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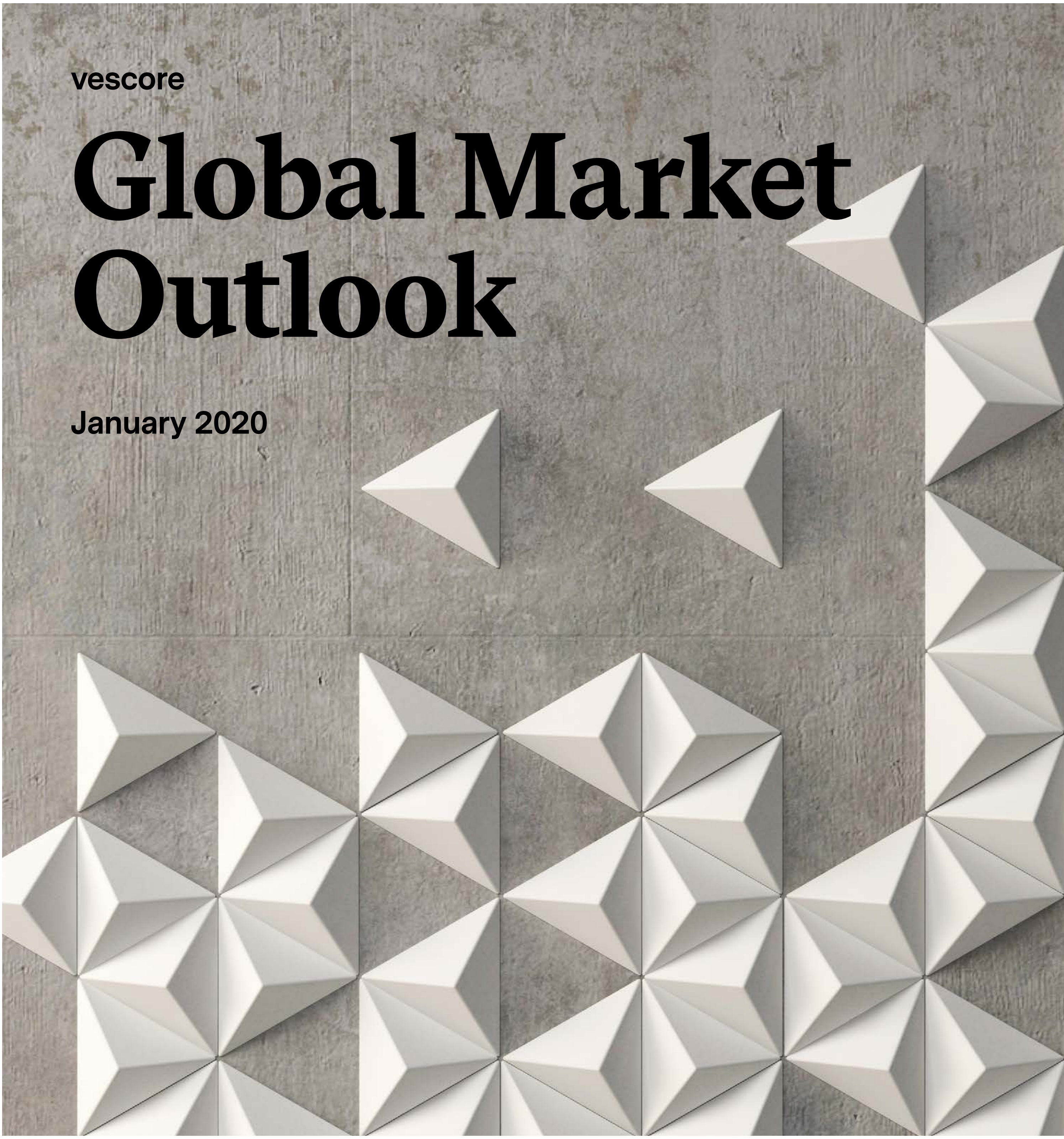
by Vontobel Asset Management



vescore

Global Market Outlook

January 2020

Approved for institutional investors in Germany, Finland, Italy, the Netherlands, Norway, Austria, Sweden, Switzerland and the UK / Not intended for public display or distribution

