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INVESTMENT OUTLOOK 09.2020

5 September 2020

The liquidity-driven equity market rally continued in August. The MSCI developed markets index surged by 6.5%. When we take a closer look, however, we observe an unusually strong dispersion within the global equity markets. Technology stocks, especially the so-called FAANG stocks (Facebook, Amazon, Apple, Netflix, Alphabet-Google) plus Microsoft and Tesla account for a major portion of the performance and help to explain why per end of August the S&P500 index is up 8.3% year-to-date while the MSCI Europe is down 13%.

Many suspect that we are observing another technology bubble. Valuations of many tech stocks look very stretched. In the first week of September, technology stocks corrected sharply, which may mark the start of a repricing of the sector and potentially the beginning of a rotation into more defensive sectors.

Meanwhile the US election campaign is gaining momentum. We expect President Trump to become increasingly aggressive where domestic and foreign policy is concerned. We continue to see heightened downside risks and remain cautiously positioned.

Trauth

Thomas Trauth
CEO – IMT Asset Management AG

TECHNOLOGY BUBBLE?

Financial markets

In August US equities continued to outperform European and emerging markets equities. The S&P500 index rose by 7.0%, the MSCI Europe by 2.7% and the MSCI Emerging Markets index by 2.1%. Technology stocks once more took center stage as the NASDAQ jumped almost 10%. Technology stocks have grown to become a major component of the US equity market indices, and thus explain a major part of the US stock market performance. If you combine the so-called FAANG stocks (Facebook, Amazon, Apple, Netflix, Alphabet-Google) with Microsoft and Tesla, those seven stocks account for 41% of the NASDAQ composite index and 22% of S&P500 index. Please note that that Tesla is not part of the S&P500 stock universe.

In early September, however, markets corrected, driven by a sell-off of tech stocks. The NASDAQ index fell by more than 6% within two days. In addition, volatility spiked as demand for hedging has been increasing in recent weeks.

In August government-bond yields rose. US 10-year yields climbed 18 basis points and European 10-year yields 13 basis points. On the back of Jerome Powell's comments about relaxing the inflation target, the US 10-year inflation expectations increased by 25 basis points. Meanwhile credits rallied in line with the general risk-on environment. For example, high-yield spreads tightened by 53 basis points

The strong gold rally stalled in August and the gold price fell more than 7% within a few days. Since then it has stabilized around USD 1,950. Meanwhile the oil price rose by about 5% in August but has corrected in the last couple of days. Industrial metals prices rose by 7% in August. REITS rose 1% in August, and thus clearly underperformed broad equity indices. However, in September REITS could de-couple from the sell-off

The USD continued to weaken in August. However, in the recent risk-off environment the USD rebounded and confirmed its status as a safe-haven asset. Many emerging markets currencies weakened in August, especially the BRL und the TRY, which lost more than 5% vis-à-vis the USD. Implied volatility in the currency markets rose sharply in August as demand for hedging rose.

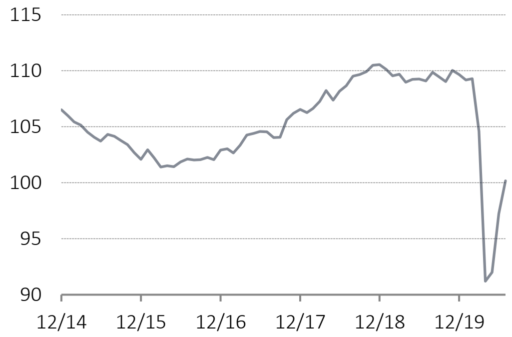
Covid-19

The total number of cases rose to about 27 m and the number of new daily cases to 300,000. While the number of new cases has been declining in the US, it remains among the highest in the world there. In many European countries we are observing a second wave of infections, but so far, the rate of spread has clearly been slower than in March and April. Furthermore, fortunately, the numbers of hospitalizations and deaths have stayed very low in Europe. The US bankruptcy index continued to rise, which is certainly indicative for many other countries. Likewise, the US Consumer Confidence Index dropped further. This suggests it is unlikely that we will be seeing a full-blown economic recovery sometime soon.

Macroeconomics

The cyclical rebound continued. The US ISM, for example, rose to 56.0 in August after 54.2. Nevertheless, economic activity remains clearly below pre-pandemic levels. US industrial production is almost 10% below levels observed in February (see figure below).

