vescore
by Vontobel Asset Management

Global Market Outlook

What our models signal while central banks are weighing up economic risks

June 2022

Current topic: China makes metal prices move

Asset Management

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Weighing up economic risks

At the beginning of June, the mix of inflation and monetary policy, geopolitical turbulence, and the fight against the pandemic dominates the fundamental economic environment. At the center of this sit the central banks, which have to weigh up the risks of rampant inflation and muted economic growth.

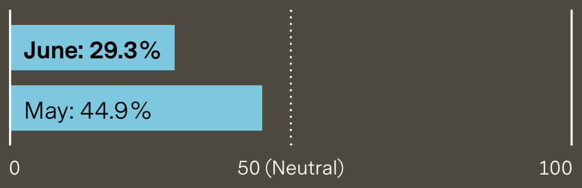
In May, the US Federal Reserve raised interest rates by 50 basis points to a band of 0.75 – 1.0 %, as expected. Looking ahead, further interest rate hikes of this scale and a substantial reduction in the Fed balance sheet are to be expected. In addition, unexpectedly weak economic data from China strained market participants' risk appetite. The Beijing government's strict zero-Covid strategy massively curtailed day-to-day life and business in the People's Republic, with dramatic consequences for supply chains and sales markets of companies around the world. However, this strategy has been significantly relaxed as of late, encouraging a temporary recovery on equity markets.

In Europe, by contrast, the economy initially performed better than investors had anticipated. For example, the German ifo Index, the eurozone Purchasing Managers' Index and German private sector production all did unexpectedly well. In May, Eurozone inflation climbed significantly to 8.1 %. This brings the turnaround in interest rates within reach for the European Central Bank, which is likely to dim the growth prospects of many companies. Developments in Russia and Ukraine also weighed heavily on market participants' risk appetite: While Moscow suspended gas supplies to a number of European countries, EU states imposed an embargo on Russian oil exports, except for pipelines. As a result, Europe is now facing not only further global supply chain issues, but also a severe energy shortage.

In contrast to the economic slumps seen in previous years, central banks now are no longer poised at the ready to mitigate the consequences for capital markets by providing liquidity. Thus, a repricing phase seems imminent, during which economic risks will be reassessed.

Equities

Short positioning expanded

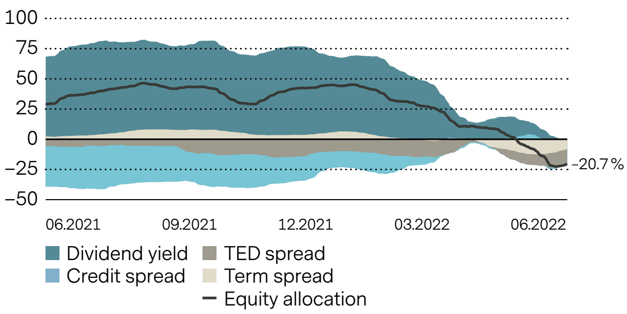


At the start of June, the equity allocation in the global GLOCAP sample portfolio (50% equities, 50% cash) stands at –20.7% compared to –5.1% in the previous month. The increase in the short positioning is due primarily to the lower contribution from the dividend yield, which declined from 12.4% to –0.5%. The credit spread contribution also slipped slightly into negative territory. Thus, all four instrumental variables now indicate short positioning, most strongly the TED spread with –11.9%.

High inflation, tighter monetary policy, supply chain disruptions, and the ongoing war in Ukraine, along with the sanctions imposed against Russia as a result, unsettled market participants and triggered sharp fluctuations in equity prices. The MSCI World fell by up to –5.4% in May, before recovering and closing the month at almost the same level as seen at the end of April. In the second half of the month, sentiment on equity markets brightened, as China was expected to gradually relax its strict zero-Covid policy, bolstering its economy and allowing supply chains to return to normal. A dampening impact, however, had the gloomy outlook for the world economy and the sharp hike in producer prices, the latter directly affecting profit margins in the manufacturing industry and, in a second-round effect, pushing up consumer prices.

