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INVESTMENT OUTLOOK 07.2021

15 July 2021

The bull market is still in full swing. Since 23 March 2020 the S&P500 index has risen 93%, the German DAX 78% and the NASDAQ technology index even 112%. We can safely assume that such a performance will not repeat itself.

Economic growth is likely to peak in Q2 or Q3. At the last Fed meeting Collin Powell sounded less dovish than he had before and signaled that a first rate-hike could happen in 2023, earlier than previously forecast. Consequently, market participants seem to assume that the Fed will take sufficient measures to keep inflation in check. As a result, market-implied inflation expectations and long-term bond yields fell.

Despite good progress with the vaccination campaigns the number of new covid cases started to rise again, especially in Europe, Asia, and Africa. This is due to the spread of the more contagious delta variant and many lockdown measures being lifted.

We remain neutral in equities but have overweighted cyclical sectors, especially industrials and financials, which should benefit from strong economic growth and rising interest rates.

Trauth

Thomas Trauth
CEO – IMT Asset Management AG

REACHING THE GROWTH PEAK

Financial markets

In June equity markets developed inconsistently. European and US markets were positive, emerging markets flat, and many Asian equity markets declined. Concerns about the outlook for the Chinese economy weighed on Asian markets, and the Chinese CSI 300 index fell 2% in June. Whereas in recent months cyclical sectors clearly outperformed, we saw some profit-taking, so that cyclicals underperformed in June. Nevertheless we continue to see positive prospects for cyclical stocks to outperform.

Short-term yields remain stable as central banks reiterated their accommodative stance, despite the Fed turning slightly less dovish at its policy meeting. While headline inflation is going up, inflation expectations and long-term yields fell in recent weeks. This suggests that market participants assume that the surge of inflation will be transitory. Credit spreads tightened further as default rates remain very low. Emerging market bonds in local currency sold off in June and clearly underperformed other fixed-income instruments.

As the momentum for cyclicals slowed and the prospects for the Chinese economy worsened, prices for industrial metals fell by 3.2% in June. Oil prices surged by 8.5%. This was caused by the OPEC countries agreeing to limit supply in combination with rising demand as economies re-opened. The gold price fell by 7%, since investors are generally upbeat. REITS and listed private equity continued to rally, by 3.6% and 5.1%, respectively.

Interestingly the USD rebounded in June. The USD gained 3%, both vis-à-vis the broad USD index (DXY) and the EUR. Safe-haven currencies, like the CHF and the JPY, appreciated. After a long phase of CNY strength, the Chinese CNY fell 1.5% against the USD.

Macroeconomics

In June the US manufacturing ISM index fell slightly to 60.6 after 61.2. The European Markit manufacturing PMI rose to 63.4 after 63.1 Most leading indicators continue to show very strong growth prospects, although growth may slow in the coming quarters. US job creation was strong in June with non-farm payrolls at 850,000. Many jobs have been created in the leisure and hospitality sector. In addition, wage growth accelerated. Average hourly earnings rose 3.6% year-on-year.

In June US inflation accelerated again. Consumer prices rose 5.4% after 5.0% in May and 1.4% in December last year. In addition, the core CPI, which excludes volatile items like food and energy, rose to 4.5% after 3.8%. A large part of the CPI increase can be attributed to pandemic-related developments. During the pandemic, capacity in many sectors was drastically reduced, and this has now led to bottlenecks, especially as economies open and high pent-up demand hits the market. For example, a third of the monthly increase in US inflation is due to rising prices for used cars, which soared 10.5%. Also, air fares rose significantly.

While there is a certain risk of runaway inflation, we assume that the inflation spike will be only transitory and that the inflation situation will normalize as supply catches up with demand. Nevertheless, we would not be surprised to see inflation remaining above 2% next year.

Covid-19

The total number of cases reached 188 m and 4.1 m people have died of covid. 3.4 bn doses of vaccine have been administered and 940 m people are fully vaccinated, i.e., 12% of the global population. Especially in Europe the pace of the vaccination roll-out accelerated in recent months. However, due to vaccination hesitancy the pace recently started to slow again. Meanwhile many countries, especially in Europe and North America eased lockdown measures, while the more contagious delta variant began to dominate in many countries. As a result, we observe rising numbers of cases especially in Asia, Africa, and Europe.

