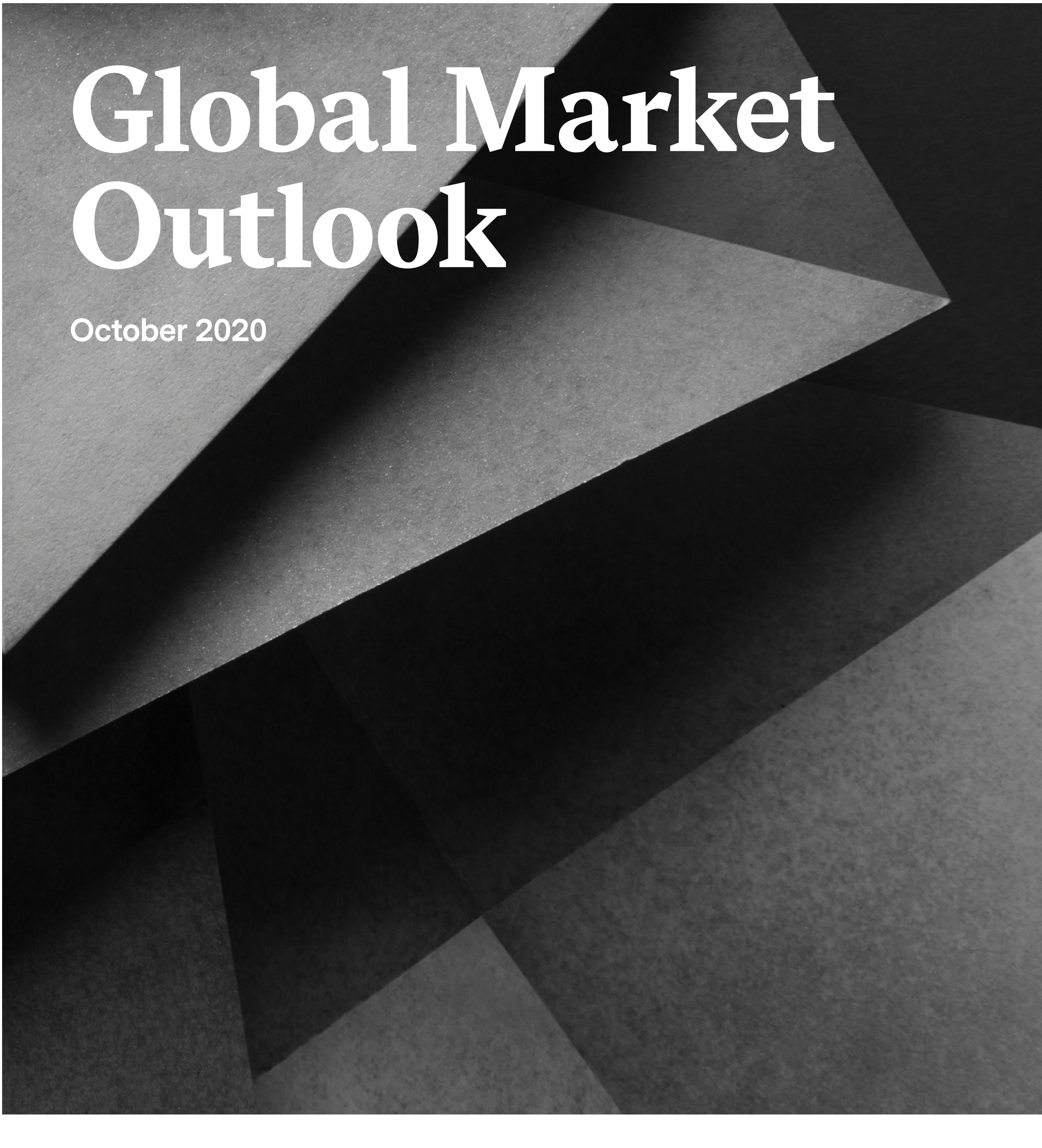
vescore
by Vontobel Asset Management

Global Market Outlook

October 2020



Asset Management

At a glance

- Equity overweighting declining further, market still attractive
- Bond allocation with small short position
- Risk indicator remains low
- Our equity factor models currently favor the growth style with a certain value diversification

Risk appetite caught between the pandemic and stimulus packages

With infection rates on the rise again, the coronavirus pandemic and its impact on the global economy are increasingly dominating market events once more. Investors are also being unsettled by the increasingly acrimonious race for the US presidency and the continued lack of agreement over the future relationship between the European Union and the UK.

