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IMT GROUP

INVESTMENT OUTLOOK 07.2019

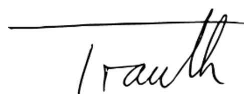
6 July 2019

After the sharp sell-off in May, markets bounced back in June. The MSCI World gained 6.5% in that month. The US stock market outperformed with a gain of 6.9%. Only the Indian NIFTY Index fell 1.1%. Meanwhile the bond rally continued, driving a large proportion of the bond market into negative-yield territory.

Central banks maintained their dovish stance. The latest Fed statement has increased the likelihood of a rate cut in the near future, while strong US labor market figures make a rate cut at the end of July less likely. ECB's chairman Mario Draghi mentioned the possibility of a fresh start of the QE program.

The market rally was further driven by encouraging developments regarding trade disputes. The US removed its threat of tariffs on Mexican goods and investors became increasingly certain that a meeting between Donald Trump and Jinping Xi at the G20 forum at the end of June would lead to reduced tensions, which it did.

We remain underweight bonds, neutral equities, slightly overweight energy, and we are retaining our equity hedge.



Thomas Trauth
CEO – IMT Asset Management AG

WILL THE FED DELIVER AN INSURANCE CUT?

Financial markets

Again, bond and equity markets rallied simultaneously, driven by dovish central banks and the prospect of more constructive trade talks.

In June 10-year bond yields dropped about 12 basis points, both in the US and in Europe. Inflation expectations collapsed, which gave central bankers additional arguments to take a dovish stance. For example, US bond markets revised their expectations regarding average inflation over the next 10 years from well over 2% in November to merely 1.65%. As a result, market expectations for Fed rate cuts this year rose substantially. Currently, the market assumes a probability of about 60% that the Fed will have delivered three or more rate cuts by December. The risk-on environment led to a further tightening of credit spreads

The bond rally drove a record number of bonds into negative yield. The amount of bonds with negative yields almost doubled between September 2018 and the end of June, from slightly more than USD 6 tn to USD 12.5 tn.

Equity markets surged in June, making up for most of or sometimes even more than the losses in May. Emerging markets indices climbed 5.7% but underperformed developed markets, which gained 6.5%. The US equity market (+6.9%) outperformed Europe (4.3%), Japan (3.3%) and China (5.4%). Notably the Indian NIFTY index fell 1.1%. Technology, industrials and consumer stocks outperformed, year-to-date.

Gold prices gained 8% and broke above USD/oz 1,400, driven by falling interest rates, a weaker USD, and geopolitical concerns. After tensions between the US and Iran rose, oil prices increased sharply, but gave some of those gains back towards the end of the month. REITS underperformed in June, the global REITS index falling 1%.

The EUR/USD exchange rate was quite volatile in June. ECB's dovish chairman Mario Draghi sent the EUR lower at the beginning of the month. Thereafter the EUR bounced back and rose from 1.12 to 1.14. The GBP remained on the weak side, while the CHF appreciated on the back of a dovish ECB.

Macroeconomics

Global PMIs softened slightly in June. The US ISM index fell to 51.7 after 52.1, the European Markit PMI fell to 47.6 after 47.7, and the Chinese PMI was at 49.4. after 50.2.

Non-farm payrolls rebounded from a disappointing May reading and exceeded the upper end of expectations, rising by 224,000. Job creation was broad-based, spanning service, factories and construction. Wage growth was unchanged at 3.1% YoY. The June labor market report confirms that the US economy is on a solid footing. Counterintuitively, equity markets sold off initially, since the likelihood of Fed rate cuts declined.

Central banks

At the 6 June ECB meeting, chairman Mario Draghi said that rates will stay low for longer and that the ECB was prepared to re-initiate the quantitative easing (QE) program. Later in the month, on 18 June, Mr. Draghi spoke at the ECB annual symposium and reiterated that the ECB may launch an expansion of its QE program, if the European inflation outlook does

not improve. This sent the EUR lower and prompted US President Trump to accuse Mario Draghi of unfairly manipulating the currency.

