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IMT
GROUP

INVESTMENT OUTLOOK 07.2018

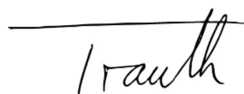
13 July 2018

Geopolitical themes have been driving financial markets. Especially Trump's policy stance has proven to be very erratic and hard to predict. The core concern for global financial markets has been an escalating trade war. Tariffs, already introduced, were not sufficient to have a lasting impact on markets, but more drastic measures could have the potential to cause more severe damage. Trade war fears clearly led to more volatility and to a sell-off of emerging markets; in particular Chinese asset prices fell.

Meanwhile, after government coalition talks in Italy proved to be difficult, Germany's coalition came under stress in attempting to reconcile opposing views on immigration. European equity markets, led by the German DAX, underperformed in June, but has managed to recover somewhat thereafter.

Global growth has become less synchronized. While European growth slowed, the US economy grew strongly, and the outlook for earnings in Q2 is very promising.

We continue to avoid interest-rate risks, remain neutral regarding equities and overweight commodities.



Thomas Trauth
CEO – IMT Asset Management AG

EMERGING MARKETS UNDER SELLING PRESSURE

Financial markets

June was a difficult month for financial markets, as geopolitical events, especially in the form of erratic US policies, dominated market developments. A major victim was the Chinese equity market, which fell 7.7% in June and dragged down the broad emerging market index, which fell 4.6%. Developed equity markets were down only slightly, i.e., by 0.2%. The US S&P500 and the Japanese Nikkei 225 both gained 0.5%, while the MSCI Europe fell 0.9%, depressed by disruptive German coalition talks.

Government yields remained roughly stable in June, with the exception of US short-term yields, which rose 10 basis points. Inflation expectations remained more or less unchanged. However, credit spreads, especially for high-yield and emerging markets, continued to widen. Emerging market bonds came under severe selling pressure in May and June, which transformed a 4% YTD performance end of April to a 6.4% YTD performance end of June.

REITS, which suffered from a significant sell-off in January and February, bounced back strongly and gained almost 10% from end of March.

The Bloomberg Commodity index fell 3.5% in June, mainly due to softening prices for agriculture (10.5%), industrial metals (-4.8%), and gold (-3.5%). In contrast, the price for Brent oil rose 2.4% in June.

With markets being driven by politics rather than fundamentals, hedge funds had difficult times: the HFRI UCITS index fell 0.7% in June.

The EUR-USD exchange rate stabilized between 1.16 and 1.18 from end of May. Asian currencies, especially CNY and JPY weakened. The GBP depreciated, due to uncertainties around Brexit talks and the recent reshuffling of the British government. The CHF regained some strength after the Italian elections and the Germen coalition talks, but gave back some of the gains in June.

Macro economics

The US economy is heading towards 4% growth in Q2 QoQ, annualized, and earnings of S&P500 companies should grow in excess of 20% YoY, according to the latest estimates of Thomson Reuters. The US ISM index rose to 60.2 in June after 58.7.

At the same time, we saw some softening of major Euro-area growth indicators. For example, the EMU Markit manufacturing PMI fell distinctly from 60.6 in December last year to 54.9 in June. This can partly be explained by the EUR appreciating 6% in 2017, which significantly lowered export growth. However, the current PMI reading remains strong in absolute terms and indicates continued vigorous European growth.

In line with strong growth, US consumer price inflation rose to 2.9% in June, while the more stable US PCE core inflation rate rose to 2% in May.

In the EMU the June inflation rate rose to 2% from 1.9% in May. At the same time, the EMU core inflation rate fell to 1.0% after 1.1% in May.

Central banks

On 13 June the US Fed hiked rates to a new federal funds target range of 1.75-2.0%. It further indicated rate hikes once a quarter for at least the next 12 months. We are carefully monitoring the development of core PCE inflation, since a clear overshoot above 2.0% could trigger additional Fed rate hikes.

On 14 June the ECB kept rates unchanged and signaled the end of asset purchases in December. It is unlikely that the ECB will hike rates before summer of next year. The ECB can afford this "dovish tightening" policy stance since core inflation continues very stable around 1.0%.

