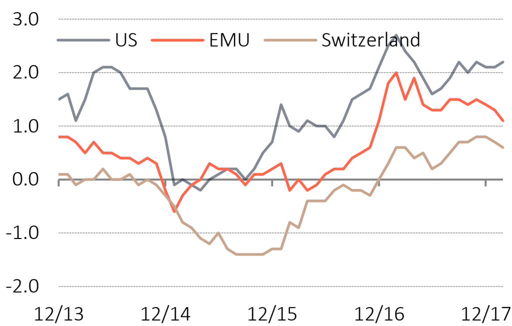


Fig. 4: Consumer price inflation, in % YoY

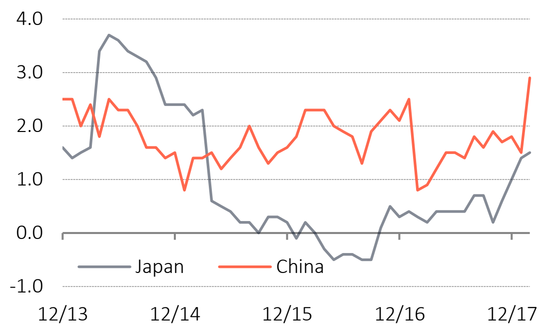


Fig 5: Unemployment rates, in %

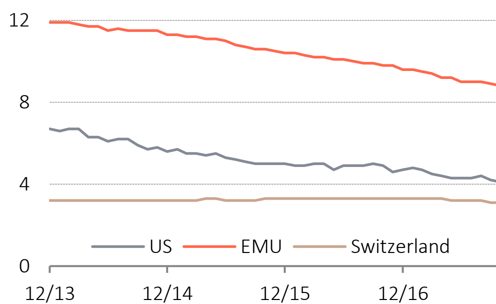
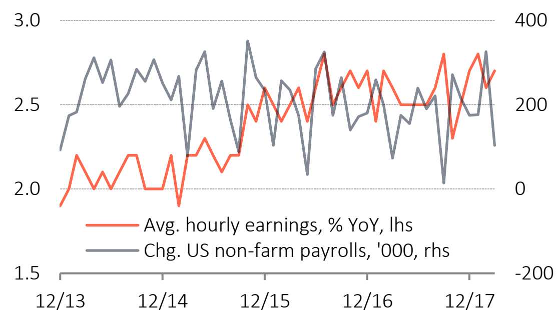


Fig 6: US labor market



FIXED INCOME

Government bonds benefitted from the risk-off environment. US 10-year yields fell 12 basis points and German 10-year yields even 16 basis points. The Fed rate hike had only a limited impact on the short-end of the curve (around the 2-year segment), since the rate hike was broadly expected. High-yield spreads widened somewhat. The high-yield market proved to be very resilient.