Christine Lagarde, currently managing director of the International Monetary Fund (IMF), was nominated to be the new chairman of the ECB, when Mario Draghi's term ends in October. This nomination was a surprise, especially since central bank management is usually dominated by monetary policy experts. Ms. Lagarde is a lawyer without formal economics training or working experience in a central bank.

At its policy meeting on 19 June the US Fed kept rates unchanged but became clearly more dovish. Fed chair Jay Powell hinted at rising uncertainties about the economic outlook and at inflation remaining below its target of 2%. The Fed would "… act as appropriate to sustain the expansion …". This may suggest that the Fed will cut rates as early as at its next policy meeting on 31 July.

President Trump has nominated Judy Shelton, an outspoken critic of the Fed, as a new board member. She was an economic adviser to Mr. Trump's 2016 presidential campaign. Ms. Shelton questions, among other things, whether the US Fed should have rate-setting power. Furthermore, she sympathizes with the gold standard, and is in favor of overhauling the monetary system in general.

Will the Fed deliver an insurance cut?

Since the Fed turned significantly more dovish at the beginning of the year, market expectations regarding future policy rates have been revised significantly. The market now expects at least two to three rate cuts this year. A typical easing cycle starts when the economy is about to fall or already has fallen into a recession. While some forecasters expect a recession to approach sometime soon, most economists agree that a US recession is very unlikely in the next 9-12 months. We agree with the second assessment, based on how strong important US leading economic indicators remain.

So why should the US Fed already cut rates now? The answer is that the US Fed may cut interest rates preemptively, based on the rise in geopolitical uncertainties and their potential impact on the real economy. Such a preemptive rate cut is often referred to as an "insurance cut". The objective of an insurance cut is to stabilize the economy and expectations. Historically, insurance cuts have been very positive for risky assets. In such a scenario, we think that the US Fed would cut rates at most 1-2 times and underdeliver on market expectations. Thereafter, and if economic growth should stabilize, the Fed would keep rates constant for longer or even start to raise rates again.

Based on the recent Fed communication we think it has become likely that the Fed will cut rates during the summer months. On 5 July US non-farm payrolls came in strongly and clearly above expectations, and this has lowered the probability of a US rate cut on 31 July.

Outlook

Since the beginning of the year we have observed a remarkable rally of bonds and equities. This can be explained by a noteworthy shift in the rhetoric of the ECB and the US Fed. Expansive monetary policy can lift the major asset classes simultaneously while, as we remember from December, the prospect of a more restrictive monetary policy can drive both bonds and equities down. In most other cases, however, you expect bonds and equities to move in opposite directions. Stronger growth and inflation, for example, is usually negative for bonds and positive for equities and vice versa.

Although in all likelihood monetary policy has been the major performance driver, it is worth thinking about what bond and equity markets tell us about the economic outlook. Not surprisingly, the stories differ.

Bond yields at current levels suggest that the Fed will start an easing cycle sometime soon. The magnitude of rate cuts until 2020 further suggests that the Fed will need to fight a recession. A similar picture is

painted by current ultra-low inflation expectations. A recession is tantamount to a dis-inflationary or even deflationary environment. In addition, we have seen a slightly inverted US yield curve, between 3-month and 10-year rates, which historically has been a reliable recession precursor.

At the same time, the strength of the equity markets suggests that there is a very positive outlook for growth and corporate earnings.

You could conclude that either bond or equities markets must be wrong.

Our view remains that global growth looks sufficiently robust to be sustained for at least another 12 months, albeit at a slower pace than in 2017 and 2018. We receive confirmation for this view especially from the very robust US consumer confidence and the acceleration of Chinese credit growth. We also think that central banks will stay accommodative, especially for the rest of 2019. The Fed is likely to deliver 1-2 insurance cuts this year.

