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INVESTMENT OUTLOOK 02.2019

7 February 2019

In January markets rebounded strongly and compensated for a significant part of Q4 losses. To some extent this can be seen as a technical correction of extremely oversold markets in December. Since global growth has slowed down but recession risks remain muted, investors seem to be wondering whether the glass is half-full or half-empty. The Q4 correction together with continuously rising earnings had a strong impact on equity valuations, which fell clearly below historical averages in December.

Interestingly, despite still healthy US growth and accelerated wage growth, the market currently sees a higher probability of a rate cut (almost 20%) then a rate hike (5%) by the end of this year. In contrast, we believe that the Fed will continue to raise rates in 2019 but certainly at a reduced pace compared to 2018.

We maintain a neutral position for equity markets, stay underweight in interest rate and credit risk, and overweight energy.

Thomas Trauth
CEO – IMT Asset Management AG

EQUITY MARKET REBOUND

Financial markets

In January equity markets rebounded sharply. The S&P500 index gained 7.9%, followed by the MSCI Europe with 6.1% and the Nikkei 225 with 3.8%. Among emerging markets the Brazilian Bovespa index outperformed with 10.8%, followed by the Russian Moex index, up 6.4% and the Chinese CSI 300 index, up 6.3%. It is noteworthy that in Q4 equity valuations fell below historic averages, driven by falling prices and rising profits. Best performing sectors in January were industrial, energy and technology stocks.

Bonds rallied in December when markets were in risk-off mode, a pattern which is normal. Interestingly, bonds continued to rally when the equity market rebounded in January. In January 10-year government bond yields fell a further 9 basis points in Europe and 5 basis points in the US. However, yields fluctuated widely during the month. It is noteworthy that more than half of the bond rally since end of November can be attributed to falling inflation expectations. In our view, this reflects exaggerated pessimism regarding the US economic outlook, and it surprises us, given that US wage growth has been accelerating.

Credits performed very well in January. Credit spreads for high-yield and emerging markets bonds tightened by about 40 basis points each.

REITS performed exceptionally well. While REITS held up relatively well in Q4, losing about 5%, they gained 10.4% in January.

Commodities performed very well in January. Prices of Brent oil rose 15%, industrial metals by 8%, and gold by 3%.

The EUR-USD exchange rate continued to move sideways and remained in its trading range between 1.120 and 1.155, which has held since October. The CHF, which strengthened in Q4 as financial and political uncertainties in Europe rose, gave back most of its gains in January. It ended the month at about 1.14 to the EUR. Despite Theresa May's defeat in parliament regarding her Brexit deal proposal, the GBP strengthened by about 3% against the EUR in January.

Macro economics

After a soft manufacturing US ISM index in December, the January reading came in stronger. The ISM rose to 56.6 from 54.3 but remains below the November level of 58.8. The US government shutdown certainly had an impact. Other US indicators remain very solid. The outlook for consumption is very positive, since average hourly earnings rose by 3.2% YoY and the consumer confidence index is close to its historic high. Non-farm payrolls in January surprised on the upside with 304,000 additional jobs created in January.

Meanwhile the EMU manufacturing PMI fell to 50.5 after 51.4, reflecting persistence weakness in Europe. The German manufacturing sector even declined. The US-China trade dispute, weakness in the auto sector, protests in France and Brexit uncertainties took their toll.

The Chinese PMI fell further below the 50 level and stood at 48.3 in January after 49.7. It remains to be seen how the stimulus measures of the PBoC will affect the economy in the coming months.

US inflation declined to 1.9% in December on the back of falling energy prices. However, and more importantly, core inflation continues to be above 2%. The last available figure is 2.2% (for December).

The picture is a bit different in Europe. Inflation was at 1.4% in January, down from 1.6% due to falling energy prices. EMU core inflation remains solidly anchored at about 1%.

Central banks

The People's Bank of China (PBoC) injected a record USD 84 bn into the banking system in January. It seems that the PBoC is becoming increasingly concerned about the slowing economy. This comes in addition to the cut in the reserve requirements ratio in October, which was a permanent measure. The recent cash injection is being implemented via reverse repo programs, and is rather short-term in nature. The PBoC is addressing a seasonal liquidity shortfall due to a peak in tax payments and higher cash needs because of the Chinese New Year.

