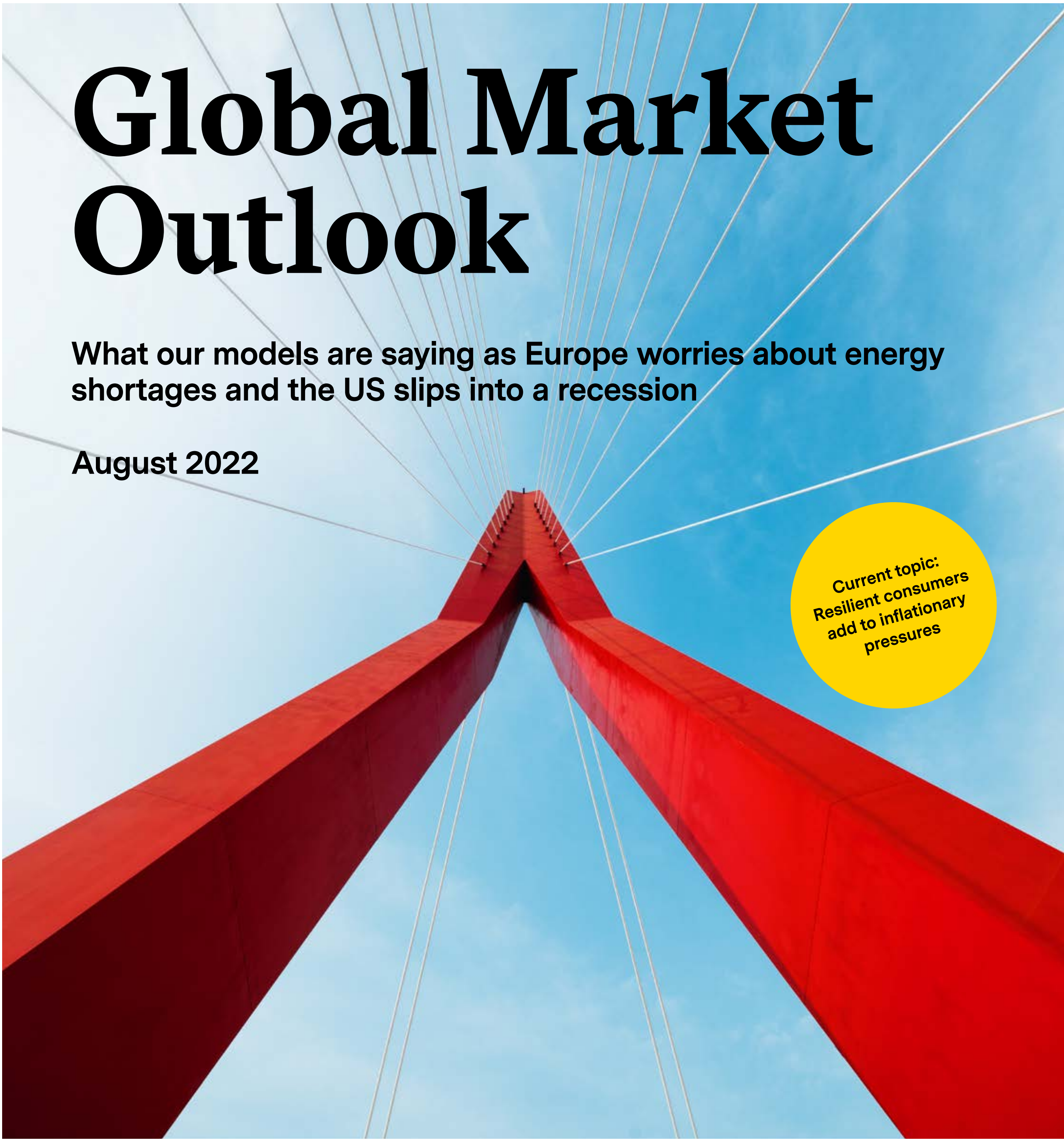
vescore
by Vontobel Asset Management

Global Market Outlook

What our models are saying as Europe worries about energy shortages and the US slips into a recession

