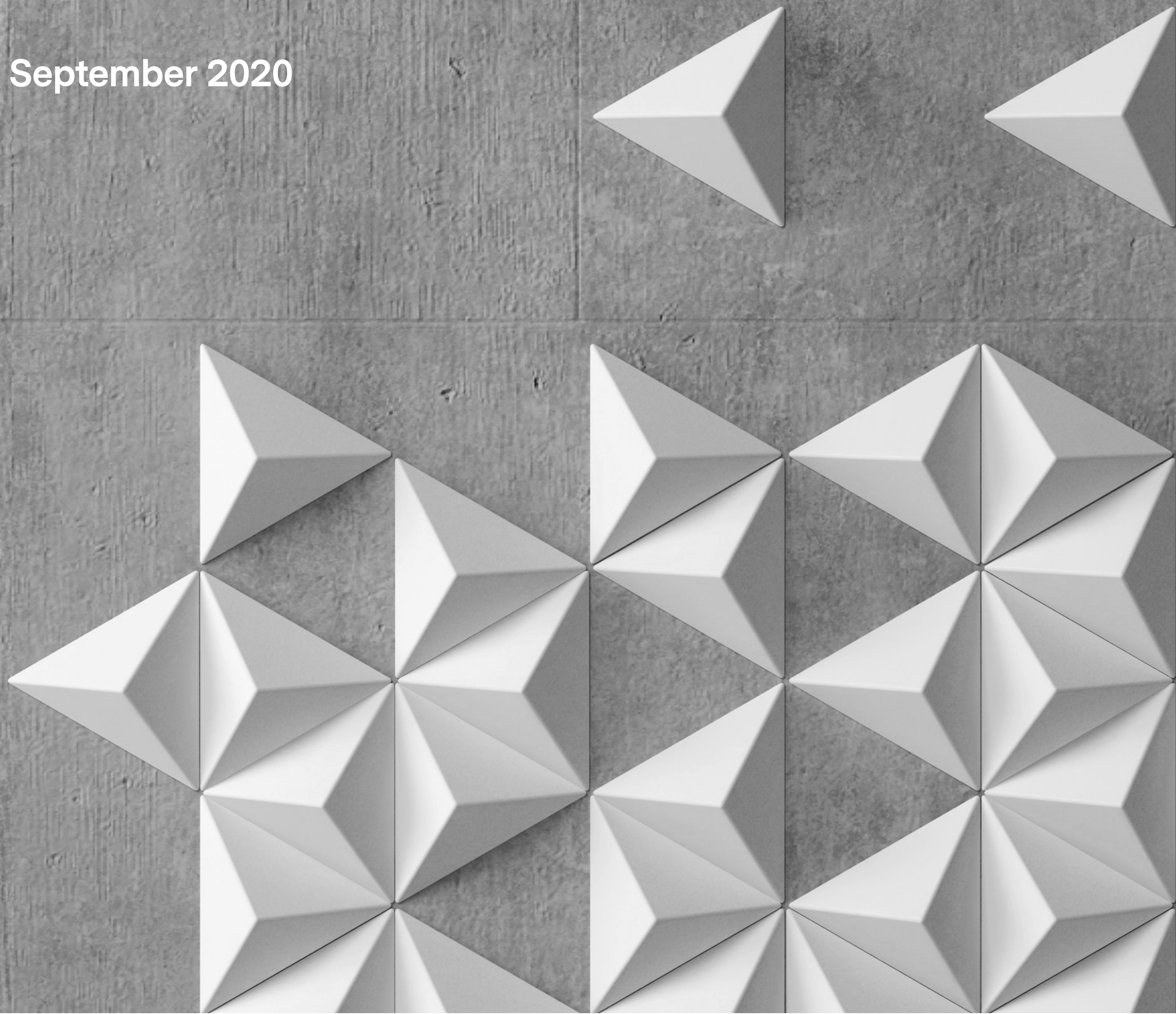
vescore
by Vontobel Asset Management

Global Market Outlook

September 2020



Asset Management

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At a glance

- Equities overweighted, but less so
- Bond model increases short position
- All markets segments still becoming significantly calmer
- Our artificial intelligence predicts market development defined by economic data

