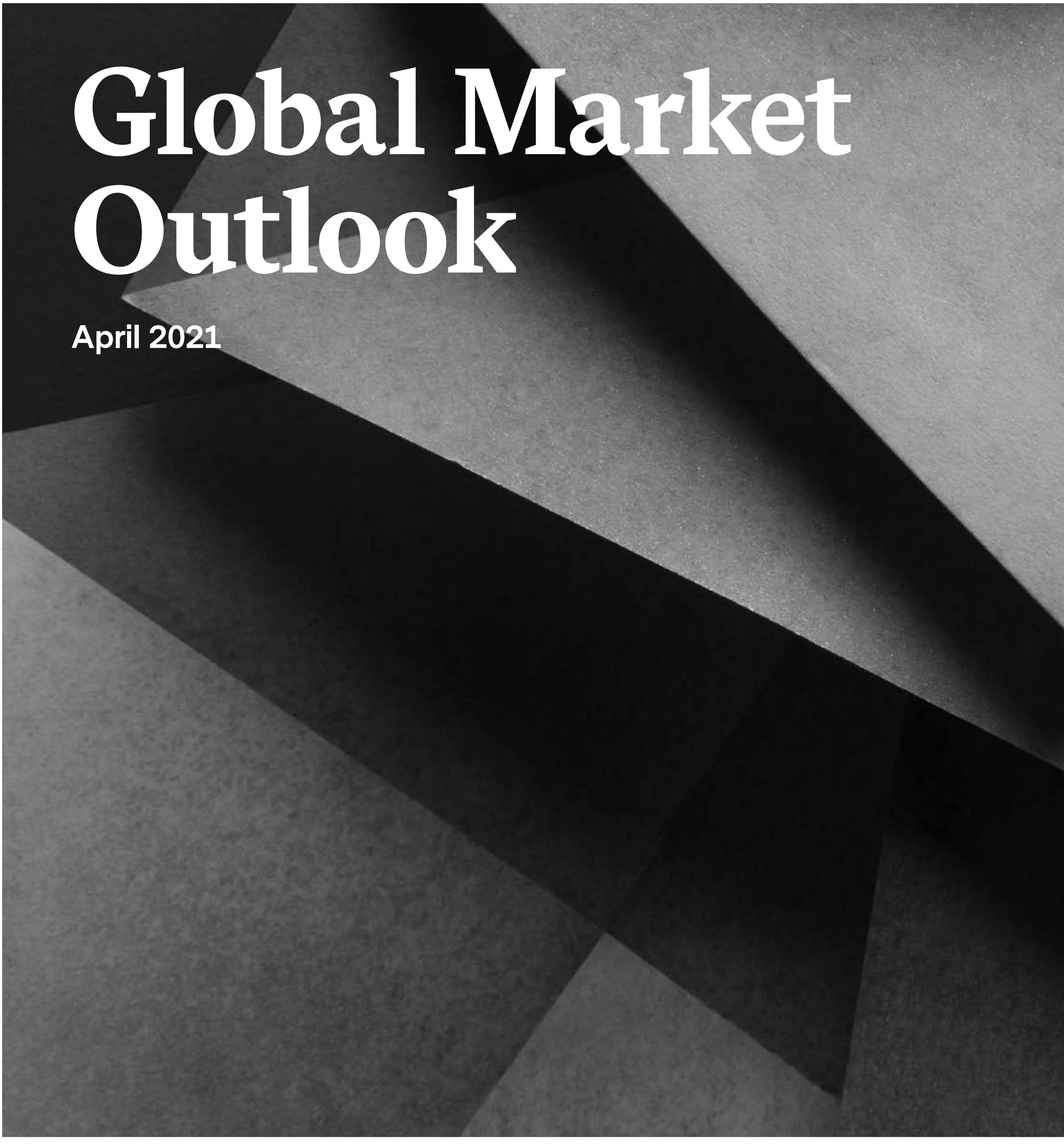
vescore
by Vontobel Asset Management



Global Market Outlook

April 2021

Asset Management

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At a glance

- Equities:
  Overweighting unchanged
- Government bonds:
  Short positioning reduced significantly
- Risk environment:
  Risk indicator higher
- Current topic:
  Commodities to hedge against inflation

Strong risk appetite among market participants

The fundamental economic market environment is currently defined by a strong appetite for risk among market participants. In addition to the global economic recovery, there is also still support in the form of monetary and fiscal policy relief efforts.

