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IMT
GROUP

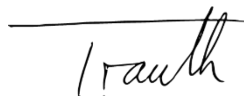
INVESTMENT OUTLOOK 06.2019

13 June 2019

Markets jittered when the Sino-US trade dispute ran hot in May. After President Trump announced his intention to raise tariffs on all Chinese import goods from 10% to 25% and a little later to sanction the Chinese technology giant Huawei, China retaliated with threats to block sales of rare earths and to stop negotiations unless the US eased tariffs. The next milestone meeting between President Trump and President Xi Jinping is expected during the G20 meeting in Japan at the end of June.

Given how hostile the rhetoric became, the market reaction was surprisingly measured. In May, the S&P500 fell 6.6% and the MSCI Europe 5.7%. The Chinese market reaction was stronger however: the CSI300 fell 7.2% in May but lost peak-to-trough 13.5%. In June, markets started to recover on the back of a more positive outlook regarding a potential trade talk solution.

We are holding on to our small tactical tilts and we remain relatively close to our strategic asset allocation. Our equity hedge cushioned the equity market losses in May.



Thomas Trauth
CEO – IMT Asset Management AG

PRESIDENT TRUMP – AGAIN

Financial markets

The equity market sell-off began on Monday 6 May, after President Trump had tweeted on Sunday 5 May that he would raise tariffs on Chinese goods to 25%, if no trade deal were agreed by the end of the week. Those rising tensions between the US and China together with softer growth data, i.e., weakening PMIs, falling inflation expectations, and downward earnings revisions, clearly worsened investors' sentiment. Developed equity markets fell 6.1% and emerging markets 7.5%. The main victims have been the Asian markets: the Hang Seng index lost 9.4%, the CSI 300 7.2%, and the Nikkei 225 7.4%. In the US, the equity sectors which lost most were energy, technology, and industrials. This may suggest that the trade war has the potential to backfire on those US companies which have been major value drivers in recent years.

Credits also suffered from the risk-off market move. High-yield bond spreads clearly widened and the high-yield performance index fell 1.25% in May.

Conversely, government bond markets rallied strongly. Especially the US yield curve moved down by about 35 basis points with a slight flattening tilt between 2s and 10s. Fixed income markets are almost certain – with a probability of 80% – that the US Fed will cut rates twice by December this year. We find those expectations exaggerated, and in our base-case scenario expect no change of rates this year, although the probability of a rate cut to tame markets has clearly risen. In addition, we saw a significant drop of inflation expectations, as measured for example by 10-year break-even inflation rates (see Fig. 9). Rate-cut expectations and falling inflation expectations both indicate major growth concerns.

Growth-sensitive commodities, like energy (-12%) and industrial metals (-6%), fell in May. The price of gold recovered somewhat and rose 1.7%. Global REITS ended the month flat and proved their role as a defensive asset class within the portfolio

In May the USD remained on the strong side, but started to weaken at the end of the month. After President Trump announced further tariffs on Chinese imports the CNY clearly depreciated. The GBP came under significant selling pressure when Brexit uncertainties spiraled at the beginning of May. In general, safe-haven currencies, like the CHF and the JPY, strengthened in May.

Macro economics

Global growth data weakened in May. The US ISM index fell to 52.1 vs 52.8 and the European Markit PMI fell to 47.7 after 47.9. Meanwhile, the Chinese PMI was 50.2, unchanged compared to the previous month. In addition, non-farm payrolls disappointed at only 75,000 in May vs a downward revised 224,000 in April.

European inflation fell to 1.2% vs. 1.7% in April and US inflation fell to 1.8% after 2.0%. US core inflation dipped slightly lower to 2.0% after 2.1%. As mentioned above, market-based inflation expectations have become very depressed, almost back to the early-January lows. The market doubts Jay Powell's view that low inflation is only "transitory". To us the current US inflation outlook is rather surprising, since labor markets have been tightening and tariffs are also inflationary.

