vescore
by Vontobel Asset Management

vescore

Global Market Outlook

February 2020

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At a glance

- Slight increase in equity allocation
- Neutral duration positioning
- Risk indicator rises slightly
- Minimum volatility equities in Switzerland more attractive

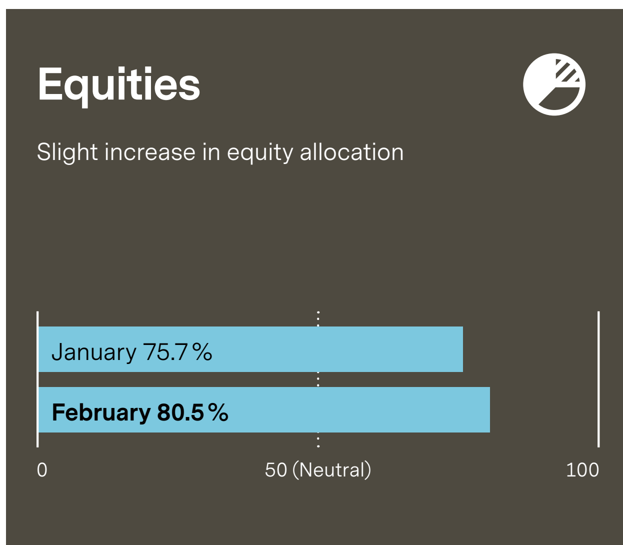
Fears of virus outbreak increase risk aversion

After a good start to the year on global capital markets, market participants' risk aversion picked up noticeably in January. The environment for risk-bearing investments is currently marked by concerns of the repercussions of an outbreak of a new virus in China.

Equity markets saw considerable gains at the start of January, shored up primarily by the trade deal agreed by the US and China. Nonetheless, escalation in the Middle East conflict created uncertainty after just a few days. Iran's shooting down of a Ukrainian passenger airplane, supposedly accidentally, also increased investor uncertainty until Trump's surprisingly restrained response, where he called for collaboration with the Iranian leadership, instilled confidence in markets.

However, a new element of uncertainty emerged in the second half of the month in the form of the coronavirus, undoing the tentative restoration of calm. Uncertainty on markets grew visibly after the World Health Organization (WHO) declared an international global health emergency in light of the sharp increase in the number of cases and many countries took their own measures to protect the public.

The outbreak of the virus in China and the global spread of the still largely unexplored pathogen are currently shaping sentiment. Going forward, future trade relations between the European Union and the UK, which left the EU on January 31, also need to be worked out.



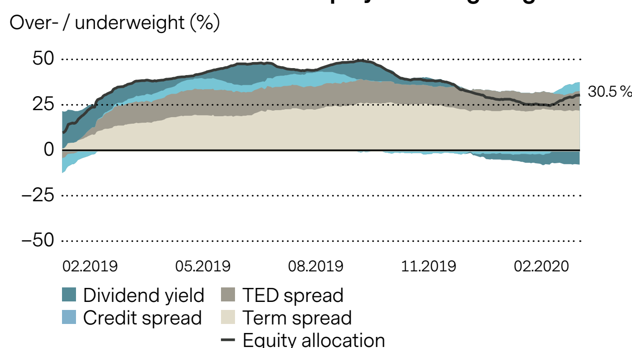
At the beginning of February, the equity overweighting in the global GLOCAP sample portfolio (50 % equities, 50 % cash) was 30.5 %. The decline in the equities ratio reached its temporary all-time low at the start of January. Equity allocation has since risen by around 5 percentage points. As in previous months, the two macroeconomic variables of the TED spread and the term spread remain the driving factors behind equity overweighting. The dividend yield is subduing the ratio slightly, while the credit spread moves from negative to positive. Accordingly, the contributions of the model variables remain constant, with the exception of the now positive contribution of the credit spread (due to lower credit risk premiums) and the more negative contribution of dividend yields (due to lower dividend yields).

2020 initially began as 2019 had finished, with some new record levels achieved on the equities markets. As there had not been any unwelcome surprises in the reporting season so far, the general sentiment remained positive until the spread of a new coronavirus in China unsettled equities markets.