US industrial production (Index base year 2012)



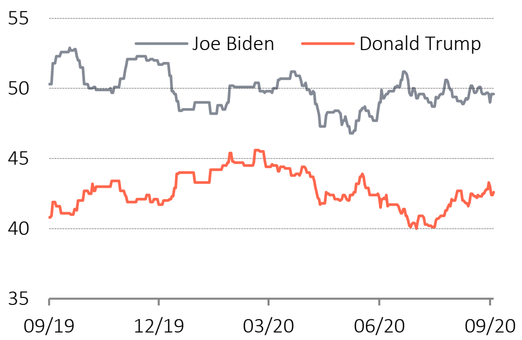
In August non-farm payrolls surprised to the upside with 1.37 m new jobs. The unemployment rate fell by 2 %-points to 8.4%. However, the number of permanent job losers increased by 0.5 m to 3.4 m and many companies, especially airlines but also automakers announced further job cuts.

Geopolitics

The US election campaign is heating up. Black Lives Matter (BLM) protestors clashed with armed white Trump supporters. President Trump took a clear stance emphasizing his focus on establishing law and order, while Joe Biden showed sympathy with the BLM movement.

Though Joe Biden is leading the polls by a wide margin (see figure below) the outcome of the elections remains uncertain. Donald Trump showed a strong last-minute performance during the last campaign.

US election poll averages (Source: Real Clear Politics)



Meanwhile, the US administration is considering banning TikTok and WeChat, two Chinese apps and has imposed sanctions on Hong Kong's leaders. This can be seen as President Trump's attempt to take a tough approach to China in order to please his voters.

Monetary policy

This year's Jackson Hole meeting of central bankers was held on 27 and 28 August and conducted online due to the pandemic. Nevertheless, Jerome Powell's speech especially was particularly important since he announced an important shift in US monetary policy. The US Fed has rephrased its so-called "Statement of Longer-Run Goals and Monetary Policy Strategy". Previously, the US Fed had symmetric goals, aiming for maximum employment and price stability and giving both objectives equal weight. Going forward, the US Fed will firstly allow inflation to overshoot 2%, its previous inflation rate associated with price stability, and secondly will stay accommodative even if full employment has been achieved.

In its policy framework the US Fed is now applying a so-called "average inflation targeting". Since inflation has been persistently below 2% it will now allow inflation to remain above 2% for longer in order to compensate.

With regard to its employment goal, the US Fed previously observed the so-called NAIRU (natural rate of unemployment), intending to tighten monetary policy once full employment was achieved. The idea was that being accommodative in times of full employment would sooner or later lead to accelerating inflation. Now, however, the US Fed has abandoned the NAIRU concept and will remain accommodative even if full employment has been achieved, unless inflation rises to unwelcome levels.

As a result, the US Fed basically introduced an easing bias for the long-term. Markets rallied after chairman Powell's speech and the USD weakened further.

Outlook

The only explanation for the strong rebound of markets since March is the unprecedented concerted policy response to the pandemic. In August, the US Fed even redefined its mandate, introducing a long-term easing bias, which fueled another up-leg in markets.

Nevertheless, we see many areas of concern and remain cautious. The fact that only few sectors have driven the equity market rally and many of those stocks have reached very stretched valuations, does not bode well for the sustainability of the bull market. We may even be faced with another technology bubble. It remains to be seen if the market correction in the first week of September is short-lived or has the potential to fuel a sizeable correction.

We increased our exposure to REITS, from underweight to neutral, since we see value in certain areas of the REITS market.

ECONOMICS

The cyclical recovery continued. The US ISM, for example, rose to 56.0 in August after 54.2. Nevertheless, economic activity remains clearly below pre-pandemic levels. US industrial production is almost 10% below levels observed in February. In August non-farm payrolls surprised to the upside with 1.37 m new jobs. The unemployment rate fell by 2 %-points to 8.4%. However, the number of permanent job losers increased by 0.5 m to 3.4 m and many companies, especially airlines but also automakers announced further job cuts.

