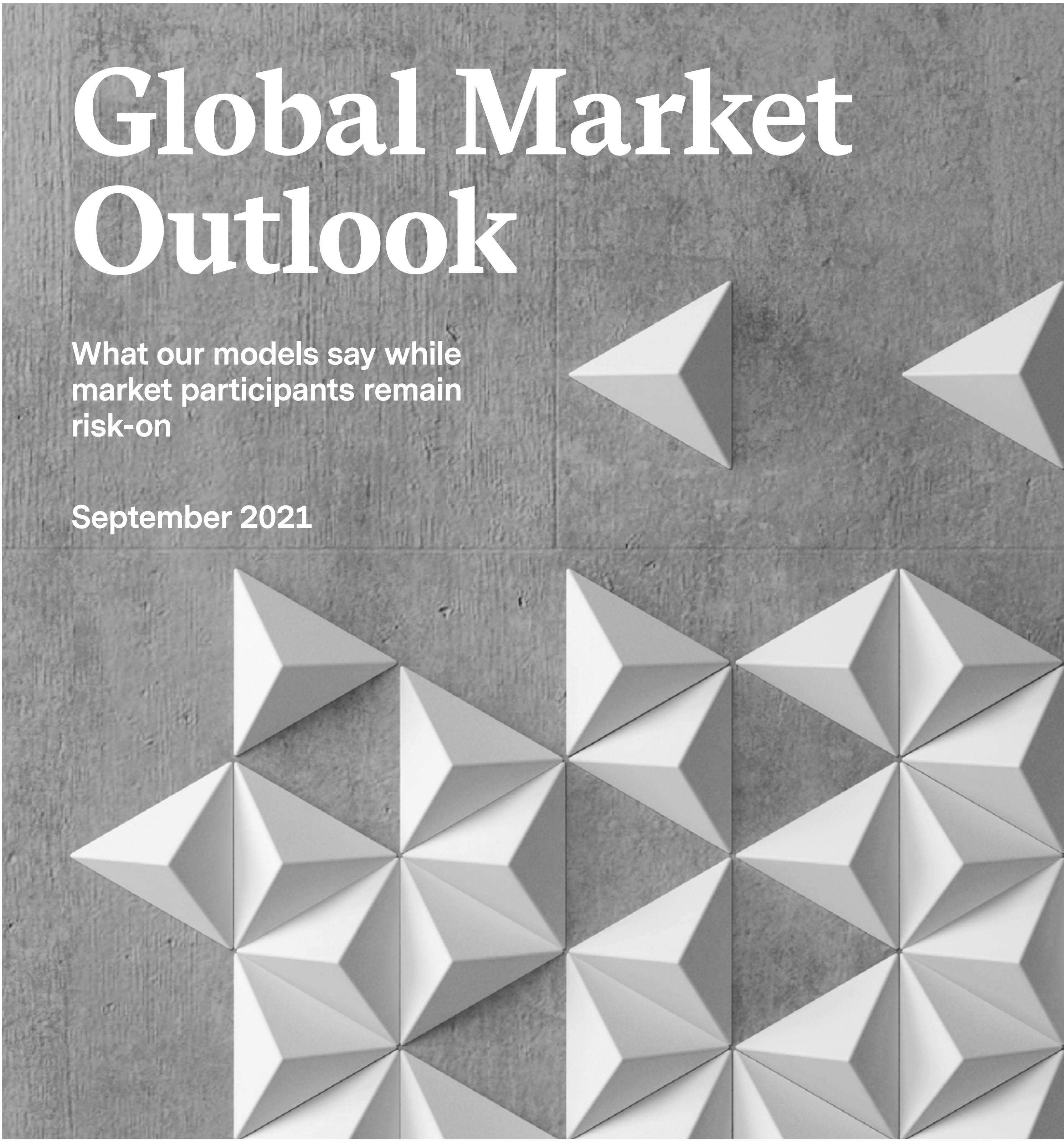
vescore
by Vontobel Asset Management

Global Market Outlook

What our models say while market participants remain risk-on

September 2021



Asset Management

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High risk appetite among market participants

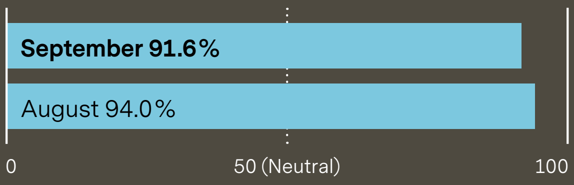
Sentiment on the capital markets is currently characterized by stable risk appetite among market participants. Although some of the economic data is lagging behind expectations, particularly strong corporate data and the consistently loose monetary policy are resulting in new highs on the global equity markets.

