vescore
by Vontobel Asset Management

Global Market Outlook

June 2021

Asset Management

At a glance

- Equities:
  Overweighting down
- Government bonds:
  End of short positioning
- Risk environment:
  Risk indicator lower
- Current topic:
  EU carbon allowances – a political tool to put a cost on pollution

Market participants focusing on inflation and central banks

At the start of June, sentiment on the capital markets is split by positive economic data on the one hand and the associated concerns over inflation on the other. Fears of a less loose monetary policy are dampening the optimism of advancing economic recovery. Overall, demand for risk-bearing investments is nonetheless high.

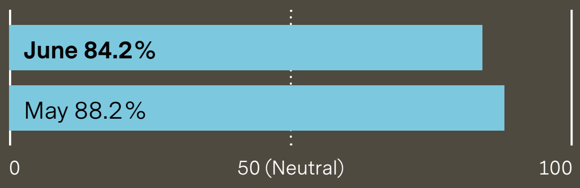
The economic data published in May attest to a strong economic recovery on both sides of the Atlantic. In the US, private sector employment is up significantly, with similarly positive data for the services sector, production ex-agriculture and demand for imports. The numbers in Europe were correspondingly promising, and there was an easing of tensions regarding the whole coronavirus pandemic situation. This allowed protective measures to be relaxed further, which should help the economic recovery. However, this optimism was not felt throughout the equities markets in May. This is because US consumer prices experienced their highest increase since September 2008 in April, meaning that inflation in the US clambered above the 4 %-hurdle in May.

At times, market participants' concerns that monetary policy will be tightened in response to rising inflation weakened demand for risk-bearing investments. Nevertheless, the US Fed is sticking to its argument that the rise in inflation as the economy starts picking up will only be temporary. Thus, no changes in current monetary policy are expected at this time.

Looking ahead, market participants will likely be focusing on the economic data, the trend in inflation and the resulting monetary policy. It is hoped that the June meetings of the US Fed and the European Central Bank will produce meaningful statements regarding the future direction of monetary policy. A possible end to ultra-loose monetary policy would reduce investors' risk appetite overall.

Equities

Overweighting down

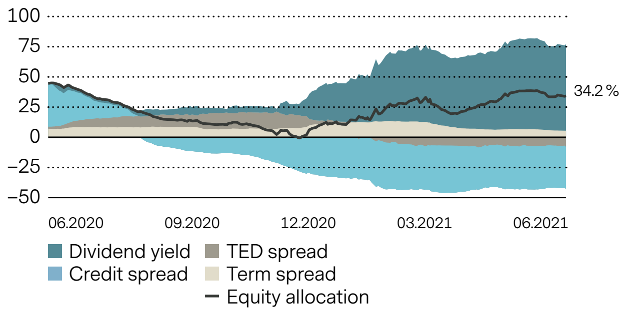


At the start of June 2021, the equity overweighting of the global GLOCAP sample portfolio (50% equities, 50% cash) stands at 34.2% and is thus lower than in the previous month. The decline is mainly due to the dividend yield contribution, which was down by 2.9 percentage points in May. The changes in the TED spread and credit spread contributions virtually neutralize each other. The term spread contribution continued to diminish in the past month, and is now only a marginal factor in equity overweighting. While the equity markets and the allocation in the sample portfolio had reached new highs for the year at the start of the previous month, the overweighting dropped in the middle of the month and has been stuck there ever since.

The term spread continued to climb over the past month to currently 0.9%. The negative sensitivity of this instrumental variable that has been established for months still persists. It is contradictory to the economic intuition that the term spread would rise in the face of more positive economic prospects and that equity prices would therefore pick up. This interpretation leads to this sub-model indicating a reduction in equity overweighting despite the fact that the term spread has been on the rise since the year began. If the economy were to prosper more rapidly, the central banks could be prompted to scale back their loose monetary policy at a faster rate than market participants are expecting.

Chart 1: Equity allocation down slightly

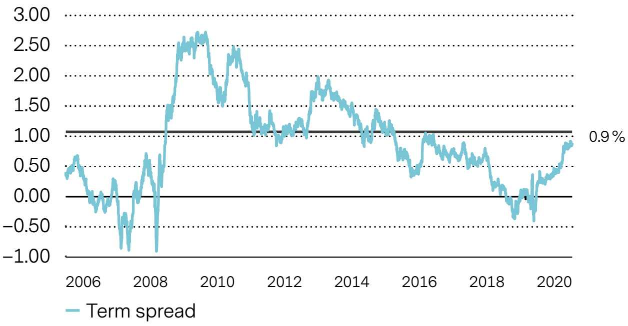
Over/underweighting (%)



