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INVESTMENT OUTLOOK 10.2021

19 October 2021

In September the euphoria that had gripped the financial markets evaporated. Several developments unnerved market participants: the global growth slow down, high inflation, rising numbers of Covid-19 cases, central banks hiking rates or starting to taper, the regulatory crackdown on Chinese private education and technology companies, disrupted supply chains, rising energy prices, and the default of the Chinese property developer Evergrande. Many market participants fear that such developments could result in stagflation.

While we do see the potential risk of stagflation, we rather think it is a tail risk. We expect global growth to stay robust and inflation pressure to ease. Although central banks will start tapering, monetary conditions will continue to be loose for the foreseeable future. As a result, we are constructive for equity markets but bearish for government and high-grade bonds. We remain neutral in equities and overweight in cyclical sectors, like industrials and financials.

Trauth

Thomas Trauth
CEO – IMT Asset Management AG

STAGFLATION FEARS

Financial markets

In September most equity markets sold off, developed markets by 4.3% and emerging markets by 4.2%. A notable exception was the Japanese Nikkei index, which advanced 4.9% on the back of hopes that the new prime minister, Fumio Kishida, would introduce fresh stimulus measures. In September energy stocks outperformed by a wide margin, driven by surging energy prices. Technology stocks suffered, however, due to concerns about new international tax rules and regulatory pressure in China.

After remaining steady since March 2020, US short-term yields started to rise in September, going up by 7 basis points. This indicates that the market thinks rates will probably be hiked earlier than hitherto thought . US 10-year yields also rose, by 18 basis points, while inflation expectations remained almost unchanged. Credit spreads widened as risky assets sold-off, high-yield spreads for example by 25 basis points.

The strong rally of energy and oil prices took center stage. The Bloomberg index of various energy prices rose 17% in September, with oil prices up 7.5%. The price of gold fell about 3%. Other alternatives fell as investors became more risk averse. Global REITS declined 4.3%, listed private equity 3.2%, and industrial metals prices 4.4%.

The USD strengthened in September, the USD index gained 1.7% and the USD appreciated about 2% vis-à-vis the EUR. Some emerging markets currencies came under selling pressure, for example the Brazilian BRL lost about 6% and the Turkish TRY 7%.

Macroeconomics

Macro indicators confirm that growth remains healthy but is slowing. The US ISM manufacturing index for September improved slightly to 61.1 after 59.9. The European Markit manufacturing PMI fell to 58.6 after 61.4. Again, US non-farm payrolls disappointed. The US economy added only 194,000 jobs in September, far fewer than the 366,000 which were created in August and below the consensus expectations of 500,000. Child-care issues and supply-side constraints seem to be preventing the economy from recovering more vigorously. Despite disappointing non-farm payrolls, the unemployment rate fell to 4.8% after 5.2%. In September Eurozone's inflation rate rose further from 3% to 3.4%, while US inflation remained almost unchanged at 5.4%.

Stagflation risk

Inflation has clearly risen in recent months and, as growth is slowing at the same time, concerns about looming stagflation are rising. Stagflation is characterized by a stagnating or even declining economy in combination with rising prices. Typically, inflation is high when the economy booms and low when the economy stagnates or falls into a recession. In such situations inflation is demand-driven, with prices going up as demand for products and services rises and vice versa. If, however, prices rise due to supply-driven factors, e.g, because of rising costs companies' profit margins and consumers' purchasing power decline, resulting in a slowing economy.

Currently, inflation is mostly driven by such cost-push factors. Energy and other commodity prices are surging, supply-chain disruptions have led to massively higher prices for semi-conductors and other intermediate goods, and shipping costs have risen 14-fold since 2019. Many of those factors seem to be transitory and will normalize in the coming quarters.

However, there is the risk that inflation expectations will rise and remain high for a long period. As a result, more people will take future inflation into account when setting prices. Consequently, wages and interest rates could rise and lead to second-round inflationary pressure.