Central banks

At its policy meeting on 6 June, the ECB kept rates unchanged and will keep rates at current levels at least until mid-2020. This was an extension of the ECB's forward guidance, since in earlier statements it always indicated that it would keep rates unchanged until end of 2019. President Draghi was very dovish and highlighted downside risks from geopolitical uncertainties, rising protectionism and vulnerabilities in emerging markets. He also expressed his concern about low and even falling inflation. He further said that the ECB is ready to "use all the instruments that are in the toolbox" if a weak export sector should spill-over to other sectors of the currency union. Such measures could also include a renewed quantitative easing program. After the meeting, stock markets rallied and European short-term rates fell.

Also Jay Powell, chairman of the US Fed, indicated in a speech in early June that he was prepared to cut rates should the global trade war impact the US economy.

Outlook

The US is increasingly pursuing an aggressive foreign policy, exerting its economic power to achieve political and economic objectives. Tariffs and sanctions have become weapons of choice to openly demand that other states change their actions. The list of examples is long. The US demands that China should change its trade practices and what the US sees as a disregard for intellectual property laws. On 3 June President Trump threatened to impose tariffs on Mexican imports, if Mexico did not become more active in countering immigration to the US. Mexico was fast to react, and Trump dropped this intended measure just a few days later. Recently, on 13 June, President Trump threatened Germany with sanctions over a gas pipeline project with Russia.

Although President Trump comes over as very aggressive in announcing such measures, he does not always follow through on them. In fact he can be quick to call them off. Nevertheless, the risk is high that, if other states reject US demands for action, Trump could see himself on a battle ground where giving in becomes impossible without losing face.

On top of geopolitical concerns, growth and inflation data softened in May. It is, therefore, natural to feel very concerned and bearish for risky assets.

Are there any positive developments which could justify a constructive view of equity markets despite the above-mentioned concerns? What explains the fact that developed equity markets gained 4.5% in the first two weeks of June?

In our view there are three answers. First, while we do see the danger that President Trump's aggressive policy stance could lead to uncontrolled escalation, we believe he is clearly focusing on being re-elected in 2020. Therefore, he will have to avoid anything which could lead to a US recession.

Second, China's stimulus measures have been decisive and are showing the first signs of success. Chinese credit growth has been surging back since January. Generally this should trigger increased economic activity in China itself and among its trading partners. This effect usually sets in with a 3-12 months lag. Therefore, we expect growth data to improve in the second half of this year.

Third, central banks have already eased monetary conditions, by more dovish rhetoric alone. Interest rates clearly fell. For example, US 2-year yield fell 1.2 percentage points from the end of November. Both the Fed and the ECB announced recently that they are prepared to either lower rates (US Fed) or to reintroduce a bond-buying program (ECB). Such monetary stimulus, even if only announced rather than actually implemented, is clearly supportive for risky assets.

On balance, and given elevated uncertainties, we remain neutral on equities and are maintaining our equity hedge. We also remain cautious on duration risks, especially at current levels, and on high-yield bonds, which we regard as priced to perfection.

ECONOMICS

Global growth data weakened in May. The US ISM index fell to 52.1 vs 52.8 and the European Markit PMI fell to 47.7 after 47.9. Also, non-farm payrolls disappointed at only 75,000 in May vs a downward revised 224,000 in April. Meanwhile, the Chinese PMI was 50.2 unchanged compared to the previous month. European inflation fell to 1.2% vs. 1.7% in April and US headline inflation to 1.8% after 2.0%.