At a glance

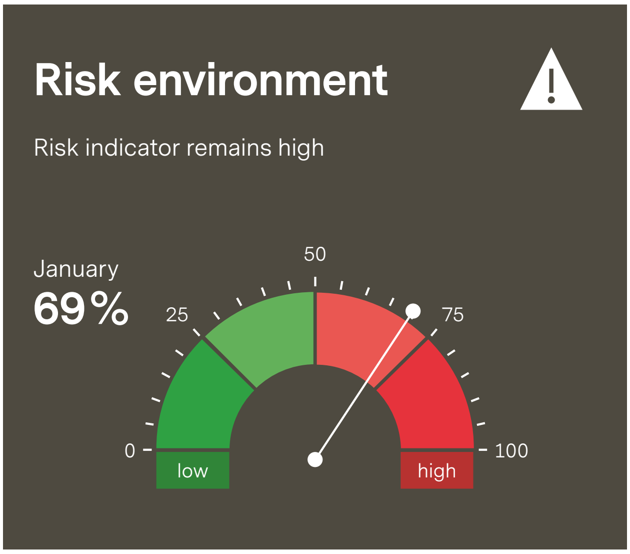
- Risk appetite largely stable
- Ongoing decline in equity overweighting
- Short position in global bonds continues
- Current topic: Assessing the economic environment using artificial intelligence methods

Risk appetite largely stable

The fundamental economic market environment at the beginning of January continued to be marked by stable appetite for risk among investors. Following the escalation in the US-Iran conflict at the start of the year, market players seem confident that the situation will not continue to worsen.

Market activity in December was shaped primarily by developments in international trade conflicts. After initial worries that global trade conflicts would escalate, a partial agreement reached in the US-China trade conflict significantly increased demand for risk-bearing investments. As well as the partial agreement between the US and China, the landslide victory scored by the UK Conservative party under Boris Johnson shored up equity markets, as the result should make negotiating the UK's exit from the European Union on January 31 significantly easier. In addition, in the reporting month, expectations of market participants were met regarding the future monetary policy stance of the US Federal Reserve and the European Central Bank at their regular meetings.

At the beginning of the year the situation in global capital markets is likely to remain dominated by various geopolitical crises. Moreover, with the publication of quarterly and annual reports, market participants are again shifting their focus to corporate data.



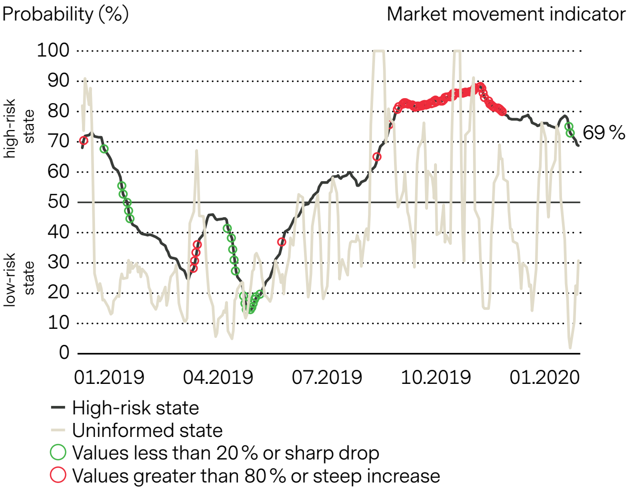
Risk environment

Risk indicator remains high

The aggregate probability of a future high-risk state fell again in December (down 7 percentage points), but remains at an elevated level of 69%. In equity markets, the risk assessment saw the most substantial decline (down 26 percentage points) and is now at 73%. Assessments of bond markets and currency markets are virtually unchanged at 78% and 55% respectively.

The risk assessment for emerging markets also slid considerably in comparison to the previous month, falling below the 50% mark to 47%. At 58%, the assessment for equity markets is well below the previous month's figure (down 26 percentage points). The picture is similar for bond markets at 77% (down 18 percentage points). For currency markets, the figure remains exceptionally low at 6%.