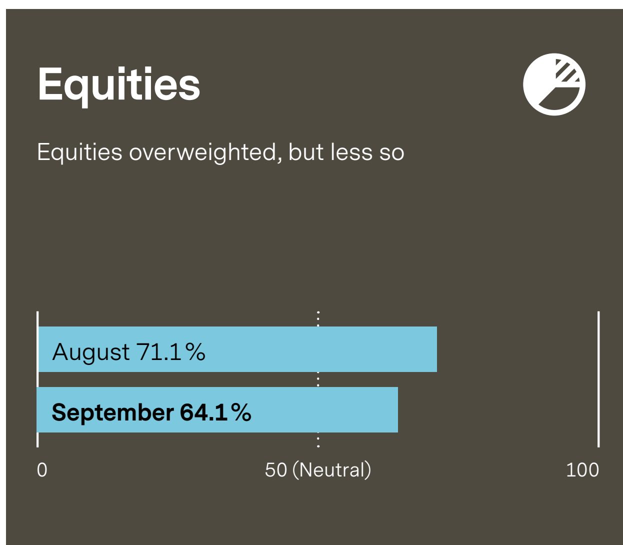
US Federal Reserve changes the rules

The change in US interest rate policy is essential to assessing the fundamental economic market environment at the start of September: In his opening speech at the annual Federal Reserve symposium in Jackson Hole, Fed Chair Powell announced a revised inflation target and a stronger focus on the labor market.

Following a thorough revision of its monetary policy, the Fed announced that it was standing by its annual inflation target of 2.0 % but that this would be targeted as an average. This means that higher inflation will be tolerated for a certain period of time if it was previously – as it is now – lower than the 2.0 % target. In former times, the Fed began combating price overheating if inflation approached the 2.0 % mark. The direct consequence of this move is that relaxed monetary policy will continue for longer. This new target can be placed in the context of various developments that have occurred since 2012:

Lower rates of growth in the US and globally, low interest rates, and a very strong US labor market that did not necessarily bring about higher inflation. Looking ahead, the focus will likely be on the labor market, with low and medium earners targeted to benefit the most from the new approach – think “catch-up growth”. The US yield curve increased at the long end as a result, with the US equity markets enjoying particular gains. Meanwhile, the US dollar was down slightly.

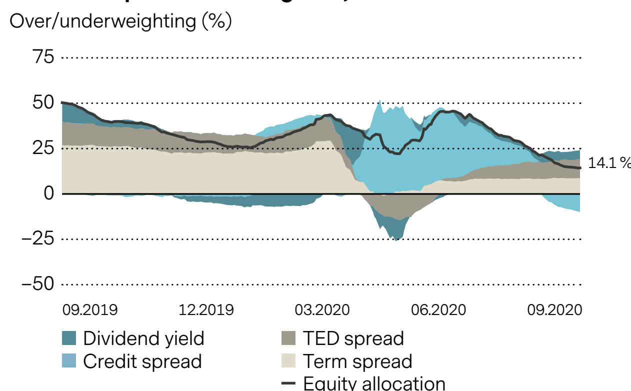
Following the Fed’s revision of its interest rate policy at the end of August, it remains to be seen whether and to what extent other central banks around the world will follow suit. This provides more scope to maintain more relaxed monetary policy for longer going forward and to stimulate the global economy. Given the recent fall in consumer prices in the euro area, the ECB is particularly likely to remain committed to expansive monetary policy.



At the beginning of September, the equity overweighting in the global GLOCAP sample portfolio (50% equities, 50% cash) was 14.1%, significantly lower than in the previous month. The decline is due solely to the now negative contribution by the credit spread, which at times was the sole reason for the equity overweighting in recent months. The other instrumental variables are still contributing positively to equity overweighting, and slightly increased their contributions.

