vescore
by Vontobel Asset Management

Global Market Outlook

August 2020

Asset Management

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At a glance

- Equity overweighting declining further, market still attractive
- Bond allocation still negative, but no longer as pronounced
- Signs point to low risk for first time since June 2019
- Commodities: Central bank and government stimulus benefits metal prices

Risk appetite diminishing over month

The pandemic and its impact are still dominating the global economic scenario. Investors' propensity for risk changed significantly over the course of July: While there was still demand and thus gains for risky investments in the first half of the month – with a push from June's positive data – they lost most of this ground when new global economic data confirmed a crash of historic proportions.

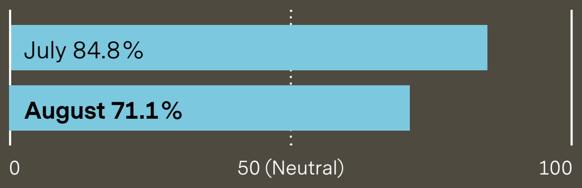
In particular, market participants' confidence at the start of July was built on the figures published for the previous month and the expectations of the development of a vaccine for COVID-19. In the US, the labor market and purchasing manager sentiment both left forecasts behind. Italian economic data were better than expected and, along with French industrial data, helped to prop up market developments. In Germany as well, both the GfK Consumer Confidence Index and the ifo Business Climate Index outperformed expectations. Finally, the EU stimulus package of EUR 1.8 trillion that was agreed after several days of tough negotiations, also boosted investors' risk appetite.

But the picture changed in the middle of July: The historic slump in GDP of 10.1 % in Germany and 9.5 % in the US caused risk aversion to rise again. Fears that the pandemic might escalate, spurred by high infection figures in some areas, also weighed on investor sentiment, as did the further downturn in the data. The still-smoldering conflict between China and the US is also currently depressing sentiment and market performance.

With travel increasing significantly, in many areas due to vacations and the easing of restrictions, the trend in infection figures is likely to remain highly relevant to market participants' risk appetite in August as well. Similarly, investors are increasingly paying attention to the forthcoming US elections in November.

Equities

Equity overweighting declining further, market still attractive



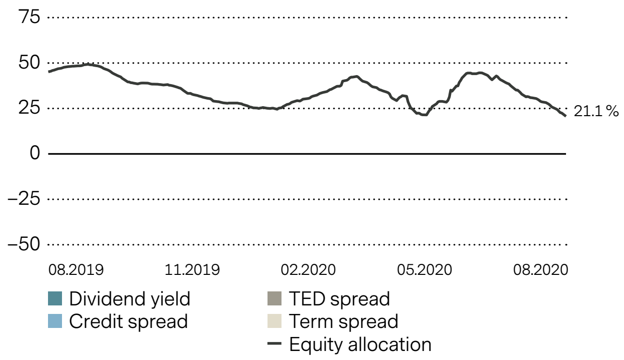
At the beginning of August, the equity overweighting in the global GLOCAP sample portfolio (50% equities, 50% cash) fell to 21 % month-on-month, resulting in a reduced level of 71.1 % (50 % plus 21.1 %).

All four model variables continue to support the positive bond allocation. The drop in overweighting is essentially due to the waning credit spread contribution. With investors' risk appetite returning to average levels, the equity markets now look to be fairly valued. However, the low TED spread and the term spread in particular mean that equities still appear attractive.

The credit spread's allocation contribution virtually vanished over the month, dwindling from 17.1% to 0.3%. This indicator reflects "confidence in corporates" in the GLOCAP model. However, after the COVID-19 shock on the markets, the model primarily interpreted this as a measure for the priced-in equity risk premiums, causing the allocation to rise – based solely on this signal – by 50% at its peak in the middle of April. As the equity market recovered, credit risk premiums have even since fallen to slightly below-average levels. Consequently, the effect of these variables on the equity position has swung back to neutral.

Chart 1: Equities overweighted, but less so

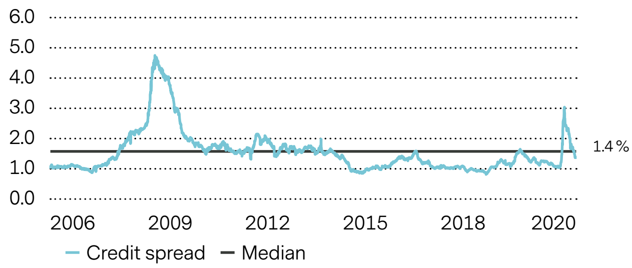
Over/underweighting (%)



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 August 3, 2020
Source: Vescore

Chart 2: Credit spread signal now neutral

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 August 3, 2020.
Source: Vescore

