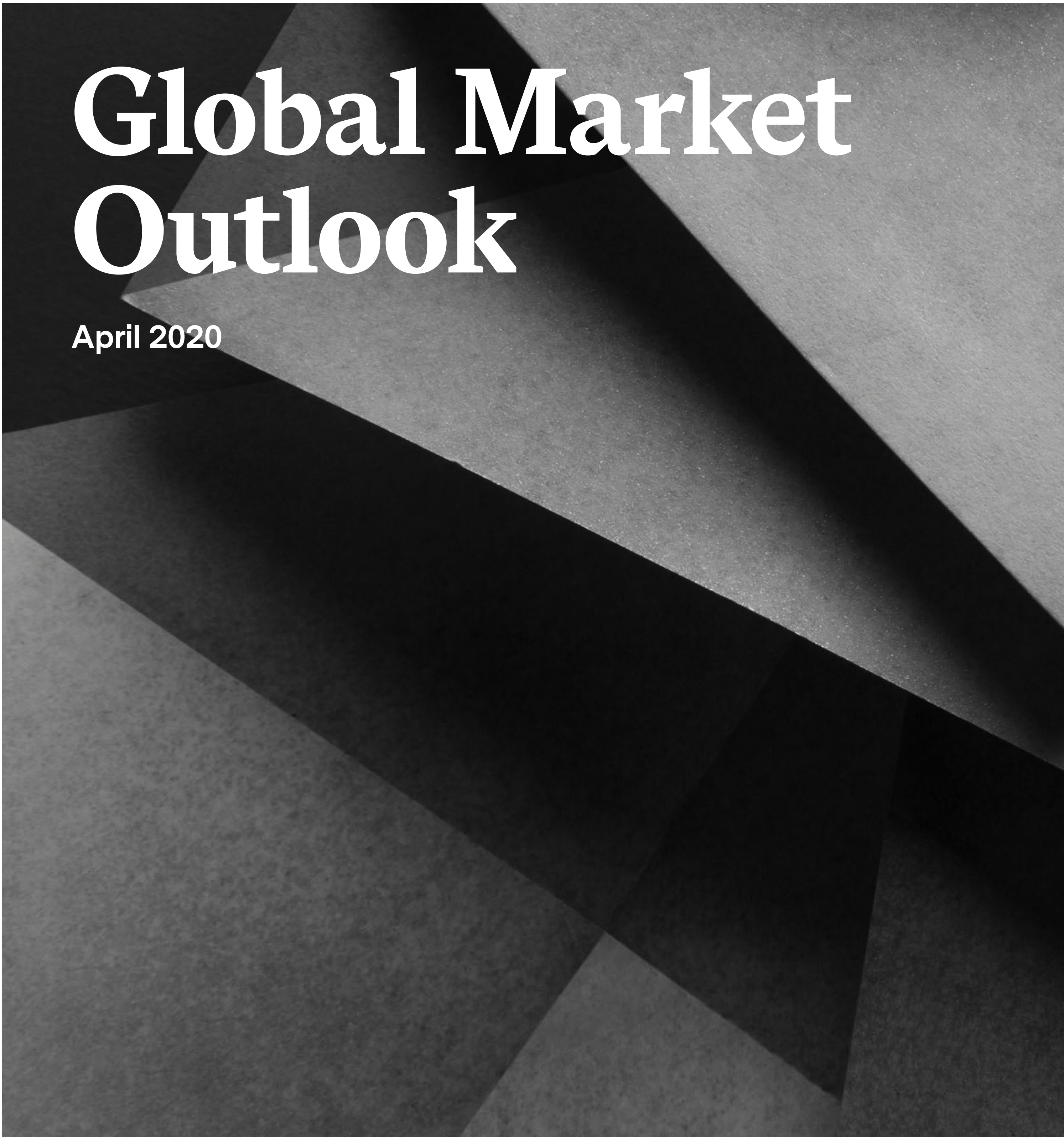
vescore
by Vontobel Asset Management

Global Market Outlook

April 2020



Asset Management

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At a glance

- Decrease in equity overweighting
- Neutral duration positioning
- Risk indicator high
- In focus: the oil price and gold

The World Holds its Breath – So Do Capital Markets

The global capital markets have suffered dramatic price slumps over the past month. The global outbreak of the SARS-CoV-2 virus triggered a massive surge in market participants' risk aversion, with the economic consequences of government measures as yet incalculable but certainly far-reaching.

