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IMT GROUP

# INVESTMENT OUTLOOK 01.2020

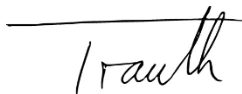
**20 January 2020**

As usual, we are dedicating our first Investment Outlook of the year to an assessment of our last year's predictions, and we are setting out our new predictions for the current year.

2019 was an exceptionally good year for investors as almost all asset classes performed positively. We will discuss the causes and the performance results in more detail below.

As always, we hope you enjoy reading this issue and welcome any comments you may want to share with us.

We wish you and your families all the best: success, happiness, and health in 2020.



**Thomas Trauth**
CEO – IMT Asset Management AG

# REVIEW 2019 AND LAST YEAR'S PREDICTIONS

## What happened in 2019?

After a very turbulent end-phase of 2018, the 2019 investment year went surprisingly positively. Surprisingly because such a development was not to be expected given the economic, monetary and geopolitical situation at the turn of the year. At the end of 2018, markets were dominated by interest-rate and recession fears, which had their origins in the Sino-American trade conflict, a significant weakening of the global economy and four interest-rate hikes by the US Federal Reserve. As a consequence, both bond and equity markets suffered substantial losses.

So what were the reasons for the turnaround in 2019? Although the global economy weakened, a global recession was avoided. The most important central banks, which had aimed at a normalisation of monetary policy and had thus tightened the monetary reins in 2018, staged an abrupt turnaround. The ECB, for example, lowered its short-term deposit rates further and re-started its bond-purchasing programme, while the US Fed cut its interest rate three times. Furthermore, in the second half of the year the trade conflict between the US and China eased as signs of a possible «Phase-1-Deal» emerged. Finally, in December, the sweeping victory of Boris Johnson in the UK-parliamentary elections made a «hard Brexit» very unlikely.

Due to the uncertain state of the economy and markedly elevated geopolitical risks, we opted for a defensive positioning throughout the entire year. We kept equity exposure at its neutral weight and were able to realize successive profits through our consistent rebalancing. Furthermore, we hedged part of the equity exposure using put-options. With respect to interest-rate and credit risks we were underweight and maintained a higher liquidity cushion as a risk buffer.

## Lasts year's prediction

In the following, we critically review our forecasts for last year. For the details, we refer to our Investment Outlook 01.2019.

In summary, we were right with our macro-economic predictions (growth and inflation), but we failed to foresee the central banks' clear turnaround, which put an abrupt stop to the normalization of their policies and saw them becoming very supportive once again. As a result, while we expected the US Fed to hike rates, it actually cut rates three times in 2019. Consequently, we were also unable to accurately forecast the direction taken by bond yields.

Furthermore, we were rather too cautious regarding the outlook for risky assets. We expected small positive returns for equities, for example, while in fact returns were clearly double-digit.

| Last year's prediction | Actual outcome | |
|---|---|---|
| **1. Growth (real GDP)** | | |
| US: 2.3% | 2.4% | ✓ |
| Eurozone: 1.4% | 1.2% | (✓) |
| Japan: 0.9% | 0.9% | ✓ |
| China:6.1% | 6.1% | ✓ |
| Note that GDP growth for 2019 is based on the latest estimates since official 2019 figures are not yet available. | | |
| **2. Inflation (end of period)** | | |
| US: 2.5% | 2.3% | (✓) |
| Eurozone: 1.0% | 1.3% | (✓) |
| **3. Central Banks** | | |
| Fed: 2-3 hikes | 3 rate cuts | ☹ |
| ECB: 1 rate hike, but close call | 1 rate cut, renewed asset-purchase program | ☹ |
| **4. Rates (10-year yields)** | | |
| US: 3.5% | 1.92% | ☹ |
| Eurozone: 0.75 | -0.19% | ☹ |
| US inflation expectations to rise | Small increase from 1.71% to 1.79% as measured by 10-year break-even inflation rates | ✓ |
| **5. Credit** | | |
| Credit spreads to move sideways or to rise | Credit spreads tightened across the board. | ☹ |
| **6. Equities** | | |
| Positive returns and the US to outperform | Equity markets rallied strongly and the US outperformed. | ✓ |
| **7. Emerging markets** | | |
| Moderately positive returns | Emerging markets performed very well (+15.4%), but clearly underperformed developed markets. | (✓) |
| Last year's prediction | Actual outcome | |

