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by Vontobel Asset Management

Global Market Outlook

October 2019

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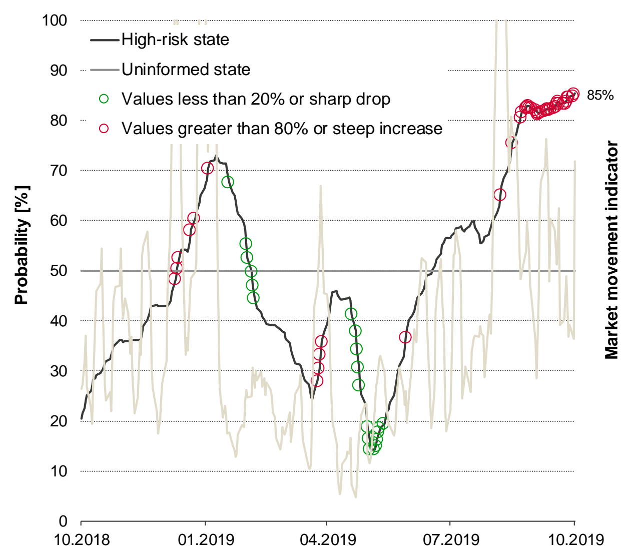
Capital markets driven by central banks and hope of trade talks
The fundamental economic market environment in September was marked by a high appetite for risk among market participants.

After geopolitical crises curbed risk appetites in August, global equities markets recovered in September. The resumption of trade talks between the US and China scheduled for the start of October provided a hospitable environment for global equities at the beginning of the month. After negotiations faltered in August, hopes of a resolution to the trade dispute have now been revived. The recovery on the equity markets was also supported by the latest monetary policy decisions by the European Central Bank and the US Federal Reserve. At its regular meeting, the European Central Bank decided to resume its bond-buying program and lower the deposit facility rate. In addition, Mario Draghi's statements suggest that an end to the low interest rate policy is a long way off. Market participants' expectations ahead of the meeting were therefore largely met, which particularly benefited the European equity markets. The US Fed likewise provided further monetary easing and cut its benchmark rate by 0.25 percentage points for the second time in a row.

Looking ahead, market participants are likely to be paying more attention to corporate data as the reporting season begins. On top of this, the geopolitical crises remain a potential risk to the market environment that should not be dismissed.

Risk environment

Risk indicator remains in high-risk state
The aggregate probability of a future high-risk state rose only slightly in September (+3%) and remained at a relatively high level of 85% at the end of the month. The risk environment in a high-risk state is therefore increasingly stabilizing. As in the previous month, the increase was attributable to the bond and currency markets with current risk assessments of 77% and 82%. Only in the equity markets did the probability of a future high-risk state fall slightly by two percentage points to 96%.
In contrast to the developed markets, the risk assessment in the emerging markets fell month on month and, at 72%, is now back below the high-risk state threshold of 80%. While the bond markets' assessment remained stable and risk in the equity markets also declined slightly, the assessment of a future high-risk state in the currency markets in particular has now fallen to 27% (previous month: 63%).



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 October 1, 2019.

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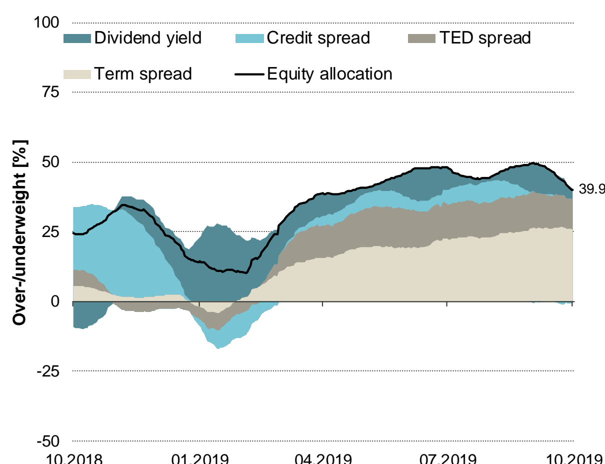
Equities

Reduction in equity overweighting

At the beginning of October, the equity overweighting in the global GLOCAP sample portfolio (50% equities, 50% cash) was 39.9%. Consequently, the equity allocation has been decreased by 9.7 percentage points since the start of September. Since March this year, the foundation for equity overweighting has been built on the two macroeconomic system variables of term spread and TED spread. Both contributions declined slightly over the course of the month and now amount to 25.8% and 10.7% respectively. However, the main reason for the reduction in the high equity allocation was the lower dividend yield and thus the return to a less attractive valuation level on the equity market. The dividend yield's contribution to equity overweighting fell to 3.9%. The current level of the fourth system variable, the credit spread, is currently assessed as neutral by the model. The contribution to the equity position is negligible at only -0.5%.

