

# Global Market Outlook

July 2020

## At a glance

- Equity overweighting reduced but broader based
- Negative duration positioning
- Risk indicator declines further
- Commodities: Long-short risk premium strategies

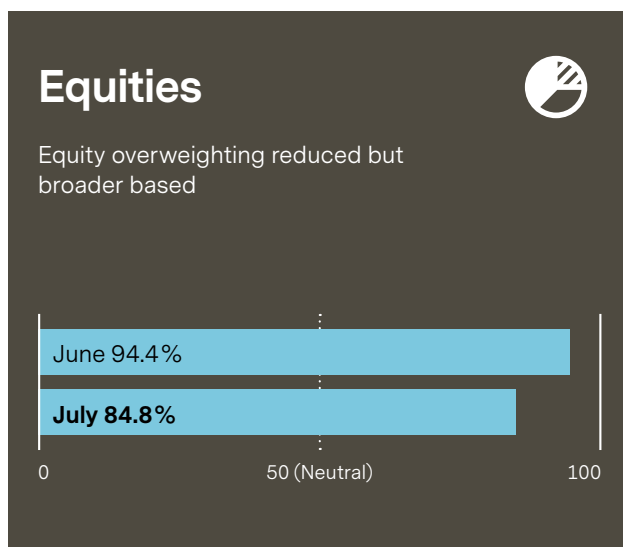
## Optimism prevails

Optimism is prevailing on global capital markets at present. With most countries now having gradually relaxed the restrictions introduced to contain the COVID-19 pandemic, the first positive effects on the economy have become apparent. Monetary and fiscal policy support by central banks and governments also massively shored up investors' risk appetite.

The start of June was marked by declining numbers of cases, cautiously optimistic sentiment and mostly better-than-expected economic data. For example, the US labor market added around 2.5 million jobs and the unemployment rate fell from 14.7% to 13.3%. Durable goods orders made a strong recovery in May after collapsing in the previous month, and US retail sales grew by 17.7% in May, far exceeding the 7.7% expected. In turn, the New York economic index fell only narrowly short of the expansion threshold in June at  $-0.2$ . In Germany, too, the ifo Business Climate Index slightly exceeded expectations in June at 86.2 points.

At the same time, central banks are continuing their accommodating monetary policy, with the US Fed boosting the market by issuing statements on its plans to purchase corporate bonds and the ECB announcing its intention to increase the PEPP program by an additional EUR 600 billion. Meanwhile, Christine Lagarde painted a sobering picture for the eurozone, saying that GDP will likely fall by 8.7% this year. In addition, fears of a second wave in the pandemic remain high. An upturn in cases in the US and Brazil, as well as in many other countries, is indicative of this risk.

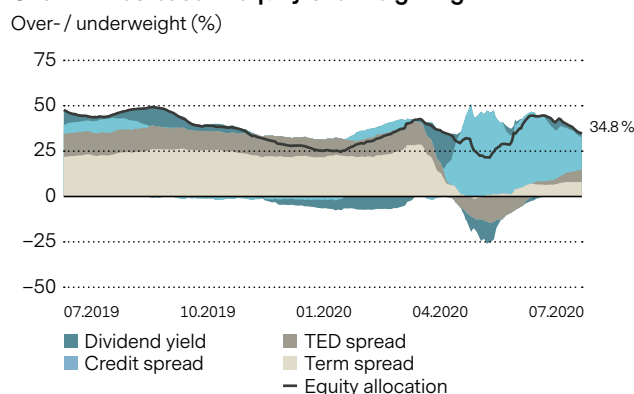
While market participants consider encouraging economic figures, some of which considerably exceed expectations, as a sign of rapid economic recovery, uncertainties remain going forward. If cases were to flare up again, a return to potentially far-reaching restrictions on daily life would likely be unavoidable, prompting fears of further repercussions for the global economy. Moreover, the second half of 2020 will be marked by a ground-breaking event in the form of the US presidential elections.



At the beginning of July, the equity overweighting in the global GLOCAP sample portfolio (50% equities, 50% cash) was 34.8%, much lower than one month before.

The reduction in equity allocation is due exclusively to the lower contribution of the credit spread, with all other variables now making a positive contribution to the overweight. The now broad-based allocation, based on a redistribution of variables, indicates calmer markets for risk-bearing investments. Accordingly, massive interventions by central banks to tackle the COVID-19 crisis seem to be taking effect.

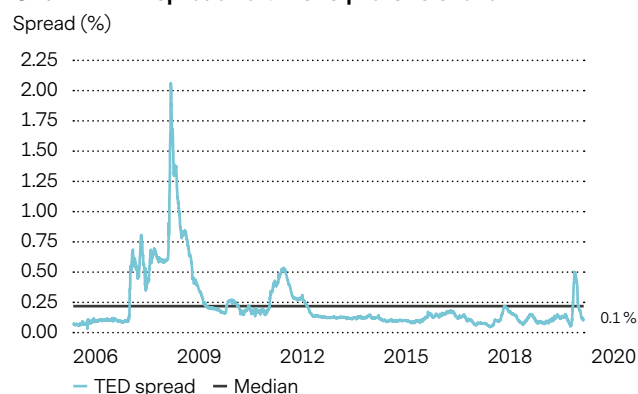
**Chart 1: Decrease in equity overweighting**



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 July 1, 2020

The most significant rise this month was seen by the TED spread, which increased its contribution to the overweight from 1.7% to 6.8%. In the GLOCAP model, the TED spread represents the “stability of the financial system and the liquidity preferences” and is measured by the difference between the interbank interest rate and a default-proof investment. TED spread values have returned to pre-COVID-19 levels in the last few weeks, which may be interpreted as a sign that the risk and liquidity situation in the financial system is settling down.