Government measures aimed at slowing the spread of the SARS-CoV-2 virus have considerably restricted public life and curbed the real economy in many places across the world, in some cases even bringing it to a standstill. With the exception of a few sectors, private consumption has also plummeted. These dramatic developments hit in a market environment where flat, in some cases inverse yield spreads had been pointing to a global recession for some time. All of this culminated in a rapid surge in risk aversion and triggered enormous losses on capital markets, with investors initially fleeing to safe havens such as government bonds or liquidity. In addition, the considerable supply-side slump in the price of oil also took a toll on equity markets. Consternation on capital markets was also reflected in a sharp rise in fluctuation, with the CBOE volatility index for the S&P 500, the VIX, closing at over 80% over the month.

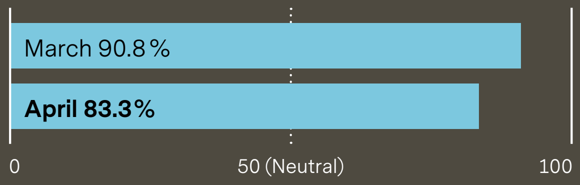
Extensive money policy measures introduced by central banks have so far largely fizzled out on markets but should provide the liquidity required moving ahead, especially in the banking sector.

Meanwhile, expectations are directed at governments, which are coming under pressure to employ fiscal policy to counter the damaging impact on the real economy. They launched billion euro rescue packages to stabilize the economy and improve the bleak prospects of many companies by way of emergency loans, guarantees and more. At the same time, this passes some of the risk over to countries, which can currently be seen in the moderate increase in credit default swaps (CDS). All told, sentiment on global capital markets has not yet stabilized, also a result of poor economic data (ifo index, US unemployment).

A decline in the sense of alarm witnessed on markets will be determined primarily by the pace at which SARS-CoV-2 continues to spread. The slowdown required and the flattening of the exponential curve is highly dependent on how effective the measures taken prove to be. It remains unclear whether fiscal support will be able to sustainably absorb the damage to companies and the real economy around the world. Nonetheless, the final trading days in March show the first signs of slight easing on capital markets.

Equities

Decrease in equity overweighting



At the beginning of April, the global GLOCAP sample portfolio (50 % equities, 50 % cash) remains 33.3 % overweight in equities. Nonetheless, the assessment of the fundamental economic market environment has changed significantly given the serious turbulence on global capital markets:

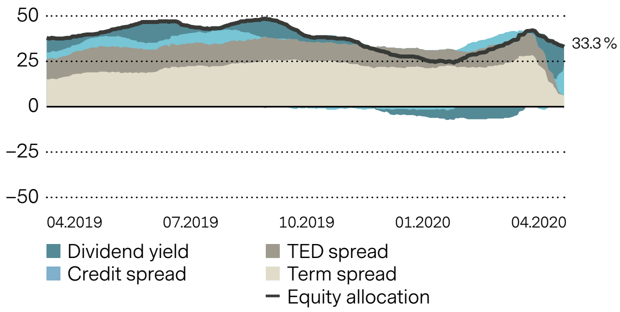
The model has recognized that the fundamental link between a weak economic outlook and central bank support has broken down. The picture is now being shaped by the severe deterioration of the global economy. This is reflected by the sensitivity of the allocation to economic expectations, measured using the yield spread which has now turned positive – the "normal" economic view.

The TED spread – which measures the difference between the interbank interest rate and a default-proof investment – has climbed massively in the last few weeks. This indicates perceptions of a considerably higher credit risk, some of which is being passed on to banks – although it is still far from the levels seen in the financial crisis over a decade ago.

How equity allocation develops moving forward depends on how willing market participants are to take risks. For example, the increase in credit spreads also shows that company solvency is currently more critical than in the previous month. It remains to be seen whether government support packages can boost confidence in companies and whether short-term support for equity overweighting will bear out.

Chart 1: Decrease in equity overweighting

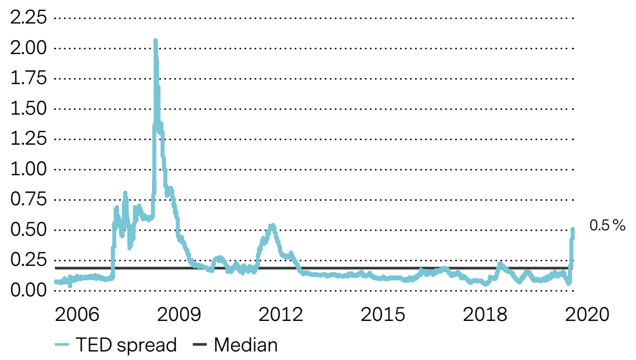
Over- / underweight (%)



