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INVESTMENT OUTLOOK 10.2018

5 October 2018

In September the US economy and US equity market maintained momentum and continued to rally. Meanwhile we observed further signs of growth decelerating in Europe and China.

Market participants' major concerns currently center on the trade war and its implications, especially for China, the implications of the upcoming US mid-term elections, as well as the Italian budget and what it could mean for the European union. As a result, equity markets were almost flat in developed economies and fell in emerging markets.

The US Fed continued its path of policy normalization and hiked interest rates by 25 basis points in September, the third such step this year. It is very likely that a fourth rate hike will follow in December. US rates went up sharply, pushing 10-year yields clearly above 3.0%.

Oil prices continued to surge, driven primarily by reduced supply and falling US inventories.

We remain cautious and maintain our defensive portfolio tilt, with a slight overweight of US equities. We took profit on our long energy position.

Trauth

Thomas Trauth
CEO – IMT Asset Management AG

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Financial markets

In September uncertainties clearly dominated and led to very volatile markets. Many equity markets lacked clear direction. The US and the EU equity markets were slightly up, both by 0.4%. The Japanese Nikkei 225, however, was up 5.5% driven by better growth data and a weaker yen. At the same time, emerging markets equities lost 0.8% in September. While the Chinese CSI300 gained 3.1%, the Indian Nifty index lost 6.4%, driven by losses in the energy and financial sectors. The Indian central bank surprisingly left interest unchanged and the government reduced prices for gasoline and diesel.

Government bond yields climbed significantly in September. US 10-year yields broke above 3.0%. Last week, we observed another sharp upwards move towards 3.2%. European yields rose as well, albeit not as strongly. Interestingly, 10-year break-even rates, which indicate expected inflation, did not move much. As a result, inflation-linked bonds also suffered from losses. Credit spreads tightened across the board. Local emerging market bonds gained 2.6% and, in contrast to emerging market equities, were able to make up for some of the losses incurred earlier this year.

The Bloomberg Commodity index rose 1.9% in September, mainly driven by higher energy prices. The price for Brent oil surged by 6.8%. Prices for industrial metals rose 2.2% and the gold price fell by 0.9%.

In September EUR-USD traded sideways. A better outlook for a potential “soft” Brexit deal pushed the GBP strongly up against the EUR. The JPY weakened clearly as markets became more risk seeking, and the Bank of Japan (BoJ) remains very expansive. USD-CNY stabilized between 6.8 and 6.9. As markets reassessed the risk of a European crisis, the CHF weakened again. The EUR-CHF exchange rate rose from 1.12 to 1.14.

Macro economics

Many PMI values for September softened. The US ISM index fell to 59.8 after 61.3, the EMU PMI fell to 53.3 after 54.6, and the China PMI fell to 50.0 after 50.6.

US non-farm payrolls increased by 134,000 in September, which was clearly below expectations and the previous month’s figure. However, the September reading is strongly distorted due to hurricane Florence. Weather-related payrolls were depressed and wage increases were exaggerated because of extra work in the construction and utility sectors. Average hourly earnings were at 2.8% YoY after 2.9% in August.

In Europe, concern mostly centered around the future path of Italian public finances. The Italian anti-establishment coalition of the Northern League and the Five Star Movement presented an aggressive fiscal budget. The European Union will comment on it by the End of November. The planned budget will increase public debt, which currently stands at about 130% of GDP, even further. Urgently needed structural reforms have been avoided by the new government. As a result, yields of Italian 10-year government bonds rose as high as 3.4%, which results in a yield gap to German bonds of almost 300 basis points. This will translate not only into higher funding costs for future government debt but also via the higher reference rate into higher borrowing costs for the Italian economy.

Central banks

On 13 September the ECB kept rates unchanged. The ECB expects rates to remain unchanged at least through the summer of 2019. It also clarified its planned tapering measures. Bond purchases will drop from EUR 30 bn to EUR 15 bn in October and will remain there until December 2018. Depending on economic data, bund purchases will end thereafter.

On 26 September the US Fed raised the target range for federal funds by 0.25% to 2% to 2.25%. This had been widely expected and did not result in major market corrections after the meeting. The Fed has already hiked rates three times this year and indicated that another hike in December is likely. Furthermore, FOMC members maintained their forecast of three additional rate hikes for 2019. It is interesting to note that the market probability for three more hikes until December 2019 remains at only 20%. The Fed dropped its statement characterizing its policy as accommodative, suggesting that it regards current policy rates to be at or about neutral.