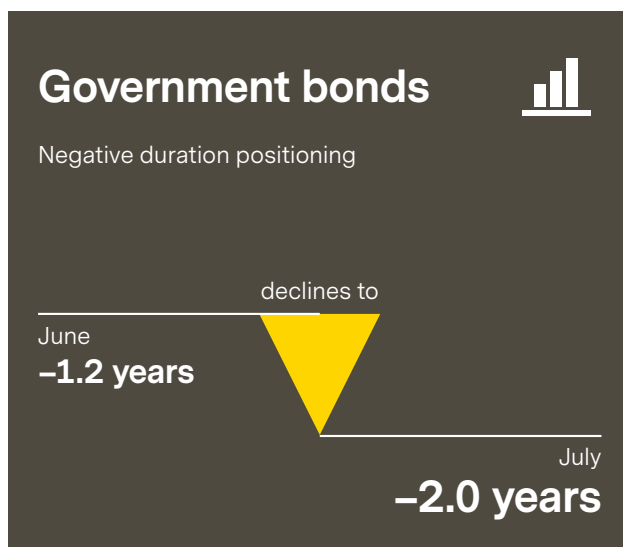
**Chart 2: TED spread returns to pre-crisis level**



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. It shows the TED spread (blue line) and the median (light gray line). Information as of July 1, 2020

	JULY 1	JUNE 1
<b>Equity overweighting</b>	<b>34.8%</b>	<b>44.4%</b>
Contribution of the term spread	8.3%	6.9%
Contribution of the TED spread	6.7%	1.7%
Contribution of the credit spread	17.1%	36.1%
Contribution of dividend yield	2.7%	-0.3%

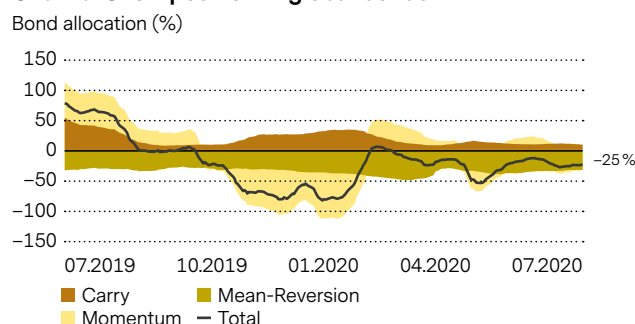
The table shows the contributions of the instrumental variables to the equity overweighting at the beginning of the month.



The allocation ratio of a global bond portfolio is down as against the previous month and was -25% at the start of July, representing a duration of -2.0 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 carry and mean reversion component models are virtually unchanged at 9% and -33% respectively, the contribution of the momentum component has fallen from +10% to 0%, thus making a neutral contribution to the total portfolio allocation.

Global central banks remain steadfast in their determination to address the economic impact of the COVID-19 pandemic. Both the ECB and the Bank of England again increased the volume of their bond buying programs. In addition, the US Federal Reserve virtually ruled out interest rate hikes until the end of 2021 on account of its gloomy prospects for the US economy and labor market. Against this backdrop, yields on 10-year global government bonds were slightly positive, with eurozone bonds seeing particularly positive market movements. While the Bund closed the month up 0.6%, French and Italian government bonds reported gains of 1.1% and 2.6% respectively. This puts the spread between German and Italian bonds at the end of the month at 1.71%, on par with its level at the end of February.

**Chart 3: Short position in global bonds**



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 July 1, 2020

	TOTAL	CARRY	MEAN REVERSION	MOMENTUM
Global	-25%	9%	-33%	0%
Germany	-2%	1%	-3%	0%
France	4%	3%	-4%	5%
Italy	5%	2%	-1%	4%
Great Britain	-4%	0%	-5%	1%
Switzerland	-8%	1%	-5%	-5%
US	-2%	1%	-4%	1%
Canada	-7%	0%	-8%	1%
Japan	-11%	1%	-4%	-7%

