vescore
by Vontobel Asset Management

Global Market Outlook

What our models say while a wave of risk aversion sweeps the market environment

October 2021

Asset Management

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Wave of risk aversion

A wave of risk aversion has swept the fundamental economic market environment. The emerging uncertainty is due to concerns over weaker global growth prospects, the future attitude of the central banks, and the embattled Chinese real estate corporation Evergrande.

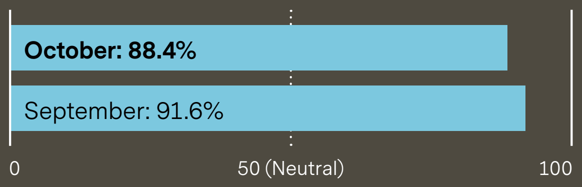
The US Fed left its strategy unchanged in September: Its lending rate remains low at 0–0.25 %, while its monthly securities purchases will continue for the time being at USD 120 billion. However, according to Chairman Jerome Powell, a reduction of the purchase program could be resolved at the next meeting at the start of November. The European Central Bank has also declared its intention to keep its current interest rate level as is. Its President Christine Lagarde announced that the PEPP purchase program, which had been expanded in the summer, would be scaled back slightly if necessary to ensure flexibility, given the inflation forecast is fraught with uncertainty.

While Germany's elections had no notable impact on market developments, investors were focused on the sharp rise in energy prices, particularly for natural gas, and the distortion in the Chinese real estate sector. The possible collapse of the faltering Chinese real estate giant Evergrande is being eyed with concern by market participants as it could mean a financial crisis and the risk of other sectors becoming infected. There are no enduring positive signals to be found in the fundamental data for September. Hence the second half of the month was characterized by falling equity markets and a sharp rise in volatility.

Market participants' risk appetite in the fourth quarter is likely to be primarily defined by the development of the global economic scenario as well as inflation, especially in energy prices.

Equities

Slight decline in overweighting

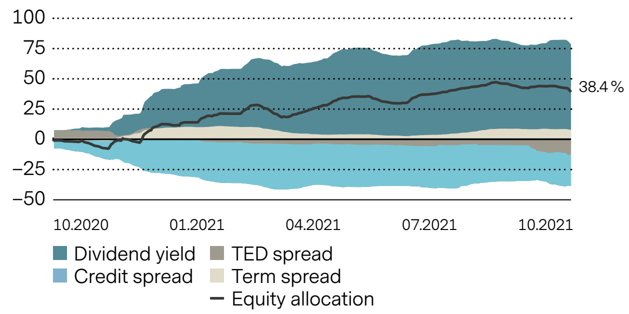


At the beginning of October, the global GLOCAP sample portfolio (50% equities, 50% cash) remains overweight in equities at 38.4%. Daily estimates are currently reacting to distortions on the capital markets and reducing the equity allocation considerably, which can be seen by a slight decline in the level of equities month-on-month. The fundamental economic environment is still defined by weak overall economic expectations (as measured using the term spread), an adequate supply of liquidity (TED spread), low credit risk premia (term spread), and a lower fundamental valuation (dividend yield).

GLOCAP incorporates the wave of risk aversion that has been sweeping the market environment since the middle of September via the instrumental variables. The positive dividend yield contribution, which had been a major player in equity overweighting in recent months, has declined significantly in the past two weeks. It can be assumed that most market participants are now questioning the extremely confident growth expectations for companies of late. Accordingly, the model is weighting fundamental valuation visibly less and thus reducing its global equity allocation.