The Bank of Japan remains committed to its yield curve control policy. As a result, the Bank of Japan may end up as the last central bank performing quantitative easing.

Outlook

Mid-April we reduced our equity allocation to neutral, and thus reduced portfolio risks. Since we remained underweight in bonds, we increased the cash position in the portfolios.

We have kept our more defensive stance, as trade war risks remain elevated. However, if we were to see trade war risks abating, we would consider a more pro-risk portfolio stance, as growth and earnings dynamics remain strong and valuations have become less demanding.

Nevertheless, down-side risks have clearly risen, especially since central banks and governments are much less likely to bail-out financial market investors in times of stress. Rising US inflation, driven by an economy running at full capacity, further boosted by substantial fiscal stimulus and rising trade tariffs, will prevent the Fed from easing monetary policy measures. In Europe inflation is only gradually evolving, but the ECB has shifted its policy stance and is likely to continue its shift towards policy normalization. In China, the government has become concerned about oversupply and leverage and is focusing on structural reforms and deleveraging. Monetary easing has, therefore, become less likely, even if markets should come under stress. However, the Chinese government may start, or may even have already started, to soften monetary conditions by weakening its currency.

ECONOMICS

In recent months we observed a divergence between the EMU and US PMI. While the EMU PMI softened further, the US PMI strengthened. The EMU PMI, however, remains solidly above 50, suggesting that EMU growth is still strong. In line with strong growth data, inflation is rising. US inflation was at 2.9% and EMU inflation at 2.0% in June. The US labor market added another 213,000 jobs in June, while wage gains unexpectedly slowed.

