vescore
by Vontobel Asset Management

Global Market Outlook

August 2019

- Economic woes weigh on risk appetite
- Rise in risk indicator slows
- Equity overweighting declines
- Reduction in bond allocation
- Commodities: Price correction on grain
- Swiss equities: Appeal of value factor continues to rise

Economic woes weigh on risk appetite

There are signs of a shift in the relationship between the economy and monetary policy at the start of August: While sentiment had been dominated by hopes of monetary easing in the first half of the year, investors are now focusing on the US trade conflict and the more downbeat global growth forecasts.

After the expectation of an easing of monetary policy in both the US and the euro area had leant massive support to risk appetite and thereby demand for risk-bearing assets in the first half of the year, market participants' confidence gradually ebbed away in July in the face of rising economic concerns. Although the US S&P 500 index hit a record high of more than 3,000 points during the month, growing risk aversion in the last few days has led to significant losses on financial markets around the world. US President Trump's latest escalation of his trade dispute with China put a noticeable dent on the stock markets while at the same time the blame was pinned on the US Federal Reserve. However, the Fed's interest rate cut is likely to be seen as a response to the president's destructive trade policy. The Chinese central bank's response to the announced punitive tariffs was to devalue the yuan. In addition to the conflict with Iran, the lingering specter of Brexit and the EU's problems with Italy, this had the effect of exacerbating the political situation.

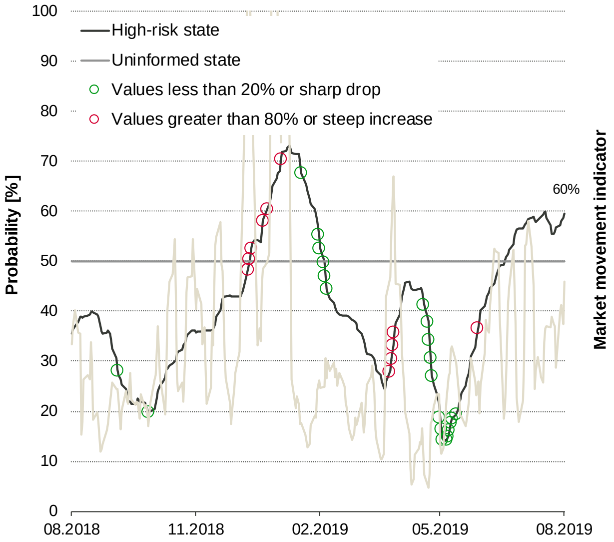
The downturn in global growth prospects will remain a key factor in market participants' risk propensity moving ahead. US foreign policy will therefore continue to play a key role in market developments.

Risk environment

Rise in risk indicator slows

The rise in the aggregate probability of a future high-risk state slowed in July, but at 60% the risk indicator is 4% higher than in the previous month. The risk assessment for the equities market climbed to 90% (previous month: 86%). Similarly, the risk assessment on the currency market increased to 26% (previous month: 17%). The currency market is therefore still contributing least to overall risk. By contrast, the risk assessment for the bond markets fell from 66% in the previous month to 60%.

The non-predictive risk assessment of the emerging markets fell significantly to 60% in July (previous month: 74%). The bond markets have a particularly strong impact on the assessment in these regions (95%).



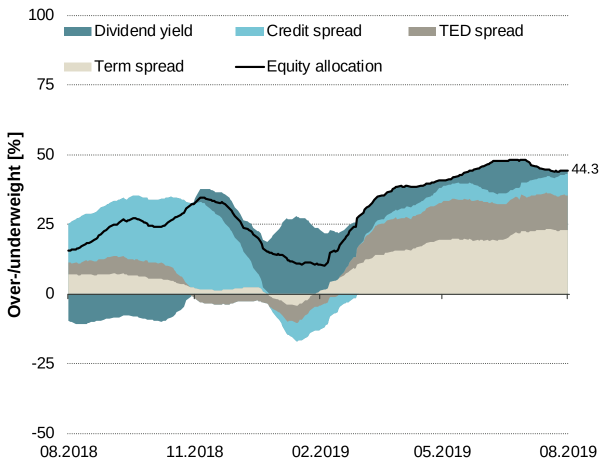
The chart shows the development of the probability of a high-risk market environment in the industrialized countries in the near future (black line). The aggregated probability is calculated in three market segments: equities, bonds and currencies in industrialized countries. Specific characteristics 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 August 1, 2019.

Equities

Equity overweighting declines

At the beginning of August, the equity overweighting in the global GLOCAP sample portfolio (50% equities, 50% cash) was 44.3%. Consequently, the equity allocation has been reduced by 3.9% since the start of July.

