vescore
by Vontobel Asset Management

Global Market Outlook

May 2020

Asset Management

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At a glance

- Reduction of equity overweighting
- Negative duration positioning
- Risk indicator still elevated
- Price of oil falls to historic lows

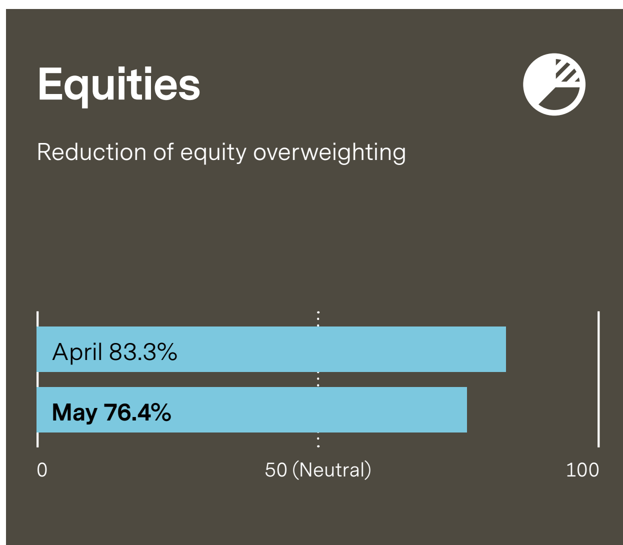
Caught between confidence and fear

At the start of May, sentiment on the capital markets was still defined by the COVID-19 pandemic and its global impact on society and the economy. In recent weeks, market events have been caught between confidence – based on monetary and fiscal policy measures – and the fear of a uncontrolled spread of the virus and enormous, ongoing economic slumps.

The capital markets seemed to have overcome the initial shock of the pandemic and its repercussions in April. Thus, the easing seen on the stock markets is primarily due to a slowdown in the spread of infection in some of the hard-hit regions of Europe. This can be taken as an indication that the measures taken to protect against infection are having an effect, and that – contrary to initial fears – many countries are not yet or no longer being pushed to the limit. Against this backdrop, some of the restrictions on day-to-day life and business have been lifted again. Initial good news on the development of a vaccine and medication provided further grounds for cautious optimism. Market participants' waning risk aversion took another shot in the arm from the immense monetary and fiscal policy support provided by central banks and governments.

On the other hand, the very weak economic data tell an unsettling story about the economic repercussions of the pandemic. Unemployment rose massively in the US, while retail and industrial production reported dramatic slumps. For instance, the Empire State Manufacturing Index fell to an all-time low of –78.2 and US industrial production experienced its worst decline since 1946. Things are much the same in Europe: The deterioration of the ifo index was worse than originally forecasted in April, and purchasing managers' indices likewise fell to new lows. The ongoing turbulence also rocked sentiment on the commodities market. The price of oil has fallen to a historic low.

Looking ahead, the ongoing development of all aspects of the COVID-19 pandemic is continuing to define investors' risk appetite. While market participants have probably processed the "initial shock" by now, uncertainty is still high in all market segments – and is likely to remain so for the time being.



At the beginning of May, the equity overweighting in the global GLOCAP sample portfolio (50% equities, 50% cash) was 26.4%, much lower than one month before.

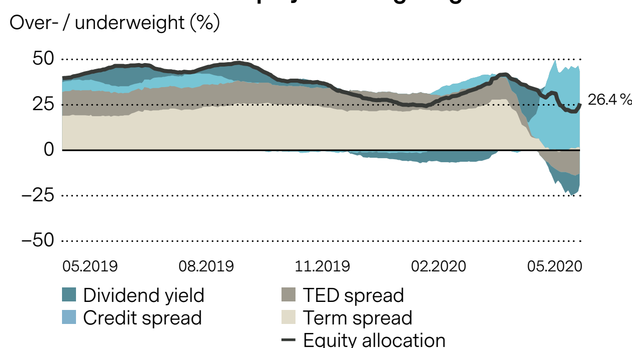
The reduction in equity allocation is due in particular to the lower dividend yield following the market recovery and uncertainty in the financial system, as measured by the TED spread. The fact that even now GLOCAP considers the fundamental economic market environment to be positive for risk-bearing investments is primarily because of the confidence in companies, as measured by the credit spread.

