vescore
by Vontobel Asset Management

Global Market Outlook

August 2021

Asset Management

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At a glance

- Equities:
  Overweighting increased
- Government bonds:
  Still a significant long positioning
- Risk environment:
  Risk indicator stable
- Current topic:
  Comeback of reflation trades?

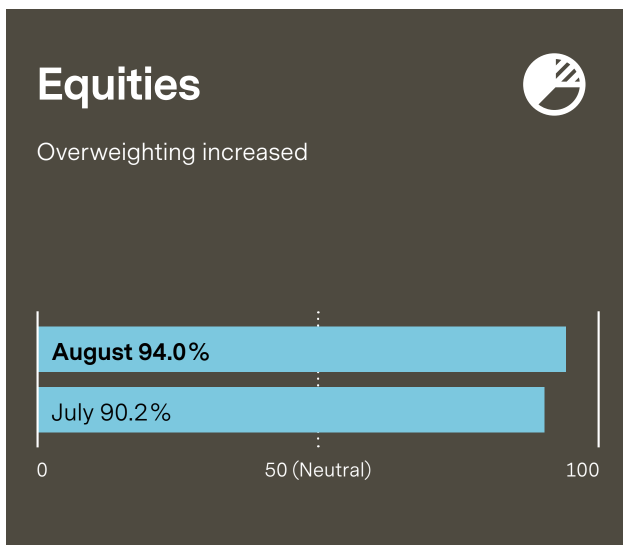
A fine line between recovery and inflation

At the start of August, market participants' risk appetite was still based on the strong economic recovery of a large number of industrialized countries – while the slowly gathering clouds in the form of inflation fears and rising Covid-19 cases were not enough to dampen their mood for long.

Predominantly positive economic indicators emphasized the sense of a dynamic upswing again in July. Although ongoing materials shortages – in particular for raw materials and components (especially semiconductors) – slowed industrial production, indicators such as the German purchasing managers' index for the manufacturing industry were at a high level. Against this backdrop, consumer prices remained under close observation: While they had risen faster than expected in the US in June, and the labor market had also recovered significantly, inflation nonetheless remained within the parameters set out by the US Federal Reserve. As the Fed had been counting on a temporary rise in inflation, it left its interest rate and monthly bond purchases unchanged as expected. The stock markets therefore initially reacted quite calmly in the face of the highest annual inflation rate in 13 years. However, as the month drew on, Fed Chairman Jerome Powell admitted that the inflation projection could exceed previous expectations after all. The capital markets saw this statement as an indication of a tighter monetary policy.

Meanwhile, the European Central Bank (ECB) – as many market participants had anticipated – followed the Fed's lead on price stability: Announcing its new inflation target of 2 %, the ECB said that it would tolerate inflation above this level at times as well. It also kept its interest rate unchanged and left its billion-euro bond purchases untouched.

Investors' confidence in a resilient recovery of the global growth scenario has the upper hand at this time. But the closer fall comes, the more the ongoing development of the pandemic is likely to come under the spotlight again. In addition, there is a political crossroads ahead in Germany with its parliamentary elections due in September.

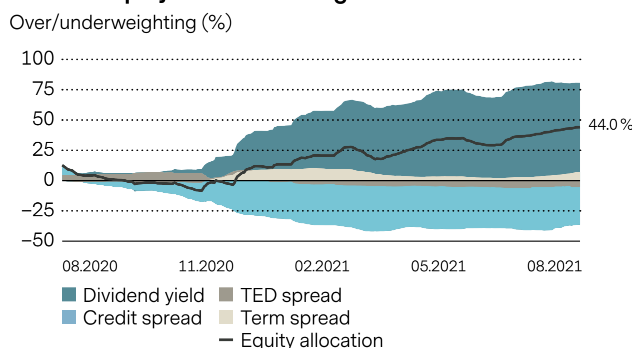


At the start of August, the equity overweighting in the global GLOCAP sample portfolio (50% equities, 50% cash) is 44.0%, again higher than in the previous month. The main driver behind the overweighting is still the dividend yield, which reflects the positive momentum on the stock markets. The rising equity allocation is due to the lower negative contributions from confidence in corporations (credit spread) and liquidity preferences (TED spread). The term spread contribution also rose slightly.