Chart 1: Equities overweighted, but less so

Over/underweighting (%)

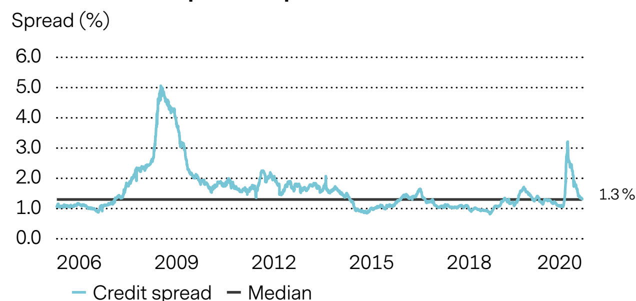


The chart shows the active equity weight (black line) of a global portfolio in euros with a neutral allocation of 50% equities and 50% cash. Foreign currencies are hedged. It also shows the contributions of the individual driving forces (term spread, TED spread, credit spread and dividend yield), which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

The contribution by trust in corporations, measured by the credit spread, is down further, reducing equity allocation by currently 9.8%. After widening in the wake of the COVID-19 crisis, intervention by various central banks, in particular the ECB's and Fed's bond purchase programs, caused spreads to narrow significantly from April onwards. Credit risk premiums on the markets of the euro area and the US under observation then stabilized almost at pre-crisis levels in the past month, hence this variable is not sending any positive signals at this time and the equities position is shrinking.

Chart 2: Credit spread at pre-crisis level

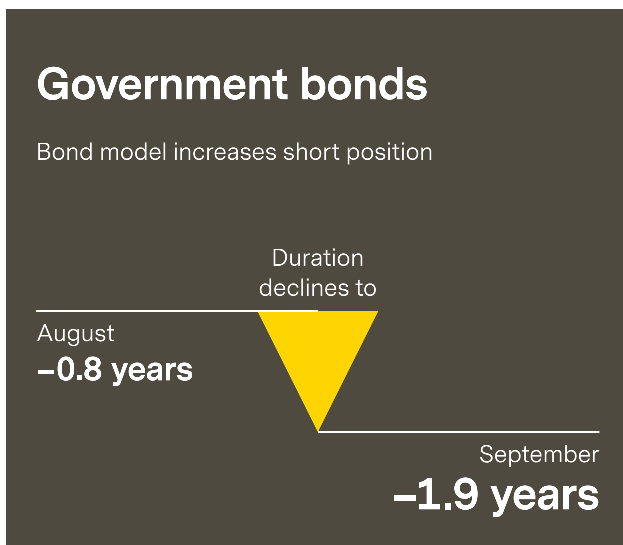
Spread (%)



The chart shows the credit spread 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 September 1, 2020.
Source: Vescore

	SEPTEMBER 1	AUGUST 3
Equity overweighting	**14.1%**	**21.1%**
Contribution of the term spread	8.4%	8.1%
Contribution of the TED spread	10.3%	9.2%
Contribution of the credit spread	–9.8%	0.3%
Contribution of dividend yield	5.3%	3.4%

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



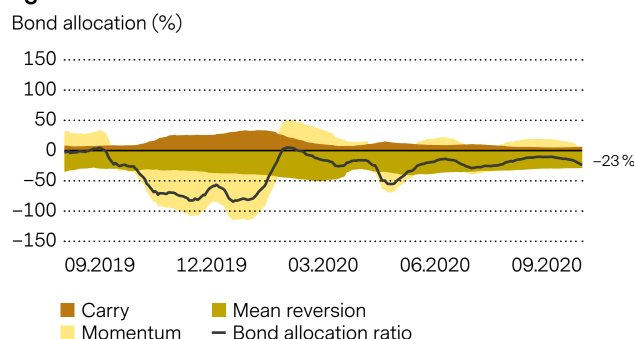
The allocation ratio of a global bond portfolio is down against the previous month and was –23% at the start of September, representing a duration of –1.9 years. The position in global government bonds held in the portfolio comprises the contributions of the individual carry, mean reversion, and momentum models. While the absolute changes in the carry and mean reversion component models are marginal at 1% each, the weighting of the momentum component is down by 15 percentage points and now even having a minimal negative effect with a contribution of –1%. The main driver of the short position is still the mean reversion model with a contribution of –29%, while the carry is having a marginally positive effect with a contribution of 7%.