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 April 1, 2020

Chart 2: Jump in TED spread

Spread (%)



The chart shows the indicator for liquidity preferences and systemic risk that measures the stability of the financial system in correspondence 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. Information as of April 1, 2020

	APRIL 1	MARCH 2
Equity overweighting	**33.3 %**	**40.8 %**
Contribution of the term spread	6.5 %	28.5 %
Contribution of the TED spread	–1.6 %	12.8 %
Contribution of the credit spread	19.6 %	1.4 %
Contribution of dividend yield	8.8 %	–1.9 %

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

Government bonds

Neutral duration positioning

rises slightly to

April
–1.4 years

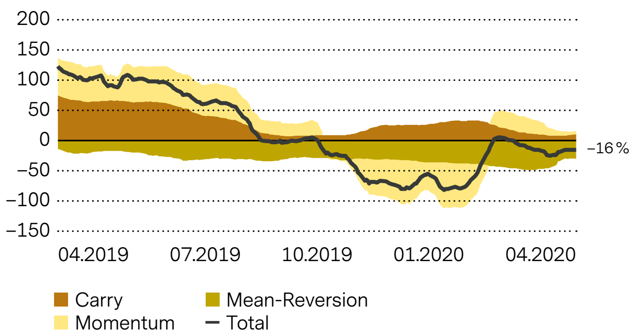
March
–2 years

The allocation ratio of a global bond portfolio remained constant against the previous month and amounted to –16 % at the start of April, representing a duration of –1.4 years. The position in global government bonds held in the portfolio comprises the contributions of the individual carry, mean reversion, and momentum models. The contribution of each sub-model in absolute terms declined during the reporting period, stabilizing the bond allocation ratio at a slightly negative level. The most significant changes were seen in the momentum model, where the positive contribution fell from 24 % to 6 %. The negative contribution of the mean reversion model also decreased from – 50% to –31 %. Carry strategies contribute 10 % to bond allocation.

The strong momentum seen on capital markets in March as a result of the SARS-CoV-2 virus and disagreement between the oil-producing countries Saudi Arabia and Russia was also reflected on bond markets, an example being the yield on ten-year US Treasuries fluctuating between 0.31 % and 1.27 %. While government bonds in the global bond portfolio remained in high demand in the first few days of the reporting period as “safe havens”, some of these subsequently suffered heavy losses, prompting steeper yield curves. Market participants had to process new monetary and fiscal policy changes on an almost daily basis. Around the world, central banks attempted to tackle the uncertainty with unscheduled interest rate cuts and generous liquidity provisions. At the same time, several countries announced economic measures to contain the damage to their economies that have nearly shut down as a result of SARS-CoV-2. This will translate into increased issuing activities by these states in the near future.

Chart 3: Duration slightly short

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 April 1, 2020

	TOTAL	CARRY	MEAN REVERSION	MOMENTUM
Global	–16%	10%	–31%	6%
Germany	–3%	1%	–5%	1%
France	–3%	4%	–6%	0%
Italy	–3%	3%	–3%	–3%
Great Britain	–5%	0%	–6%	1%
Switzerland	–3%	1%	–4%	0%
US	–1%	0%	–5%	3%
Canada	–1%	0%	–3%	2%
Japan	2%	1%	0%	2%

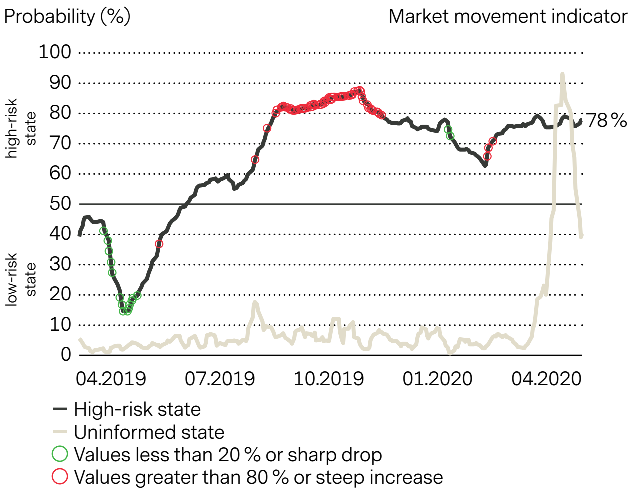
The table shows the bond allocation of a global portfolio in euros (total) broken down into individual countries. It also lists the contribution of the short-term forecast models carry, mean reversion and momentum to the total bond allocation. Information as of April 1, 2020

The risk indicator has been showing a significantly elevated probability of a high-risk state since the end of January. Since January 27, turbulence – which is based on the forecastless risk indicator – has recorded a sharp jump. This turbulence assesses the fluctuations on equity, bond and currency markets, measured by looking at the variance and covariance of individual investments and comparing current and past figures.