August 2022



Current topic:
Resilient consumers add to inflationary pressures

Asset Management

At a glance

— Equities:
Only slightly underweighted

— Government bonds:
Duration significantly longer

— Risk environment:
Assessment stagnates

— Current topic:
Resilient consumers add to inflationary pressures

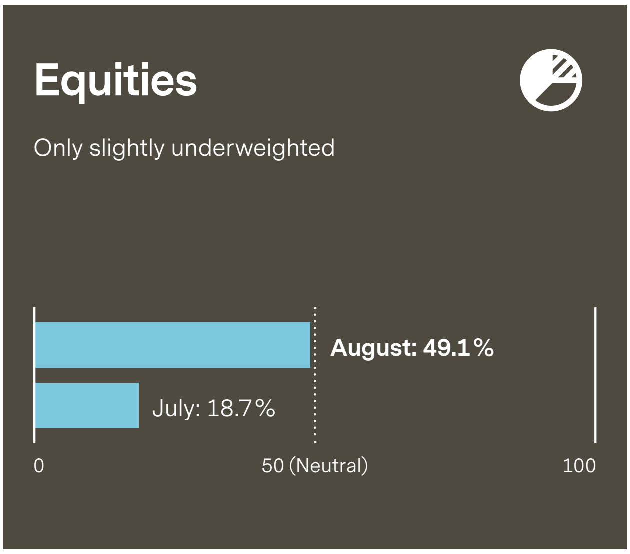
Energy shortages in Europe, recession in the US

At the start of August, market players seem somewhat more optimistic than in the previous month—although the fundamental challenges for the global economic scenario remain. Against this backdrop, central banks are still facing the balancing act of tackling inflation without dramatically curbing the economy.

In July, European news was dominated by uncertainty over Russian gas supplies and by debates about supply security, some of which grew heated. The "Nord Stream 1" pipeline was initially shut down for planned maintenance work. Gas flows then resumed, albeit with significantly reduced supply. As a result, the industry and with it also the governments in Germany and other European Union countries are now anxious to ensure sufficient stores for next winter. Skyrocketing energy prices are one of the main causes of inflation in Europe, which has climbed to 8.6%. The European Central Bank (ECB) responded to this with an unexpectedly high interest rate hike, raising rates from 0 to 0.50% after previously announcing a rise of 0.25 percentage points. Nevertheless, many economists think this move comes too late and is not enough to rein in run-away inflation. In addition, the tool proposed by the ECB to contain diverging government bond yields of some EU member states—known as the Transmission Protection Instrument (TPI)—was poorly received.

In the US, the latest fundamentals slightly exceeded expectations, with the current company reporting season also going surprisingly well so far. Meanwhile, inflation climbed to more than 9% for the first time in over 40 years. Based on this, the US Federal Reserve raised interest rates by a further 0.75 percentage points to between 2.25 and 2.50%. Nevertheless, two consecutive quarters of negative GDP growth mean that the US is now in a recession, according to a common definition.

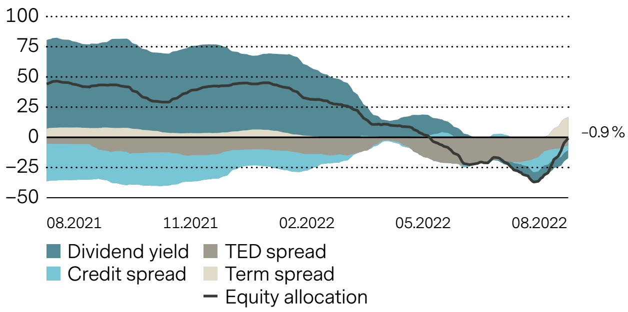
In the weeks and months ahead, investors are likely to turn their attention also to political issues such as the new elections in Italy and the American midterm elections, besides company growth and earnings prospects as well as the still critically viewed central bank monetary policy.



At the start of August, the equity allocation in the global GLOCAP sample portfolio stands at –0.9 % and is thus close to neutral allocation (50 % equities, 50 % cash), compared to –31.3 % in the previous month. The main cause of this significant decrease in underweighting is the term spread, whose contribution climbed from –7.3 % to 16.5 %. However, this now positive signal is canceled out by the three other instrumental variables whose contributions are still negative, with the TED spread (now –7.2 % compared to –12.7 %) and the dividend yield (now –6.7 % compared to –7.7 %) weaker than at the start of July, while the credit spread remained unchanged at –3.6 %. This went hand in hand with a significant recovery for global equity markets: The MSCI World picked up by 10.7 % in July, marking its best monthly performance since April 2020, because market players hoped that central banks would take a somewhat less brash approach to raising interest rates in the future given the sharp increase in energy costs and recession fears, so as not to further jeopardize the economy. Fed funds futures now price in a probability of just 21.5 % that US interest rates will be increased by a total of at least 1.25 % by the end of 2022. In line with this, long-term interest rates are falling sharply at present, while short-term rates largely stagnate. This creates a flatter yield curve, increasing equities' risk premiums. The GLOCAP model reflects this mechanism in the positive term spread contribution.