At its policy meeting on 24 January, the ECB decided to keep rates unchanged, which was widely expected. Given that the European growth indicators have weakened, the ECB saw that the balance of risk has tilted to the downside. It is expected that the ECB will lower its growth forecast when it revises its growth projections in March. After the meeting, many market observers do not expect the ECB to hike before December. The implied probability of a hike in December is about 40% currently.

On 30 January the US Fed kept rates unchanged. President Powell's rhetoric turned out to be clearly more dovish compared to the last Fed meeting in December. Powell specifically mentioned tepid inflation and rising risks to global economic growth as concerns. He mentioned slower growth in China and Europa as well as elevated uncertainties around government policies including trade, the US government shutdown and Brexit. Already in December market-implied rate-hike expectations changed significantly. The futures market currently sees a higher probability of a rate cut (almost 20%) then a rate hike (5%) by the end of this year. In contrast, we believe that the Fed will continue to raise rates in 2019 but certainly at a reduced pace compared to 2018.

Outlook

The US economy continues to be stronger than most other regions, especially Europe and China. We expect the US to continue to grow healthily at or above trend, but at a slower pace than 2018. Meanwhile the European and the Chinese economies slowed markedly. We regard it as likely that further fiscal and monetary stimulus in China will be implemented. This could revive economic activity and eventually help the European export sector.

A major risk remains the outcome of the US-China trade dispute. The fact that the new United States Mexico Canada Agreement (USMCA), which replaced the NAFTA agreement, was agreed rather quickly after a hefty debate shows that President Trump may be willing to conclude a dispute pragmatically, if it seems fit.

Since political risks remain elevated in our view, we see balanced upside and downside risks for equity markets and we remain neutral, also regarding the regional allocation.

We continue to see oil prices well supported and remain overweight in energy. Saudi Arabia and Russia seem to be committed to cut supply by 1.2 m barrels per day. Since one-year forward oil prices are currently very low and US shale producers usually sell forward their oil production, they have little incentive to boost production currently. Furthermore, the disruptive political situation in Venezuela is likely to have a negative impact on oil production. Disruption in Venezuela could eliminate the supply of 700-800,000 barrels per day.

ECONOMICS

PMI data for January generally softened, with the exception of the US ISM index, which rose to 56.6 after 54.3. US non-farm payrolls rose to 304,000, clearly above expectations. Average hourly earnings rose 3.2% YoY, which indicates continued wage pressure. Eventually, this should feed through to goods prices and push core inflation up.

