MORNING NEWSLETTER

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01

Global trade - A slowdown which preceded the implementation of tariffs

Despite all the announcements, tweets and threats of the past few months, additional tariffs on US imports of Chinese goods and China's reciprocal measures had yet to be implemented at the end of June, with the first wave of tariffs affecting $34bn of goods on each side set to take effect 6 July.

Yet, global trade was already slowing last month. After expanding at its fastest level in several years in 2017, world trade growth significantly cooled down this year. Before tariffs took effect, the loss of momentum may have reflected the negative impact US-led protectionist rhetoric was already having on market sentiment.

Admittedly, the trade slowdown is probably just as much the consequence of softer growth witnessed across most large economies – except the US – during the first half of the year. The PMI, which measures global industrial activity, declined from its seven-year high of late 2017 and global industrial production also slowed down. The recent implementation of tariffs is unlikely to reverse this trend and threatens to further dampen an already slowing global economic dynamic.

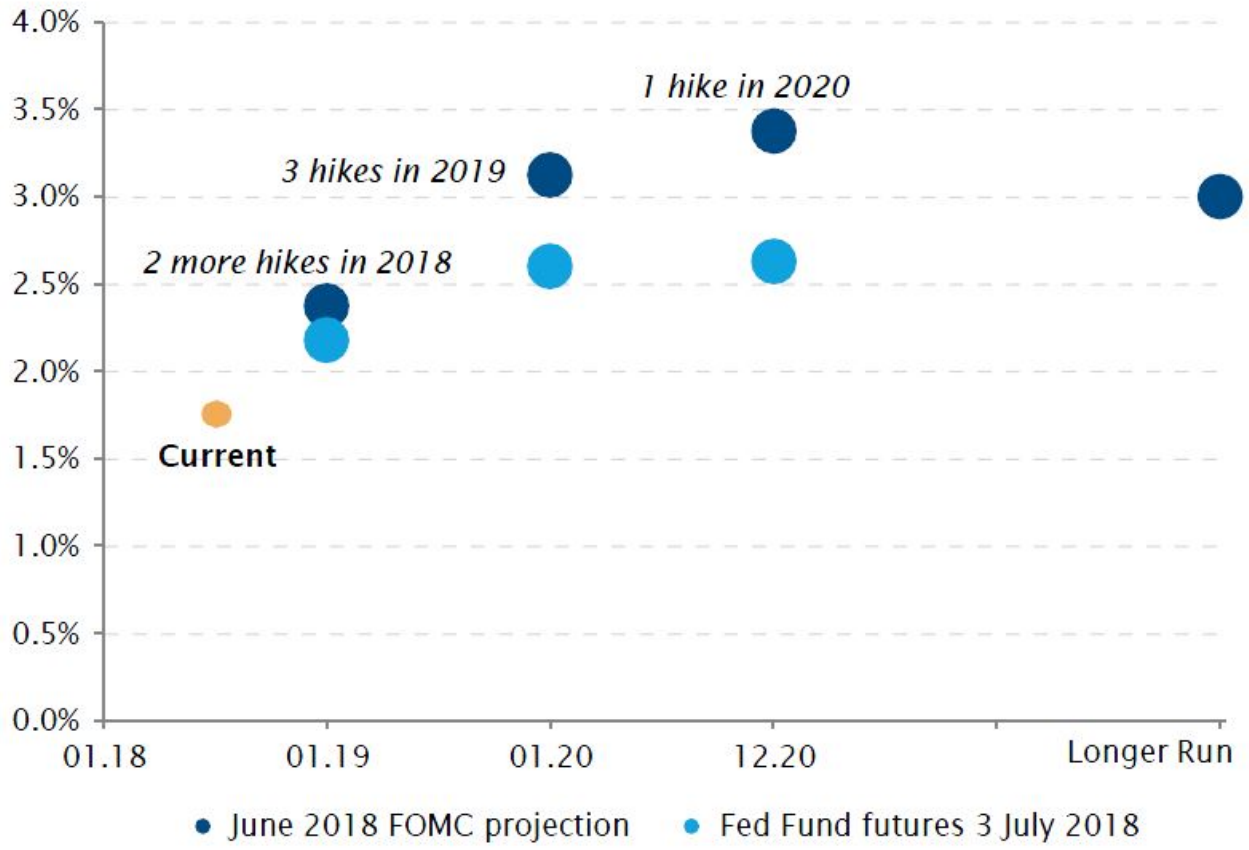
Global trade has been slowing along with global industrial activity in 2018

