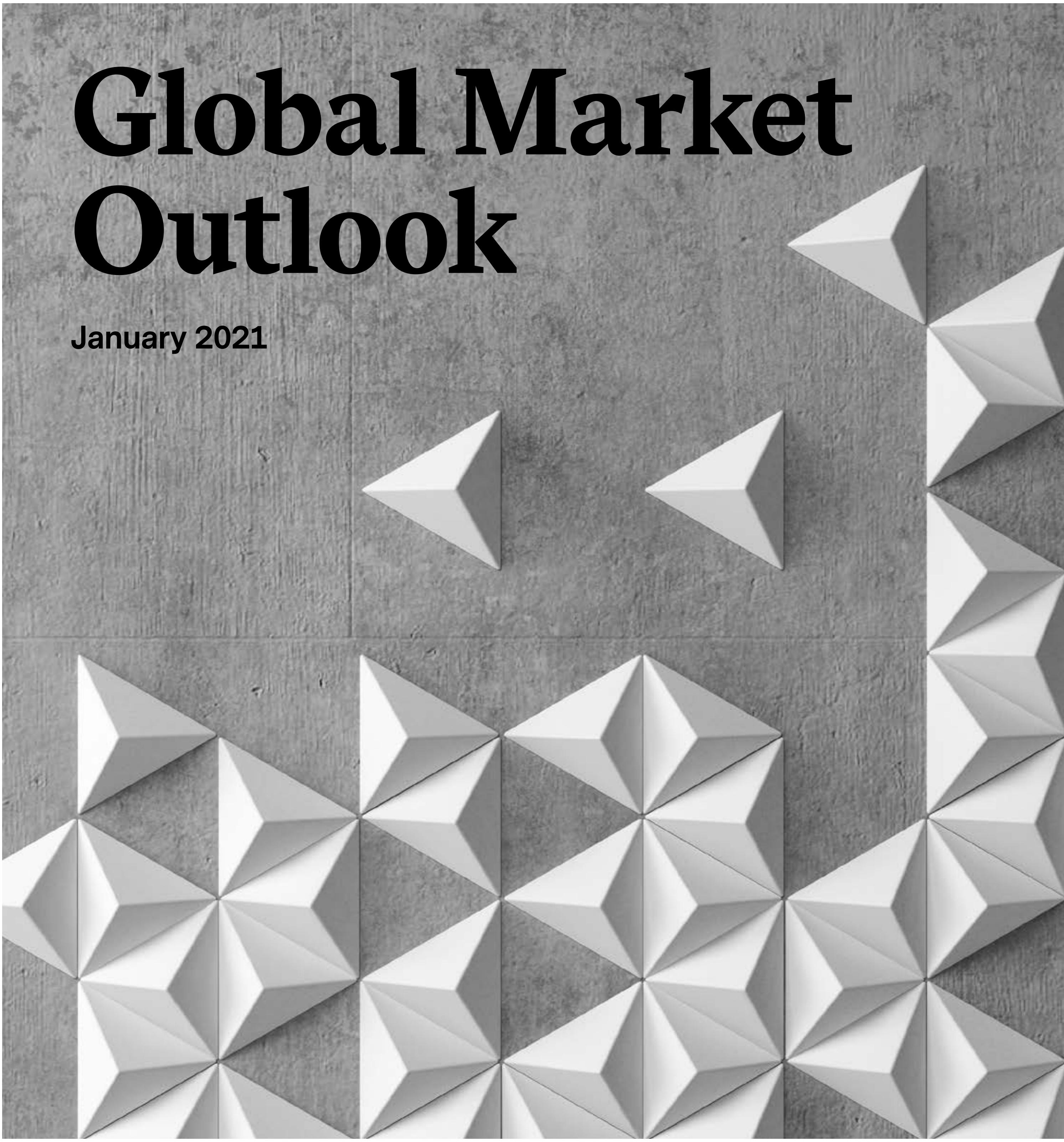
vescore
by Vontobel Asset Management

Global Market Outlook

January 2021



Asset Management

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Risk aversion gives way to optimism

The market environment at the start of the new year is marked by a further decline in market participants' risk aversion. Although economic data does not yet provide a uniformly positive assessment of global growth, optimism is prevailing at present.

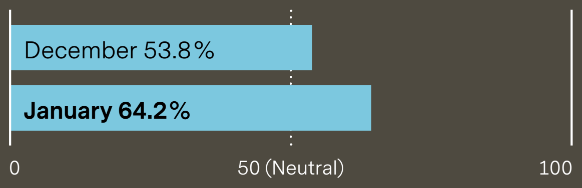
In December again, attention focused on the development of the COVID-19 pandemic. While the situation again became critical in many countries as cases continued to rise, the approval of multiple vaccines at the same time came as a visible relief to markets and also fueled demand for risk-bearing investments. Mixed economic data on both sides of the Atlantic reflect the massive losses sustained by many sectors – chiefly the travel and services industries as well as small and medium sized companies – across the world, combined with the unexpected robustness of other sectors such as industrial production, construction and telecommunications.