| | | |
|---|---|---|
| **8. Commodities** | | |
| Moderately positive on oil | The price for oil underwent a marked rise of 22.7%. | ✓ |
| Negative on industrial metals | Prices for industrial metals rose 7.0%. | ☹ |
| Negative on gold | The price for gold rose 18.3%. | ☹ |
| **9. Alternatives** | | |
| Positive for REITS | REITS gained 20.6%. | ✓ |
| Absolute-return strategies to recover and perform positively | The broad UCITS index gained about 5%. | ✓ |
| **10. Currencies** | | |
| Positive for the USD | The USD appreciated mildly by 2.2% in 2019, having risen very strong until September before giving back most of its gains in Q4. | ✓ |

# OUTLOOK 2020 – TEN PREDICTIONS

## 1. Growth

There are initial signs of a bottoming out. The German ZEW and IFO indices have recently improved again. In China, the decline of industrial production and retail sales has also been stopped. Additionally, the price for copper, the most cyclical commodity, has again risen. Nonetheless, we do not believe that the leading indicators are convincing enough to allow us to predict a pick-up in global economic growth with certainty. We are currently waiting to see whether the global leading indicators can undergo a broadly based improvement.

We expect US real GDP growth of 2.1% (down from 2.4% in 2019), Euro area growth of 1.4% (up from 1.2%), Japanese growth of 0.5% (down from 0.9%) and Chinese growth of 5.8% (down from 6.1%).

## 2. Inflation

In Europe, inflation remains very low, and as there are still unused capacities, no strong increase in inflation is expected in the near future. In the US, however, there is full employment and production capacity is fully utilised despite the recent slowdown in growth. Wages have been rising at 3% and more for some time now. In our view, market participants underestimate the US inflation risk. US inflation persistently remained below 2% in 2019, but accelerated in November and climbed to 2.1.%. A further acceleration could impel the US Fed to take back the recent rate cuts, although Fed-Chairman Jerome Powell has made it clear that he would tolerate some inflation overshooting.

We expect US inflation to pick-up somewhat to 2.4%, EMU inflation to remain stable at 1.3%, Japanese inflation to remain depressed at 0.2% and Chinese inflation to pick up slightly to 2.4%.

## 3. Central Banks

All major central banks are currently committed to maintaining an expansionary policy stance. The US Fed made clear they would accept inflation to overshoot its 2% target. Furthermore, we see it as unlikely that the Fed would turn hawkish in an election year. So we do not expect the Fed to signal any intention to hike this year. If it happens at all, then maybe towards the end of 2020.

The ECB and the Bank of Japan are very unlikely to turn hawkish this year, as deflationary forces in Europe and Japan continue to dominate.

## 4. Rates

Since we expect US growth to stabilize and inflation to rise modestly, we think that US 10-year treasury yields are likely to rise. However, due to very loose global monetary conditions, the yield increase will be moderate. We expect US 10-year yields to reach 2.5%.

European yields will tick somewhat higher. We see European 10-year yields reaching 0.25% in 2020.

## 5. Credits

While credit spreads are very tight and corporate leverage is rising, we expect credit spreads to remain stable. Stable growth, loose monetary policy, and huge piles of negative-yielding bonds will push yield-

seeking investors into credits, exploiting even small yield pick-ups.

## 6. Equities

Stabilizing growth, loose monetary policy, China's stimulus measures, a high likelihood of a trade war truce ahead of the US elections — these factors should all support equity markets in general. In a late cycle, equity markets tend to be more volatile with a higher probability of corrections, but as history shows, returns can be very high.

Since US stocks have become very expensive, with a forward P/E of 18, and as the valuation gap versus Europe has widened, we would not be surprised to see European equities outperforming US equities.

## 7. Emerging markets

We are constructive on EM assets, including EM local currency bonds, EM USD-denominated bonds and EM equities. As growth stabilizes and the US-China trade truce has become likely, emerging markets should be able to recover from a challenging environment in 2018 and 2019. Since we expect the USD to remain on the strong side (see 10. Currencies), we do not expect EM equities to outperform developed markets. A strong USD creates headwind for emerging market assets.

## 8. Commodities

We expect demand for oil to pick up somewhat in 2020, on the back of better growth data. Furthermore, Saudi Arabia and Russia are likely to maintain their supply discipline this year. As a result, we are mildly positive for oil prices.

We expect rising prices for industrial metals, as global and especially Chinese growth is picking up.