Fig. 1: PMIs

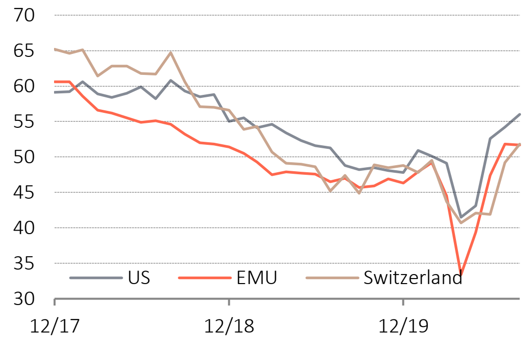


Fig. 2: PMIs

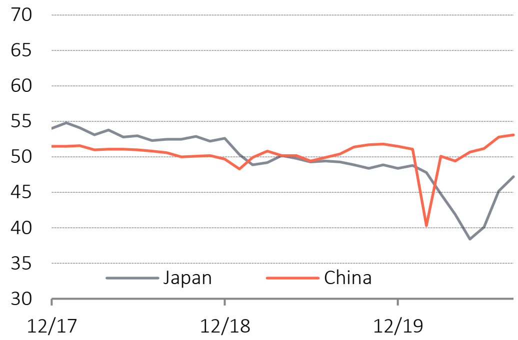


Fig 3: Consumer price inflation, in % YoY

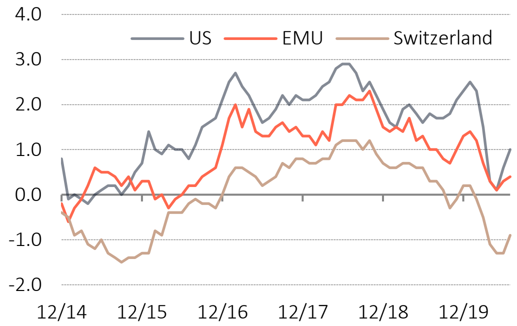


Fig. 4: Consumer price inflation, in % YoY

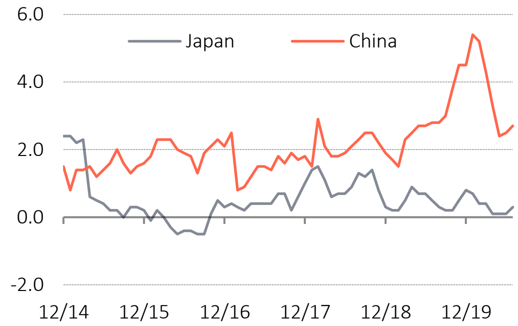


Fig 5: Unemployment rates, in %

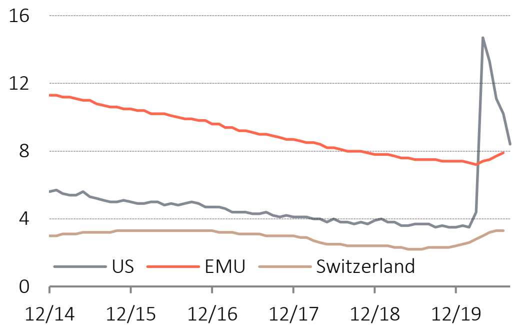
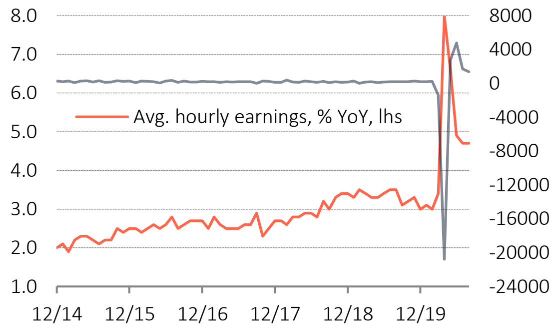


Fig 6: US labor market



FIXED INCOME

In August government-bond yields rose. US 10-year yields climbed 18 basis points and European 10-year yields 13 basis points. On the back of Jerome Powell's comments about relaxing the inflation target, the US 10-year inflation expectations increased by 25 basis points. Meanwhile credits rallied in line with the general risk-on environment. For example, high-yield spreads tightened by 53 basis points.