Central banks

At the last Fed meeting Collin Powell expressed confidence about the economic recovery and sounded less dovish than hitherto. The Fed signaled it would probably raise rates at the start of 2023, earlier than previously anticipated. Furthermore, the Fed minutes revealed that the board debated at length about an earlier start of policy tapering, i.e., reducing the asset purchase program.

The ECB reviewed its strategy and announced the resultant changes on 8 July. Firstly, the ECB revised its inflation target and will tolerate inflation moving temporarily above 2%. This is a significant change to its very conservative policy doctrine with an inflation target at all events below 2%. Secondly, the ECB will try to tackle climate change, shifting rules for its asset purchases and collateral rules away from large carbon-emitting companies.

As early as April this year the Bank of Canada (BoC) was the first major central bank to start tapering its asset purchase program. At its latest policy meeting on 14 July, the BoC announced it would further trim its quantitative easing program and reduce its weekly purchase of government bonds.

Outlook

Global growth will peak in the coming months and then slow down again somewhat. Nevertheless, economic growth will remain above the long-term trend for much longer.

The Delta variant and recent easing measures will lead to a rebound of Covid cases over the summer. However, the impact on the health system and the economy will be much smaller than previously, due to higher vaccination coverage of the most vulnerable age groups. U.S. inflation will rebound somewhat but may remain above the 2% mark.

We expect 10-year US government bond yields to rise to about 2% by the end of the year. Equity markets will continue to perform positively, even though the performance in H2 will in all likelihood lag behind the performance in H1.

For the reasons mentioned above, we remain neutrally positioned in equities. We remain underweight in high-yield bonds and overweight in insurance-linked bonds.

In our view, cyclical sectors will benefit in the coming months — all the more as many companies in these sectors have relatively moderate valuations. We have therefore built up an overweight in the US financial sector. US financial companies are benefiting from rising credit demand and higher interest rates. In contrast, we are less optimistic about the European financial sector and have accordingly not built up an overweight there. This is mainly due to the fact that European banks continue to face structural problems. Banks are suffering from significant margin pressure, increasing regulation and non-performing assets. In the last quarter we furthermore overweighted industrial stocks (US and Europe). The industrial sector is benefiting not only from the global growth acceleration but also from a large number of planned infrastructure programs.

ECONOMICS

In June the US manufacturing ISM index fell slightly to 60.6 after 61.2. The European Markit manufacturing PMI rose to 63.4 after 63.1 Most leading indicators continue to show very strong growth prospects, although growth may slow in the coming quarters. US job creation was strong with non-farm payrolls at 850,000. Many jobs have been created in the leisure and hospitality sector. In addition, wage growth accelerated. Average hourly earnings rose 3.6% year-on-year. US consumer prices rose 5.4%, well above expectations and the fastest rise since August 2008.