We are clearly cognizant of such inflation risks and their potential impact on economic growth. However, we would currently regard stagflation only as a tail risk. We expect inflation to fall from the current elevated levels but to remain above 2% for a considerable time. As long as inflation is not starting to spiral we think that the economy and financial markets will not be affected negatively by somewhat higher inflation rates.

Covid-19

The total number of cases exceeds 240 m with 4.9 m deaths. 6.7 bn doses of vaccine have been administered. Currently about 20.4 m doses are being administered per day. 47.5% of the world population has received at least one dose. While in the US the number of new cases is declining, the numbers are still rising in the EMEA Region and the UK.

Outlook

While global growth is slowing down at present, it will nevertheless stay above trend growth for the next 12 months. This is basically a very positive prerequisite for equity markets to remain robust. That said, however, the extraordinarily strong performance of the last 1.5 years will certainly not be repeated. Instead, what can be expected is increasing volatility with occasional corrections.

The central banks will slowly and carefully take initial steps to normalize monetary policy. We assume that this will not have lasting adverse effects on the equity markets. In line with this scenario the US Fed will probably announce a reduction in its purchasing program in the fourth quarter, and it will effect an initial rate hike at the end of 2022.

We expect that inflation, which has risen most steeply in the USA, will fall again because many special contributory factors stemming from the Corona pandemic will prove to be temporary. This is also what the markets are anticipating. Even so, we see a risk that inflation could persist above the target level of 2% for a longer period.

In our opinion, the growth slowdown in China combined with the bankruptcy of the Evergrande property development group will induce the Chinese government to put together a rescue package. This might enable the thoroughly shaken Chinese stock market to recover. As monetary policy begins to return to normal and economic growth continues to be robust, we can expect higher bond yields. By the end of the year, 10-year US bond yields could climb to 2% or even rather higher.

We made no changes to our tactical portfolio positioning. We are retaining our neutral equity weighting, remain underweight in high-yield bonds and overweight in insurance-linked bonds. At the same time we are retaining our overweight in the cyclical sectors, US and European industrials and US financials. The industrial sector will benefit from the planned infrastructure measures, and the financial sector from the rising interest rates.

ECONOMICS

Macro indicators confirm that growth remains healthy but is slowing. The US ISM manufacturing index for September improved slightly to 61.1 after 59.9. The European Markit manufacturing PMI fell to 58.6 after 61.4. Again, US non-farm payrolls disappointed. The US economy added only 194,000 jobs in September, far fewer than the 366,000 which were created in August and below the consensus expectations of 500,000. In September Eurozone's inflation rate rose further from 3% to 3.4%, while US inflation remained almost unchanged at 5.4%.