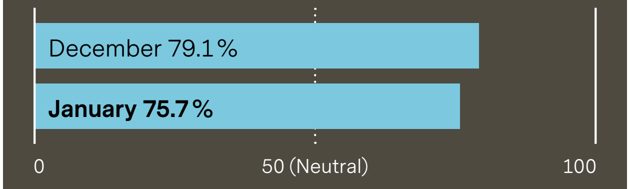
Chart 1: Risk indicator remains high



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 January 2, 2020.

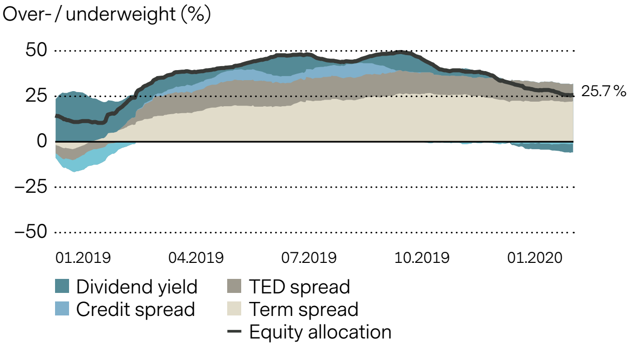
Equities

Ongoing decline in equity overweighting



At the beginning of January, the equity overweighting in the global GLOCAP sample portfolio (50 % equities, 50 % cash) was 25.7 %. Consequently, the equity allocation has been decreased by another 3.4 percentage points since the start of December. As in previous months, the two macroeconomic variables of the TED spread and the term spread remain the driving factors behind equity overweighting. On the other hand, the two macroeconomic variables, dividend yield and credit spread, continue to subdue the ratio slightly. With the exception of the term spread, where the influence on equity allocation is stabilizing, the contributions of all instrumental variables are declining, with positive developments on equities markets (in particular the lower dividend yield) reducing the ratio at the end of the month by 4.7 %.

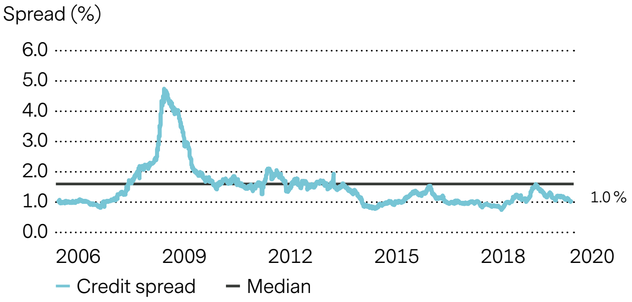
Chart 2: Ongoing decline in equity overweighting



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 January 2, 2020.

1st Year was marked by investors searching for risk-bearing investment opportunities. Some record highs were achieved in the equity market, with the MSCI World Index enjoying the best close to the year since 2009 with an increase of 25.2 %, thanks to corporate profits performing better than expected. Yet it was the major central banks, countering fears of recessions and reserve shortages with sufficient liquidity, that brightened the mood in equity markets. The credit spread narrowed significantly in light of this, although its contribution to the equity ratio remains slightly negative given that sensitivity is fluctuating around zero.

Chart 3: Credit risk spread approaching multi-year lows



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 January 2, 2020.

	JANUARY 2	DECEMBER 2
Equity overweighting	**25.7 %**	**29.1 %**
Contribution of the term spread	22.4 %	22.4 %
Contribution of the TED spread	9.6 %	11.1 %
Contribution of the credit spread	–1.5 %	–1.3 %
Contribution of dividend yield	–4.7 %	–3.0 %

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

Government bonds

Short position in global bonds continues

stays at

December
–7 years

January
–7 years

The allocation ratio of the global bond portfolio is almost unchanged compared with the previous month and amounted to –82% at the start of January, translating into a duration of –7 years. The position in global government bonds held in the portfolio comprises the contributions of the individual carry, mean reversion, and momentum models.