Fig. 1: PMIs

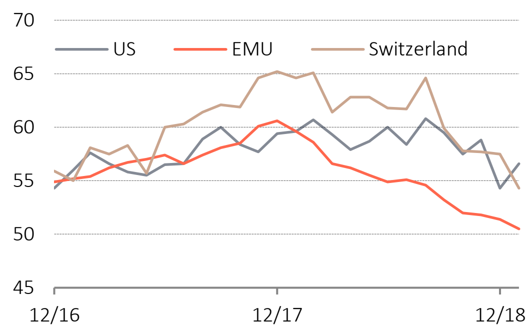


Fig. 2: PMIs

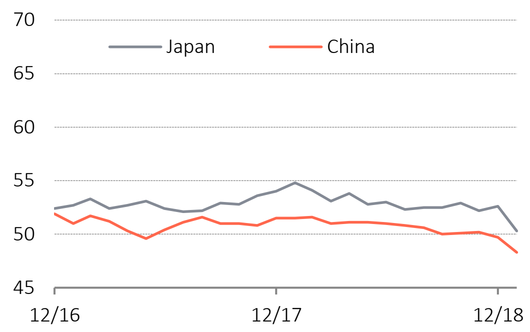


Fig 3: Consumer price inflation, in % YoY

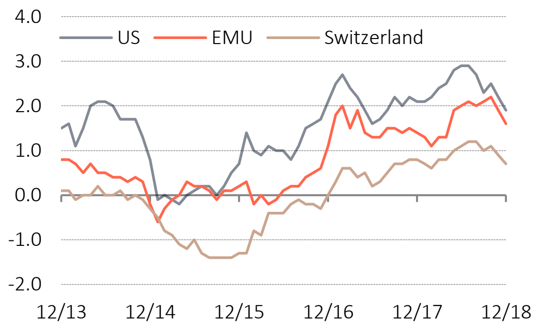


Fig. 4: Consumer price inflation, in % YoY

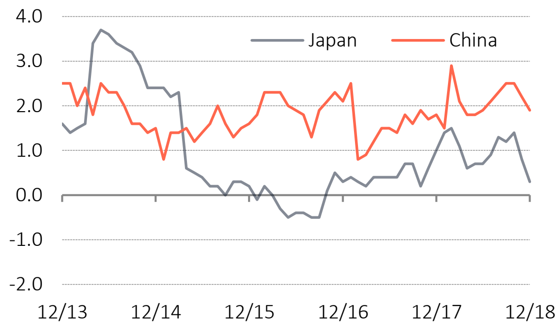


Fig 5: Unemployment rates, in %

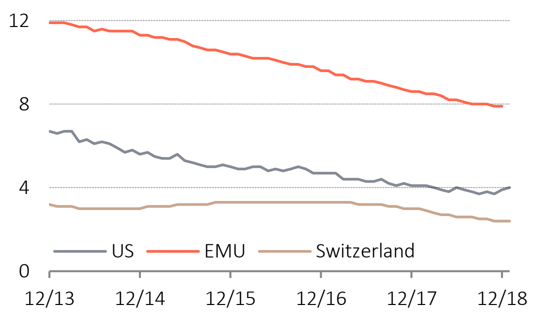
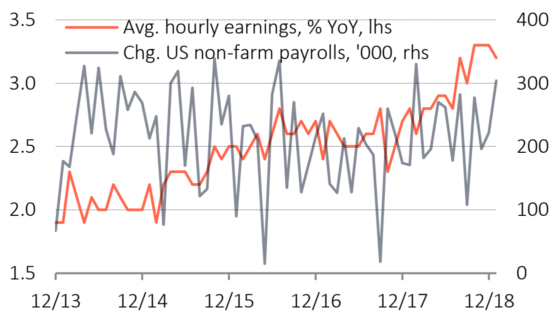


Fig 6: US labor market



FIXED INCOME

The risk-off environment in Q4 and especially December sparked a significant bond rally. Despite the equity market rebound, the bond rally continued, not least because the Fed turned dovish at its January meeting. The short end of the US curve, reflecting Fed rate-hike expectations, was fundamentally re-priced. The long end of the curve rallied as well, in large part driven by much reduced inflation expectations. In contrast, the high-yield market, which sold-off in Q4, recovered in January.

Fig.7: 2Y government bond yields

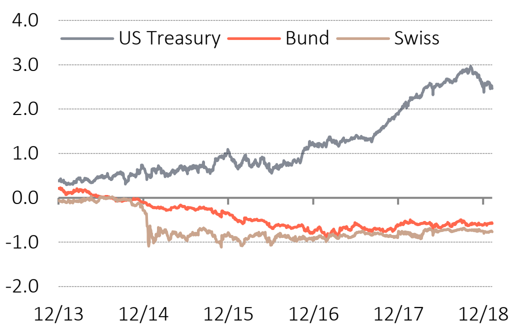


Fig. 8: 10Y government bond yields

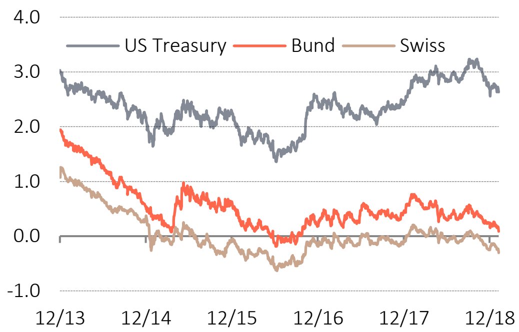


Fig 9: 10Y break-even inflation

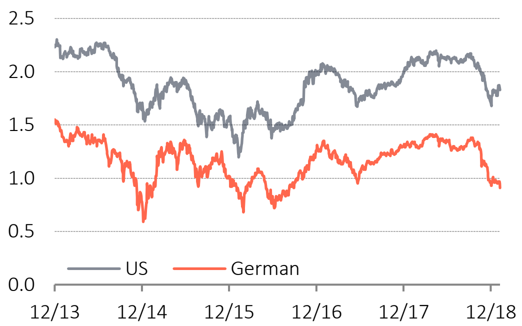


Fig. 10: Credit spreads, 5Y credit default swaps

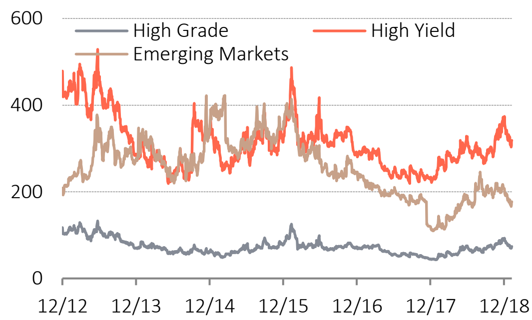


Fig 11: Money market spreads (3M-2Y)