Fig.7: 2Y government bond yields

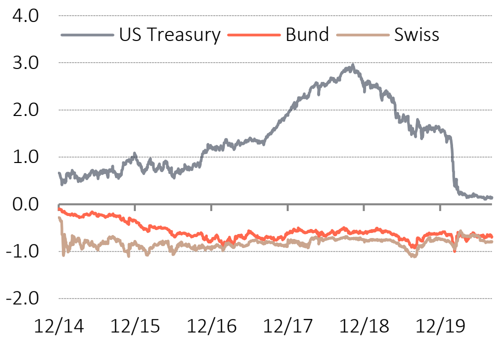


Fig. 8: 10Y government bond yields

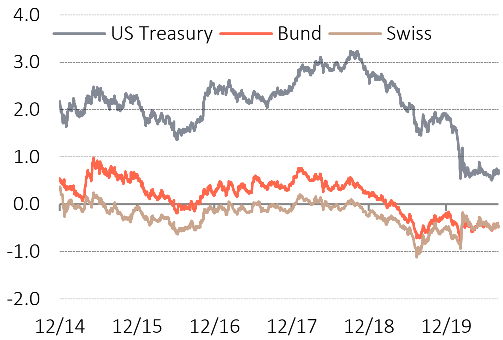


Fig 9: 10Y break-even inflation

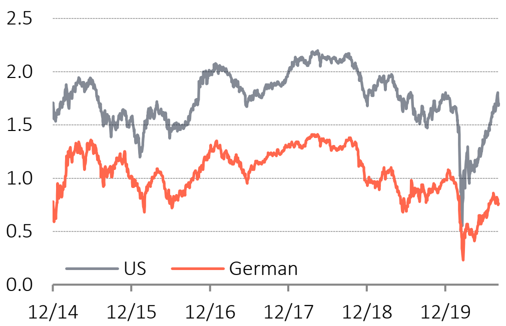


Fig. 10: Credit spreads, 5Y credit default swaps

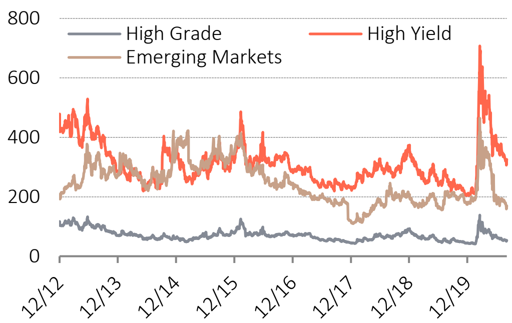


Fig 11: Money market spreads (3M-2Y)

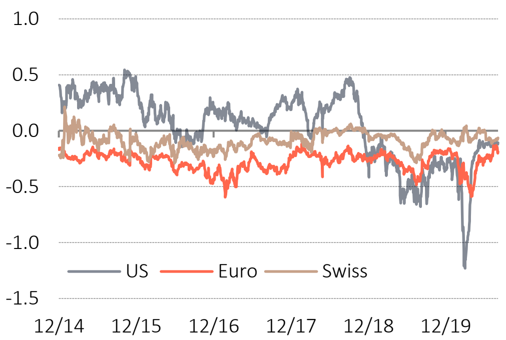
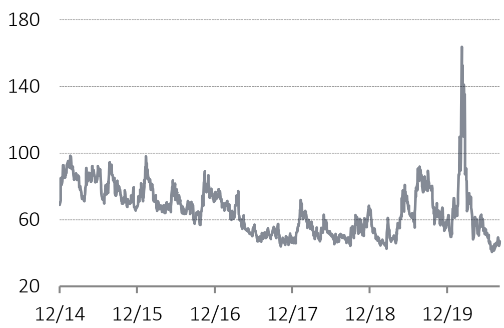


Fig 12: Merrill Lynch volatility index (MOVE)



EQUITIES

In August US equities continued to outperform European and emerging markets equities. The S&P500 index rose by 7.0%, the MSCI Europe by 2.7% and the MSCI Emerging Markets index by 2.1%. Technology stocks once more took center stage as the NASDAQ jumped almost 10%. In early September, however, markets corrected, driven by a sell-off of tech stocks. Volatility spiked as demand for hedging has been increasing in recent weeks.