Fig. 1: PMIs

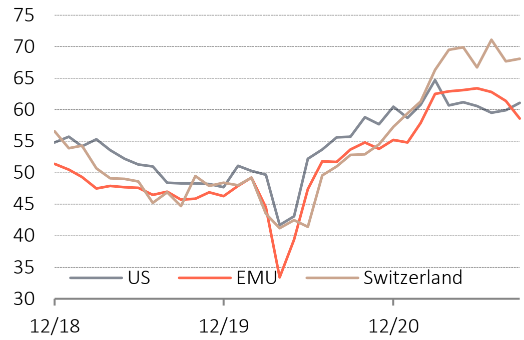


Fig. 2: PMIs

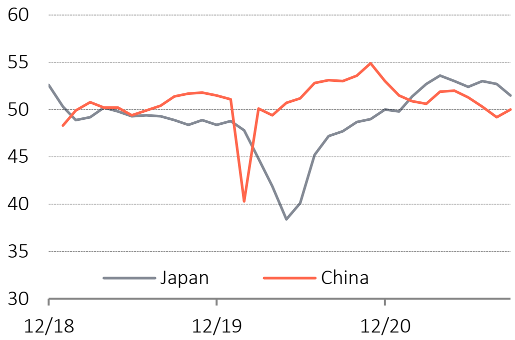


Fig 3: Consumer price inflation, in % YoY

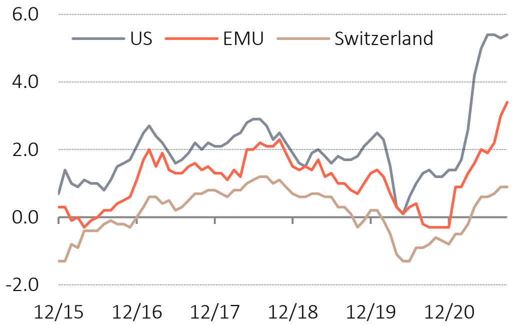


Fig. 4: Consumer price inflation, in % YoY

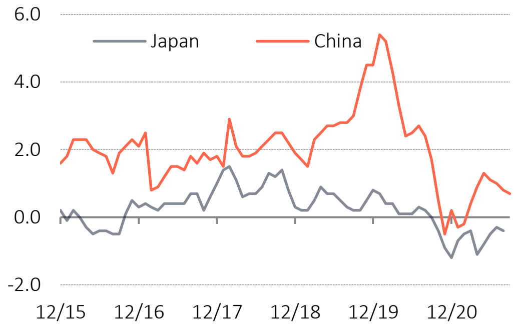


Fig 5: Unemployment rates, in %

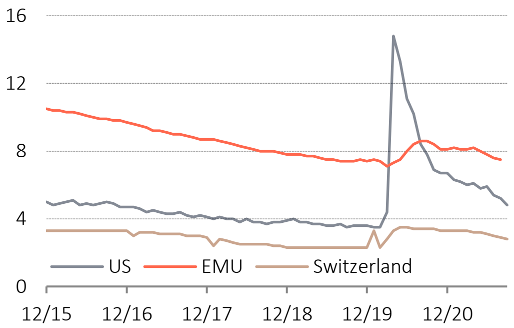
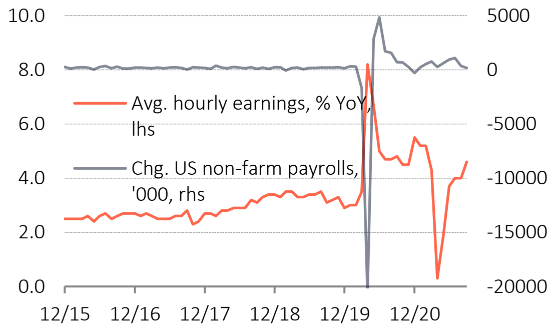


Fig 6: US labor market



FIXED INCOME

Afte remaining steady since March 2020, US short-term yields started to rise in September, going up by 7 basis points. This indicates that the market thinks rates will probably be hiked earlier than hitherto thought . US 10-year yields also rose, by 18 basis points, while inflation expectations remained almost unchanged. Credit spreads widened as risky assets sold-off, high-yield spreads for example by 25 basis points.