In light of this economic situation, key central banks are continuing their stimulus policies, with the European Central Bank topping up its pandemic program by half a billion euro to support the bond market by way of purchases until at least March 2022. The US Federal Reserve also announced that it will continue its crisis policies. In addition, after lengthy disputes the US government approved another USD 900 billion stimulus package intended to alleviate some of the harmful effects of the pandemic, particularly for small businesses and the unemployed. The deal that was ultimately agreed following deadlocked Brexit negotiations also shored up stock markets at the close of the year.

Sentiment was shaped by familiar issues at the start of January. Hopes of improved prospects ahead in large swathes of the global economy now hinge on the COVID-19 vaccine providing a first step back to normality.

Equities

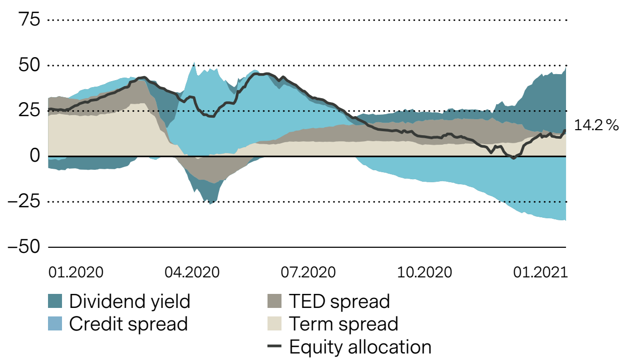
Overweighting increases again considerably



The equity overweighting in the global GLOCAP sample portfolio (50 % equities, 50 % cash) increased at the start of January 2021 and was again far higher than at the beginning of December 2020. The higher equity allocation was driven chiefly by the positive contribution from dividend yields, which easily offset the negative changes in the TED spread and credit spread. The positive contribution of the term spread also increased slightly.

Chart 1: Equity overweighting increases again considerably

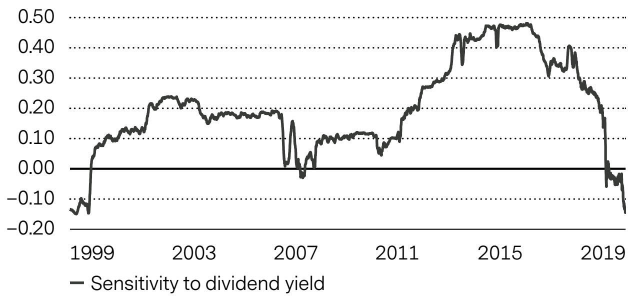
Over/underweighting (%)



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 combine to give the active equity allocation. Information as of January 4, 2021.
Source: Vescore

With equity markets picking up, the dividend yield's contribution had a major impact at the beginning of 2021. Lower (higher) prices give rise to a higher (lower) dividend yield, which usually means a higher (lower) equity risk premium. This correlation does not apply at present. In certain market phases with marked trends, the normal correlation between dividend yields in the GLOCAP model can change if the sensitivity to dividend yields drops into negative territory (see chart 2). Thus, the prevailing trend is expected to continue. This situation has been seen before in other extreme market phases in the past, such as after the dotcom bubble burst or during the financial crisis.

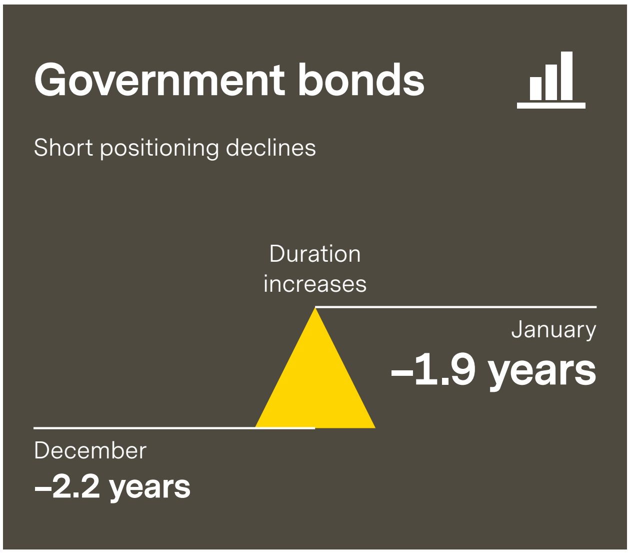
Chart 2: Negative sensitivity to dividend yield