Chart 1: Equity allocation now almost neutral

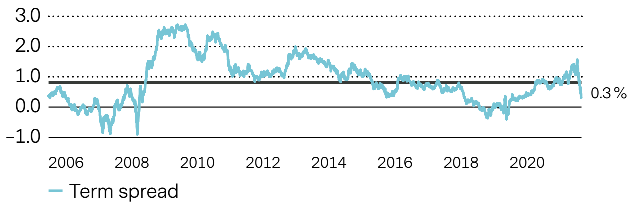
Over-/underweighting (%)



The chart shows the active equity weighting (black line) of a global portfolio in euros, based on 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 02, 2022.
Source: Vontobel Asset Management

Chart 2: Term spread back in positive territory

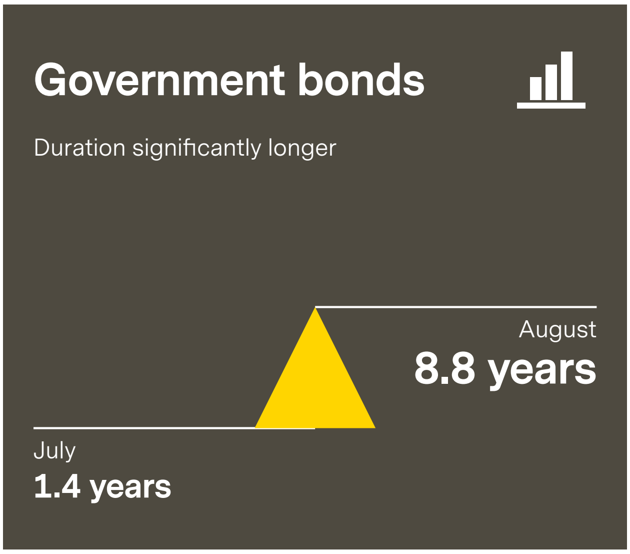
In %



The chart shows the term spread for the major industrialized countries, which reflects market participants' economic expectations. It is measured by the difference between long-term and short-term interest rates. A high term spread is typically associated with positive economic forecasts, whereas a flat yield curve reflects a rather downbeat outlook on the part of market participants. The chart shows the weighted average (blue line) and the median of the instrumental variable (horizontal black line). Information as of August 02, 2022.
Source: Vontobel Asset Management

	AUGUST 2	JULY 4
Equity weighting	**–0.9 %**	**–31.3 %**
Contribution of the term spread	16.5 %	–7.3 %
Contribution of the TED spread	–7.2 %	–12.7 %
Contribution of the credit spread	–3.6 %	–3.6 %
Contribution of the dividend yield	–6.7 %	–7.7 %

The table shows the contributions of the instrumental variables to the equity weighting. Information as of August 2, 2022.
Source: Vontobel Asset Management



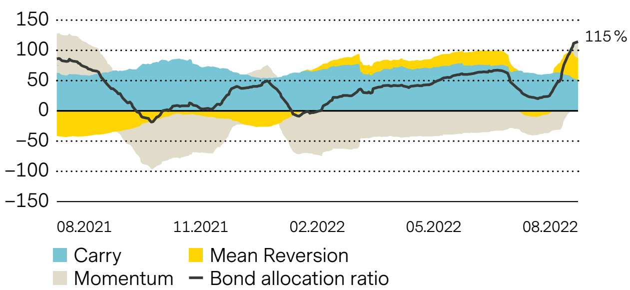
At the start of August, the allocation ratio of a global bond portfolio, which comprises the contributions of the carry, mean reversion and momentum components, stands at 115% and is thus far higher than the previous month's 22%. This increases the duration by more than 7 years to 8.8 years. Previously, only carry signaled a positive allocation. Now, the contributions of all three sub-models are positive again: While carry declined somewhat from 62% to 52%, mean reversion climbed from -9% to 36% and momentum from -31% to 27%.

In July, bond markets were again dominated by significant volatility but—unlike in previous months—this took the form of declining interest rates and, in turn, higher bond prices. This was driven primarily by investors' worries about the economy's resilience, as well as purchasing managers' indexes in the US and the eurozone, which were lower than expected and below the threshold of 50 that indicates expansion. Recession worries fueled by this ultimately caused interest rates to decline in the second half of the month.

Meanwhile, global central banks continued to raise rates, with the Reserve Bank of Australia increasing interest rates by 50 basis points, the US Fed by 75 basis points and the Bank of Canada by as much as 100 basis points in July. The ECB had announced that it would initially raise rates by 25 basis points, but then increased this to 50. It also revealed initial details about the tool it intends to use to stop government bond yields within the eurozone drifting further apart (the so-called Transmission Protection Instrument). The 10-year futures observed in the global bond portfolio saw month-on-month increases of between 1.3% (Japan) and 6.0% (Germany).