Fig.7: 2Y government bond yields

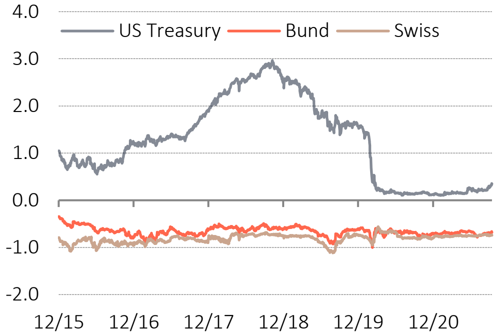


Fig. 8: 10Y government bond yields

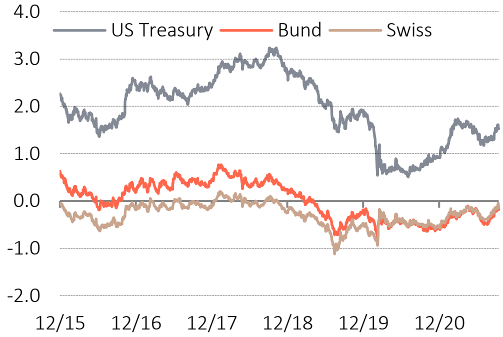


Fig 9: 10Y break-even inflation

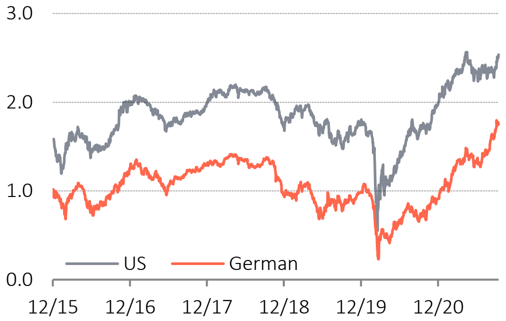


Fig. 10: Credit spreads, 5Y credit default swaps

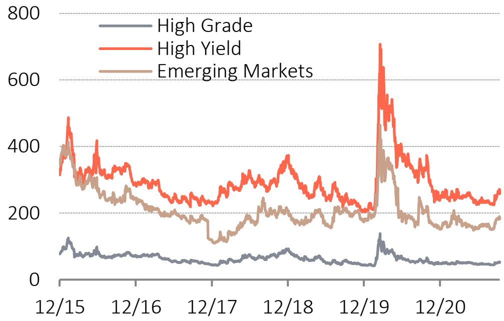


Fig 11: Money market spreads (3M-2Y)

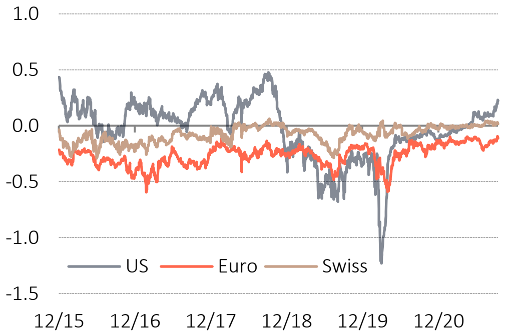
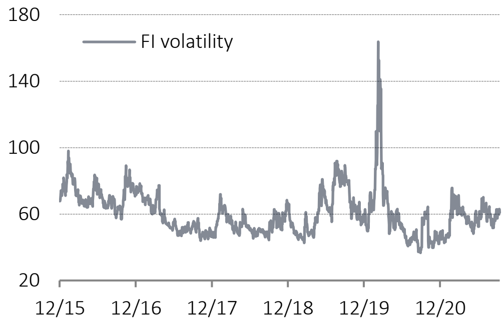


Fig 12: Merrill Lynch volatility index (MOVE)



EQUITIES

In September most equity markets sold off, developed markets by 4.3% and emerging markets by 4.2%. A notable exception was the Japanese Nikkei index, which advanced 4.9% on the back of hopes that the new prime minister, Fumio Kishida, would introduce fresh stimulus measures. In September energy stocks outperformed by a wide margin, driven by surging energy prices. Technology stocks suffered, however, due to concerns about new international tax rules and regulatory pressure in China.