This relationship – which seems counterintuitive at first glance – was already emerging at the end of March: While credit risk premiums rose tangibly in both the US and Europe, they are a positive driving force for equity allocation in the model. This is because central banks are effectively taking the risk out of companies' hands, which is reflected by the credit risk spread in a model context.

After risk aversion surged in March and declined again in April, the current allocation reflects the tactical assessment that overweighting equities is still attractive. This is based on market participants' confidence that, with the help of fiscal policy support and central banks, companies are robust overall.

Chart 1: Decrease in equity overweighting

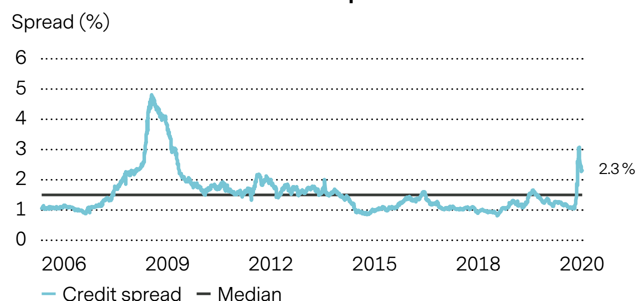
Over- / underweight (%)



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 May 1, 2020

Chart 2: Increase in the credit spread

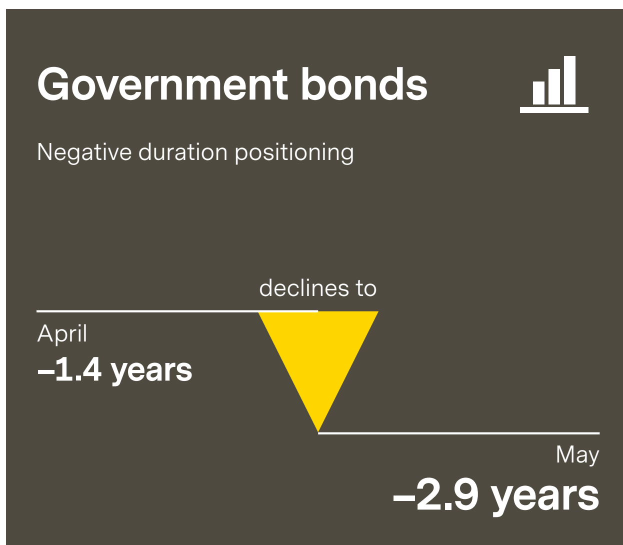
Spread (%)



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 May 1, 2020

	MAY 1	APRIL 1
Equity overweighting	**26.4%**	**33.3%**
Contribution of the term spread	1.5%	6.5%
Contribution of the TED spread	–12.5%	–1.6%
Contribution of the credit spread	41.8%	19.6%
Contribution of dividend yield	–4.3%	8.8%

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

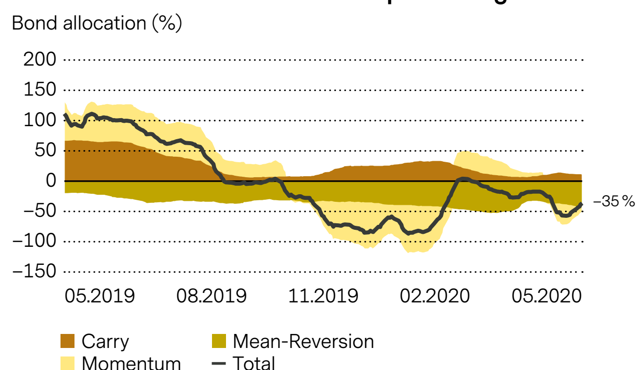


The allocation ratio of a global bond portfolio is down as against the previous month and was –35 % at the start of May, representing a duration of –2.9 years. The position in global government bonds held in the portfolio comprises the contributions of the individual carry, mean reversion, and momentum models. The drop in the bond ratio is due to the decline in the mean-reversion sub-model, from –31 % to –40 %, and in the momentum component, from 6 % to –6 %. Meanwhile, the carry sub-model rose slightly from 10 % to 12 % in the reporting month. This is above all due to the somewhat steeper yield curves as against the previous month.