Fig. 1: PMIs

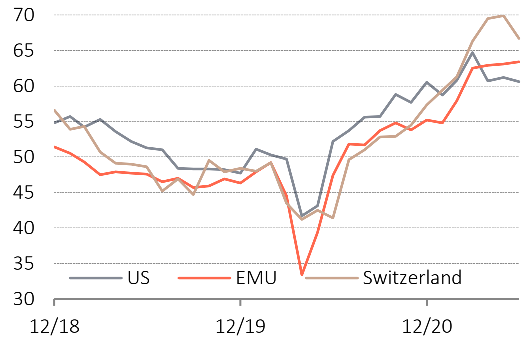


Fig. 2: PMIs

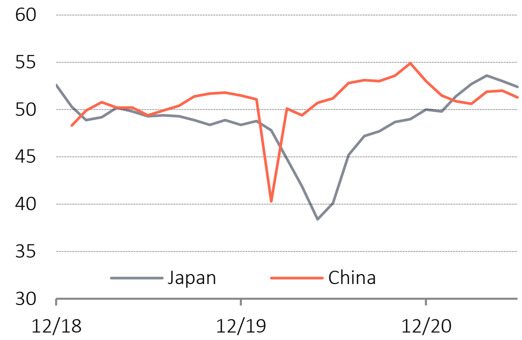


Fig 3: Consumer price inflation, in % YoY

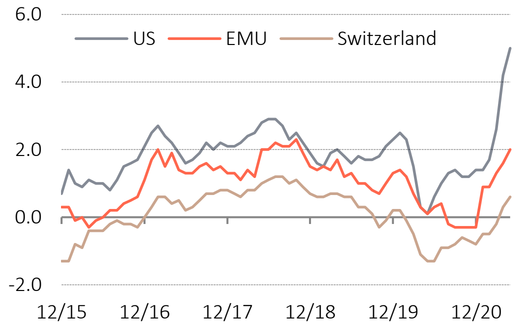


Fig. 4: Consumer price inflation, in % YoY

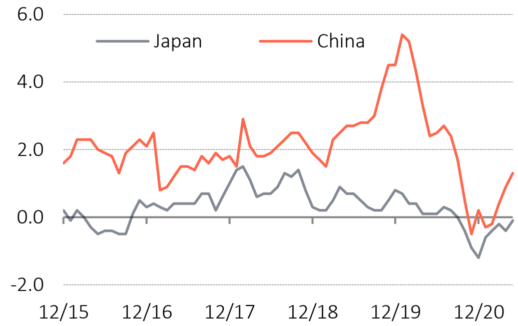


Fig 5: Unemployment rates, in %

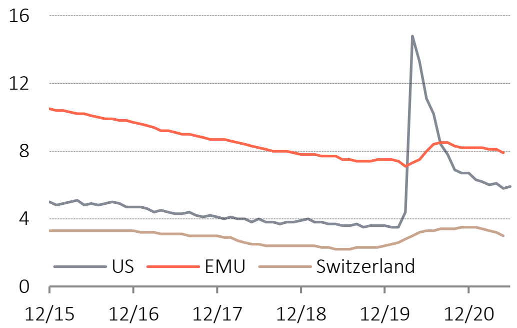
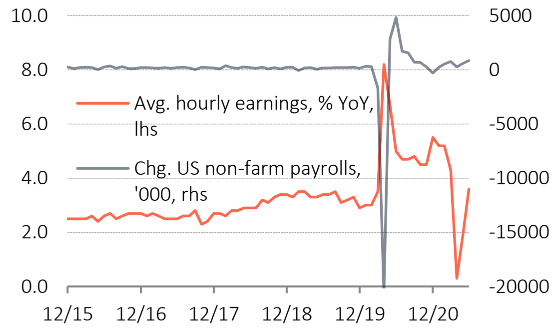


Fig 6: US labor market



FIXED INCOME

Short-term yields remain stable as central banks have reiterated their accommodative stance, despite the Fed turning slightly less dovish at its policy meeting. While headline inflation is going up, inflation expectations and long-term yields fell in recent weeks. This suggests that market participants assume that the surge of inflation will be transitory. Credit spreads tightened further as default rates remain very low. Emerging market bonds in local currency sold off in June and clearly underperformed other fixed-income instruments.