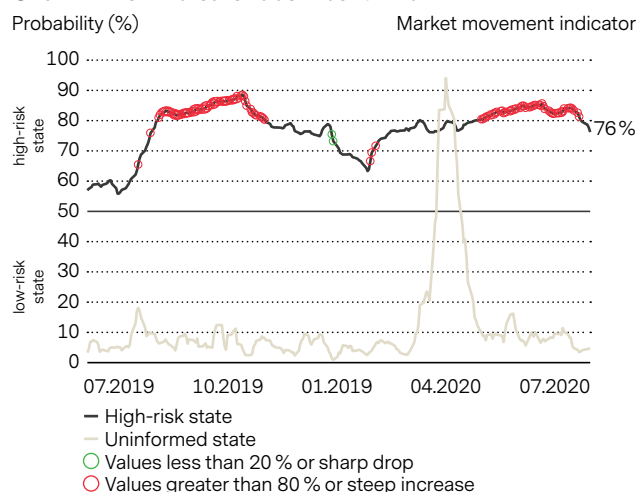
The table shows the bond allocation of a global portfolio in euros (total) broken down into individual countries. It also lists the contribution of the short-term forecast models carry, mean reversion and momentum to the total bond allocation. Information as of July 1, 2020



The aggregated probability of a future high-risk state in developed markets fell substantially from 83% to 76% in July. This was driven by lower risk assessments for equity markets (from 89% to 77%) and bond markets (from 77% to 60%). By contrast, the probability of a high-risk state on currency markets rose slightly, increasing by 2 percentage points to 90%.

While the risk assessment in developed markets fell, the figure for emerging markets increased by 5 percentage points against the previous month. This is based on a far higher risk assessment for currency markets in emerging markets, which climbed from 72% to 90%. The probability of a high-risk state decreased to 82% on equity markets (down 2 percentage points) and to 92% for bonds (down 5 percentage points).

**Chart 4: Risk indicator declines further**



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 July 1, 2020

## Current topic



Commodities: Long-short risk premium strategies

The long-only approach, that benefits from rising prices, is the standard approach for investing in commodities. This has made long-only commodity indices (such as BCOM and S&P GSCI) and long-only ETFs (such as gold or oil) extremely popular. Although these investments have many positive commodity-specific features (such as inflation hedging, little correlation with traditional asset classes, geopolitical hedge and cyclical yields), long-only investments occasionally suffer from the cyclical nature of commodities, higher volatility and negative roll yields. At times when commodity spot prices have fallen, as was the case in April when the oil price even slipped into negative territory, the S&P GSCI Index (down 40% in Q1) and the BCOM Index (down 25% in Q1) had to content with massive losses. In these cases, a long-short approach that can speculate both on increasing and decreasing prices may be a more suitable alternative.

### Why a short strategy makes sense for some commodities

Underlying futures positions for commodities investments must be rolled each month to remain invested. Depending on the shape of the futures curve, the resulting roll yield is either positive (if the curve declines, known as backwardation) or negative (if the curve increases, known as a contango). Only a few commodities trade in structural backwardation in the long term and have a positive roll yield. By contrast, the group of commodities with a structural contango is not only larger, the absolute of negative roll yields is also higher in absolute terms. Long-only indices also invest in contango commodities and this also explains the most-recent underperformance of passive commodity investments. In light of this, some investors have withdrawn from this asset class entirely.

Nonetheless, it is possible to benefit from commodities in contango – by using them as part of a long-short strategy.

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

### Combining various long-short risk premium strategies creates diversification

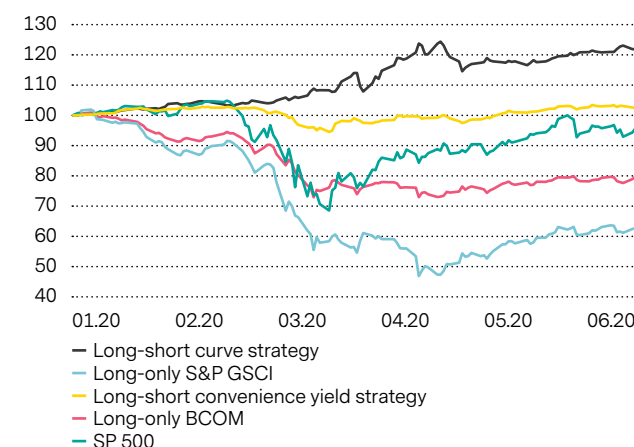
The most important long-short commodity risk premium strategies are curve strategies, which allocate various contracts to the futures curve of the same commodity as long and short, and convenience yield strategies, which can underweight or overweight individual commodities on the basis of the shape of their curve. Combining different risk premium strategies takes advantage of the low correlation between these risk premiums.

### Long-short strategies outperform

In the unprecedented market conditions experienced in the first six months of 2020, long-short strategies offered strong hedging characteristics and outperformed not only the long-only commodities indices (BCOM and S&P GSCI) but also other risk investments such as stock market indices (S&P 500). They are outperforming long-only commodity indices not only in a crisis environment but also over a longer period of time.

### Performance of various stock market and commodity indices in 2020 (as of end of June)

Indexed (1.1.20 = 100)



Convenience yield strategy: Morgan Stanley Dynamic Roll HDX Radar Outperformance (MOTC3426 Index), curve strategy: Seasonal Carry SG Vontobel Seasonal Carry Index, (SGIXV60E Index), long-only BCOM: Bloomberg Commodity Index (BCOM Index), long-only SP GSCI: S&P GSCI Index Spot (SPGSCI Index), SP 500: S&P 500 Index (SPX Index)

## Glossary

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### 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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### 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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### 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.

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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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