Former Fed chairwoman Janet Yellen spoke at BCA's annual conference End of September. BCA is a leading macro and financial market research firm. In her keynote speech, she described the US economy as very strong, not least due to the fiscal stimulus. Financial conditions remain supportive and the labor market continues to create about 200,000 jobs per month. She does not expect a recession until after 2019. As wage growth slowly picks up, the challenge for the Fed clearly is to provide for a soft landing, which is always a daunting task and could, if not successful, lead to recession.

Outlook

It looks as if the growth gap between the US on the one hand and Europe, Japan and China on the other hand is widening. This will be a factor in maintaining the divergence of monetary policies. Main beneficiaries are likely to be US equities and the USD.

At the same time the valuation gap has widened significantly. European and especially emerging market equities look quite attractive from a relative valuation perspective. Within the equity markets, value stocks have become very attractive relative to growth stocks.

While we are carefully observing the above-mentioned value play, we currently do not see the catalyst, which would be able to change market behavior and trigger a shift towards those market segments.

Oil prices have surged since February. Brent oil has risen from USD 56 to USD 74 currently. We think this move was less driven by global demand, since we saw growth outside the US moderating, than by global supply developments. We continue to have a positive outlook for oil, but we have taken profit recently, based on tactical considerations. US sanctions against Iran are likely to shave off 800,000 to 1 m barrels a day from global oil supply. In addition, the political collapse in Venezuela and possible production outages in Iraq and Libya have the potential to disrupt supply further.

We remain cautious and maintain our defensive portfolio tilt, with a slight overweight of US equities. We remain underweight in interest rate and credit risk.

ECONOMICS

PMI data for September came in weaker. The US ISM index fell to 59.8 after 61.3, the EMU PMI fell to 53.3 after 54.6, and the China PMI fell to 50.0 after 50.6. US non-farm payrolls dropped to 134,000, clearly below expectations and the previous month's figure. However, the September reading is strongly distorted due to hurricane Florence. Weather-related payrolls were depressed and the wage increase was exaggerated through extra work in the construction and utility sectors.