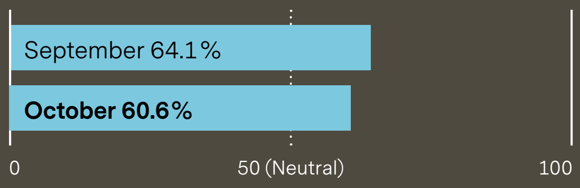
As the number of new coronavirus cases in Europe rises again, market participants are becoming increasingly concerned about a second wave. In particular, the infection trend in France and Spain, with individual local lockdowns, gives cause to doubt the stability of the European economic recovery. Brexit negotiations over a free trade agreement from 2021 are also still ongoing. With the UK on the offensive, there is now a greater risk that the situation will end in a no-deal Brexit after all. This could have dramatic consequences – not just for the UK but also for the economies of EU countries.

The coronavirus infection trend in the US is not quite as negative – after record figures in previous months, the number of new cases per day has currently stabilized at a rather lower level. In addition, the economic data gives hope of a sustained recovery. However, the lack of agreement between Republicans and Democrats on a new government stimulus package and the highly charged US election campaign have led to increased volatility in the global capital markets.

Looking ahead, the tension between the COVID-19 pandemic and monetary and fiscal policy stimulus is continuing to define investors' risk appetite. Coupled with other sources of unrest – such as the UK's unresolved exit from the European Union and the highly charged US election campaign – increased volatility is to be expected in the global capital markets.

Equities

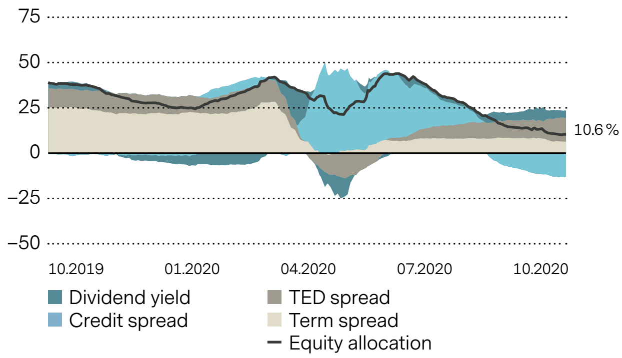
Equity overweighting declining further, market still attractive



At the beginning of October, the equity overweighting in the global GLOCAP sample portfolio (50 % equities, 50 % cash) was 10.6 %, significantly lower than in the previous month. This development was due to the higher negative contribution of the credit spread. The positive contribution of the term spread also declined compared with the previous month. The other instrumental variables, the TED spread and the dividend yield, are still contributing positively to equity overweighting and increased their contributions slightly compared with the previous month.

Chart 1: Equities overweighted, but less so

Over/underweighting (%)

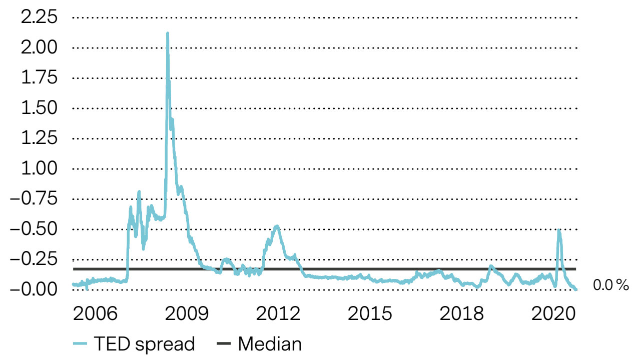


The chart shows the active equity weight (black line) of a global portfolio in euros with a neutral allocation of 50 % equities and 50 % cash. Foreign currencies are hedged. It also shows the contributions of the individual driving forces (term spread, TED spread, credit spread and dividend yield), which come together to give the active equity allocation. Information as of October 1, 2020
Source: Vescore

The TED spread saw the more pronounced rise this month, increasing its contribution to the overweight from 10.3 % to 13.5 %. In the GLOCAP model, the TED spread represents the “stability of the financial system and the liquidity preferences” and is measured by the difference between the interbank interest rate and a default-proof investment. TED spread values have declined significantly following their sharp rise in March in response to the coronavirus crisis and have now returned to pre-COVID-19 levels. The low TED spread shows that market participants currently consider the financial system to have a good liquidity supply.