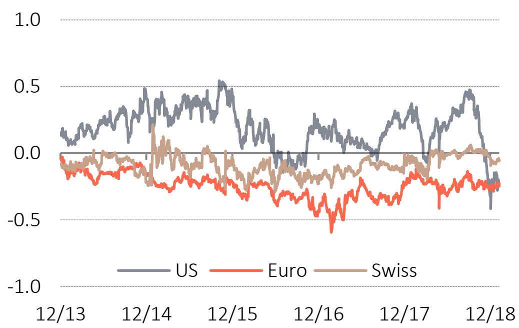
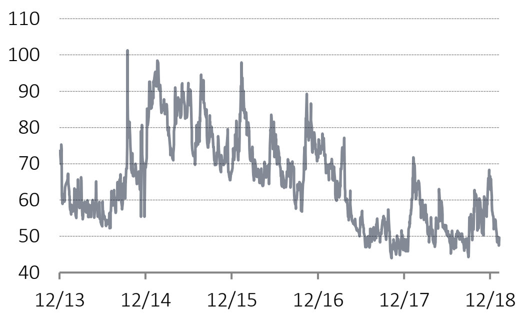


Fig 12: Merrill Lynch volatility index (MOVE)



EQUITIES

In January equity markets rebounded sharply. The S&P500 index gained 7.9%, followed by the MSCI Europe with 6.1% and the Nikkei 225 with 3.8%. Among emerging markets the Brazilian Bovespa index outperformed with 10.8%, followed by the Russian Moex index, up 6.4% and the Chinese CSI 300 index, up 6.3%. Best performing sectors in January were industrial, energy and technology stocks.

