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INVESTMENT OUTLOOK 08.2019

10 August 2019

Equity markets consolidated in July. Most developed markets equity indices rose slightly (S&P500 by 1.3%, MSCI Europe by 0.2%, Nikkei 225 by 1.2%). In contrast, emerging markets equities declined by 1.7%. Bond markets rallied further with the exception of the short-end of the US yield curve.

Central banks took center stage in July. At its policy meeting on 25 July the ECB promised a further rate cut and/or an additional asset-purchase program. At first sight, the US Fed met market expectations, when on 31 July it lowered interest rates by 25 basis points. However, the rhetoric of the US Fed underwhelmed market participants, since it made it clear that it does not intend to enter into a full-blown easing cycle. As a result, markets sold off and US short-term rates rose.

Additional disquiet for the markets followed, when in early August US President Trump announced another round of tariffs on USD 300 bn of Chinese imports. As a result, markets for risky assets sold-off significantly and the bond rally accelerated.

Trauth

Thomas Trauth
CEO – IMT Asset Management AG

THE US FED'S HAWKISH RATE CUT

Financial markets

In July markets consolidated, as market participants were waiting for decisive central-bank policy meetings, the ECB on 25 July, the Bank of Japan on 30 July, the US Fed on 31 July, and the Bank of England on 1 August.

Most equity markets were slightly up (S&P500 by 1.3%, MSCI Europe by 0.2%, Nikkei 225 by 1.2%), except for emerging markets equities, which fell by 1.7%. At the beginning of August, however, markets sold off, since the US Fed sounded more hawkish than anticipated and the US announced the imposition of additional tariffs on Chinese imports.

In July bond markets continued to rally with the exception of the short-end of the US curve. 2-year US government bond yields rose 21 basis points as markets revised their Fed rate-hike expectations. The bond rally accelerated in early August when trade tensions triggered safe-haven flows.

Credit spreads tightened slightly in July, but widened in August.

The gold price remained well supported and rose 0.3% in July. In early August, after uncertainties heightened, gold rallied strongly, approaching USD/oz 1,500. Oil prices fell in July, as growth fears remained high. The price for Brent oil declined by 2.1%. REITS rallied in July with the global REITS index rising 2.5%.

The CHF strengthened in July driven by a dovish ECB. At the same time, the GBP weakened on the back of concerns regarding a no-deal Brexit, while the CNY weakened on the back of rising tensions between the US and China. The USD-CNY exchange rate broke above 7, which resulted in President Trump accusing China of unfairly manipulating its currency. In general, the USD remained well supported

Macroeconomics

PMIs declined further in July. The US ISM index fell to 51.2 after 51.7 and the European Markit PMI decreased distinctly to 46.5 after 47.6, remaining clearly below the 50 level, and thus, in contraction territory. Meanwhile, the Chinese PMI rose slightly to 49.4 after 49.3.

Non-farm payrolls rose by 164,000 in July, which is regarded as a healthy pace, although the prior month figures were revised downward, from 224,000 to 193,000 in June. The three months average of the non-farm payrolls was 140,000, which is the slowest rate in two years. This can be either interpreted as a sign that labor market conditions have gotten tighter or that growth is slowing. Wage growth picked up somewhat, to 3.2% yoy after 3.1% in prior months.

Industrial production in Germany fell 1.5% month on month in June, a bigger decrease than expected. This adds to recession fears in Germany. This comes after the German economy rebounded in the first three months of 2019. Most industrial sectors suffered from a decline: intermediate capital, energy, and consumer goods.

US president Trump announced the introduction of a 10% tariff on the remaining USD 300 bn of imports form China. The US already introduced tariffs of 25% on USD 250 bn of import goods from China. Trump expressed his discontent with the progress of the trade talks and said that this could be a first move with further stepwise increases of tariffs, possibly beyond 25%.