Sources: Factset, SYZ Asset Management. Data as at : 3 July 2018



Market expectations in line with Fed projections for 2018, not for 2019

Sources: Federal Reserve, Bloomberg, SYZ Asset Management. Data as at: 3 July 2018



02

US - Visibility on future Fed rate hikes for 2018, doubts for 2019

The Federal Reserve raised its short-term rate by 25bps in June, a move which was completely expected and therefore did not generate much market reaction on US rates and the dollar.

There is currently no reason for the Fed not to hike, as Jerome Powell pointed out after the last meeting. The US job market is strong, household spending and business investments are rising and inflation has moved closer to the Fed's 2% target. It was therefore no surprise Fed members displayed higher confidence in their outlook and rate projections, with two additional rate hikes of 25bps expected by year end, followed by three in 2019.

Investors are also convinced the hiking cycle will continue in the coming months. However, looking into next year, market expectations for short-term rates are much lower than the Fed's outlook, with barely one 25bps hike priced in. For the moment, investors doubt the Fed will be able to carry on in a context where growth is softening in the rest of the world and other large developed central banks are not following on the path to normalisation.

03

Eurozone - The ECB commits to keeping a very accommodative monetary policy

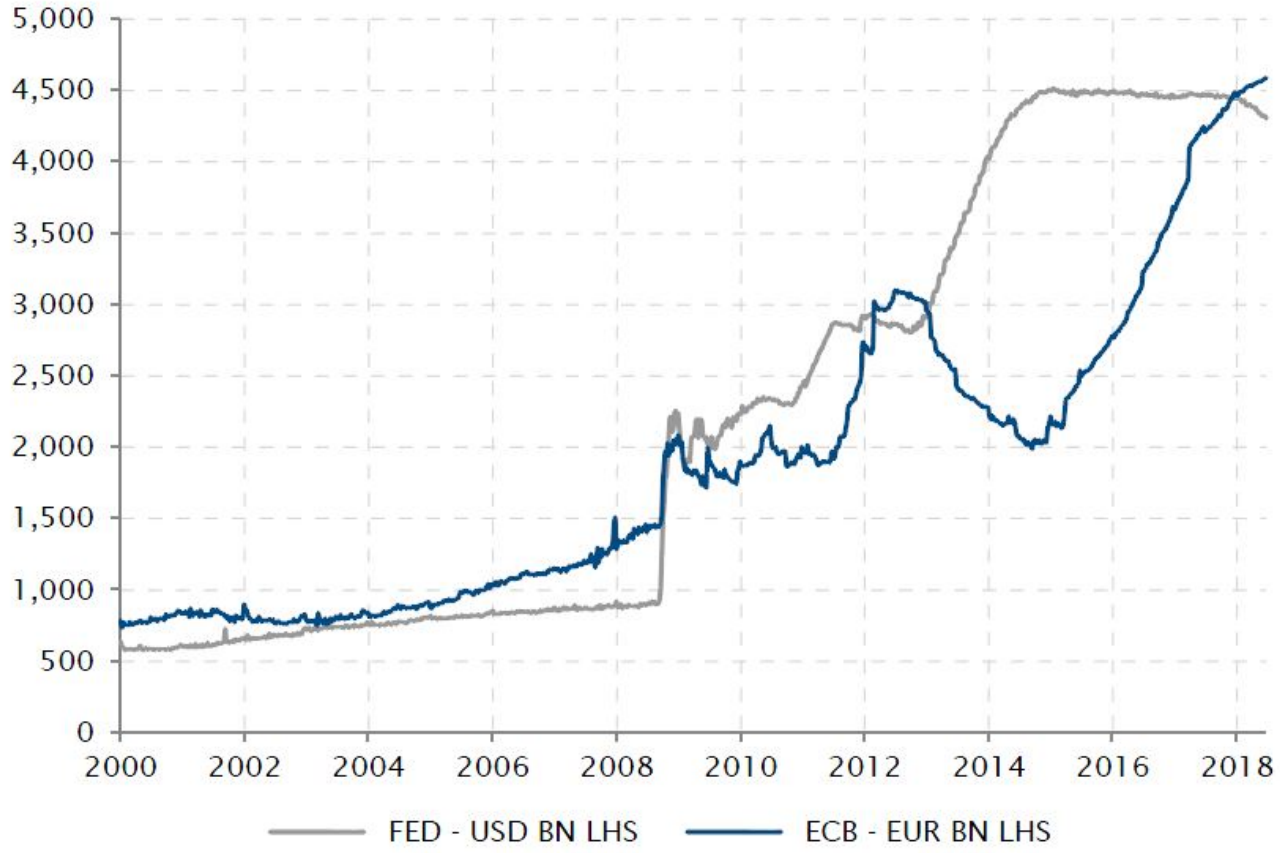
The June ECB meeting had long been flagged as a potentially key meeting. One day after the Fed meeting, three months before the expiration of the existing QE programme and one year after Mario Draghi's Sintra speech – in which he signalled a shift toward monetary policy normalisation – the ECB was due to clarify how and how rapidly it intended to eventually normalise monetary policy.

