vescore
by Vontobel Asset Management

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Global Market Outlook

March 2020

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At a glance

- Increase in equity overweighting
- Slightly negative duration positioning
- Surge of the risk indicator
- Equity weighting: equal weighting vs. capital weighting in negative markets

Surge in risk aversion

Current sentiment is marked by the growing spread of the new coronavirus (COVID-19). While market participants initially assumed that the economic impact would be manageable, risk aversion grew noticeably over the course of the month, resulting in some cases in massive price losses on global equity markets.

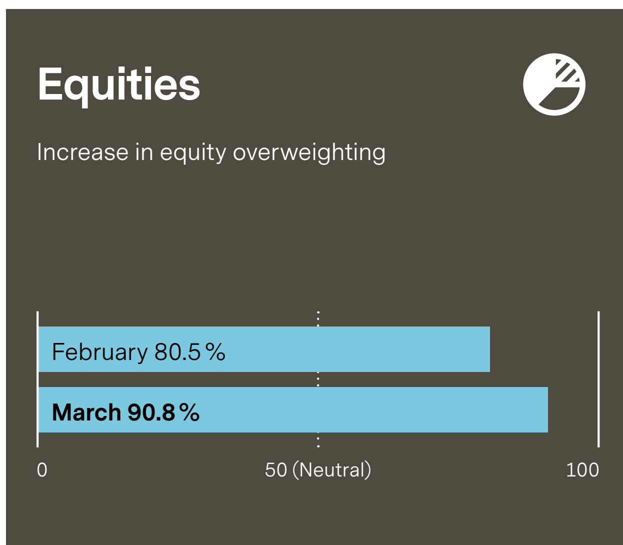
Good news from the current reporting season at the start of February generated rising demand and thus higher prices for risk-bearing investments. Although the economic repercussions of COVID-19 were not predicted, it was thought that the spread in China had already peaked. Yet as, contrary to expectations, the number of cases rapidly spiked in Europe over the month, fears of a pandemic and worries about global growth soared. In turn, the abrupt surge in market participants' risk aversion caused significant distortion on capital markets, especially on equity markets where volatility climbed to its highest level since September 2001.

Other geopolitical crises faded into the background in light of these developments. These included increasing tensions in the Middle East, where the conflict between Turkey and Russia-backed Syria continued to escalate, primarily in the North Syrian Idlib region, which represents the last stronghold of the Islamist rebels. Finally, Turkish President Erdogan also stepped up pressure on NATO and the EU to provide support in its efforts against Syria by abandoning the deal to prevent Syrian refugees from traveling on to Europe.

In March, market participants will continue to focus on developments relating to the virus outbreak and its impact on global growth prospects. Potential accompanying or accommodating measures by central banks or governments could help ease the high risk aversion.

Update COVID-19

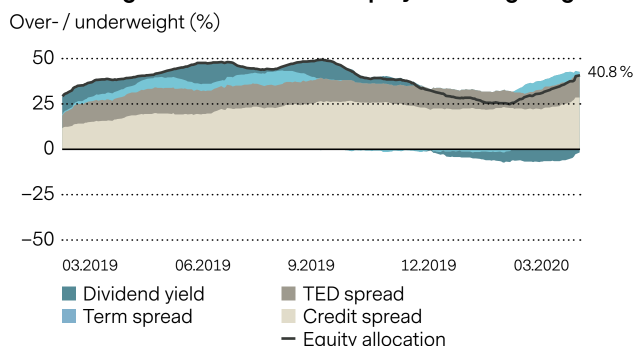
COVID-19: Update on business continuity planning from Vontobel AM
As the coronavirus continues to spread, our Chief Operating Officer provides information on the measures we have taken to ensure business continuity, the safety of our customers and colleagues and the resilience of our investment operations. Please follow the ***link*** to find out more.



At the beginning of March, the equity overweighting in the global GLOCAP sample portfolio (50 % equities, 50 % cash) was 40.8 %. The equity ratio is thus continuing to increase, with equity allocation increasing by around ten percentage points against the previous month. As in previous months, the two macroeconomic variables of the TED spread and the term spread remain the driving factors behind equity overweighting. The dividend yield is subduing the ratio only minimally, with the credit spread continuing to have a slightly positive impact. Accordingly, model variables remain constant, although the term spread and the dividend yield have seen significant growth of 6 and 5 percentage points respectively in comparison to the previous month.

