vescore
by Vontobel Asset Management

Global Market Outlook

March 2021

Asset Management

At a glance

— Equities:
Slight increase in overweighting

— Government bonds:
Short positioning expanded significantly

— Risk environment:
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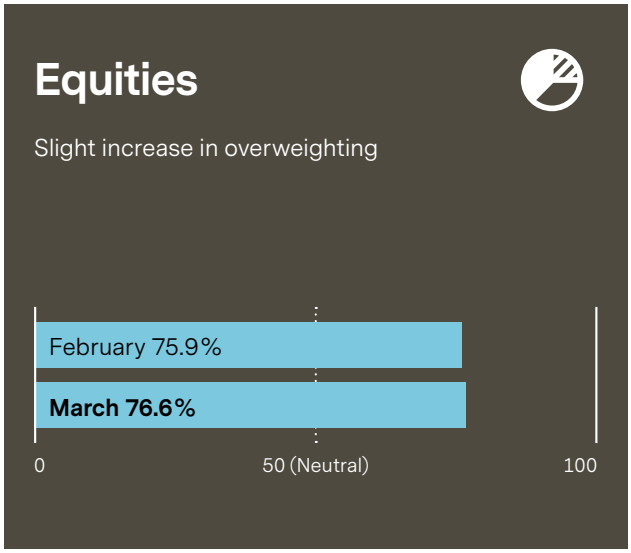
Burgeoning inflation worries stir up markets

Market participants' risk appetite is currently still fluctuating between confidence, founded on the slowing rate of infection and vaccination progress, and deep-seated concern over the economic prospects and rising inflation.

Stock markets around the world reported significant price increases in the first half of February. As the month went on, euphoria on the markets declined considerably. The economic data showed positive trends, including for the German export industry. In contrast, the latest developments in the COVID-19 pandemic are weighing on growth expectations: The advancing spread of potentially more infectious virus variants is bumping up against the general hope for an easing of lockdown restrictions, which is considered critical especially for small and medium-sized businesses.

Halfway through the month, sharp increases in bond yields in the US slowed demand for risk-bearing investments around the world and sparked another sell-off on the stock markets. In particular, the rapid rise in interest rates was triggered by inflation concerns over the multi-trillion-dollar US stimulus package. Although Fed Chairman Jerome Powell reiterated that the ultra-loose monetary policy will continue, interest rates on 10-year US Treasuries are continuing to rise and briefly hit a high of 1.6%. An excessive interest rate is generally considered to be harmful to equities, as the higher refinancing costs depress companies' growth prospects. Equities then promptly felt a clear drop in demand. In response to these developments, the European Central Bank also restated its expansive monetary policy, which still has ample leeway for intervention buying through the pandemic emergency purchase program (PEPP).

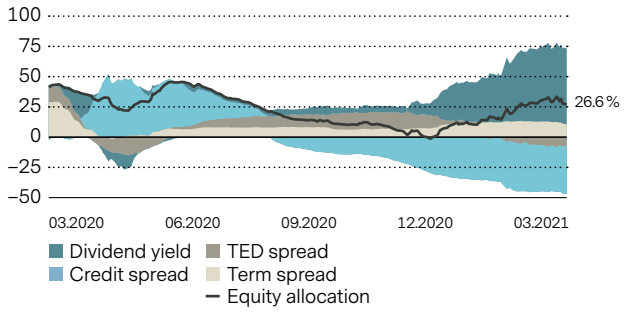
A key factor in market participants' risk propensity in March will be how politicians on both sides of the Atlantic manage the balancing act between easing, which should aid the economy, and as comprehensive control of the pandemic as possible. Also incipient inflation expectations are likely to play a weighty role.