Fig. 1: PMIs

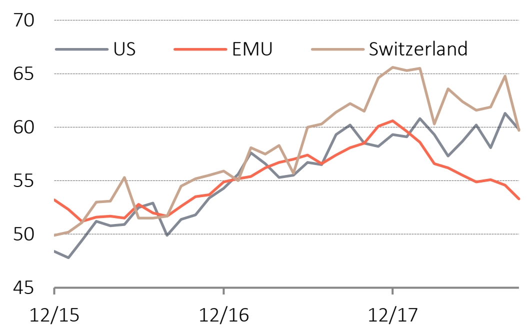


Fig. 2: PMIs

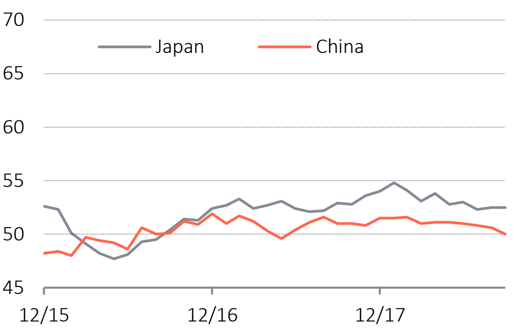


Fig 3: Consumer price inflation, in % YoY

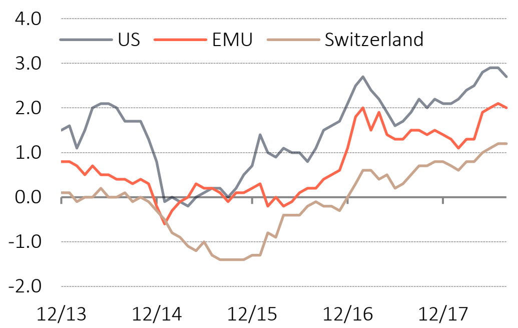


Fig. 4: Consumer price inflation, in % YoY

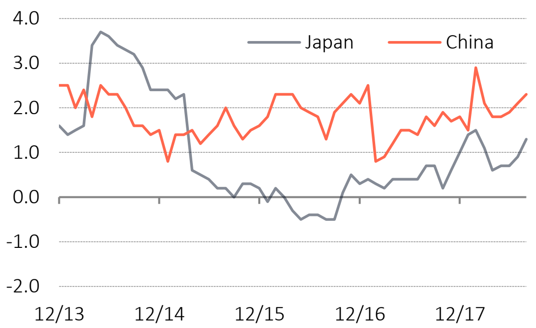


Fig 5: Unemployment rates, in %

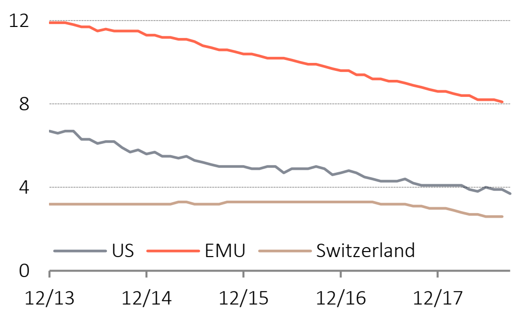
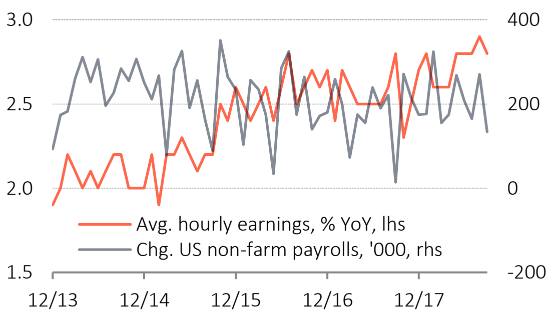


Fig 6: US labor market



FIXED INCOME

Interest rates, especially in the US, moved sharply up in September. US 10-year yields broke above 3.0%. Beginning of October, we observed another sharp move upwards to 3.2%. European yields rose as well, albeit not as strongly. Interestingly, 10-year break-even rates, which indicate expected inflation, did not move much. As a result, inflation-linked bonds suffered from losses. Credit spreads tightened. Local emerging-market bonds gained 2.6% in September.

Fig.7: 2Y government bond yields

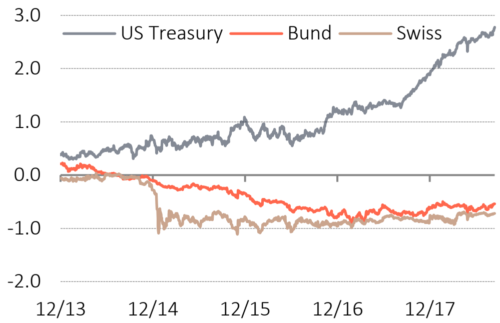


Fig. 8: 10Y government bond yields

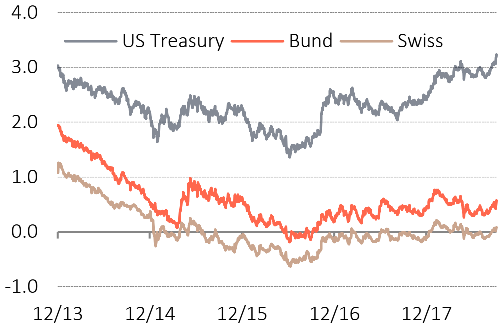


Fig 9: 10Y break-even inflation

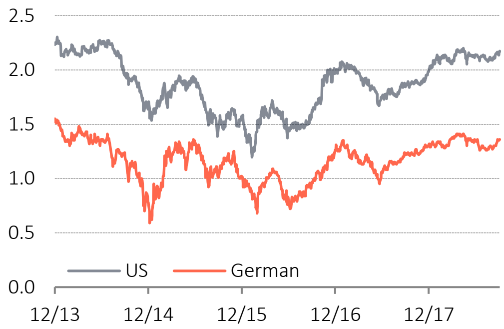


Fig. 10: Credit spreads, 5Y credit default swaps

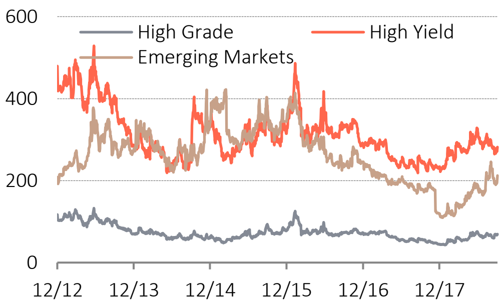


Fig 11: Money market spreads (3M-2Y)

