vescore
by Vontobel Asset Management

Global Market Outlook

September 2019

- Intact asset pricing on political markets
- Risk indicator shows high-risk state
- Equity overweighting close to maximum
- Neutral bond allocation
- Commodities: Focus on trade dispute escalation
- Swiss equities: Value factor still attractive

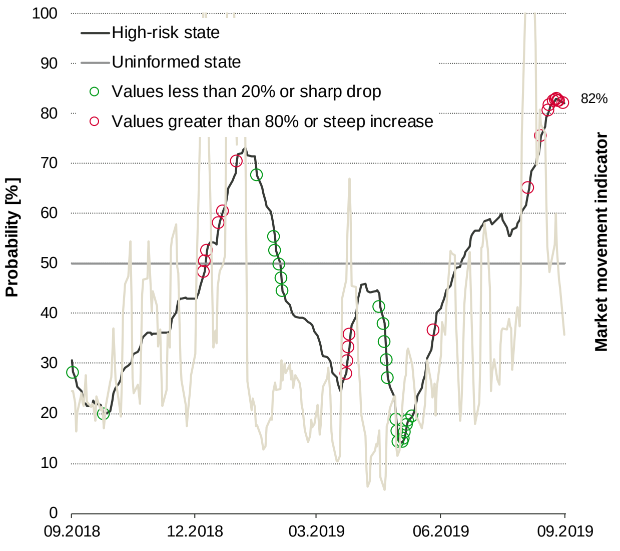
Intact asset pricing on political markets
The market environment is currently defined by political upset and tensions. Meanwhile, fundamental/economic asset pricing is still intact.

The escalation of the trade conflict stoked by the additional punitive tariffs on Chinese imports announced by the US government and China's countermeasures triggered significant price losses on the global stock markets in the first half of August. Above all, China's willingness to abandon its previous course in support of its currency exposed the calcified fronts between the two powers. Also, investors were further spooked by the lingering Brexit crisis, the unrest in Hong Kong, and a spiraling government crisis in Italy. Yields on ten-year US government bonds fell below the level for two-year bonds for the first time since 2007. Such an inversion of the yield curve is generally seen as an indicator that investors expect significantly lower interest and inflation rates moving ahead – which is typically the case when the economy weakens or a recession becomes likely. Just towards the end of the month, the global stock markets started to recoup some of their losses after a willingness to resume talks was signaled by the US and China.

Looking ahead, the capital markets will likely continue their balancing act between global growth prospects and future monetary policy. On top of this, the geopolitical hotspots mean potential for risk propensity among market participants that should not be dismissed.

Risk environment

Risk indicator shows high-risk state
The aggregate probability of a future high-risk state rose steadily in August, and is 82% as of the end of the month after 59% before. A high-risk state is therefore currently indicated. The main factor contributing to this development is the sharp rise in the risk assessment of the currency markets, which climbed from 23% to 76%. At 98%, the risk assessment for the equity market is still the only component in a high-risk state, while the assessment of the bond markets has risen from 60% in the previous month to 74%.
The non-predictive risk assessment climbed in August for the emerging markets as well, also entering a high-risk state at 84% (previous month: 60%). The assessment on the currency markets is most significant at 63% (previous month: 10%), while the two other components are already in a high-risk state with values in excess of 96%.



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 September 2, 2019.

Equities

Equity overweighting close to maximum

At the beginning of September, the equity overweighting in the global GLOCAP sample portfolio (50% equities, 50% cash) was 49.6%. Consequently, the equity allocation has been increased by 5.3 percentage points since the start of August.

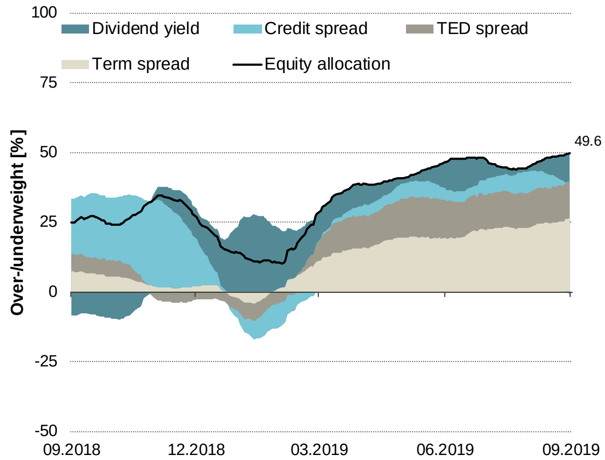
The foundation for equity overweighting is built on the two macroeconomic instrumental variables of term spread and TED spread. Their contributions climbed as August progressed to presently 26.5% and 13.0%. By contrast, the contributions by the two microeconomic variables remained low. The rise in the dividend yield over the month has now led to an overweighting of 10.7%, while the credit risk spread contribution is negligible at -0.6%.

