vescore

by Vontobel Asset Management

Global Market Outlook

May 2021

Asset Management

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Balancing act between optimism and inflation worries

Capital market sentiment at the start of May is shaped by stable risk appetite among market participants. This is based on optimism that global economic recovery is in sight thanks to vaccination process and the boost provided by monetary policy.

The rapid pace of vaccination campaigns, especially in the US, stabilized demand for risk-bearing investments and with it equity markets, although US authorities have since paused use of the Johnson & Johnson vaccine. Yet this unsettled investors only temporarily and their appetite for risk remained so high that many of them used temporary setbacks as a chance to buy in.

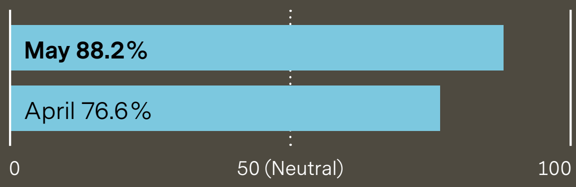
At the same time, monetary and fiscal policy signals bolstered the labor market recovery and growth expectations, with both the European Central Bank and the US Federal Reserve announcing that they would stand by their current strategy. The federal funds rate in the US remains very low at 0.0% to 0.25% and monthly securities purchases of around USD 120 billion are being continued as a way of shoring up the economy.

Accordingly, US President Biden's plans to raise taxes on wealthy Americans to fund infrastructure projects and support programs for families depressed investor sentiment only temporarily. Sentiment on equity markets did not shift until the end of the month, when a rise in COVID-19 cases, including in India, and the spread of potentially dangerous virus variants prompted new concerns about the pandemic.

Looking ahead, market participants are still focusing their attention on the balancing act between economic optimism and the risk of further setbacks due to developments in the pandemic. The rise in consumer prices expected is likely to have a particularly negative impact on bond markets. With that, anticipated tapering, i.e. potentially the end of ultra-loose monetary policy, would reduce investors' risk appetite overall.

Equities

Further increase in overweighting



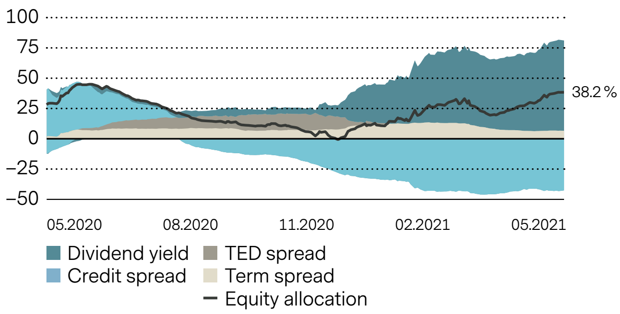
At the start of May 2021, the equity overweighting of the global GLOCAP sample portfolio (50 % equities, 50 % cash) was 38.2 %, higher than in the previous month. The greatest change in absolute terms was in the dividend yield contribution. This rose by 11.4 percentage points in April to 74.7 % and is the main allocation driver, as changes in the contribution of the term spread, the TED spread and the credit spread more or less balance each other out.

The temporary decline in equity allocation took a turn in March and has now reached a new annual high.

The overall picture is unchanged: The dividend yield is still having the biggest effect on the equity overweighting, although it remains below the average of 2 %. This is economically unintuitive. The reason behind it is the negative sensitivity of this instrumental variable, which is due to the fact that market participants are expecting significant earnings growth ahead, and so are making do with lower dividends for now.

Chart 1: Equity allocation at annual high

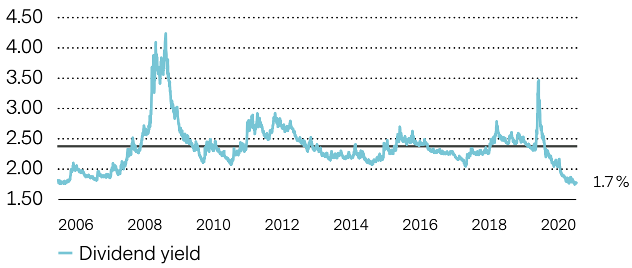
Over/underweighting (%)



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 May 3, 2021. Source: Vescore