Fig. 1: PMIs

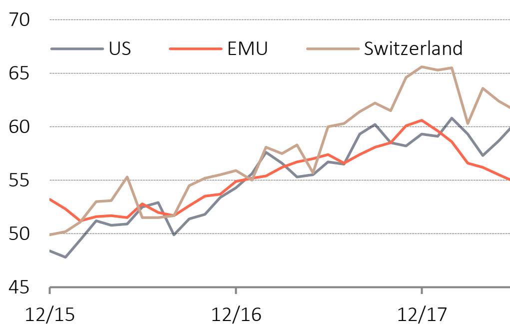


Fig. 2: PMIs

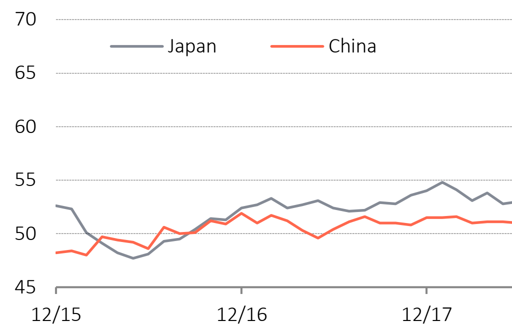


Fig 3: Consumer price inflation, in % YoY

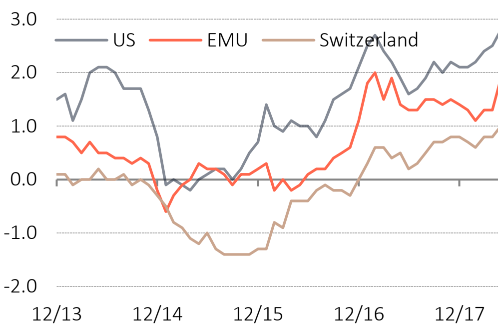


Fig. 4: Consumer price inflation, in % YoY

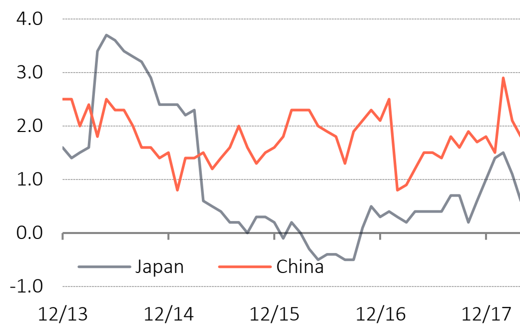


Fig 5: Unemployment rates, in %

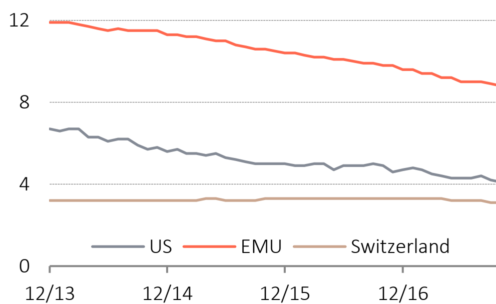
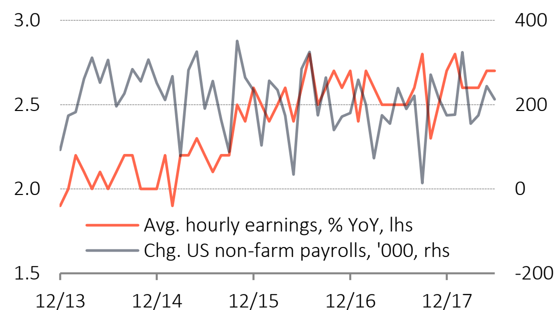


Fig 6: US labor market



FIXED INCOME

In June, interest rates stabilized, with the exception of the short end of the US curve, which rose on the back of the Fed rate hike. In addition, inflation expectations remained stable, although headline inflation rose in the US and Europe. Credit spreads widened, especially of high-yield and emerging-market bonds. Insurance-linked bonds were about flat in June.

Fig.7: 2Y government bond yields

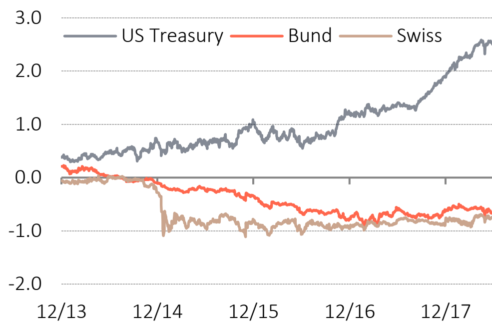


Fig. 8: 10Y government bond yields

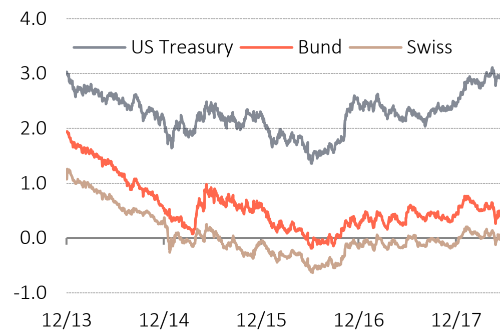


Fig 9: 10Y break-even inflation

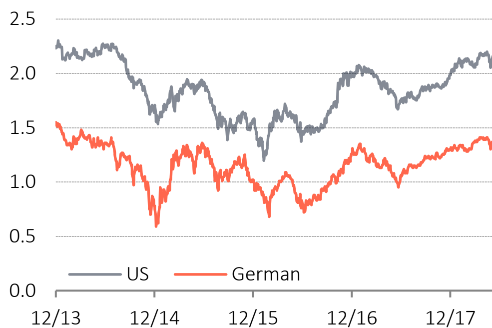


Fig. 10: Credit spreads, 5Y credit default swaps

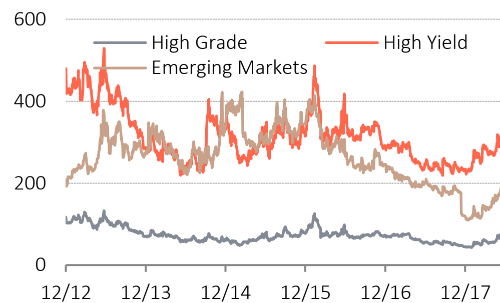


Fig 11: Money market spreads (3M-2Y)