Term spread falls deeper into negative territory

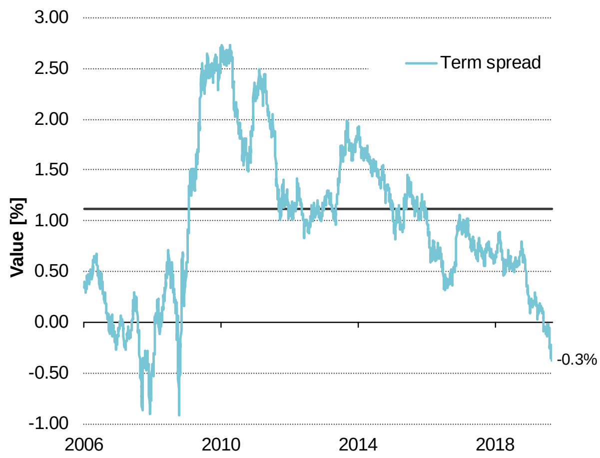
The weighted average spread for the major industrialized countries fell much deeper into negative territory in August. The trend towards flat to inverse term spreads has intensified significantly once again (global average), falling by more than 20 basis points from -0.1% to -0.3% in August. This primarily reflects market participants' more downbeat growth and inflation forecasts for the coming years. In addition to the inverse US yield curve, the flattening of the curve in Italy in particular was also a factor in August.

Flat term spreads in the GLOCAP sample portfolio are translating into high levels of equities, which should be seen in the context of the accommodating monetary policy.

At the same time, the dividend yield rose sharply again with the price declines at the start of August. An average level of 2.5% signals that prices on the equity markets are still moderate.



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 September 2, 2019.



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 spread is typically associated with positive economic forecasts, while a flat term 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 September 2, 2019.

	September 2	August 1
Equity overweighting	**49.6%**	**44.3%**
Contribution of the term spread	26.5%	22.9%
Contribution of the TED spread	13.0%	12.4%
Contribution of the credit spread	-0.6%	7.8%
Contribution of dividend yield	10.7%	1.2%

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

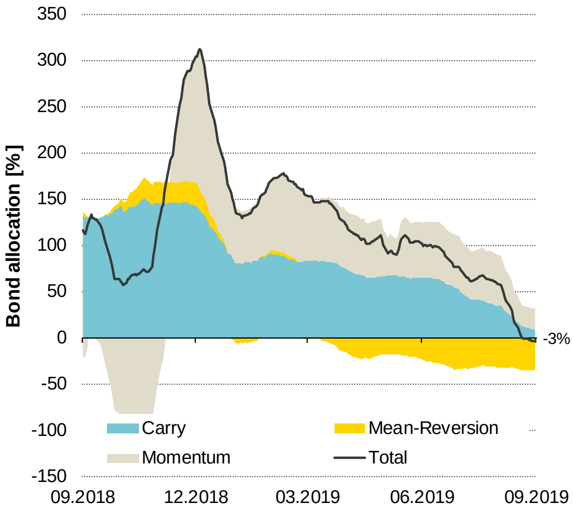
Management of equity allocation with GLOCAP: Active divergences from the neutral position (50% cash, 50% equities) are entered into on the basis of an assessment of the economic environment. The long-term economic expectations (term spread), the stability of the financial system and the liquidity preferences (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.

Government bonds

Neutral bond allocation

The bond allocation ratio of a global portfolio fell by a further 64 percentage points to a neutral -3% at the end of August. The position in global government bonds held in the portfolio comprises the contributions of the individual carry, mean reversion, and momentum models.

The decline in bond allocation last month was driven by all three model components, with the carry and momentum components accounting for the lion's share with declines of 27 and 33 percentage points respectively. The mean reversion component is also down by 4 percentage points month-on-month. Thus, while the carry and momentum components still have positive allocations of 8% and 23%, they are cancelled out by the negative weight of the mean reversion model of -35%, with the result that the portfolio as a whole is negatively positioned at -3%.



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 September 2, 2019.

Country weightings in narrow ranges

The individual country weightings have only low allocations in the portfolio as a whole. The concentration on the European market still evident in the previous month has been broken down, and Japan is now the heaviest country in the portfolio with a weight of 5%. By contrast, French bonds are at the lower end of the range at -6%. Compared to previous months, this marks a significant narrowing of country weighting ranges.