The USD 1.9 trillion COVID-19 relief package approved by US President Joe Biden in March sparked positive sentiment on both sides of the Atlantic. The US Fed likewise chipped in by signaling the continuation of its extremely loose monetary policy to help combat the repercussions of the coronavirus pandemic. It has said that it will retain its current policy until the goals of full employment and longer-term inflation of 2% are achieved.

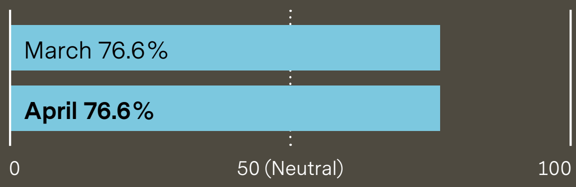
These policies were also buoyed by recent better-than-expected US economic data and positive developments in the US vaccination campaign. This is giving market players hope for a quick return to a pandemic-free economy that will continue to recover. Meanwhile, Germany's benchmark DAX index has risen past 15,000 points for the first time. Moreover, the eurozone industry ramped up production by an unexpectedly high degree in the middle of the second coronavirus wave.

By contrast, rising fears of a third wave and the accompanying negative impact on the economic recovery weighed heavily on market participants' sentiment in March. Investors also continue to be unsettled by the sharp spike in bond yields. While good US labor market data witness a recovery of the US economy, at the same time they are stoking market participants' inflation worries.

The defining factors are still the economic recovery around the world and the ongoing course of the pandemic, which is itself dependent on global vaccination progress. In addition, investor attention is once again shifting to geopolitical tensions with the burgeoning unrest between China and the Western powers.

Equities

Overweighting unchanged



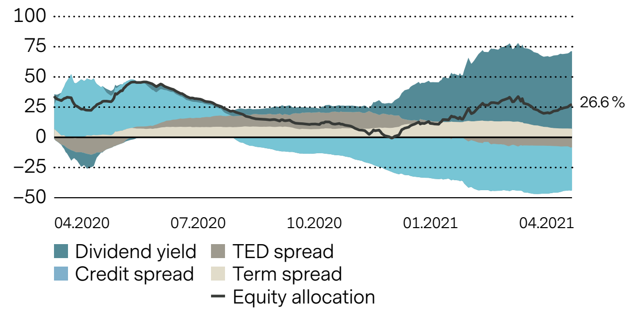
At the start of April 2021, the equity overweighting of the global GLOCAP sample portfolio (50% equities, 50% cash) stands at 26.6%, as in the previous month. The biggest absolute change was in the term spread, whose positive contribution to equity allocation decreased by 4.1 percentage points. This, and the TED spread's increased negative contribution, are reducing the equity overweighting. However, this effect is countered by the changes in the credit spread and the dividend yield, which are increasing the allocation.

Over the month, the model delivered a significantly lower equity allocation: In the middle of March, the overweighting sank to just over 19% before scrambling back to its current level. The decline around the middle of the month was mainly due to the temporarily lower contribution by the dividend yield, which was ultimately on the way up again towards the end of the month.

The overall picture is thus unchanged: The dividend yield is still having the biggest effect on the equity overweighting with a positive contribution of 63.3%, in spite of a still weak dividend yield of less than 2%. This is economically unintuitive. The reason behind it is the negative sensitivity of this instrumental variable, which is due to the fact that market participants are expecting significant earnings growth ahead, and so are making do with lower dividends for now.

Chart 1: Equity overweighting unchanged vs. March

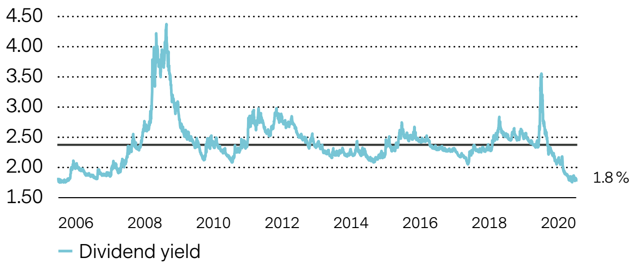
Over/underweighting (%)



The chart shows the active equity weight (black line) of a global portfolio in euros with a neutral allocation of 50% equities and 50% cash. Foreign currencies are hedged. It also shows the contributions of the individual driving forces (term spread, TED spread, credit spread and dividend yield), which come together to give the active equity allocation. Information as of April 6, 2021. Source: Vescore

Chart 2: Dividend yield sensitivity negative

In %



The chart shows the indicator for fundamental valuation, which measures the aggregated ratio of dividend to price and reflects the expected equity market yield as the central valuation parameter. The chart shows a weighted average of the dividend yields of the major industrialized countries (blue line) and the median of this instrumental variable (black line). Information as of April 6, 2021. Source: Vescore