The term spread describes the steepness of global yield curves and is generally taken as an indicator for market participants' long-term business expectations. After turbulent months on the interest markets, July – at least at first – seemed to mark a return to quieter times, and market participants increasingly shifted their attention to corporate fundamental data as the quarterly reporting season got underway. With interest rates falling at the long end in the key currency areas, the term spread was also trending down recently. Typically this indicates more downbeat economic expectations, but has to be seen in the context of central bank activity – the more stable the economy, the more likely they are to close the liquidity floodgates. GLOCAP therefore sees a decline of the term spread as a positive factor for the equity allocation.

Chart 1: Equity allocation rising

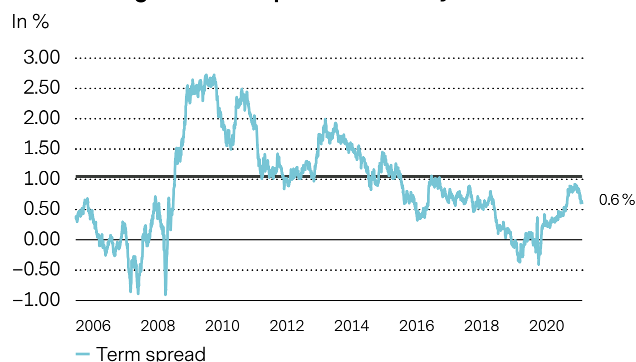
Over/underweighting (%)



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 August 2, 2021. Source: Vescore

Chart 2: Negative term spread sensitivity

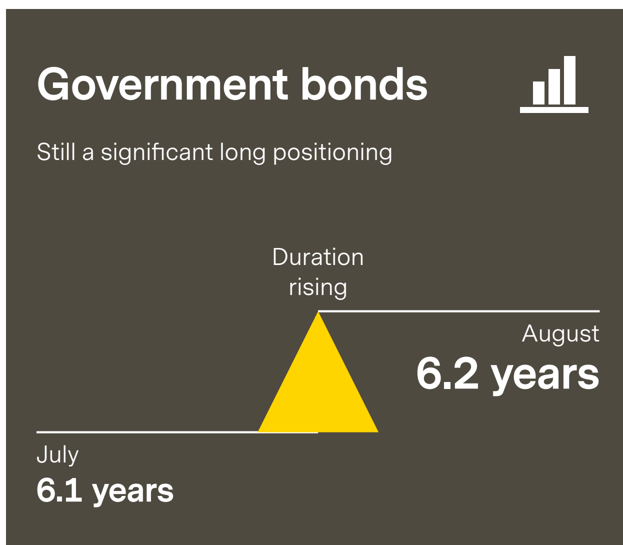
In %



The chart shows the term spread, which reflects market participants' economic expectations through the difference between long-term and short-term interest rates. A high term spread is typically associated with positive economic forecasts, while a flat term spread tends to reflect a more downbeat outlook on the part of market participants. The chart shows a weighted average of the term spreads of the major industrialized countries (blue line) and the average of this instrumental variable (black line). Information as of August 2, 2021. Source: Vescore

	AUGUST 2	JULY 2
Equity overweighting	**44.0%**	**40.2%**
Contribution of the term spread	6.9%	6.0%
Contribution of the TED spread	–5.6%	–9.5%
Contribution of the credit spread	–31.1%	–35.6%
Contribution of dividend yield	73.8%	79.3%