Chart 1: Equity allocation declines further

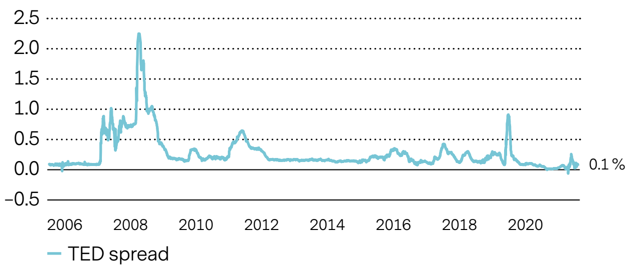
Over-/underweighting (%)



The chart shows the active equity weighting (black line) of a global portfolio in euros, based on 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 June 02, 2022. Source: Vontobel Asset Management

Chart 2: TED spread clearest indicator of short positioning

In %



The chart shows the TED spread, which reflects the stability of the financial system in line with the aggregate liquidity preferences of market participants. It is measured by the difference between the interbank interest rates for short-term loans in US dollars and euros and the respective 3-month overnight index swap rate. The chart shows the weighted average (blue line) and the median (horizontal black line) of the instrumental variable. Information as of June 02, 2022. Source: Vontobel Asset Management

	JUNE 2	MAY 3
Equity weighting	**–20.7%**	**–5.1%**
Contribution of the term spread	–8.1%	–11.7%
Contribution of the TED spread	–11.9%	–8.7%
Contribution of the credit spread	–0.1%	2.9%
Contribution of the dividend yield	–0.5%	12.4%

The table shows the contributions of the instrumental variables to the equity weighting. Information as of June 2, 2022.
Source: Vontobel Asset Management

Government bonds

Long positioning expanded significantly

Duration higher

June
4.9 years

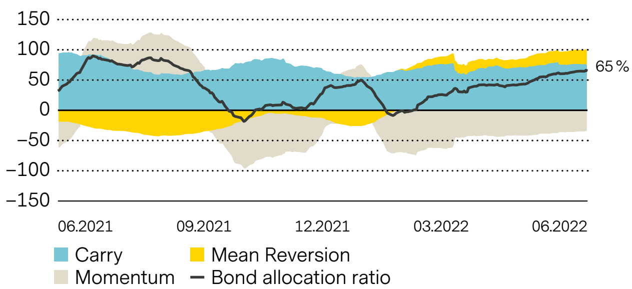
May
4.4 years

At the start of May, the allocation ratio of a global bond portfolio, which comprises the contributions of the carry, mean reversion and momentum components, stands at 65 %, far higher than the previous month's 55 %. Duration thus rose by half a year to 4.9 years. Half of the expansion of the long positioning can be attributed to the mean reversion component and half to the momentum component, with the contribution of the former rising from 20 % to 25 % and the contribution of the latter declining from –39 % to –34 %. The carry component's contribution decreased only slightly from 75 % to 74 % and thus remains the main factor behind the current bond allocation.

Runaway inflation rates continued to shape the market environment in May. As market participants had expected, the US Fed responded by raising interest rates by 50 basis points to 1 %. The US has not seen an interest rate hike on this scale since 2000. Fed Chairman Jerome Powell also said that rates could be increased by a further 50 basis points at future Fed meetings. The continued climb in inflation rates combined with tighter central bank monetary policy took a particular toll on the prices of European government bonds. Interest rates on 10-year German government bonds thus increased by 25 basis points to 1.10 %, with 21 basis points of this attributable solely to the rise in term premiums, which price in higher inflation expectations. By contrast, the expected interest rate for short maturities rose by just 4 basis points. Interest rates for 10-year US Treasuries moved in the opposite direction to their European counterparts, falling by 8 basis points to 2.84 %.

Chart 3: Carry main factor behind overweighting

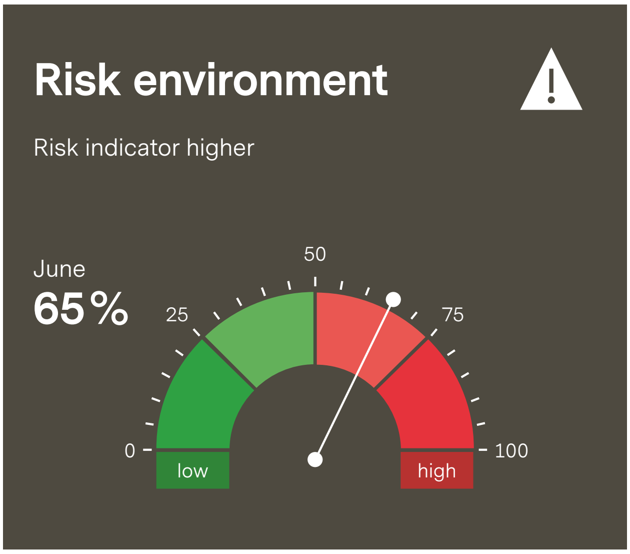
Bond allocation (%)