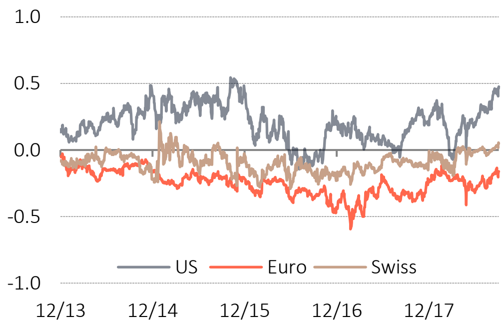
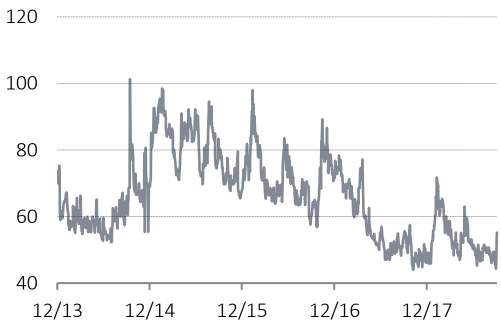


Fig 12: Merrill Lynch volatility index (MOVE)



EQUITIES

In September, developed equity markets were slightly up (0.4%) and emerging markets dropped (-0.8%). The Nikkei 225 outperformed and rose 5.5%. The Chinese CSI 300 index recovered and climbed 3.1%. The Indian Nifty index, however, fell sharply, driven by falling energy and financial stocks. Surprisingly, the Indian central bank kept rates unchanged and the government announced cuts in gasoline and diesel prices.

Fig. 13: MSCI equity indices – major regions

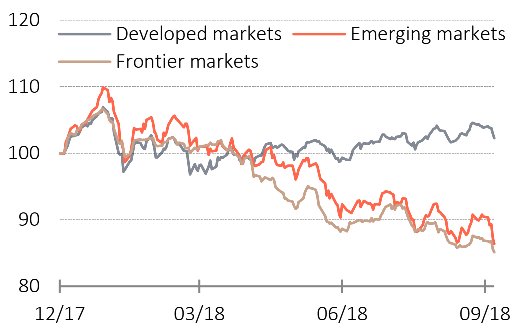


Fig.14: Equity indices – major developed markets

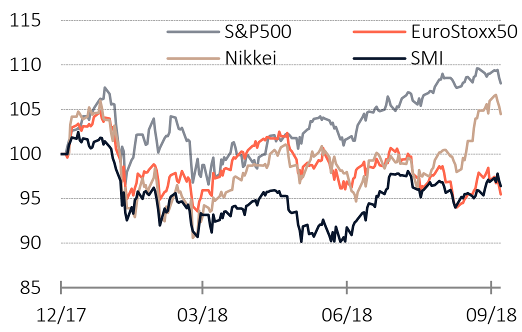


Fig 15: Equity indices – major emerging markets

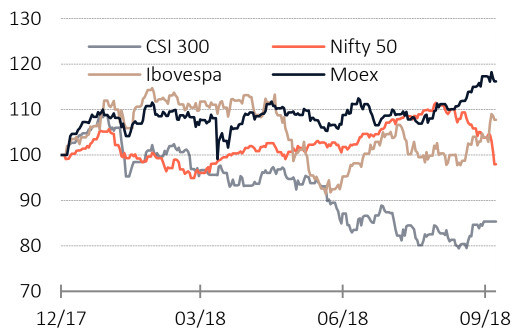


Fig. 16: Sector performance, MSCI Europe, 2017

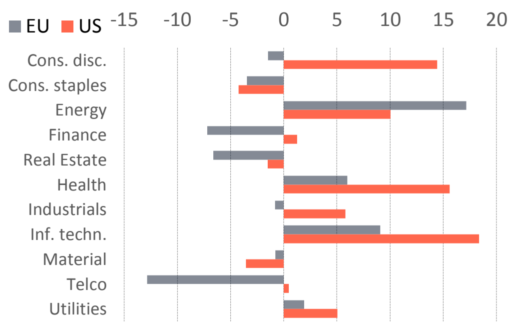


Fig 17: Price-earnings ratios

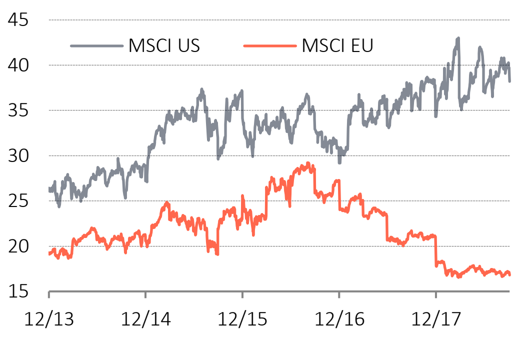
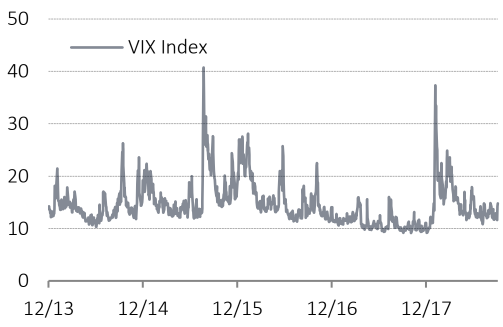