Chart 1: Significant increase in equity overweighting

Over- / underweight (%)



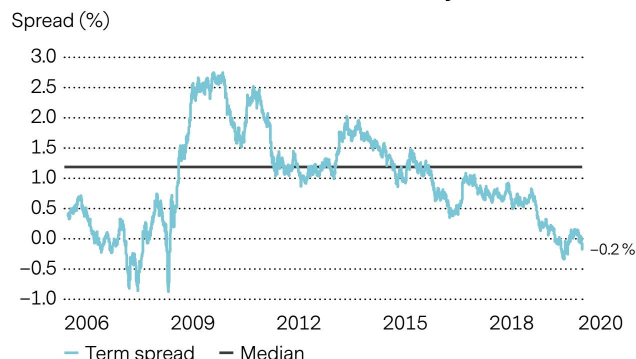
The chart shows the active equity weight (black line) of a global portfolio in euros with a neutral allocation of 50 % equities and 50 % cash. Foreign currencies are hedged. It also shows the contributions of the individual driving forces (term spread, TED spread, credit spread and dividend yield), which come together to give the active equity allocation. Information as of March 2, 2020

The TED spread also increased its contribution by 2 percentage points against the previous month, while the contribution of the credit spread declined.

February began on a positive note, with some new highs achieved on the equity markets mid-month. Nonetheless, the mood turned sour as more and more cases of coronavirus were reported outside China and the growing risk of a global pandemic was priced in. This caused a sharp fall in stock market indices around the world, with the MSCI World Index closing February down 8.6 %.

Chart 2: Yield curves flatten considerably

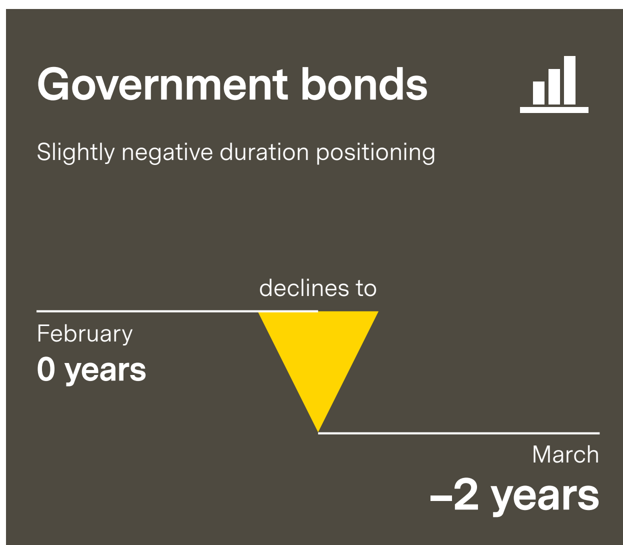
Spread (%)



The chart shows the term spread, which reflects market participants' economic expectations through the difference between long-term and short-term interest rates. A high term spread is typically associated with positive economic forecasts, while a flat yield spread tends to reflect a more downbeat outlook on the part of market participants. The chart shows a weighted average of the term spreads of the major industrialized countries (blue line) and the average of this instrumental variable (black line). Information as of March 2, 2020

	MARCH 2	FEBRUARY 2
Equity overweighting	**40.8 %**	**30.5 %**
Contribution of the term spread	28.5 %	22.2 %
Contribution of the TED spread	12.8 %	10.7 %
Contribution of the credit spread	1.4 %	4.9 %
Contribution of dividend yield	–1.9 %	–7.0 %

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

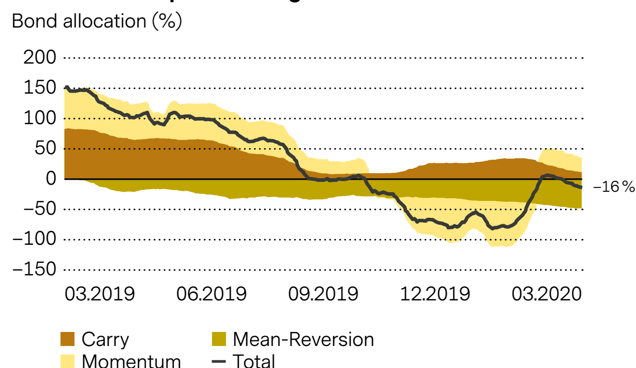


The allocation ratio of a global bond portfolio declined in February and amounted to –16 % at the start of March, representing a duration of –1.6 years. The position in global government bonds held in the portfolio comprises the contributions of the individual carry, mean reversion, and momentum models. Momentum was the only submodel to increase its allocation contribution in February from 21 % to 24 %. This reflects high demand for safe haven government bonds on account of the coronavirus, which prompted interest rates to decline further. In the long term, however, global yield curves flatten out and even invert in the US, meaning that the carry model contributes only 11 % to allocation and declines by 15 percentage points. Mean reversion models clearly indicate a rise in interest rates and, with an allocation contribution of –50 %, are the main cause of the low bond allocation.