The equity overweighting in the global GLOCAP sample portfolio (50 % equities, 50 % cash) is slightly higher at the start of March 2021 versus the previous month, mainly on account of the increased contribution from the dividend yield. The negative contribution of the credit spread and the positive contribution of the term spread are less than in the previous month. The negative contribution of the TED spread has increased and is reducing equity allocation by 6.4 percentage points. This instrumental variable is calculated from the respective TED spread for the US, the eurozone and Japan. The correlation between the TED spread and its effect on equity allocation – called sensitivity – is usually negative, i.e. if the TED spread declines, equity allocation rises. However, this mechanism is out of action at the moment and the sensitivity is positive, i.e. the model is translating the falling TED spread into a lower allocation, which is currently even negative. Given the significant increases on the stock markets over the last months, this suggests an anticyclical pattern, which has rarely been the case to date for the TED spread. This is due to the fact that the glut of liquidity provided by the world's central banks in conjunction with the pandemic on the one hand calmed the capital markets, which is why the TED spread kept on falling, and on the other hand, partially flowed into the stock markets. Thus, prices have been rising significantly since March 2020, as a result of which the TED spread currently considers the stock market risk premium to be below-average. For the first time in January 2021, the US Fed discussed bringing its bond purchase program to a close, which might draw liquidity away from the capital markets. It is now important to keep an eye on whether the positive sensitivity will persist.

Chart 1: Equity overweighting increases again

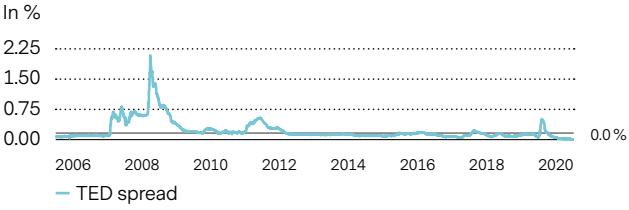
Over/underweighting (%)



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 March 2, 2021. Source: Vescore

Chart 2: Low TED spread – abnormal sensitivity

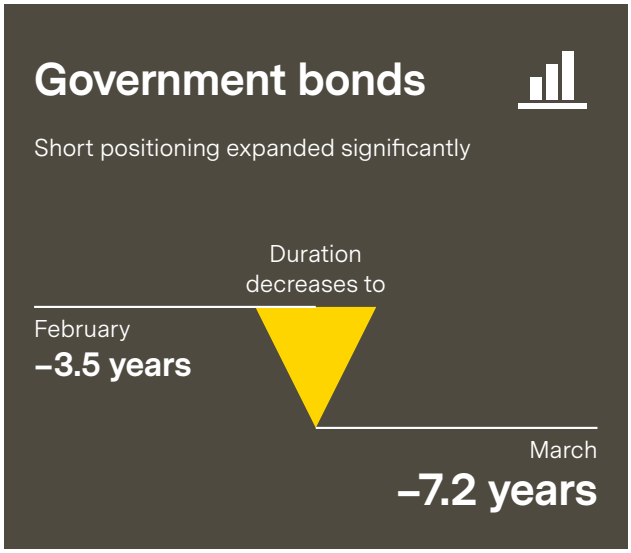
In %



The chart shows the TED spread, which measures the stability of the financial system according 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 the average (blue line) and the median (black line). Information as of March 2, 2021. Source: Vescore

	MARCH 2	FEBRUARY 2
Equity overweighting	**26.6 %**	**25.9 %**
Contribution of the term spread	10.8 %	12.9 %
Contribution of the TED spread	–6.9 %	–4.0 %
Contribution of the credit spread	–38.5 %	–39.3 %
Contribution of dividend yield	61.3 %	56.3 %

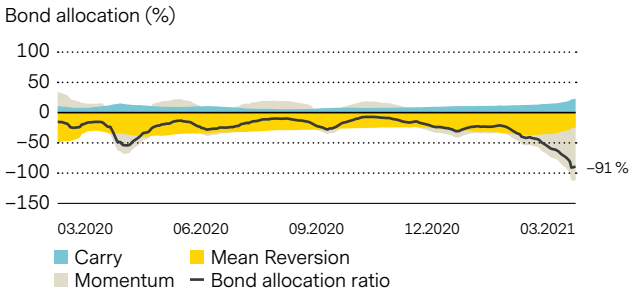
The table shows the contributions of the instrumental variables to the equity overweighting at the beginning of the month. Source: Vescore