We expect gold prices to stabilize at current levels or to go up slightly. It seems unlikely to us that the strong gold rally will continue in 2020. Currently, for us gold appears to be overbought. Nevertheless, we think that the gold price will remain supported by low real interest rates and demand from EM central banks. Many central banks have been diversifying their reserves by buying gold and reducing their US treasury holding.

## 9. Alternatives

The expected market environment, with low interest rates and positive growth, should be very positive for REITS. We observe a great appetite for real and income-paying assets. Large private-market funds continue to seek opportunities to take REITS private. In doing so, they are hoping to capitalize on hidden valuation reserves. However, we are currently shying away from overweighting REITS, since last year's performance was stellar.

## 10. Currencies

We currently see a consensus calling for a weaker USD in 2020. This is often justified by an overvaluation of the USD against many other currencies. On a trade-weighted basis it is argued that the USD is 25% overvalued. In addition, the twin deficits (fiscal and current account) seem to be expanding further, which is usually negative for a currency. However, we believe that, while the USD has little upside from current levels, it will remain resilient and may even appreciate slightly. This is based on a continued growth and yield advantage on the part of the US vis-à-vis most other developed countries

We see the CHF as overvalued and expect a mild depreciation from current levels.

### What are the major risks for 2020?

In particular the conflict between the USA and Iran, as well as the situation in North Korea, bear a considerable risk of escalation with potentially significant effects on global goods and financial markets. Despite the killing of the Iranian General Soleimani and the Iranian retaliatory strikes in Iraq, we assume that both sides are aware that they can only lose if the conflict further escalates. Therefore, the financial

markets have reacted only relatively moderately to this event. Nonetheless, we are monitoring these geopolitical hot spots closely in order to further reduce portfolio risks if necessary.

The same applies to the trade war between the USA and China. Recent developments suggest that at least a short-term partial agreement and some easing of tensions can be expected. At the same time, the danger that the positions will once more harden and that Europe could become the centre of attention for the US administration remains. Having said that, we expect that the US government will not risk any further escalations of trade disputes prior to the elections in November 2020.

Finally, we would not exclude the possibility of a more substantial increase in US inflation. This could cause the US Fed to become more hawkish, despite past statements by Fed officials that they would be happy to allow an inflation overshoot. A hawkish Fed could easily derail financial markets and cause bonds and equity markets to sell off.

## Review of our strategic asset allocation

As at the end of every year, we reviewed our strategic asset allocation in December. We decided to amend our allocation to government and investment-grade bonds. While thus far we had invested in domestic European bonds, we decided to extend to a more global bond ambit. This should lead to a more diversified exposure to global bond markets.

Other than that, we did not see any need to change our investment strategy as it has proved to be very solid.

## Current tactical positioning

We do not expect a recession to occur in 2020 or geopolitical tensions to escalate. The central banks will maintain their very expansive monetary policy. Nevertheless, we remain defensively positioned due to the continued heightened economic and political uncertainties. Bonds remain underweighted while equities are held at neutral. Furthermore, we are retaining the partial hedge of the equity exposure.

# ECONOMICS

The development of the PMI data illustrates well to what extent world growth slowed over the last two years. This was certainly a major concern for market participants. However, in recent months we have observed a certain stabilization of the leading indicators.

Also, headline inflation seems to be picking up slightly. Chinese inflation surged to 4.7% in December. This was predominantly caused by a strong increase in pork prices on the back of a prolonged African swine fever epidemic.