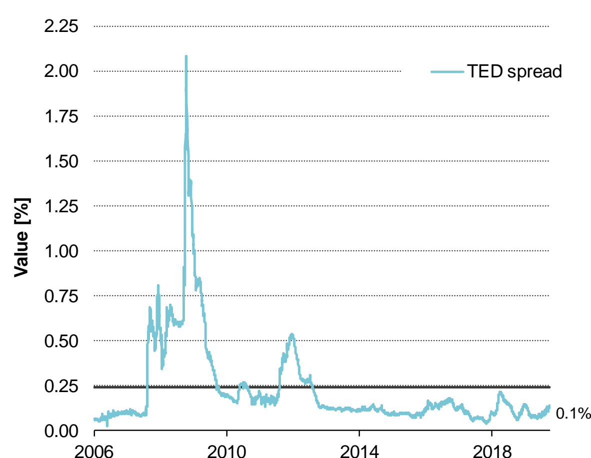


The chart shows the active equity weight (black line) of a global portfolio in euros with a neutral allocation of 50% equities and 50% cash. Foreign currencies are hedged. It also shows the contributions of the individual driving forces (term spread, TED spread, credit spread, and dividend yield), which come together to give the active equity allocation. Information as of October 1, 2019.

TED spread signals sufficient liquidity supply

GLOCAP uses the TED spread, weighted equally across the euro, US dollar, and Japanese yen money market, as an indicator for the supply of liquidity in the banking system. It measures risk premiums of interbank rates versus risk-free interest rates over three months.

On the US money market in September, there was a surprising liquidity shortage between the banks, which was reflected in a surge in the overnight repo rate. The US Fed was then forced to supply additional liquidity. However, this phenomenon seems to have been driven mainly by technical and scheduling factors and was therefore restricted to the US and extremely short maturities. As a result, our global measurement of the liquidity supply based on the TED spread, at 0.13%, does not indicate a full-fledged liquidity crisis, but rather only a continued minor rise in liquidity preferences.



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. The value shown is the average. Information as of October 1, 2019.

	October 1	September 2
Equity overweighting	**39.9%**	**49.6%**
Contribution of the term spread	25.8%	26.5%
Contribution of the TED spread	10.7%	13.0%
Contribution of the credit spread	-0.5%	-0.6%
Contribution of dividend yield	3.9%	10.7%

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

Management of equity allocation with 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.

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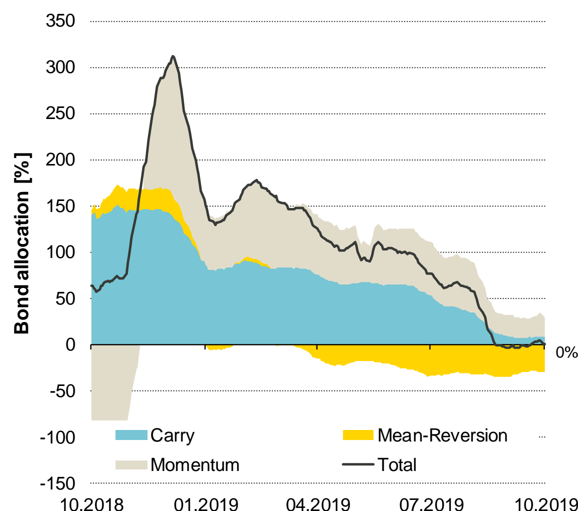
Government bonds

Neutral global bond allocation
The allocation ratio of a global bond portfolio remained virtually stable over the course of the month and amounted to a neutral 0% at the start of October. The position in global government bonds held in the portfolio comprises the contributions of the individual carry, mean reversion, and momentum models.

The carry and momentum components made virtually unchanged contributions to the bond allocation compared with the previous month. Only the mean reversion models changed their position by +5 percentage points and now amount to -30%. Thus, while the carry and momentum components still have positive allocations of 9% and 22% respectively, they are entirely canceled out by the negative weight of the mean reversion model, with the result that the portfolio as a whole is neutrally positioned at 0%.

Country weightings in narrow ranges
The individual country weightings have only low allocations in the portfolio as a whole. It is still the case that no individual market is noticeably prioritized. Italy is still the heaviest country in the portfolio with a weight of 15%. Due to th

e latest narrowing of the spread, the momentum model signals a higher allocation in Italy. In contrast, French bonds again constitute the largest short position at -7%.