Despite the clear recovery of the global equity markets and the improved risk-on sentiment among market participants, the prices of global government bonds continued to rise in April. Accordingly, the 10-year interest rates on German and US government bonds fell by 0.10 % and 0.14 % respectively in the reporting month. This is supported on the demand side by the fact that the central banks are delivering liquidity on a massive scale with extensive bond purchase programs. For example, the US Fed bought more than USD 900 billion of US government bonds to counter the economic effects of coronavirus last month; the ECB is also planning to step up the European PEPP (Pandemic Emergency Purchase Program) crisis program to at least EUR 750 billion by the end of the year.

Chart 3: Increase in short duration positioning

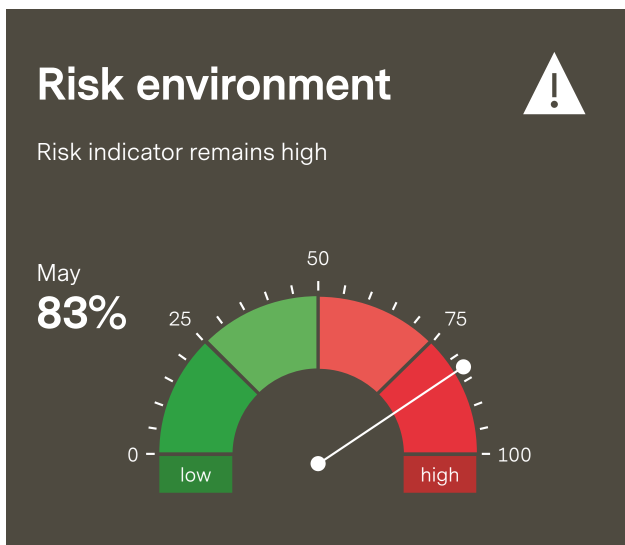
Bond allocation (%)



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 May 1, 2020

	TOTAL	CARRY	MEAN REVERSION	MOMENTUM
Global	-35%	12%	-40%	-6%
Germany	-4%	1%	-4%	0%
France	-5%	7%	-6%	-6%
Italy	-3%	2%	-1%	-3%
Great Britain	-4%	0%	-5%	1%
Switzerland	-8%	2%	-6%	-3%
US	3%	0%	-2%	4%
Canada	-4%	0%	-7%	3%
Japan	-11%	0%	-10%	-2%

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 May 1, 2020

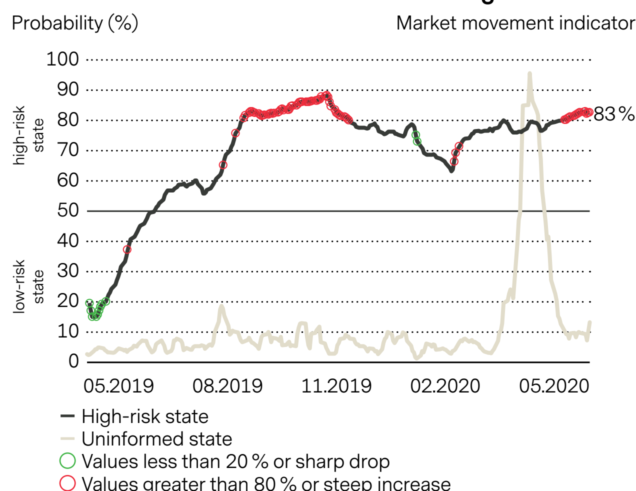


The risk indicator has been showing an elevated probability of a high-risk state since the end of January. The turbulence on which the non-predictive risk indicator is based had risen dramatically in March but diminished again as April progressed. This turbulence assesses the fluctuations on equity, bond and currency markets, measured by looking at the variance and covariance of individual investments and comparing current and past figures.

A rise in turbulence reflects a more "jittery" covariance matrix, thereby suggesting an increased probability of a high-risk state. This is currently true for all three market segments analyzed (equities, bonds and currencies), in industrial countries and emerging markets alike.