Chart 1: Slight reduction in equity allocation

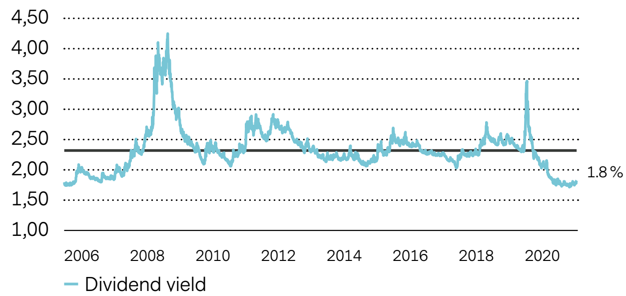
Over-/underweighting (%)



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 October 2, 2021.
Source: Vontobel Asset Management

Chart 2: Less influence of fundamental valuation

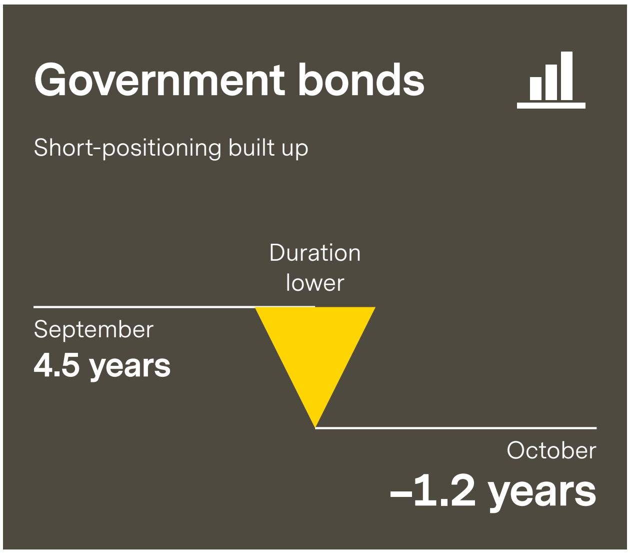
In %



The chart shows the dividend yield as indicator for fundamental valuation, which measures the aggregated ratio of dividend to price and reflects the expected equity market yield as the central valuation parameter. The chart shows a weighted average of the dividend yields of the major industrialized countries (blue line) and the median of this instrumental variable (black line). Information as of October 2, 2021.
Source: Vontobel Asset Management

	OCTOBER 2	SEPTEMBER 2
Equity overweighting	**38.4%**	**41.6%**
Contribution of the term spread	6.8%	7.4%
Contribution of the TED spread	-13.3%	-5.9%
Contribution of the credit spread	-26.1%	-29.5%
Contribution of the dividend yield	71.0%	69.6%

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

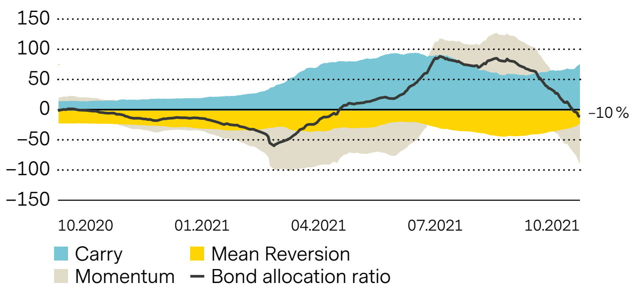


At the start of October, the allocation ratio of a global bond portfolio, which comprises the contributions of the three sub-models carry, mean reversion and momentum, stands at –10% after +61% in the previous month, equivalent to a duration of –1.2 years. This severe drop in bond allocation is due solely to the momentum model, whose contribution plunged by 104 percentage points to currently –66% as bond prices tumbled around the world, hence this sub-model now evaluates bonds negatively. Hand in hand with the rise in interest rates, the yield curve grew steeper in September, buoying the carry model contribution by 16 percentage points to currently 78%. As the medium-term overvaluation of bonds decreased, the negative mean reversion model contribution lessened from –39% to currently –22%.