The allocation ratio of a global bond portfolio is down significantly versus the previous month at –91% at the start of March, corresponding to a duration of –7.2 years. The position in global government bonds in the portfolio comprises the contributions of the three sub-models carry, mean reversion and momentum. The negative contribution of the momentum model increased sharply. It is currently –89% and is the main factor behind the pronounced short position. By contrast, the mean reversion model reduced its negative contribution by 13 percentage points and is now contributing just –25% to overall allocation. As a result of the steeper yield curves of the global bond markets, the carry model alone is expanding its long position by 10 percentage points to 23%.

The first half of February was dominated by Italy's search for a new prime minister following the resignation of Giuseppe Conte and the dissolution of the government. Ultimately, Mario Draghi, former president of the European Central Bank, won a parliamentary majority and was sworn into office in mid-February. The response on the bond markets was euphoric: The spreads between 10-year Italian government bonds and their German counterparts narrowed to 90 basis points, the lowest level in more than five years. As the month wore on, global bonds came under massive pressure to sell. Interest rates on 10-year German government bonds picked up approximately 30 basis points in February, and those on their US and UK counterparts even rose by 35 and 50 basis points respectively. This is due to higher inflation expectations as a result of accommodative central bank policy and the significant economic recovery hoped for in view of vaccination progress. The response from central banks has so far been mixed: The US Fed and the Bank of England communicated the sharp rise in interest rates as market confidence in future economic strength. By contrast, the ECB expressed concern that higher interest rates would slow the economic recovery and require further stimulus measures.

Chart 3: Short position increases



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 March 2, 2021. Source: Vescore

BOND ALLOCATION	TOTAL	CARRY CONTRIBUTION	MEAN REVERSION CONTRIBUTION	MOMENTUM CONTRIBUTION
Global	**–91%**	**23%**	**–25%**	**–89%**
Germany	–12%	1%	–4%	–9%
France	–13%	1%	–5%	–9%
Italy	0%	2%	–2%	1%
Great Britain	–16%	3%	–8%	–11%
Switzerland	–14%	4%	–1%	–17%
US	–4%	4%	–2%	–7%
Canada	–10%	5%	–4%	–10%
Japan	–22%	3%	1%	–26%

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 March 2, 2021. Source: Vescore

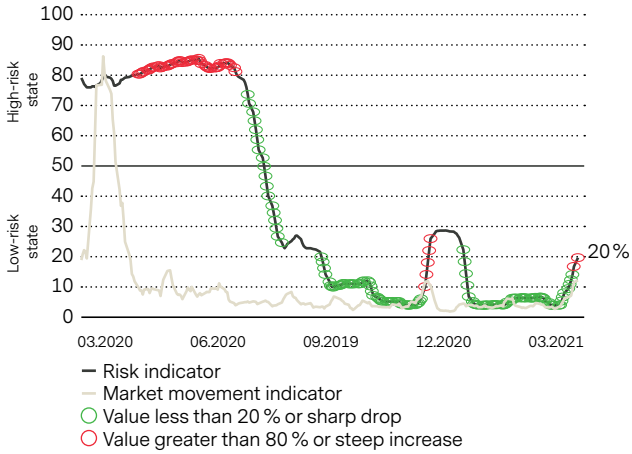
The risk indicator has risen from a very low 4 % in the previous month to a level last seen at the start of December. The aggregate probability of a future high-risk state on developed markets is now 20 %. The risk indicator analyses the current environment and shows whether the future risk is high or low. It does this by comparing short-term yields with long-term yields.

The rise in the measure of risk is mainly due to a strong increase in risk probability on the bond markets. For these, the model is currently showing a high-risk probability of 44 % versus 6 % in the month prior. The greater perceived volatility in bonds at the start of March is mainly due to the significant rise in interest rates, specifically at the long end of the yield curve, which is reflecting the current rise in market participants' inflation expectations. The risk assessment is currently 4 % for bonds and 11 % for currencies.

