vescore
by Vontobel Asset Management

Global Market Outlook

November 2020

Asset Management

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US elections, coronavirus and the economy

A game-changing political event is imminent – the US presidential election. Investors still have their eye on the other known causes of market uncertainty as well: The COVID-19 pandemic and the measures imposed to contain its spread, the economic repercussions of this and the risk of a no-deal Brexit.

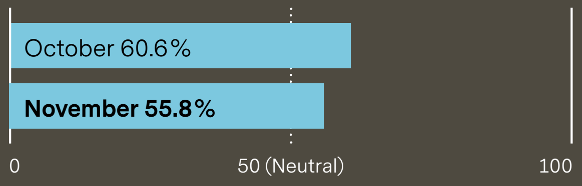
Market sentiment in October once more was shaped by the development of the COVID-19 pandemic. Given the rapid rise in new cases, many European countries again imposed restrictions on public life. As in the spring, these are likely to take a hefty toll on many sectors of the economy, which was negatively received by the equity markets – especially those in Europe. Meanwhile, US president Trump rebuffed the billion-dollar economic stimulus package called for by the Democrats, which had long been bitterly fought over by the government and congress. This stoked fears that the economic recovery in the US would falter despite good October figures.

Arduous negotiations between the European Union and the UK are also suppressing market participants' risk appetite. The dispute over a free trade agreement is focused on the rules for single market access. Meanwhile, the European Central Bank confirmed that it would stand by its current monetary policy and a benchmark interest rate of 0%.

The risk appetite of investors in November is likely to be shaped chiefly by the outcome of the US elections on November 3. A clear result had not yet emerged as of the time that this Global Market Outlook was prepared. For the rest of the year, it is assumed that investors' attention will be on the interaction between the restrictive and stimulative economic measures introduced by governments and central banks, and on the many Brexit questions still unanswered.

Equities

Overweighting reduced to almost neutral

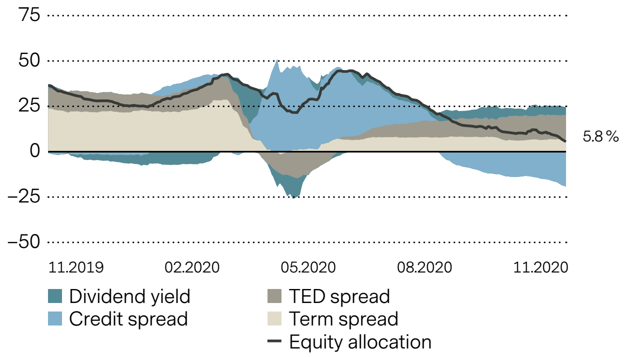


At the beginning of November, the equity overweighting in the global GLOCAP sample portfolio (50% equities, 50% cash) was 5.8%, and thus very close to neutral. This decline as against the previous month was due to the higher negative contribution once again of the credit spread. The positive contributions of the other instrumental variables – term spread, TED spread and dividend yield – remain virtually unchanged as against the previous month, though the TED spread is still dominant, indicative of the good supply of liquidity on the capital market.

The term spread is still relatively insignificant to the current equity allocation, but had been a key driver of overweighting until the end of February. It is derived from the difference between long-term and short-term interest rates on government bonds and serves as an indicator for long-term business expectations. With the economic situation as it is right now, the current slight expansion of the term spread can be attributed more to growing inflation concerns or rising government debt than to economic confidence.

Chart 1: Equity overweighting close to neutral

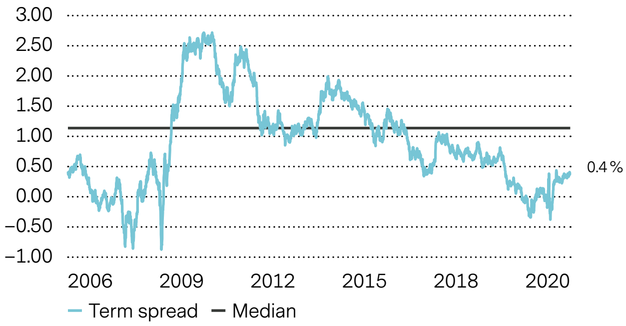
Over/underweighting (%)



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 November 2, 2020
Source: Vescore

Chart 2: Turnaround in term spread?