Chart 2: TED spread returns to pre-crisis level

Spread (%)



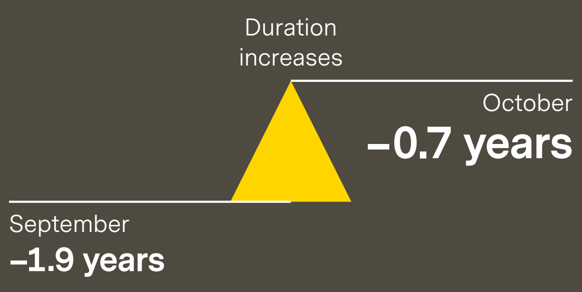
The chart shows the TED spread, which measures the stability of the financial system in correspondence to the aggregated liquidity preferences of market participants. It is the difference between LIBOR interest rates for USD, JPY, and EUR loans and the associated 3M overnight index swap rates. It shows also the mean (black line). Information as of October 1, 2020
Source: Vescore

	OCTOBER 1	SEPTEMBER 1
Equity overweighting	**10.6 %**	**14.1 %**
Contribution of the term spread	6.5 %	8.4 %
Contribution of the TED spread	13.5 %	10.3 %
Contribution of the credit spread	–13.4 %	–9.8 %
Contribution of dividend yield	4.1 %	5.3 %

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

Government bonds

Bond allocation with small short position



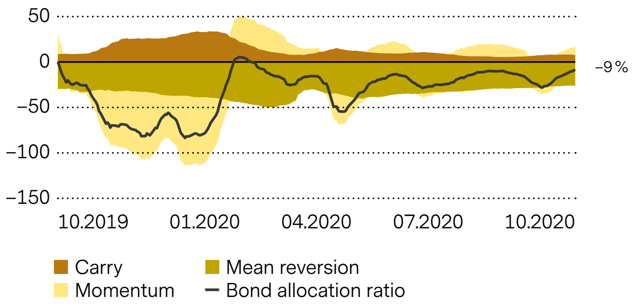
The allocation ratio of a global bond portfolio is almost as low as in the previous month, amounting to –9% at the start of October and representing a duration of –0.7 years. The position in global government bonds held in the portfolio comprises the contributions of the individual carry, mean reversion, and momentum models. While the absolute changes in the carry and mean reversion component models are positive at +2 and +4 percentage points respectively, the weighting of the momentum component has fallen by 4 percentage points. The main driver of the short position is still the mean reversion model with a contribution of –26%, while the carry and momentum are having a marginally positive effect with contributions of +8% and +10%.

In light of corrections on the equity market, global bonds saw considerable growth in some cases in September. In particular, the setbacks on the highly valued US technology stocks market led to increased risk aversion with regard to equities in general, and hence a flight to safer government bonds. Euro bonds led the way, with futures prices for German Bunds and French OATs rising by +1% and +1.2% respectively. The gap in yields between Italian 10Y bonds and those of Germany also declined further to 1.32%, lower than the level recorded in January. UK gilts were also clearly positive at +0.8%. With the USD strengthening, US treasury futures only rose by 0.1%.

In addition to technology stock valuations, an upturn in safe havens such as bonds was driven by tensions concerning the negotiations on the future partnership between the EU and the UK, as well as the impending US presidential election. Key economic indicators like inflation, the labor market and retail sales in the US were also worse than expected in September. In light of this, the optimism for growth in the previous months appears to have been excessive.

Chart 3: Model retains short position in global bonds

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 October 1, 2020
Source: Vescore

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

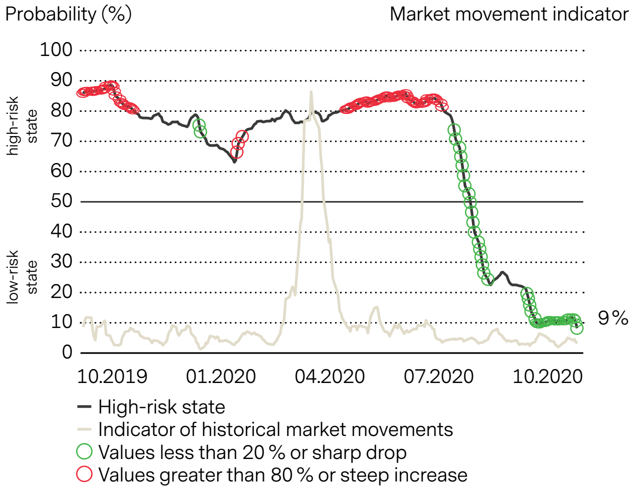
The table shows the bond allocation of a global portfolio in euros (the "total" column) broken down into individual countries. It also lists the contribution of the short-term forecast models carry, mean reversion and momentum to the total bond allocation. Information as of October 1, 2020
Source: Vescore

The risk indicator remains low. The aggregate probability of a future high-risk state on the developed markets again declined slightly from 10 % in September to 9 % in October. The risk indicator analyses the current environment and shows whether the market is trending "high risk" or "low risk". The reason for the current "low-risk state" is the significantly lower volatility level in recent months as opposed to market turbulence in the first quarter.