The risk indicator in the analysis for emerging markets decreased as well, from 19 % to 7 %. While the assessment for a future high-risk state on equity markets increased slightly versus the previous month, from 5 % to 11 %, probabilities for the two asset classes bonds and currencies are down significantly: the indicator for bond markets fell from 30 % to 6 % and the one for currency markets from 21 % to 4 %.

Chart 4: Risk indicator higher, but still in the green range

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 equity, fixed income and foreign exchange. 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 March 2, 2021. Source: Vescore

Current topic

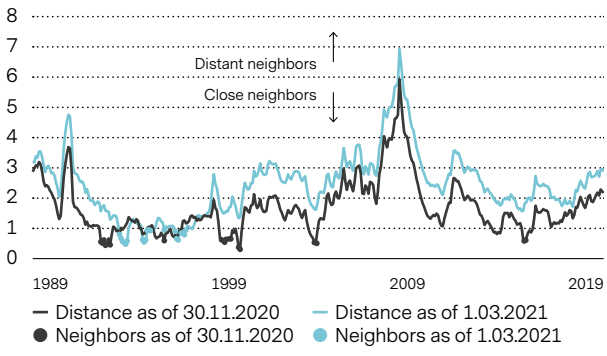
AI currently focusing on risk parity model

AI forecast liability lower versus November 2020

Vescore uses methods based on artificial intelligence (AI) and machine learning, known as "artificial market intelligence" (AMI). To determine the optimal allocation for the current economic environment, periods in the past with economic conditions as similar as possible to today are systematically identified. Measurement is based on the four instrumental variables used under GLOCAP (term spread, TED spread, credit spread and dividend yield), global inflation and various economic trends. Comparing the current environment to that at the end of November (see Global Market Outlook, December 2020) shows that the economic distance has grown wider, while the current "economic distance" line has almost always been higher than the line at the end of November 2020 for almost 30 years. This signals that forecast reliability has deteriorated in recent months.

Chart 5: Fewer "economic neighbors"

Economic distance as of March 1, 2021 and November 30, 2020



The chart shows how close current conditions and those at the end of November 2020 are in economic terms to those in the past, starting in 1988. The dots indicate the points in time of the greatest "economic proximity", i.e. phases that are most comparable with today's environment. Information as of March 2, 2021. Source: Vescore

"Economic neighbors" found only in 1993-97

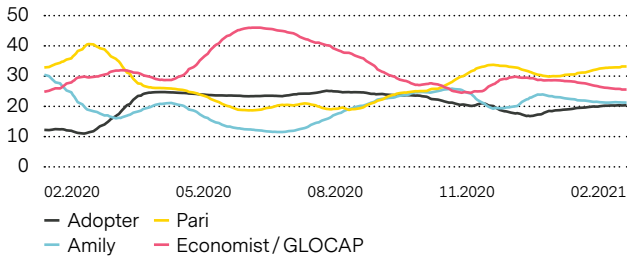
While the "economic neighbors" for summer 2020 were in the phase of the dotcom crisis of 2001–03, the periods with the greatest economic proximity to the last few months moved further back into the past. The periods with a high economic proximity are currently between September 1993 and May 1997. During this phase, global GDP growth climbed from 2.1 % (1993) to 4.0 % (1997). This kind of concentration on a single period has never been seen before since the model was established. It signals the end of an economic downturn.

Focus on risk parity model

On the basis of this analysis, AMI is now significantly overweighted at 33 % in the risk parity model (Pari), as in March, April and November 2020, and the weight of the economic model (Economist / GLOCAP) has fallen to a neutral 25 %. The Adopter model (trend) and the Amily model (artificial intelligence) are underweighted at 20% and 21 % respectively. Overall, AMI is thus currently opting for an allocation shaped by risk diversification.

Chart 6: Risk parity model dominant

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 March 2, 2021. 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 based on financial market research with the aim of achieving an attractive risk-adjusted performance in the long term.

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