vescore
by Vontobel Asset Management

Global Market Outlook

July 2021

Asset Management

At a glance

- Equities:
  Overweighting higher
- Government bonds:
  Now a significant long positioning
- Risk environment:
  Risk indicator rising
- Current topic:
  AI model weights all four strategies equally

The liquidity floodgates stay open for now

At the start of the second half of the year as well, the environment for risk-bearing investments is dominated by the COVID-19 pandemic and the anticipated economic growth trajectory.

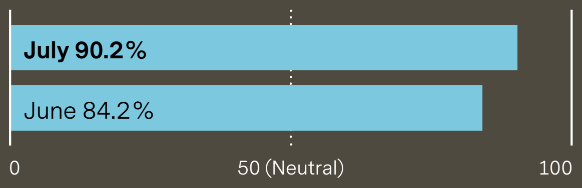
While the positive data in June had initially increased pressure on central banks on both sides of the Atlantic to reconsider their ultra-loose monetary policy and perhaps to close the liquidity floodgates earlier than expected, the agreement in the US on an infrastructure package of around USD 950 billion ultimately bolstered the equity markets. In the euro area, economic sentiment clambered to its highest level in 21 years. In Germany, the ifo Employment Barometer took a mighty leap forward, as did the ifo Business Climate Index and the GfK Consumer Confidence Index. US consumer sentiment brightened as well. These indicators of a significant upswing and rising consumer prices sowed the seeds of concern among investors that monetary policy may be tightened. But both the European Central Bank (ECB) and the US Fed once again confirmed their accommodative monetary policy at their June meetings.

The ECB also announced that it would pick up the pace under its pandemic emergency purchase program (PEPP) in the third quarter. At the same time, price increases for private consumer spending rose less than feared. While the PCE deflator primarily used by the Fed to calculate inflation climbed to well above the May level of 3% in its core calculation, inflation rose by 3.9% overall year-on-year, thus achieving its strongest increase since 2008. Nonetheless, inflation was less pronounced than expected month-on-month. US Fed Chairman Jerome Powell reiterated past assertions that this inflation is only temporary.

Future monetary policy will primarily be dependent on the ongoing development in consumer prices. While the central banks are continuing their ultra-loose monetary policy for the time being, an early end to the flood of liquidity will likely bring the hammer down on risk propensity.

Equities

Overweighting higher



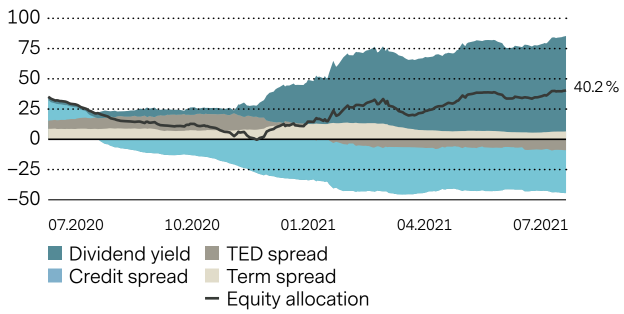
At the start of July 2021, the equity overweighting of the global GLOCAP sample portfolio (50% equities, 50% cash) stands at 40.2% and thus is higher than in the previous month. This is mainly due to the dividend yield contribution, which was up by 7.5 percentage points in June. The term spread contribution remains positive as well, while this is being counteracted by the negative contributions of the credit spread and the TED spread. The changes in the term spread and credit spread contributions neutralize each other entirely. The negative contribution of the TED spread broadened by –1.4 percentage points. However, the overall stability of the equity allocation is unchanged.

The equity allocation decline in May proved temporary, turning in the opposite direction over the course of June. The current overweighting marks a new high-water mark for the equity allocation since the start of the current year.

At present, the dividend yield stands at 1.7% an thus is well below its long-term average. However, the current markedly negative sensitivity of this instrumental variable transforms this into a significant overweighting. The dividend yield is therefore still having the strongest impact on equity allocation.