Fig.7: 2Y government bond yields

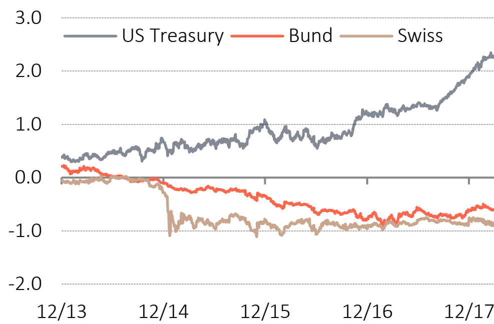


Fig. 8: 10Y government bond yields

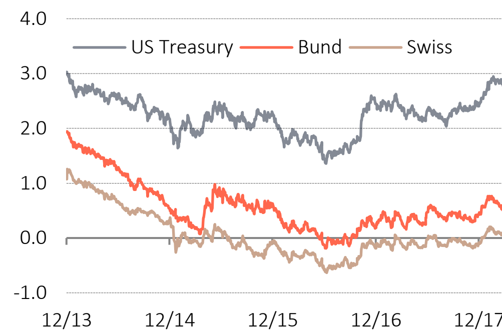


Fig 9: 10Y break-even inflation

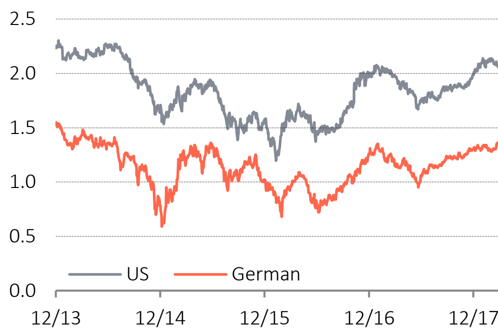


Fig. 10: Credit spreads, 5Y credit default swaps

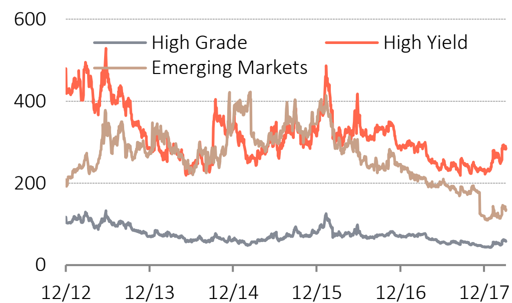


Fig 11: Money market spreads (3M-2Y)

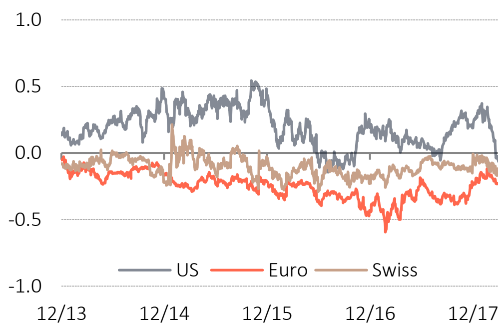
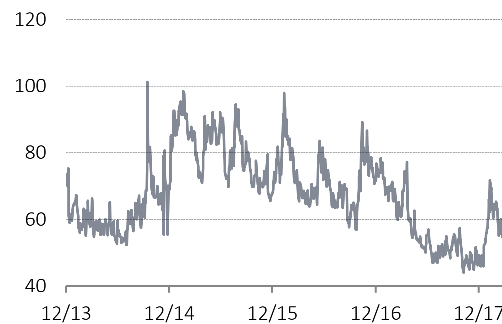


Fig 12: Merrill Lynch volatility index (MOVE)



EQUITIES

In March we first saw a recovery, which was followed by a sell-off driven by trade war fears. Overall equity indices fell in March. The US S&P500 fell 2.7% and the Chinese CSI300 3.1%. Europe was able to slightly outperform, with the MSCI Europe falling 2.4%. Emerging markets fell 2.0% in March. President Trump's critical remarks on Amazon and Facebook's issues with improper use of user data, had a strong negative impact on the technology sector, which had been outperforming in recent months.