Still, we remain positioned cautiously, since geopolitical tensions could derail markets for risky assets, and there is a certain risk that markets have overpriced the degree of monetary stimulus, which creates the potential for disappointment.

We are keeping our tactical asset allocation unchanged, underweighting bonds, neutral equity, slightly overweighting energy, and maintaining our equity market hedge.

ECONOMICS

Global PMIs softened slightly in June. The US ISM index fell to 51.7 after 52.1, the European Markit PMI fell to 47.6 after 47.7, and the Chinese PMI was at 49.4. after 50.2. Non-farm payrolls rebounded from a disappointing May reading, exceeding expectations. In June payrolls rose 224,000. Job creation was broad-based, spanning service, factories and construction. Wage growth was unchanged at 3.1% YoY.

Fig. 1: PMIs

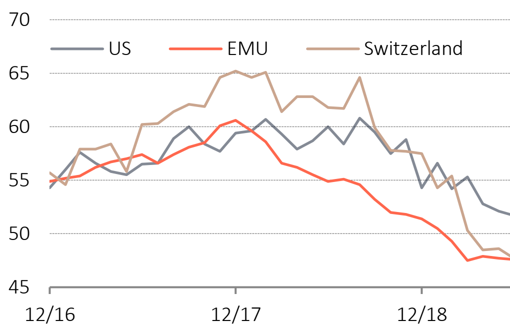


Fig. 2: PMIs

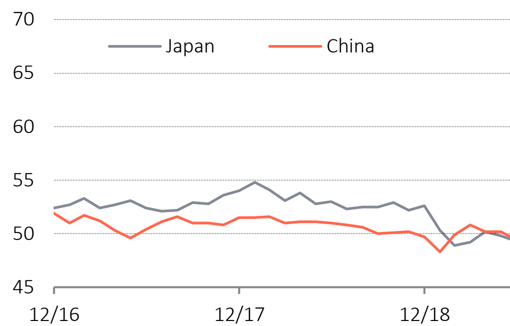


Fig 3: Consumer price inflation, in % YoY

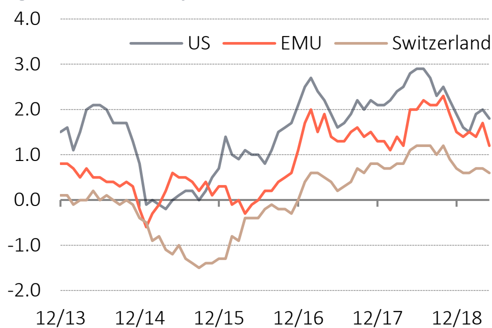


Fig. 4: Consumer price inflation, in % YoY

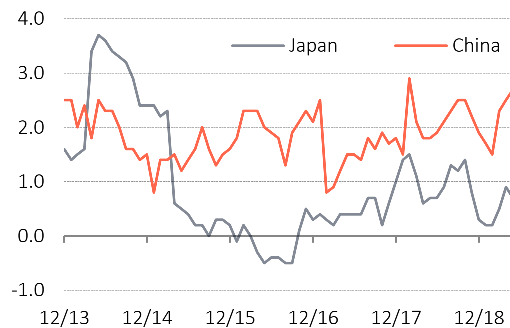


Fig 5: Unemployment rates, in %

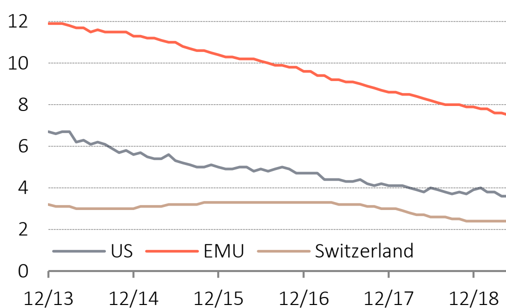
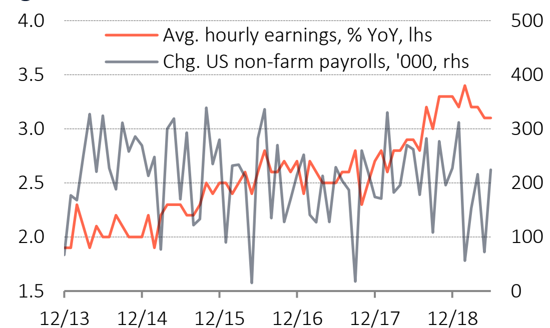