Fig. 1: PMIs

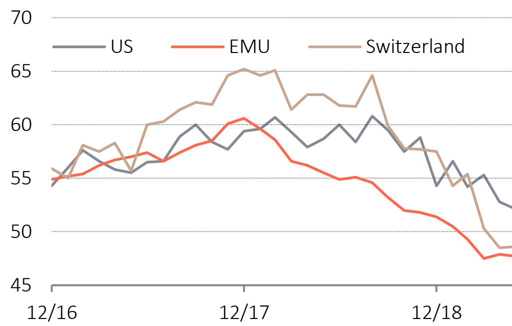


Fig. 2: PMIs

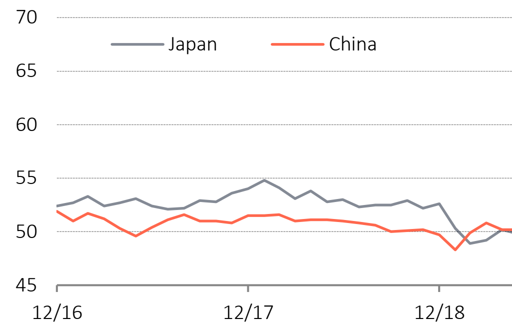


Fig 3: Consumer price inflation, in % YoY

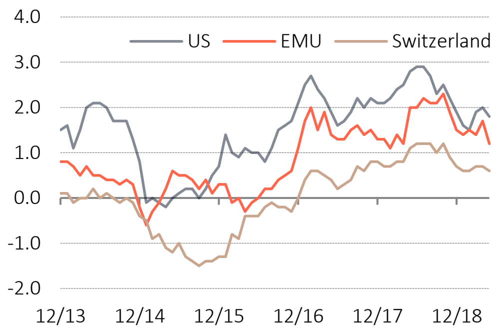


Fig. 4: Consumer price inflation, in % YoY

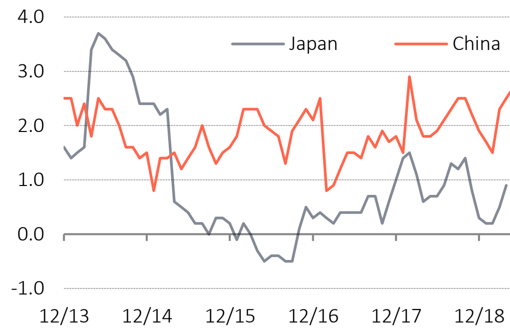


Fig 5: Unemployment rates, in %

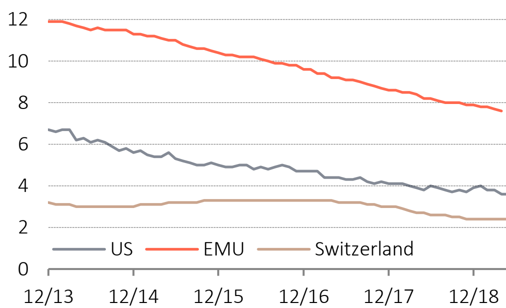
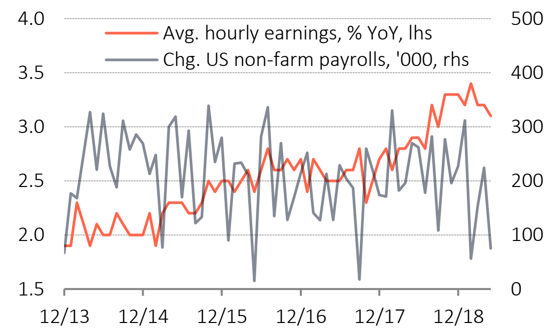


Fig 6: US labor market



FIXED INCOME

Bond-markets rallied in May. Investors were seeking safe-haven assets, and also revised their expectations regarding the path for future Fed fund rates. The market currently implies an almost 100% probability of at least one interest-rate cut and about 80% of more than one cut before year end. As a result, 2-year yields fell by 35 basis points. In addition, 10-year US treasuries yields fell as low as 2.1%, driven largely by falling inflation expectations. Credit spreads widened in May.