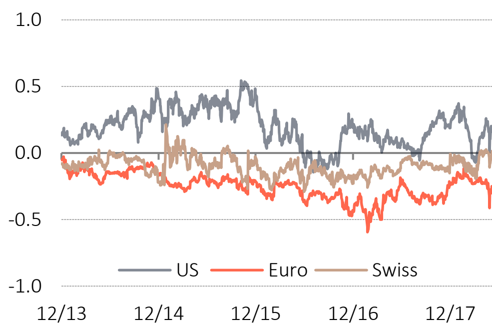
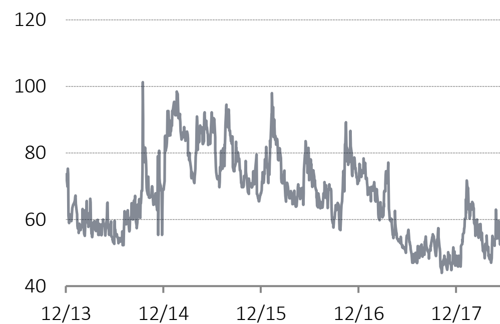


Fig 12: Merrill Lynch volatility index (MOVE)



EQUITIES

June was a difficult month for equity markets. Especially emerging market equities sold-off. The Chinese CSI300 lost 7.7% and the Brazilian Bovespa 5.2%. Among major developed markets, the US S&P500 and the Japanese Nikkei225 outperformed with gains of 0.5% each. The MSCI Europe fell by 0.9% and the German DAX even by 2.4%. Uncertainties regarding the stability of the German coalition took their toll. The best performing sectors have been technology, energy, and consumer goods.