Chart 2: Dividend yield sensitivity negative

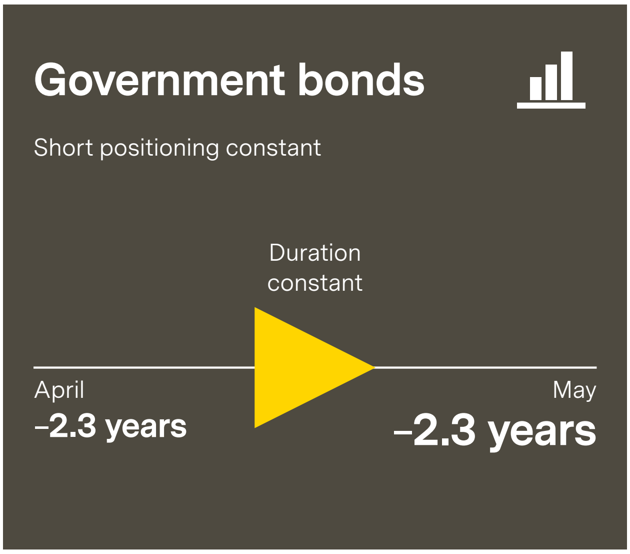
In %



The chart shows the indicator for fundamental valuation, which measures the aggregated ratio of dividend to price and reflects the expected equity market yield as the central valuation parameter. The chart shows a weighted average of the dividend yields of the major industrialized countries (blue line) and the median of this instrumental variable (black line). Information as of May 3, 2021. Source: Vescore

	MAY 3	APRIL 6
Equity overweighting	**38.2%**	**26.6%**
Contribution of the term spread	6.5%	6.7%
Contribution of the TED spread	–6.5%	–8.4%
Contribution of the credit spread	–36.4%	–35.0%
Contribution of dividend yield	74.7%	63.3%

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



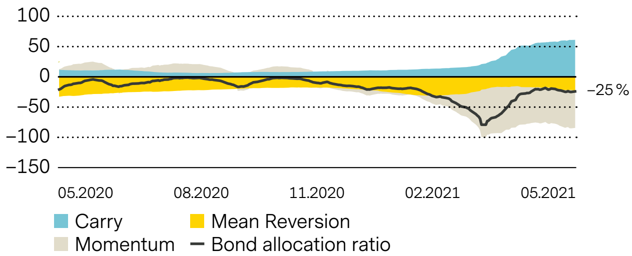
The allocation ratio of a global bond portfolio is up marginally as against the previous month at –25% at the start of May, still corresponding to a duration of –2.3 years. The short position comprises the contributions of the three sub-models carry, mean reversion and momentum. The positive contribution of the carry model rises to 61%, whereas the mean reversion model considers bonds to be slightly negative and contributes –23%. The still weak momentum brightens somewhat and so its model currently contributes only –62% to overall allocation.

Interest rates diverged in April. While rates in Anglo-Saxon countries remained stable or declined, the eurozone saw yields pick up and a widening interest rate differential between German and Italian government bonds. Interest rates on 10-year German government bonds increased by 9 basis points to –0.2% and rates for their Italian counterparts by an additional 15 basis points to 0.9%, pushing the spread over the one percentage point mark. The model mirrors this development: Due to steeper yield curves, the carry model now shows higher contributions for the eurozone and the momentum model stronger negative contributions. Valuations of the remaining government bonds tracked are more positive.

Some market participants had hoped for a future shift regarding monetary policy or fresh stimulus from the European Central Bank and the US Fed, but they made no changes to their interest rate policies or bond buying programs. At press conferences, their chairmen stressed that the situation was still data-dependent and that they saw no need to modify current measures.
The Bank of Canada's meeting was even more remarkable. It announced its intention to cut back its weekly bond buying by a quarter and expects inflation in Canada to remain at its target of 2% in 2022.

Chart 3: Short momentum signal growing weaker

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 May 3, 2021. Source: Vescore

BOND ALLOCATION	TOTAL	CARRY CONTRIBUTION	MEAN REVERSION CONTRIBUTION	MOMENTUM CONTRIBUTION
Global	**–25%**	**61%**	**–23%**	**–62%**
Germany	–12%	7%	–6%	–12%
France	–14%	9%	–7%	–16%
Italy	–7%	8%	–7%	–7%
Great Britain	–9%	7%	–8%	–8%
US	5%	10%	1%	–7%
Canada	4%	9%	1%	–5%
Australia	2%	4%	1%	–2%
Japan	5%	8%	2%	–5%

