vescore
by Vontobel Asset Management

Global Market Outlook

February 2021

Asset Management

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Growth expectations vs. economic intuition

A few abnormalities have been observed in the environment for risk-bearing investments since the start of February. One year after the outbreak of the COVID-19 pandemic, global capital markets are still feeling its effects and following a familiar pattern.

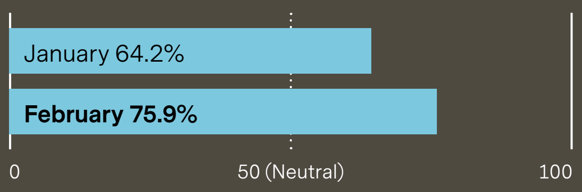
In the wake of turbulence in February and March 2020, equity markets made impressive gains in the last few months. M&A activity – which was essentially a wasteland – picked up again considerably, with the high number of IPOs also reflecting a very optimistic market environment. Rarely had capital – both equity and debt capital – been so affordable. In addition, remarkable valuations of individual equities (e.g. Apple or Tesla) and events such as the GameStop phenomenon give reason to look back 20 years. Share prices also skyrocketed in the "New Economy" period at the end of the 1990s, propelled by market players' euphoria about growth. The parallels, as well as the differences, between these two periods are investigated in a separate analysis and assessed from the perspective of the GLOCAP model.

Capital markets had an exceptionally good start to January. The transfer of power to new US President Joe Biden – albeit overshadowed by clashes in Washington D.C. – gave particular grounds for optimism. Prospects of USD 1.9 trillion in government support also shored up markets, as did the progress made in vaccination development. Nonetheless, the pandemic caused risk appetite to diminish towards the end of the month: The increasing spread of more contagious virus mutations, delays in delivering vaccinations, and the extension of restrictions squashed expectations of a quick economic recovery and, accordingly, performance of equity markets.

Going forward, investors will focus chiefly on the near-term development of the pandemic and its critical variables: incidence rates and vaccinations. The relationship between fundamentals-driven and momentum-driven prices must also be taken into account.

Equities

Overweighting increases again

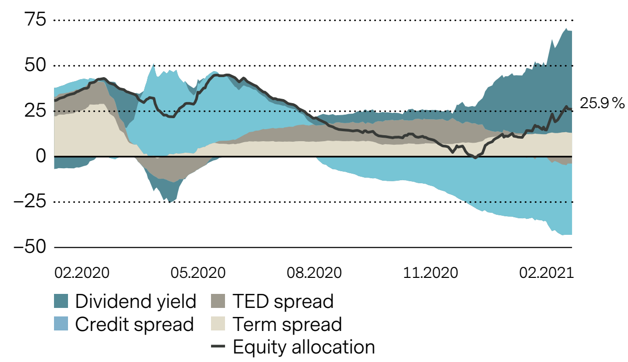


The equity overweighting in the global GLOCAP sample portfolio (50 % equities, 50 % cash) was even higher at the start of February 2021 than in the previous month. The higher equity allocation is driven chiefly by the positive contribution from dividend yields, aided by the consistently positive contribution of the term spread. This is not offset by the TED and credit spreads' negative contributions.

As in the previous month, the dividend yield contribution had a significant impact on equity allocation. Two factors are pushing down the dividend yield to an exceptionally low level: the strong positive momentum on the equities market around the turn of the year, and the high number of dividends that were reduced or not paid at all last year. This lowers the dividend yield ratio to well under 2 %, a level last seen in 2006/07 before the major financial crisis. The usual correlation – whereby the GLOCAP model interprets low dividend yields as an expectation of low equity risk premiums and subsequently underweights equities – does not apply at present. GLOCAP reinterpreted the variable, recognizing that the lack of dividends did not cause any sustained fall in prices on the equities market while momentum was strong. This creates a negative sensitivity, as occurred in the past in phases of extremely strong trends.

Chart 1: Equity overweighting increases again

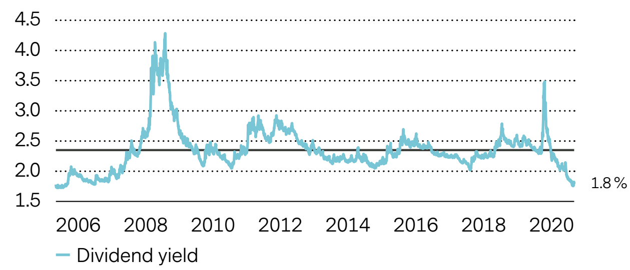
Over/underweighting (%)



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 February 2, 2021.
Source: Vescore