Chart 3: All three model components positive again

Bond allocation (%)



The chart shows the government bond ratio of a global bond portfolio in euros. The model allocation is calculated by means of the short-term forecast models carry, mean reversion, and momentum. Information as of August 02, 2022.
Source: Vontobel Asset Management

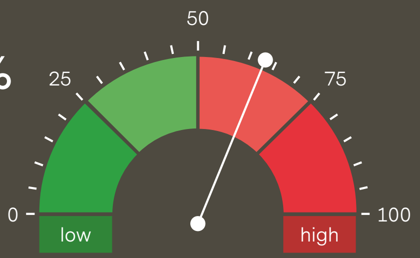
BOND ALLOCATION	TOTAL	CARRY CONTRIBUTION	MEAN REVERSION CONTRIBUTION	MOMENTUM CONTRIBUTION
Global	**115%**	**52%**	**36%**	**27%**
Germany	14%	4%	7%	3%
France	12%	6%	3%	3%
Italy	9%	5%	4%	0%
Great Britain	4%	3%	0%	2%
US	2%	0%	0%	1%
Canada	4%	2%	1%	2%
Australia	15%	4%	8%	3%
Japan	54%	28%	14%	12%

The table shows the government bond ratio of a global euro-denominated portfolio and the contributions of the short-term forecast models carry, mean reversion, and momentum to this, in total (row "Global") and by country. Information as of August 02, 2022.
Source: Vontobel Asset Management

Risk environment

Assessment stagnates

August
63%



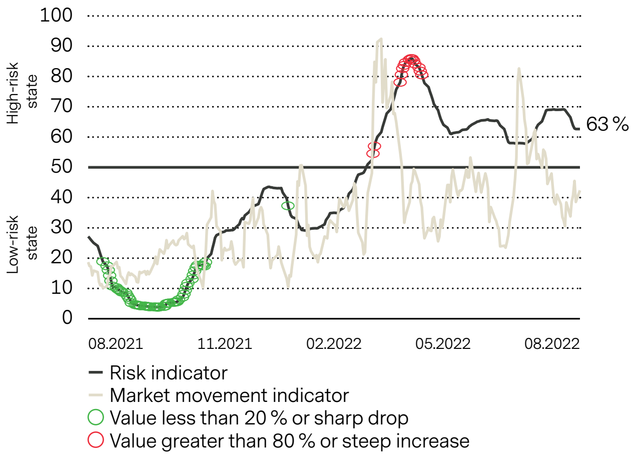
The risk indicator assesses the current market environment and the probability of a future high-risk state on financial markets. It does this by comparing short-term and long-term yields on equity, bond and currency markets.

In developed markets, the probability of a future high-risk state stands at 63% at the start of August. In July, it initially rose to 69% within two weeks, before declining again to just under the previous month's figure of 64%. The risk indicator for bond markets remained high at 96%, continuing to indicate volatility given the tension between rising interest rates and worsening economic expectations. The risk indicator for bond markets declined from 20% to 4%. By contrast, the indicator for currency markets rose from 76% to 88%, indicative of a future high-risk state. These two opposing effects offset each other in the aggregate indicator.

In emerging markets, the aggregate probability of a future high-risk state is currently 35%, only marginally higher than the 34% seen in the previous month. Almost on a par with its developed market counterpart, the risk indicator for bond markets now stands at 95% compared to 92% in the previous month, with the indicator declining from 3% to 2% for equity markets and from 12% to 8% for currency markets.

Chart 4: Risk indicator tracking sideways for months

Probability (%)



The chart shows aggregate probability of a high-risk state in the near future for developed markets (black line), as determined by the corresponding probabilities of the three segments equities, bonds, and currencies. Particularly calm market conditions are marked in green, particularly turbulent ones in red. The uninformed assessment of the future market environment is plotted at 50% (horizontal black line). In addition, the chart shows the aggregate indicator of materialized market movements in the three segments (light gray line). Information as of August 02, 2022. Source: Vontobel Asset Management

Current topic

Resilient consumers add to inflationary pressures

Company results tell a different story so far
The recently started reporting season has so far failed to reveal clear signs of a hot economy cooling off—despite central banks' restrictive stance. Should this continue, central banks won't have any other choice than to keep on tightening the screws if inflation is to be brought down. In the first half of 2022, in an environment of record-high inflation, European gas shortages, hawkish central bank policies, and decreasing real wages, many expected that consumer spending would weaken. In fact, markets seem to be pricing in a full-fledged recession with investors pulling out of consumer discretionary companies and sticking with consumer staples instead (see Chart 5).