Fig 6: US labor market



FIXED INCOME

The bond-market rally continued, driven by dovish central banks. Inflation expectations collapsed, which gave central bankers arguments for a dovish stance. Bond markets expect average US inflation of 1.65% over the next 10 years. Market expectations for Fed rate cuts this year rose substantially. Currently, the market assumes a probability of about 60% that the Fed will have delivered three or more rate cuts by December. The risk-on environment led to a further tightening of credit spreads.

Fig.7: 2Y government bond yields

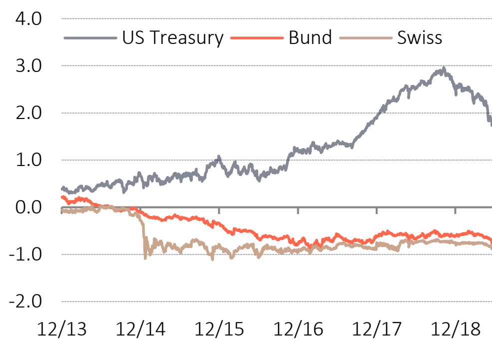


Fig. 8: 10Y government bond yields

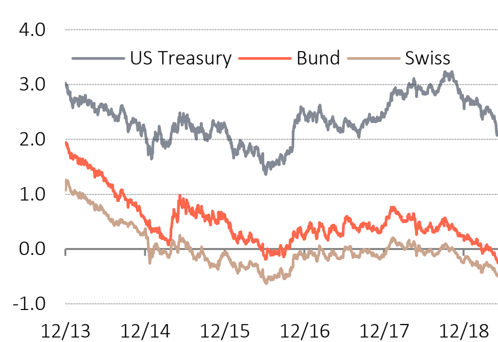


Fig 9: 10Y break-even inflation

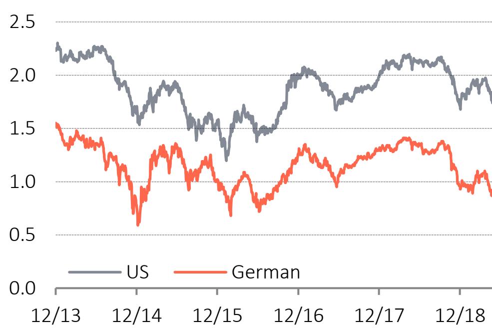


Fig. 10: Credit spreads, 5Y credit default swaps

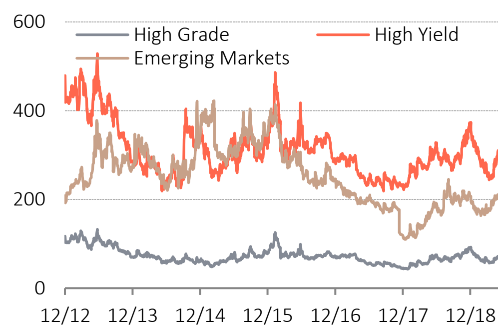


Fig 11: Money market spreads (3M-2Y)