While economic data have recently been mostly positive, the momentum of the economic recovery is now easing off somewhat. For example, US gross domestic product in the second quarter slightly underperformed what the consensus had hoped for: it still climbed by a robust 6.5%, but market expectations had been even higher at 8.5%. Reasons for the slowdown of recovery include delivery problems and supply shortages for primary products and personnel shortages in some sectors. This partly explains the consistently high inflation rates as well. By contrast, corporate data tell a different story: The fiscal and monetary policy measures by governments and central banks were reflected in a fulminant reporting season. In particular, the recovery of corporate profits fostered positive investment sentiment. It is also benefiting from the consistently loose monetary policy of central banks. At the central bankers' annual Jackson Hole meeting, US Fed Chairman Jerome Powell hinted at the tapering of bond purchases before the end of the current year, but also cited the fresh surge in coronavirus risks. As expected, his comments on the financial markets were guarded. Moreover, he again reiterated that the significant rise in inflation would be just a temporary phenomenon.

With the reporting season now largely wrapped up, market participants are again shifting their attention to the economic data and the response by central banks. The situation in Afghanistan also means incipient geopolitical risks. And last but not least, there is a political crossroads ahead in Germany with its parliamentary elections due in September.

Equities

Slight reduction in overweighting

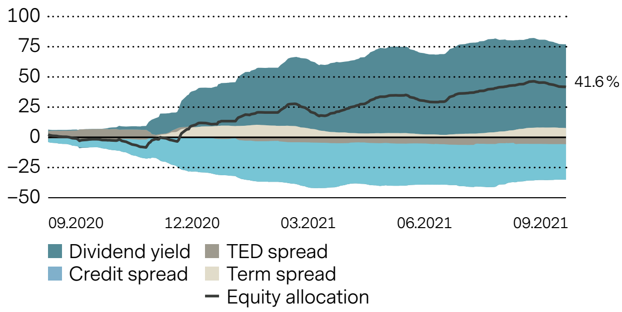


At the start of September, the equity overweighting in the global GLOCAP sample portfolio (50% equities, 50% cash) stands at 41.6%, slightly lower than in the previous month. The decline in equity allocation is primarily due to the lower dividend yield contribution – this variable reflects the fundamental valuation. Secondly, there was also the effect of the higher negative TED spread contribution – this variable reflects liquidity preferences. A stronger decline in the equity allocation as a whole was counteracted by the more positive term spread contribution, and above all the weaker negative credit spread contribution. This variable measures market participants' confidence in corporates based on refinancing conditions in the US and Europe. The credit spread is still reading at a historically low level, and the sensitivity of this instrumental variable is still positive according to GLOCAP. A low value therefore reduces allocation. Given this mechanism, in the model, the recently seen credit spread rise has the effect of weakening the negative contribution of this instrumental variable.

Overall, the equity markets were up for the seventh month in a row. Market participants have recently interpreted comments by US Fed Chairman Jerome Powell as meaning that the cycle of raising interest rates would begin later than previously expected. This calmed the trend in long-term interest rates and the associated drop in interest rates supported the equity markets.

Chart 1: Decline in equity allocation

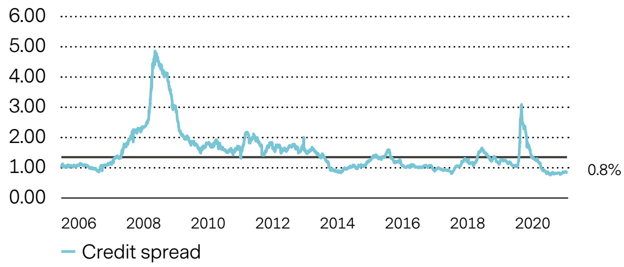
Over-/underweighting (%)



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 September 2, 2021. Source: Vontobel Asset Management

Chart 2: Credit spread sensitivity positive

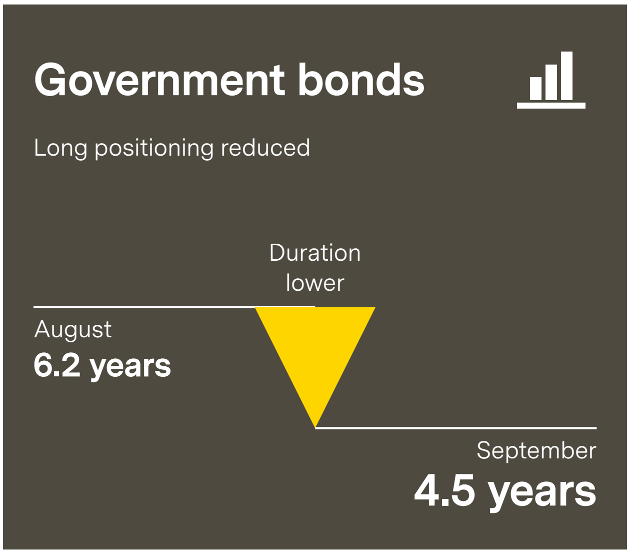
In %



The chart shows the credit spread, which reflects market participants' prevailing trust in the financial stability of corporations. It is calculated by the spread of BBB-rated European and US corporate bonds versus their top-rated counterparts. The chart shows a weighted average (blue line) and the average of this instrumental variable (horizontal black line). Information as of September2, 2021. Source: Vontobel Asset Management