	AUGUST 3	JULY 1
Equity overweighting	**21.1%**	**34.8%**
Contribution of the term spread	8.1%	8.3%
Contribution of the TED spread	9.2%	6.7%
Contribution of the credit spread	0.3%	17.1 %
Contribution of dividend yield	3.4%	2.7%

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

Government bonds

Bond allocation still negative,
but no longer as pronounced

rises to

August
–0.8 years

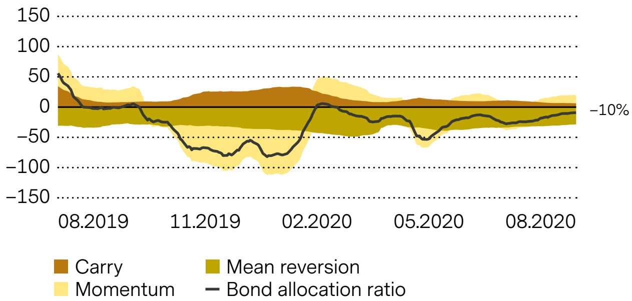
July
–2.0 years

The allocation ratio of a global bond portfolio is up as against the previous month and was –10% at the start of August, representing a duration of –0.8 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 of 3% each in the carry and mean reversion component models (currently contributing 6% and –30%) offset each other, the momentum contribution in particular is rising from 0% to 14%. This is therefore the driving force behind the higher allocation of the portfolio as a whole.

As before, the central banks are defining developments on the government bond markets. The action they are taking is increasingly affecting the development of longer-term interest rates, as shown by the discussion of potential yield curve control by the US Federal Reserve. Neither the Fed nor the ECB changed their monetary policy in July. Rather, they stood by their current programs and are awaiting data before making any changes. Against this backdrop, there is currently hardly any change in government bonds with low risk of default, such as German Bunds and US Treasuries, as can be seen by the close range of around 20 basis points for the respective 10Y yields. Nonetheless, these were both at the lower ends of their ranges for the past few months at the end of July. Among others, Italian government bonds are benefiting from the generous monetary policy in the euro area. This reduced the gap in yields between Italian 10Y bonds and those of Germany to just 1.54% by the end of July.

Chart 3: Model retains short position in global bonds

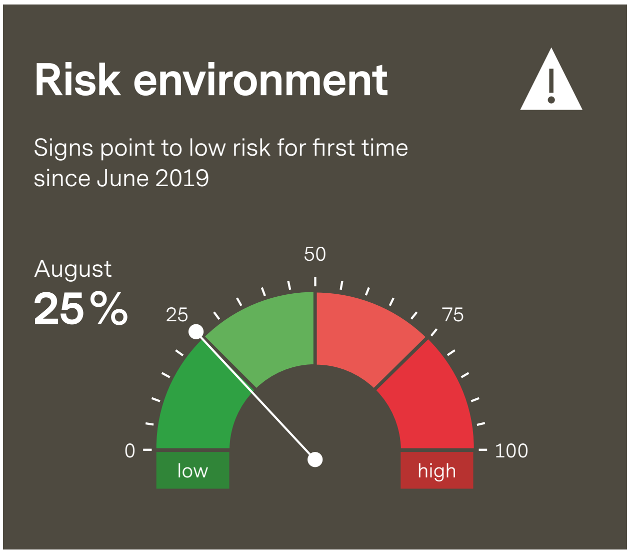
Bond allocation (%)



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 August 3, 2020
Source: Vescore

	TOTAL	CARRY	MEAN REVERSION	MOMENTUM
Global	–10%	6%	–30%	14%
Germany	0%	0%	–2%	1%
France	0%	1%	–3%	2%
Italy	4%	1%	–1%	3%
Great Britain	–3%	0%	–5%	2%
Switzerland	–1%	1%	–4%	1%
US	–1%	1%	–4%	2%
Canada	–5%	0%	–7%	1%
Japan	–2%	1%	–4%	1%

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 August 3, 2020
Source: Vescore



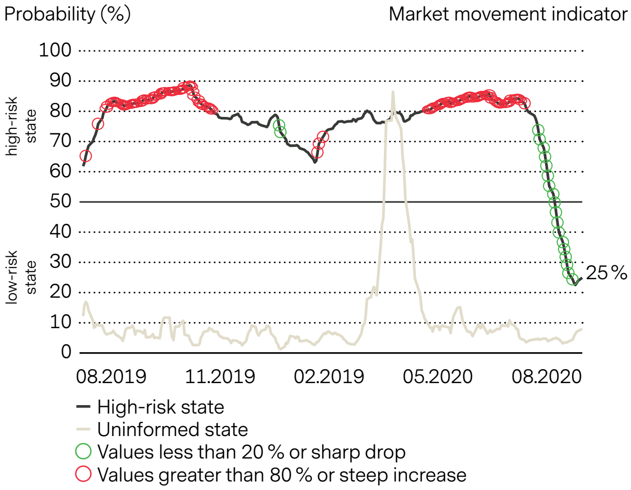
The risk indicator is in the green for the first time since June 2019. The aggregate probability of a future high-risk state on the developed markets declined significantly from 76 % in July to 25 % in August.