Fig. 13: MSCI equity indices – major regions

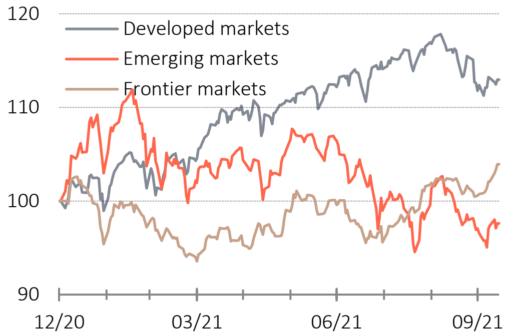


Fig.14: Equity indices – major developed markets

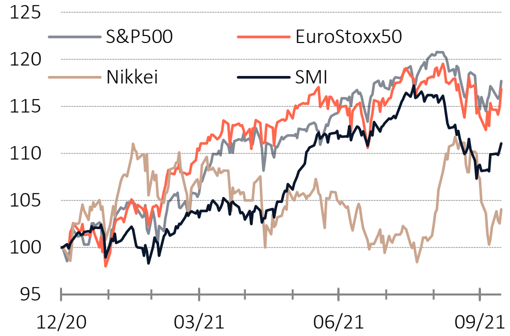


Fig 15: Equity indices – major emerging markets

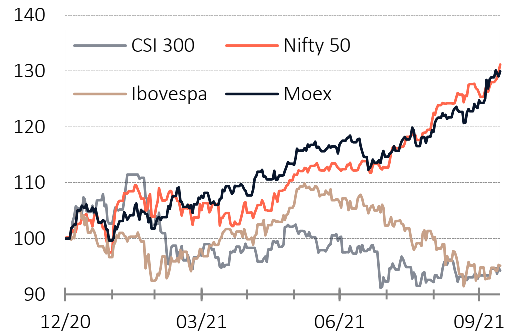


Fig. 16: Sector performance, MSCI Europe, YTD

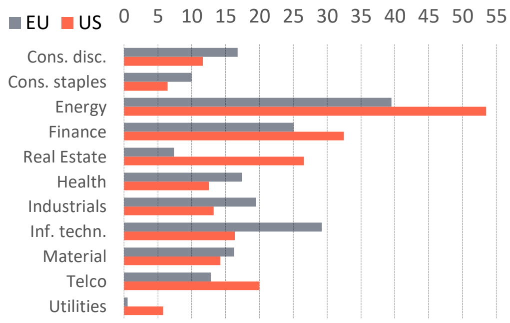


Fig 17: Price-earnings ratios

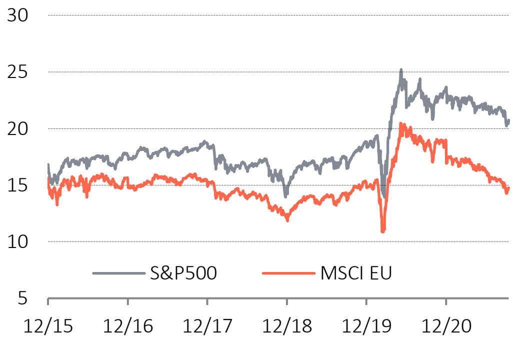
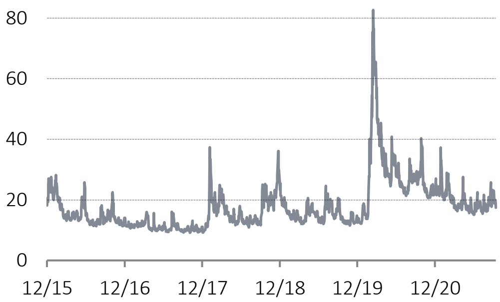


Fig 18: Equity volatility – S&P500 VIX index



ALTERNATIVE INVESTMENTS

The strong rally of energy and oil prices took center stage. The Bloomberg index of various energy prices rose 17% in September, with oil prices up by 7.5%. The price of gold fell about 3%. Other alternatives fell as investors became more risk averse. Global REITS declined 4.3%, listed private equity 3.2%, and industrial metals prices 4.4%.