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



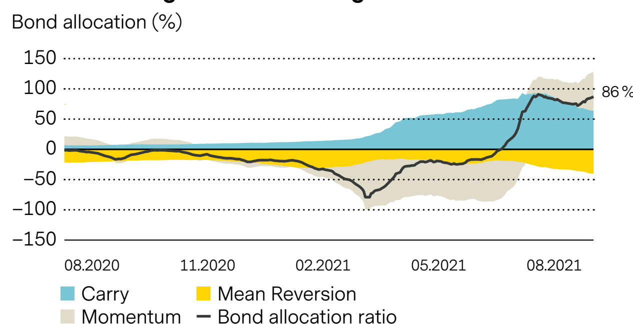
The allocation ratio of a global bond portfolio, which comprises the contributions of the three sub-models carry, mean reversion and momentum, rose from 84% last month to 86% this month. This means a duration of 6.2 years. Even though it doesn't look like it judging by the only minor change in the overall ratio, the contributions from the individual sub-models have changed significantly since last month. The momentum model's contribution rose by 39 percentage points to currently 65% and is mainly responsible for the rise in the bond allocation. The carry model contribution declined by 27 percentage points to 63%, while the mean reversion model contribution widened by –10 percentage points to –41%.

The interest rates for global government bonds faded significantly across the board in July. Those for 10-year German and US global government bonds lost around 25 basis points, while interest rates for their Australian counterparts were down by as much as 35 basis points as against the previous month. These changes impressively reflected the rise in the momentum model.

A variety of circumstances contributed to the marked decline in interest rates: The ongoing spread of the highly contagious delta variant of the Sars-CoV-2 virus and the renewed rise in infection numbers fueled fears of another round of restrictions on public life and the associated stifling of the economic recovery. This line of thinking was reinforced by the recently published data that, surprisingly, were mostly negative. Moreover, the US Fed – the most important central bank in the world – was still not prompted to reduce its economic support. It remains to be seen whether it will take the first steps in this direction at its next meeting in September.

Chart 3: Stronger momentum signal increases duration

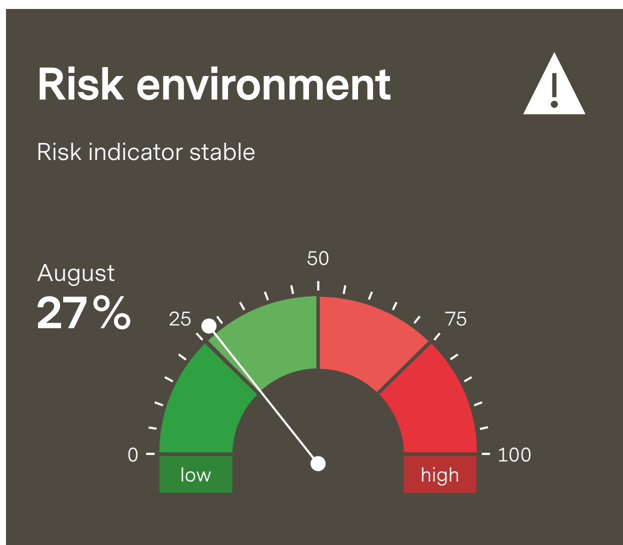
Bond allocation (%)



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 August 2, 2021. Source: Vescore

BOND ALLOCATION	TOTAL	CARRY CONTRIBUTION	MEAN REVERSION CONTRIBUTION	MOMENTUM CONTRIBUTION
Global	**86%**	**63%**	**-41%**	**65%**
Germany	-6%	2%	-10%	2%
France	6%	9%	-8%	5%
Italy	11%	11%	-9%	9%
Great Britain	5%	4%	-4%	5%
US	27%	12%	-1%	16%
Canada	11%	6%	-3%	8%
Australia	5%	4%	-4%	5%
Japan	27%	15%	-3%	15%

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 August 2, 2021. Source: Vescore