Fig. 13: MSCI equity indices – major regions

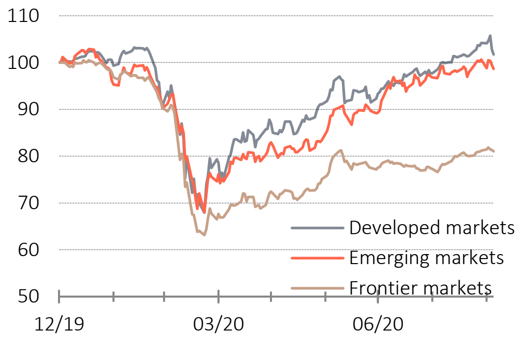


Fig.14: Equity indices – major developed markets

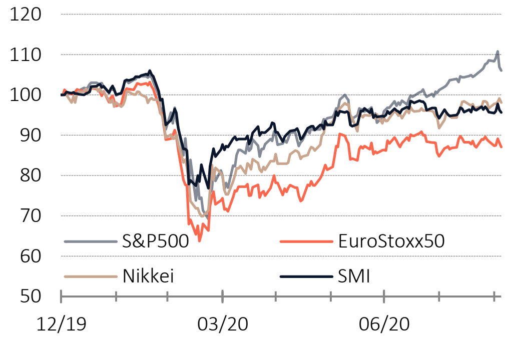


Fig 15: Equity indices – major emerging markets

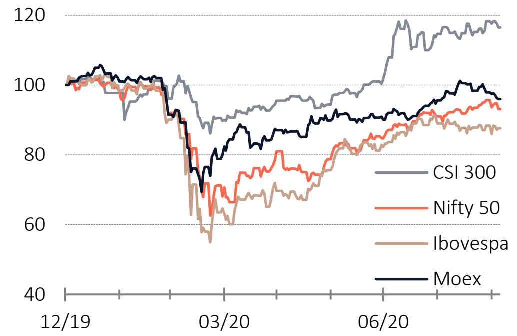


Fig. 16: Sector performance, MSCI Europe, YTD

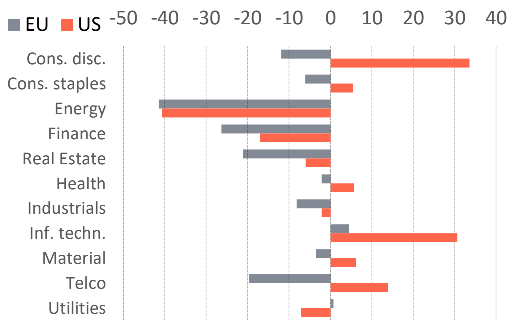


Fig 17: Price-earnings ratios

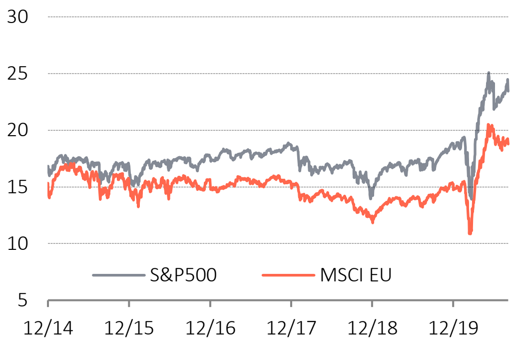
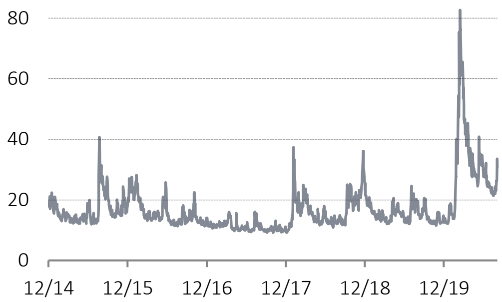


Fig 18: Equity volatility – S&P500 VIX index



ALTERNATIVE INVESTMENTS

The strong gold rally stalled in August and the gold price fell more than 7% within a few days. Since then it has stabilized around USD 1,950. Meanwhile the oil price rose by about 5% in August but has corrected in the last couple of days. Industrial metals prices rose by 7% in August. REITS rose 1% in August, and thus clearly underperformed broad equity indices. However, in September REITS could de-couple from the sell-off.

