

Our monthly view on asset allocation (September 2018)

Friday, 09/28/2018

While the macro backdrop continues to support risky assets, there are visible storm clouds gathering that could precipitate a change in risk appetite. Today, it is all the more important to balance risks in a portfolio and in particular be mindful of how assets will behave should there be a market dislocation. Most market observers agree we are late in the market cycle, however, a 'risk on' approach may still generate attractive performance for some time to come.



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Not all equities are born equal

The Turkish lira crisis and limited contagion in vulnerable emerging market (EM) assets have not derailed the overall supportive economic backdrop. This is especially true for developed markets and the US economy: growth, inflation and monetary policy dynamics have not changed and will stay constant, as long as the EM crisis remains contained to a few structurally flawed economies – which is our base case scenario. As a result, despite the rout in several EM assets, ongoing trade tariff tensions and concerns about the Italian budget, we are maintaining a pro-risk stance, still favouring well-insulated US equities, which were at the heart of our risk preference increase in June.

While it could be tempting at this stage to increase duration, in order to hedge – or at least mitigate – risk in the portfolio, the decorrelation benefits are currently quite meagre. As long as the global picture remains unchanged – growth and inflation are not expected to nose dive – it would be wiser to directly decrease the risk within the portfolios. Given current valuations and our economic analysis, the path of least resistance for rates is still tilted to the upside. Our duration stance was thus kept as a mild disinclination.

Markets have been challenging this year; equity performances within the NASDAQ were extremely divergent – with a few emblematic stocks reaping all the rewards – while the rest of developed markets are struggling and several EMs are even experiencing bear markets. Stein's Law, which states 'if something cannot go on forever, it will stop', applies to this phenomenon. Thus, we need to have an idea of if and when the rest of global equities will catch up to the US, or rather if the NASDAQ will close the gap. Our economic cycle, asset valuation and risk balancing committees favour the latter suggestion: a rebalancing towards value over growth should happen before year-end.

As far as the catalyst is concerned, and to answer the 'when' question, this will only be once we see less divergence in growth, inflation and monetary policy dynamics across major economies. Once investors are convinced growth in Europe and China is bottoming out and US growth will not accelerate further, or once the Fed approaches neutral rates and the ECB and BOJ become less dovish, laggards should start to outperform current market cheerleaders. If we are proved right, US dollar strength should end, lifting price and sentiment across the world – to the detriment of current optimism around the US technology sector.

—Fabrizio Quirighetti

Economic backdrop in a nutshell and global economic review

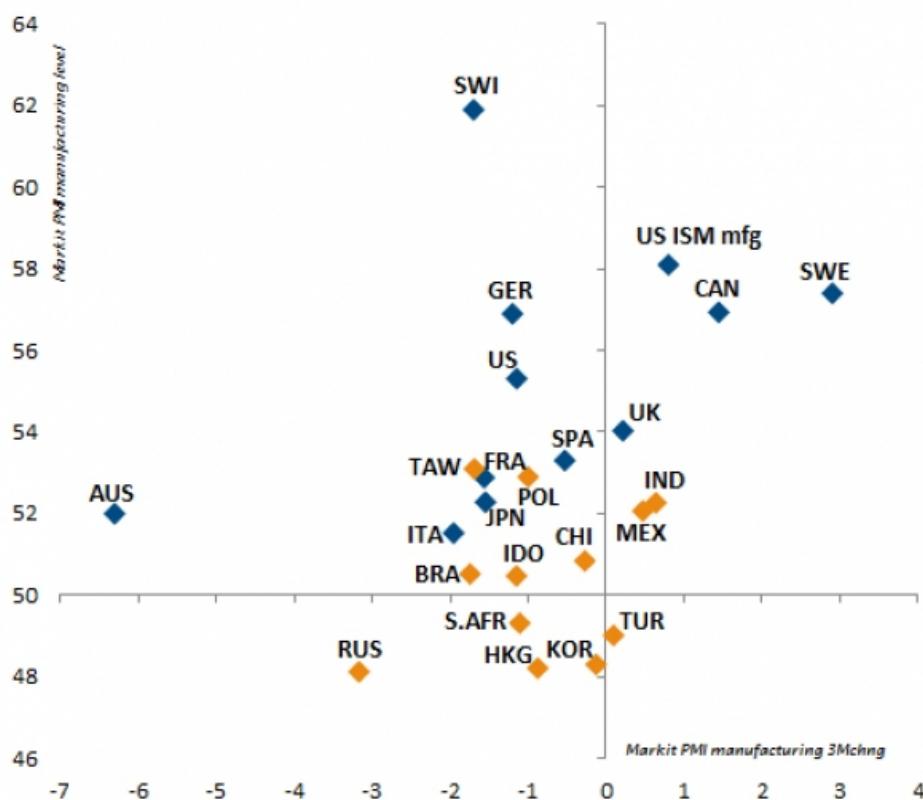
The outburst of tensions in Turkey has recently dominated macroeconomic headlines. Its diplomatic rift with the US around a jailed pastor was the straw which broke the camel's back – the eighth largest economy was already highly fragile and its economic backdrop deteriorating; this sent the lira to a fresh historical low. In a context of softer-than-expected global growth, China's slowdown, yuan depreciation and trade tensions, developments in Turkey have fuelled questions and concerns around emerging market growth, especially their ability to withstand the Fed's monetary policy normalisation, with its higher rates and stronger US dollar.