Fig. 19: Gold price, USD/oz

Fig.20: Brent oil price, USD/bl

Fig 21: Bloomberg commodity indices

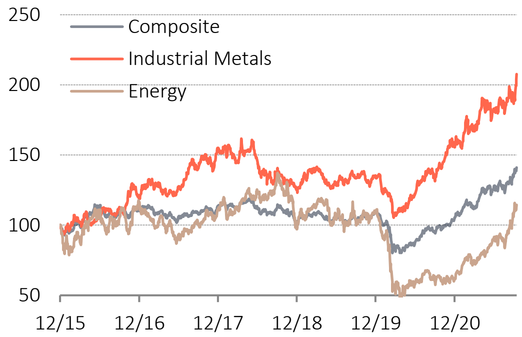


Fig. 22: HFRU hedge fund indices

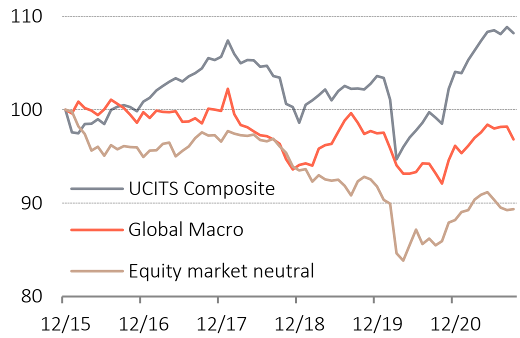


Fig 23: FTSE EPRA/NAREIT global REITS index

Fig 24: LPX global listed private equity

CURRENCIES

The USD strengthened in September; the USD index gained 1.7% and the USD appreciated about 2% vis-à-vis the EUR. Some emerging markets currencies came under selling pressure, for example the Brazilian BRL lost about 6% and the Turkish TRY 7%.

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 exceeds 240 m with 4.9 m deaths. 6.7 bn doses of vaccine have been administered. Currently about 20.4 m doses are being administered per day. 47.5% of the world population has received at least one dose. While in the US the number of new cases is declining, the numbers are still rising in the EMEA Region and the UK.

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

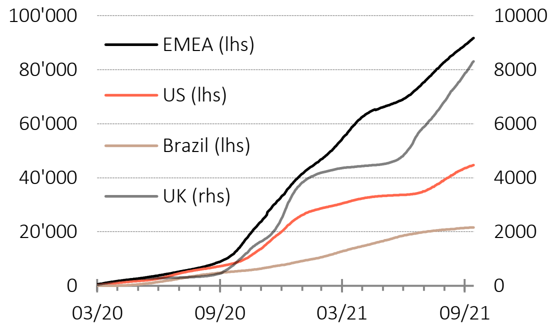


Fig. 32: New cases per day (7-day average)

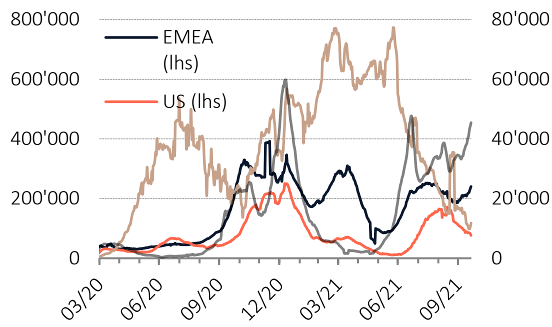


Fig 33: Global vaccination campaign
(doses per 100 people)

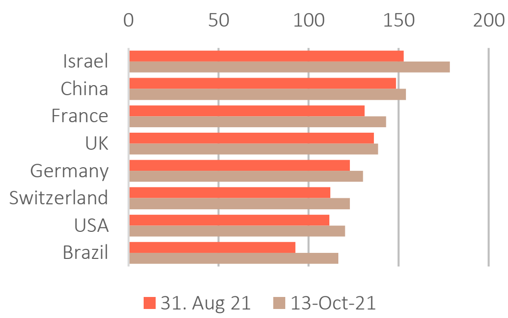


Fig.34: Central bank total assets (indexed)

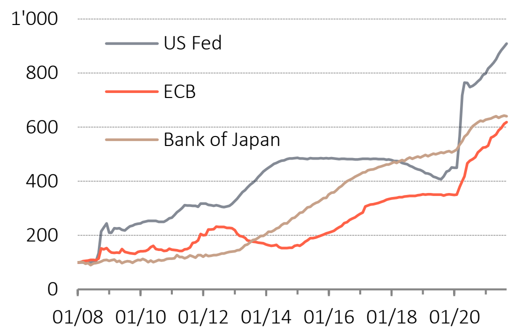


Fig 35: US bankruptcy index

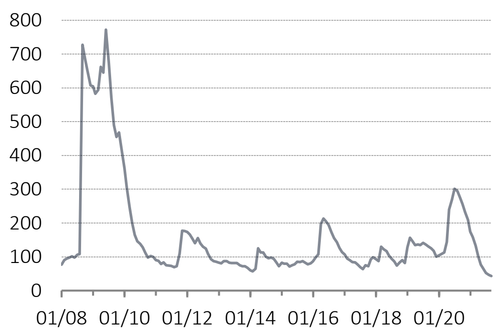
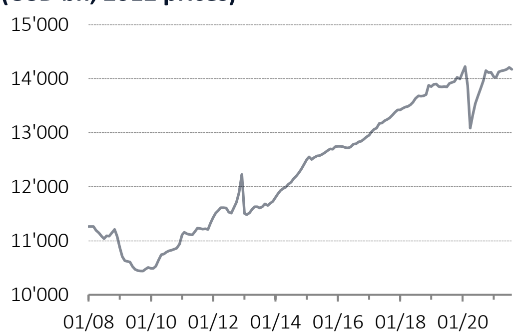