With stable contributions of 22.9% and 12.4%, the macroeconomic indicators of instrumental variables, term spread and TED spread, are again providing a foundation for equity overweighting. There has been a shift in the indicators of credit risk spread and dividend yield. The dividend yield was down in the reporting period, in line with the new all-time highs on the US equities markets, thus reducing its contribution to the equity ratio. Given this positive sentiment and the rhetoric of monetary easing, the credit risk spread is falling and thereby driving up the equity ratio in the model.

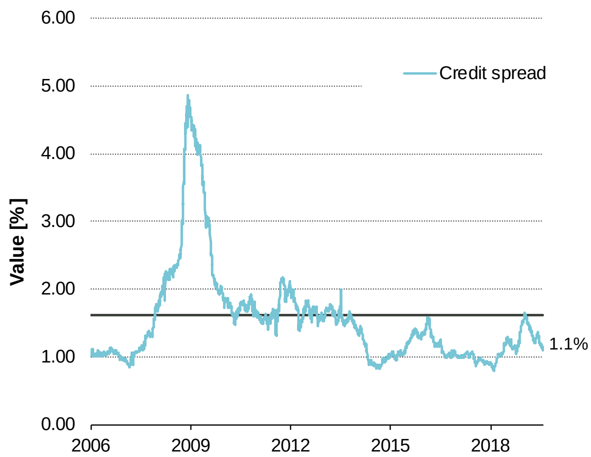


The chart shows the active equity weight (black line) of a global portfolio in euros with a neutral allocation of 50% equities and 50% cash. Foreign currencies are hedged. It also shows the contributions of the individual driving forces (term spread, TED spread, credit spread and dividend yield), which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

Credit risk spread still at low level

As a result of profit expectations largely being exceeded on the one hand and mixed macroeconomic data on the other, the credit risk spread is still at its lowest levels in many years, increasing its contribution to the equity ratio by 3.3% to 7.8% in the reporting period. This decline on the markets of Europe and the US was presumably brought about by expectations of European Central Bank and Fed monetary policy moves.

Hopes for further monetary policy stimulus have not yet been entirely fulfilled. While the Fed cut its interest rates by 0.25%, the ECB has not progressed past announcements at this time. It is now expected that the ECB could lower its current deposit rate of -0.4% once again and launch a new quantitative easing program.



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 August 1, 2019.

	August 1	July 1
Equity overweighting	**44.3%**	**48.2%**
Contribution of the term spread	22.9%	22.7%
Contribution of the TED spread	12.4%	12.8%
Contribution of the credit spread	7.8%	4.5%
Contribution of dividend yield	1.3%	8.2%

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 (yield 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 yield spread 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 credit spread is the spread of corporate bonds with low ratings versus first-rate 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

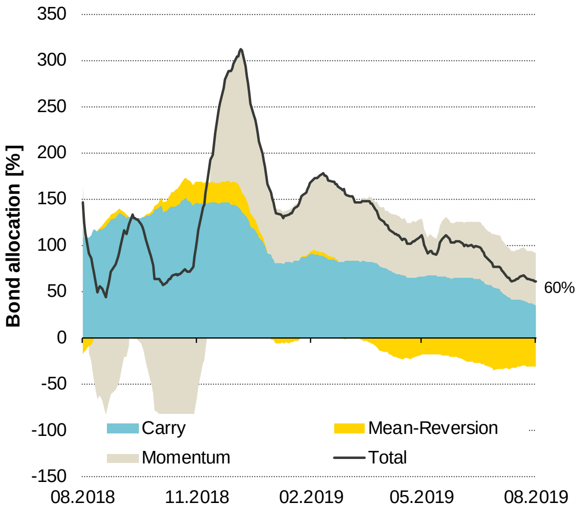
Reduction in bond allocation

The bond allocation ratio of a global portfolio fell by a further 17 percentage points over the course of the month to 60% at the end of July. The position in global government bonds held in the portfolio comprises the contributions of the individual carry, mean reversion, and momentum models.

The drop in bond allocation in the past month is mainly due to the carry component, the contribution of which is now just 35%, having fallen by 18 percentage points. The contributions by the other model components have changed only marginally. The mean reversion component is up by three percentage points on the previous month, while the momentum components have fallen by two percentage points. As of the end of July, the model allocation provides for long positions on most government bonds; only UK bonds are neutral and US treasuries are slightly negative.

Momentum model the main driver in bond allocation

Following the decline in the carry component, the momentum model is the main driver in long positions with a contribution of 56 percentage points. The contribution by the carry models is positive at 35 percentage points, while that of the mean reversion models is negative at 31 percentage points. European government bonds from Germany, France and Italy are still weighted the heaviest.



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 August 1, 2019.

