vescore
by Vontobel Asset Management

# Global Market Outlook

June 2020

Asset Management

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## At a glance

— Increase in equity overweighting
— Negative duration positioning
— Risk indicator remains high
— Artificial intelligence:
Unique economic environment

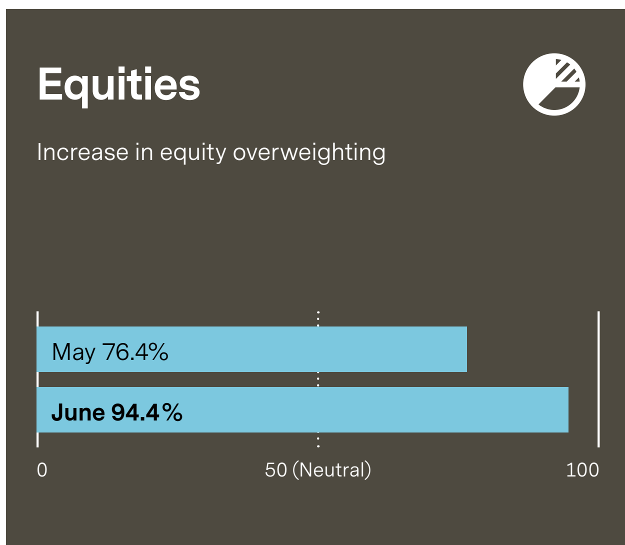
# A balancing act for risk appetite

Market participants gradually regained their risk appetite in May. Global capital markets are attempting to juggle cautious optimism and fear of a "second wave" in the SARS-CoV-2 pandemic. This balancing act is complicated by a mixture of new and recurring political and geopolitical uncertainties.

Over the course of the month, increasing numbers of countries eased current restrictions on social and economic life that had been introduced to prevent the pandemic from spreading further. In Germany, the ifo Business Climate Index rose unexpectedly in May, reflecting a surprisingly substantial improvement in economic prospects. The US reported a decline in the number of claims for unemployment benefits filed each week, although the figure remains very high. Although the US unemployment rate reached its highest level since records began in 1948 at 14.7 % in April, this was lower than expected. The EU's EUR 750 billion aid package also supported the return of risk appetite to the market. Nonetheless, these positive developments were offset by growing uncertainties, with the easing of restrictions prompting fears – including by the WHO – that this could be too far-reaching and provoke a second wave of the pandemic.

German GDP shrank by 2.2 % in the first quarter in comparison to the previous quarter and almost 39 million people have lost their jobs in the US since March, at least temporarily. At the same time, the US-China conflict escalated further. It no longer centers purely around trade but has now also incorporated a moral aspect in terms of who is to blame for the pandemic. Last but not least, mounting unrest in numerous US cities following demonstrations protesting racism and police brutality represent another source of uncertainty for sentiment.

The outcome of the current tightrope act will depend heavily on how the pandemic develops moving forward and the need to reimpose further restrictions on economic activity in connection with this. We also cannot ignore the repercussions of escalating conflicts that are smoldering both domestically in the US and in its foreign relations.



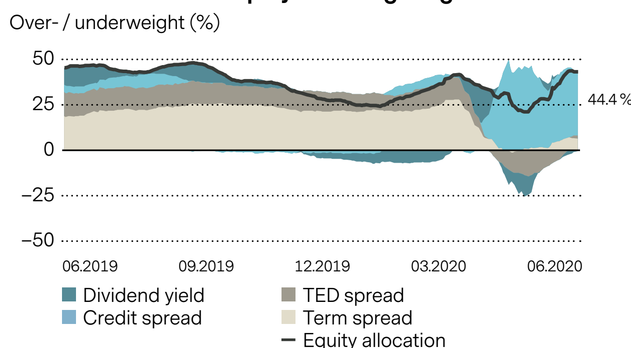

At the beginning of June, the equity overweighting in the global GLOCAP sample portfolio (50% equities, 50% cash) was 44.4%, again much higher than in the previous month.

The rise in equity allocation is primarily due to the normalization of the information variables TED spread and term spread. This also caused their contributions to equity allocation to return to positive territory. The fact that even now GLOCAP considers the fundamental economic market environment to be positive for risk-bearing investments is primarily because of confidence in corporate financing, as measured by the credit spread.