Fig.7: 2Y government bond yields

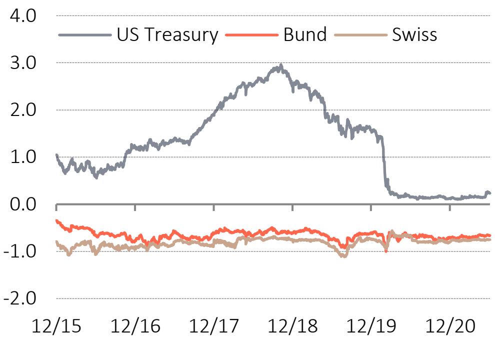


Fig. 8: 10Y government bond yields

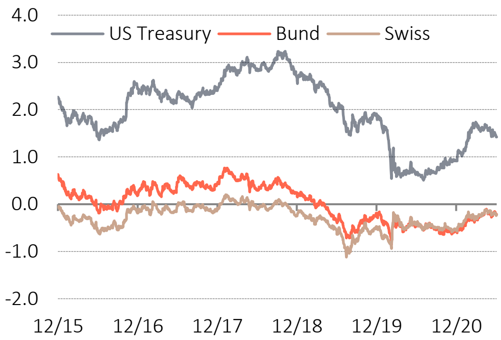


Fig 9: 10Y break-even inflation

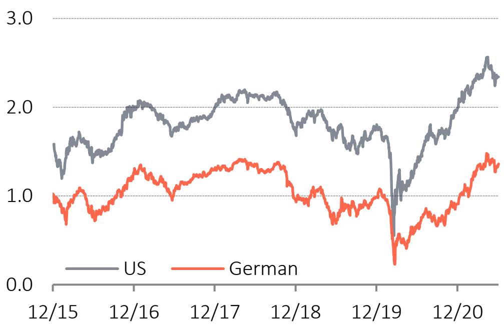


Fig. 10: Credit spreads, 5Y credit default swaps

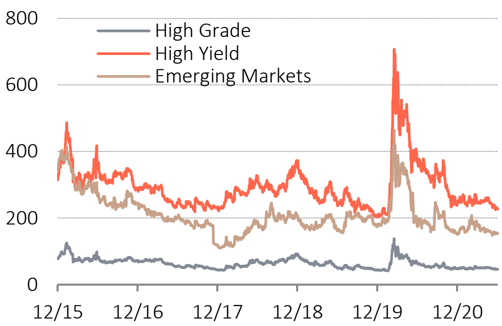


Fig 11: Money market spreads (3M-2Y)

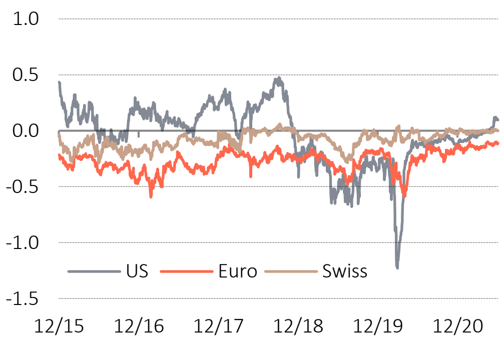
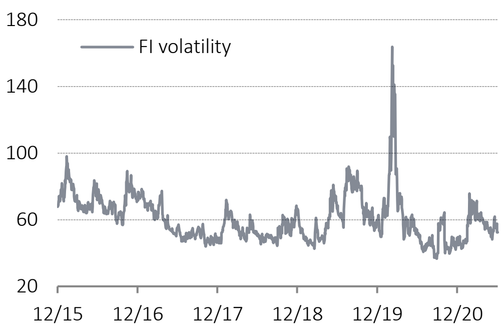


Fig 12: Merrill Lynch volatility index (MOVE)



EQUITIES

In June equity markets developed inconsistently. European and US markets were positive, emerging markets flat and many Asian equity markets fell. Concerns about the outlook for the Chinese economy weighed on Asian markets and the Chinese CSI 300 index fell 2% in June. Whereas cyclical sectors clearly outperformed in recent months, we saw some profit-taking with the result that cyclicals underperformed in June. Nevertheless we continue to see positive prospects for cyclical stocks to outperform.