Fig.7: 2Y government bond yields

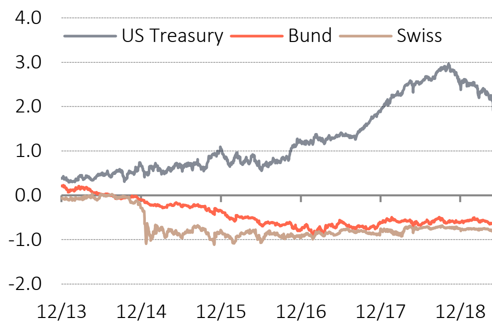


Fig. 8: 10Y government bond yields

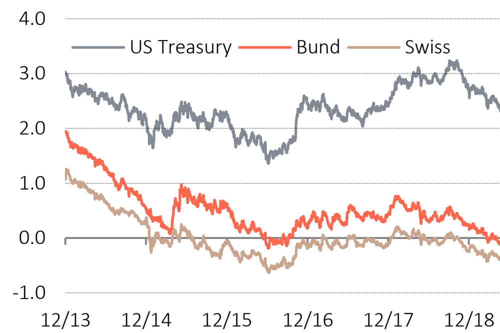


Fig 9: 10Y break-even inflation

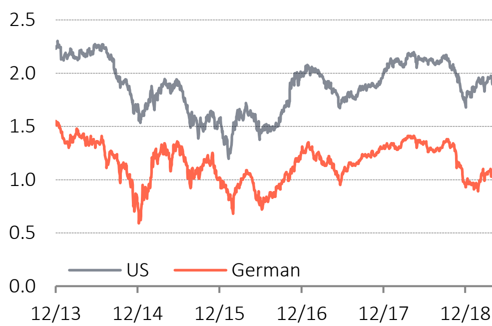


Fig. 10: Credit spreads, 5Y credit default swaps

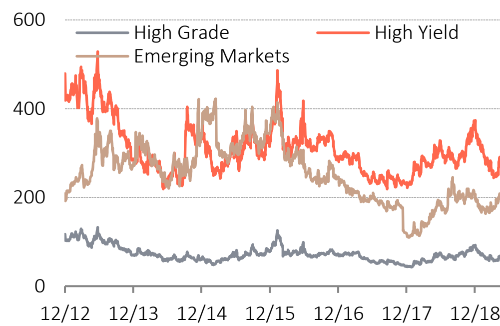


Fig 11: Money market spreads (3M-2Y)

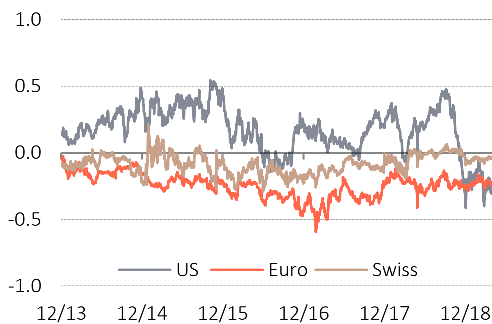
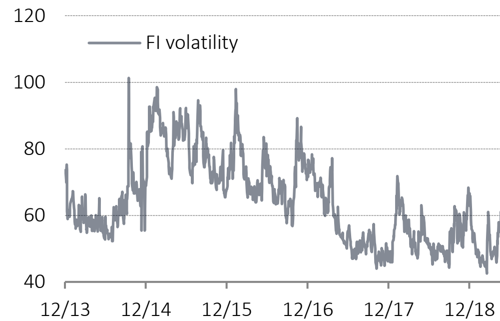


Fig 12: Merrill Lynch volatility index (MOVE)



EQUITIES

After a strong rally equity markets corrected significantly in May. Developed markets fell 6.1% and emerging markets 7.5%. Major victims have been the Asian markets: the Hang Seng index lost 9.4%, the CSI 300 7.2% and the Nikkei 225 7.4%. In the US the equity sectors which lost most were energy, technology, and industrials. This could imply that the trade war has the potential to backfire on those US companies which have been major value drivers in recent years.