Fig. 13: MSCI equity indices – major regions

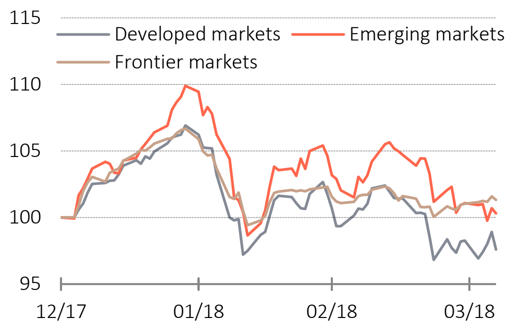


Fig.14: Equity indices – major developed markets

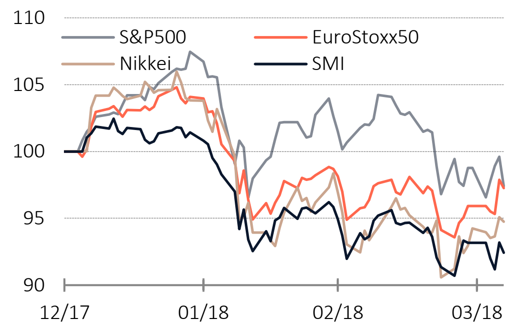


Fig 15: Equity indices – major emerging markets

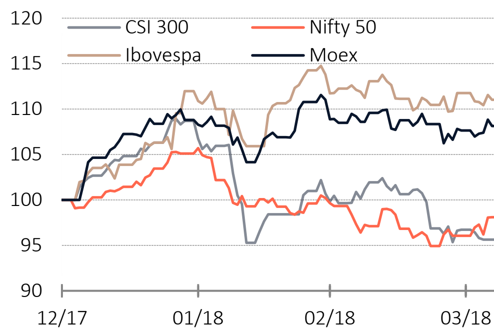


Fig. 16: Sector performance, MSCI Europe, 2017

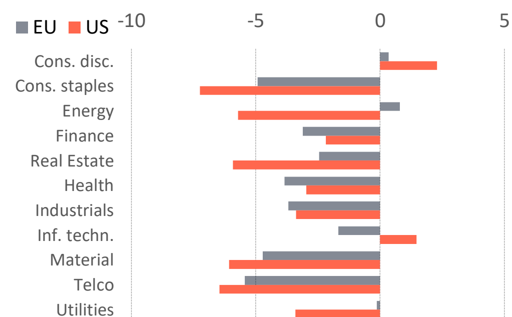


Fig 17: Price-earnings ratios

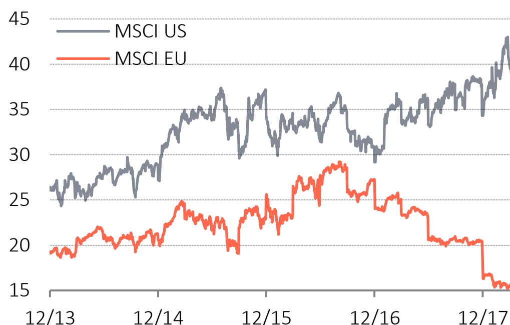
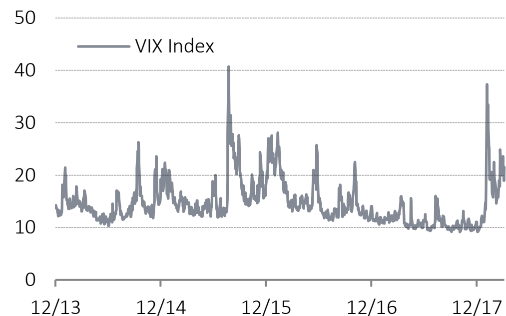


Fig 18: Equity volatility – S&P500 VIX index



ALTERNATIVE INVESTMENTS

In March oil prices rose 6.8% but then recently fell, because trade tensions have the potential to dampen global growth and, in turn, the demand for oil. Prices for industrial metals fell 4.4% in March, because of planned tariffs on steel and aluminum. Hedge funds had a difficult month and lost 1% on average. REITS managed to rebound somewhat, after a sharp sell off early this year.

Fig. 19: Gold price, USD/oz

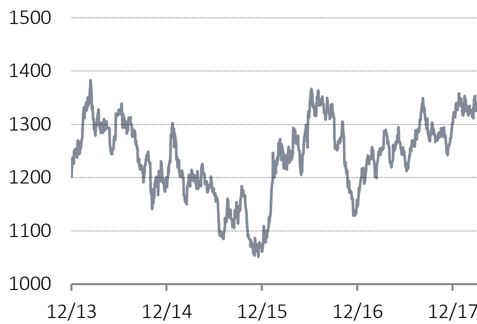


Fig.20: Brent oil price, USD/bl

Fig 21: Bloomberg commodity indices

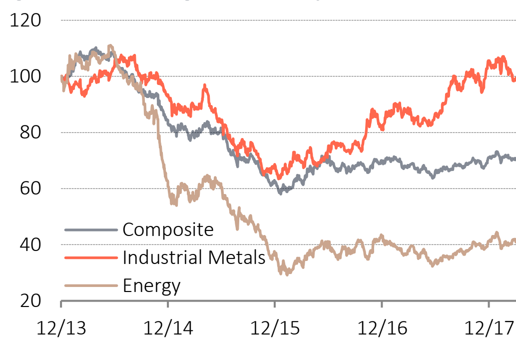


Fig. 22: HFRU hedge fund indices

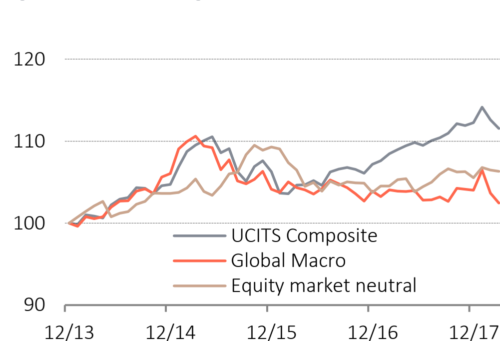


Fig 23: FTSE EPRA/NAREIT global REITS index

Fig 24: LPX global listed private equity

CURRENCIES

The EUR remained strong. It gained 1.1% against the USD, 0.7% against the JPY and 2.0% against the CHF. The GBP rebounded and rose 0.8% vis-à-vis the EUR. Trade tensions led to a sell-off of commodity currencies, like AUD and CAD. The JPY had strengthened since the beginning of the year but was then subject to a sharp correction. Meanwhile, especially towards the end of March, the JPY gained as a safe haven asset on the back of the trade tensions mentioned.