Fig. 13: MSCI equity indices – major regions

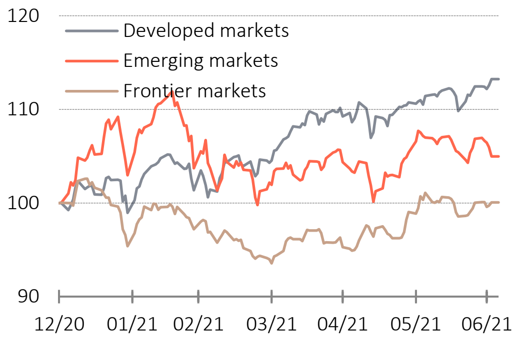


Fig.14: Equity indices – major developed markets

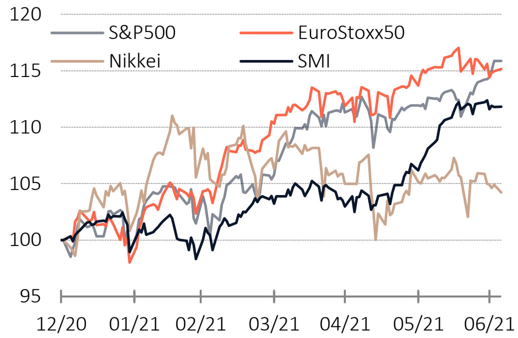


Fig 15: Equity indices – major emerging markets

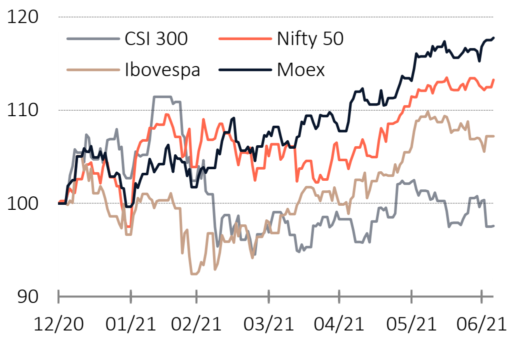


Fig. 16: Sector performance, MSCI Europe, YTD

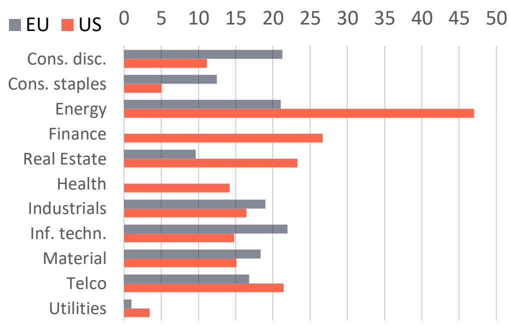


Fig 17: Price-earnings ratios

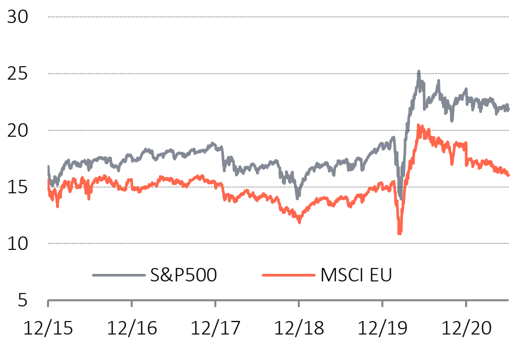
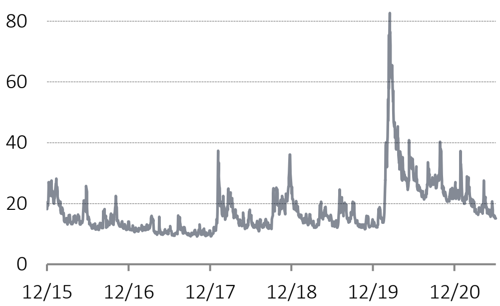


Fig 18: Equity volatility – S&P500 VIX index



ALTERNATIVE INVESTMENTS

As the momentum for cyclicals slowed and the prospects for the Chinese economy worsened, prices for industrial metals fell by 3.2% in June. Oil prices surged by 8.5%. This was caused by the OPEC countries agreeing to limit supply in combination with rising demand as economies re-opened. The gold price fell by 7% as investors are generally upbeat. REITS and listed private equity continued to rally, by 3.6% and 5.1%, respectively.

Fig. 19: Gold price, USD/oz

Fig.20: Brent oil price, USD/bl

Fig 21: Bloomberg commodity indices

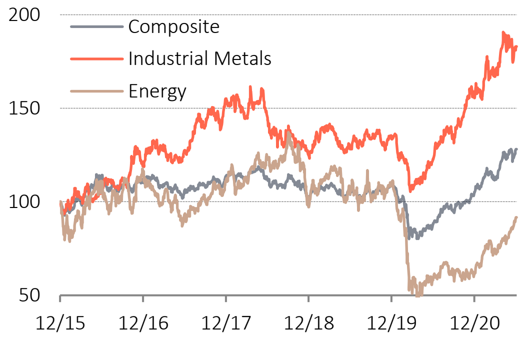


Fig. 22: HFRU hedge fund indices

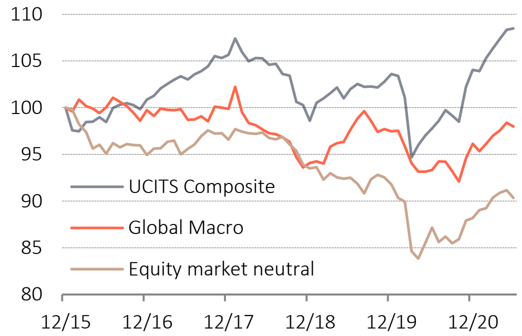


Fig 23: FTSE EPRA/NAREIT global REITS index

Fig 24: LPX global listed private equity

CURRENCIES

Interestingly the USD rebounded in June. The USD gained 3%, both vis-à-vis the broad USD index (DXY) and the EUR. Safe-haven currencies, like the CHF and the JPY, appreciated. After a long phase of CNY strength, the Chinese CNY fell 1.5% against the USD.