The chart shows the government bond ratio of a global bond portfolio in euros. The model allocation is calculated by means of the short-term forecast models carry, mean reversion, and momentum. Information as of June 02, 2022.
Source: Vontobel Asset Management

BOND ALLOCATION	TOTAL	CARRY CONTRIBUTION	MEAN REVERSION CONTRIBUTION	MOMENTUM CONTRIBUTION
Global	**65%**	**74%**	**25%**	**–34%**
Germany	2%	6%	2%	–6%
France	2%	10%	–1%	–7%
Italy	9%	8%	6%	–5%
Great Britain	2%	3%	0%	–2%
US	–7%	3%	–7%	–3%
Canada	–3%	4%	–3%	–4%
Australia	11%	8%	8%	–5%
Japan	50%	32%	21%	–4%

The table shows the government bond ratio of a global euro-denominated portfolio and the contributions of the short-term forecast models carry, mean reversion, and momentum to this, in total (row "Global") and by country. Information as of June 02, 2022.
Source: Vontobel Asset Management

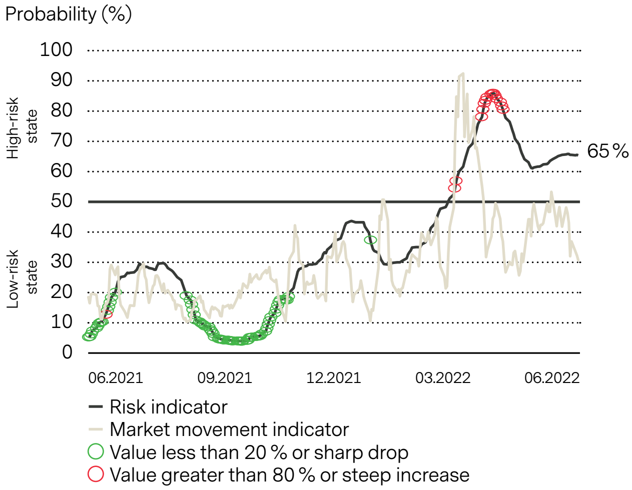


The risk indicator analyses the current environment and shows whether the future risk should be considered high or low. It does this by comparing short-term and long-term yields in equity, bond and currency markets.

In developed markets, the probability of a future high-risk state rose from 62 % in the previous month to 65 %. The risk indicators picked up in all three market segments, from 6 % to 12 % for equity markets, from 94 % to 96 % for bond markets, and from 84 % to 88 % for currency markets. This happened in an environment where market participants took every central bank statement at face value to draw conclusions for monetary policy. Moving to geopolitical issues, tensions between Russia and the West continued to escalate as Finland and Sweden declared their intention to join NATO. Hence, Russia now extends its gas supply freeze for Poland and Bulgaria to Finland, the Netherlands, and Denmark.

Also in emerging markets, the aggregate probability of a future high-risk state picked up, from 29 % in the previous month to 40 % at the start of June. Like in developed markets, risk indicators rose in all three market segments compared to the previous month, from 1 % to 2 % for equity markets, from 69 % to 92 % for bond markets, and from 18 % to 27 % for currency markets.

Chart 4: Risk higher in all three market segments



The chart shows aggregate probability of a high-risk state in the near future for developed markets (black line), as determined by the corresponding probabilities of the three segments equities, bonds, and currencies. Particularly calm market conditions are marked in green, particularly turbulent ones in red. The uninformed assessment of the future market environment is plotted at 50 % (horizontal black line). In addition, the chart shows the aggregate indicator of materialized market movements in the three segments (light gray line). Information as of June 02, 2022. Source: Vontobel Asset Management

Current topic

China makes metal prices move

China's lockdown hits industrial metals

After a two-year rally and 125% increase, industrial metals reached their highest level since 2008 in mid-March. Nevertheless, they then came under considerable pressure, dropping 20% by mid-May due primarily to the weak Chinese economy, whose growth might deccelerate even further in the second quarter. Major industry and trading centers such as Shanghai and Beijing have been largely under lockdown for weeks on account of the pandemic. Obviously, China was not ready for the highly contagious Omicron variant. Over the last two years, the Chinese government considered itself superior to the rest of the world in the methods it took to tackle the pandemic and with the strength of its economy. Abandoning its strict zero-Covid strategy now is a political challenge with an eye to the 20th Party Congress planned in autumn. Industrial metals in particular depend on easing restrictions, given China has accounted for 50% of their demand in recent years.