The impact of the virus on global trade and global growth is still unclear but the MSCI World Index relinquished its initial gains, closing January at –0.5 %.

Chart 1: Stabilization of the equity overweighting

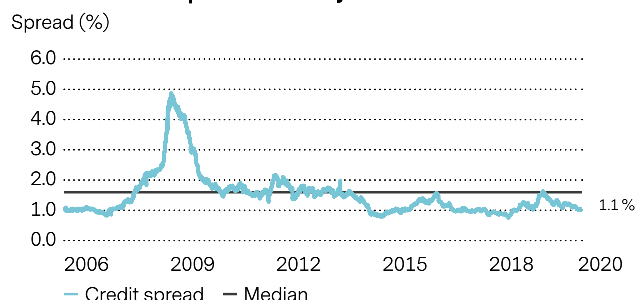
Over- / underweight (%)



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 February 3 2020.

Chart 2: Credit spread at a very low level

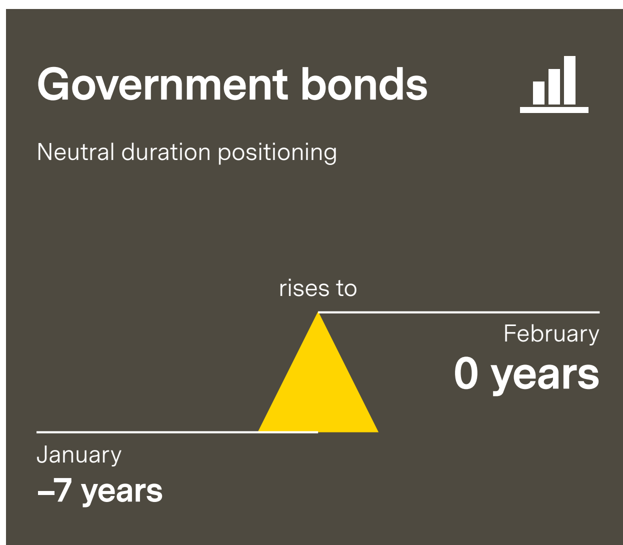
Spread (%)



The chart shows the indicator for confidence in corporates that measures market participants' prevailing confidence in the financial stability of corporations. It is given by the spread of BBB-rated European and US corporate bonds versus top-rated securities. The chart shows a weighted average of the indicators for confidence in corporates (blue line) and the average of this instrumental variable (black line). Information as of February 3 2020.

	FEBRUARY 2	JANUARY 2
Equity overweighting	**30.5 %**	**25.7 %**
Contribution of the term spread	22.2 %	22.4 %
Contribution of the TED spread	10.7 %	9.6 %
Contribution of the credit spread	4.9 %	–1.5 %
Contribution of dividend yield	–7.0 %	–4.7 %

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



The allocation ratio of a global bond portfolio is performing very strongly compared with the previous month and amounted to +3% at the start of February, representing a duration of 0 years. The position in global government bonds held in the portfolio comprises the contributions of the individual carry, mean reversion, and momentum models.

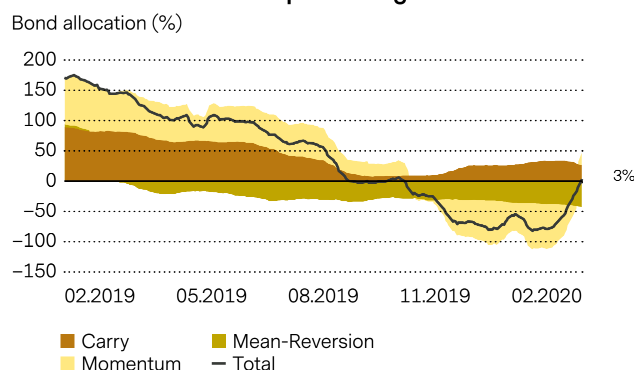
The rise in the bond allocation in January is attributable exclusively to the momentum sub-model, which increased its contribution from –76% to 21% in wake of higher investor risk aversion and the lower interest rates that this entails. The rally on the bond markets also flattened out the global yield curves and so the carry model now contributes 26% to bond allocation, 6 percentage points fewer than in the previous month. This means that only the mean reversion component had a negative effect at the start of February at –44%.