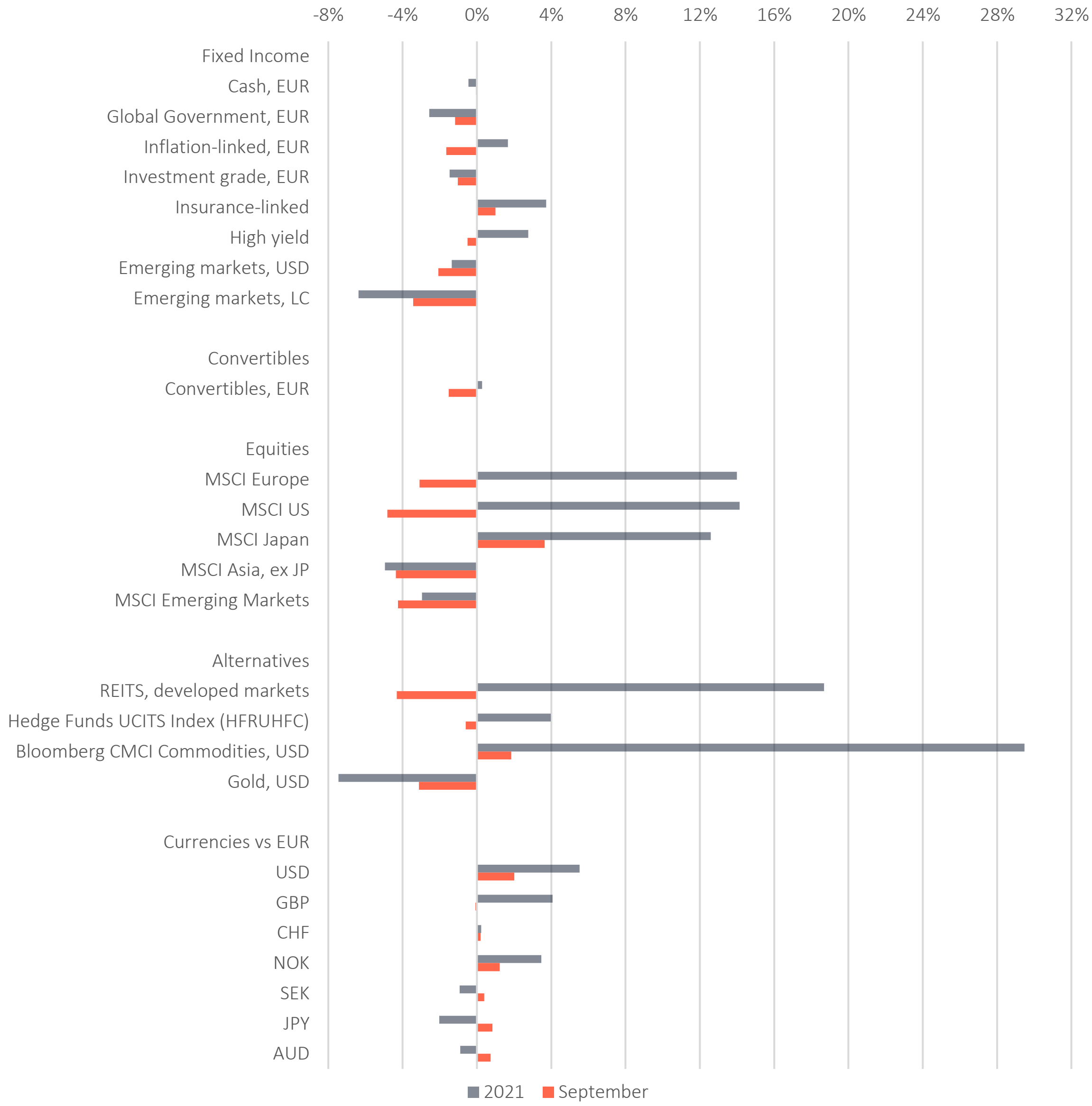
Fig 36: US personal income, excl. transfers (USD bn, 2012 prices)