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 June 2, 2021. Source: Vescore

Chart 2: Negative term spread sensitivity

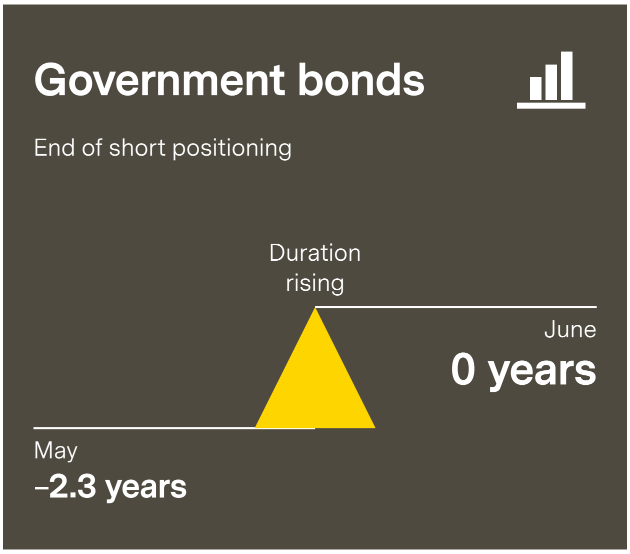
In %



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 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 June 2, 2021. Source: Vescore

	JUNE 2	MAY 3
Equity overweighting	**34.2%**	**38.2%**
Contribution of the term spread	5.3%	6.5%
Contribution of the TED spread	−8.1%	−6.5%
Contribution of the credit spread	−34.9%	−36.4%
Contribution of dividend yield	71.8%	74.7%

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



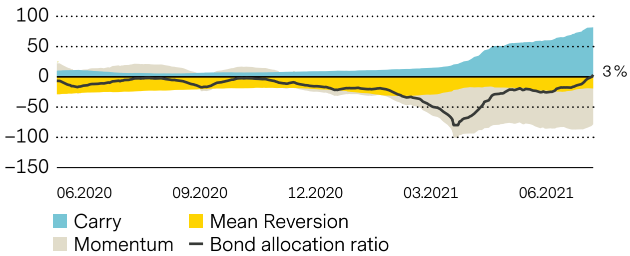
The allocation ratio of a global bond portfolio is up as against the previous month at 3% at the start of June, corresponding to a neutral duration of 0 years. The position comprises the contributions of the three sub-models carry, mean reversion and momentum. The carry model is currently contributing a significantly higher 82%. The mean reversion model is rating bonds still negatively, albeit to a lesser degree, now contributing –20%. Momentum is still having a very negative effect, with the model's contribution almost the same as in the previous month at –59%. The increase in the carry model and the associated change to a neutral portfolio duration predominantly results from eurozone countries, which gave the most pronounced carry signals. Overall, however, European government bonds are still weighted negatively in the model portfolio.

The global interest markets moved only slightly in May. In the eurozone, interest rates on 10-year government bonds rose by 1 to 2 basis points, though in the Anglo-Saxon countries they were down by a few basis points, most noticeably in the UK by approximately –5 basis points.

The markets continue to be dominated by rising inflation expectations and the monetary policy of the global central banks. The rising price pressure is now also evident in various sets of published data. The PCE core deflator, the widely regarded US consumer price index, was up by 3.1% year-on-year in April, a surge not seen since 1992. However, spokespeople for central banks on both sides of the Atlantic are mostly reiterating the temporary nature of the inflation currently being witnessed. Thus, both the US Fed and the European Central Bank will likely be sticking to their current monetary policy for now.

Chart 3: Stronger carry signal neutralizes duration

Bond allocation (%)



The chart shows the government bond allocation of a global bond 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 June 2, 2021. Source: Vescore

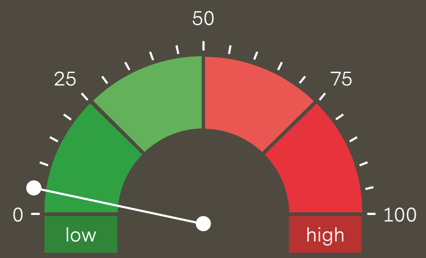
BOND ALLOCATION	TOTAL	CARRY CONTRIBUTION	MEAN REVERSION CONTRIBUTION	MOMENTUM CONTRIBUTION
Global	**3%**	**82%**	**-20%**	**-59%**
Germany	-9%	10%	-5%	-14%
France	-6%	20%	-4%	-23%
Italy	-8%	12%	-7%	-12%
Great Britain	-7%	8%	-7%	-8%
US	11%	11%	1%	0%
Canada	8%	9%	0%	-1%
Australia	3%	4%	0%	-2%
Japan	11%	9%	2%	1%