Central banks

On July 25 the ECB kept rates unchanged but indicated that it was prepared to cut rates further and/or to introduce an additional quantitative easing package. Chairman Mario Draghi, who will depart from the ECB and hand over to Christine Lagarde in October, expressed the ECB's discomfort with inflation remaining clearly below its target of 2%. Market participants expect the ECB to decide on new stimulus measure at its next policy meeting on 12 September. As a result, European yields fell to all-time lows.

On 31 July, the US Fed cut interest rates by 0.25 percentage points. This was widely expected and represented the first US rate cut for more than ten years. The market reaction, however, reflected disappointment. The S&P500 index fell 1.6% during the press conference and the USD strengthened further. The market reaction can be explained by Jerome Powell's comments at the press conference, when he disappointed those who were expecting the start of an aggressive easing cycle. Mr. Powell said that the rate cut was intended to address weak global growth, trade policy uncertainty and muted inflation, but he also pointed out that the rate cut should be seen as a "mid-cycle adjustment" and not the start of a full-blown easing cycle. In other words, he confirmed the notion of an insurance cut (see our Investment Outlook 07.2019). However, later in the press conference, he made it clear that a second rate cut was likely.

The rate-cut decision was not unanimous: two of the twelve FOMC members favored leaving rates unchanged, none of the members dissented by calling for more dramatic easing. Some observers labelled the Fed decision a hawkish rate cut.

On 1 August the Bank of England (BoE) unanimously voted to hold interest rates steady at 0.75%. Furthermore, Mark Carney, the BoE governor, indicated that borrowing costs would eventually need to rise to keep inflation at its 2% target. The BoE sees a one-in-three chance that the UK economy will shrink early next year as Brexit uncertainties and trade tensions weigh on the British economy.

The Bank of Japan (BoJ) decided on 30 July to keep its main interest rate unchanged at -0.1%. Furthermore, it decided to continue with its unconventional policy measures, buying government bonds at a rate of the equivalent of USD 735 bn pa, maintaining a cap on 10-year bond yields at zero, and buying equity exchange-traded funds and Japanese REITS.

Outlook

We expect heightened volatility in the coming weeks. Macro-economic data have worsened, and it is entirely possible that Germany is entering a recession. Growth in the US and China has clearly slowed. Still, it seems unlikely that during the coming twelve months, the US or the global economy will enter into a recession. Central banks remain very accommodative. Furthermore, especially in the US, there will be additional fiscal stimulus, although the effects from the tax cuts are rolling over.

We still believe there is a good chance that the US-Sino trade dispute will be solved, since both parties have strong incentives to avoid a full-blown trade war. US President Trump's approval ratings are among the weakest compared to other presidencies at the same point in time during the election cycle. If a trade war pushed the US economy into a recession, his chances of being re-elected would most likely fall to zero.

Nevertheless, in our view, the risk landscape has worsened. We identified two major risks to our base-case scenario. First, US growth data may continue to worsen, leading to a recession. Although US consumer sentiment continues to be very strong, the trade dispute has already had an impact on the attitude and investment activities of US corporates. Second, the trade dispute could well run into a dead end, especially if face-saving behavior prevented one or both parties from agreeing to a compromise.

As a result, we remain cautiously positioned and maintain our equity hedge. We continue to carefully monitor early warning indicators of a US recession and signs of further escalations of the trade dispute. This includes further sanctions on tech companies, e.g., on Huawei, Apple or others, and Chinese restrictions on rare earth exports.