Uncertainty caused by new virus props up safe investments

January was shaped by increasing concerns about the spread of the new coronavirus 2019-nCoV. These fears produced sharp price gains on global bond markets, with 10-year interest on German and US government bonds falling by 0.25% and 0.41% respectively in the reporting month.

Chart 3: Neutral duration positioning

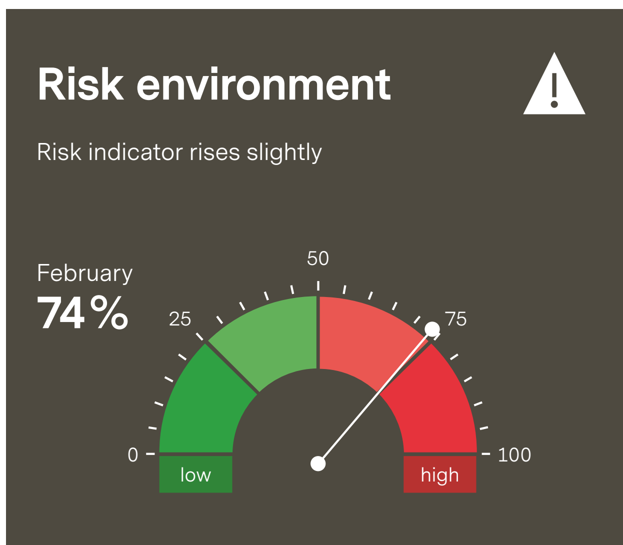
Bond allocation (%)



The chart shows the bond allocation of a global 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 February 3 2020.

	TOTAL	CARRY	MEAN REVERSION	MOMENTUM
Global	3%	26%	–44%	21%
Germany	2%	6%	–7%	3%
France	5%	10%	–8%	3%
Italy	5%	5%	–3%	3%
Great Britain	–2%	0%	–5%	3%
Switzerland	0%	3%	–7%	4%
US	–1%	0%	–4%	3%
Canada	1%	0%	–1%	2%
Japan	–7%	2%	–9%	0%

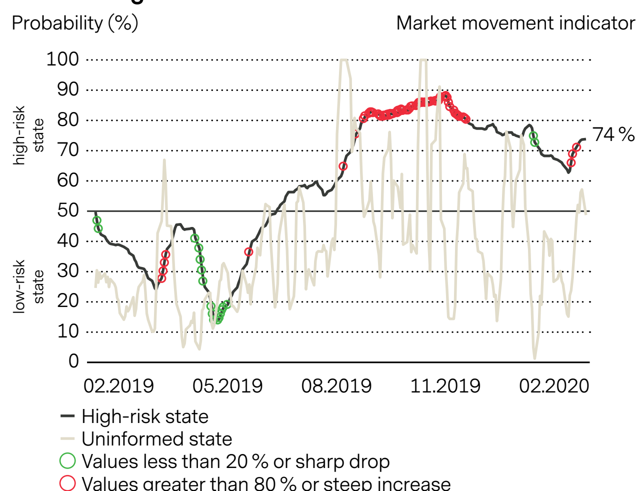
The table shows the bond allocation of a global portfolio in euros (total) broken down into individual countries. It also lists the contribution of the short-term forecast models carry, mean reversion and momentum to the total bond allocation. Information as of February 3 2020.



The aggregate probability of a future high-risk state rose again in January (up 5 percentage points), remaining at an elevated level of 74%. The risk assessment for equity markets saw the most substantial increase (up 26 percentage points) and is now back at 99%. Assessments of bond markets rose by 4 percentage points against the previous month to 82%, while the probability for currencies declined by 15 percentage points to 41%.

The risk assessment for emerging markets also climbed once again in comparison to the previous month, again putting it above the 50% mark at 68%. At 99% and 91% respectively, the assessments for equity and bond markets are considerably higher than in the previous month. By contrast, although the assessment for the currency markets increased against the previous month, it remains low at 14%.