Global government bond prices fell in September, causing interest rates to rise significantly in some cases – by around 18 basis points for 10-year German and US government bonds. The increases were less pronounced at the short end – at around 7 basis points for 2-year US government bonds. That is why the US yield curve grew steeper. The mood on the bond markets suffered not least on account of the latest – again higher – inflation figures published. A key factor in this was higher energy costs as oil and gas became much more expensive in recent months. Central banks continue to assess higher inflation as temporary, but it could last longer than so far expected. So the European Central Bank slightly adjusted its bond purchase program but without calling it “tapering”. The US Fed raised the prospect of statements on scaling back its securities purchases for its November meeting, provided that the labor market would not disappoint in October. The Bank of England was considering raising interest rates as early as 2022 while continuing its bond purchase program. Of the G10 central banks, Norway’s Norges Bank was the first to raise its interest rate, by 0.25%, since the pandemic began.

Chart 3: Momentum signal drops below zero

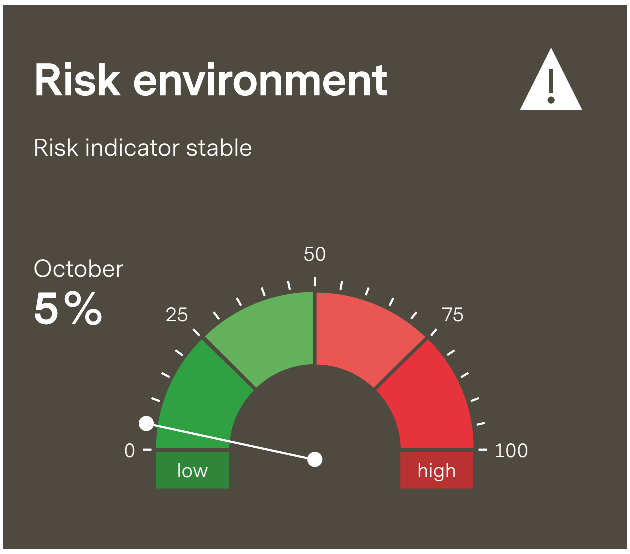
Bond allocation (%)



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 October 2, 2021.
Source: Vontobel Asset Management

BOND ALLOCATION	TOTAL	CARRY CONTRIBUTION	MEAN REVERSION CONTRIBUTION	MOMENTUM CONTRIBUTION
Global	**–10%**	**78%**	**–22%**	**–66%**
Germany	–17%	3%	–4%	–16%
France	–5%	13%	–5%	–13%
Italy	1%	15%	–10%	–4%
Great Britain	–4%	6%	–2%	–9%
US	11%	11%	2%	–2%
Canada	3%	7%	–2%	–2%
Australia	2%	5%	–2%	–2%
Japan	–1%	18%	0%	–20%

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 October 2, 2021. Source: Vontobel Asset Management



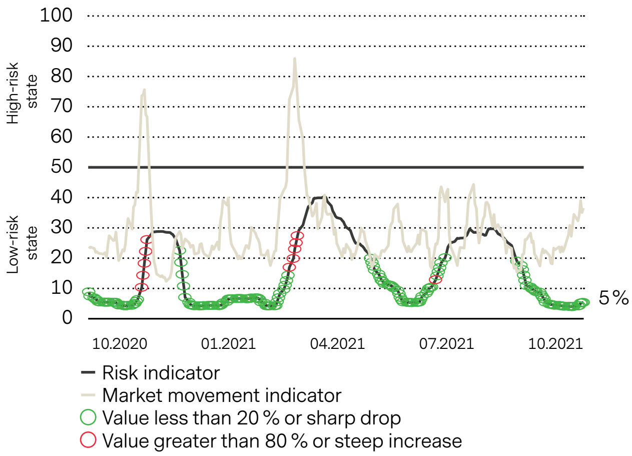
The risk indicator analyses the current environment and shows whether the future risk should be considered high or low. It does this by comparing short-term and long-term market yields. It begins October at 5 %, thus practically unchanged from the previous month's 7 %. The aggregate probability of a future high-risk state on developed markets is therefore still considered low. The probabilities for the equities and currencies market segments remain at a very low 3 % and 1 %. The risk indicator for bonds fell to 11 % month-on-month, albeit rising at the end of September due to more volatile trading days.

