vescore
by Vontobel Asset Management

Global Market Outlook

November 2019

- **Capital markets driven by trade talks**
- **Risk indicator remains high**
- **Reduction in equity overweighting**
- **Bond allocation slides below zero**
- **Commodities: rising roll yields**
- **Swiss equities: Value stocks less attractive**

Capital markets driven by trade talks

The market environment for risk-bearing investments remains positive, with hopes of a resolution in the trade conflict between the US and China prompting price gains on global equities markets despite the somewhat weaker global economic outlook.

The main factor behind the good developments seen on global equities markets in October was the prospect of a potential trade deal between the US and China. A tentative agreement helped significantly calm trade tensions between the two countries this month. In addition, the monetary policy decision made by the US Federal Reserve also shored up demand for risk-bearing investments. Responding to weaker economic data, the Fed lowered its key interest rate for the third time in a row by 0.25%, as expected. The ECB also confirmed that it will resume its bond purchases in November. Securities totaling around EUR 20 billion are to be purchased each month. At the same time, fundamental corporate development appears sound, with around 80% of S&P 500 listed companies exceeding their profit estimates in the current reporting season.

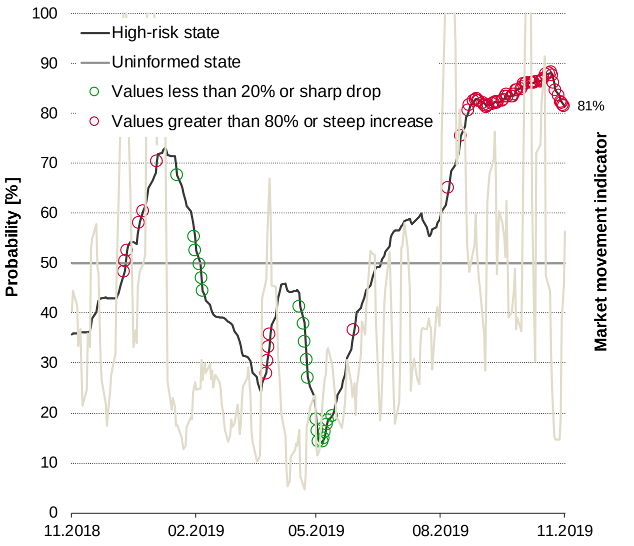
Going forward, investors will remain focused on negotiations between the US and China attempting to resolve the trade dispute. Despite the deadline being postponed to January 31, 2020, Brexit continues to represent a source of uncertainty for capital markets. It is unclear what path the new UK government will take after the upcoming elections on December 12.

Risk environment

Risk indicator remains high

The aggregate probability of a future high-risk state fell slightly in October (down 3 percentage points) but remains at a relatively high level of 81%. The decline is attributable to a downturn in risk assessments for bond and currency markets, which are currently put at 73% and 75% respectively. By contrast, the probability of a future high-risk state on the equity markets rose by one percentage point to 97%.

The risk assessment for emerging markets slid considerably in comparison to the previous month, falling to 64%. While the assessment of equity markets (93%) remained stable and the likelihood of a high-risk state on the bond markets (91%) declined slightly, the assessment of a future high-risk state in the currency markets in particular has now fallen to just 8% (previous month: 27%).



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 November 1, 2019

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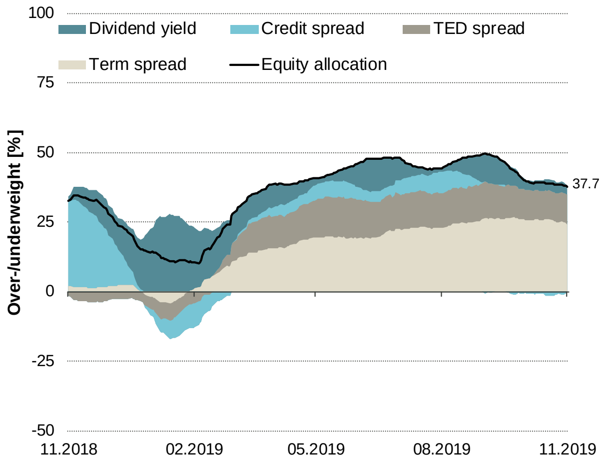
Equities

Reduction in equity overweighting

At the beginning of November, the equity overweighting in the global GLOCAP sample portfolio (50% equities, 50% cash) was 37.7%. Consequently, the equity allocation has been decreased by 2.2 percentage points since the start of October.