Fig. 25: EUR-USD exchange rate

Fig. 26: GBP-USD exchange rate

Fig 27: USD-JPY exchange rate

Fig. 28: USD-CNY exchange rate

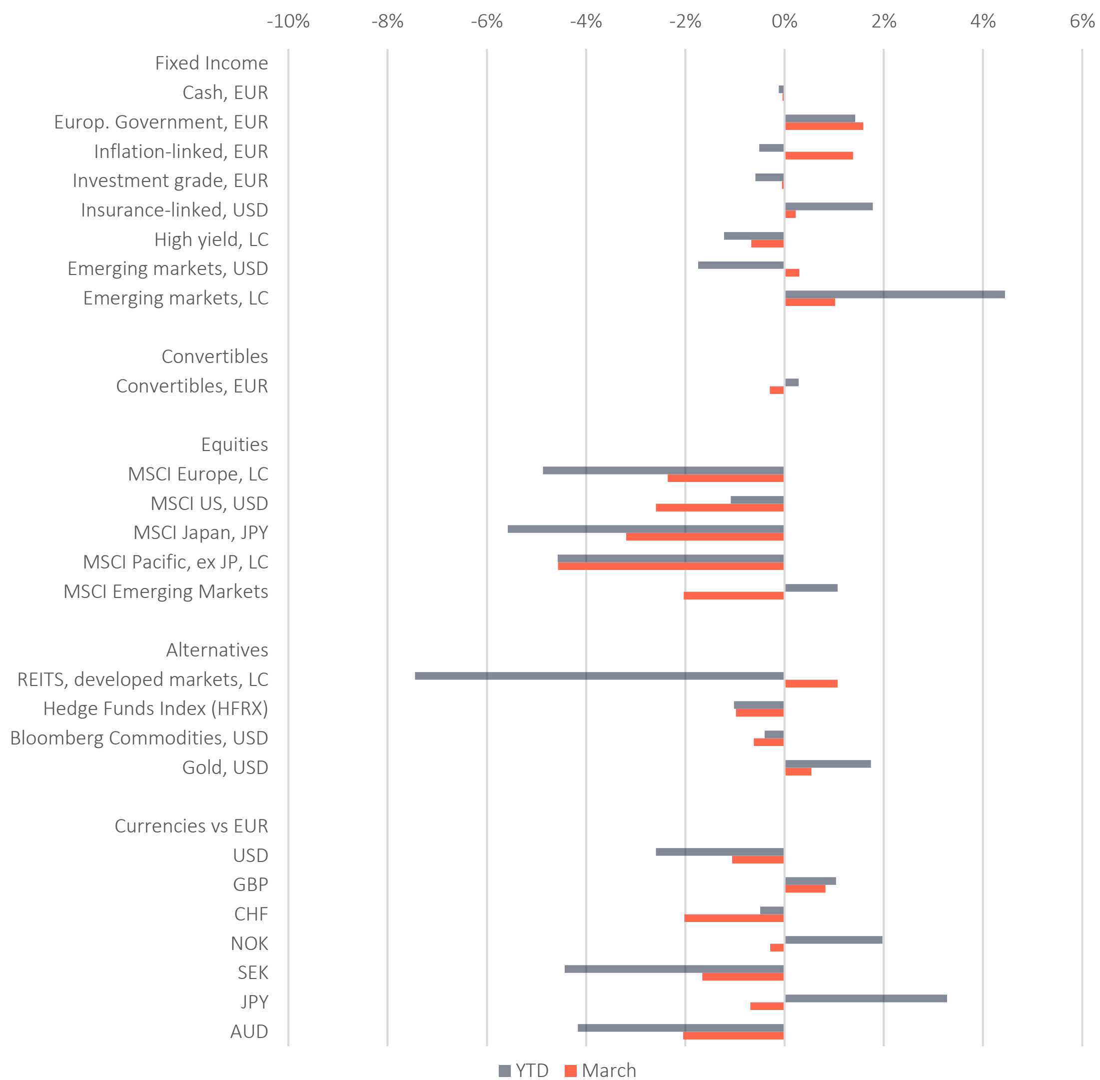
Fig 29: EUR-CHF exchange rate

Fig 30: USD-CHF exchange rate

ASSET ALLOCATION

In March risky assets underperformed. Especially equity markets had a negative performance impact on multi asset class portfolios. The exceptions were local currency emerging markets bonds and REITS. REITS managed to rebound after a hefty sell-off earlier this year. Government bonds, inflation-linkers and gold performed positively in March. The EUR strengthened vis-à-vis most major currencies with the exception of the GBP.