Fig. 13: MSCI equity indices – major regions

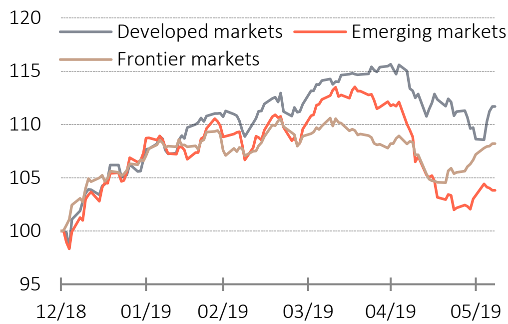


Fig.14: Equity indices – major developed markets

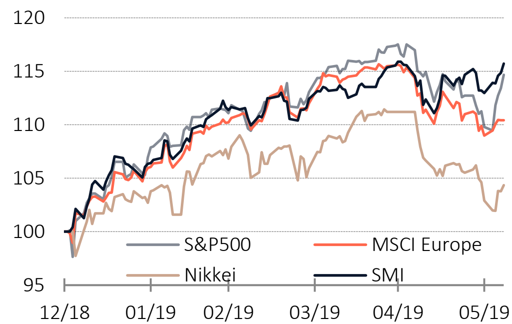


Fig 15: Equity indices – major emerging markets

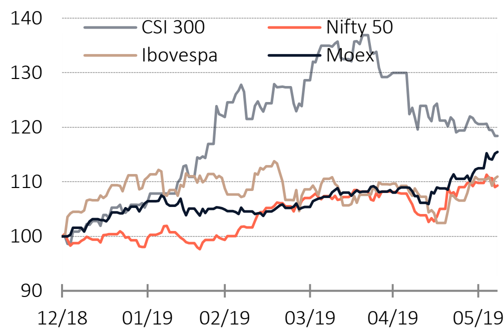


Fig. 16: Sector performance, MSCI Europe, 2018

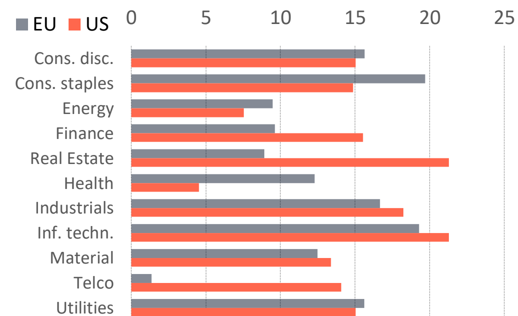


Fig 17: Price-earnings ratios

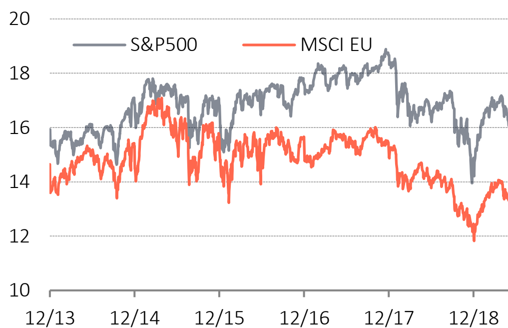
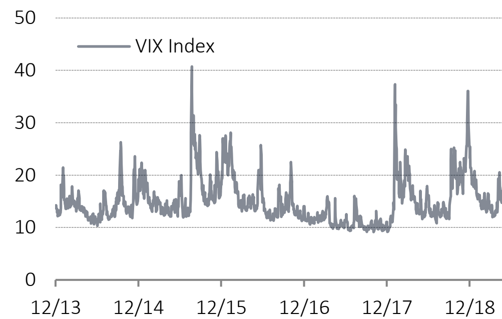


Fig 18: Equity volatility – S&P500 VIX index



ALTERNATIVE INVESTMENTS

Growth-sensitive commodities, like energy (-12%) and industrial metals (-6%), fell in May. The price for gold recovered and rose 1.7%. Global REITS ended the month flat and proved their role as a defensive asset class within the portfolio.