Chart 1: Equity allocation rising again

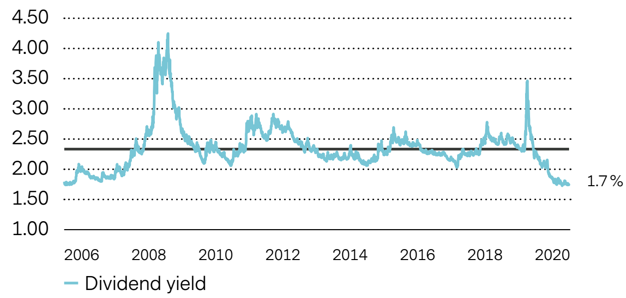
Over/underweighting (%)



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 July 2, 2021. Source: Vescore

Chart 2: Negative sensitivity to dividend yield

In %



The chart shows the dividend yield, 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 (horizontal black line). Information as of July 2, 2021. Source: Vescore

	JULY 2	JUNE 2
Equity overweighting	**40.2%**	**34.2%**
Contribution of the term spread	6.0%	5.3%
Contribution of the TED spread	–9.5%	–8.1%
Contribution of the credit spread	–35.6%	–34.9%
Contribution of dividend yield	79.3%	71.8%

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

Government bonds

Now a significant long positioning

Duration rising

June
0 years

July
6.1 years

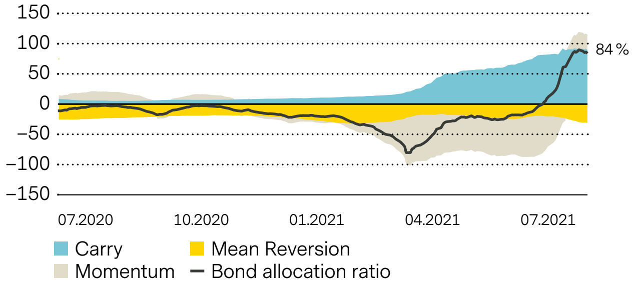
The allocation ratio of a global bond portfolio, which comprises the contributions of the three sub-models carry, mean reversion and momentum, rose erratically over the past month. At the start of July it is now 84%, after 3% in the previous month, which translates into a significant long position with a duration of 6.1 years. The significant rise in the bond allocation is mainly due to the higher contribution from the momentum model, this time 26%. The biggest contribution to the positive allocation still stems from the carry model, this time 90%. The contribution of the mean reversion model remains negative at –31%. Broken down by country, the portfolio duration increased on all sub-markets due to higher bond allocations, with the US and Japan experiencing the strongest increase as against the previous month. At the start of July, only German government bonds are still negatively weighted in the sample portfolio.

On the global interest market, the majority of rates for 10-year government bonds rose moderately in June, though Canadian and US paper moved the most by –10 and –13 basis points respectively. The significant increase in the momentum model for these two markets is due to falling interest rates and, as a result, higher bond prices.

There is widespread concern on the market that the ultra-loose monetary policy may soon be coming to an end. This is at odds with the virtually unanimous assertions by global central banks on both sides of the Atlantic that price increases are an only temporary phenomenon and that there is currently no need for a more restrictive monetary policy. Even if the interest markets have settled at least slightly in June, it remains to be seen how this will be affected by the ongoing ramp-up of national economies in the coming months. It also remains to be seen how the current spread of the highly infectious Delta variant of the Sars-CoV-2 virus affects the economic recovery and the future strategy of central banks.

Chart 3: Stronger momentum signal increases 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 July 2, 2021. Source: Vescore

BOND ALLOCATION	TOTAL	CARRY CONTRIBUTION	MEAN REVERSION CONTRIBUTION	MOMENTUM CONTRIBUTION
Global	**84%**	**90%**	**-31%**	**26%**
Germany	-8%	3%	-9%	-2%
France	4%	13%	-6%	-3%
Italy	11%	15%	-8%	4%
Great Britain	1%	7%	-7%	1%
US	28%	16%	2%	9%
Canada	11%	9%	-1%	3%
Australia	9%	7%	-2%	4%
Japan	28%	19%	1%	8%

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 July 2, 2021. Source: Vescore

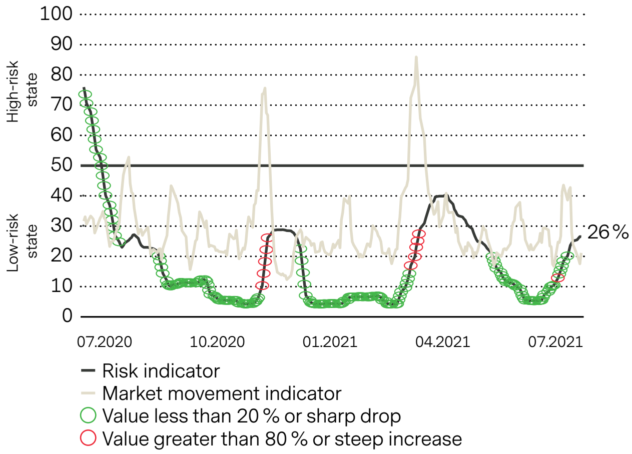
The risk indicator analyses the current environment and shows whether the future risk should be considered high or low. It does this by comparing short-term and long-term market yields. The risk indicator stands at 26 % at the start of July, a clear increase as against the previous month's 5 %. The aggregate probability of a future high-risk state on developed markets can currently be regarded as moderate. All asset classes considered show higher risk now. However, the probability of a high-risk state increased particularly on the bond markets and is currently 66 % after 9 % in the previous month.

