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.
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.

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

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

<table>
<thead>
<tr>
<th></th>
<th>FEBRUARY 2</th>
<th>JANUARY 4</th>
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</thead>
<tbody>
<tr>
<td>Equity overweighting</td>
<td>25.9%</td>
<td>14.2%</td>
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<tr>
<td>Contribution of the term spread</td>
<td>12.9%</td>
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<tr>
<td>Contribution of the TED spread</td>
<td>-4.0%</td>
<td>-0.4%</td>
</tr>
<tr>
<td>Contribution of the credit spread</td>
<td>-39.3%</td>
<td>-34.0%</td>
</tr>
<tr>
<td>Contribution of dividend yield</td>
<td>56.3%</td>
<td>36.5%</td>
</tr>
</tbody>
</table>

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

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

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
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.

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
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.

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

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</tbody>
</table>

Data as of December 31, 2020
Source: Bloomberg
Global Market Outlook  / February 2021

Vescore's proprietary equity allocation model, Global Conditional Asset Pricing (GLOCAP), assesses the economic environment and market participants' trust in corporations' creditworthiness. It evaluates indicators like term spread, financial system stability, liquidity preferences, corporate bond spreads, and dividend yields to determine active equity overweighting. The Fixed Income Allocator (FINCA) forecasts interest rate changes, analyzing carry, mean reversion, and momentum models. Vescore's Risk Indicator supports equity and bond allocation by signaling risk levels, protecting against market stress.

Glossary

GLOCAP: Global Conditional Asset Pricing is Vescore's equity allocation model.
FINCA: Fixed Income Allocator forecasts yield curve changes.
Risk Indicator: Identifies market regimes, adjusting equity and bond exposure.

Vescore employs a quantitative investment strategy based on financial research to achieve risk-adjusted performance in the long term.
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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