Fig 18: Equity volatility – S&P500 VIX index



ALTERNATIVE INVESTMENTS

Oil continued its rally and rose 6.8% (Brent) in September. Industrial metals rose 2.2%. The gold price stabilized around USD/oz 1,200. REITS took a breather and corrected. The global REITS index fell 2.3%. Macro hedge funds continue to have a hard time.

Fig. 19: Gold price, USD/oz

Fig.20: Brent oil price, USD/bl

Fig 21: Bloomberg commodity indices

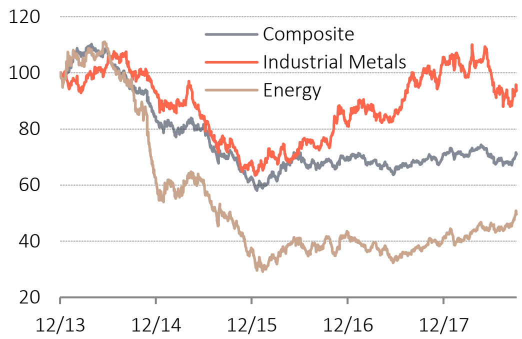


Fig. 22: HFRU hedge fund indices

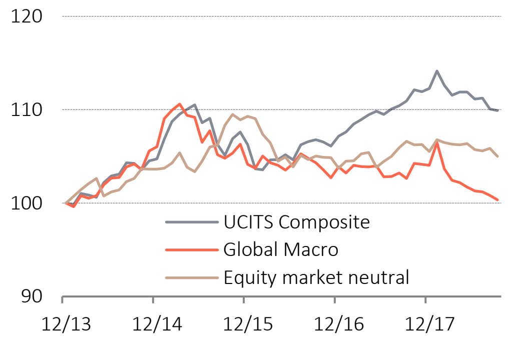


Fig 23: FTSE EPRA/NAREIT global REITS index

Fig 24: LPX global listed private equity

CURRENCIES

In September EUR-USD traded sideways. A better outlook for a potential "soft" Brexit deal pushed the GBP strongly up against the EUR. The JPY weakened clearly, as markets became more risk seeking, and the BoJ remains very expansive. USD-CNY stabilized between 6.8 and 6.9. As markets reassessed the risk of a European crisis, the CHF weakened again.