Fig. 19: Gold price, USD/oz

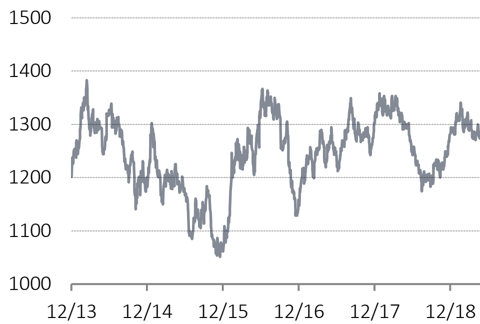


Fig.20: Brent oil price, USD/bl

Fig 21: Bloomberg commodity indices

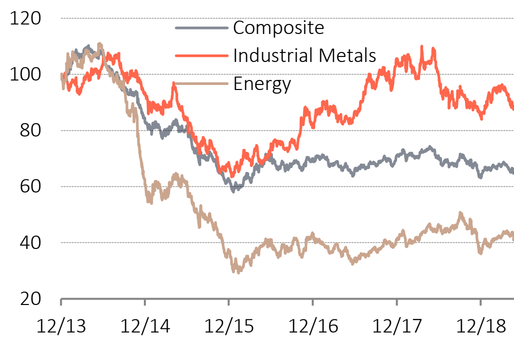


Fig. 22: HFRU hedge fund indices

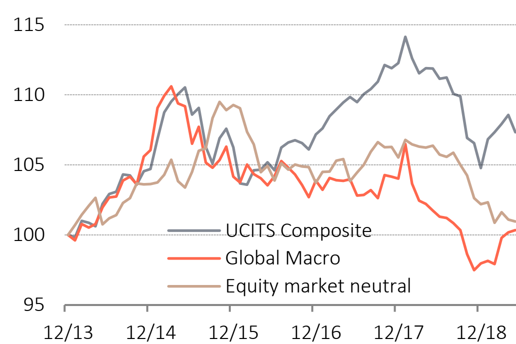


Fig 23: FTSE EPRA/NAREIT global REITS index

Fig 24: LPX global listed private equity

CURRENCIES

In May the USD remained on the strong side, but started to weaken at the end of the month. After President Trump announced further tariffs on Chinese imports the CNY clearly depreciated. The GBP came under significant selling pressure when Brexit uncertainties spiraled at the beginning of May. In general, safe-haven currencies, like the CHF and the JPY, strengthened in May.