Combat the pandemic or the economic slowdown?

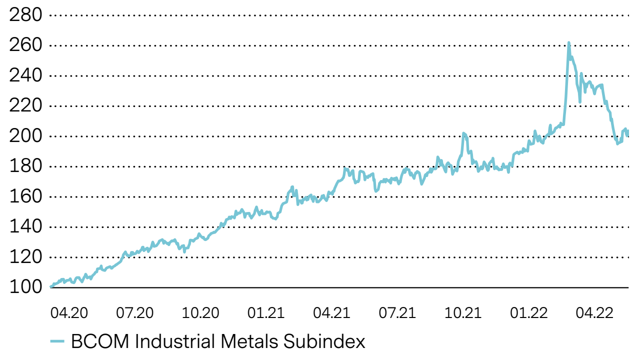
Over the last decade, economic slowdowns in China prompted tough fiscal and monetary policy measures. This year's growth target, set before the Omicron outbreak, is at least 5%. To achieve this, the big guns will need to be brought in in the second half of the year. Accordingly, new measures to shore up the economy are expected at the next politburo meeting in July. The Shanghai municipality government announced its 50 measures on the last weekend of May, including tax relief for companies and subsidies for electric vehicles. Yet the government will have to do more if it wants to see a noticeable effect, either by distributing checks to the people, which is rather unlikely, or appear as a demand driver itself, most likely by investing in infrastructure—a key political tool.

Soon tailwind for metals again

Building bridges and roads as well as expanding rail networks and power grids requires copper, aluminum, nickel, and zinc. Prices of these seem to have heard the ever louder voices of politics and stabilized in the second week of May. They have experienced a significant recovery since, with zinc in the lead, climbing by 13% in the last two weeks of May. China's state economic stimulus will likely buoy industrial metals again, as it did in the past. Once the economic giant also emerges from the lockdown and catches up on pent-up demand, metals will gain additional momentum—especially with global inventories as low as they are at the moment.

Chart 5: Price development in the industrial metals sector

Index points



Information as of May 30, 2022.
Sources: Bloomberg, Vontobel Asset Management

Our models and indicators

GLOCAP

GLOCAP (Global Conditional Asset Pricing) is our proprietary equity allocation model. Active deviations from the neutral positioning (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 equity market valuation (dividend yield) are evaluated and quantified. The sum of the contributions of these indicators reflects the active equity over- or underweighting. The term spread is measured by the difference between the long-term and short-term interest rates of the major industrialized countries. The TED spread is measured by the difference between the interbank interest rates for short-term loans in US dollars and euros and the respective 3-month Overnight Index Swap rate. The credit spread is measured by the risk premia of corporate bonds with lower ratings versus top-rated ones. The dividend yield is measured by the aggregated ratio of dividend to price on the global equity markets.

FINCA

FINCA (Fixed Income Allocator) is our 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 based on 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

Our proprietary Risk Indicator acts in conjunction with our equity and bond allocation models GLOCAP and FINCA as a "second referee" to recognize quickly whether capital markets are in risk-on or risk-off mode. It 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. It responds fast to changes in international financial markets while simultaneously showing high persistence. A probability of 50% reflects an uninformed, non-predictive assessment of the future market environment. When the Risk Indicator anticipates a low-risk, low-volatility environment (value below 50%), it increases portfolio exposure to equity and bond strategies. When it anticipates a high-risk, high-volatility environment (value above 50%), it reduces such exposure. The Risk Indicator's active response should protect investors particularly in periods of market stress by limiting drawdowns.

Using the models and indicators described above we pursue a quantitative investment approach based on financial market research with the aim of achieving an attractive risk-adjusted performance in the long term.

Disclaimer

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