	APRIL 6	MARCH 2
Equity overweighting	**26.6%**	**26.6%**
Contribution of the term spread	6.7%	10.8%
Contribution of the TED spread	–8.4%	–6.9%
Contribution of the credit spread	–35.0%	–38.5%
Contribution of dividend yield	63.3%	61.3%

The table shows the contributions of the instrumental variables to the equity overweighting at the beginning of the month. Source: Vescore

Government bonds

Short positioning reduced significantly

Duration increases

April
–2.3 years

March
–7.2 years

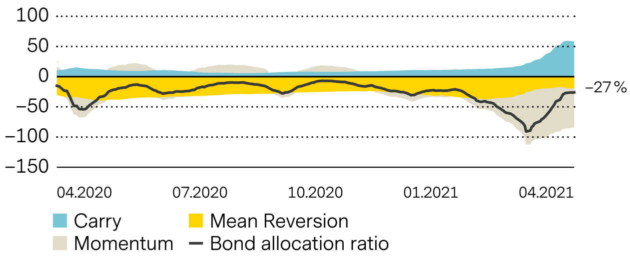
The allocation ratio of a global bond portfolio is up significantly as against the previous month at –27% at the start of April, corresponding to a duration of –2.3 years. The sample portfolio is therefore still short. The position in global government bonds in the portfolio comprises the contributions of the three sub-models carry, mean reversion and momentum. As before, the carry model is the only one making a positive contribution to allocation. Due to steeper yield curves the contribution rose by 36 percentage points to 59%, making it the major driver of the change in allocation. The negative contribution of the momentum model lessened to –66%, while that of the mean reversion model faded to –20%.

The global yield growth on 10-year treasuries slowed in much of the world in March. Interest rates on all markets, barring the US and Canada, halted their rise or in some cases even declined slightly. By contrast, the US 10-year interest rate added another 30 basis points to arrive at 1.7%.

Interest rates had risen significantly all over the world at the start of the year, accompanied by the expectation of higher inflation. On top of this, the Biden administration approved the long-awaited relief package for the USA in March. The roughly two-trillion-dollar program for investment in outdated sections of the US infrastructure will stimulate both growth and new debt for the US in the years ahead. These two factors will potentially amplify the rise in interest rates in the US. The biggest impediment to further interest rate rises in March was once again the world's central banks. The US Fed, for instance, reiterated that it will continue its bond purchases until the labor market has substantially recovered. Interest rate hikes will likely become a possibility only once full employment has been achieved, i.e. probably not until 2023. Thus, the anchor for short-term interest rates will for now remain at its very low level on the interest market.

Chart 3: Short momentum signal weaker

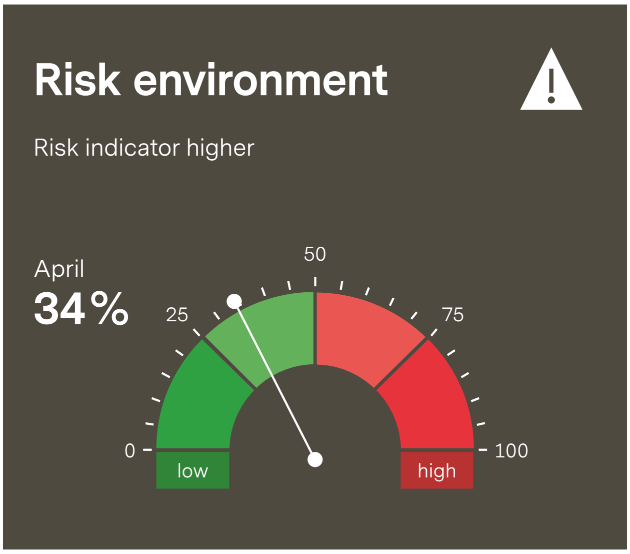
Bond allocation (%)



The chart shows the government bond allocation of a global bond portfolio in euros. The model allocation is calculated on the basis of the short-term forecast models carry, mean reversion and momentum. Information as of April 6, 2021. Source: Vescore

BOND ALLOCATION	TOTAL	CARRY CONTRIBUTION	MEAN REVERSION CONTRIBUTION	MOMENTUM CONTRIBUTION
Global	**–26.7%**	**59.0%**	**–20.0%**	**–65.7%**
Germany	–7.7%	4.5%	–5.8%	–6.4%
France	–6.1%	6.2%	–6.8%	–5.5%
Italy	0.0%	4.9%	–5.1%	0.3%
Great Britain	–11.7%	6.8%	–8.6%	–9.9%
Switzerland	–1.3%	10.2%	–1.0%	–10.6%
US	–1.1%	9.1%	1.1%	–11.3%
Canada	–3.8%	7.9%	–0.4%	–11.3%
Japan	4.8%	9.4%	6.5%	–11.1%

