

Our monthly view on asset allocation (October 2018)

Tuesday, 10/23/2018

While the causes and symptoms of later-cycle dynamics are legitimate, we are still constructive and maintain our pro-risk stance of equities over bonds. A stabilisation of global growth (positive-yet-softer expansion) was expected, but this 'toughening' of growth has been bumpy when looking at individual country performance. In terms of regional asset allocation, the U.S. is still our top region, but less so in favour of Europe and Japan where we see good value. Finally, on the inflation front, we have seen figures continue to trend higher - not yet a material concern, but worth keeping a close eye on.



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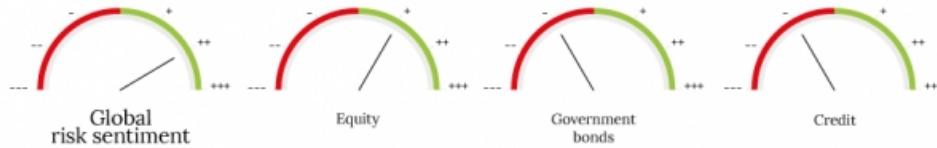
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The cycle is not dead... yet

Recurring concerns about possible causes (e.g., trade tariffs) or symptoms (e.g., flatter yield curve) about the US economic cycle is legitimate at this stage, but still premature. While disappointments may be inevitable after stronger-than expected growth posted over the last few quarters, it won't be an outright recession – as long as inflation behaves well and monetary policy isn't too restrictive. As the maxim goes "the Cycle dies when the Fed puts a bullet in its forehead", either by policy misstep or the hand of inflation.

Applying the same reasoning to Europe, given current ECB posture and core inflation level, we shouldn't be excessively concerned by the poor economic performances in euro area. These, to some extent, are due to the bloc economies producing less than their potential.

There is still plenty of catch-up potential in domestic demand. Thus, with absolutely no signs of economic exuberance, we may see a prolonged period of contraction. Encouragingly, recent tangible signs of stabilisation in eurozone activity, coupled with decent to strong growth elsewhere on the continent, should help restore confidence beyond the Italian budget saga.

This leaves us with China, where the government is now trying to mitigate and indirectly reverse the slowdown in credit expansion it triggered last year. A bottoming out in China activity, still on the cards, should help to lift sentiment towards non-US equities and EM assets more specifically.

As a result, we haven't changed our key stance to favour equities over bonds. Tactically, eurozone and Japan equities were upgraded and, thus, our relative preference for US equities, while still in place, was indirectly reduced. As long as the music is playing, we should keep dancing.

[Fabrizio Quirighetti](#)



Economic backdrop in a nutshell and global economic review

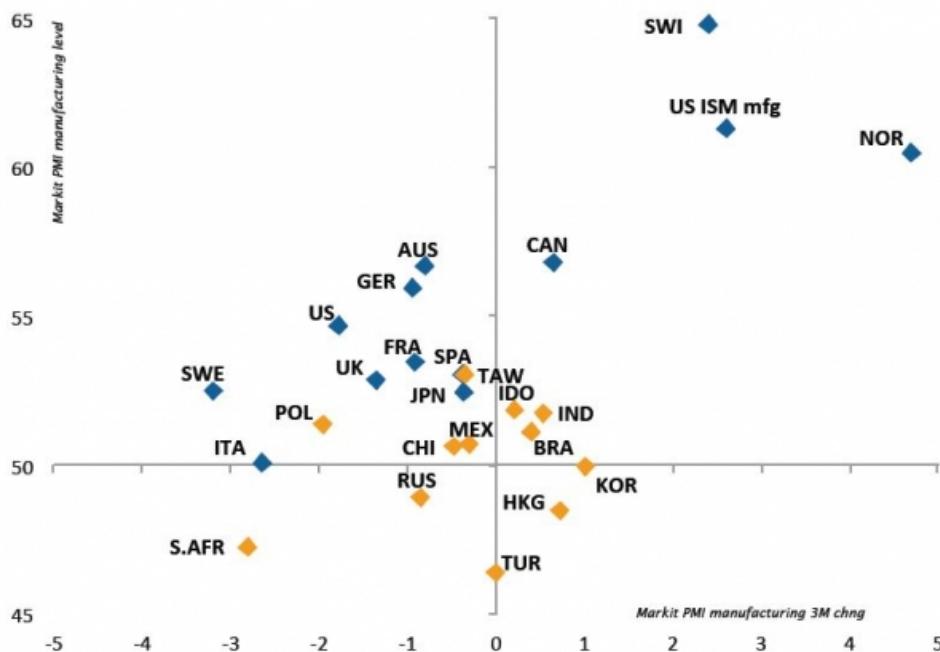
The global economy is entering Q4 in a situation of 'unstable stabilisation'. Several of this summer's concerns have gradually become less acute. Firm domestic demand in Europe is supporting economic activity, despite the continuing slowdown in export-oriented industrial sectors. Early signs of growth stabilisation in China, yet to be confirmed, have appeared, suggesting monetary and fiscal stimulus are gradually percolating through to the economy. While the end result of the ongoing US-China trade war, Brexit negotiations and of Italian government fiscal policy can hardly be predicted, the risks linked to these three issues are now better known and priced in by financial markets. Argentina's negotiations for IMF support have helped to stem the peso's fall, while a sizeable – if belated – rate hike by the Central Bank of Turkey has finally put a floor under the price of Turkish assets. These developments are welcome news after a particularly volatile summer.