Global bonds came under pressure in August, and in some cases ended the month deep in negative territory. Italian government bonds were again the most stable in the 10-year range with a performance of –0.1%, while UK gilts are at the bottom of the table at –1.9%.

In the first half of the month, this was due to positive economic developments and hopes that the COVID-19 pandemic would continue more mildly. Then, in the last week of August, focus shifted to the speech by Fed Chairman Powell at the annual symposium in Jackson Hole. The announced evaluation of central bank policy over the last few years resulted in an adjustment of the inflation target: The target of 2% is still in place, but moving ahead efforts will be made to achieve this as an average over a defined period. The consequence of this adjustment will be a more prolonged, supportive central bank policy, which will lead to higher peak inflation rates in the medium to long term. Yield curves grew steeper as a result, driven by the long end.

Chart 3: Model increases short position in global bonds again

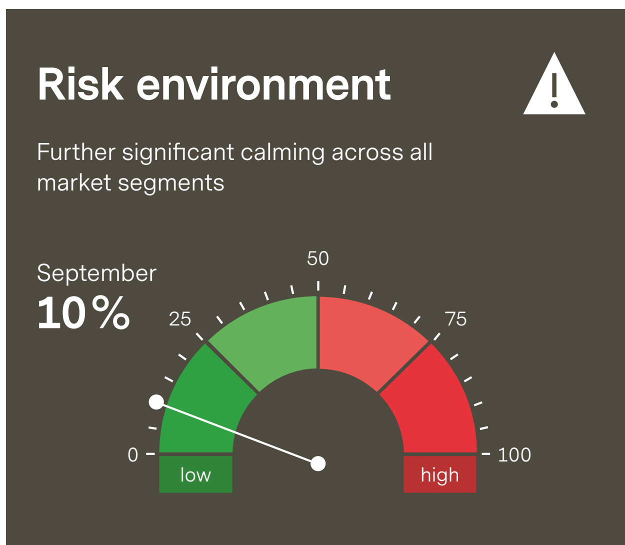
Bond allocation (%)



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 September 1, 2020
Source: Vescore

	TOTAL	CARRY	MEAN REVERSION	MOMENTUM
Global	–23%	7%	–29%	–1%
Germany	0%	1%	–1%	1%
France	–2%	1%	–3%	1%
Italy	3%	1%	–1%	2%
Great Britain	–4%	1%	–5%	0%
Switzerland	–6%	2%	–4%	–3%
US	–3%	1%	–4%	1%
Canada	–6%	0%	–7%	0%
Japan	–6%	1%	–4%	–3%

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 September 1, 2020
Source: Vescore



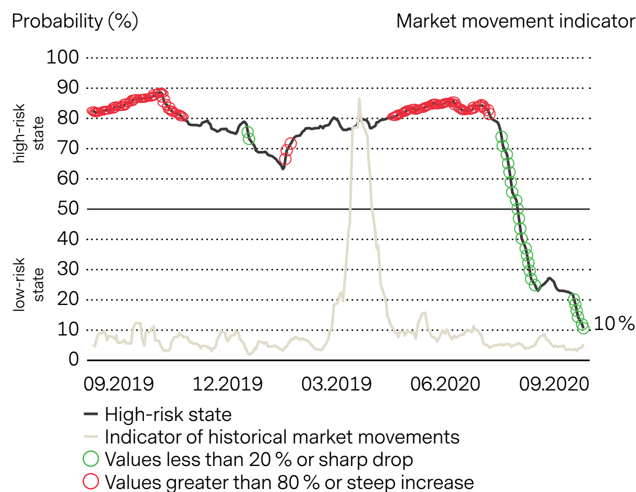
The risk indicator stabilized in the green in the past few weeks. The aggregate probability of a future high-risk state on the developed markets declined further from 25 % in August to 10 % in September.