Chart 4: Slight increase in the risk indicator



The chart shows the development of the probability of a high-risk market environment in the industrialized countries in the near future (black line). The aggregated probability is calculated in three market segments: equities, bonds, and currencies in industrialized countries. Specific characteristics are indicated by green or red circles. Green indicates a calm and red an unsettled market environment. The uninformed assessment of the future market environment is shown at 50% (thick gray line). An aggregated indicator of the historical market movements in the three segments is shown in the background (beige line). Information as of February 3 2020.

Current topic

Minimum volatility equities in Switzerland more attractive

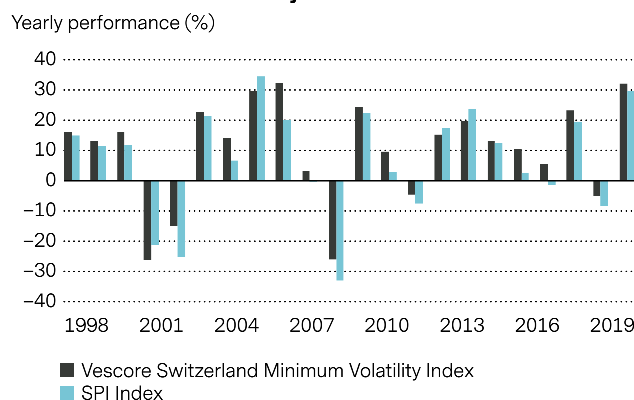
Positive price trend for minimum volatility portfolio
According to models for the dynamic weighting of the Swiss factor portfolio, minimum volatility equities, i.e. equities that experience minor price fluctuations, are once again becoming more attractive. The weighting of the minimum volatility factor portfolio rose by 15 percentage points in the last two months to over 20%. This upturn is a result primarily of the economic environment and the fact that minimum volatility equities are attractive in the short-term, but it also reflects the factor portfolio's medium-term price trend.

In fact, the minimum volatility portfolio performed well again recently. The Vescore Switzerland Minimum Volatility Index performed significantly better than the Swiss equities markets in January, when the market was somewhat more volatile due to worries about the coronavirus (1.3% vs. SPI Index 0.2%). It is not unusual for minimum volatility equities to outperform in uncertain market phases. At the time of the financial crisis in 2008, for example, the Vescore Switzerland Minimum Volatility Index outperformed by around 7% against the SPI Index.

The main reason minimum volatility portfolios tend to outperform in uncertain market phases is the high allocation in defensive sectors such as the consumer staples, health and utilities sectors. Among Swiss equities, for example, it is not uncommon to see a high weighting of the three large caps Nestlé, Roche and Novartis, as well as the telecommunications and IT company Swisscom. We currently see a high positioning in the real estate and financial sector in particular, from which the Vescore Switzerland Minimum Volatility Index benefited recently.

Chart 5: Minimum volatility more stable in bear markets

Yearly performance (%)



The chart shows the annual performance of the Vescore Switzerland Minimum Volatility Index and the SPI Index since December 31, 1997. It is an official back calculation of the index back to the launch on December 31, 2013. Information as of December 31, 2019.

The simulated performance up to December 31, 2013 is for illustration only. It does not reflect past performance and is not a reliable indicator of current or future performance.

	1 YEAR	3 YEARS	5 YEARS	10 YEARS	SINCE LAUNCH
Vescore Switzerland Minimum Volatility Index	25.7%	16.1%	13.8%	11.6%	8.9%
SPI Index	22.4%	12.4%	9.3%	8.7%	5.6%

	JAN. 31, 2019 – JAN. 31, 2020	JAN. 31, 2018 – JAN. 31, 2019	JAN. 31, 2017 – JAN. 31, 2018	JAN. 31, 2016 – JAN. 31, 2017	JAN. 31, 2015 – JAN. 31, 2016
Vescore Switzerland Minimum Volatility Index	25.7%	0.7%	23.5%	8.7%	12.2%
SPI Index	22.4%	–2.1%	18.5%	5.3%	4.2%

The tables show the annualized yields of the Vescore Switzerland Minimum Volatility Index and the SPI Index since December 31, 1997. It is an official back calculation of the index back to the launch on December 31, 2013. Information as of February 3, 2020.

Glossary

GLOCAP

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 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 protects investors particularly in periods of market stress by limiting drawdowns.

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