Heading into autumn, these circumstances allow financial markets to refocus on ongoing monetary policy normalisation in the US and the phasing out of QE in the eurozone. However, most of the issues from the past few months are not definitely settled and might come back to haunt investors in the near future. Investors should also beware of the US political agenda, as mid-term elections could potentially undermine Trumponomics, which have been so favourable to US equities and the dollar. Recent market stabilisation may therefore not endure.

Growth

Growth divergences witnessed so far this year between the US economy and the rest of the world – with Europe and China leading the pack – is no longer widening. This means global growth should settle at a positive-yet-softer expansion pace.

Growth dynamics soften in EMs and stabilise in Europe



Source

SYZ Asset Management. Data as at: 20 September 2018

Inflation

Inflation continues to be on a very mild upward trend across developed markets, fueled by a mix of wage growth – which provides retailers a measure of pricing power – and rising energy prices. Foreign exchange remains the main determinant of emerging market (EM) inflation dynamics.

Monetary policy stance

Generally speaking, monetary policy is becoming less supportive across the globe, as the US normalises rates and several large EM central banks reverse course. However, a few key economic areas continue to enjoy accommodative financing conditions, such as Europe, Japan and China.

Developed economies

While US data keeps painting a fairly strong growth backdrop, early signs suggest economic momentum is somewhat softening. By no means is this a total growth slowdown – fiscal stimulus and low unemployment still support domestic demand. But the odds of further acceleration, or sustained expansion at a 4% annualised rate, are limited. Still, it is enough for the Fed to keep its policy normalisation going for the moment.

In the eurozone, cyclical headwinds, including global trade tensions and soft China growth still weigh on industrial sectors. However, robust domestic demand allows for stabilisation in the service sector, with the notable exception of Italy, where political uncertainty is dampening economic momentum. In this context, the ECB has confirmed its intention to phase out QE in Q4, while acknowledging downside risks to the outlook have 'gained more prominence recently'. Uncertainty is also the name of the game in the UK, where Brexit negotiations appear stalled even though the deadline for reaching a deal is fast approaching.

Natural disasters may temporarily affect economic activity in Japan, but underlying growth dynamics remain positive, supported by sustained domestic demand and yen depreciation, benefitting exports.