ECONOMICS

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Fig. 1: PMIs

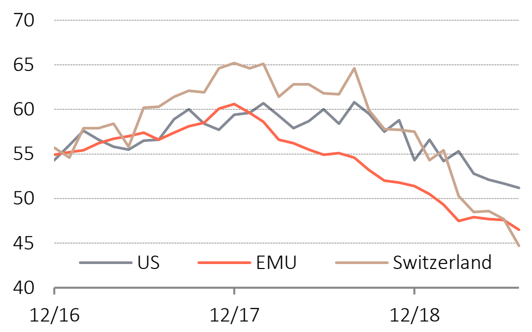


Fig. 2: PMIs

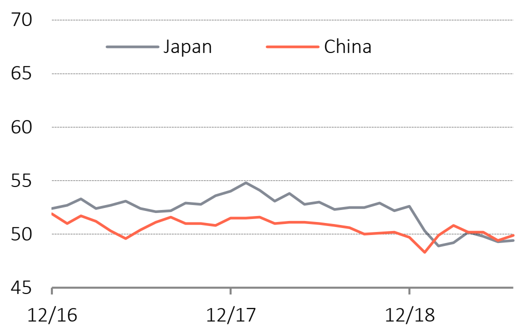


Fig 3: Consumer price inflation, in % YoY

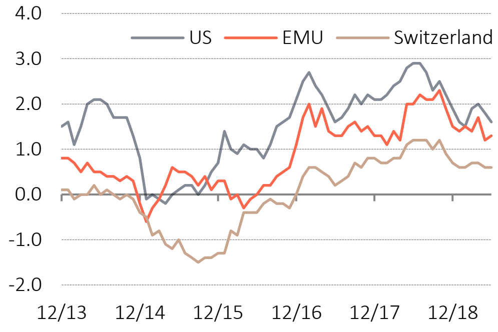


Fig. 4: Consumer price inflation, in % YoY

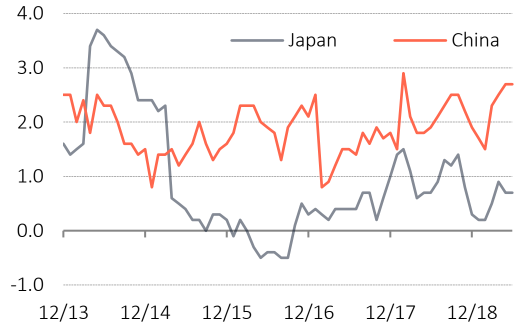


Fig 5: Unemployment rates, in %

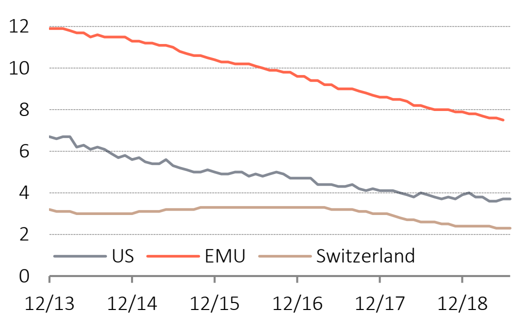
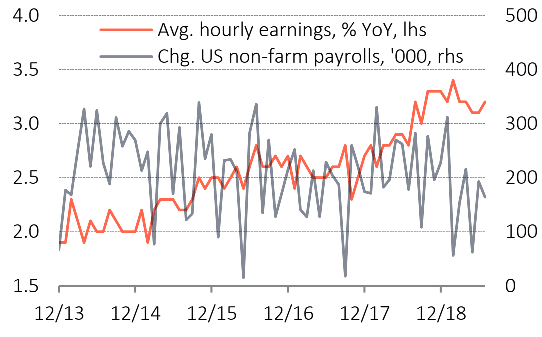


Fig 6: US labor market



FIXED INCOME

In July, after the so-called hawkish rate cut by the US Fed, US 2-year yields snapped back and rose by 12 basis points. US 10-year rates remained almost unchanged. Meanwhile, a dovish ECB coupled with weaker economic data sent European yields to the lowest levels in 2019. Credit spreads declined slightly in July.

