

Our monthly view on asset allocation (August 2018)

Friday, 08/10/2018

Our stance today is currently 'risk-on'. That said, this is not 2017 and asset allocation is critically important given the many risks that investors currently face, whether it is asset valuation-related or driven by geopolitics.



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Hartwig Kos

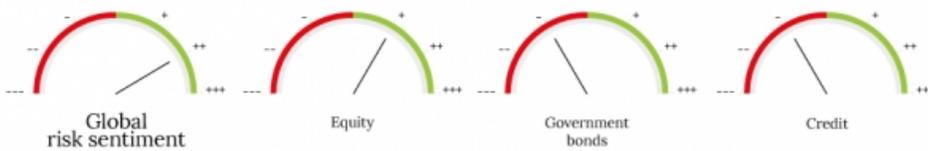


Adrien Pichoud
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- Despite the better part of the global recovery behind us and geopolitics at the fore, we currently retain a pro-risk – albeit cautious – stance.
- We remain constructive on equities, with a U.S. bias. While in bonds, even though we are mildly negative on duration, we are finding pockets of value.
- Inflation is trending higher, but it is not yet a top priority for central banks.



Give credit to growth

The not-so-bright geopolitical backdrop, dominated by trade war rhetoric, has been on the forefront of investors' minds over the last several months. At the same time, economic growth indicators in Europe and Japan have disappointed expectations – which were inflated after an exceptionally good year in 2017. Moreover, the US yield curve has continued to flatten and could be inverted within the next six to twelve months – in the past, this has signalled a recession was coming in the next half year to a year. US expansion is not in its infancy; the better part of its recovery and expansion are now behind us and thus a recession, or at least growth moderation or stagnation, will happen in the future. But this is still too early to call and it is too early for us to act accordingly in our portfolios. Furthermore, tentative signs of growth stabilisation in the rest of the developed economies are reassuring. The picture is more mixed in emerging markets, but we also expect it to improve going forward, as the dollar should stabilise and the Fed's tightening has been priced in for the foreseeable future.

On the bright side, overall growth remains decent, inflation is behaving well and, except for the Fed, other major central banks' monetary policies remain clearly supportive. China's slowdown remains under control as its government switched back to an easing policy of monetary and fiscal stimulus and a weaker yuan. US Q2 earnings season started on a strong note, as banks announced massive shares buyback, and US equities valuations, which were very expensive at the beginning of the year, appear close to fair value. Credit, especially European high yield and investment grade, has also become less expensive over the last few months.

In a context where inflation has not yet become an issue, financial conditions remain on an accommodative side and growth has not faltered, we have kept a favourable stance on risk and a mild disinclination on duration – the path of least resistance for rates remains on the upside. However, in order to somewhat hedge our pro-risk positioning from an eventual trade war escalation, which remains impossible to predict or quantify, our geographic equities positioning remains clearly tilted towards the US and avoids strong sectorial bias globally. On the fixed income side, an additional pinch of European credit – or at least a relative overweight compared to US credit – seems a good way to recognise European growth.

_Fabrizio Quirighetti

Economic backdrop in a nutshell and global economic review

The global economy currently looks like a large poker table where several high-stakes games are being played. The main one involves the US and China; both sides are willing to call each other's bluff and let the stakes rise. For Donald Trump, this game is a chance to display strength and toughness ahead of midterm elections – by proposing another round of tariffs on \$200bn of Chinese goods – all the while claiming loud and clear he is acting to defend free trade. China's tactic seems to be playing soft and quiet in order to defend its position without appearing confrontational: raising its own tariffs only after the US does – in a purely reciprocal way – favouring alternatives to US imports and all the while innocently witnessing the yuan fall against the dollar.

But this is not the only bluffing game going on. In Europe, the UK and EU's (absence of) negotiation also resembles a poker game in which the EU is exerting maximum pressure, while Theresa May is trying to straddle the fence with a 'hard-soft Brexit deal', which is neither acceptable to UK Brexiteers nor to the EU. There are also other smaller poker games going on: in Turkey, between Erdogan and the FX market on whether the central bank should raise interest rates; in Mexico, where president-elect AMLO appears to have convinced investors he will not be the dreaded anti-market leftist leader many were fearing – bluff or no bluff?

Growth

Beneath the noisy surface, most of the global economy is still doing fine in terms of growth, with domestic demand supporting activity in developed markets. However, uncertainties related to the ongoing poker games are a risk for the global outlook, as negative sentiment could weigh on positive growth.

Inflation

As the production and employment gap gradually narrows across the globe, inflation is trending mildly higher, supported by oil and commodity prices. But aside from a few very specific cases, inflationary pressures remain very soft and do not warrant central bank action.