Fig. 25: EUR-USD exchange rate

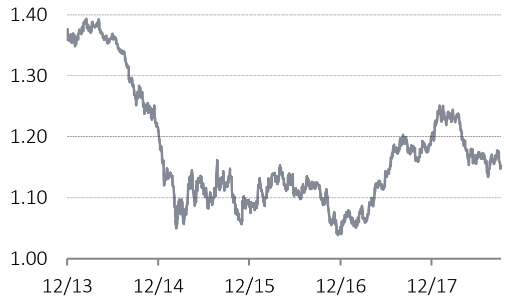


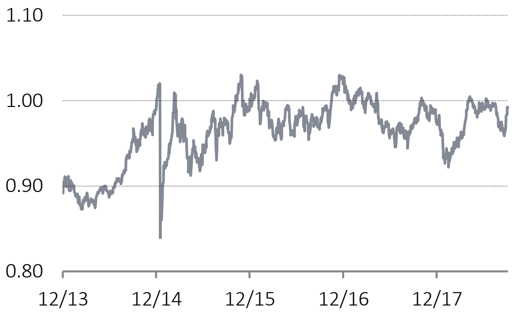
Fig. 26: GBP-USD exchange rate

Fig 27: USD-JPY exchange rate

Fig. 28: USD-CNY exchange rate

Fig 29: EUR-CHF exchange rate

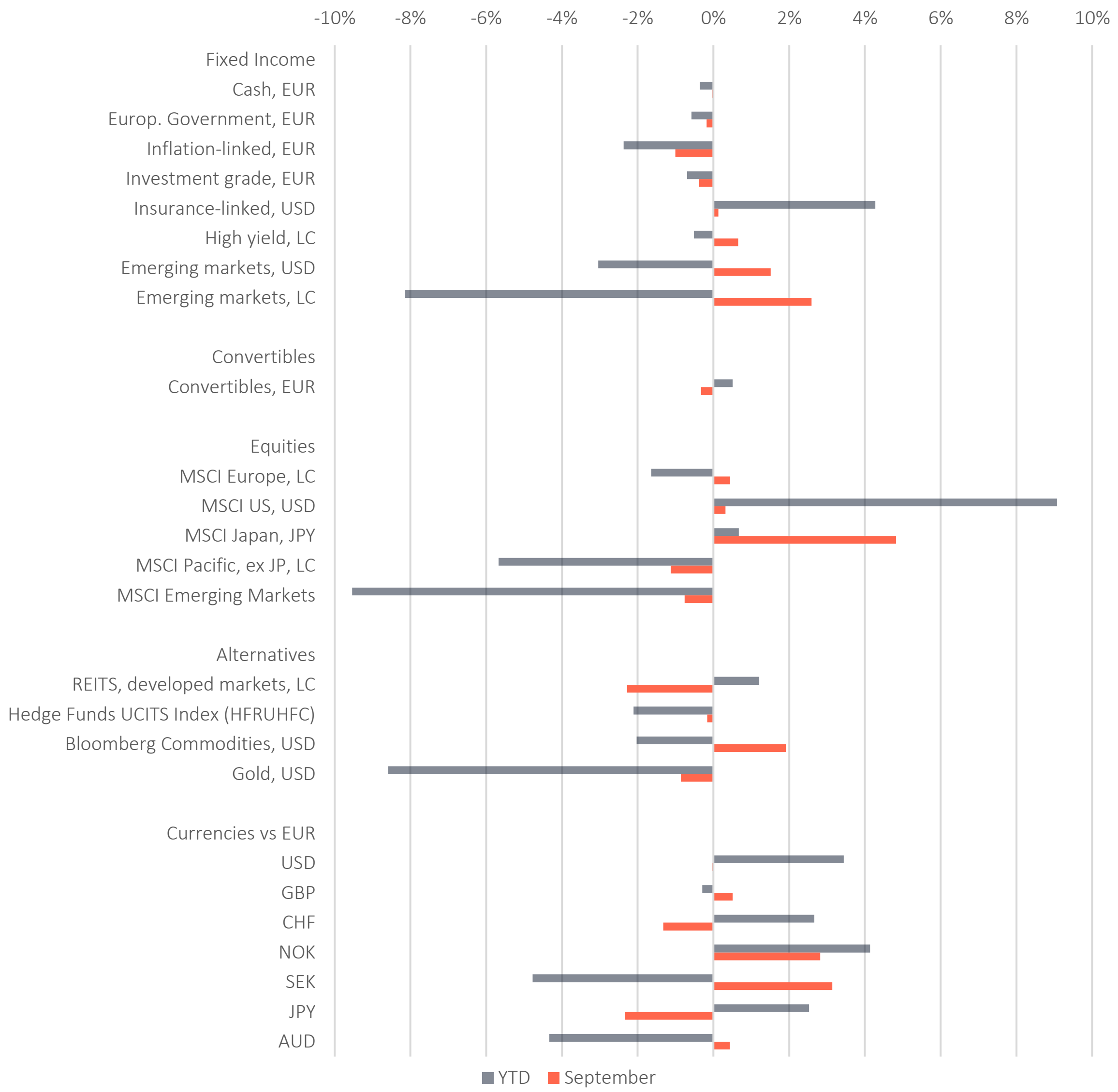
Fig 30: USD-CHF exchange rate



ASSET ALLOCATION

In September government bonds, inflation-linkers and investment-grade bonds lost due to rising nominal and real rates. Credit, especially emerging market credit recovered noticeably. Among equities, Japanese stocks outperformed. US and European stocks were up marginally. Emerging markets equities continued to sell-off. Global REITS lost 2% while commodities, driven by rising energy prices, gained about 2%.

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



RISK MONITOR

We remain in a benign risk environment as measured by our risk indicators. Our political risk index primarily measures war and terrorist risks, and thus does not capture trade disputes or uncertainties regarding democratic elections. The banking sector has come under selling pressure due to higher risks of default for Turkish and Italian bonds. As a result, the systemic risk indicator has risen. Monetary tightening risks reflect the central banks' move towards normalization.

Fig. 32: IMT Risk Monitor

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

DISCLAIMER

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