The aggregate probability of a future high-risk state is still high at the beginning of May (83 %). The risk indicator is therefore not reacting to the recovery that has dominated the equity markets especially in recent weeks. The risk indicator also puts the probability of a high-risk state in emerging markets at 84 %.

Chart 4: Risk indicator continues to show high-risk state



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 black line). An aggregated indicator of the historical market movements in the three segments is shown in the background (beige line). Information as of May 1, 2020

Current topic

Price of oil falls to historic lows

Historical decline in price of WTI oil in April
A historically unprecedented price development was witnessed on April 20: the price of the US crude oil benchmark, West Texas Intermediate (WTI), cratered to approximately USD –40 per barrel. However, this only affected the May 2020 contract, which ended the next day. Usually, investors roll their contracts into the next contract due shortly before they expire to prevent physical delivery. WTI crude oil has to be physically collected at the place of delivery: Cushing, Oklahoma. Refineries normally buy up investors' contracts when they are close to expiring so as to receive the actual delivery. But this time was different. Fearing that US crude oil stockpiles would soon reach their capacity limits, no one wanted to physically own crude oil anymore. As a result, an additional incentive had to be created to convince oil traders to accept the physical oil. At the same time, investors were prepared to pay a premium to get rid of the expiring contracts and stave off actual delivery.

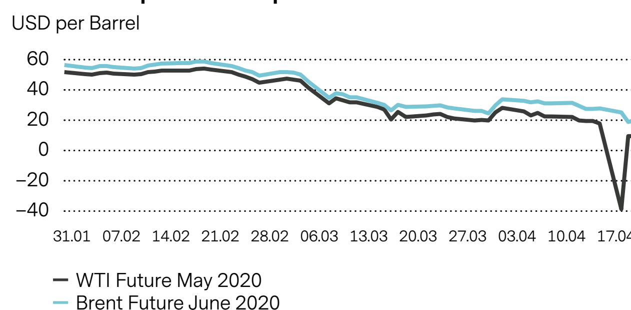
Opec+ agrees to curb production
All this happened even though, just one week before, Opec+ had agreed an equally historic production cutback of approximately 10 million barrels, also motivated by the prospect of storage capacity running out. However, the US did not agree to certain cutbacks. Unlike in the OPEC+ states, oil production in the US is mainly privately owned. Moreover, antitrust law makes it difficult to implement a joint curtailment of production. In the meantime, however, there are several indications that the low price of oil is having an effect and is increasingly compelling (shale) producers to cut production in the US.

Brent held up better
The Brent contract next due for delivery (June 2020) did not experience the same pressure as WTI, as it was not immediately on the brink of expiring (last trading day was April 30). In addition, the Brent contract is settled in cash when it matures, rather than being physically delivered. Moreover, it is easier to store Brent oil in tankers out at sea, as compared to land-locked Cushing, Oklahoma.

Which strategies benefit?
As the WTI forward curve took on an extreme contango form with massive volatility at the front end in April, some passive investors and large oil ETFs came under pressure. Strategies that invested in longer-term oil contracts fared better in this market environment as they were less volatile and had more attractive roll returns.

Optimism returning at the end of April
The growth in US stockpiles at the end of April was less drastic than had been anticipated, and the number of drill holes was down by half in the space of 1.5 months. The low price of oil is presumably causing production to halt more quickly than previously assumed. Together with the OPEC+ cutbacks that took effect at the beginning of May, this caused the price of WTI to rise by 50 % in the last two days of the month. The easing of the coronavirus restrictions is also contributing to rising demand for oil and currently propping up prices.

Chart 5: Oil price development
USD per Barrel



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 should protect investors particularly in periods of market stress by limiting drawdowns.

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Vontobel Asset Management AG
Gotthardstrasse 43
8022 Zurich
Switzerland
T +41 58 283 71 11

Vontobel Asset Management SA
Munich branch
Leopoldstrasse 8 – 10
80802 Munich
Germany
T +49 89 211 133 0

Vontobel Asset Management
Australia Pty Ltd.
Level 20, Tower 2, 201 Sussex St
NSW 2000 Sydney
Australia

vescore.com