Fig.7: 2Y government bond yields

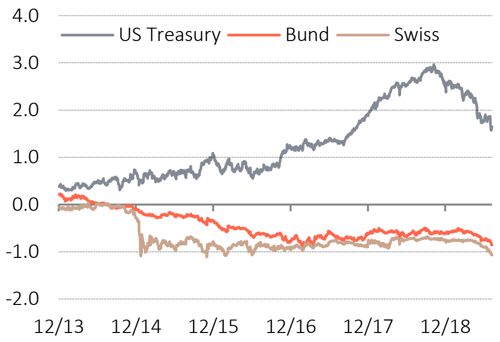


Fig. 8: 10Y government bond yields

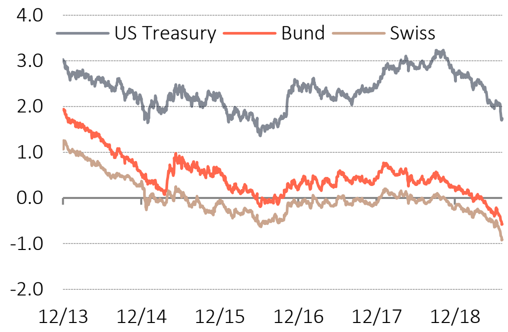


Fig 9: 10Y break-even inflation

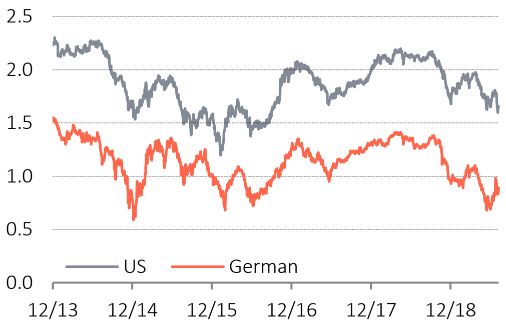


Fig. 10: Credit spreads, 5Y credit default swaps

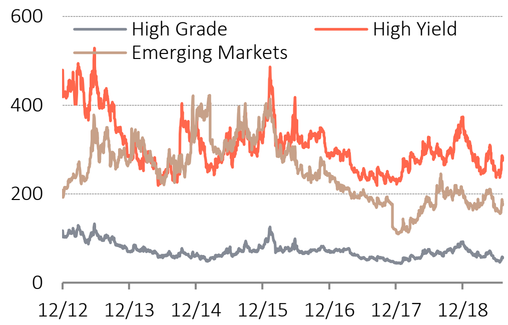


Fig 11: Money market spreads (3M-2Y)

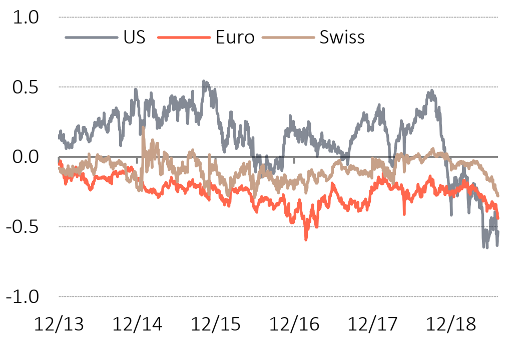
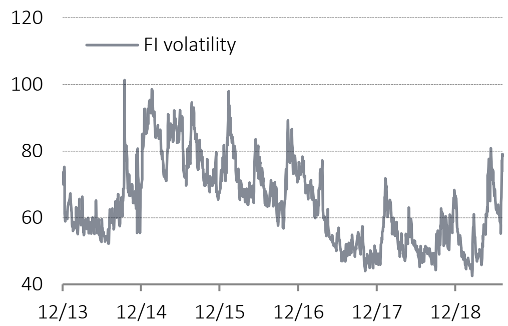


Fig 12: Merrill Lynch volatility index (MOVE)



EQUITIES

In July most equity markets were slightly up (S&P500 1.3%, MSCI Europe 0.2%, Nikkei 225 1.2%), except for emerging markets equities, which fell 1.7%. At the beginning of August, markets sold off on the back of renewed trade tensions with the US imposing additional tariffs on Chinese imports. Furthermore, the weakening of the Chinese CNY, with the USD-CNY exchange rate breaking above 7, and President Trump's accusation that China was unfairly manipulating its currency, caused additional market turmoil.