	SEPTEMBER 2	AUGUST 2
Equity overweighting	**41.6%**	**44.0%**
Contribution of the term spread	7.4%	6.9%
Contribution of the TED spread	–5.9%	–5.6%
Contribution of the credit spread	–29.5%	–31.1%
Contribution of dividend yield	69.6%	73.8%

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

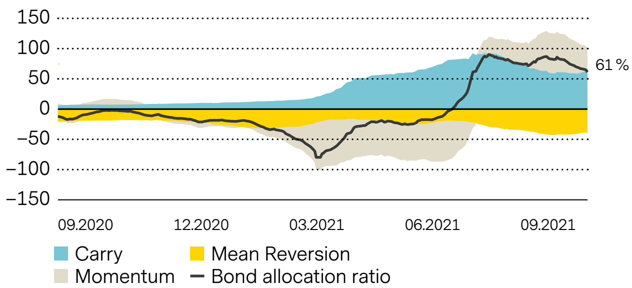


At the start of September, the allocation ratio of a global bond portfolio, which comprises the contributions of the three sub-models carry, mean reversion and momentum, stands at 61 % after 86 % in the previous month. This means a duration of 4.5 years. The main reason for the decline in bond allocation is the momentum model, the positive contribution of which decreased by 27 percentage points to currently 38% as the positive momentum of June and July slowed in August. The contributions of the other two model components changed only minimally: that of the carry model was down by 1 percentage point at 62 % while that of the mean reversion model increased by –2 percentage points to –39 %.

The summer's interest rate decline on global government bonds has been stopped in its tracks for now. Compared to the previous month, the interest rate on 10-year US government bonds rose by around 10 basis points, while that for their German counterparts climbed by 8 basis points. Overall, interest rates were relatively stable in August. This was helped by central bankers' statements coming from this year's annual Jackson Hole conference, which did not contain any major surprises for investors. US Fed Chairman Jerome Powell has so far been able to disarm market participants' fears of excessive inflation, which could lead to a rapid rise in interest rates. At the same time, the Fed is making visible efforts to prepare for an early and cautious tapering of bond purchases in order to avoid an unexpectedly harsh market response (taper tantrum) such as was witnessed after the global financial crisis in 2013. Given the latest statements, it can be assumed that bond purchases could be scaled back before the end of this year. However, the US Fed is deliberately pushing its first interest rate hike further down the line to maintain its support for the recovery on the labor market.

Chart 3: Momentum signal noticeably weaker

Bond allocation (%)



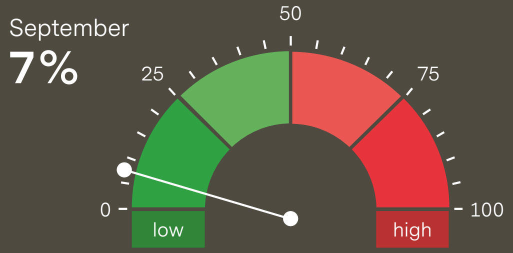
The chart shows the government bond allocation of a global bond portfolio in euros. The model allocation is calculated on the basis of the short-term forecast models carry, mean reversion and momentum. Information as of September 2, 2021.
Source: Vontobel Asset Management

BOND ALLOCATION	TOTAL	CARRY CONTRIBUTION	MEAN REVERSION CONTRIBUTION	MOMENTUM CONTRIBUTION
Global	**61 %**	**62 %**	**39 %**	**38 %**
Germany	-8 %	-2 %	-11 %	0 %
France	5 %	9 %	-8 %	3 %
Italy	10 %	12 %	-11 %	9 %
Great Britain	3 %	4 %	-3 %	2 %
US	18 %	11 %	0 %	8 %
Canada	8 %	5 %	-3 %	6 %
Australia	6 %	4 %	-2 %	5 %
Japan	18 %	15 %	-3 %	6 %

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 September 2, 2021. Source: Vontobel Asset Management