Fig. 19: Gold price, USD/oz

Fig.20: Brent oil price, USD/bl

Fig 21: Bloomberg commodity indices

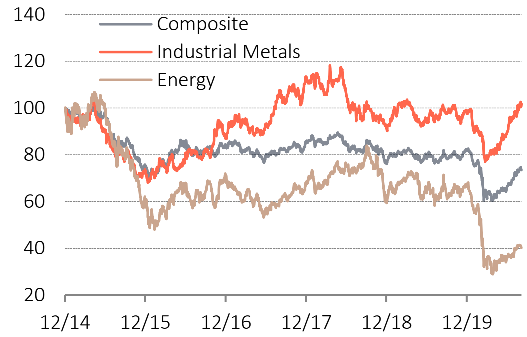


Fig. 22: HFRU hedge fund indices

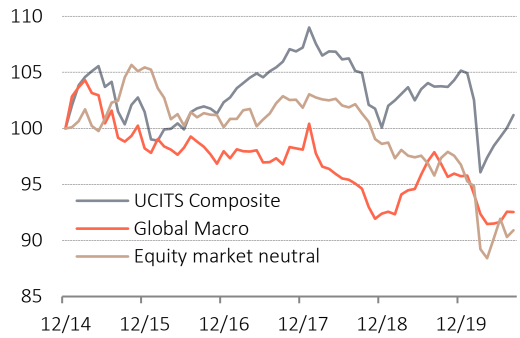


Fig 23: FTSE EPRA/NAREIT global REITS index

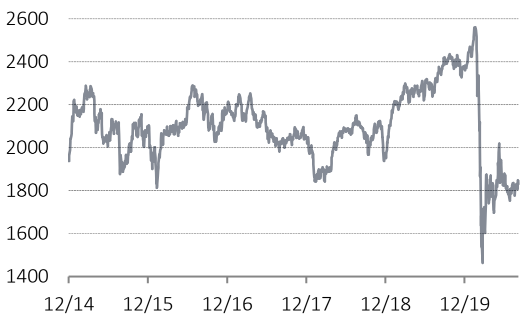


Fig 24: LPX global listed private equity

CURRENCIES

The USD continued to weaken in August. However, in the recent risk-off environment the USD rebounded and confirmed its status as a safe-haven asset. Many emerging markets currencies weakened in August, especially the BRL und the TRY, which lost more than 5% vis-à-vis the USD. Implied volatility in the currency markets climbed sharply in August as demand for hedging rose.

Fig. 25: EUR-USD exchange rate

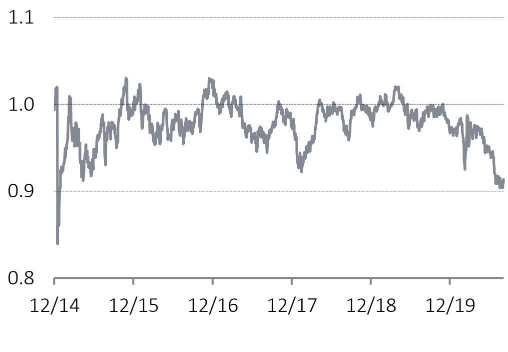
Fig. 26: GBP-USD exchange rate

Fig 27: USD-JPY exchange rate

Fig. 28: USD-CNY exchange rate

Fig 29: EUR-CHF exchange rate

Fig 30: USD-CHF exchange rate



COVID-19

The total number of cases rose to about 27 m and the number of new daily cases rose to 300,000. While the number of new cases has been declining in the US, it remains among the highest in the world there. In many European countries we are observing a second wave of infections, but so far the rate of spread is clearly slower than in March and April. Furthermore, the numbers of hospitalizations and deaths remain very low in Europe. The US bankruptcy index continued to rise, which is certainly indicative for many other countries. Likewise, the US Consumer Confidence Index dropped further.

Fig. 31: Total Covid-19 cases (x 1000)

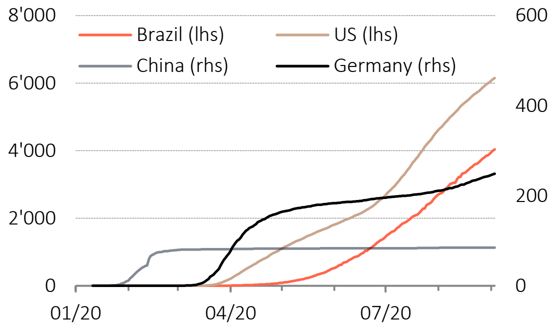


Fig. 32: New cases per day (7-day average)

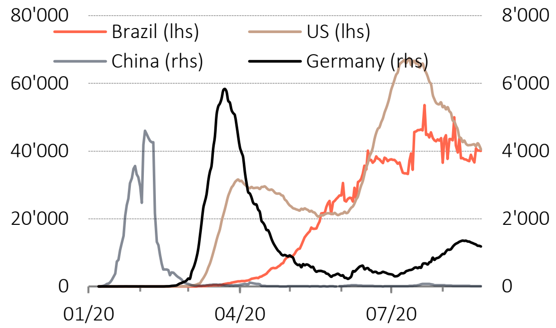


Fig 33: US bankruptcy index

Fig.34: US personal income, excl. transfers (USD bn, 2012 prices)