However, beneath these noisy headlines, the global economy continues to exhibit broad-based expansion, fuelled by firm demand across the developed world. In this context, Turkey is seen as a basket case, due to its combination of reckless fiscal spending, heavy reliance on external funding and unorthodox monetary policy, rather than a potential canary in the coalmine for the emerging world. With activity stabilising at a decent level in Europe and across most of emerging Asia after the H1 soft patch, along with strong expansion in the US, the global economy is still expanding, although less impressively and smoothly than last year.

Growth

While business cycle dynamics are generally softening across most large economies, the absolute level of expansion remains positive. The main contributors of final demand in developed economies are still firmly in place: positive job market and wage dynamics, as well as easy credit conditions underpinning real estate.

PMI Manufacturing trends and level



Source

Factset, SYZ Asset Management. Data as at: 22 August 2018

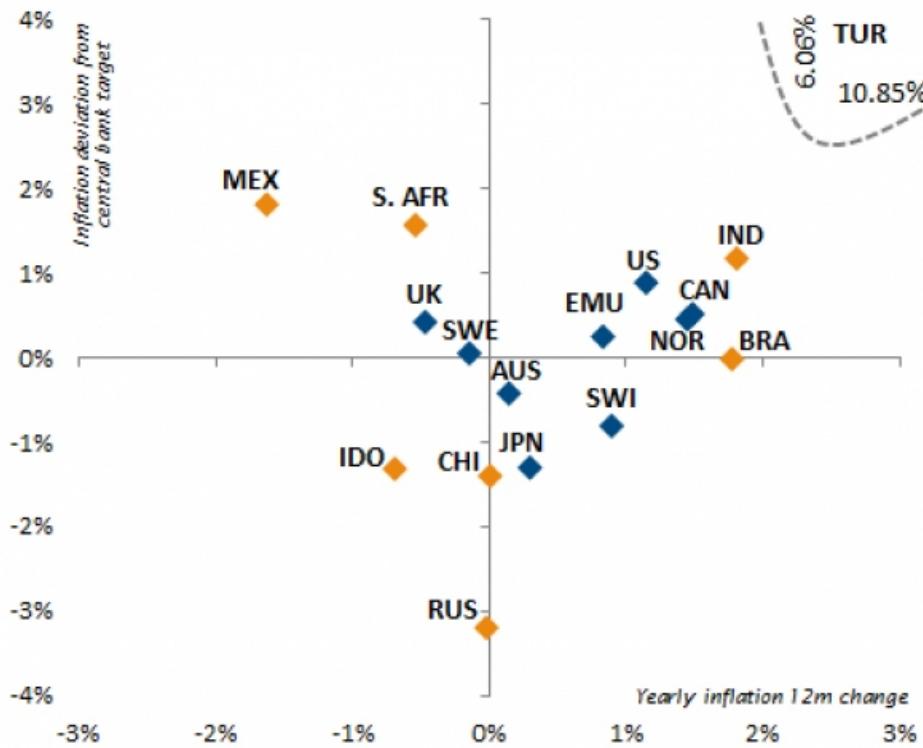
Inflation

Inflation dynamics remain moderately positive across developed economies as economic expansion and rising wages support a moderate pace of price increase – although still hampered by structural headwinds. Inflation dynamics are more diverse across emerging markets, where currency movements often exacerbate endogenous trends.

Monetary policy stance

Despite the latest Bank of England rate hike, the broad landscape remains one of very accommodative monetary policy across developed economies. In the US, the Fed's path of least resistance is to continue its gradual rate hike cycle toward a slightly restrictive stance.

Inflation trend and deviation from Central Bank target



Source

Factset, Markit, SYZ Asset Management. Data as at: 22 August 2018

Developed economies

After a fairly strong Q2, the US economy began the summer on a similarly firm footing, still driven by buoyant domestic consumption. However, capacity constraints limit the potential for additional acceleration and, at the margins, US macro dynamics appear more likely to stabilise or slow down slightly in the months ahead – all the while remaining fairly elevated. Ongoing monetary policy tightening is balanced by fiscal stimulus, which continues to support solid economic expansion.

After softening growth in the first half of the year, the eurozone shows signs of stabilisation. The pace of expansion is no longer surpassing expectations, but all indicators still point to a stabilisation around 1.5% annualised GDP growth. Moreover, market consensus has now adjusted to this level. Hence, the eurozone is objectively poised to deliver above-potential and in-line-with-expectations growth during the remainder of 2018. The Bank of England, also faced with resilient economic growth – despite Brexit uncertainties – and above-target inflation, decided to raise its short-term rate to 0.75%.

Economic dynamics also stabilised in Japan, as reflected by the consumption-led GDP rebound in Q2. The Bank of Japan took a very small first step to normalising its monetary policy by raising the ceiling for JGB 10-year rates, in the context of its 'yield curve control' policy. However, it is still far from withdrawing its very accommodative stance.

In Australia, business dynamics lost momentum, faced with the double headwind of a Chinese slowdown and US tariffs on the one hand, and falling commodity prices on the other hand.