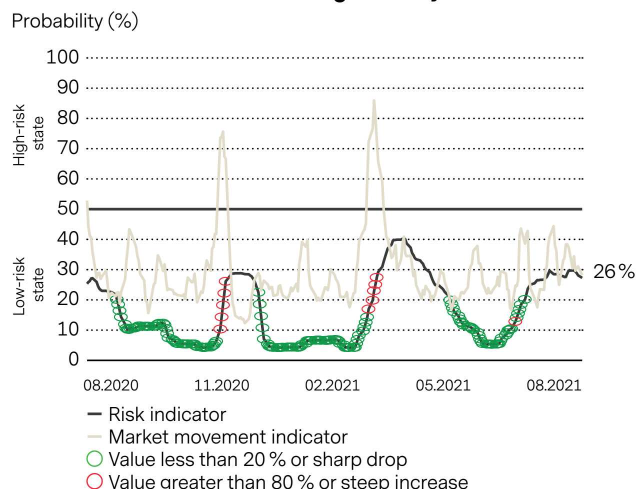
The risk indicator analyses the current environment and shows whether the future risk should be considered high or low. It does this by comparing short-term and long-term market yields. It starts August at 27%, a marginal increase of 1% as against the previous month. The aggregate probability of a future high-risk state on developed markets can therefore still be considered moderate. The increase is fueled by the asset classes of bonds and currencies, while equities are accorded a lower risk probability.

As in the previous month, the probability of a high-risk state is particularly pronounced on the bond markets at 66%. As before, market participants are weighing up how to reconcile the recent rise in inflation data with comments by central bank representatives on the timeline of this price increase. The risk estimates for the developed markets' equities and currencies were mixed in July and are currently still low at 5% and 8% respectively.

The risk indicator for emerging markets tells a different story, falling to 3% in July after 8% in the previous month. All three asset classes had a hand in this decline. The current probability of a high-risk state is 3% for the emerging markets' equities and bonds and 2% for their currencies.

Chart 4: Risk indicator tracking sideways

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, fixed income 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 August 2, 2021. Source: Vescore

Current topic

Comeback of reflation trades?

Commodities benefited from reflation trades
In the first half of this year, everyone was talking about reflation trades – reflation being a portmanteau of recovery and inflation. This type of trade promises a return when economic activity and prices rise simultaneously after a recession. This time the reason for that development – together with the reopening of shut-down sectors of the economy after the coronavirus crisis – was the ultra-loose monetary and very generous fiscal policy intended to kick-start the economy and help it back to full employment.

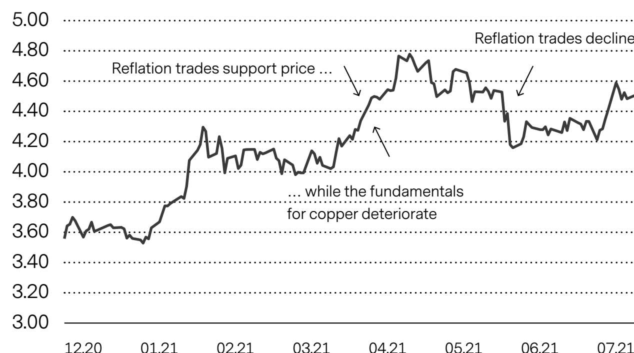
Reflation trades are typical in asset classes that benefit particularly from high economic growth, price pressure, and higher yields. Recently they were especially popular in commodities, above all crude oil and copper, which proved highly cyclical in the first half of the year and rose by 55% and 27% respectively by the end of July. Investors held significant net long positions on the futures markets. The price of copper therefore went on rising, even though its fundamental data increasingly deteriorated.

Interest in reflation trades evaporating
However, investor interest in reflation trades has diminished over the past one and a half months, and the rising trend in copper and oil has faltered. The growing concern over an economic downturn has replaced the fears of excessive inflation that have dominated the markets in recent months.

It has again been confirmed that copper is traded when the world economy is doing alright, as its price temporarily distanced itself from the improving fundamental data and sank significantly. The lower interest in reflation trades caused the net long position in copper on the COMEX to crash by 75% compared to its high in December 2020.

Reflation reversal running out of breath
Yields on US government bonds are back at the level of the start of 2021, while inflation figures are remaining surprisingly high. The reversal of the reflation trend will therefore probably soon run out of steam. If the global economic recovery remains intact, there will presumably be nothing to stop a resurgence in reflation trades and the next upswing in copper following the latest correction.

Chart 5: Copper price dependent on reflation trades
In USD



Data: COMEX, January 4, 2021 to July 31, 2021
Past performance is not an indicator of current or future performance.
Source: Bloomberg, Vontobel

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 based on financial market research with the aim of achieving an attractive risk-adjusted performance in the long term.

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