**Fig. 1: PMIs**

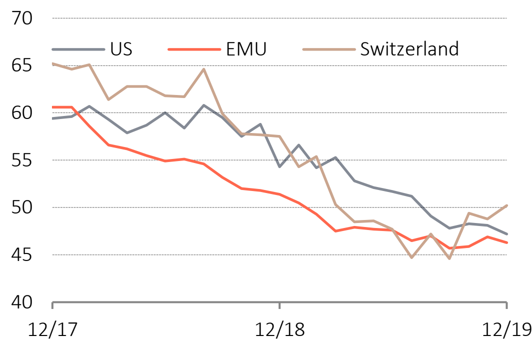



**Fig. 2: PMIs**

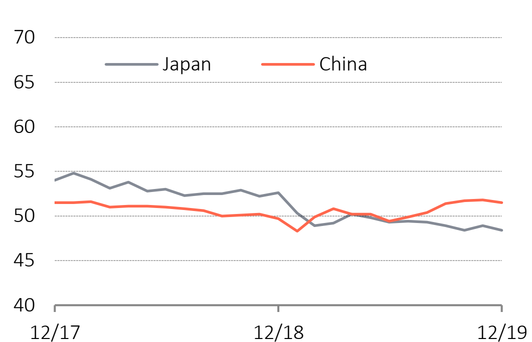



**Fig 3: Consumer price inflation, in % YoY**

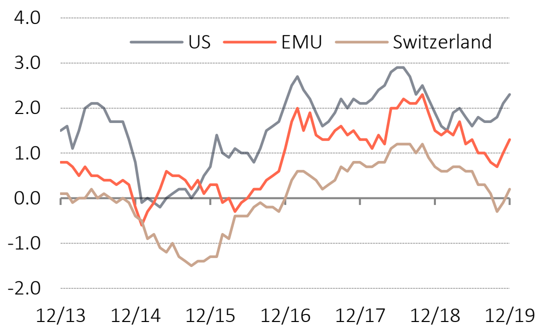



**Fig. 4: Consumer price inflation, in % YoY**

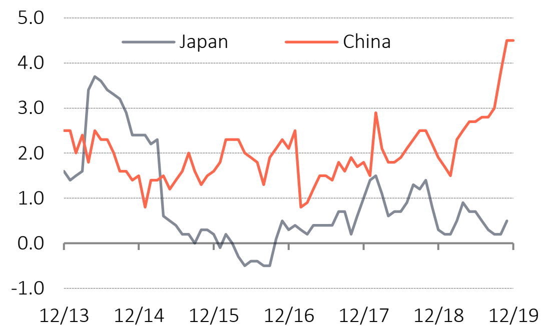



**Fig 5: Unemployment rates, in %**

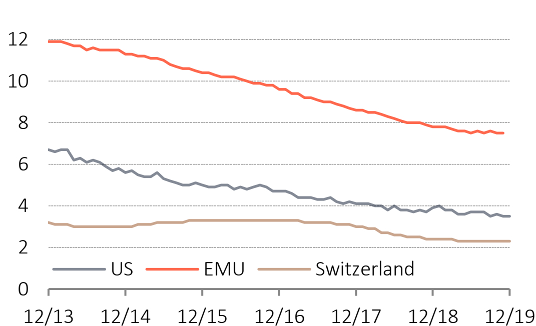
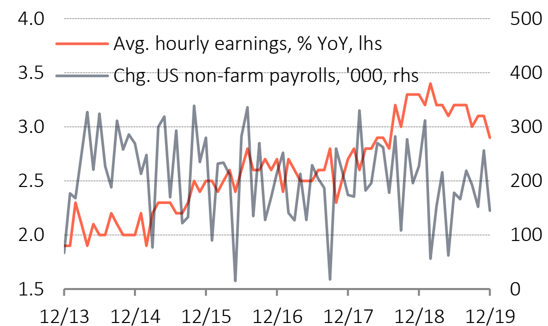



**Fig 6: US labor market**



# FIXED INCOME

In 2019 bond yields fell across the board. This was the result of the global growth slowdown, stubbornly low inflation rates and expansive monetary policies. Only towards the end of the year did inflation expectations start to rise somewhat, while nominal yields stabilized. Credit spreads fell and made investments in credits quite profitable in 2019.