Fig. 25: EUR-USD exchange rate

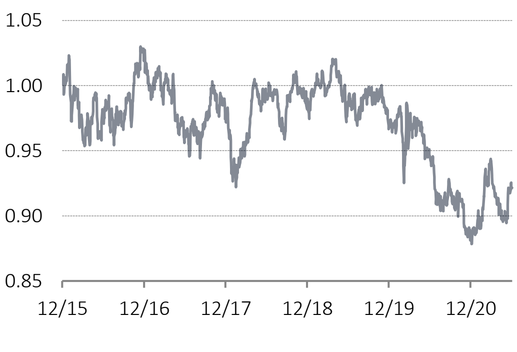
Fig. 26: GBP-USD exchange rate

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 reached 188 m and 4.1 m people have died of covid. 3.4 bn doses of vaccine have been administered and 940 m people are fully vaccinated, i.e., 12% of the global population. In Europe the pace of the vaccination roll-out accelerated in recent months. However, due to vaccination hesitancy the pace recently started to slow again. Meanwhile many countries, especially in Europe and North America, eased lockdown measures, while the more contagious delta variant began to dominate in many countries. As a result, we observe rising numbers of cases especially in Asia, Africa, and Europe.

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

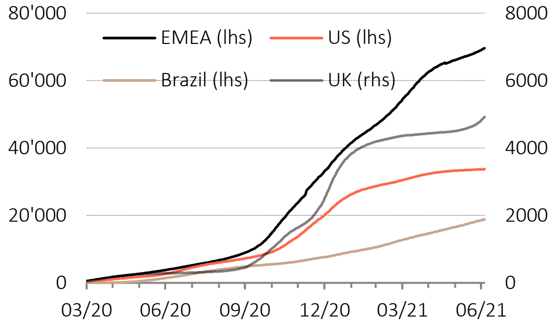


Fig. 32: New cases per day (7-day average)

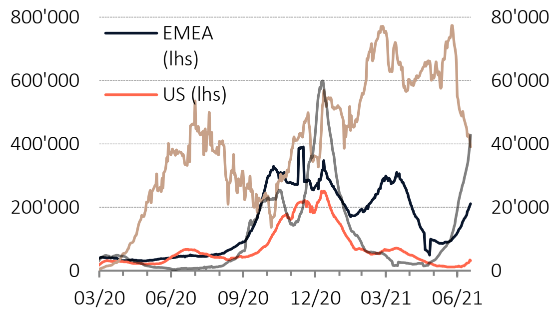


Fig 33: Global vaccination campaign (doses per 100 people)

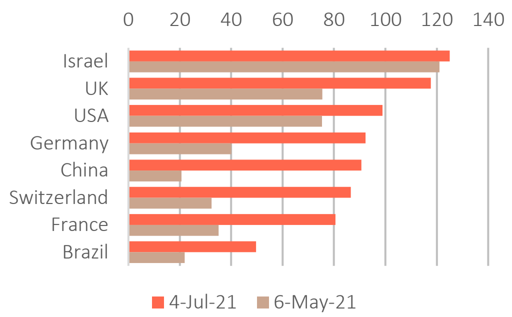


Fig.34: Central bank total assets (indexed)