Over the past few months, the model has taken to heart an investment principle that many market participants currently also seem to be turning to: “Don’t fight the Fed”. As well as the central bank stimulus, known as the central bank put, COVID-19 saw the introduction of an additional fiscal put, the main purpose of which is not to drum up inflation but to prevent a high number of companies declaring insolvency. We believe that this will put a ceiling on the credit spread. In light of this, it should be noted that the model regards a higher but not spiraling credit spread as a positive signal for the equities market as it implies ongoing stimuli and stabilization purchases by central banks and governments.

**Chart 1: Increase in equity overweighting**

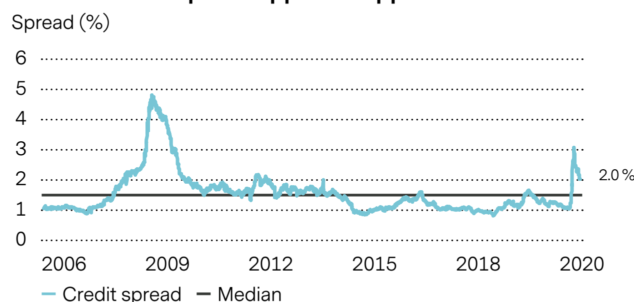
Over- / underweight (%)




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 June 1, 2020

**Chart 2: Credit spread appears capped**

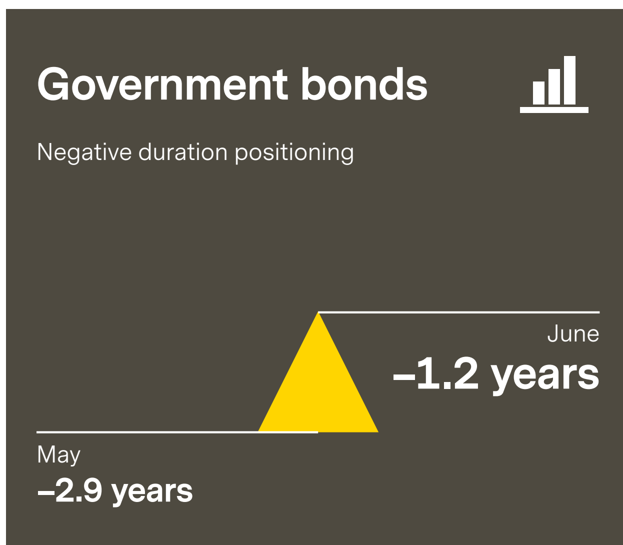
Spread (%)




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 June 1, 2020

| | JUNE 1 | MAY 1 |
|---|---|---|
| **Equity overweighting** | **44.4%** | **26.4%** |
| Contribution of the term spread | 6.9% | 1.5% |
| Contribution of the TED spread | 1.7% | –12.5% |
| Contribution of the credit spread | 36.1% | 41.8% |
| Contribution of dividend yield | –0.3% | –4.3% |

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

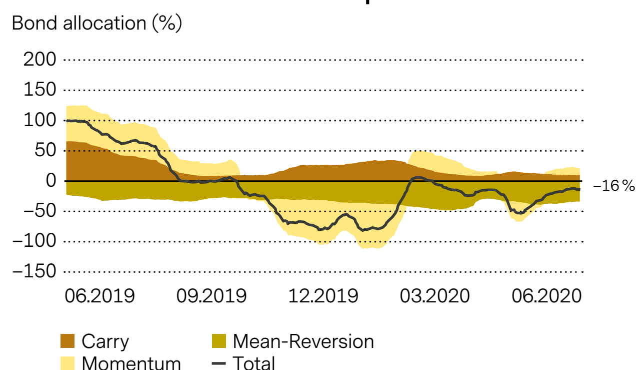



The allocation ratio of a global bond portfolio is up as against the previous month and was –16 % at the start of June, representing a duration of –1.2 years. The position in global government bonds held in the portfolio comprises the contributions of the individual carry, mean reversion, and momentum models. Whereas the carry sub-model declined slightly from 12 % to 9 %, the mean reversion component rose from –40 % to –35 % and the momentum component from –6 % to 10 %. The latter thus has a long position, taking account of the recently hospitable environment for government bonds.

Tensions remain on government bond markets between expansive fiscal policy support measures to alleviate the economic impact of the SARS-CoV-2 pandemic and monetary policy stimulus to combat this. Against this backdrop, the 10-year interest rates on German and US government bonds trended upwards slightly, by 0.14 % and 0.01 % respectively. Bolstered by hopes of a European rescue fund, funded by EU Commission bonds, spreads in the eurozone between e.g. 10-year German and Italian government narrowed from 2.35 % to 1.92 % during the month. By contrast, the US Federal Reserve launched its "Secondary Market Corporate Credit Facility" program in May, which includes it purchasing corporate bond ETFs. Its volume totaled USD 34.9 billion within the first month.