The risk indicator analyses the current environment and shows whether the market is trending “high risk” or “low risk”. The concept is based on a regime-switching approach between high and low-risk environments, taking into account the unexpected changes in the covariance structure on the equity, bond and currency markets. The reason for the shift in probability towards a “low-risk state” is the significantly lower volatility level in recent weeks.

Specifically, the risk estimates for the developed markets dropped from 90 % to 15 % for currencies, from 77 % to 30 % for equities and from 60 % to 31 % for bonds. This indicates widespread calming across all market segments.

The risk indicator for the emerging markets fell by even more than for the developed markets: from 90 % to 14 %. The risk estimates for the emerging markets declined from 82 % to 7% for equity markets, from 92 % to 16 % for bond markets and from 90 % to 20 % for currency markets.

Chart 4: Risk indicator now green



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 August 3, 2020
Source: Vescore

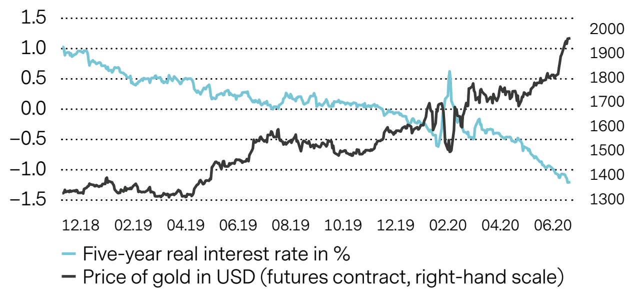
Current topic

Commodities: Central bank and government stimulus benefits metal prices

Until recently, the focus in commodities was on energy sources, with the price of oil falling by more than 70 % by the end of April (WTI crude oil), only to rise by 60 % again within the space of two months. This rebound paused in July, and investors shifted their attention to metals in the past month. Gold beat its all-time high from 2011, silver climbed to a seven-year high and copper is now more than 30 % above its March lows. And there are indications that this strength in metals could continue for a while to come.

Gold supported on all sides
Statistically speaking, real interest rates are the most important drivers for the price of gold, as they represent the opportunity costs for gold at no interest. While real interest rates are mired at historic lows (–1.2 % on five-year US Treasuries, see chart), some investors are turning their backs on negative-yielding fixed-income investments in search of alternatives. Also, US Federal Reserve Chairman Jerome Powell recently reiterated that he is not wasting any time thinking about a future hike in interest rates.

Chart 5: Declining real interest rates good for gold



Real interest rate on 5Y US Treasuries: Difference between US Generic Govt 5 Year (USGG5YR Index) and US Breakeven 5 Year (USGGBE05 Index)
Price of gold: Generic 1st Gold Future GC1 Comdty (as of start of August)
Past performance is not an indicator of current or future performance.
The return can rise or fall as a result of currency fluctuations.
Source: Bloomberg, Vescore

Given that the central banks intend to keep nominal interest rates at these low levels for some time to come, only rising inflation expectations could cause real interest rates to fall even further. While there are currently no indications of inflation, prices will start to pick up some time, especially as the central bank and government stimulus packages are becoming more and more massive.

There is no clear trend in physical demand for gold. While sales of gold jewelry in China and India are currently faltering, gold ETFs are putting up record numbers. Not just private investors, but increasingly institutional investors as well want to take advantage of this option to protect themselves against the economic repercussions of the pandemic. However, gold exposure still has the potential to keep on going, as it currently accounts for only around 3 % of investors' allocation relative to the volume on the global equity markets. For reference, in 2012 this figure was approximately 4 %.

Sustainability requirements helping metals
Commodity prices are set to benefit from the enormous stimulus packages, some of which will channel funds towards building or overhauling infrastructure. Government measures also often include a "green" component. The anticipated investment in renewable energies should lead to rising demand for various industrial and precious metals. Silver is needed for solar cells, platinum for hydrogen drives, nickel for batteries and copper for electric vehicles, which use around three times as much copper as internal combustion engines. In turn, palladium is used to reduce emissions in conventional gas cars.

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.

Disclaimer

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