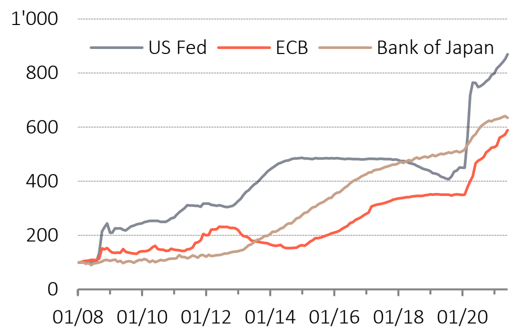
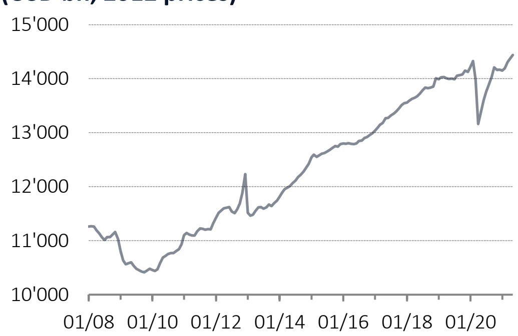


Fig 35: US bankruptcy index

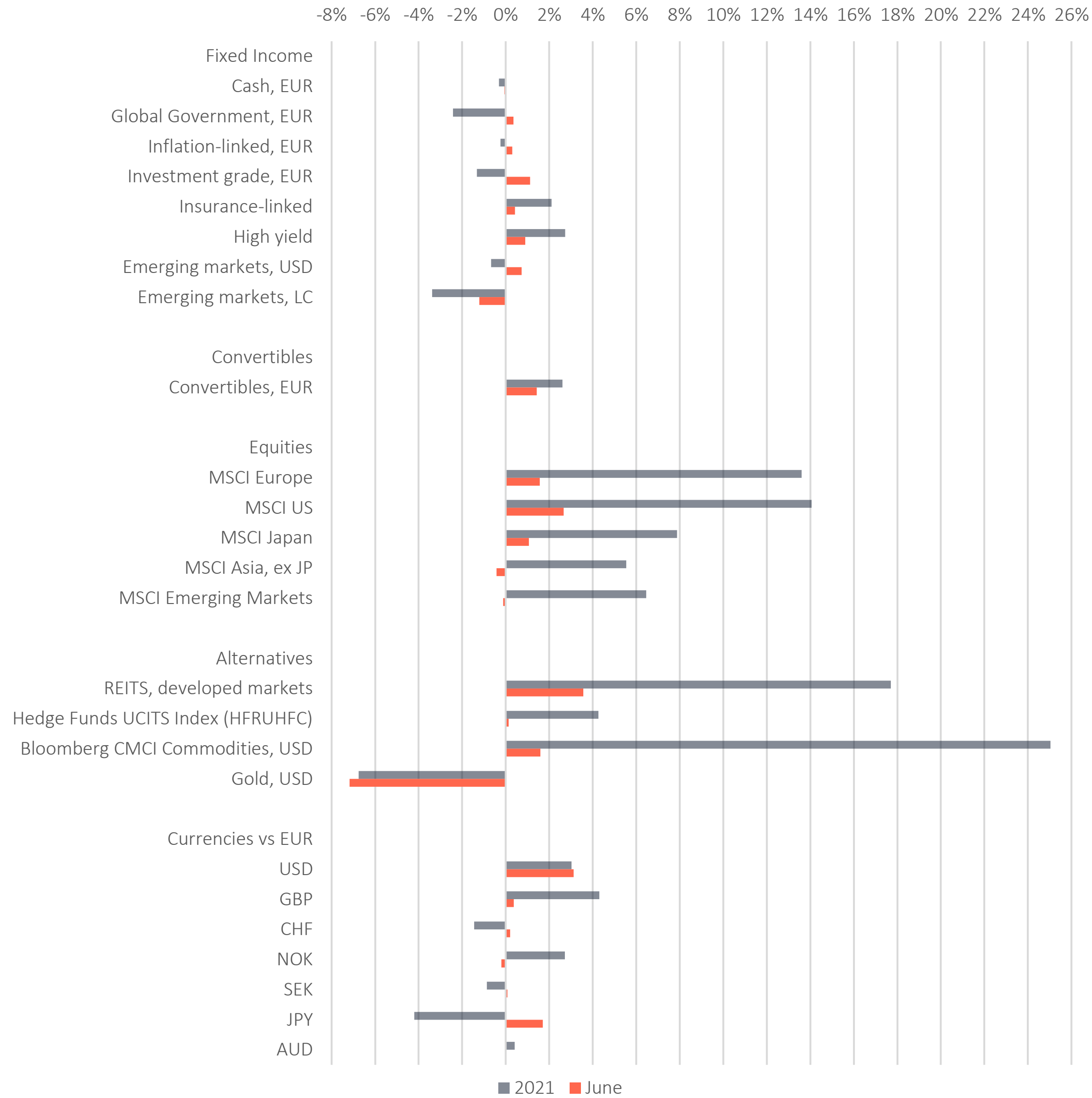
Fig 36: US personal income, excl. transfers (USD bn, 2012 prices)