Chart 2: Dividend yield falls below 2 %

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 (black line). Information as of February 2, 2021.
Source: Vescore

	FEBRUARY 2	JANUARY 4
Equity overweighting	**25.9 %**	**14.2 %**
Contribution of the term spread	12.9 %	12.2 %
Contribution of the TED spread	–4.0 %	–0.4 %
Contribution of the credit spread	–39.3 %	–34.0 %
Contribution of dividend yield	56.3 %	36.5 %

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

Government bonds

Short positioning expanded

Duration decreases to

January
–1.9 years

February
–3.5 years

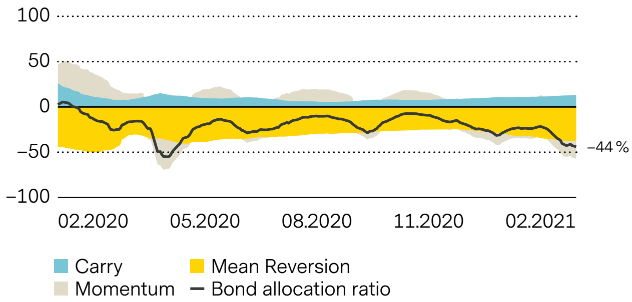
The allocation ratio of a global bond portfolio is down significantly as against the previous month at around –44% at the start of February, corresponding to a duration of –3.5 years. The position in global government bonds in the portfolio comprises the contributions of the three sub-models Carry, Mean Reversion, and Momentum. The negative contribution of the Momentum model increased particularly sharply. It is currently –20% and is the main factor behind the increase in the short position. The Mean Reversion model increased its negative contribution by a further 5% and remains the clearest indicator of the portfolio's short position. Only the Carry model allocates global government bonds positively and is up 2% on the previous month due to increasingly steep yield curves in the US and Canada.

Interest rates on government bonds rose around the world in January, with the eurozone seeing a moderate increase and Anglo-Saxon countries a more pronounced upturn. Interest rates on 10-year German government bonds picked up by 5 basis points, and those on 10-year US Treasuries by 15 basis points. The US yield curve steepened given that interest rates for short maturities remained more or less unchanged.

The implied expectation of strong economic recovery in the US was based primarily on hopes of a stimulus package by the new US government, which includes direct payments to households and further support for small businesses at a total of USD 1.9 trillion. Discussions over the timing of potential tapering by the US Federal Reserve also strained US Treasuries, despite the Fed Chair attempting to stave this off at the press conference that followed the Fed's regular meeting.

Chart 3: Short position increases

Bond allocation (%)



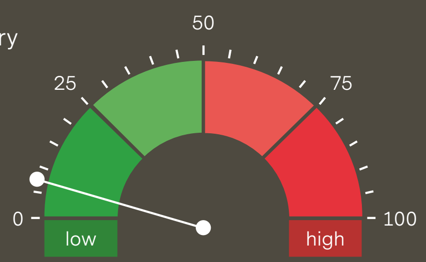
The chart shows the government bond allocation of a global bond portfolio in euros. The model allocation is calculated on the basis of the short-term forecast models Carry, Mean Reversion, and Momentum. Information as of February 2, 2021.
Source: Vescore

BOND ALLOCATION	TOTAL	CARRY CONTRIBUTION	MEAN REVERSION CONTRIBUTION	MOMENTUM CONTRIBUTION
Global	**–44%**	**13%**	**–38%**	**–20%**
Germany	–5%	1%	–4%	–2%
France	–6%	1%	–5%	–2%
Italy	0%	1%	–2%	0%
Great Britain	–9%	1%	–9%	–2%
Switzerland	–7%	1%	–4%	–4%
US	–4%	3%	–3%	–4%
Canada	–6%	3%	–7%	–3%
Japan	–6%	1%	–5%	–3%

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 February 2, 2021.
Source: Vescore