Spread (%)



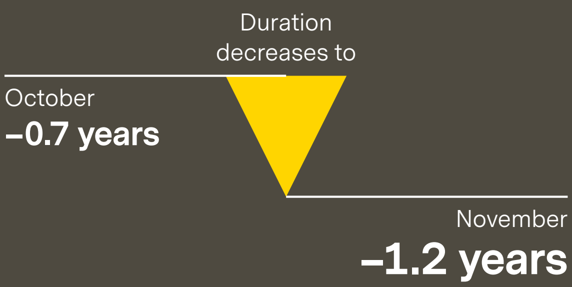
The chart shows the term spread, which reflects market participants' economic expectations through the difference between long-term and short-term interest rates. A high term spread is typically associated with positive economic forecasts, while a flat yield curve tends to reflect a more downbeat outlook 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 November 2, 2020.
Source: Vescore

	NOVEMBER 2	OCTOBER 1
Equity overweighting	**5.8%**	**10.6%**
Contribution of the term spread	7.0%	6.5%
Contribution of the TED spread	13.6%	13.5%
Contribution of the credit spread	–19.0%	–13.4%
Contribution of dividend yield	4.2%	4.1%

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

Government bonds

Short positioning increased slightly

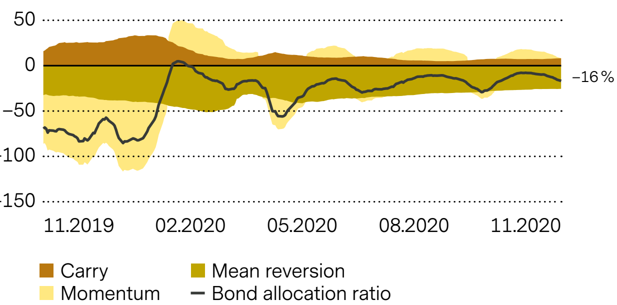


The allocation ratio of a global bond portfolio is down slightly as against the previous month at –16% at the start of November, corresponding to a duration of -1.2 years. The position in global government bonds held in the portfolio comprises the contributions of the individual carry, mean reversion, and momentum models. While the absolute changes in the carry and mean reversion component models are positive, with both up by 1 percentage point, the weighting of the momentum component has declined by 10 percentage points. The defining model for the short positioning is still the mean reversion model with a contribution of –25%, while the carry model is now contributing 9% and the momentum model 0%.

Global bonds ended October unevenly: In the euro area, 10-year government bonds were up by around 1%, while in the Anglo-Saxon countries they contracted by 0.5%, or even as much as 1.0% in the US. Therefore, the effect of global bonds as a risk buffer was limited when equity markets fell in the second half of the month. US bond prices declined over the entire month. Even though Republicans and Democrats were not able to reach an agreement on another stimulus program, hope for further fiscal measures remained strong in view of the possible victory – according to polls – of the Democrat Joe Biden. In that case, the supply of government bonds would grow, medium-term inflation prospects would rise and interest rates would pick up at the long end. In Europe, the markets were dominated by the rising number of coronavirus infections. The numbers for confirmed cases and deaths were up across almost the entire continent, prompting several governments to reintroduce lockdowns of varying degrees and to enhance existing protective measures. Interest in European government bonds grew as the economic outlook worsened.

Chart 3: Model retains short positioning

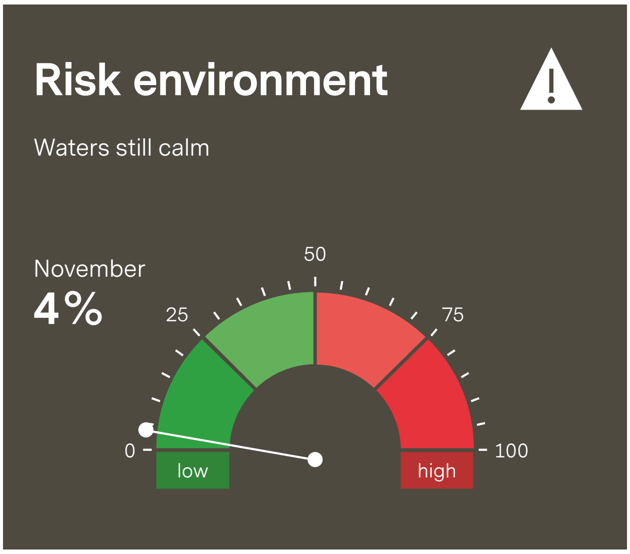
Bond allocation (%)



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 November 2, 2020
Source: Vescore

BOND ALLOCATION	TOTAL	CARRY CONTRIBUTION	MEAN REVERSION CONTRIBUTION	MOMENTUM CONTRIBUTION
Global	**–16%**	**9%**	**–25%**	**0%**
Germany	1%	1%	–1%	1%
France	–1%	1%	–4%	2%
Italy	3%	1%	–1%	3%
Great Britain	–6%	1%	–6%	–1%
Switzerland	0%	1%	–2%	1%
US	–5%	2%	–4%	–3%
Canada	–7%	1%	–7%	–1%
Japan	–1%	1%	0%	–2%

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 November 2, 2020
Source: Vescore