Since March this year, the foundation for equity overweighting has been built on the two macroeconomic variables of term spread and TED spread. The positive contribution of the term spread decreased to 24.2% over the course of the month, with the contribution of the TED spread remaining unchanged at 10.7%. The refinancing environment for companies, as measured by the credit spread, and price levels on equity markets, as measured by the dividend yield, indicate a more neutral equity position of -0.5% and 3.3% respectively.

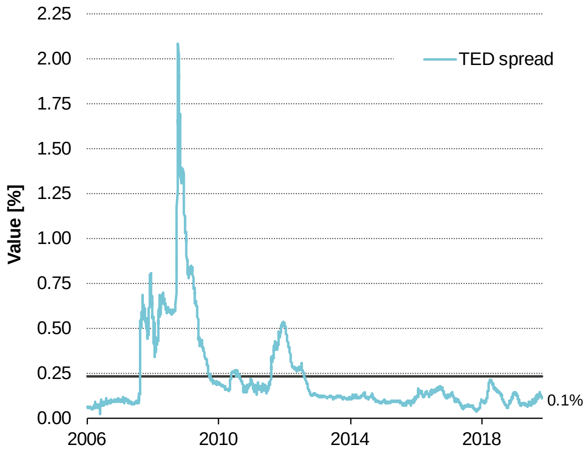


The chart shows the active equity weight (black line) of a global portfolio in euros with a neutral allocation of 50% equities and 50% cash. Foreign currencies are hedged. It also shows the contributions of the individual driving forces (term spread, TED spread, credit spread and dividend yield), which come together to give the active equity allocation. Information as of November 1, 2019

TED spread signals sufficient liquidity supply

Tensions on the US money market, which first made themselves felt in September when the overnight repo rate experienced an at times dramatic surge, were sustained in October in the form of further interventions by the Fed. For many market players, this is an initial warning signal of future liquidity shortages.

GLOCAP uses the TED spread, weighted equally across the EUR, USD, and JPY money market, as an indicator for the supply of liquidity in the banking system. It measures risk premiums of interbank rates versus risk-free interest rates over three months. This indicator even suggests a slight improvement to liquidity supply in October. The TED spread declined slightly. So far, the liquidity problems seem to constitute an isolated phenomenon on the US overnight repo market.



The chart shows the indicator for liquidity preferences and systemic risk that measures the stability of the financial system in correspondence to the aggregated liquidity preferences of market participants. It is the difference between LIBOR interest rates for USD, JPY, and EUR loans and the associated 3M overnight index swap rates. The value shown is the average. Information as of November 1, 2019

	November 1	October 1
Equity overweighting	**37.7%**	**39.9%**
Contribution of the term spread	24.2%	25.8%
Contribution of the TED spread	10.7%	10.7%
Contribution of the credit spread	-0.5%	-0.5%
Contribution of dividend yield	3.3%	3.9%

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

Management of equity allocation with 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.

Government bonds

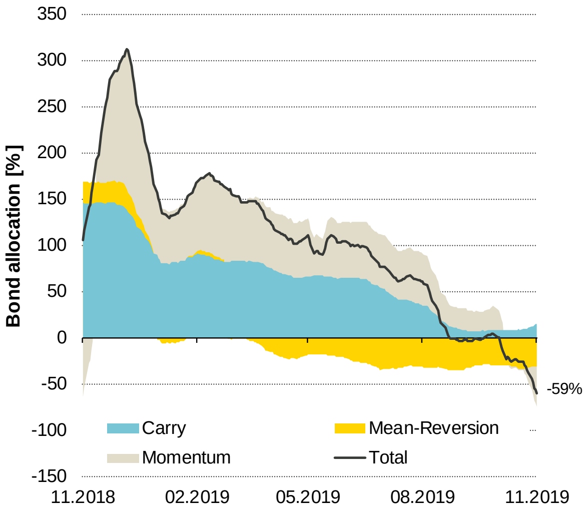
Global bond allocation slides below zero

The allocation ratio of a global bond portfolio fell sharply over the course of the month, reaching negative -59% at the start of November. The position in global government bonds held in the portfolio comprises the contributions of the individual carry, mean reversion, and momentum models.

As at the start of the month, the momentum component is responsible for the majority of the decline after falling considerably by -66 percentage points. The mean reversion models saw barely any change during the month, whereas the carry models contributed an additional 6 percentage points. This means that only the carry components still have positive allocations to the portfolio as a whole at present at +15%, whereas the contribution of mean reversion and momentum models is now negative at -31% and -44% respectively.