ASSET ALLOCATION

September was the first down month for our multi-asset class portfolio in 2021. With few exceptions most asset classes posted losses. The exceptions were insurance-linked bonds, Japanese stocks, commodities, driven by higher prices for energy, and the USD.

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



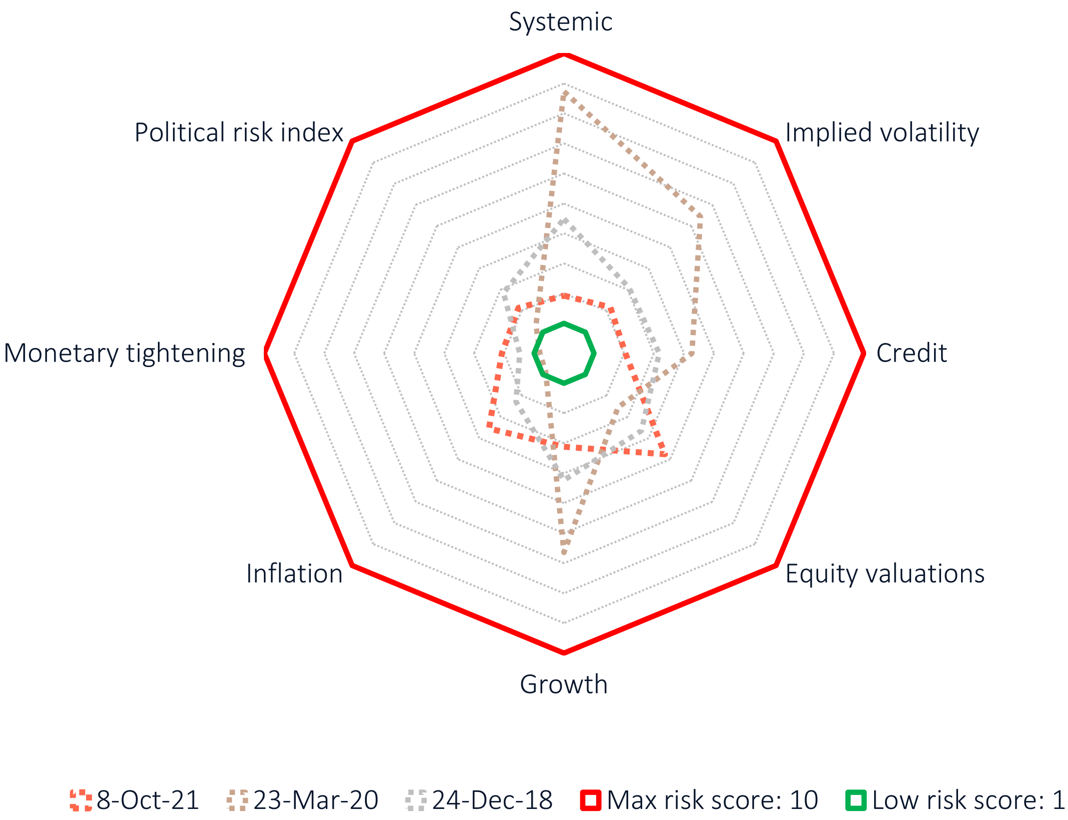
RISK MONITOR

Our risk indicators were little changed compared to last month. The exception is the monetary tightening risk indicator, which edged somewhat higher.

Equity valuations remained relatively high and inflation risks have risen since the beginning of 2020.

Fig. 38: IMT Risk Monitor

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



DISCLAIMER

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.