Clarification was provided, but not quite in the direction markets were expecting. The ECB chose to convey a strong accommodative message and only committed to moving very slowly and cautiously towards the withdrawal of its current supportive stance. First, asset purchases under the QE programme will be reduced beyond September and should be halted at the end of the year, but only provided inflation and economic data keep evolving in the direction expected. This leaves the door open for an extension of QE if needed. Second, the ECB does not expect to raise its key short-term rates before the latter part of 2019, an unusually clear commitment to maintaining very easy financing conditions for at least one year.

As a result, the divergence between the Fed, which is raising rates and reducing the size of its holdings, and the ECB, which is adding assets to its balance sheet and maintaining rock-bottom rates, will only widen in the next 12 months.

ECB and Fed monetary policies will continue to evolve in opposite directions

Sources: Bloomberg, Fed, ECB, BoJ, SYZ Asset Management. Data as at: 3 July 2018



The yuan experienced its largest ever monthly decline in June

Sources: Factset, SYZ Asset Management. Data as at: 3 July 2018



04

China - A record drop in the yuan in June

Recently, China has been in the news with regards to its trade conflict with the US, which could continue to escalate. However, in the meantime, its economic growth has gradually been slowing down. Political attempts to contain excessive credit growth, at play since last autumn's Party Congress, may finally have affected economic activity.

In response, the central bank has changed its monetary policy stance in the past few months. It has relaxed the ability for commercial banks to lend, with two cuts in the RRR. It has also refrained from increasing short-term rates in the wake of the Fed's June rate hike, which it had done after previous Fed rate hikes.

This shift towards a more accommodative monetary policy triggered a brisk depreciation of the Chinese currency in June. Its 3.2% drop against the US dollar was the largest monthly decline ever recorded. It remains unclear whether this move was desired and orchestrated by Chinese authorities as a response to US tariffs, or if it is merely a sign the currency is now more sensitive to market forces, shifts in rates and growth dynamics. Only time will tell.

India - The RBI’s first rate hike after more than four years

The Reserve Bank of India decided to follow the path of other Asian central banks, such as Bank Indonesia or the Philippines’ central bank, by hiking its repo rate by 25bps to 6.25% at the June MPC meeting. The move was not fully expected; 25 out of 35 analysts predicted rates would remain unchanged in a Bloomberg survey. The RBI acted ahead of the widely anticipated Fed rate hike to try to stem market pressures. The six MPC members were unanimous in their decision to hike rates, however they highlighted the risk to the inflation outlook.

CPI inflation continued to increase in May at 4.9%, versus 4.6% in April, and is expected to trend higher in a context of a closing output gap, rising oil prices, a weaker Indian rupee and higher agricultural Minimum Support Prices (MSP). The RBI could follow in the footsteps of Bank Indonesia, which hiked rates three consecutive times, and will raise interest rates by 25bps in its August meeting.