A rise in turbulence reflects a more “jittery” covariance matrix, thereby suggesting an increased probability of a high-risk state. A high-risk state is characterized by changes in the correlation structure of market segments, with diversification potential typically dwindling away in these phases. One use of the instrument is for managing the exposure of quantitative investment processes and it can reduce active allocation in periods of stress.

The aggregated probability of a future high-risk state remains high in March (78 %). The risk indicator also puts the probability of a high-risk state in emerging markets at 86 %.

Chart 4: Risk indicator continues to show high-risk state



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 April 1, 2020

Current topic

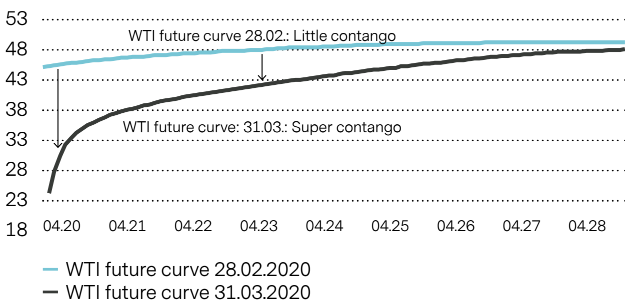
In focus: the oil price and gold

As for all risk-bearing asset classes, commodities markets are severely affected by the demand shock generated by the SARS-CoV-2 pandemic. Growth prospects at the start of the year were excellent, but these have since been lowered considerably. Metals that are sensitive to cyclical trends (copper down 20 % since the start of the year) and energy carriers (WTI crude oil down 66 % since start of the year; gasoline down 68 %) have come under particular price pressure.

Simultaneous supply and demand shock for crude oil
As well as the fall in demand, the price war between Saudi Arabia and Russia also hurt energy carriers. Saudi Arabia intends to ramp up its production by 3.5 million barrels a day, a move that will soon put global stocks to the test. Storage capacities could max out in the next two months, ultimately forcing Russia and Saudi Arabia back to the negotiating table.

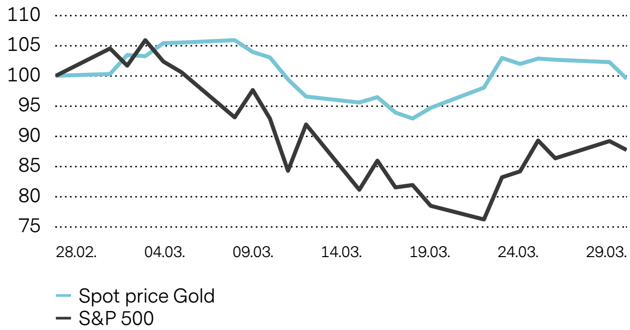
Crude oil future curves are currently in what's known as a "super contango": while front-month contracts are suffering as a result of massive oversupply, contracts dated further into the future are holding up relatively well. This is because many producers (e.g. US shale) are being squeezed out of the market in the medium term while, at the same time, demand for oil is expected to stabilize again in the second half of the year. Our CYD Diversified Commodities strategy takes advantage of this. It retains an underweight position in the energy sector and also selects contracts with longer terms that have lower roll costs on account of the flatter forward curve in this area.

Chart 5: Future curve of oil before the crisis and now
Price in US Dollars per barrel



Gold failing to shine as safe haven
Gold was unable to live up to its role as a safe-haven asset in March and came under pressure mid last month at the same time as stock markets. This stemmed from lower inflation expectations and, above all, servicing margin calls in other asset classes through sales on the liquid gold market. Despite this, unprecedented cash injections by global central banks shored up gold somewhat in the last week of March.

Chart 6: Equities and gold in sync
Price index (100 – index at 28.02.2020)



Glossary

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 (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 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.

Vontobel Asset Management AG
Gotthardstrasse 43
8022 Zurich
Switzerland
T +41 58 283 71 11

Vontobel Asset Management SA
Munich branch
Leopoldstrasse 8–10
80802 Munich
Germany
T +49 89 211 133 0

Vontobel Asset Management
Australia Pty Ltd.
Level 20, Tower 2, 201 Sussex St
NSW 2000 Sydney
Australia

vescore.com