The chart shows the GLOCAP model's sensitivity to the dividend yield. Information as of January 4, 2021.
Source: Vescore

	JANUARY 4	DECEMBER 2
Equity overweighting	**14.2 %**	**3.8 %**
Contribution of the term spread	12.2 %	8.9 %
Contribution of the TED spread	–0.4 %	7.3 %
Contribution of the credit spread	–34.0 %	–29.8 %
Contribution of dividend yield	36.5 %	17.4 %

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



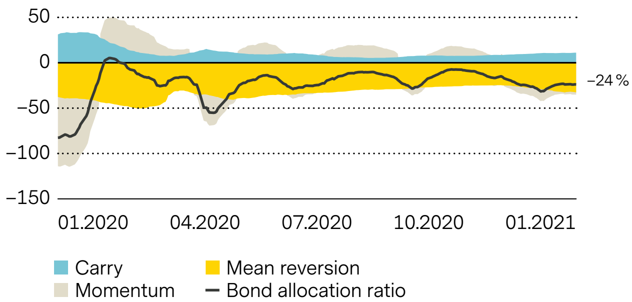
The allocation ratio of a global bond portfolio is down slightly as against the previous month at around –24 % at the start of January, corresponding to a duration of –1.9 years. The position in global government bonds in the portfolio comprises the contributions of the three sub-models carry, mean reversion and momentum. The positive contribution of the carry model rose by around 1 percentage point to 11 %. The negative contribution of the momentum model declined by 6 percentage points to –2 %. The negative contribution of the mean reversion model increased by 5 percentage points to –33 %, thus remaining the clearest indicator of the portfolio's short position.

Global bonds were a mixed bag at the end of December: Whereas most markets under observation ended the month close to zero, 10-year Italian government bonds rose by 0.6 %, while 10-year British government bonds even picked up by 0.8 %. As expected, the prices of the latter had declined when a withdrawal agreement was eventually reached between the European Union and the UK, putting to bed the issue of a no-deal Brexit that had dominated markets last year. Nevertheless, another surge in COVID-19 cases and reports that the virus had mutated in the UK drove up prices in the following days, provoking a significant increase for long-term British government bonds.

In the US, Democrats and Republicans agreed on another economic stimulus package of almost USD 900 billion. 10-year US Treasuries had contracted in the days before the announcement but remained virtually unchanged in the days following.

Chart 3: Short position slightly reduced

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 January 4, 2021.
Source: Vescore

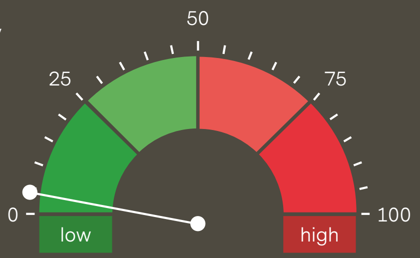
BOND ALLOCATION	TOTAL	CARRY CONTRIBUTION	MEAN REVERSION CONTRIBUTION	MOMENTUM CONTRIBUTION
Global	**–24 %**	**11 %**	**–33 %**	**–2 %**
Germany	–2 %	1 %	–3 %	0 %
France	–3 %	1 %	–4 %	0 %
Italy	3 %	1 %	0 %	2 %
Great Britain	–6 %	1 %	–8 %	1 %
Switzerland	–5 %	1 %	–4 %	–2 %
US	–2 %	3 %	–3 %	–2 %
Canada	–7 %	2 %	–7 %	–3 %
Japan	–1 %	1 %	–3 %	0 %

The table shows the bond allocation of a global portfolio in euros (the "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 January 4, 2020
Source: Vescore

Risk environment

Risk indicator falls to 12-month low for all market segments

January
4%

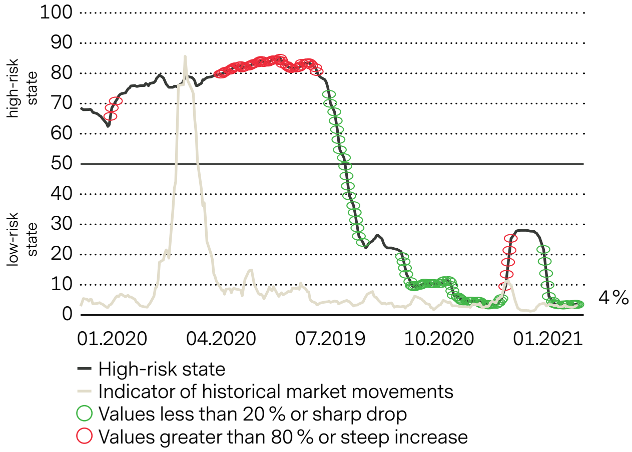


The risk indicator declined last month and now stands at a 12-month low. Whereas the aggregate probability of a future high-risk state in developed markets was 28% at the start of December, it now stands at 4%. The risk indicator analyses the current environment and shows whether the future risk is high or low. It does this by comparing short-term yields with long-term yields. Despite marginally higher market volatility in industrialized countries in December, the model does not consider the current risk environment a high-risk state. Accordingly, the risk probability declined in all asset classes (equities, bonds and currencies). At present, the probability for a future high-risk state is 3% for equity markets, 6% for bond markets and 3% for currency markets in industrialized countries.