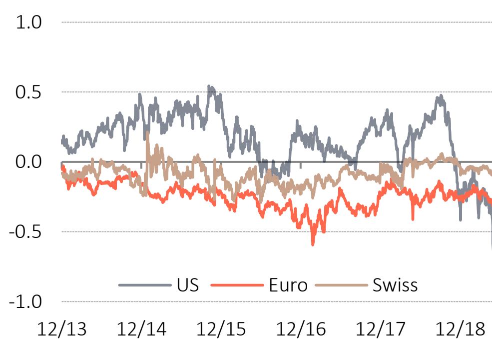
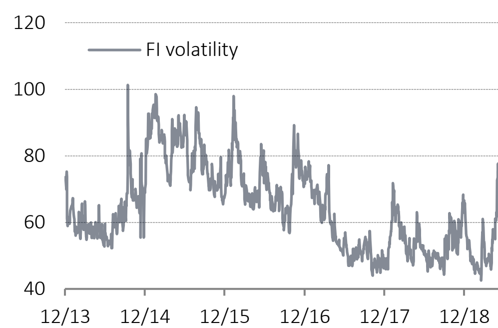


Fig 12: Merrill Lynch volatility index (MOVE)



EQUITIES

In June equity markets rebounded strongly, making up for most of or sometimes even more than the losses in May. Emerging markets indices climbed 5.7% and underperformed developed markets, which gained 6.5%. The US equity market (+6.9%) outperformed Europe (4.3%), Japan (3.3%) and China (5.4%). Notably the Indian NIFTY index fell 1.1%. Year-to-date technology, industrials and consumer stocks outperformed.