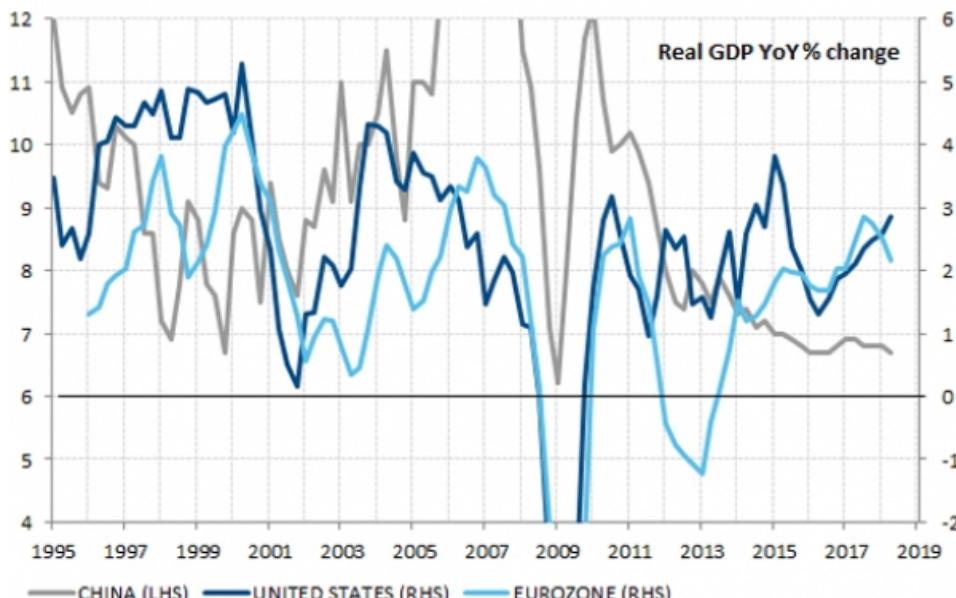
Emerging economies

The crisis in Turkey has brought up bad memories of emerging economies unsettled and dragged into crisis by Fed rate hike cycles. However, so far, the Turkish story remains unique. Higher short-term rates and a firmer dollar are only additional headwinds to home-grown structural fragility. Turkish economic policies go against creditors' interests, while the country relies on those very creditors to finance its economy. The politicisation of the central bank's monetary policy, the lack of meaningful response to the surge in inflation and currency collapse are all domestically-engineered factors, on top of a diplomatic and trade dispute with the US.

Thus the 'contagion risk' to other emerging economies appears so far limited. Growth has continued to soften in China and, as a consequence, across South-East Asia, but fiscal and monetary policy easing in China should ensure a stabilisation, if not a rebound in activity by the end of the year.

Adrien Pichoud

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



Source

Factset, SYZ Asset Management. Data as at: 22 August 2018

Asset valuation & investment strategy group review

Risk and duration

The summer scare triggered by fears about Turkey and the devaluation of the lira ebbed quickly, and so did market volatility. The macroeconomic status quo remains unchanged and the temporary spike in market volatility – with equity markets mildly lower – represented more of a buying opportunity than anything else. Hence, there was no change in our preference for risk.

There was no change in our preference for duration either. While US treasuries have seen a good degree of adjustment in terms of valuations, global bond markets elsewhere remain fairly expensive. Moreover, the key central bank outside the US, the ECB, has not meaningfully altered its narrative about monetary policy just yet, which makes it difficult to adopt a more constructive stance on global duration.

Equity markets