Despite the consistently low risk indicator, international capital markets shifted their attention to a handful of risk factors, especially from the middle of September. Hence inflation concerns, sharp increases in energy prices, global supply chain problems, and the looming insolvency of the Chinese real estate firm Evergrande are currently souring the mood among market participants and weighing on global equity and government bond prices.

The risk indicator for the emerging markets stayed unchanged in September and is now still 2 %. At the start of October, the probabilities for a high-risk state for all three market segments remain at the lower end of the scale: 2 % each for emerging market equities and bonds, 1 % for emerging market currencies.

Chart 4: Risk indicator practically unchanged

Probability (%)



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, bonds, 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 October 2, 2021. Source: Vontobel Asset Management

Current topic

AI model favors GLOCAP

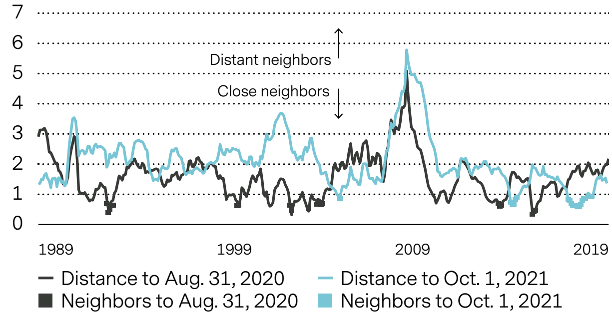
AI forecasting still less reliable than in August 2020
Vescore uses methods of artificial intelligence (AI) and machine learning known as "artificial market intelligence" (AMI). Periods in the past that had economic conditions as similar as possible to today are systematically identified and these are then used to determine the optimal allocation for the current economic environment. Measurement is based on the four instrumental variables used by GLOCAP (term spread, TED spread, credit spread, and dividend yield), global inflation, and various economic trends.

Comparing the current environment to that of the end of August 2020, when the stock markets were back at pre-Covid levels, we see that the economic distance has grown significantly wider (see also Global Market Outlook July and March 2021 and December 2020). Over a period of 30 years, the current economic distance line has almost always been well above the line for the end of August 2020 (see chart 5). This signals that forecast reliability is still poor.

In summer 2020, the economic neighbors were found in the phase of the dotcom crisis from 2001 to 2003. Now they are in two phases defined by stable global GDP growth of 3% and a certain amount of market distortion: the period from May to October 2014 was in the middle of a bear run on the commodity market, while the period from June 2017 to October 2018 ended with a significant equity market correction triggered by inflation fears and interest rate hikes.

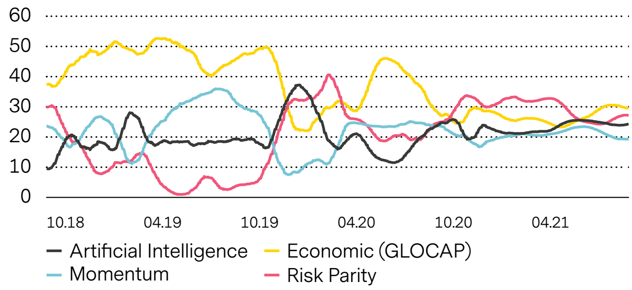
AI model favors the economic sub-model
Based on these two phases of clear economic similarity, AMI weights the GLOCAP economic sub-model the heaviest, but the risk parity sub-model only slightly less (see chart 6).

Chart 5: Economic neighbors currently found in 2014 and 2017/18
Economic distance to August 31, 2020 and to October 1, 2021



The chart shows how close current conditions and those in the summer of 2020 are in economic terms to those in the past, starting in 1988. The points indicate the times at which phases are the most comparable to the situation today. Information as of October 2, 2021
Source: Vontobel Asset Management

Chart 6: GLOCAP weighted most heavily
Allocation to sub-models by AMI in %



The chart shows the allocation between the various models on the basis of the AMI analysis. Information as of October 2, 2021
Source: Vontobel Asset Management

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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