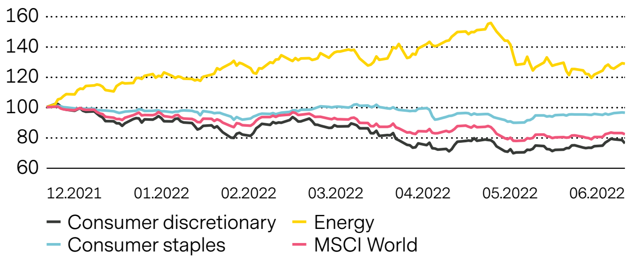
Strikingly, energy stocks benefiting from skyrocketing energy prices over the first few months of the year saw sentiment on energy demand turn sharply as markets increasingly take a recession as a given. As a result, the energy sector lost 17% since the beginning of June. In contrast, the consumer staples sector remained relatively stable. Overall market performance is eerily reminiscent of the period preceding the financial crisis of 2008. Back then, aggregated sector performances in the consumer segment gave a similar picture (see chart 6).

Although not quite as rampant as today, inflation had also embarked on an upward trend which was met with an aggressive tightening policy that ultimately led the economy into a recession. If today is a déjà vu of 2008 remains to be seen and largely hinges on whether central banks will be able to walk the tightrope of balancing inflation and growth.

Demand still going strong
For now, consumers are still spending money, and demand shows no signs of abating. As we have entered the second-quarter earnings season, several companies like Unilever, Coca Cola, and Danone have published revenue growth in line with their annual outlooks beating analyst consensus estimates. This indicates that consumers are yet to cut essential spending. More surprisingly, luxury goods company LVMH posted 27% year-on-year revenue growth, and Europe's biggest auto maker VW released results surpassing analyst estimates, despite severe supply chain disruptions over the past months.

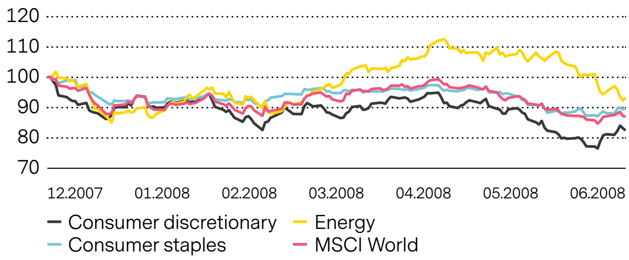
Usually, resilient consumer behavior is seen as good news, but now it is a double-edged sword: As long as consumers do not adapt based on the expectation that inflation will diminish their future spending power, demand will continue to hit a strained supply market. Consequently, central banks will have a hard time bringing down inflation and be forced to consider even more front-loaded rate hikes. Once the current reporting season is through, a clearer picture on future inflation developments and central bank policy will emerge, revealing how likely a repeat of 2008 will be.

Chart 5: Consumer staples stable, discretionary down
Indexed stock returns in local currencies



Period: January – July 2022
Source: Bloomberg, Vontobel Asset Management

Chart 6: Consumer trend in 2008 similar to today
Indexed stock returns in local currencies



Period: January – July 2008
Source: Bloomberg, Vontobel Asset Management

Our models and indicators

GLOCAP	GLOCAP (Global Conditional Asset Pricing) is our proprietary equity allocation model. Active deviations from the neutral positioning (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 equity market valuation (dividend yield) are evaluated and quantified. The sum of the contributions of these indicators reflects the active equity over- or underweighting. The term spread is measured by the difference between the long-term and short-term interest rates of the major industrialized countries. The TED spread is measured by the difference between the interbank interest rates for short-term loans in US dollars and euros and the respective 3-month Overnight Index Swap rate. The credit spread is measured by the risk premia of corporate bonds with lower ratings versus top-rated ones. The dividend yield is measured by the aggregated ratio of dividend to price on the global equity markets.
FINCA	FINCA (Fixed Income Allocator) is our 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 based on 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	Our proprietary Risk Indicator acts in conjunction with our equity and bond allocation models GLOCAP and FINCA as a "second referee" to recognize quickly whether capital markets are in risk-on or risk-off mode. It 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. It responds fast to changes in international financial markets while simultaneously showing high persistence. A probability of 50% reflects an uninformed, non-predictive assessment of the future market environment. When the Risk Indicator anticipates a low-risk, low-volatility environment (value below 50%), it increases portfolio exposure to equity and bond strategies. When it anticipates a high-risk, high-volatility environment (value above 50%), it reduces such exposure. The Risk Indicator's active response should protect investors particularly in periods of market stress by limiting drawdowns.

Using the models and indicators described above we pursue 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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