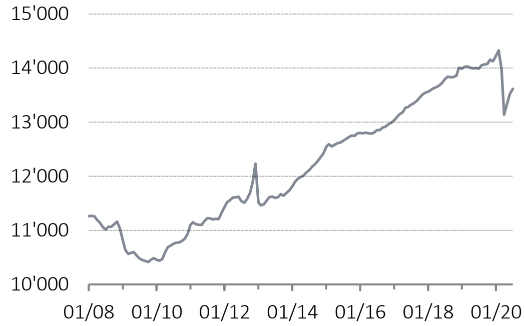


Fig 35: Central bank total assets, indexed

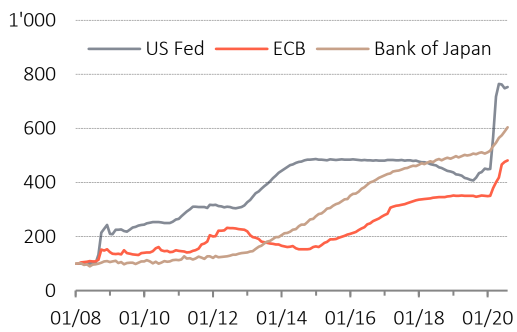
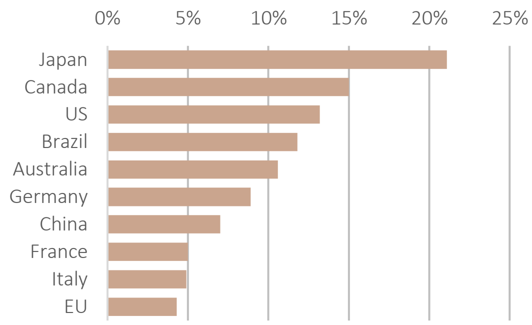


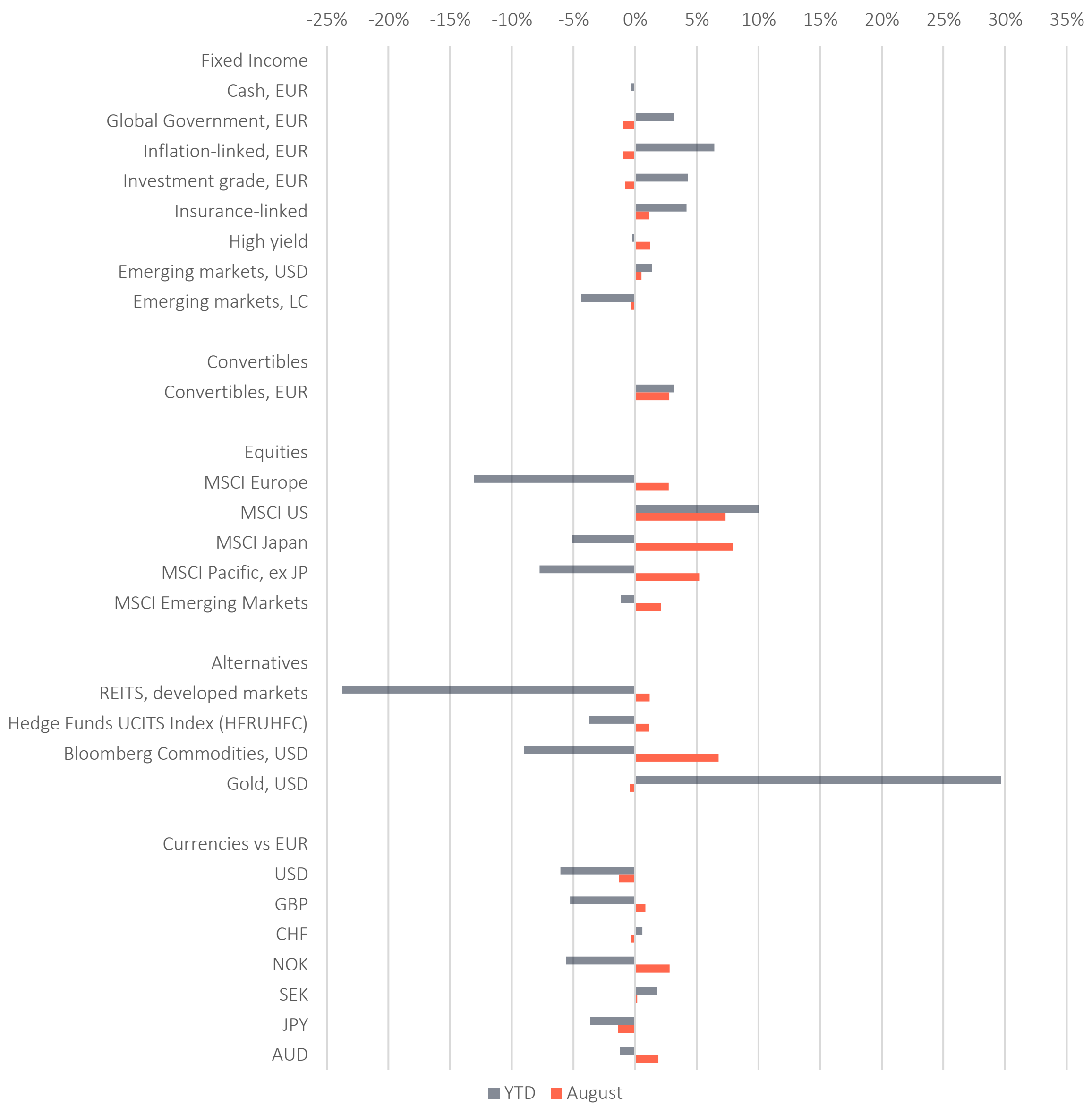
Fig 36: COVID-19 fiscal stimulus as of June 2020, % of GDP (Source: Statista)