Interest rates continue to plummet

The one-two punch of the escalation of the trade dispute and global central banks continuing to ease their monetary policy has caused interest rates to tumble around the world. For example, 10-year US interest rates fell by around 50 bps in August, translating into a 10-year US future performance of approximately 3%. Another Fed interest step is therefore fully priced in for the rest of the year, while a second and third cut appear likely and possible respectively.

	Total	Carry	Mean reversion	Momentum
Global	-3%	8%	-35%	23%
Germany	0%	1%	-5%	3%
France	-6%	1%	-10%	2%
Italy	4%	4%	-3%	2%
Great Britain	-2%	0%	-4%	1%
Switzerland	3%	2%	-2%	3%
US	-3%	-2%	-4%	3%
Canada	-4%	0%	-5%	2%
Japan	5%	2%	-3%	6%

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 September 2, 2019.

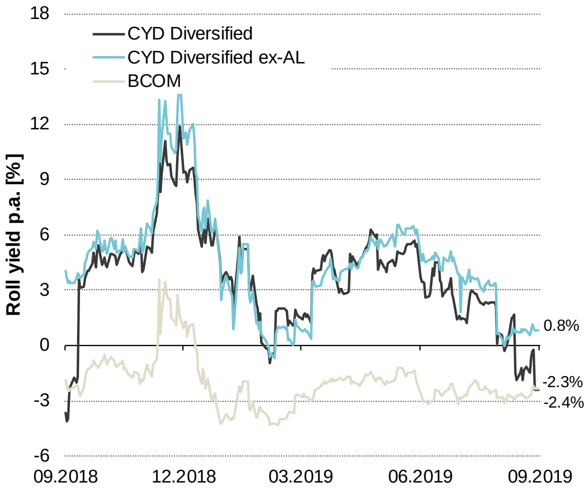
Active duration management with FINCA: The bond allocation is based on the FINCA multi-model approach, which is used as a tool for forecasting changes in the world's most important yield curves of government bonds and swaps. Short-term forecast models (carry, mean reversion, and momentum) are analyzed 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.

Select topics

Commodities: Focus on trade dispute escalation

The aggregate roll yield for the Bloomberg Commodity Index is still negative at -2.3% p.a., but could rise slightly over the course of the month. By comparison, the CYD Diversified Commodities Index aggregate roll yield fell significantly on account of livestock, and is now also negative at -2.4% p.a.

The escalation of the trade dispute and the associated economic fears weighed heavily on most energies and industrial metals in addition to agriculture in August. The only industrial metal to buck the trend was nickel, which experienced a price increase of approximately 25% on the strength of Indonesia moving up its ban on exports to January 2020. However, precious metals received substantial support from economic uncertainty and the amenability of global central banks.

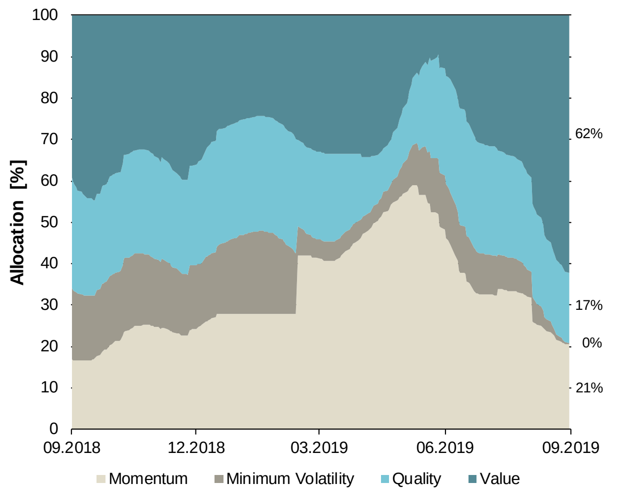


The chart shows the aggregate roll yields of the CYD Diversified Index, CYD Diversified ex-AL Index and the Bloomberg Commodity Index. Roll yields can be derived from the maturity structure of commodity futures. Information as of September 2, 2019.

Swiss equities: Value factor still attractive

In line with our models, the appeal of value stocks continues to rise on the Swiss equity market last month. The allocation of the value factor portfolio, in which financial stocks and industrial companies especially are currently overweighted, climbed to 62%. Value is therefore by far the most attractive factor at the present time. This shift was at the expense of all three of the factors. The minimum volatility weighting has since reached 0%.

The dynamic factor allocation is based on three sub-models that evaluate the economic environment, the price trend and the mean reversion potential. The move to value stocks in the past month was mainly driven by the price trend, while the signals from the other two sub-models hardly changed at all.



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 September 2, 2019.

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