**Chart 3: Momentum factor turns positive**

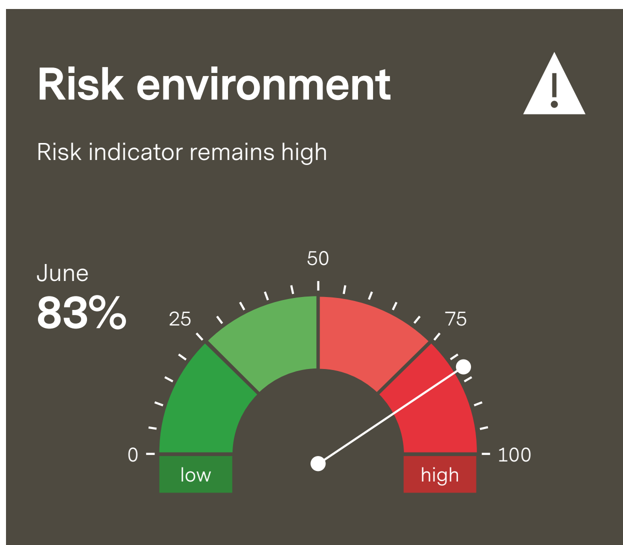
Bond allocation (%)




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 June 1, 2020

| | TOTAL | CARRY | MEAN REVERSION | MOMENTUM |
|---|---|---|---|---|
| Global | –16% | 9% | –35% | 10% |
| Germany | –2% | 1% | –3% | 1% |
| France | 3% | 5% | –4% | 2% |
| Italy | 2% | 2% | 0% | 0% |
| Great Britain | –2% | 0% | –5% | 2% |
| Switzerland | –2% | 1% | –4% | 1% |
| US | 1% | 1% | –3% | 4% |
| Canada | –6% | 0% | –8% | 2% |
| Japan | –10% | 1% | –8% | –2% |

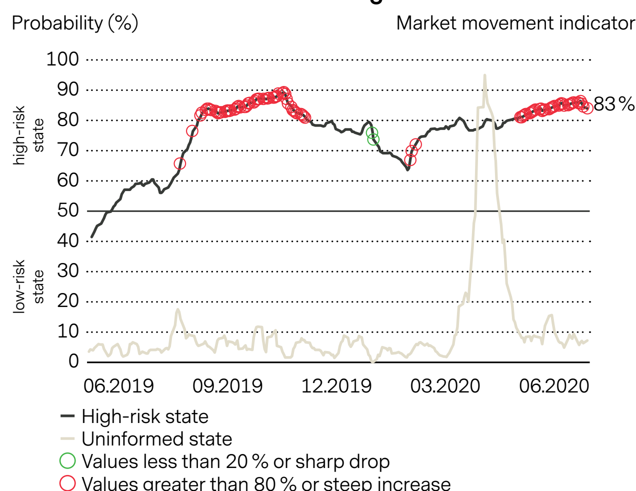
The table shows the bond allocation of a global portfolio in euros (total) broken down into individual countries. It also lists the contribution of the short-term forecast models carry, mean reversion and momentum to the total bond allocation. Information as of June 1, 2020



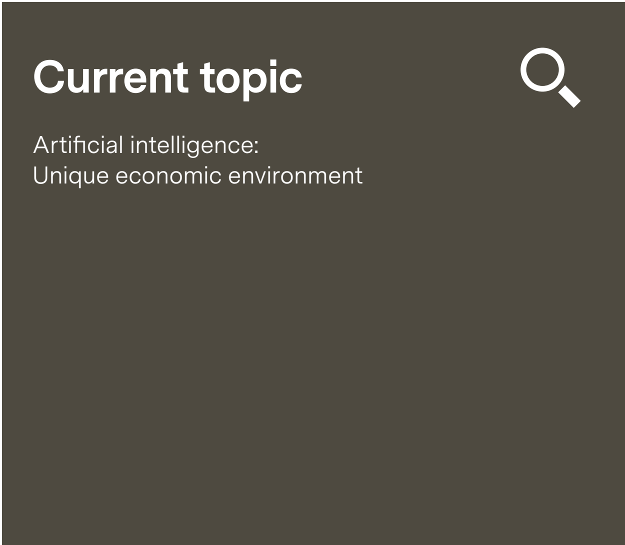

The aggregate probability of a future high-risk state was unchanged in June at the high level of 83%. The risk assessment for the bond markets improved, with the probability of a high-risk state declining from 86% to 77%. On the other hand, the risk assessment for the equity market increased by 7 percentage points to 89% and the risk assessment for currency markets picked up by 6 percentage points to 88%.