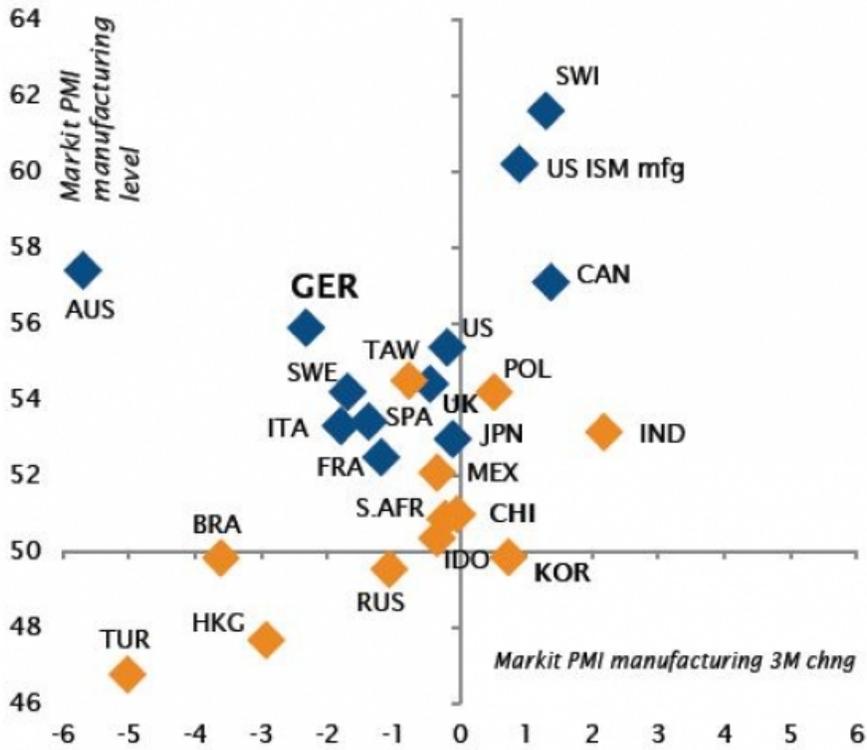
Monetary policy stance

Without much inflation, central banks' stances are driven by their confidence in the growth outlook. If the Fed is confident enough to keep normalising short-term rates, the ECB is not and committed to not raising rates anytime soon.

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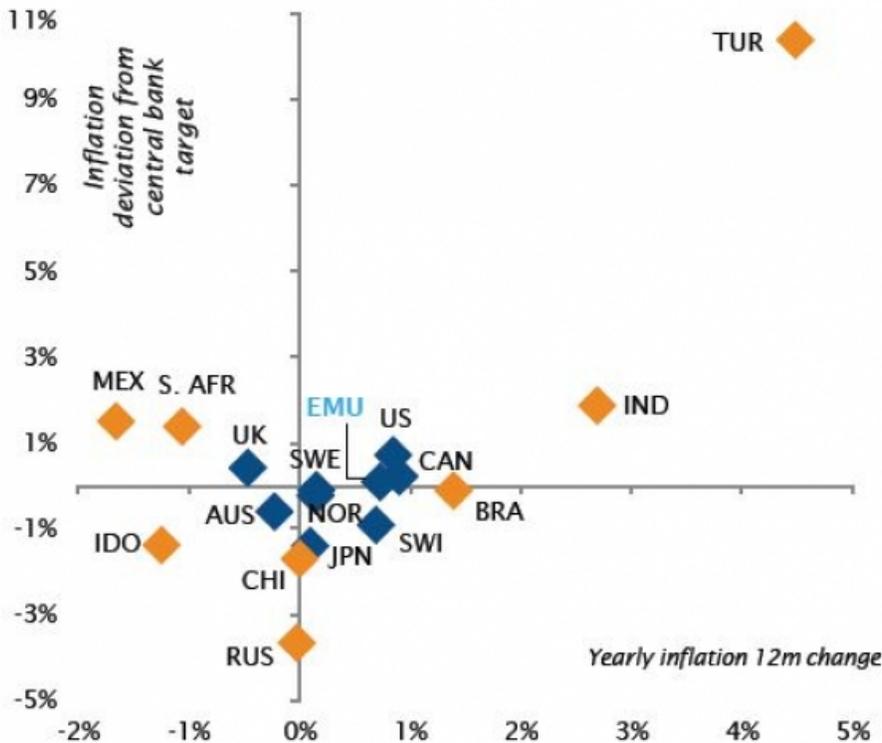
— Adrien Pichoud
Chief Economist & Senior Portfolio
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PMI Manufacturing trends and level



Source
Sources : Factset, SYZ Asset Management. Data as at : 17 July 2018

Inflation trend and deviation from Central Bank target



Source

Sources : Factset, Markit, SYZ Asset Management. Data as at : 17 July 2018

Developed economies

According to real-time estimates of US GDP growth, the US economy has grown at or possibly above 3% annualised during the spring. Such strong expansion is very much endogenous, with household consumption fuelled by low unemployment and business spending supported by tax cuts and expectations of a continuation of the current cycle. On top of this, longer-term inflation expectations remain anchored despite the recent acceleration of yearly inflation rates. In such a context, the Fed's job becomes almost easy: there is no reason not to continue hiking for the moment, as long as growth dynamics remain strong. And there is no need to tighten monetary policy aggressively and more rapidly in the absence of underlying inflation. The Fed is no longer behind the curve, and one rate hike, topped with upward revisions on growth and interest rates, was perceived as completely warranted, hence financial markets did not move much.