Fig. 25: EUR-USD exchange rate

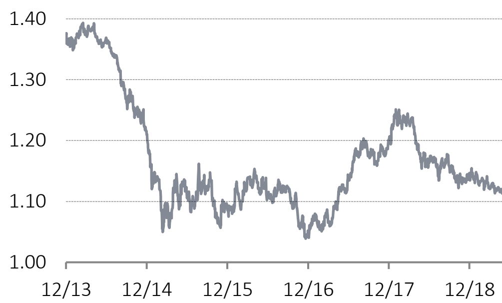


Fig. 26: GBP-USD exchange rate

Fig 27: USD-JPY exchange rate

Fig. 28: USD-CNY exchange rate

Fig 29: EUR-CHF exchange rate

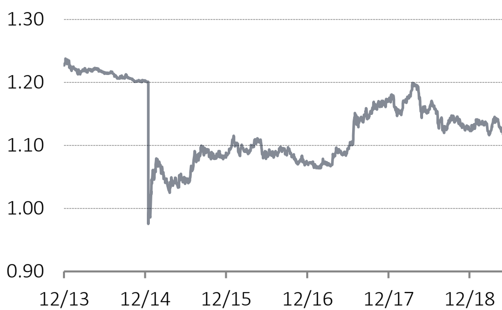
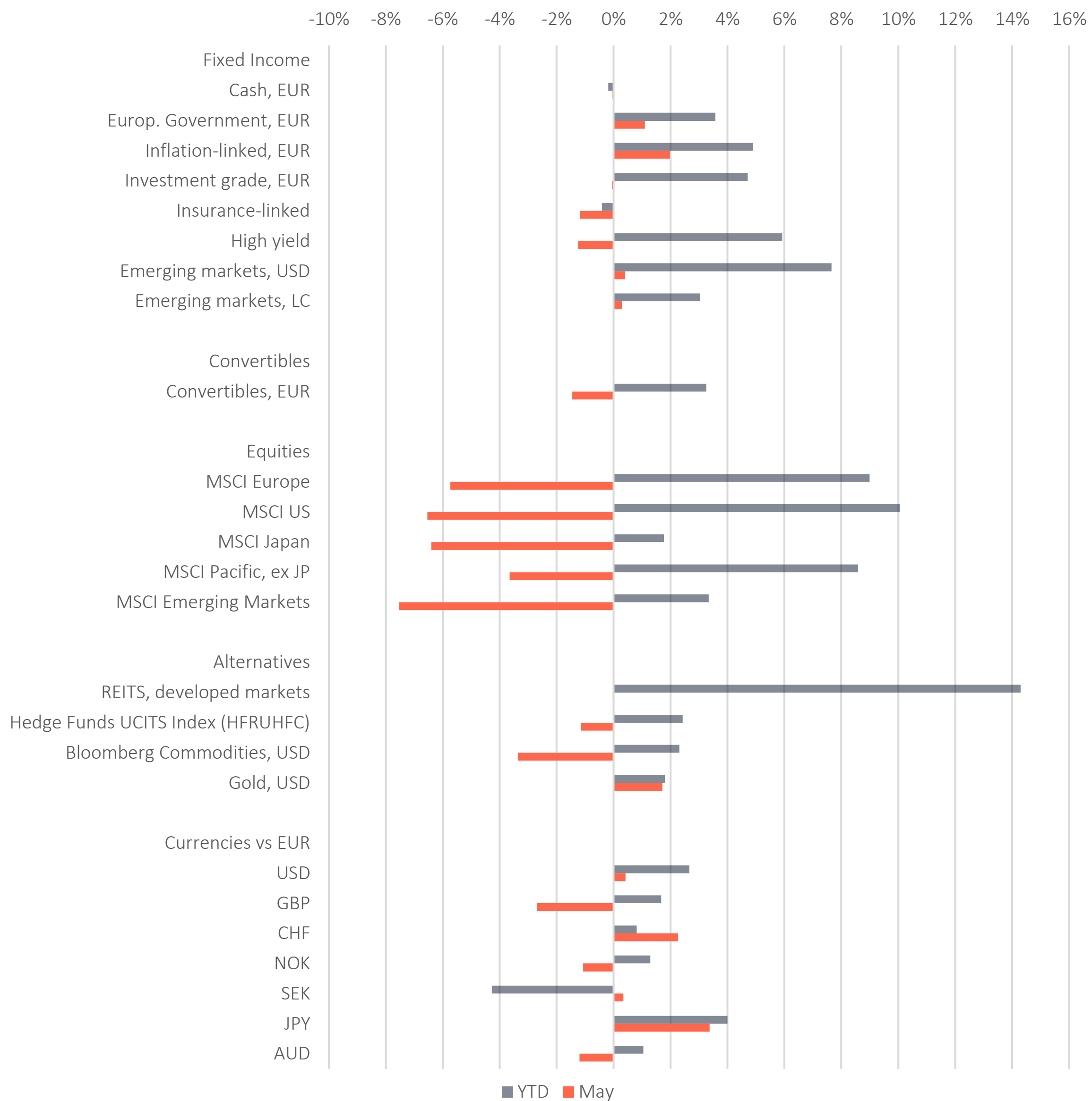


Fig 30: USD-CHF exchange rate

ASSET ALLOCATION

In May risky assets sold off and were the major contributor to the negative performance of multi-asset class portfolios. Commodity prices also fell. In contrast, bonds performed well, driven by safe-haven flows and a re-pricing of Fed rate-hike expectations. Remarkably, inflation-linked bonds performed very strongly, as real interest rates declined. The USD slightly appreciated, while the GBP weakened significantly. Safe-haven currencies, especially the CHF and the JPY appreciated.