**Fig.7: 2Y government bond yields**

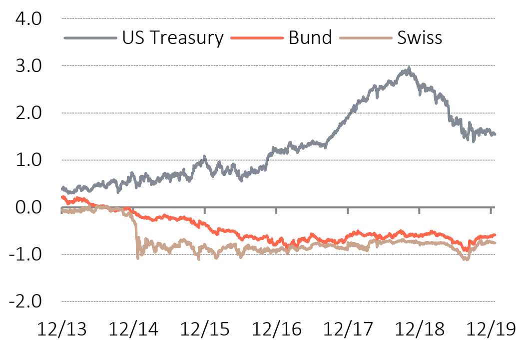



**Fig. 8: 10Y government bond yields**

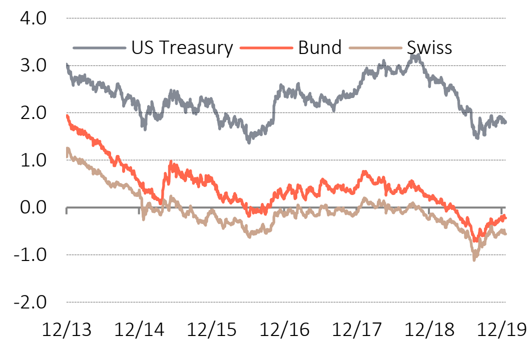



**Fig 9: 10Y break-even inflation**

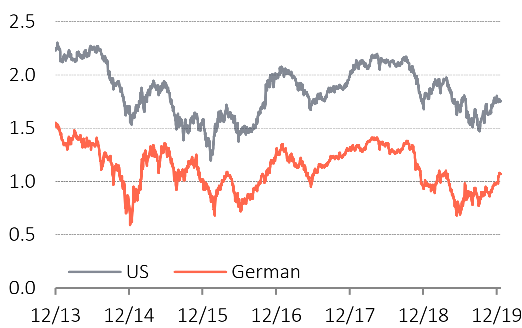



**Fig. 10: Credit spreads, 5Y credit default swaps**

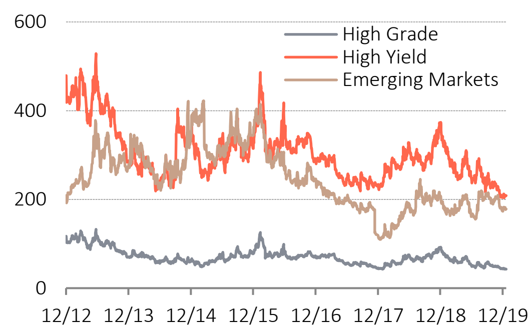



**Fig 11: Money market spreads (3M-2Y)**

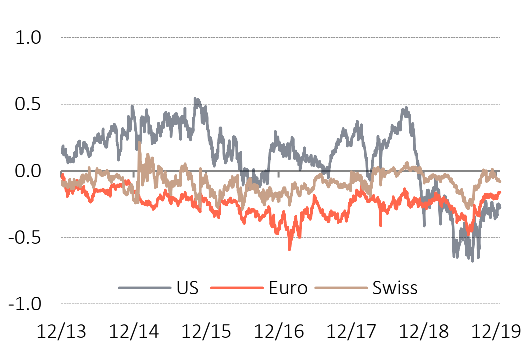
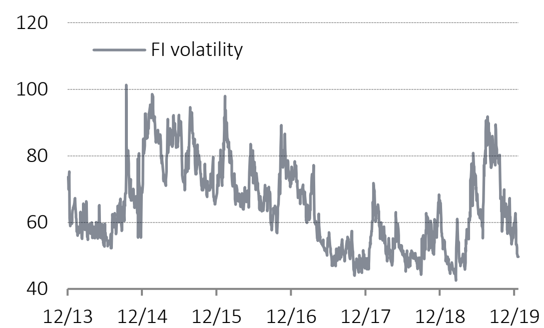



**Fig 12: Merrill Lynch volatility index (MOVE)**



# EQUITIES

Equity markets performed very strongly in 2019 and handsomely compensated for the losses in 2018. Developed markets outperformed emerging markets and the US outperformed most other developed equity markets. Despite the trade war, the Chinese equity market index, CSI300, gained 36.1%. Technology and cyclical stocks outperformed. Value stocks, however, continued to underperform tremendously.

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**Fig. 13: MSCI equity indices – major regions**