To keep with our aim of running equity-heavy, yet well-balanced portfolios, the US equity market continues to anchor the equity position within our overall asset allocation. This stance has worked well over the past few months and is in our view likely to keep working a bit longer. However, we are becoming conscious of the increasing valuation gap between the US and emerging markets (EMs) in particular. A stronger US dollar and continued tensions over global trade, paired with a political and currency crisis in Turkey, have taken a heavy toll on EM equities. There is clearly value in this segment of the market, however it is still somewhat too early to meaningfully alter our preferences in favour of emerging markets. We would need to see more progress with regards to trade negotiations, and some respite from dollar strength. The only changes we made within the EM equity block were an upgrade of India from a dislike to a mild dislike and a downgrade of South Africa to a mild dislike. India has seen a fair amount of adjustment already, while South Africa is suffering a lot of symptoms similar to Turkey's.

« A stronger US dollar and continued tensions over global trade, paired with a political and currency crisis in Turkey have taken a heavy toll on EM equities. Italy was downgraded by one notch from a mild dislike to a dislike. This was done on the basis of a politically more uncertain environment for Italy, with the ECB withholding support. »

— Maurice Harari
Senior Portfolio Manager



Bond markets

After an upgrade of investment grade credit during last month's meeting, no changes were made with regards to bond asset allocation. However, within the government bond segment, two small adjustments were undertaken. Italy was downgraded by one notch from a mild dislike to a dislike; this was done on the basis of a politically more uncertain environment for Italy, with the ECB withholding support. Australia was upgraded by one notch to a mild dislike, on valuation grounds.

Forex, alternatives and cash

Gold was upgraded by one notch to a mild dislike. The strength of the US dollar and the fact some EM central banks, such as Turkey's CBRT, had to aggressively sell their gold reserves in order to defend their freefalling currencies, has created a strong downward force for gold. The price adjustment has been meaningful; since the beginning of the year, gold has depreciated against the US dollar by about 12%. While we will not meaningfully add to gold at this point, our rather negative stance on the metal needs to be revised. We made no change in assessment elsewhere.

Maurice Harari

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