The RBI started hiking interest rates while inflation is at risk

Sources: Bloomberg, SYZ Asset Management. Data as at: 30 June 2018



European banks’ relative performance (Stoxx Europe 600 Banks/Stoxx Europe 600)

Sources: Bloomberg, SYZ Asset Management. Data as at: 4 July 2018



06

Equity – European banks are back in troubled waters

Lately, European banks have been under pressure. Financials are the worst-performing sector on a YTD basis and lag the broader index by 10%.

Expectations for improvements in European economic growth, which resulted in a steeper yield curve, dominated in 2017 and fuelled the European banks’ rally. But it seems to have peaked and for the time being, the asset class is no longer attractive.

The flat yield curve, which makes it difficult for banks to grow their net interest margin, has made the earnings outlook for banks one of the worst in the region. Moreover, non performing loans are still acting as a drag on banks’ profitability, especially in Italy. In terms of

money flow, institutional investors are no longer overweight banks.

Finally, in June, the ECB prolonged its accommodative stance for at least 12 months, dragging the overall banking sector further down.

07

Fixed Income – US two-year treasury yields have been repricing

Since the global financial crisis started nearly ten years ago, major developed central banks have been implementing ultra accommodative monetary policies. They have brought interest rates to record low levels – sometimes in negative territory – while using unconventional measures such as quantitative easing to stimulate the economy.

During this long period of financial repression, ‘risk free’ asset returns have been compressed – the US two-year treasury was for example yielding under 0.5%. However, over the same period, the US equity (S&P 500) dividend yield was hovering around 2% and top of that return, it was possible to get price appreciation from companies increasing their future earnings.

In the US, since the Federal Reserve started normalising its monetary policy, short-term rates have repriced, with US two-year treasuries yielding 2.5%, and are again becoming appealing for US investors compared to the lower and riskier 2% S&P 500 dividend yield.

US two-year treasury yield vs. S&P 500 dividend yield

Sources: Bloomberg, SYZ Asset Management. Data as at: 4 July 2018



Small caps outperform large caps

Sources: Bloomberg, SYZ Asset Management. Data as at: 29 June 2018



08

Equity - Protectionism favors local companies

Over the past few weeks, US small-cap stocks impressively outperformed large-cap stocks, generating more than 4% overperformance in the last quarter. Small caps, usually known to be more risky and volatile than large caps, have recently become less risky due to the current political landscape.

First, Donald Trump has embarked on a broad effort to reduce taxes and regulation for US businesses as part of his plan to "Make America Great Again" and this move has largely benefited smaller companies. Second, the White House's strong rhetoric against China and the escalating trade war are having a strong impact on international companies and less of an impact on US-oriented businesses. On average, US small caps rely on 20% of overseas sales and are therefore more immune to trade tensions and US dollar volatility.