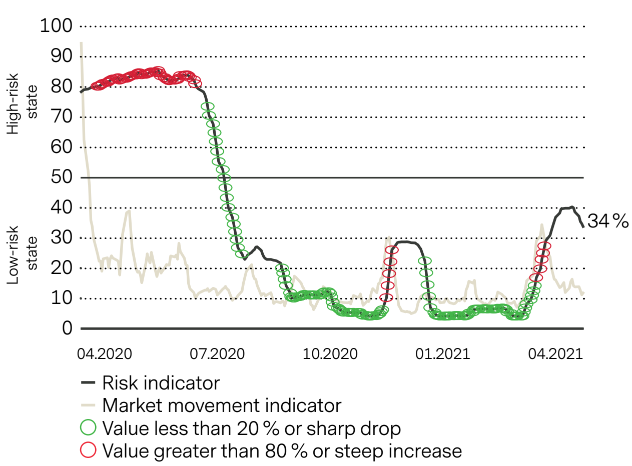
The table shows the bond allocation of a global portfolio in euros ("Total" column) broken down into individual countries. It also lists the contribution of the short-term forecast models carry, mean reversion and momentum to the total bond allocation. Information as of April 6, 2021. Source: Vescore



The risk indicator continued its rise in March and currently stands at 34% versus 20% in the previous month. The aggregate probability of a future high-risk state on developed markets can therefore currently be regarded as moderate. The risk indicator analyses the current environment and shows whether the future risk is high or low. It does this by comparing short-term yields with long-term yields. As in the previous month, the rise in the risk indicator is almost exclusively due to the increase in risk on the bond markets. The risk probability for this asset class climbed from 44% at the start of March to currently 90%. According to the risk indicator, the global bond markets are therefore in a high-risk state. This is mainly on account of the higher long-term interest rates in North America and, relatedly, the steeper yield curve. The more widespread uncertainty is due to the fact that market participants are sounding out the prospects for growth and inflation that could arise from the global fiscal and monetary policy stimuli to curb the pandemic. The risk estimates for equities and currencies are virtually unchanged at 5% and 9%.

The risk indicator is also higher for the emerging markets, though this increase from 7% to currently 13% is less than for the developed markets. The increase is mainly due to the currency markets, whose probability for a future high-risk state rose from 4% to 21%. The risk indicator for the bond markets is also higher at currently 9%. By contrast, the figure for the equity markets fell by 1% to presently 10%.

Chart 4: Risk indicator higher, but still green



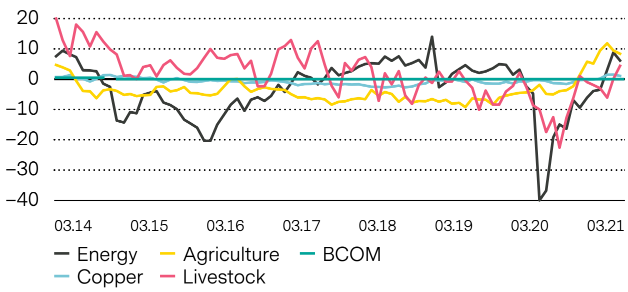
The chart shows the aggregated probability of a future high risk state in developed markets in the near future (black line). The aggregated probability is given as the average of the three individual probabilities for the market segments of equity, fixed income and currencies. Interesting values are depicted with green and red circles. Green marks a calm market environment and red a turbulent one. The uninformed assessment of the future market environment is plotted at 50% (horizontal black line). An aggregate indicator of the historical market trends in the three segments is shown in the background (light gray line). Information as of April 6, 2021. Source: Vescore

Current topic

Commodities to hedge against inflation

Commodities: strongest asset class in first quarter
In the first quarter of 2021, the commodity markets continued their positive performance from the second half of 2020: With 6.9 % and 6.1 % respectively, as measured by the BCOM and the BCOM ex AL, commodities – alongside equities – have been the strongest asset class since the year began, and across the board as well: With the exception of precious metals, all sectors made a positive contribution, from agriculture and industrial metals to energy and livestock. And the positive yields for commodities investors are not just thanks to price increases, but also to strong roll yields – a sign of an underserved market. The roll yields for most sectors are in the black. The last time that the aggregate roll yields for energy, agriculture, livestock and copper were all in positive territory was 2014.