Specifically, the risk estimates for the developed markets were the same as in the previous month for equities and currencies, at 9 % and 10 % respectively, while the risk assessment for bonds declined further from 12 % to 7 %. This indicates broad-based stability across all market segments.

By contrast, the risk indicator for the emerging economies increased slightly once again, from 6 % to 10 %, but remains at an extremely low level. Specifically, the risk estimates for the emerging economies were the same as in the previous month for equities and bonds at 6 % and 3 % respectively. The increase in the risk indicator for the emerging economies was driven by the risk assessment for the currency markets, which rose from 10 % to 21 %.

Chart 4: Risk indicator remains low



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 October 1, 2020
Source: Vescore

Current topic

Our equity factor models currently favor the growth style with a certain value diversification

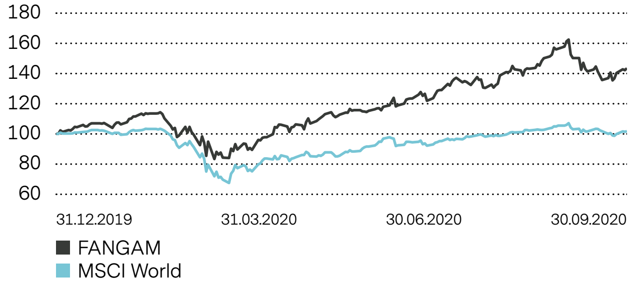
Has the rally of the FANGAM[1] stocks come to an end? The year-to-date has been another remarkable one for the major growth stocks in the technology sector. The FANGAM stocks, which account for 14 % of the market capitalization of the MSCI World[2], have recorded a capitalization-weighted total return of 42.5 % since the start of the year, while the market (MSCI World Index) has risen by just 1.7 % in the same period. However, a substantial price correction has been in progress since early September (September: FANGAM –9.0 %, MSCI World –3.4 %). What are the implications for the growth style factor?

Global low interest rate environment is conducive to growth

Inflation in the US is currently around 1.3 %, lower than it was before the onset of the COVID-19 pandemic. The markets expect the Fed to keep short-term interest rates at zero until at least the end of 2023 in order to achieve or exceed the inflation target of 2 %. The lengthy low interest rate environment would benefit growth companies such as the FANGAM stocks. The situation in other parts of the developed world is similar to that in the US.

Chart 5: Big tech substantially outperforming in 2020 despite recent setback

Indexed total return (December 31, 2019 = 100)



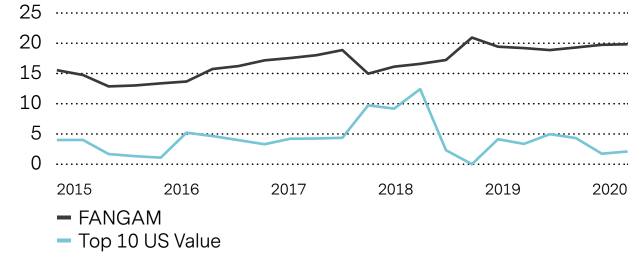
Past performance is no guide to current or future performance.
Source: Vontobel, as of September 30, 2020

For how long can the profitability gap between big tech and value stocks continue to grow?

There is an upward trend in the net profit margin of the FANGAM stocks. The profitability of value companies is now just one-fifth that of big tech and has remained stable at a low level over the last five years. These low margins could suggest that no significant style rotation from growth to value should be expected. However, the growing profitability gap makes a short-term correction more likely, and the underperformance of big tech in September might have marked the start of this process. As such, equity investments should take the form of a growth portfolio with moderate style diversification toward value, particularly with regard to US equities.

Chart 6: Big tech records rising profit margins, while value companies' margins remain low

Net profit margin (in %)



The net profit margins are the equally-weighted figures for the FANGAM companies and the ten largest value companies in the MSCI USA, a sub-index of the MSCI World.
Source: Vontobel, as of September 30, 2020

[1] FANGAM: Facebook, Apple, Netflix, Google (Alphabet), Amazon, Microsoft.
[2] The US accounts for 65 % of the MSCI World's market capitalization.

Glossary

GLOCAP

Global Conditional Asset Pricing (GLOCAP) is Vescore's 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 Vescore's 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

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.

Vescore takes a quantitative investment approach that is based on financial market research with the aim of long-term, attractive and risk-adjusted performance.

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