Fig. 13: MSCI equity indices – major regions

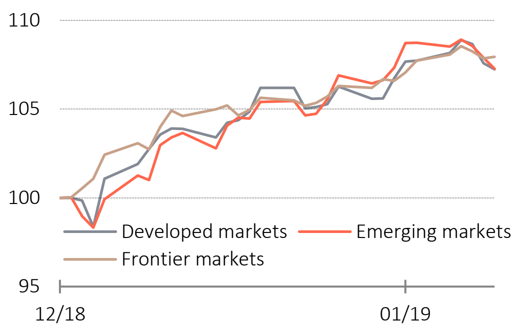


Fig.14: Equity indices – major developed markets

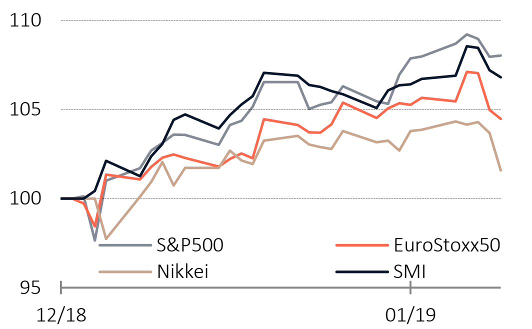


Fig 15: Equity indices – major emerging markets

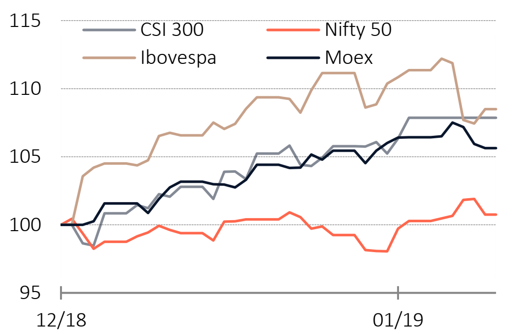


Fig. 16: Sector performance, MSCI Europe, 2018

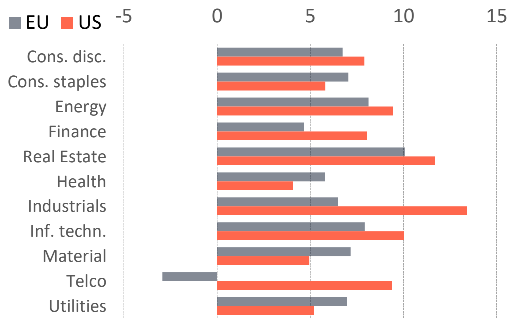


Fig 17: 1-year forward price earnings ratios

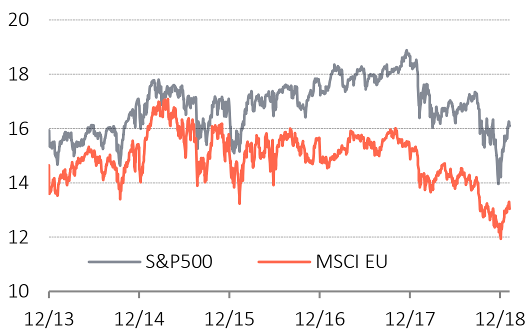
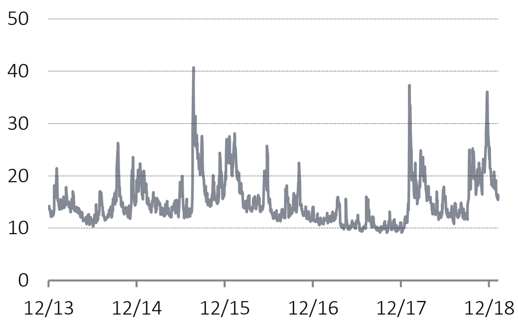


Fig 18: Equity volatility – S&P500 VIX index



ALTERNATIVE INVESTMENTS

Commodities rallied in January. The price for Brent oil rose 15%, prices for industrial metals climbed 8%. Also REITS had a very strong month. The Global REITS index advanced 10.3%.

Fig. 19: Gold price, USD/oz

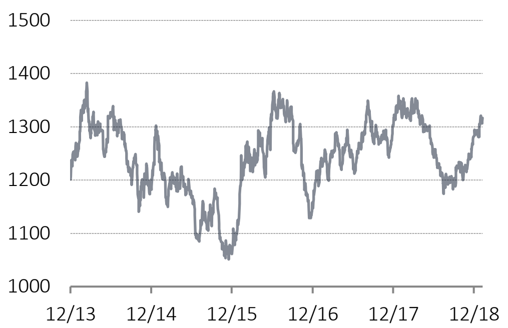


Fig.20: Brent oil price, USD/bl

Fig 21: Bloomberg commodity indices

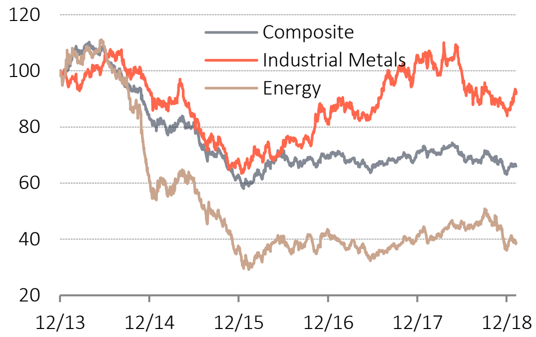


Fig. 22: HFRU hedge fund indices

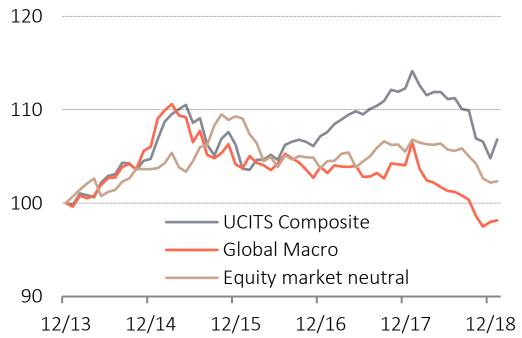


Fig 23: FTSE EPRA/NAREIT global REITS index

Fig 24: LPX global listed private equity

CURRENCIES

The EUR-USD exchange rate continued to move sideways and remained in its trading range between 1.120 and 1.155, which has held since October. The CHF, which strengthened in Q4 as financial and political uncertainties in Europe rose, gave back most of its gains in January. It ended the month at about 1.14 to the EUR. Despite Theresa May's defeat in parliament regarding her Brexit deal proposal, the GBP strengthened by about 3% against the EUR in January.