The impact of the coronavirus on the global economy resulted in sharp price gains on global equity markets, with 10-year interest on German and US government bonds falling by 0.18 % and 0.44 % respectively in the reporting month.

Chart 3: Short position in global bonds

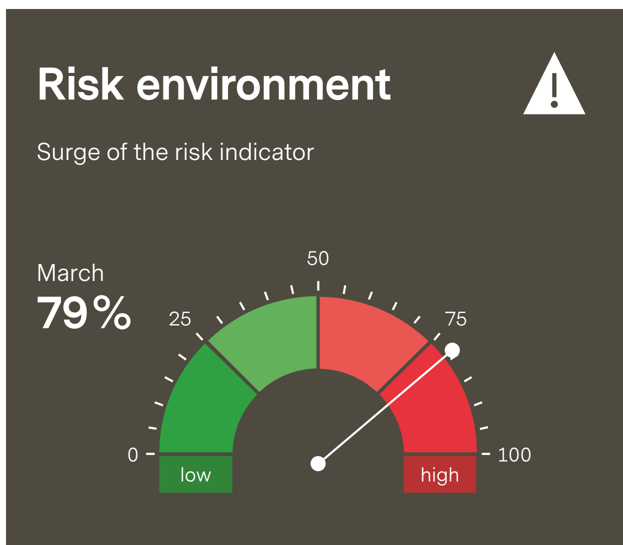
Bond allocation (%)



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 March 2, 2020

	TOTAL	CARRY	MEAN REVERSION	MOMENTUM
Global	–16%	11%	–50%	24%
Germany	–3%	1%	–7%	3%
France	0%	3%	–9%	5%
Italy	5%	4%	–4%	4%
Great Britain	–4%	0%	–5%	1%
Switzerland	–4%	1%	–8%	2%
US	–5%	0%	–8%	2%
Canada	–1%	0%	–3%	2%
Japan	–3%	1%	–8%	4%

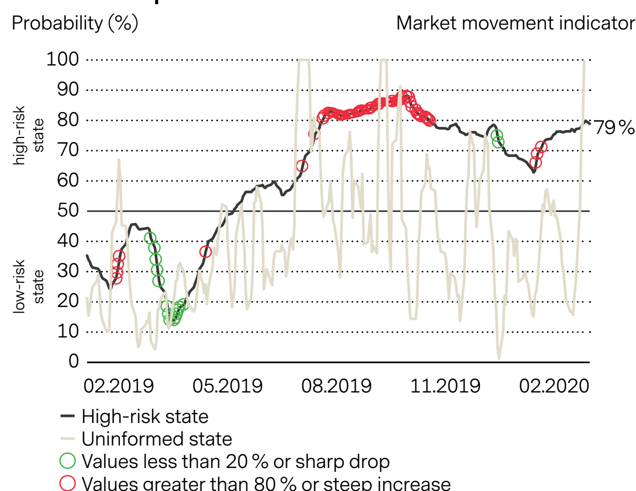
The table shows the bond allocation of a global portfolio in euros (total) broken down into individual countries. It also lists the contribution of the short-term forecast models carry, mean reversion and momentum to the total bond allocation. Information as of March 2, 2020



The aggregate probability of a future high-risk state rose again in February (up 5 percentage points) and is now at 79%. This upturn is driven exclusively by the currency markets' risk assessment, which saw a sharp increase from 41% to 64%. While the risk assessment for equity markets remains stable at a high level of 99%, on bond markets it has dropped by 8 percentage points to 74%.

The risk assessment for emerging markets slid rose considerably in comparison to the previous month from 68% to 86%, putting it in the high-risk range. The picture emerging here is similar to that in developed markets, as the risk assessment of the currency markets (up 50 percentage points) is also responsible for the rise. At 97% and 96% respectively, the assessments for equity and bond markets remain high and almost unchanged.