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 dropped from 30 % to 9 % for equities, from 31 % to 12 % for bonds and from 15 % to 10 % for currencies. This indicates that calm is returning across all market segments.

The risk indicator for the emerging markets fell by even more than for the developed markets: from 14 % to 6 %. The risk estimates for the emerging markets declined from 7 % to 6 % for equity markets, from 16 % to 3 % for bond markets and from 20 % to 10 % for currency markets.

Chart 4: Risk indicator falls further



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 September 1, 2020
Source: Vescore

Current topic

Our artificial intelligence predicts market development defined by economic data

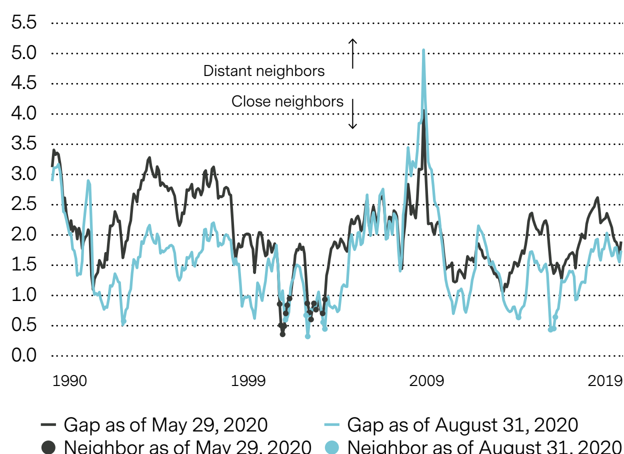
AI forecasting reliability better again in recent months
Vescore uses artificial intelligence (AI) methods and the machine learning process known as "artificial market intelligence" (AMI). Periods in the past that had economic conditions as similar as possible to today are systematically identified and these are then used to determine the optimal allocation for the current 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.

Dotcom crisis still the most important "economic neighbor"
In terms of the current situation, most "economic neighbors" can be found in the period from April 2001 to August 2003. This period saw the bursting of the dotcom bubble starting in March 2000, triggering serious asset losses among investors in industrialized countries. But other periods are becoming increasingly comparable as well, including the end of 1992 (EMS crisis), 2010 / 11 and the end of 2013 (euro crisis) and the second half of 2015 (China crisis). Comparing the economic environment in May 2020 with that of today shows that the proximity to economic neighbors has increased significantly, which is likely to improve the reliability of forecasting.

Which strategies are allocated?
As of the end of August, the fundamentals-driven allocation (Economist / GLOCAP) is clearly overweighted at 39%. The Adapter (trend) is currently at 25% while Pari (risk parity) and Amily (artificial intelligence) are underweighted at 19% and 17% respectively. In summary, this means that the development of the capital markets is currently expected to be led by economic facts, and GLOCAP is the preferred forecast model.

Chart 5: Period after the millennium the closest historic "neighbor"

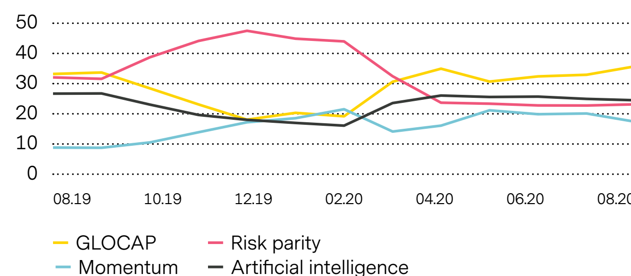
Economic gap as of May 29, 2020 and August 31, 2020



The chart shows how close current market conditions and those at the end of May 2020 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. As of September 1, 2020
Source: Vescore

Chart 6: Model allocation increasingly moving towards fundamentals

Allocation to sub-models by AMI in %



The chart shows the allocation between the various approaches on the basis of the AMI analysis. As of September 1, 2020
Source: Vescore

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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