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

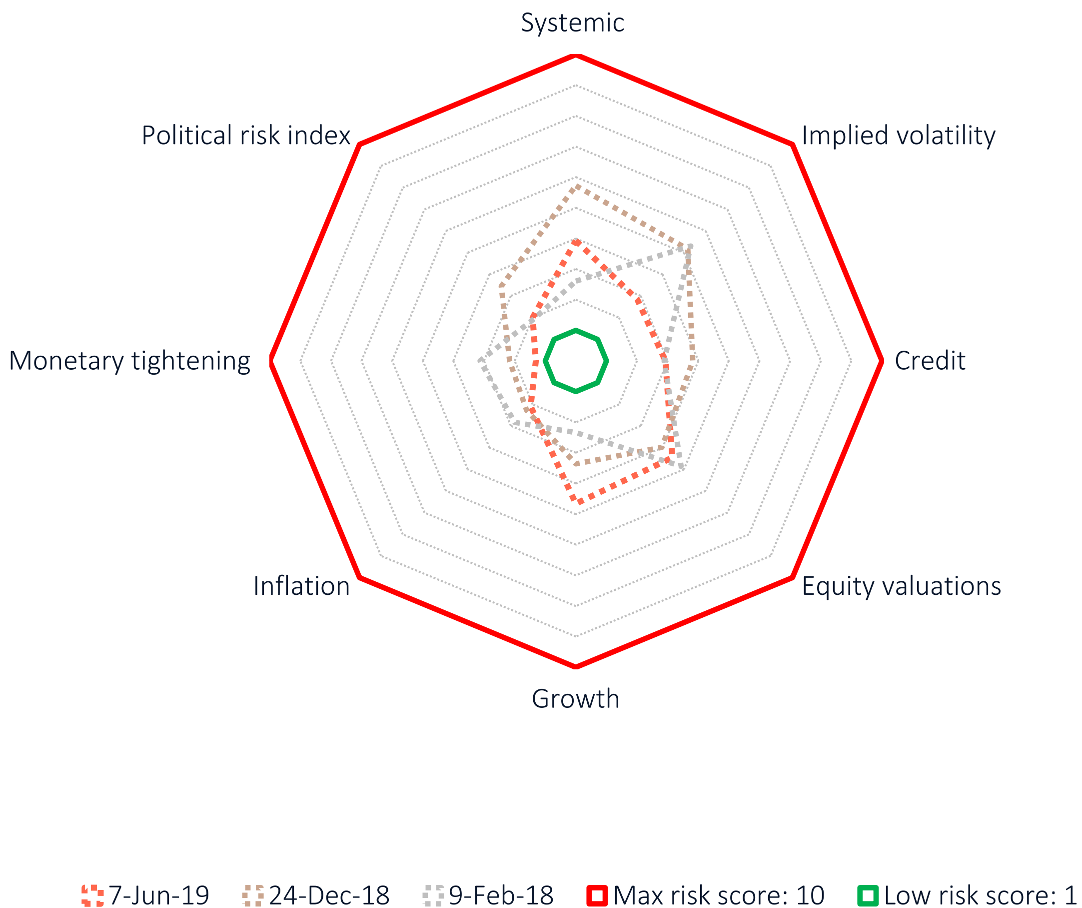


RISK MONITOR

Most risk indicators clearly fell after the end of December. Especially monetary tightening and systemic (banking sector) risks declined. The most elevated risk indicators reflect concerns about higher equity valuations and slowing economic growth.

Fig. 32: IMT Risk Monitor

24 Dec 2018: Growth and monetary tightening fears
09 Feb 2018: Inflation fear and technical correction



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