ASSET ALLOCATION

Overall, risky assets performed positively in June, although momentum clearly slowed. REITS had another strong month. The exception were Asian stock markets, which fell slightly on the back of a clouded outlook for China. Emerging-market bonds were down in June. The risk-taking environment was negative for gold and its price fell 7%.

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

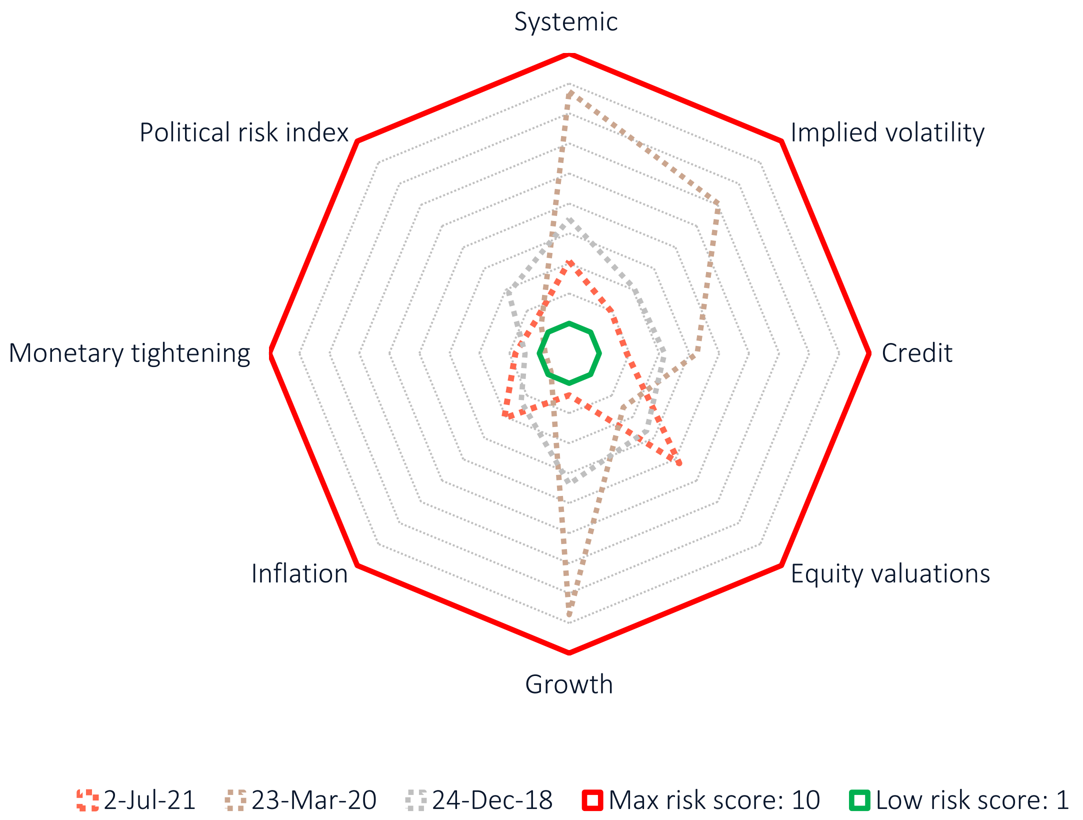


RISK MONITOR

Our risk monitor shows minimal growth and monetary tightening risks, while inflation risks are rising. Furthermore, risks in relation to elevated equity valuations are elevated. Implied volatilities, the price for hedging, remain low across asset classes. Overall, the benign risk environment continues.

Fig. 38: IMT Risk Monitor

23-Mar-2020: Global pandemic
24 Dec 2018: Growth and monetary tightening fears



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