In the eurozone, the situation is less straightforward: business investment has slowed down over the course of the first half of the year, due to headwinds including a stronger euro and US tariff threats, and business confidence remains hampered by uncertainties around the evolution of global trade. On the other hand, declining unemployment rates and cheap credit conditions support domestic consumption, as reflected in the rebound of the service sector in June. This uncertain situation, in a context where inflation is also losing momentum, is behind the ECB's cautious signal in June. Interestingly, for European countries ex-eurozone such as Switzerland or Sweden, the business cycle continues to be strong, supported by the weakening of their currencies.

Emerging economies

Mexico and Turkey have now elected the presidents that will lead them through the coming years. However, the results caused a somewhat unexpected market reaction. Turkey's choice for continuity in Mr. Erdogan – and his vision of a subordinated central bank that keeps rates low – triggered a fresh all-time high for the lira as inflation surges. In Mexico, the expected victory of left-leaning AMLO was welcomed by markets after the president-elect sent encouraging signals to the business community. Elections in Brazil, set for October, are the next big political event in emerging economies.

China remains in a soft growth patch. So far, this is probably more related to its tighter credit conditions, which were decided in late 2017, than to trade restrictions. However, the latter may start to have an impact on sentiment in the rest of Asia, which is highly sensitive to global trade and to the Chinese economy.

_Adrien Pichoud

World growth remains positive but tariff uncertainties threaten already slowing global trade



Source
Sources: Factset, SYZ Asset Management. Data as at: 17 July 2018

Investment Strategy Group Takeaways and asset valuation

Risk and Duration

Entering the summer lull, no changes to the assessment were made; risk remains a mild preference and duration a mild dislike.

Equity Markets

The idea of running an equity risk heavy, yet well balanced and boring asset allocation continues to underpin our decision-making. Bearing this in mind, we have decided to leave our relative preference for US equities intact. No other changes were made to equity allocation either.

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Bond Markets

Over the past few months, bond markets have seen significant shifts in valuations and price dynamics. US treasuries now offer good value and the triple whammy of rising bond yields, a rising dollar and the trade spat between the US and the rest of the world has left emerging market bonds in somewhat of a limbo. While there is good value to be found in emerging market debt, it is still a bit early for us to jump on the gravy train. Outside these themes – which we thoroughly discussed in the past – there were some subtle changes within the corporate credit universe.

Spreads have particularly widened in Europe. According to the ICE BofAML BBB Euro Corporate Index, option-adjusted spreads have widened by more than 60 basis points – from 0.9% to more than 1.5% – since early February. The difference between option-adjusted spreads in the European index and the equivalent US index is now as little as ten basis points, while the US index carries almost two more years of duration.

When it comes to European high yield, measured by the ICE BofAML BBB Euro High Yield Index, spreads have widened even more significantly. In February, option-adjusted spreads stood at 2.57%, more than 70 basis points lower than US high yield. Now, both market segments, the US and Europe, are at the same level of 3.55%, despite Europe displaying a mildly better duration profile and a far superior quality of index construction. US high yield consists of more than 10% relatively low-quality energy issuers, which is not the case for European high yield.

Why the substantial adjustment? A big part of this has been driven by fears about the ECB's end of its bond purchasing programme and the subsequent exodus of retail investors. Redemptions from European investment grade credit this year are approaching levels seen during the financial crisis. Given the spectre of the great ECB unwind will likely continue to make headlines, negative sentiment towards the asset class will probably persist. Yet valuations are reaching levels such that our negative stance on the asset class needs to be reassessed.



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It is clearly not time to pile into European credit when the ECB, the biggest buyer in town, is slowly disappearing. Yet being too negative on the asset class is not the appropriate stance either, considering valuations have vastly improved and corporates are clearly deleveraging their balance sheets in anticipation of the ECB's change in policy. As a result, we have upgraded investment grade credit by one notch to a mild dislike. We have not changed our assessment of high yield credit, which remains at a dislike. With regards to intra-asset class preferences, Europe has been upgraded in both investment grade and high yield from a dislike to a mild dislike.

At the same time, German bunds were downgraded to a dislike from a mild dislike; this shift was predicated on two things. Firstly, the ECB anchored interest rates well into 2019. Second, the recent bund rally has brought the ten-year back to around 0.35%, which is fairly expensive in our view. This makes the bund market a very good hedging tool, for instance to hedge duration on European investment grade credit, which has just been mildly upgraded.

Forex & Cash

No change in assessment.

_Hartwig Kos

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