ASSET ALLOCATION

August was a good month for risky assets. Equity markets, convertibles, and commodities performed very well. Year-to-date we see many diverging developments. Gold clearly outperformed, while REITS clearly underperformed. Within equity markets, it is stunning to see how the US market outperformed, driven by the large technology stocks, while Europe and other regions have been in the red since the beginning of the year. The EUR strengthened vis-à-vis most currencies.

Fig. 37: Performance of major asset classes, based on our EUR portfolio strategy

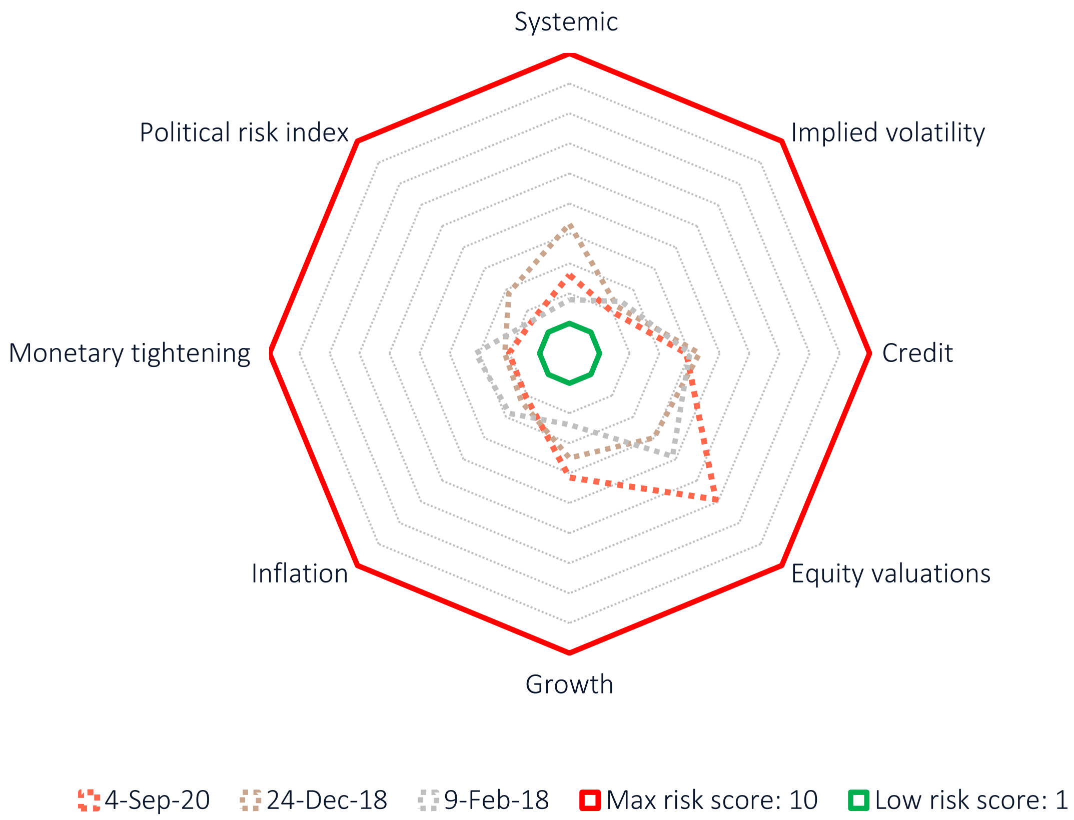


RISK MONITOR

Our risk monitor clearly flags elevated equity valuations as the major risk factor. While implied volatility rose recently, it remains relatively low for now. Other than that, most risk areas remain relatively muted.

Fig. 38: IMT Risk Monitor

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



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Source for all graphs: IMT Asset Management AG, Bloomberg, Real Clear Politics, for Fig 36 Statista (de.statista.com), for Fig. 38, the political risk index: “Measuring Geopolitical Risk” by Dario Caldara and Matteo Iacoviello at https://matteoiacoviello.com/gpr.htm.