Even though neither of the eagerly awaited meetings of the European Central Bank and the US Fed resulted in a change in current monetary policy, some market participants were surprised by the Fed's projections for US interest rates, which include two hikes by the end of 2023. This briefly led to significant fluctuations on the bond markets, as now reflected by the higher risk indicator. The risk estimates for the equity markets and currencies of the developed countries were tracking minimally upwards in June and are currently still low at 8 % and 6 % respectively.

The risk indicator for emerging markets rose by just 3 % in June to currently 8 %. This minor increase in the probability of a high-risk state is due to the equity and bond markets of the emerging economies, with risk indicators of 14 % and 6 % at the start of July, while the indicator for currencies held steady at 3 %.

Chart 4: Risk indicator higher

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 July 2, 2021. Source: Vescore

Current topic

AI model weights all four strategies equally

AI forecasting significantly less reliable than in August 2020

Vescore uses methods of artificial intelligence (AI) and machine learning known as “artificial market intelligence” (AMI). Periods in the past that had economic conditions as similar as possible to today are systematically identified and these are then used to determine the optimal allocation for the current economic environment. Measurement is based on the four instrumental variables used under GLOCAP (term spread, TED spread, credit spread and dividend yield), global inflation, and various economic trends. Comparing the current environment to that of the end of August 2020, when the stock markets had made good on the slump caused by the coronavirus crisis, now shows a significantly bigger “economic distance” (chart 5; see also Global Market Outlook March 2021 and December 2020). Over a period of 30 years, the current “economic distance” line has almost always been clearly above the line for the end of August 2020. This signals that forecast reliability has deteriorated in recent months.

Closest “economic neighbors” in 1995, 2014 and 2017/18

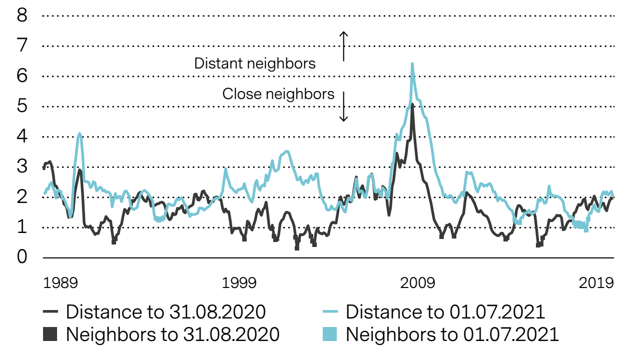
While the “economic neighbors” for summer 2020 were in the phase of the dotcom crisis of 2001-03, they can currently be found in three periods with stable global GDP growth of 3% and a certain degree of market distortion. Barings went belly-up in the phase from January to June 1995. The phase from March to September 2014 was in the middle of a bear run on the commodity market. In the 2017-18 phase, the VIX Volatility Index finally rose erratically in February 2018, facing many investors with big challenges.

Equal weighting of the four strategies

In this special situation with relatively large “economic distance”, AMI now rates the four strategies GLOCAP, risk parity, momentum and artificial intelligence equally (chart 6).

Chart 5: “Economic neighbors”

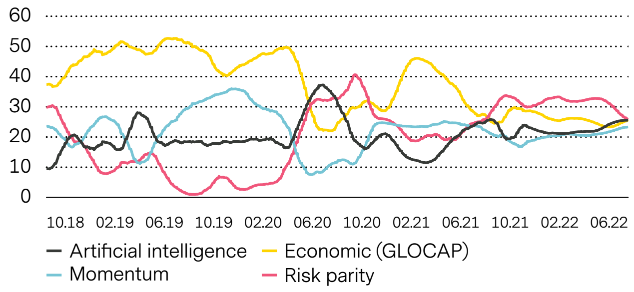
Economic distance to July 1, 2021 and to August 31, 2020



The chart shows the “economic distance” of the current conditions and those at the end of August 2020 to those in the past, starting in 1988. The squares indicate the times with the closest “economic neighbors”, i.e. the phases that are the most comparable to the situation today. Information as of July 2, 2021. Source: Vescore

Chart 6: All four strategies equally weighted

Allocation to sub-models by AMI in %



The chart shows the allocation between the various models on the basis of the AMI analysis. Information as of July 2, 2021. Source: Vescore

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

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