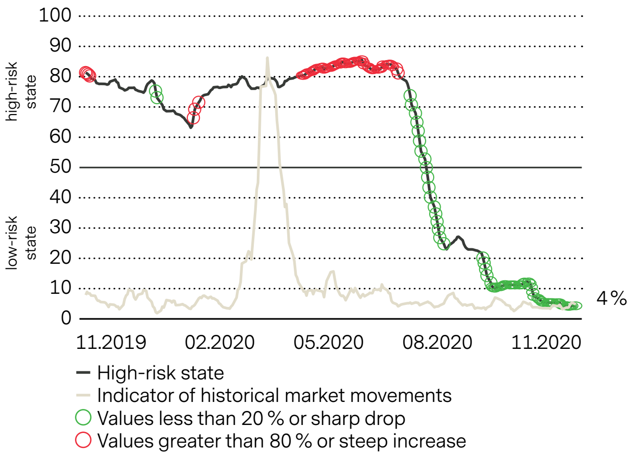


The risk indicator is still showing calm waters. The aggregate probability of a future high-risk state on the developed markets declined again month-on-month, from 9% in October to 4% in November. The risk indicator analyses the current environment and shows whether the future risk is high or low. It does this by comparing short-term yields, which have been low recently, to long-term yields, which take into account the sharp decline on the markets in the first quarter.

The lower probability for a future high-risk state on the developed markets is due to the asset classes of equities and currencies: The risk estimates declined to currently 4% for the equity markets and to 2% for currency markets, while the estimate for bond markets remained steady at 7%.

The emerging markets are also considered calm, with the risk indicator climbing 2% to 12%. However, this gradually rose to 17% as October progressed, which is solely due to the currency market component. Taking into account the effect of the significant depreciation of the Turkish lira – the risk estimate for the currency market component peaked at 44%. It was 29% by the end of the month. The probability of a high-risk state on the emerging markets is a low 3% for both the equity and bond markets.

Chart 4: Risk indicator remains 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 November 2, 2020
Source: Vescore

Current topic

Roll yields as a risk premium

Each month, based on the shape of the futures curves for metals and energy, our systematic commodities strategy ex. agriculture selects the eight commodities with the highest roll yields. Roll yields show whether there are sufficient commodities on the market (negative roll yields) or whether there are shortages (positive roll yields). Allocation predominantly in commodities with positive roll yields has two advantages:

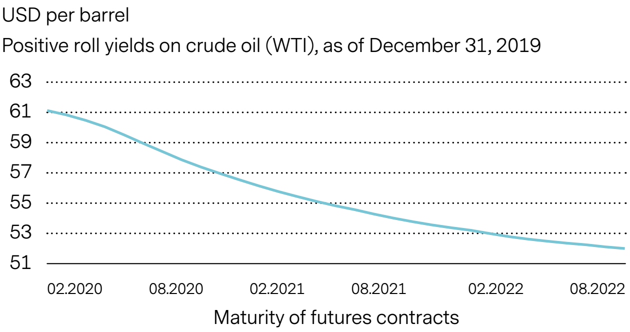
1. The prices of the corresponding commodities should rise moving forward as the market has a shortage.
2. Positive yields can be generated by rolling expiring futures to the next contract.

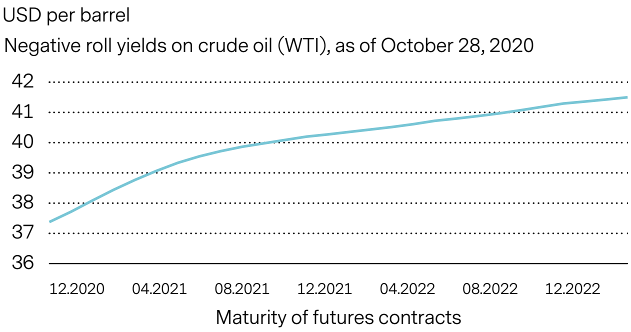
2020: Only few commodities with positive roll yields
Commodities with positive roll yields are proving rare this year. An exception to this is palladium, whose roll yields have long been positive for structural reasons. Palladium has therefore been a fixed feature of the commodities strategy in recent years. It has also benefited considerably from this selection in the current year (PA1 Comdty: +14.8% price increase and +4.6% roll yields). The scarcity on the market is due to the ever-stricter emissions standards for the auto industry and to the fact that palladium mining cannot be simply expanded at will.

Copper had positive roll yields at the front end of the curve in the first half of the year as a result of the closure of a number of mines. In recent months, the strategy has benefited considerably from selecting this industrial metal (HG1 Comdty: +9.2% price increase and +6.5% roll yields since start of year).

Monthly rebalancing rapidly captures changes
The shape of the futures curves for the individual commodities can change very quickly. It is therefore an advantage that the systematic commodity strategy regularly analyzes roll yields. At the start of this year, for example, the futures curve for crude oil (WTI) still had highly positive roll yields on account of the positive economic prospects. The strategy therefore chose the maximum allocation of 50% in the energy sector. When the pandemic spread from China to the western world, the crude oil futures curve flipped and revealed clearly negative roll yields (chart 5). The strategy responded to the change immediately and reduced the weighting in the energy sector to the minimum, 25%, in a very short time in favor of the precious metal allocation. By comparison, the Bloomberg Commodity ex-AL Capped Index came under massive pressure as its energy weighting was 45% while the price of oil plummeted in the first half of the year.

Chart 5: Price of crude oil tumbles in 2020 and rapidly changes the shape of the futures curve





Source: Bloomberg, Vontobel

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.

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