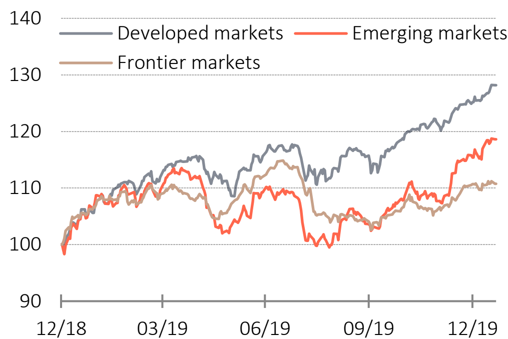



**Fig.14: Equity indices – major developed markets**

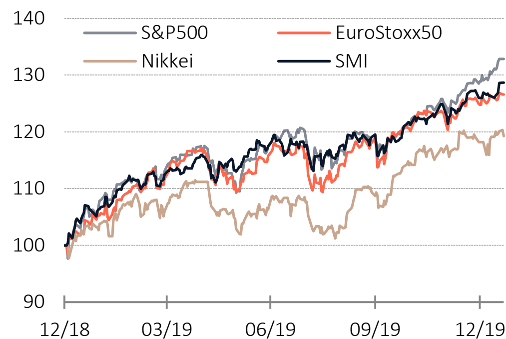



**Fig 15: Equity indices – major emerging markets**

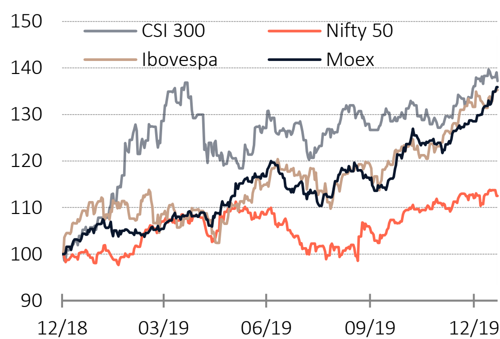



**Fig. 16: Sector performance, MSCI Europe, 2018**

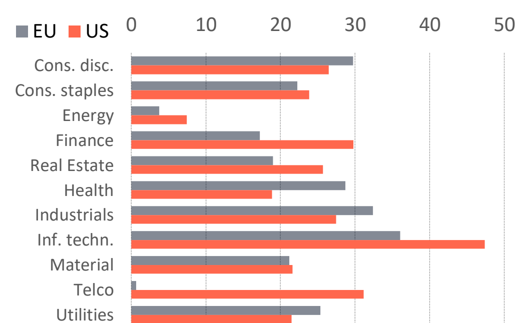



**Fig 17: Price-earnings ratios**

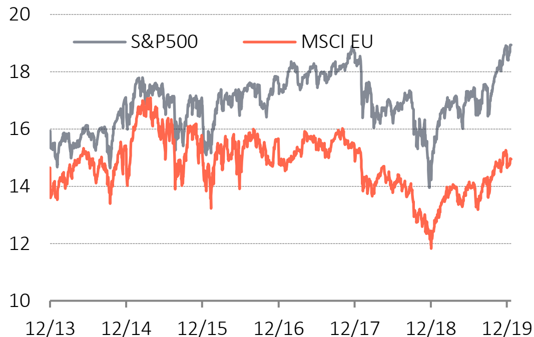
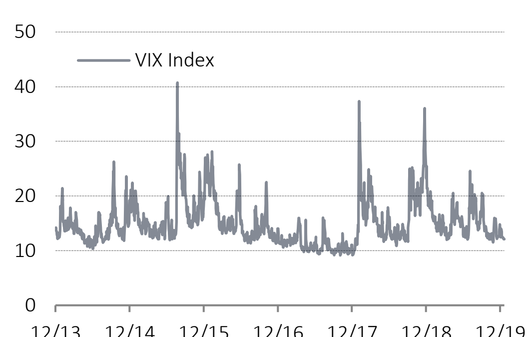



**Fig 18: Equity volatility – S&P500 VIX index**



# ALTERNATIVE INVESTMENTS

The price of gold rose 18.3% in 2019, driven by low yields and heightened uncertainties. Oil traded above USD 60/bl most of the time. Concerns about potential supply disruptions shored up the oil price. Prices of industrial metals were flat, while in December the price for copper, the most cyclical metal, started to surge. REITS had a particularly good year, supported by rising equity markets and falling interest rates.