Risk environment

Risk indicator significantly lower

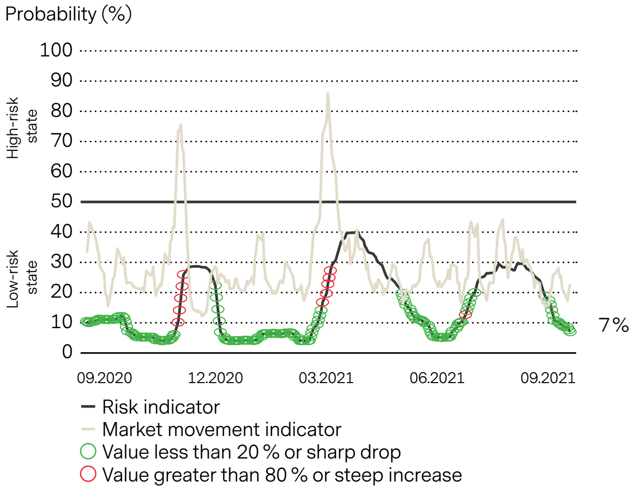


The risk indicator analyses the current environment and shows whether the future risk should be considered high or low. It does this by comparing short-term and long-term market yields. In September, it stands at 7%, a palpable reduction of 20% as against the previous month. The aggregate probability of a future high-risk state on developed markets can therefore be considered low. All three market segments are contributing to the decline, bonds most of all. While the probabilities for a high-risk state for equities and currencies declined slightly to 3% and 2% over the month, the probability for bonds is still the highest of the three segments at 16% at the start of September, even though it was down by 40 percentage points as against the previous month.

The easing on the bond markets is due to the lower interest rate momentum in August. Global interest rates for 10-year government bonds ended August without any major changes. This is partially on account of the US Fed maintaining its wait-and-see approach for the forthcoming reduction of bond purchases. There is still no real timetable for this tapering.

The risk indicator for emerging markets declined minimally by 1 percentage point in August to 2%. At the start of September, the probabilities for a high-risk state for all three market segments are at the lower end of the scale: 3% for emerging market equities and 2% for emerging market bonds and currencies alike.

Chart 4: Risk indicator significantly lower



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 equities, 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 September 2, 2021.
Source: Vontobel Asset Management

Current topic

Industrial metals: Demand rising while supply limited

Better outlook for metal demand
Both last year and in the first quarter of the current year, demand for industrial metals received a big boost from the reopening after the coronavirus crisis and the ultra-loose monetary and very generous fiscal policy. After a consolidation phase and a slight correction in prices in the last three months, the fundamental data are now improving again significantly for most industrial metals, such as copper, aluminum, nickel and tin. This also seems to have a positive impact on the current demand situation. Because:

- Many operations have depleted their metal stocks and now have to return to the physical market.
- Many market participants assume that China will end its more restrictive fiscal and monetary policy to give its economy (construction, infrastructure) significantly more support again in the coming months.

Extremely tense supply situation
Demand for metals is therefore set to improve again slightly. However, the supply situation for metals is currently tense on account of the following factors that are likely to fuel price increases:

- The outbreak of the coronavirus Delta variant has meant a massive disruption to logistics and processing chains in China – the most important producer and consumer of metals – in some cases bringing them to a complete standstill. Given its zero-Covid strategy, China temporarily closed an entire terminal of the third-largest container port in the world in Ningbo near Shanghai after a dockworker became infected. This is delaying metal imports.
- The tense coronavirus situation in other Southeast Asian countries, such as Myanmar or Indonesia, is disrupting the goods flow of recycled material. Recycled metal is important: Aluminum, for example, accounts for almost 30 % of the total metal supply.
- Since July already, smelting and refining plants and mines in China have been struggling with major shortages in the power supply. The flooding caused by typhoons is limiting the power supply in key regions, such as Hainan or Hubei, for longer than expected. Other parts of China have suffered from such severe drought this year that hydropower became a scarce commodity and coal prices soared. More and more regions are reporting restrictions at power-hungry metal smelting plants. Planned smelting capacity in the southwest of China could also be delayed due to power shortages.
- Since last year, China has been working intensively to meet its climate targets and reduce its emissions. As most of the country's emissions come from smelting plants, regions that exceed limits are repeatedly being called on to curb their production.

Price surges for industrial metals
Owing to the tense supply situation and improving demand, prices in the industrial metals sector are likely to pick up soon. Hence, the futures curves for most metals are currently in backwardation, with aluminum, copper and lead seeing significantly improved roll yields. Therefore, they are currently preferred by our systematically diversified commodity strategy (excluding agricultural goods and livestock). In our discretionary mandates, we also currently prefer the industrial metals sector to precious metals and energy.

Glossary

GLOCAP

Global Conditional Asset Pricing (GLOCAP) is our 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 our 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

Our proprietary Risk Indicator acts in conjunction with our equity and bond allocation models GLOCAP and FINCA 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 (value > 50 %). The Risk Indicator's active response should protect investors particularly in periods of market stress by limiting drawdowns.

Using the models and indicators described above we pursue 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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