Negative weightings in Europe

While the majority of the positive allocation was still attributable to Germany, France, and Switzerland at the beginning of the year, the situation has now done a complete u-turn and all of these countries now hold short positions of -14%, -14%, and -20%, thus forming the bedrock of the entire portfolio's current short position. The allocation of other countries is slightly negative with the exception of Italian government bonds, which are currently still holding on to positive territory in terms of 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 November 1, 2019

Optimism regarding trade dispute and Brexit – focus on the Fed

The past month saw tensions ease considerably in the two long-running topics, the trade dispute and Brexit. A no-deal Brexit seems to have been averted and a phase 1 deal between the US and China appears within reach, which would see the first set of agreements set out in a contract. In addition, the Fed took center stage at the end of the month when it announced the third interest rate cut of the year. Against this backdrop, most bonds declined, allowing our bond model to benefit from the increasing short positions.

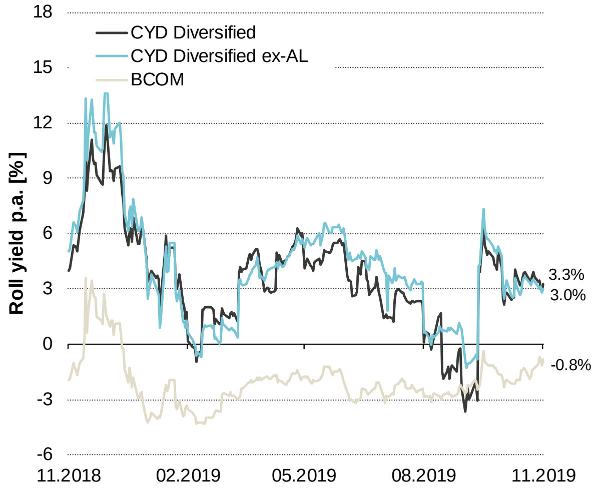
	Total	Carry	Mean reversion	Momentum
Global	**-59%**	**15%**	**-31%**	**-44%**
Germany	-14%	3%	-8%	-10%
France	-14%	5%	-10%	-9%
Italy	3%	4%	-4%	3%
Great Britain	-3%	0%	-3%	-1%
Switzerland	-20%	2%	-6%	-16%
US	-3%	0%	-4%	1%
Canada	-5%	0%	-2%	-3%
Japan	-3%	2%	5%	-9%

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 November 1, 2019

Active duration management with 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.

Select topics

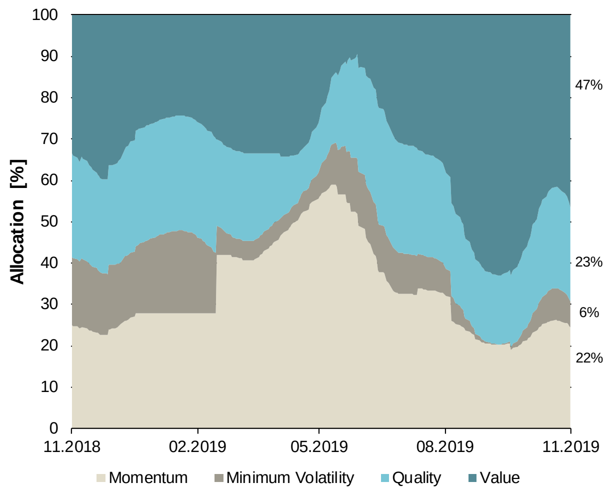
Rising roll yields on the commodity index
The aggregate roll yields of the BCOM Index (from -1.9% to -0.8% p.a.) and the CYD Diversified Commodities Index (from +2.5% to +3.3% p.a.) increased in October. Roll yields on natural gas climbed significantly at the front end of the curve on account of extremely low temperatures in the US and the higher demand for heating that this entailed. Nonetheless, stockpiles are still very high despite the increase in demand and this should keep price increases in check. Roll yields on palladium and platinum also continued to rise. Despite the slowdown on the global automotive market, tougher emissions standards mean that demand for these precious metals remains high.



The chart shows the aggregate roll yields of the CYD Diversified Index, CYD Diversified ex-AL Index and the Bloomberg Commodity Index. Roll yields can be derived from the maturity structure of commodity futures. Information as of November 1, 2019

Swiss equities: Value stocks less attractive
Although the value factor was still the most pronounced in October, the overweighting has dropped by around 8 percentage points to 47%. The medium-term trend model was particularly influential in reducing the value ratio throughout the month, benefiting the other three factors. On the other hand, the economic environment still rates value stocks as very attractive, as in previous months.

The dynamic factor allocation is based on three sub-models that evaluate the economic environment, the price trend, and the mean reversion potential.



The chart shows the factor allocation for the Swiss equities market. Based on an equally-weighted portfolio with 25% each in momentum, minimum volatility, quality and value, the factors are over- or underweighted according to market environment and attractiveness. Information as of November 1, 2019

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