Fig. 13: MSCI equity indices – major regions

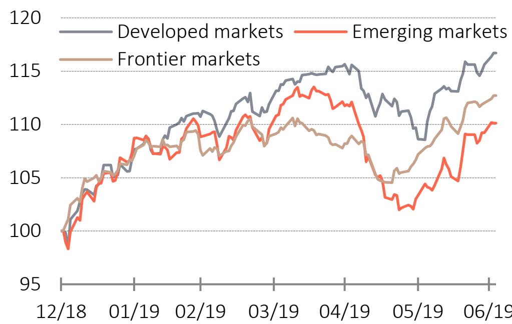


Fig.14: Equity indices – major developed markets

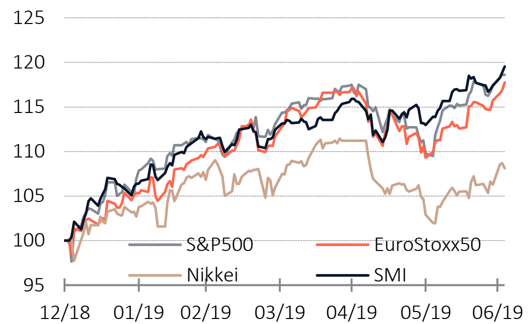


Fig 15: Equity indices – major emerging markets

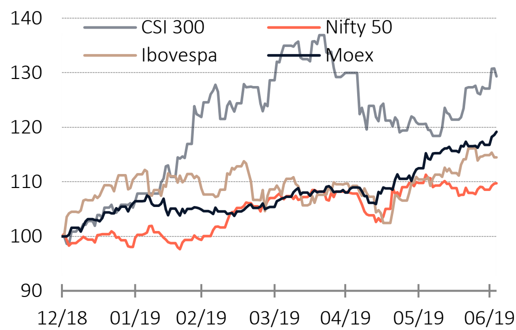


Fig. 16: Sector performance, MSCI Europe, 2018

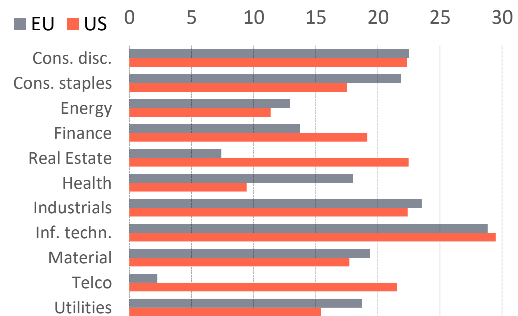


Fig 17: Price-earnings ratios

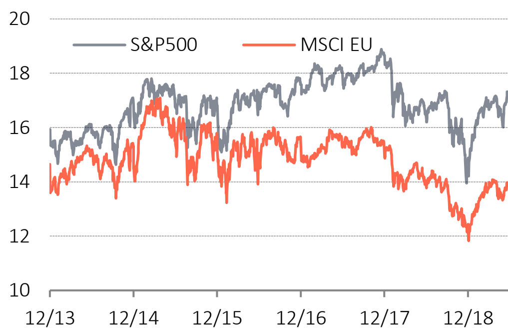
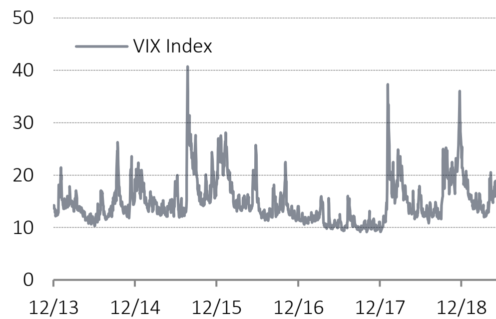


Fig 18: Equity volatility – S&P500 VIX index



ALTERNATIVE INVESTMENTS

Gold prices surged by 8% and broke above USD/oz 1,400, driven by falling interest rates, a weaker USD, and geopolitical concerns. After tensions between the US and Iran rose, oil prices increased sharply, but gave some of those gains back towards the end of the month. REITS underperformed in June the global REITS index falling 1%.

Fig. 19: Gold price, USD/oz

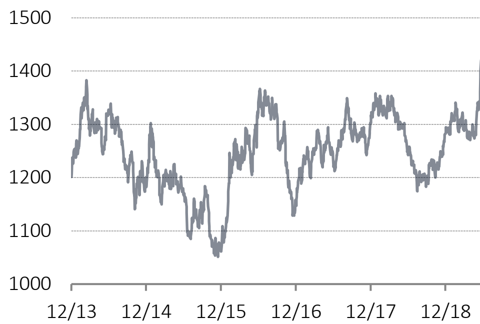


Fig.20: Brent oil price, USD/bl

Fig 21: Bloomberg commodity indices

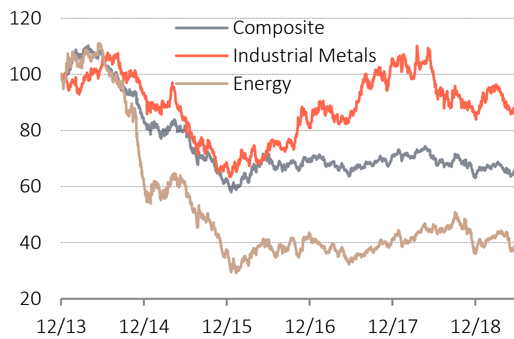


Fig. 22: HFRU hedge fund indices

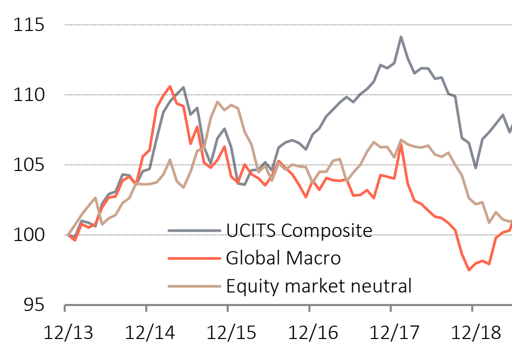


Fig 23: FTSE EPRA/NAREIT global REITS index

Fig 24: LPX global listed private equity

CURRENCIES

The EUR/USD exchange rate was quite volatile in June. ECB's dovish chairman Mario Draghi sent the EUR lower at the beginning of June. Thereafter the EUR bounced back and rose from 1.12 to 1.14. The GBP remained on the weak side, while the CHF appreciated on the back of a dovish ECB.