**Fig. 19: Gold price, USD/oz**

**Fig.20: Brent oil price, USD/bl**

**Fig 21: Bloomberg commodity indices**

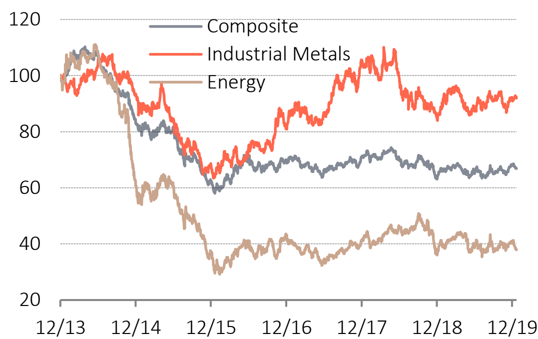



**Fig. 22: HFRU hedge fund indices**

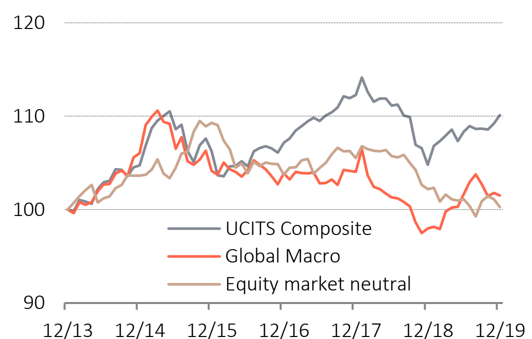



**Fig 23: FTSE EPRA/NAREIT global REITS index**

**Fig 24: LPX global listed private equity**

# CURRENCIES

Year-on-year EUR-USD was little changed. However, in the first half of the year the USD appreciated strongly, but gave back most of its gains in Q4. In contrast, the GBP was initially weak, but recovered after August due to diminishing fears of a disruptive Brexit. The CHF was on the stronger side and strengthened even further towards the end of 2019.

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**Fig. 25: EUR-USD exchange rate**