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



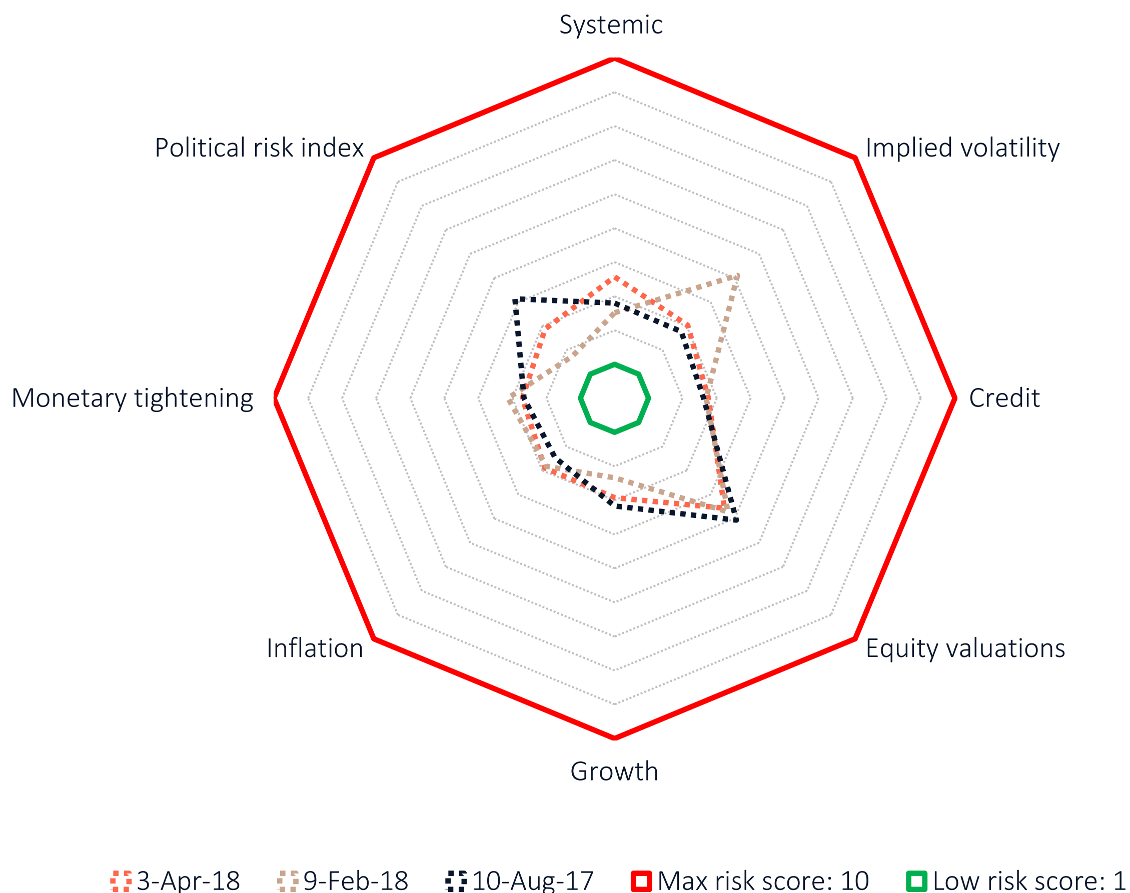
RISK MONITOR

The IMT Risk Monitor remains calm. There are no imminent areas of concern. This suggests that the trade war risk has not spilled over to the more conventional risk indicators that we use for our model.

Systemic risks, i.e., our indicator for the health of the banking system, rose somewhat. This increase was largely driven by underperforming bank stocks.

Fig. 32: IMT Risk Monitor

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



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