Fig. 13: MSCI equity indices – major regions

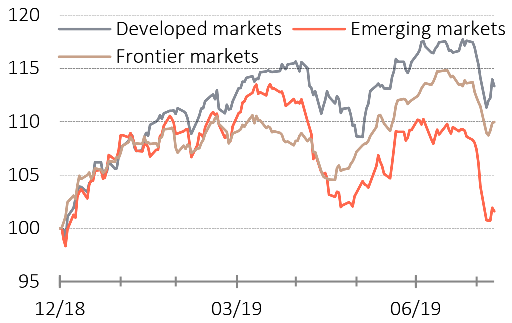


Fig.14: Equity indices – major developed markets

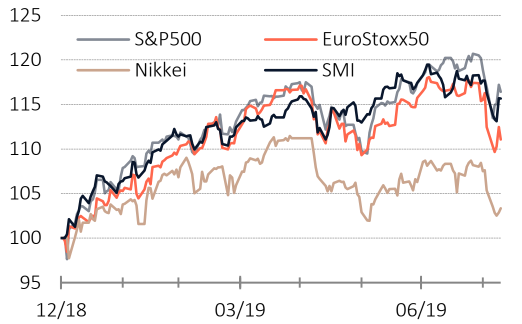


Fig 15: Equity indices – major emerging markets

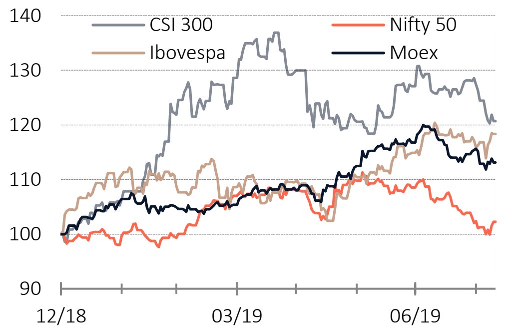


Fig. 16: Sector performance, MSCI Europe, 2018

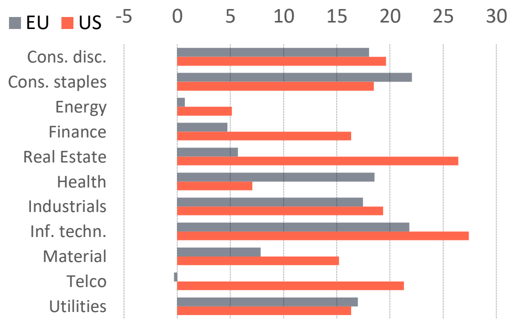


Fig 17: Price-earnings ratios

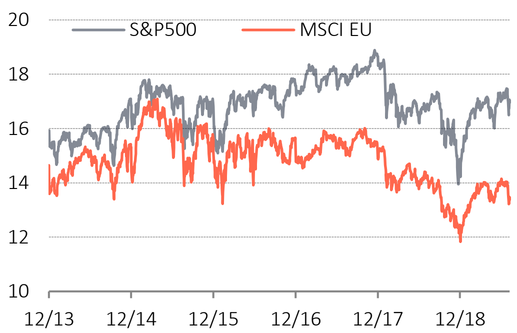
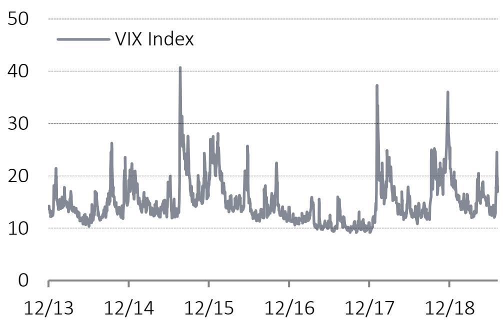


Fig 18: Equity volatility – S&P500 VIX index



ALTERNATIVE INVESTMENTS

The gold price remained well supported and rose 0.3% in July. In early August after uncertainties heightened, gold rallied strongly, approaching USD/oz 1,500. Oil prices fell in July, as growth fears remained high. The price for Brent oil declined by 2.1%. REITS rallied in July with the global REITS index rising 2.5%.