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 October 1, 2019.

Interest rate rise despite central bank stimulus
At the beginning of September, the interest rates of global government bonds corrected themselves from their lows and increased palpably. For example, the yields of 10-year German government bonds climbed from -70 basis points to a peak of -45 bps. Month on month, this meant a loss of 1.15% for the Bund Future. The resumption of the ECB's bond-buying program failed to halt the price declines, but actually temporarily triggered greater sales. This was because many market participants had hoped for a somewhat higher purchase volume on the part of the ECB.

	Total	Carry	Mean reversion	Momentum
Global	0%	9%	-30%	22%
Germany	-2%	1%	-6%	2%
France	-7%	1%	-9%	1%
Italy	15%	4%	-3%	14%
Great Britain	-2%	0%	-3%	1%
Switzerland	-4%	2%	-5%	-1%
US	-2%	-1%	-3%	2%
Canada	-4%	0%	-4%	0%
Japan	6%	1%	2%	3%

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 October 1, 2019.

Active duration management with 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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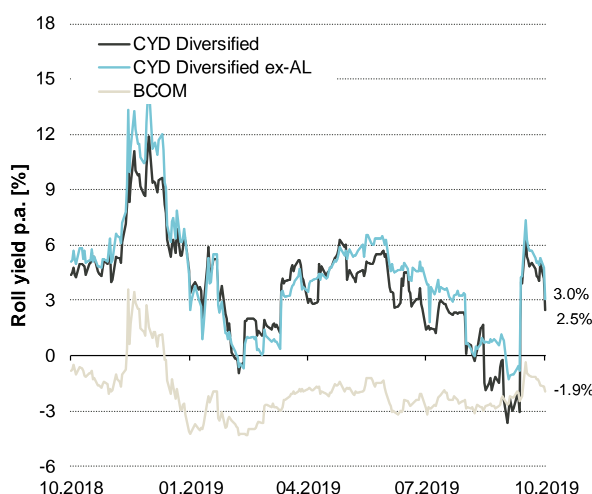
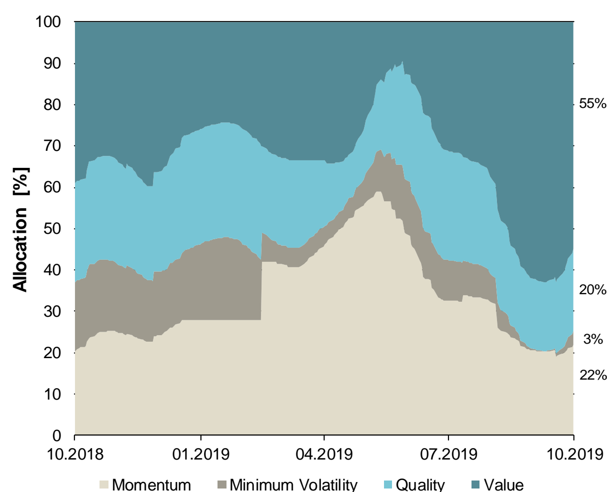
Select topics

Aggregate roll yield for the CYD Index increases significantly
The aggregated roll yield for the Bloomberg Commodity Index rose slightly in September, but remains in negative territory (-1.9% p.a.). In contrast, the aggregate roll yield for the CYD Diversified Commodities Index increased sharply to +2.5% p.a. This was due firstly to energy carriers and secondly to the selection, which did not allocate lean hogs with its significantly negative roll yield in the previous month. The most attention in September was surely drawn by the attack on the largest oil refinery in Saudi Arabia, which suddenly took a supply of nearly 6 million barrels per day off the market and caused oil prices to surge (+15%). At the end of the month, however, prices corrected back to their previous levels.



The chart shows the aggregate roll yields of the CYD Diversified Index, CYD Diversified ex-AL Index and the Bloomberg Commodity Index. Roll yields can be derived from the maturity structure of commodity futures. Information as of October 1, 2019.

Swiss equities: Value factor still attractive
In September, the allocation continued to be shaped by a constant overweighting of the value factor. Value stocks became slightly less attractive only at the end of the month, but the factor remains considerably overweight at 55%. By contrast, the minimum volatility factor remains considerably underweight at 3%.
The dynamic factor allocation is based on three sub-models that evaluate the economic environment, the price trend and the mean reversion potential. The overweighting of the value factor is based primarily on the economic environment.



The chart shows the factor allocation for the Swiss equities market. Based on an equally-weighted portfolio with 25% each in momentum, minimum volatility, quality and value, the factors are over- or underweighted according to market environment and attractiveness. Information as of October 1, 2019.

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