Chart 5: Aggregate roll yields
Roll yields p.a. in %



Source: Vontobel, Bloomberg

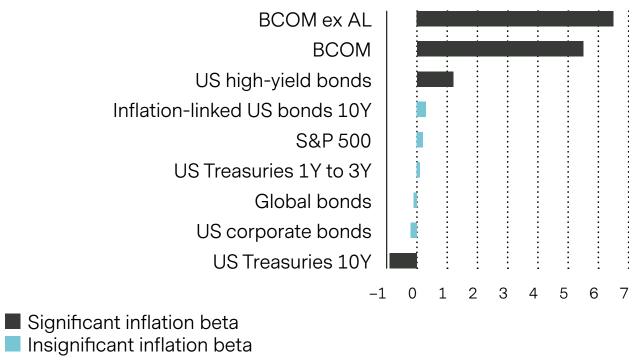
Expensive commodities fan inflation worries
Since inflation expectations have risen from last year's lows to 2.35 %, inflation fears have slowly crept back into investors' minds. The absolutely massive relief packages are generating strong demand for energy commodities and metals. The rapid rise in commodity prices also has a hand in higher inflation expectations, as higher input costs make most goods more expensive.

Chart 6: Inflation and commodities prices
In %

Source: Vontobel, Bloomberg

This means that commodities are at the heart of the reflation issue currently on everyone's lips. Commodities are the best hedge against inflation as they represent key elements of household shopping baskets and thus components of consumer prices.

Chart 7: Inflation beta



The inflation beta is the coefficient of the following regression (based on quarterly figures): US inflation rates = α + β * asset class yields. Data: January 1991 to June 2019. Source: Vontobel, Bloomberg

Glossary

GLOCAP

Global Conditional Asset Pricing (GLOCAP) is Vescore's proprietary equity allocation model. Active divergences from the neutral position (50 % cash, 50 % equities) are entered into on the basis of an assessment of the economic environment. The long-term economic expectations (term spread), the stability of the financial system, and the liquidity preferences (TED spread), market participants' trust in corporations (credit spread), and the fundamental stock valuation (dividend yield) are evaluated and quantified. The sum of the contributions of these indicators reflects the active equity over- or underweighting. The indicator for long-term business expectations is the difference between long-term and short-term interest rates of the major industrialized countries. The TED spread is the difference between interest rates for USD, JPY, and EUR investments on the euro money market and the associated government bond of the same maturity. The indicator for confidence in corporates is the spread of corporate bonds with low ratings versus top-rated securities. The global dividend yield measures the aggregated ratio of dividend to price on the equity markets and reveals the fundamental valuation on the equity market.

FINCA

The Fixed Income Allocator (FINCA) is Vescore's proprietary bond allocation model. The bond allocation is based on the FINCA multi-model approach, which is used as a tool for forecasting changes in the world's most important yield curves of government bonds and swaps. Short-term forecast models (carry, mean reversion, and momentum) are analyzed for each currency. The resulting allocation is then adjusted to economic conditions. Carry models optimally gear the portfolio dynamically to the expected carry in the respective currency. The carry results from the daily shortening of the term of a bond in combination with an interest rate change, assuming a constant or only slightly changing yield curve. Mean reversion models are aligned to the convergence of interest rates toward a long-term equilibrium. This convergence can be rationalized on the basis of the economic cycle or central banks' countercyclical setting of interest rates. Momentum models follow trends and in particular exploit quick changes in interest rates after political decisions or central bank announcements.

Risk indicator

Vescore's proprietary Risk Indicator works in conjunction with our equity and bond allocation models GLOCAP and FINCA, and acts as a "second referee" to recognize quickly whether capital markets are in risk-on or risk-off mode. The Risk Indicator works based on non-predictive information and uses the stability of the co-variance matrices for three asset classes: equities, bonds, and currencies. Up to 20 different developed markets are included for each asset class. Comparing the short- and long-term covariance, the Risk Indicator classifies markets as "low risk" or "high risk" and thereby identifies changes of the market regime. The Risk Indicator responds fast to changes in international financial markets while simultaneously showing high persistence. An uninformed, non-predictive assessment of the future market environment reflects a probability of 50 %. When the Risk Indicator anticipates a low-risk, low-volatility environment (value < 50 %), it increases portfolio exposure to equity and bond strategies, whereas the Risk Indicator reduces such exposure if it anticipates a high-risk, high-volatility environment (> 50 %). The Risk Indicator's active response should protect investors particularly in periods of market stress by limiting drawdowns.

Vescore takes a quantitative investment approach based on financial market research with the aim of achieving an attractive risk-adjusted performance in the long term.

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