Fig. 19: Gold price, USD/oz

Fig.20: Brent oil price, USD/bl

Fig 21: Bloomberg commodity indices

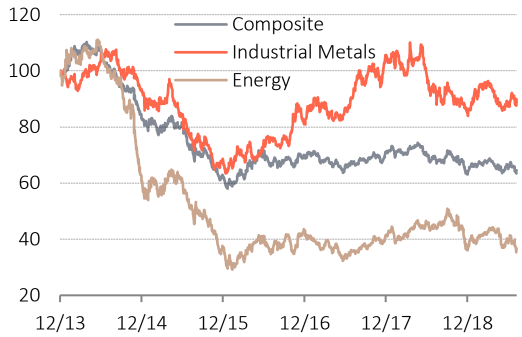


Fig. 22: HFRU hedge fund indices

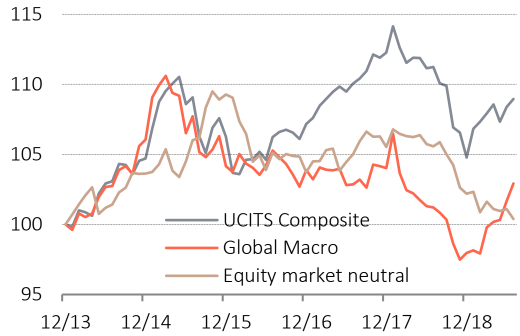


Fig 23: FTSE EPRA/NAREIT global REITS index

Fig 24: LPX global listed private equity

CURRENCIES

The CHF strengthened in July driven by a dovish ECB. At the same time, the GBP weakened on the back of concerns regarding a no-deal Brexit, while the CNY weakened on the back of rising tensions between the US and China. The USD-CNY exchange rate broke above 7, which resulted in President Trump accusing China of unfairly manipulating its currency. In general, the USD remained well supported.

Fig. 25: EUR-USD exchange rate

Fig. 26: GBP-USD exchange rate

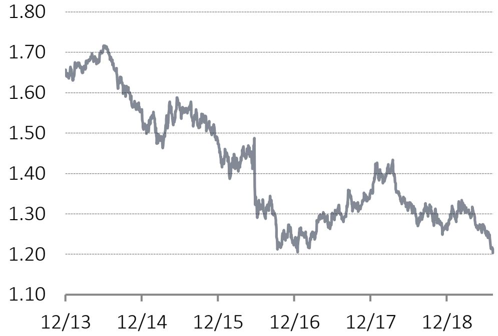


Fig 27: USD-JPY exchange rate

Fig. 28: USD-CNY exchange rate

Fig 29: EUR-CHF exchange rate

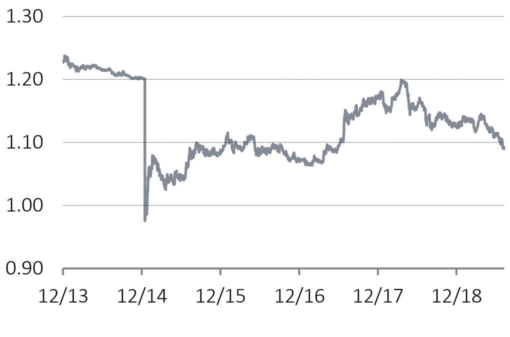
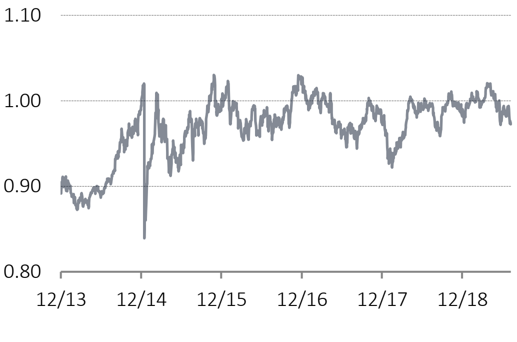