Fig. 25: EUR-USD exchange rate

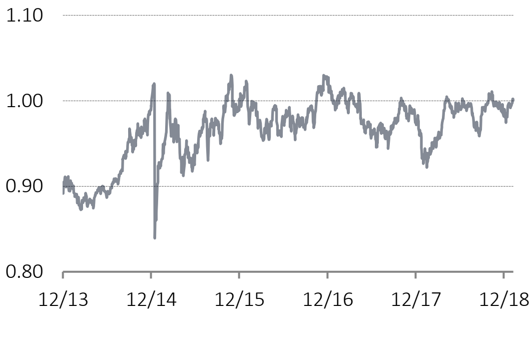
Fig. 26: GBP-USD exchange rate

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

January was a particular good month as bonds and equities rallied. All asset classes contributed positively. As a rule, risky assets outperformed defensive assets. REITS showed a remarkable performance. The USD remained almost flat to the EUR. The EUR, however, showed a tendency to weaken against other currencies, including the GBP, NOK, AUD and JPY.

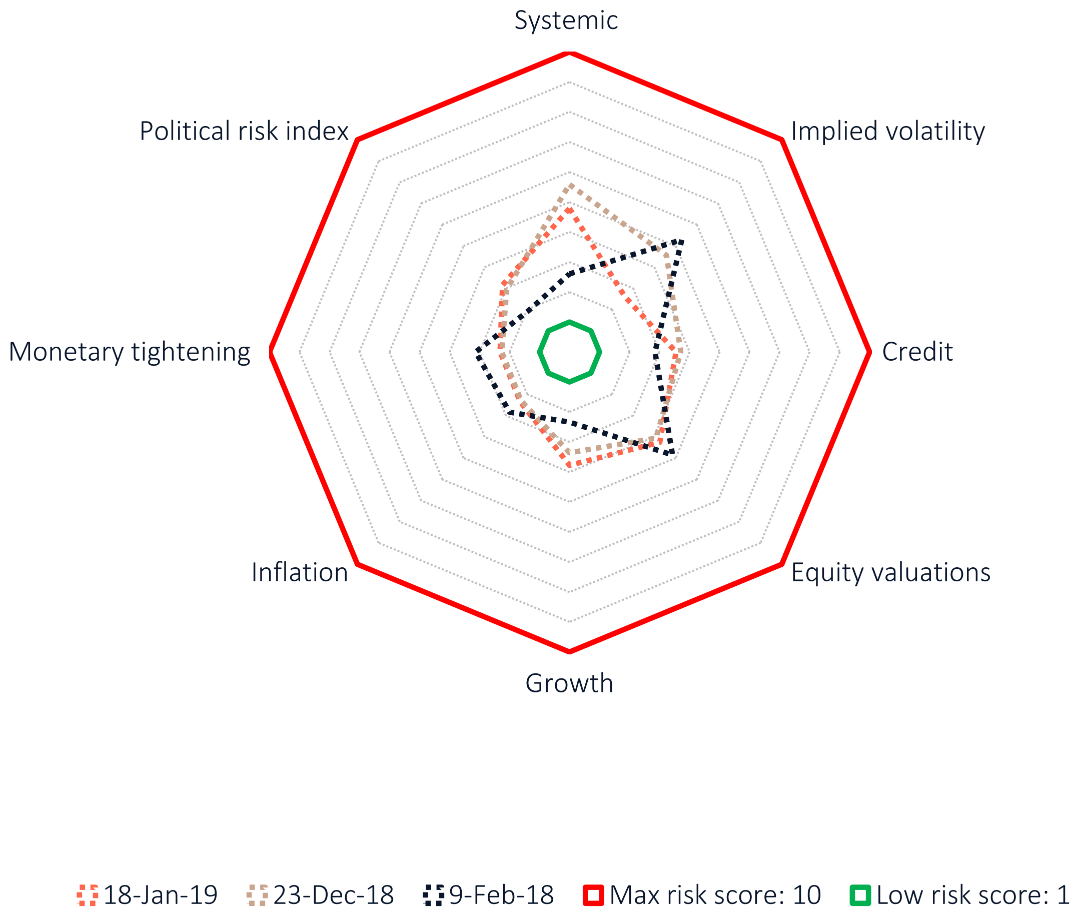
Fig. 31: Performance of major asset classes, based on our EUR portfolio strategy

RISK MONITOR

Most risk indicators calmed down in January, compared to the trough in markets just before Christmas. While growth risks have clearly risen, inflation and monetary tightening risks retreated. Doubts about the solidity of the banking sector remain somewhat elevated. Equity valuations have clearly fallen.

Fig. 32: IMT Risk Monitor

23 Dec 2018: Growth fears
09 Feb 2018: Inflation fear and technical correction



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