Chart 4: Sharp rise in risk indicator



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 March 2, 2020

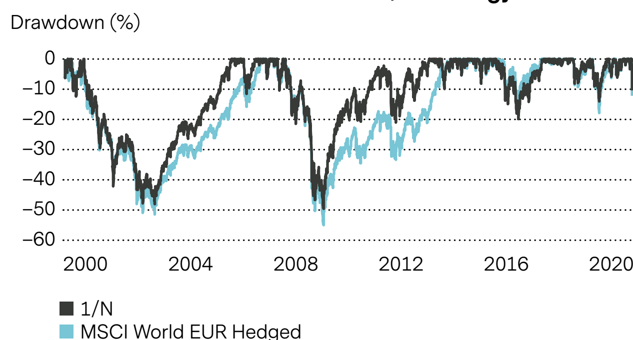
Current topic

Equity weighting: equal weighting vs. capital weighting in negative markets

Equity investments under "conventional" capital-based weighting schemes such as the MSCI World do not do justice to economic potential. A simple but effective way of constructing portfolios is through equal weighting, or 1/N weighting. The strengths of constructing without modeling or estimating yield distribution have also been empirically shown in recent financial market research. A long-term analysis shows the superiority of an equal weighting approach over a "conventional" index such as the MSCI World EUR hedged. As well as better investment performance, volatility under the 1/N approach is 14.0% as opposed to 15.1% for the MSCI World EUR hedged, with the maximum drawdown falling to 50.0% in comparison to 55.4%. There have been seven calendar years (including 2020 YTD) with recorded negative equity market performance since the year 2000. In six of these seven years, in 2000–2002, 2008, 2018 and 2020 YTD, the equal weighting approach performed significantly better.

Chart 5: Lower drawdowns under 1/N strategy

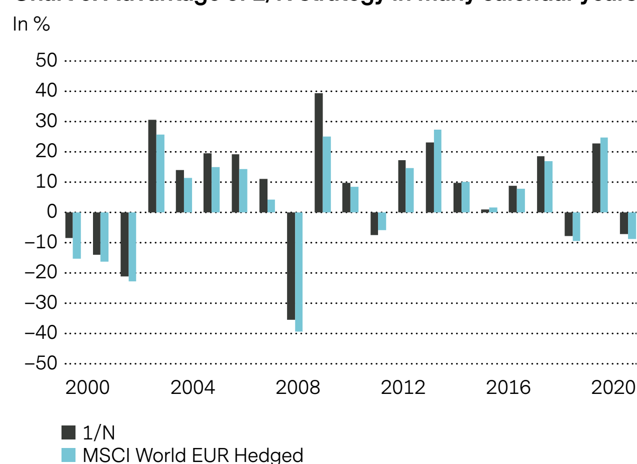
Drawdown (%)



Data: Jan. 1, 2000 – Feb. 28, 2020.

Chart 6: Advantage of 1/N strategy in many calendar years

In %



The chart shows the performance of the 1/N portfolio against the MSCI World EUR hedged index in 3 regions (North America, Europe and Asia) with 4 indices each (FTSE 100, Eurostoxx 50, OMX, SMI, Hang Seng, MSCI Singapore, TOPIX, ASX 200 each 1/12 and TSX 60, Nasdaq each 1/9 and S&P 500, Dow Jones each 1/18). Data: Jan. 1, 2000 – Feb. 28, 2020.

Better crisis resistance in February 2020

The equal weighting approach is also demonstrating its strengths in the current market situation and has resulted in significant advantages in risk/return characteristics, especially in the last week of February. For example, the 1/N portfolio has lost 7.2% since the beginning of the year, far less than MSCI World EUR hedged with a loss of 8.6%. In addition, the 1/N approach is less volatile at 14.3% compared to the capitalization-weighted index at 16.6%. 1/N is suitable for multi asset absolute return strategies thanks to its better drawdown characteristics in the long term.

	1 YEAR	3 YEARS	5 YEARS	10 YEARS	1.1.2000 – 28.2.2020
1/N	3.89%	6.15%	5.18%	8.46%	5.40%
MSCI World EUR Hedged	3.04%	4.94%	4.68%	8.26%	2.75%

	1.3.2019 – 28.2.2020	1.3.2018 – 28.2.2019	1.3.2017 – 28.2.2018	1.3.2016 – 28.2.2017	1.3.2015 – 28.2.2016
1/N	3.89%	1.62%	13.3%	21.9%	–11.7%
MSCI World EUR Hedged	3.04%	0.43%	11.7%	20.8%	–9.9%

Past performance is not an indicator of current or future performance. The return can rise or fall as a result of currency fluctuations.

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 protects investors particularly in periods of market stress by limiting drawdowns.

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