The table shows the bond allocation of a global portfolio in euros ("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 June 2, 2021. Source: Vescore

Risk environment

Risk indicator lower

June
5%

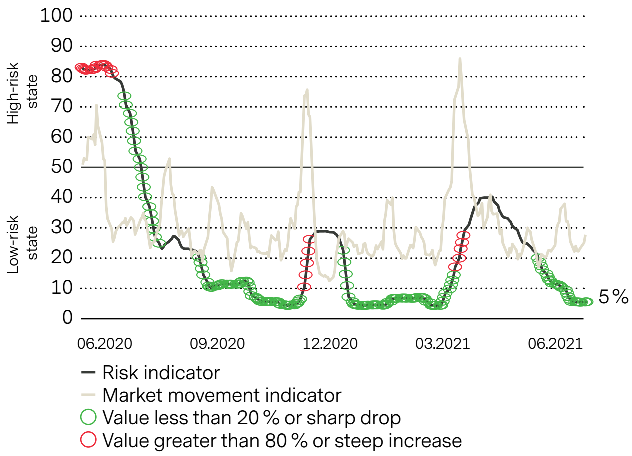


The risk indicator continued to fall in May and is currently at 5% after 15% in the previous month. The aggregate probability of a future high-risk state on developed markets can therefore currently be regarded as very low. The risk indicator analyses the current environment and shows whether the future risk should be considered high or low. It does this by comparing short-term and long-term market yields. As in the previous month, the decline in this indicator is due to the calmer global bond markets in the developed countries. Their probability for a future high-risk state has fallen to 9% after 39% in the previous month. Remarks by the US Fed that the current rise in inflation is merely a temporary phenomenon allowed the interest situation to relax. Even rumors of an imminent tapering of bond purchases by central banks did not particularly unsettle market participants. The risk estimates for developed market equities and currencies were practically unchanged in May at a very low 5% and 1%.

The risk indicator for emerging markets increased marginally from 3% in the previous month to currently 5%. The slightly higher probability of a future high-risk state is mainly due to the equity markets, where the risk indicator climbed from 3% to 10%. The risk indicators for emerging market equities and currencies are 6% and 3%.

Chart 4: Risk indicator down again

Probability (%)



The chart shows the aggregated probability of a future high risk state in developed markets in the near future (black line). The aggregated probability is given as the average of the three individual probabilities for the market segments of equities, fixed income and currencies. Interesting values are depicted with green and red circles. Green marks a calm market environment and red a turbulent one. The uninformed assessment of the future market environment is plotted at 50% (horizontal black line). An aggregate indicator of the historical market trends in the three segments is shown in the background (light gray line). Information as of June 2, 2021. Source: Vescore

Current topic

EU carbon allowances – a political tool to put a cost on pollution

EU carbon allowances (EUA) market on the rise
Besides the classical exposure to commodity sectors including energy, grains, metals, etc. investors should also consider the inclusion of carbon allowances in their portfolios. A carbon allowance is a certificate that represents the legal right to emit one tonne of carbon dioxide during a specific period. Many countries developed Emissions Trading Systems (ETS) in the form of regulated markets where governments grant and auction carbon allowances to companies in order to put a cost on pollution. The EU's ETS has become the biggest carbon allowances market worldwide and it is the EU's core strategic tool to cut emissions by 55% by 2030.

By shrinking the number of carbon allowances each year, the EU creates a strong incentive for companies to divest polluting activities and invest in future technologies to reduce emissions. Any surplus or shortfall of allowances can be resolved through trading on a secondary market. Similar to all other commodities futures, allowances are transferable and tradable on an established spot and futures market. The EU classified carbon allowances as a financial instrument because institutional investors need to participate to provide liquidity and risk-transfer services.

Carbon allowances will profit from global initiatives taken to reduce carbon emissions. We expect prices to climb significantly from today's levels, as politicians demand higher prices for pollution. Germany's Green Party, for example, sets their short-term EU carbon allowance price target at 90 euros. We assume that not yet covered European industries (shipping, car manufacturers, real estate) and major economies (UK, South Korea, US, Canada, China) will follow suit.

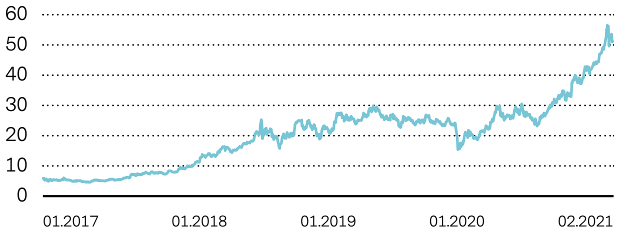
Benefits of adding EU carbon allowances to a portfolio
Participation in the carbon futures market offers three major advantages in our view:

1. Enables investors to offset the carbon footprint of their portfolio, i.e. achieve carbon neutrality within the portfolio by calculating the emissions of each position with underlying commodities and buy the equivalent amount of carbon allowances.