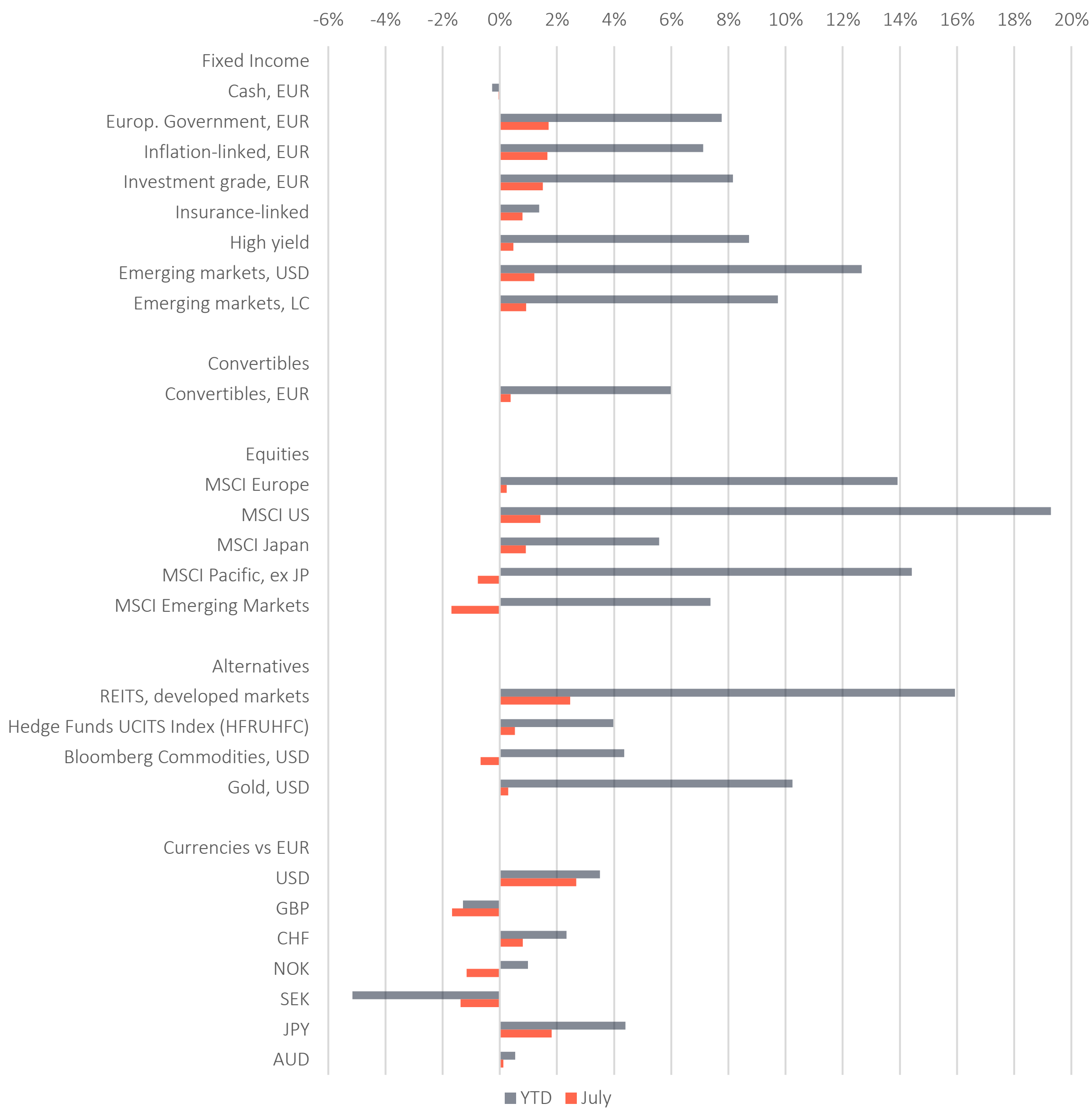
Fig 30: USD-CHF exchange rate



ASSET ALLOCATION

In July most asset classes performed positively, albeit not as strongly as in recent months. However, there have been some notable exceptions: emerging markets equities fell together with commodities. Government and inflation-linked bonds outperformed in July, driven