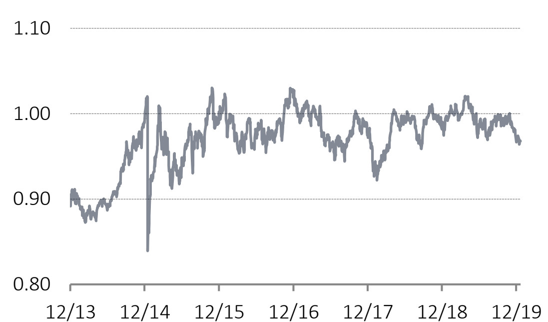
**Fig. 26: GBP-USD exchange rate**

**Fig 27: USD-JPY exchange rate**

**Fig. 28: USD-CNY exchange rate**

**Fig 29: EUR-CHF exchange rate**

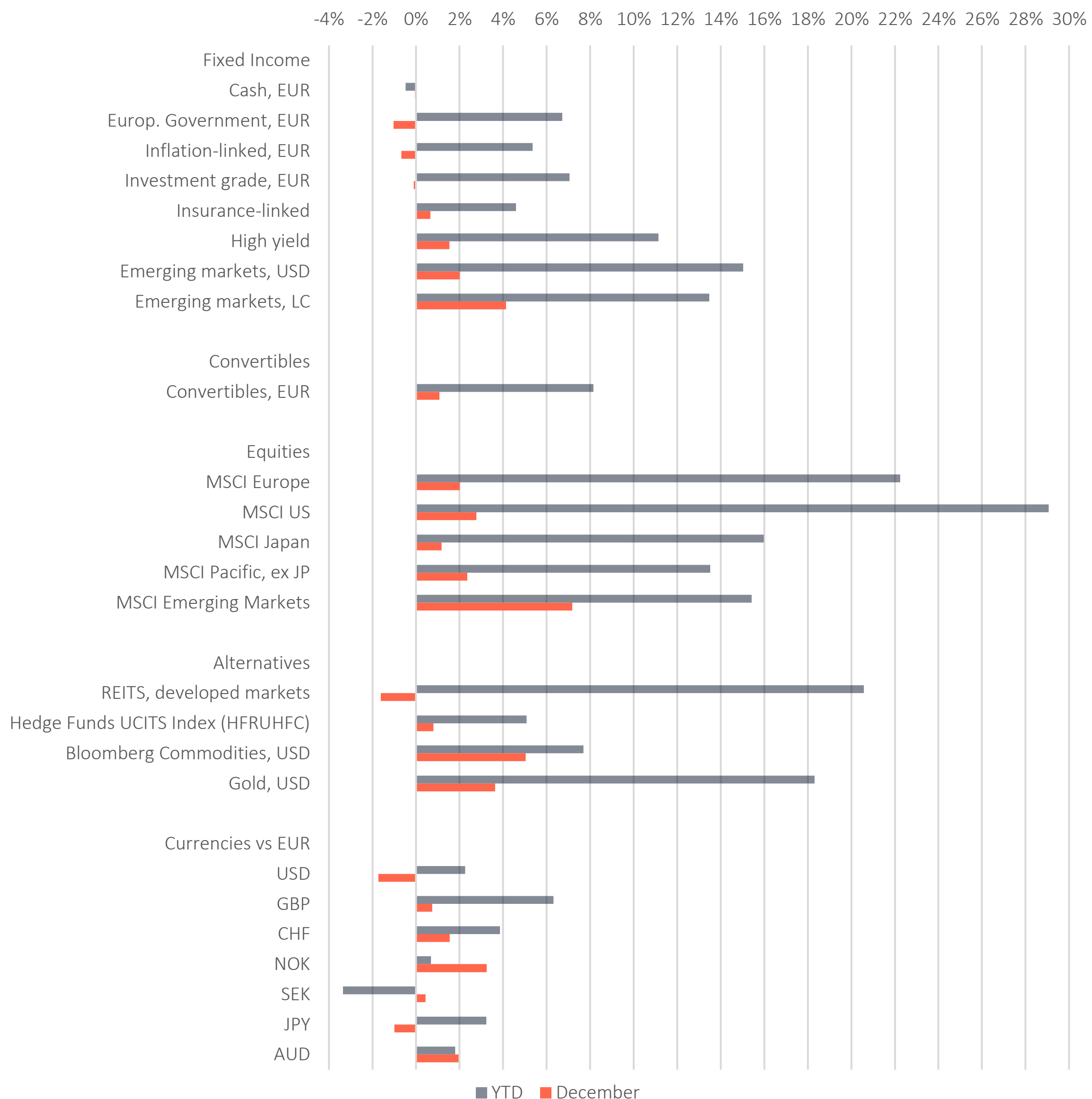
**Fig 30: USD-CHF exchange rate**



# ASSET ALLOCATION

In strong contrast to 2018, most asset classes performed positively. As a rule, risky assets outperformed. US equities gained 29%, followed by European equities with a gain of 22% and REITS with about 20%. Gold, being perceived as a safe haven asset, stood out with a very positive performance of 18%. The EUR weakened vis-à-vis most other currencies. As a result, foreign-currency exposure was a contributing performance factor.

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



# RISK MONITOR

At the end of 2019, most risk indicators stood at very low levels. Not surprisingly, the highest readings were associated with growth risks and relatively high equity valuations. The risk environment remains benign and is consistent with the recent strong performance of risky assets.

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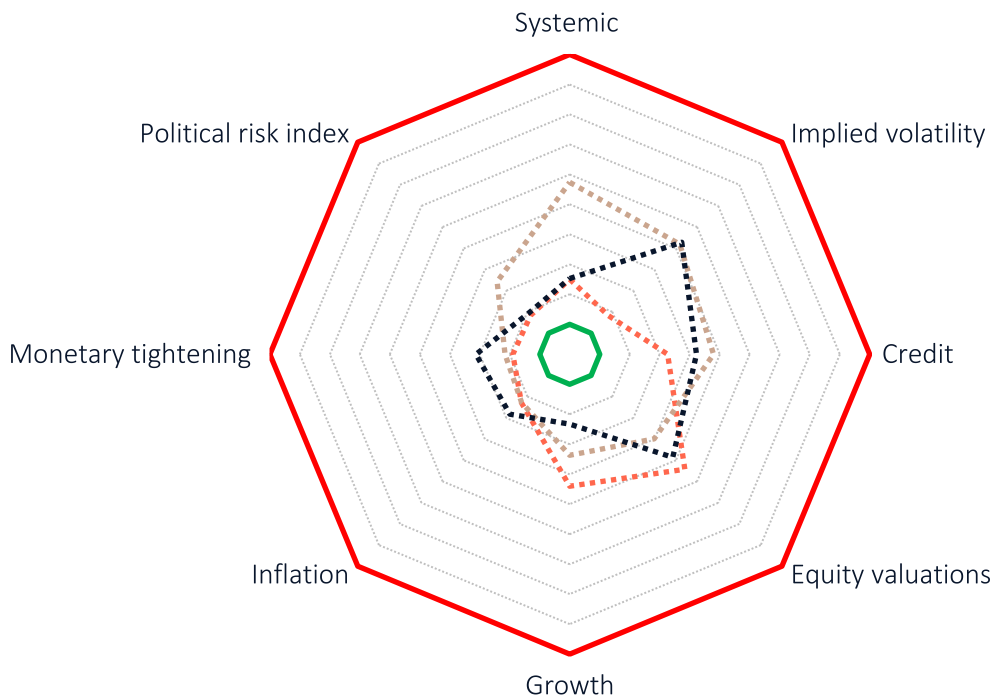
**Fig. 32: IMT Risk Monitor**

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




30-Dec-19 24-Dec-18 9-Feb-18 Max risk score: 10 Low risk score: 1

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