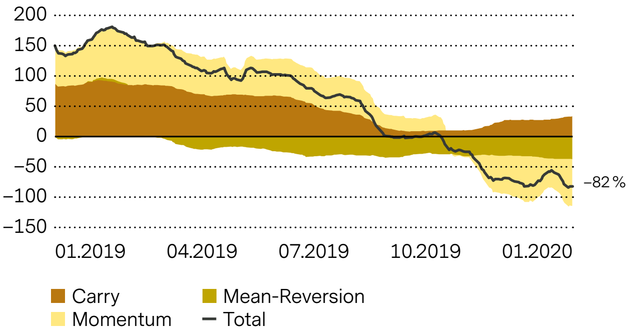
The trend towards increasing carry amounts identified in the previous month was also confirmed in December. The carry model's contribution to the bond allocation rose by 6 percentage points over the course of the month to 32%, implying steeper global yield curves. Nonetheless, the increase in the carry's allocation contribution is offset by a stronger negative contribution in the mean reversion model. It fell by 5 percentage points in December to –38%, putting it in absolute terms at a similar level to the carry component. There have been very few changes to the momentum model at portfolio level due to the virtually unchanged allocation of the global bond portfolio in comparison to December.

Optimism in trade dispute still negatively impacting bonds

Once again, the dominant issue in December was the trade dispute between the US and China. After vague signs of a détente in the previous month, which had an adverse effect on bond markets, bond prices continued to decline on the back of more serious negotiations and positive rhetoric from both sides about a "phase 1" deal expected to be signed in mid-January. This optimism is also reflected in the German 10-year yield, which increased to as much as –20 basis points in December, far off its low recorded in September (–0.70%).

Chart 4: Short position in global bond continues

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 January 2, 2020.

	TOTAL	CARRY	MEAN REVERSION	MOMENTUM
Global	–82%	32%	–38%	–76%
Germany	–12%	7%	–7%	–11%
France	–7%	12%	–8%	–11%
Italy	0%	5%	–3%	–2%
Great Britain	–7%	1%	–4%	–4%
Switzerland	–12%	5%	–8%	–9%
US	–7%	0%	–2%	–4%
Canada	–6%	0%	0%	–7%
Japan	–30%	2%	–6%	–27%

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 January 2, 2020

Current topic

Assessing the economic environment using artificial intelligence methods

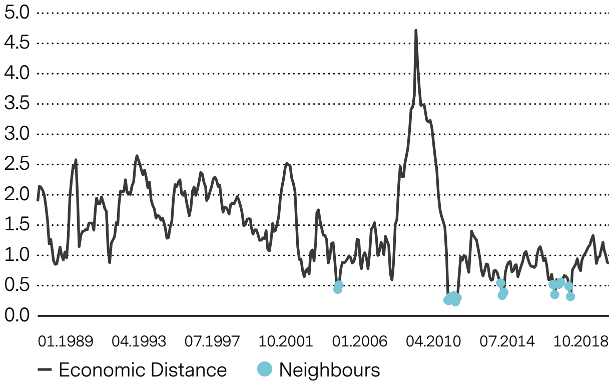
A historical comparison of the economic environment – evaluation using artificial intelligence methods

Since October 2018, another method has been used to classify the economic environment for risk-bearing asset classes in addition to the proprietary GLOCAP and FINCA models. This new method is the concept of "k-nearest neighbors", also known as the KNN method. The approach builds on methods from artificial intelligence and machine learning. 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 this environment. This model is known as artificial market intelligence (AMI).

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.

Chart 5: 2010 and 2016 as important historical neighbors

Economic Distance to 31.12.2019



The chart shows how close current market conditions 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. Information as of January 2, 2020.

AMI anticipates uncertain times moving ahead

The KNN method puts the current economic situation on par with two periods in the past: the second half of 2010 and January to November 2016.

In 2010, industrialized countries were experiencing the aftermath of the financial crisis and initially having to contend with slow economic momentum. The market environment in this period was dominated by the European debt crisis, monetary policy moves by central banks, rising government debt, and high unemployment (particularly in the US).

Donald Trump's electoral victory, and jumps in the price of oil sum up 2016. At the start of that year, equity markets were already reporting massive losses and subsequent phases of recovery were repeatedly squashed. In particular, political developments in the UK and US triggered increased uncertainty among market participants and growing risk aversion. Fluctuating oil prices and a weak Chinese currency also played a role in this, while these factors also caused global interest rates to fall even further.

The KNN method helps determine the optimal position using artificial intelligence. At present, AMI prefers a fundamentals-driven allocation and invests primarily in line with GLOCAP given that this model was also successful in 2010 and 2016.

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.

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