Fig. 13: MSCI equity indices – major regions

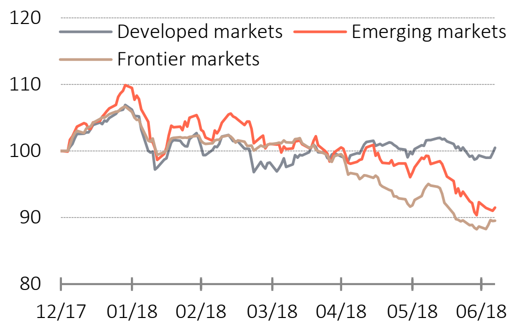


Fig.14: Equity indices – major developed markets

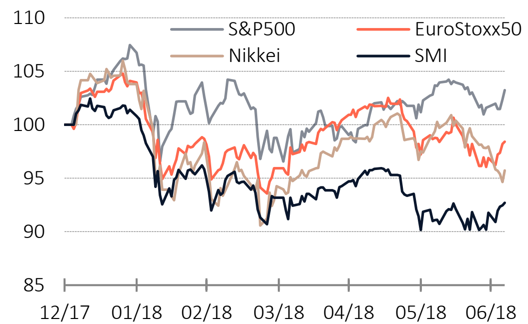


Fig 15: Equity indices – major emerging markets

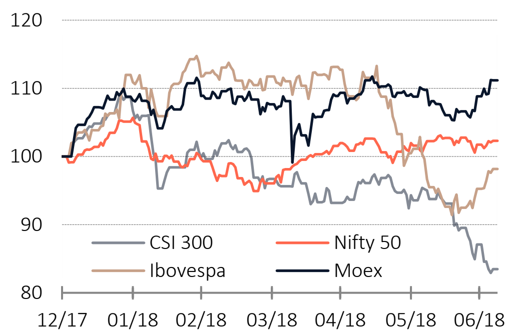


Fig. 16: Sector performance, MSCI Europe, 2017

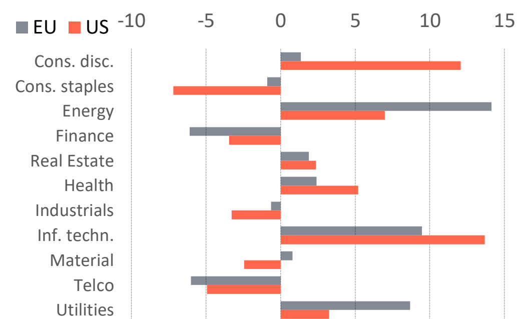


Fig 17: Price-earnings ratios

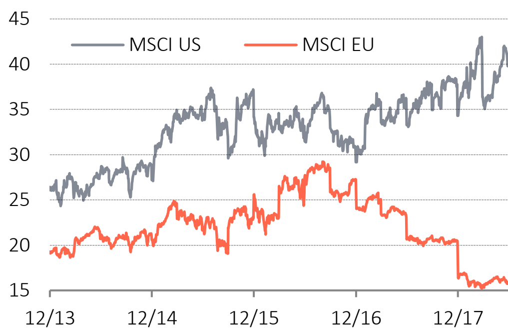
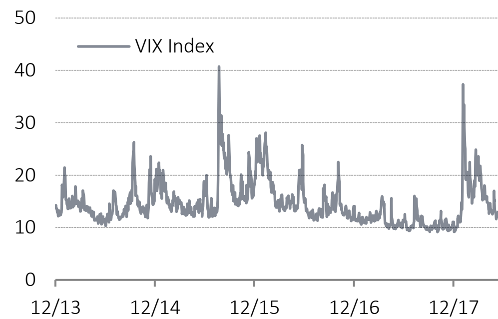


Fig 18: Equity volatility – S&P500 VIX index



ALTERNATIVE INVESTMENTS

Oil prices rose in June and gold continued to sell-off. Industrial metals suffered from trade war fears. REITS rebounded strongly. Positive growth should continue to support rental and dividend growth. Hedge funds suffered from a market environment in which geo-politics rather than fundamentals was driving.

Fig. 19: Gold price, USD/oz

Fig.20: Brent oil price, USD/bl

Fig 21: Bloomberg commodity indices

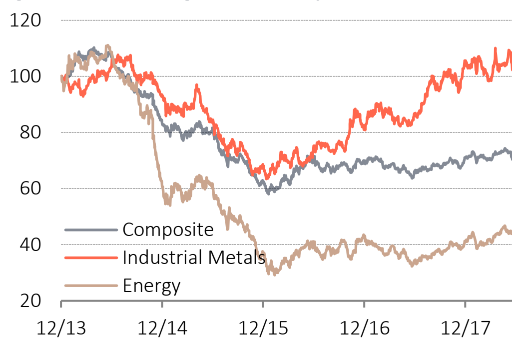


Fig. 22: HFRU hedge fund indices

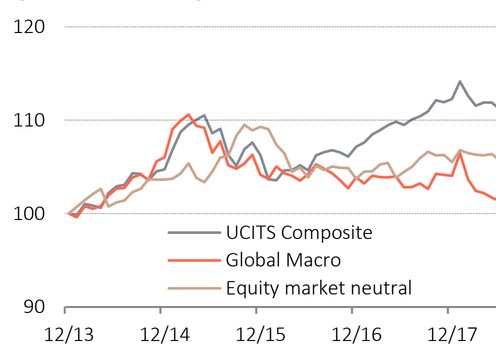


Fig 23: FTSE EPRA/NAREIT global REITS index

Fig 24: LPX global listed private equity

CURRENCIES

EUR-USD moved sideways without clear direction. Political uncertainties in Europe, related to Italy and Germany, supported the CHF vis-à-vis the EUR. The JPY and CNY weakened clearly via-a-vis the USD. Controversial Brexit discussions and the reshuffling of the UK government led to a further weakening of the GBP.