Fig. 25: EUR-USD exchange rate

Fig. 26: GBP-USD exchange rate

Fig 27: USD-JPY exchange rate

Fig. 28: USD-CNY exchange rate

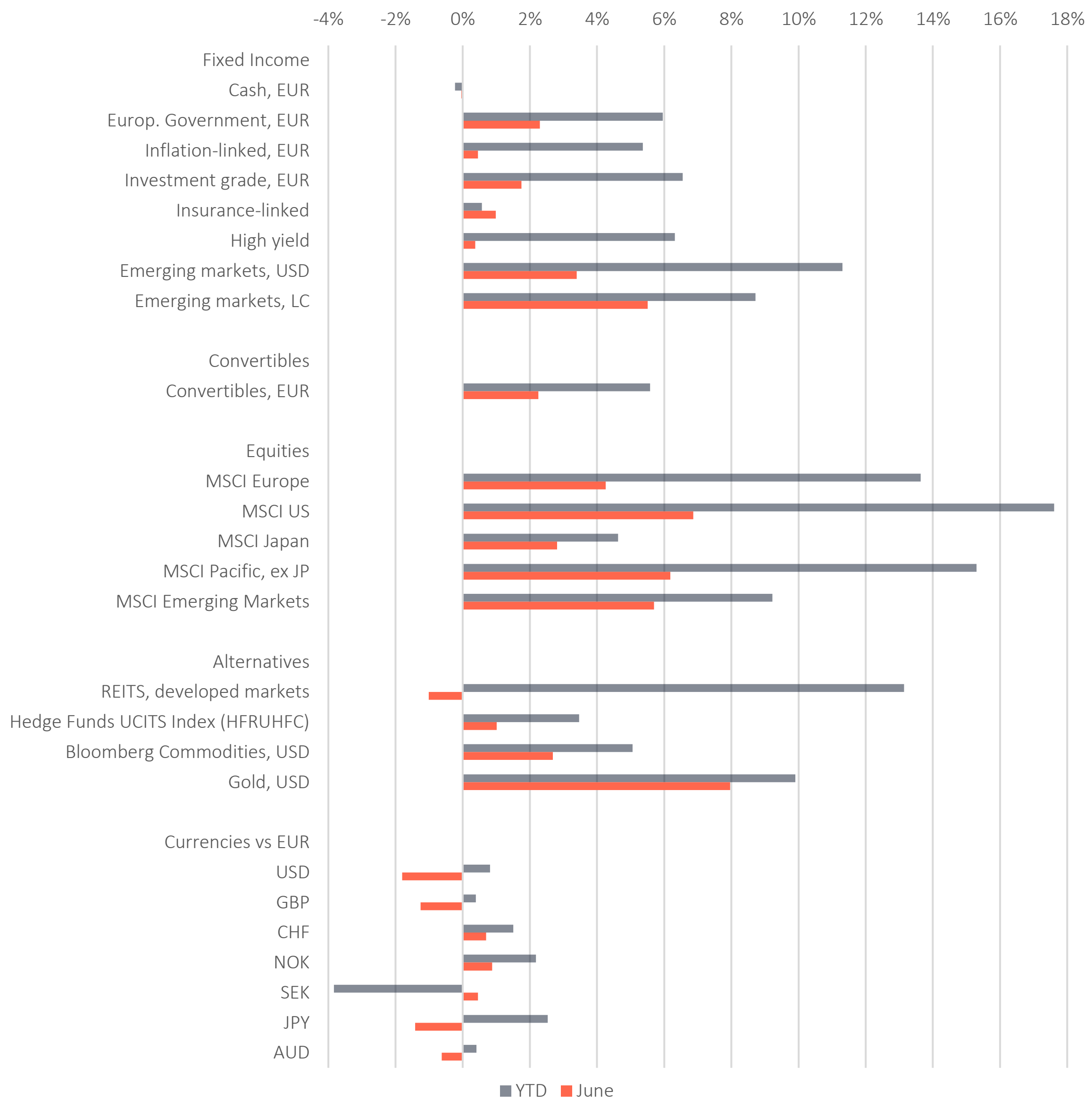
Fig 29: EUR-CHF exchange rate

Fig 30: USD-CHF exchange rate

ASSET ALLOCATION

June drove the year-to-date performance further up. Almost all asset classes, with the exception of cash, contributed positively to the portfolio performance. The strongest performance drivers have been risky assets, especially equities in the US, Europe, Asia Pacific, as well as REITS. In addition, EUR investors benefited from extra foreign currency gains, although currency movements have been relatively moderate overall.