Risk environment

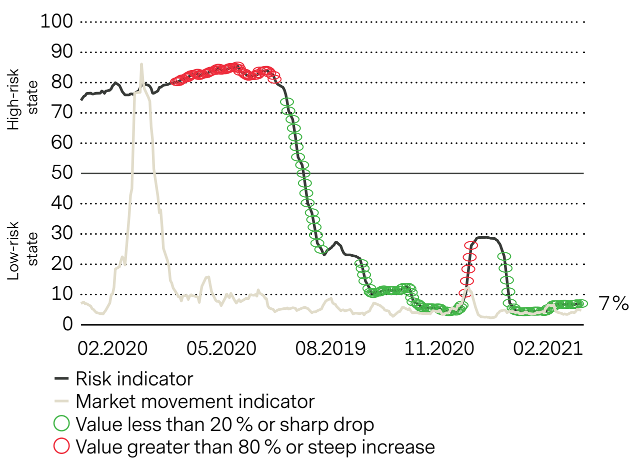
Risk indicator slightly higher



The risk indicator analyzes the current environment and shows whether the future risk is high or low, by comparing short-term yields with long-term yields. It increased slightly last month but remains at the lower end of the green range. Whereas the aggregate probability of a future high-risk state in developed markets was just 4% in the previous month, this figure now comes to 7%. The minimal rise in the measure of risk is exclusively a response to equity markets. The model is currently showing a probability of 13% for these, compared to 3% in the month prior. The assessment for bonds is currently 6%, and for currencies 1%. The model is thus consistent with the higher volatility observed on equity markets at the end of January. For example, implied volatility for the S&P 500, measured by the VIX, again climbed to over 30%, a figure not seen since the US presidential election at the beginning of November.

The risk indicator in the analysis for emerging markets also rose, from 12% to 19%. While the assessment of a future high-risk state on equity markets remains only slightly above zero following a 4 percentage point increase, the two asset classes of bonds and currencies saw probabilities increase substantially, with the indicator rising from 23% to 30% for bond markets, and from 8% to 24% for currency markets .

Chart 4: Risk indicator still low



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 three segments across developed markets: equities, bonds, and currencies. Interesting values are depicted with green and red circles. 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 (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 February 2, 2021.
Source: Vescore

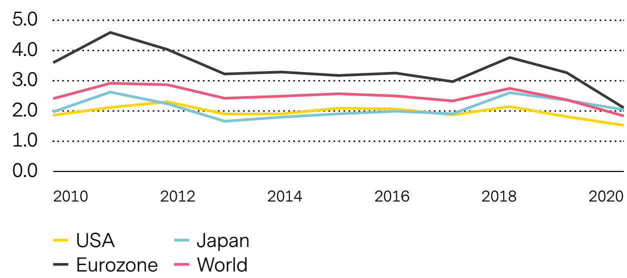
Current topic

Potential from dividend yields alone is not enough

Income is not the same as dividends
Particularly retail investors seem to be considering dividends an interesting option for future income. These are paid out frequently, are less volatile than capital gains on shares, and are generally a safe source of income. To ensure a steady stream of income, however, investors should consider share buybacks – in addition to the potential for capital gains – when making investments decisions. In recent years, these have come to make up a substantial share of shareholder remuneration.

Shareholder remuneration under pressure during coronavirus pandemic
The exceptional year 2020 was marked by political intervention in the private sector, with the negative effects varying by region. Uncertainty had a particularly high impact on companies' dividend policies in the eurozone (see chart 5). Although dividends rose steadily, they failed to keep pace with share prices, and so dividend yields have generally been trending downwards over the last decade. The pandemic intensified this trend, while also making it more difficult for investors to generate sizable dividend yields.

Chart 5: Annual dividend yields by region
In %



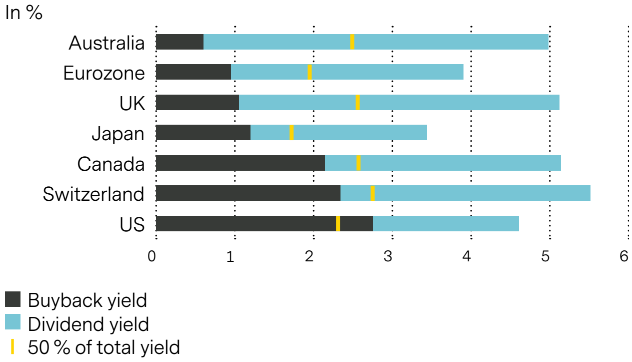
Data as of December 31, 2020
Source: Bloomberg

The declining popularity of dividend yields increasingly shifted companies' focus to share buybacks as a way of compensating shareholders. This prompted a dramatic increase in the buybacks' share of overall remuneration.

The popularity of share buybacks varies depending on the region and the sector (see chart 6). Simply ignoring them results in structural advantages or disadvantages for the regions and sectors concerned. By contrast, taking them into account in the investor portfolio – in addition to the dividend yield – can contribute to more stable returns.

Good things come in threes
Besides conventional dividends and the share buybacks, realized capital gains (synthetic dividends) offer investors a third way to optimize their returns. Considering this prevents investors from curtailing the potential for longer-term capital growth by focusing solely on one component.

Chart 6: Share buybacks not equally popular in different regions
In %



Capital-weighted average. Data as of December 31, 2020
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.

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