Fig. 25: EUR-USD exchange rate

Fig. 26: GBP-USD exchange rate

Fig 27: USD-JPY exchange rate

Fig. 28: USD-CNY exchange rate

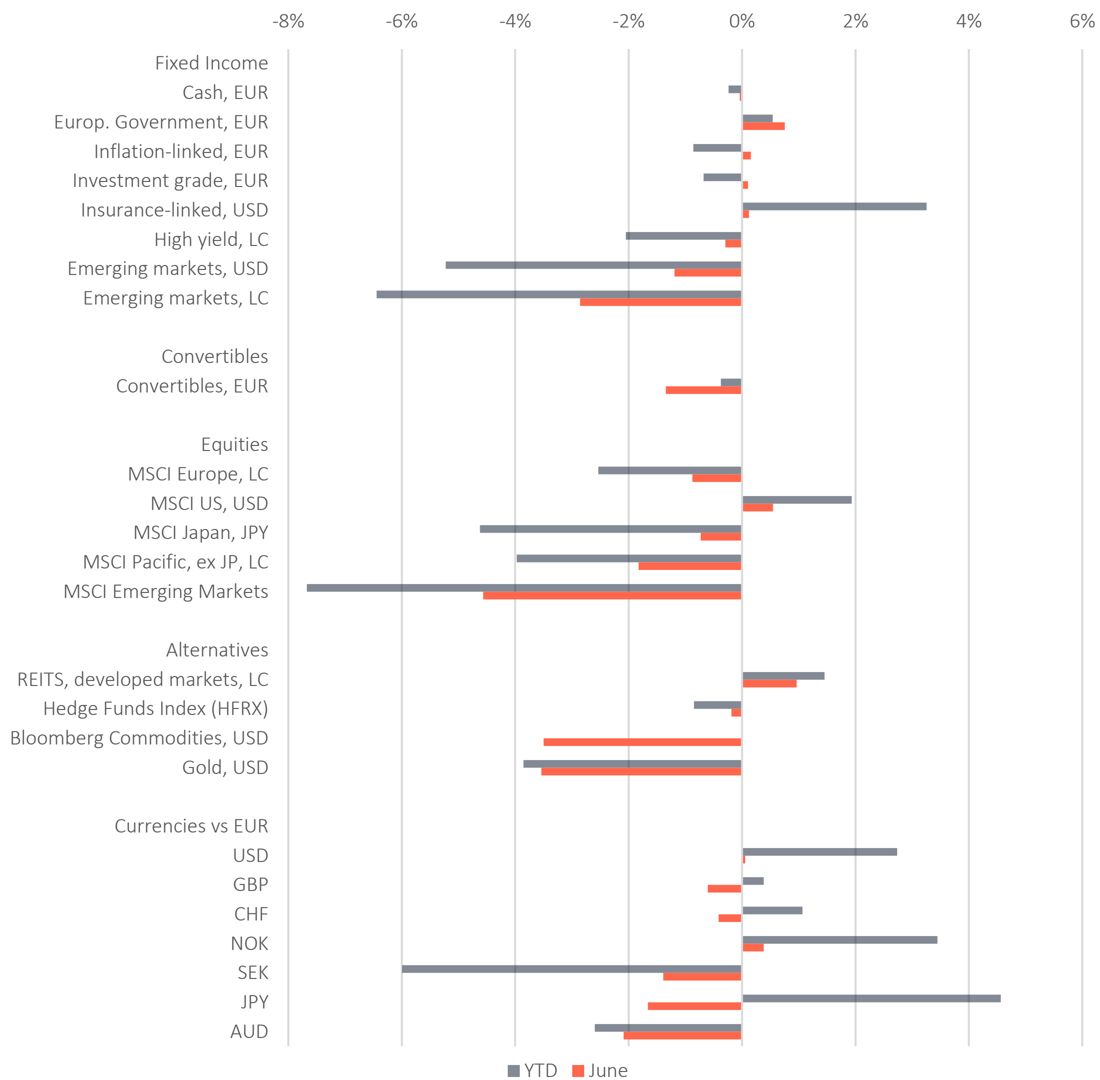
Fig 29: EUR-CHF exchange rate

Fig 30: USD-CHF exchange rate

ASSET ALLOCATION

June was a difficult month for multi-asset class investors. Only insurance-linked bonds, US equities and REITS delivered a positive performance. In addition, the EUR strengthened so that foreign currencies had a negative impact. The largest losers were emerging-markets bonds and equities, followed by commodities and especially gold.

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



RISK MONITOR

In recent months we saw our risk indicators for inflation, monetary tightening, credit and systemic risks increase somewhat. The systemic risk indicator reflects the underperformance of the financial sector in equity and credit markets. Since equity markets corrected somewhat, equity valuations declined a little.

Fig. 32: IMT Risk Monitor

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

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