The analysis for emerging markets reveals a similar picture, with the risk indicator declining by 8 percentage points to 12%. At 8%, the contribution by currency markets was down 14 percentage points on the previous month, while the equity markets declined from 34% to 6%. Propelled by optimism thanks to the launch of the first COVID-19 vaccination programs, emerging market equities enjoyed a stronger upturn in December than those in industrialized countries (5% vs. 3.6%).

Chart 4: Risk indicator declines to 12-month low

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 foreign exchange. Interesting values are depicted with green and red circles. The color green represents a calm environment and red stands for a turbulent market environment. The probability of 50% represents a uniform expectation for the future market environment (horizontal black line). An aggregate indicator of the historical market trends in the three segments is shown in the background (beige line). Information as of January 4, 2021.
Source: Vescore

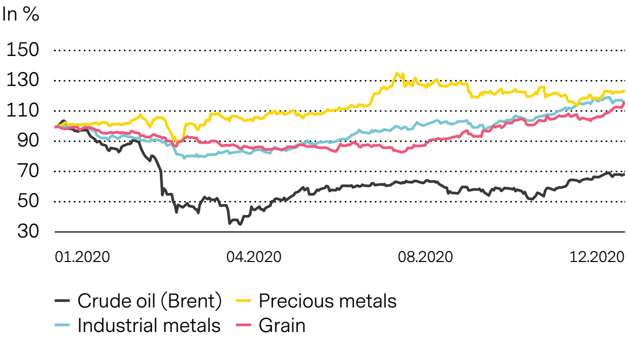
Current topic

Commodities: positive outlook for 2021

2020: A roller coaster ride
2020 was without a doubt a year for the history books. The global spread of the coronavirus, the worst pandemic since the Spanish flu, resulted in lockdowns across the world and a collapse in economic output. The energy sector suffered in particular from the slump in demand for oil and managed only a slight recovery by the end of the year (see chart 5). With Saudi Arabia and Russia unable to agree on production cuts, the unthinkable happened: the price of oil tumbled, even briefly slipping into negative territory at just under –40 US dollars (May 2020 contract).

By contrast, precious metals enjoyed a boost last year as investors increasingly sought out safe havens. Additional support was provided in the form of low or negative interest rates, a weak US dollar as well as expansive monetary and fiscal policy stimulus. In the second half of the year, industrial metals even reached multi-year highs. After bottoming out in mid-March, copper rose by 60% due to supply and logistics problems experienced by mine operators combined with high demand from China. Grain also halted its downward trend of the last decade, generating multi-year highs due to strong demand from China and weather concerns in South America.

Chart 5: Price development of commodities in 2020



Data as of December 31, 2020
Source: Bloomberg, Vontobel

2021: Year of commodities?
Many investors have overlooked commodities as an asset class in recent years – unsurprisingly, considering that prices mostly declined as a result of excess supply in most sectors (metals, oil, grain, etc.). This structural underinvestment is still accelerating, partly because of sustainability concerns and partly because of projects that were postponed on account of the coronavirus pandemic.

The trend towards declining commodities prices seen in the last 10 years now seems to be coming to an end as – in addition to the potential supply problems in the future – demand for commodities looks set to pick up. China's rapid economic recovery has already shown how quickly commodities markets can slip into a deficit. Looking towards the COVID-19 vaccination programs, which may allow a return to normality in the west, another commodities shortage is increasingly likely.

Massive support from expansive fiscal policy across the world is creating upward pressure on prices – the US alone passed a rescue package last year equal to almost 20% of economic output. Expansive monetary policy is also having a positive effect on commodities markets. As US interest rates are not expected to increase before the end of 2023, inflation expectations look set to continue to grow as the recovery picks up, with real interest rates staying at a low level. The US dollar is expected to weaken further in 2021, propping up commodities denominated in US dollars.

Last but not least, the growing trend towards sustainability is also causing a shift in commodity requirements. While oil is likely to suffer in the decades ahead due to targets for reducing CO_2 emissions, industrial metals will emerge as a clear winner of this trend.

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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