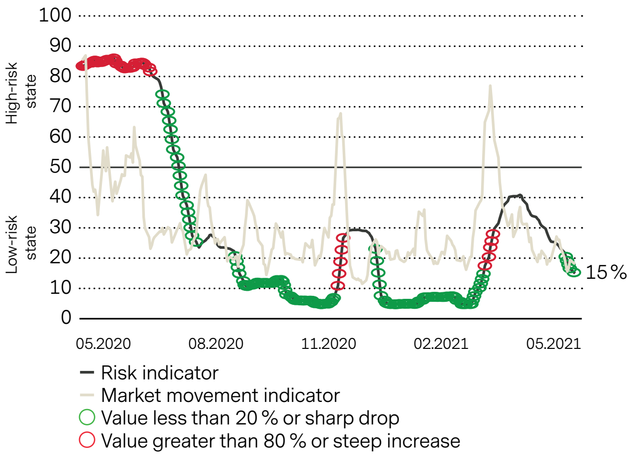
The table shows the bond allocation of a global portfolio in euros ("Total" column) broken down into individual countries. It also lists the contribution of the short-term forecast models carry, mean reversion and momentum to the total bond allocation. Information as of May 3, 2021. Source: Vescore

The risk indicator declined consistently in April and is currently at 15 % after 34 % in the previous month. The aggregate probability of a future high-risk state on developed markets can therefore be regarded as relatively low. The risk indicator compares short-term market yields against long-term yields to assess the current market environment and to estimate whether the future risk is high or low. The decline in the indicator is largely a result of lower risk on bond markets, where the probability of a future high-risk state more than halved between the start of April (90 %) and the present (39 %). This reflects significantly calmer global bond markets and fewer inflation worries among market participants as a result. It was chiefly statements by the European Central Bank and the US Fed, in which they announced their intentions to continue their ultra-loose monetary policy indefinitely, that caused interest rates to ease. The risk estimates for equities and currencies in industrialized countries fell slightly in April to 3 % and 1 % respectively.

The risk indicator for emerging markets is currently very low at 3 %, compared to 13 % in the previous month. The probability of a future high-risk state is currently equally divided between equity, bond and currency markets, at 3 % in each case.

Chart 4: Decline in risk indicator

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 equity, 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 May 3, 2021. Source: Vescore

Current topic

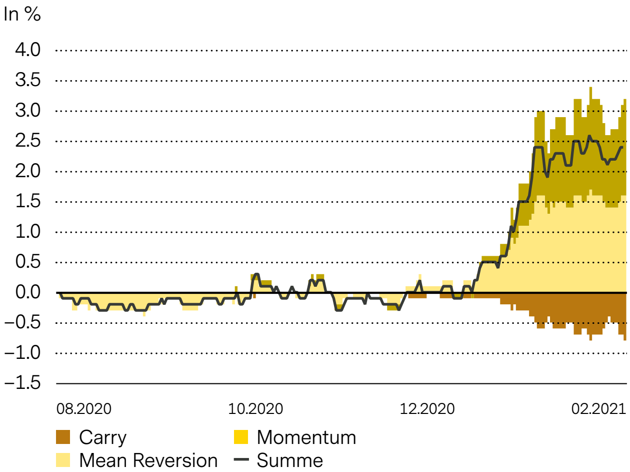
Positive bond returns in a time of rising interest rates

Focus on duration as interest rates rise

With the upturn in interest rates in the first quarter of 2021, focus shifted to a form of risk / return management that is often sidelined in times of falling interest rates: the duration overlay. Many institutional investors are obliged to hold large portfolios of fixed-rate bonds with long maturities. When interest rates climb substantially, this means losses for them. A dynamic duration overlay can cushion these.

Vescore uses a proprietary multi-model approach to adjust the duration of the overlay to take account of the prevailing market environment and to best tap the yield curve momentum.

Chart 5: Excess returns versus EUR money market



The chart shows the attribution of the model's excess returns using the three sub-models carry, mean reversion and momentum. Data: August 2020 to March 2021. Past performance is not an indicator of current or future performance. Source: Bloomberg, Vescore

In the last few months, model signals anticipated a potential rise in interest rates. This resulted in a short position, which was expanded considerably until the end of February. It helped the model grow significantly in value as interest rates began to rise.

Vescore models: skilled at predictions

An analysis of the drivers of the value growth using chart 5 shows:

- The slight long position of the carry models due to the steep yield curve resulted in minor losses at the start of 2021, but these were offset by gains in the two other sub-models.
- The value growth was based on the medium-term expectation of a rise in interest rates using the mean reversion models.
- The dynamics of the momentum model in the volatile period at the end of February also played a key role.

The Vescore models have thus once again demonstrated that they are a useful tool for successfully managing bond portfolios, even when interest rates are rising.

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.

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