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

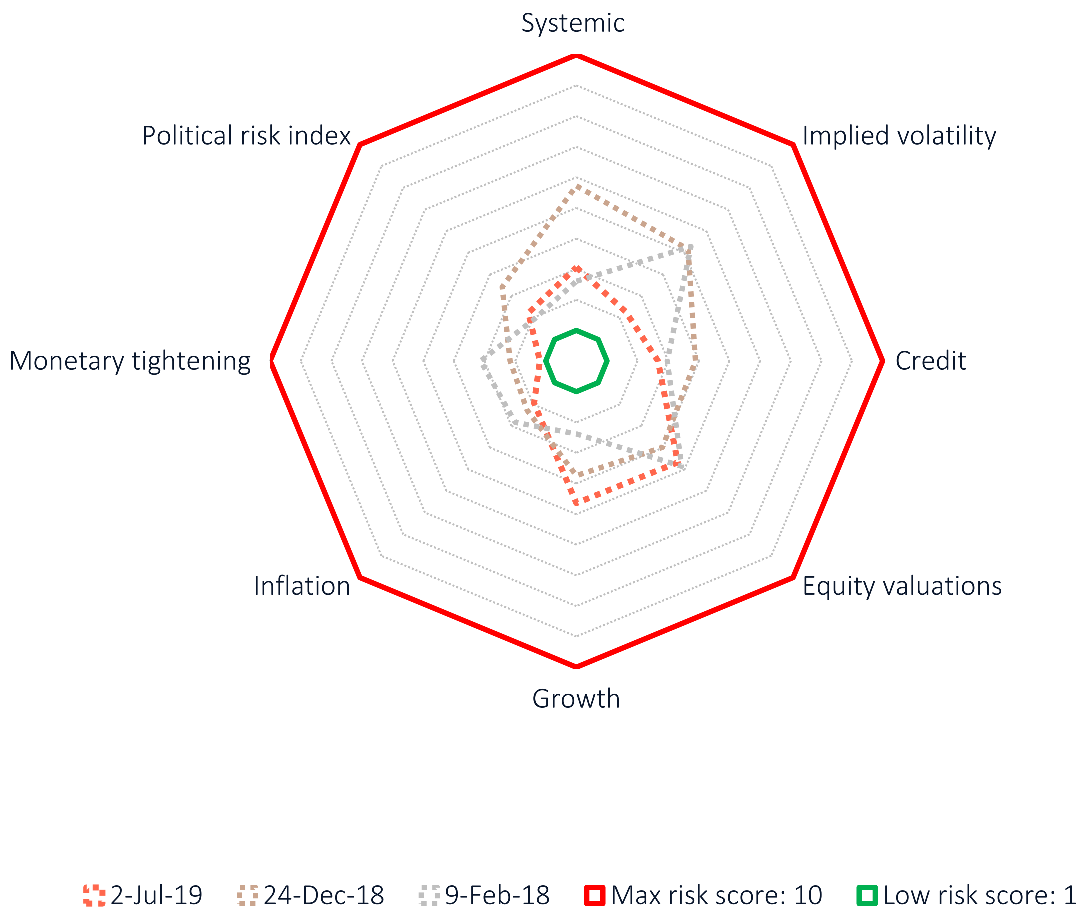


RISK MONITOR

Monetary tightening risks almost vanished, since markets take it for granted that central banks will deliver on their dovish rhetoric. Also systemic (financial sector) risks and inflation risks dropped recently. The risk indicators with the highest reading remain growth risks, as global growth has slowed, and equity valuation risks.

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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