The risk assessment for emerging markets also rose slightly in comparison to the previous month from 84% to 85%, putting it in the high-risk range. The risk assessment for equity markets (up 3 percentage points) rose to 88% and for currencies (up 1 percentage point) to 72%. Risk assessments for bonds came to 97%.

**Chart 4: Risk indicator remains high**




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 June 1, 2020

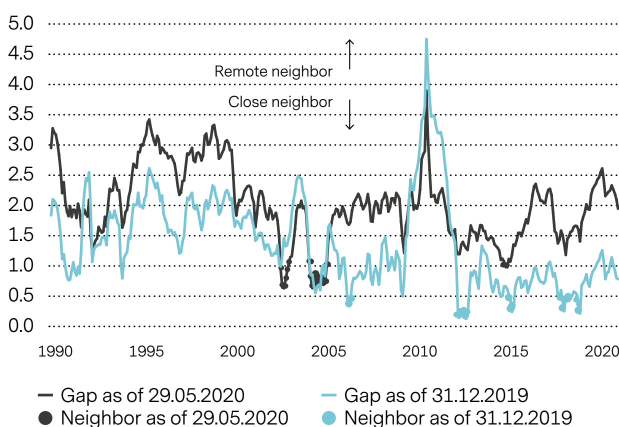



**Current situation significantly further removed from the end of 2019 in economic terms**
We introduced the artificial intelligence and machine learning process known as “artificial market intelligence” (AMI) back in January 2020’s edition of GMO. Periods in the past that had economic conditions as similar as possible to today are systematically identified and these are then used to determine the optimal allocation for the current environment. The economic environment is measured based on the four instrumental variables used under GLOCAP (term spread, TED spread, credit spread and dividend yield), global inflation and various economic trends.

Looking at how comparable the current economic situation is to that at the end of 2019 shows that this gap has widened significantly overall. The economic gap between the end of 2019 and its “economic neighbor” was around 0.3 whereas this figure has now risen to around 0.8, more than twice as high. This initially implies a high degree of uncertainty.

**Chart 5: Period after the millennium the comparable historic “neighbor”**

Economic gap as of December 31, 2019 and May 29, 2020




The chart shows how close current market conditions and those at the end of 2019 are in economic terms to those in the past, starting in 1988. The points indicate the times at which market phases are the most comparable to the situation today. Information as of June 1, 2020

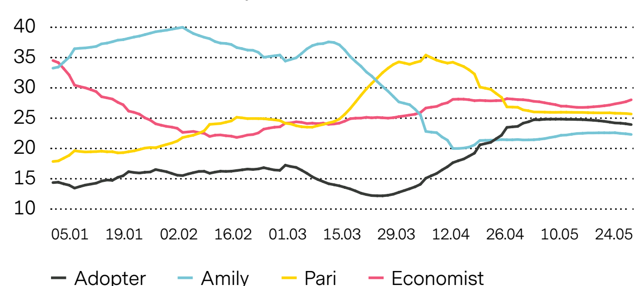
**Dotcom crisis considered an “economic neighbor”**
In terms of the current situation, most “economic neighbors” can be found in the period from February 2001 to July 2003. This period saw the bursting of the dotcom bubble starting in March 2000, triggering serious asset losses among investors in industrialized countries. Nonetheless, the analysis model still considers this phase only a “distant” neighbor.

**Which strategies are allocated?**
Based on this analysis, the allocation of AMI to the four different approaches has been substantially adjusted over the last few months. While AMI at the end of 2019 preferred a mix of fundamentals-driven allocation (Economist / GLOCAP) and artificial intelligence (Amily), the risk parity approach (Pari) became increasingly significant throughout the COVID-19 crisis.

Given to the lack of suitable historical reference points, the allocation between the various approaches has developed towards an equal weighting over the last few weeks. The Economist approach (GLOCAP) is currently at 28% and Pari (risk parity) at 26%, while Adapter (trend) and Amily (artificial intelligence) are weighted at 24% and 22% respectively.

**Chart 6: Balanced model allocation**

Allocation to sub-models by AMI in %




The chart shows the allocation between the various approaches on the basis of the AMI analysis. Information as of June 1, 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 should protect investors particularly in periods of market stress by limiting drawdowns.

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