09

FX - Risk off for emerging currencies

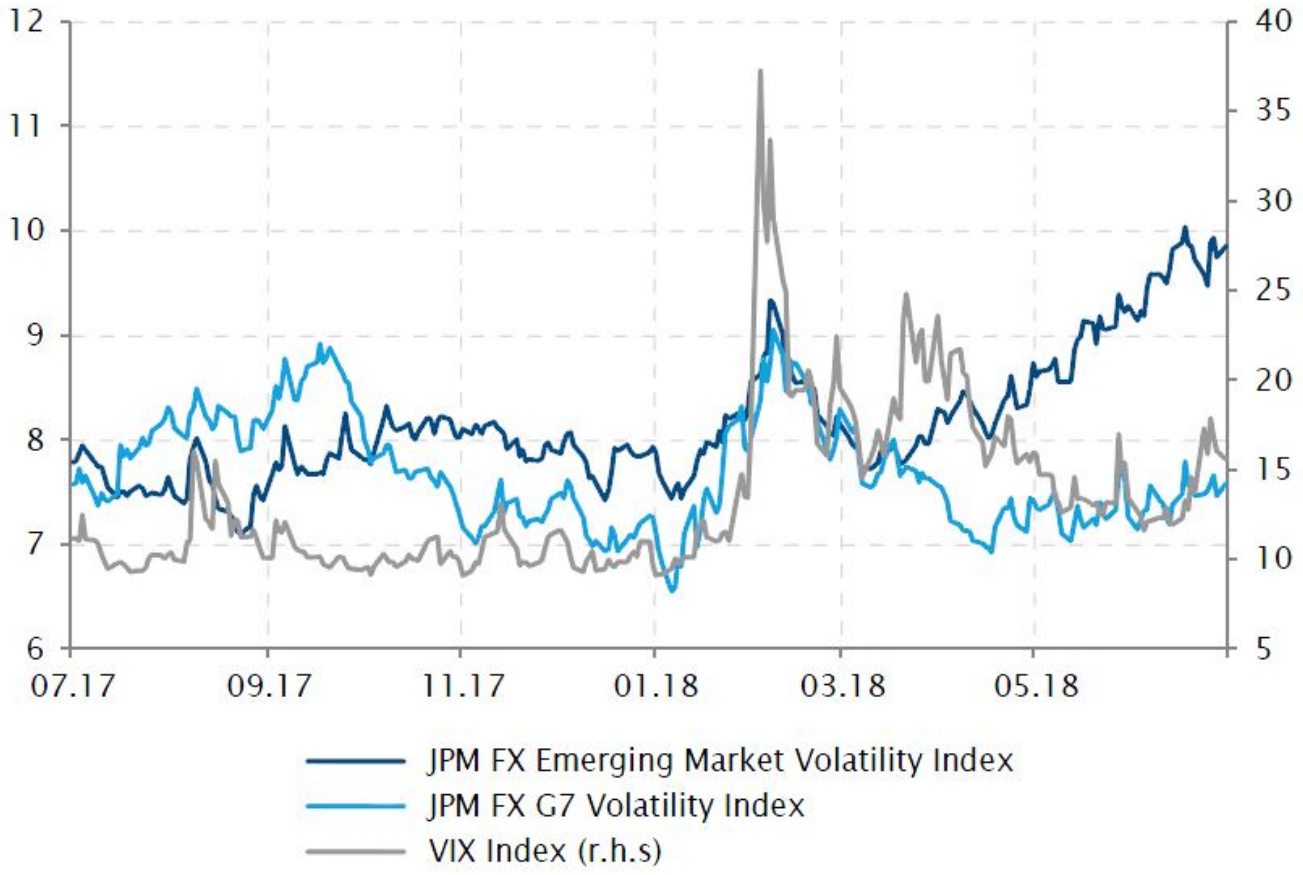
While volatility in equity markets has so far been relatively contained, the foreign exchange market is telling another story, particularly in emerging markets. Turkey, Brazil, Russia, Mexico, have all seen their currency volatility jump to very high levels over the last three months.

In June, the JPM emerging volatility index, a gauge of aggregate implied volatility for emerging currencies, reached its highest level since February 2017. On a year-on-year basis, the Turkish lira's volatility jumped by close to 60% while the volatility of the Mexican peso and the Brazilian real increased by 25% in June. Aside from internal political issues, emerging markets have been under pressure from US monetary policy normalisation, protectionist measures and fears of a turning point in global synchronised growth.

This situation may not come to an end anytime soon as trade frictions between the world's biggest economies are still escalating.

Emerging market FX volatility decoupling from G7 currencies

Sources: Bloomberg, SYZ Asset Management. Data as at: 29 June 2018



After rising for several months, inflation expectations have stabilised in Q2

Sources: Bloomberg, SYZ Asset Management. Data as at: 3 July 2018



Interest rates - Inflation expectations no longer rising

Inflation, or rather inflation expectations, have been a central topic for the past twelve months. With US wages finally rising, as the unemployment rate dropped to a multi-decade low, and the Eurozone finally experiencing sustained above-potential expansion, the spectre of deflation has dissipated.

The 75% rise in oil prices since mid-2017 provided a tailwind to this trend, driving headline inflation at or above central bank targets on both sides of the Atlantic. Forward-looking expectations have also logically repriced higher since 2017, pushing US and German long-term government rates to their highest level in several years.

However, medium and long-term rate expectations stabilised this spring, reflecting low market confidence that inflation could continue to accelerate. Ten-year inflation breakevens derived from inflation-linked bonds and expectations of five-year inflation, central banks' preferred gauge of medium-term inflation expectations, are no longer rising. Inflation expectations now appear capped by the lack of capacity for global growth to accelerate further. As long as this lasts, it will also cap any increase in ten-year government rates.

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