2. Offers an inflation hedge against accelerating costs of the energy transition and protects against the risk of producers rolling these costs over to the end consumer (similar to the "Energiewende" in Germany, which caused an enormous price spike for end consumers).

3. Offers further price upside, considering that prices of EU carbon allowances gained massively over the last 3 years (+250%) and that year to date, a cold winter and the reopening of the EU economy pushed them further up by almost 60% to 51.50 euros.

Chart 5: Price acceleration of generic EUA future
In EUR



Data: 1 January 2017 – 31 May 2021. Past performance is not a reliable indicator of current or future performance.
Source: Vontobel, Bloomberg (Ticker: MO1 Comdty)

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 based on financial market research with the aim of achieving an attractive risk-adjusted performance in the long term.

Disclaimer
This marketing document was produced by one or more companies of the Vontobel Group (collectively “Vontobel”) for institutional clients.

This document is for information purposes only and nothing contained in this document should constitute a solicitation, or offer, or recommendation, to buy or sell any investment instruments, to effect any transactions, or to conclude any legal act of any kind whatsoever.

Past performance is not a reliable indicator of current or future performance. The return may go down as well as up, e.g. due to changes in rates of exchange between currencies. The value of invested monies can increase or decrease and there is no guarantee that all or part of your invested capital can be redeemed.

Although Vontobel believes that the information provided in this document is based on reliable sources, it cannot assume responsibility for the quality, correctness, timeliness or completeness of the information contained in this document.

Except as permitted under applicable copyright laws, none of this information may be reproduced, adapted, uploaded to a third party, linked to, framed, performed in public, distributed or transmitted in any form by any process without the specific written consent of Vontobel. To the maximum extent permitted by law, Vontobel will not be liable in any way for any loss or damage suffered by you through use or access to this information, or Vontobel’s failure to provide this information. Our liability for negligence, breach of contract or contravention of any law as a result of our failure to provide this information or any part of it, or for any problems with this information, which cannot be lawfully excluded, is limited, at our option and to the maximum extent permitted by law, to resupplying this information or any part of it to you, or to paying for the resupply of this information or any part of it to you. Neither this document nor any copy of it may be distributed in any jurisdiction where its distribution may be restricted by law. Persons who receive this document should make themselves aware of and adhere to any such restrictions. In particular, this document must not be distributed or handed over to US persons and must not be distributed in the USA.

Vontobel is represented in Australia by Vontobel Asset Management Australia Pty Limited (ABN 80 167 015 698), which is the holder of Australian Financial Services Licence number 453140 (“Vontobel Australia”). Vontobel and Vontobel Australia are also an Overseas Financial Adviser in the meaning of the Financial Advisers Act 2008 of New Zealand (“FAA”) and neither Vontobel nor any of its affiliates or subsidiaries has a presence in New Zealand.

This information is only intended to be provided to persons:
- in Australia if that person is a wholesale client for the purposes of section 761G of the Corporations Act of Australia; and
- in New Zealand if that person is a wholesale client for the purposes of section 5C of the FAA.

This document is not intended to be distributed or passed on, directly or indirectly, to any other class of persons in Australia or New Zealand. This document has not been prepared specifically for Australian or New Zealand investors.

It:
- may contain references to dollar amounts which are not Australian or New Zealand dollars;
- may contain financial information which is not prepared in accordance with Australian or New Zealand law or practices;
- may not address risks associated with investment in foreign currency denominated investments; and
- does not address Australian or New Zealand tax issues

This document was approved by Vontobel Asset Management SA, Munich Branch, which has its registered office at Leopoldstrasse 8 – 10, 80802 Munich and is authorized by the Commission de Surveillance du Secteur Financier (CSSF) and subject to limited regulation by the Federal Financial Supervisory Authority (BaFin). Details about the extent of regulation are available from Vontobel Asset Management SA, Munich Branch, on request.

Vontobel Asset Management AG
Genferstrasse 27
8022 Zurich
Switzerland
T +41 58 283 71 11

Vontobel Asset Management SA
Munich branch
Leopoldstrasse 8 – 10
80802 Munich
Germany
T +49 89 211 133 0

Vontobel Asset Management
Australia Pty Ltd.
Level 20, Tower 2, 201 Sussex St
NSW 2000 Sydney
Australia

vescore.com