by expectations of further loosening of monetary policies. The USD, the CHF and the JPY strengthened vis-à-vis the EUR.

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

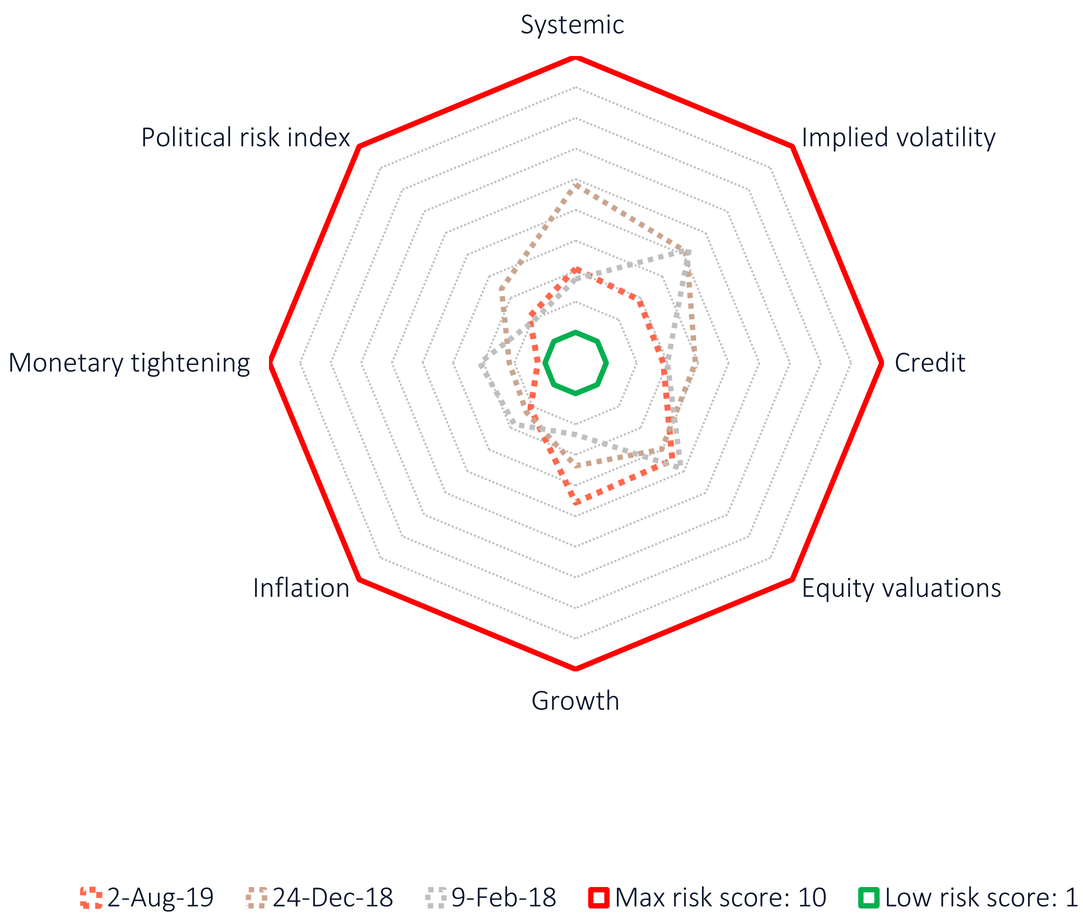


RISK MONITOR

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



DISCLAIMER

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