Fed cuts key interest rate by 25 basis points

As anticipated, the Fed dropped its key interest rate by 25 basis points at its meeting at the end of July. As Chairman Powell is calling this a mid-cycle adjustment, market participants disagree on what this could mean for further interest rate policy, hence the yield on US was slightly negative in July. On the other side of the Atlantic, European and Italian bonds in particular made significant gains. This was due firstly to the ongoing crystallization of measures by the ECB and secondly to the EU Commission's decision not to pursue an excessive deficit procedure against Italy. Italian bonds (10Y) climbed by more than 4% in July.

	Total	Carry	Mean reversion	Momentum
Global	60%	35%	-31%	56%
Germany	18%	8%	-4%	13%
France	18%	11%	-9%	16%
Italy	13%	6%	-2%	10%
Great Britain	-1%	1%	-4%	2%
Switzerland	10%	6%	-4%	7%
US	-4%	0%	-6%	2%
Canada	1%	0%	0%	1%
Japan	5%	3%	-2%	4%

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 August 1, 2019.

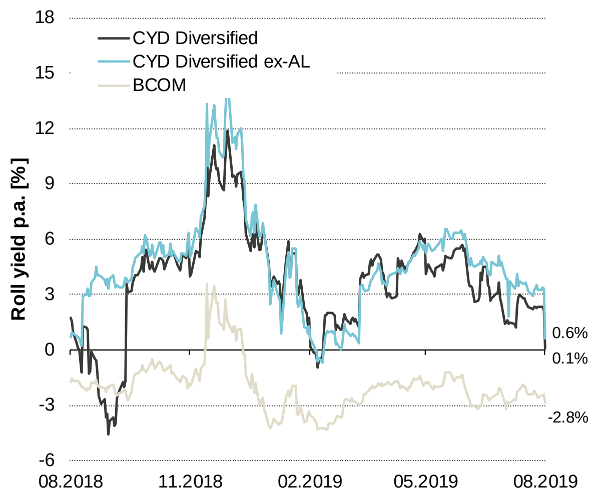
Active duration management with FINCA: The bond allocation is based on the FINCA multi-model approach, which is used as a tool for forecasting changes in the world's most important yield curves of government bonds and swaps. Short-term forecast models (carry, mean reversion, and momentum) are analyzed 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

Commodities: Price correction on grain

The aggregate roll yield for the Bloomberg Commodity Index is still negative at -2.8% p.a., while the CYD Diversified Commodities Index is just hanging on in positive territory with a roll yield of 0.1% thanks to optimized selection.

Massive rainfall had delayed the sowing of corn, wheat and soybeans in key US growing regions in May, triggering a rally in grain prices (+20% corn, wheat). Grain commodities have since corrected from their high levels as a result of better weather conditions and a good harvest. Silver rose by 7% in July, following the movements in the price of gold the previous month. The gold-silver price ratio thus dropped slightly from its highest level in 25 years.

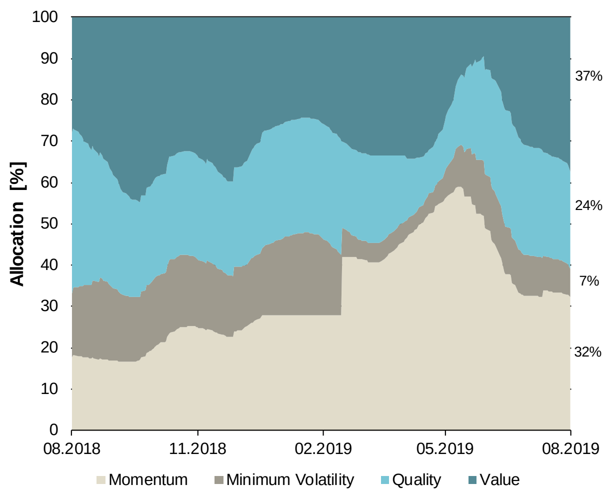


The chart shows the aggregate roll yields of the CYD Diversified Index, CYD Diversified ex-AL Index and the Bloomberg Commodity Index. Roll yields can be derived from the maturity structure of commodity futures. Information as of August 1, 2019.

Swiss equities: Appeal of value factor continues to rise

According to our models for the Swiss equities market, the attractiveness of value stocks rose again in the past month. The allocation of the value factor portfolio, in which financial stocks and industrial companies especially are currently overweighted, climbed to 37%. Value is therefore the most attractive factor at the present time. This shift was at the expense of quality and minimum volatility factors. By contrast, momentum allocation is unchanged at 32%.

The dynamic factor allocation is based on three sub-models that evaluate the economic environment, the price trend and the mean reversion potential. The move to value stocks in the past month was mainly driven by the price trend, while the signals from the other two sub-models hardly changed at all.



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 August 1, 2019.

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