Emerging economies

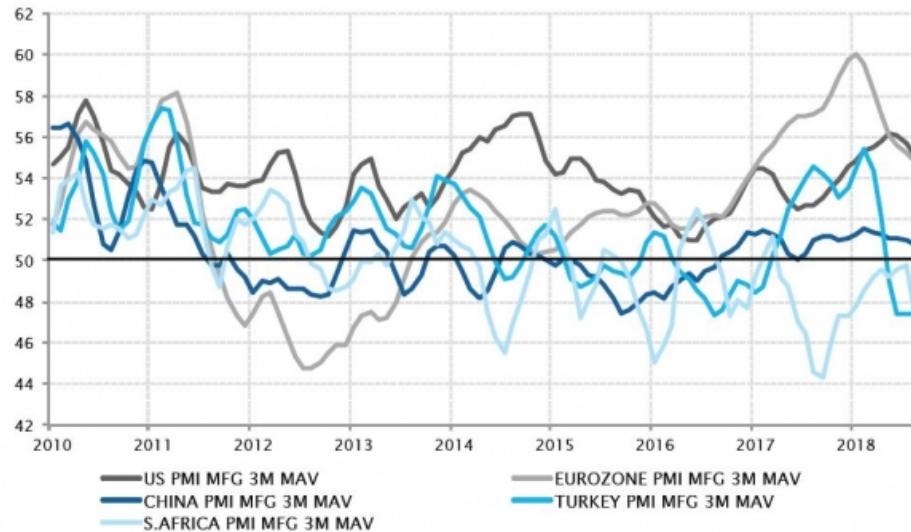
Softer growth momentum and more restrictive monetary policies have spread to the majority of the emerging world.

This is obvious in Turkey, Argentina and South Africa. Currency routs in a context of large current account deficits have prompted central banks to switch to a hawkish stance and public spending has had to be cut back, which immediately impacted economic confidence and activity negatively.

Aside from these basket cases, the softer growth environment in China also affects business cycle dynamics across the EM world. Associated downward pressures on EM currencies forced several central banks to tighten monetary policy in order to contain inflationary pressures. However, Chinese fiscal and monetary policy stimulus is expected to ultimately support growth and help stabilise the EM complex.

Adrien Pichoud

Recession in Turkey, South Africa and Argentina, China still slowing down



Source

Factset, SYZ Asset Management. Data as at: 20 September 2018

Asset valuation & investment strategy group review

Risk and duration

The economic backdrop remains supportive and valuations have not deteriorated. At the margins, they have improved in the euro area, with tangible signs of activity stabilisation in Europe.

At the same time, some emerging market central banks are taking necessary steps – the Central Bank of Turkey for example hiked more than expected – and we believe the US dollar will not get much stronger than current levels. We also expect an improvement in Chinese activity, which should provide additional support to riskier assets. Hence, there was no change in our risk assessment, which was kept at a 'preference'.

On the duration front, while we believe it is premature to increase duration, we are not overly concerned, as long as rates increase at the same time as nominal growth improvement. As a result, the duration score remained at a 'mild disinclination'.

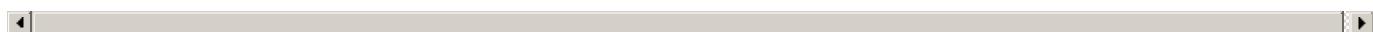
Equity markets

We made a few changes to our equity allocation. First, we upgraded both Japan and the eurozone to a 'mild preference', hence reducing indirectly the relative preference towards US equities. On a sectorial allocation, in Europe, we upgraded financials and continue to favour energy and pharmaceuticals, while in the US, energy and industrials remain our preferred sectors.

We are of the view there is some catch-up potential for these markets and sectors in a context of improving macroeconomics in the rest of the world and overall higher developed market rates. Going forward, we do not believe US equities will rally much further. The US will not be the main beneficiary of the economic recovery or rebound coming through in the rest of the world. Nevertheless, US markets remain the best risk-adjusted investment within the equity world.

In the emerging markets space, we continue to monitor China for an eventual upgrade – it now sits at a 'mild preference'. We are waiting for a catalyst to lift headline clouds on Chinese equities and for the result of increased domestic stimuli to potentially offset trade concerns – which are starting to be overdone.

Finally, we downgraded UK equities to a 'mild disinclination' as volatility increases in the final rounds of Brexit negotiations. We fear the pound and the UK equity market could evolve in tandem – this is a binary risk we are not willing to take.



« US markets remain the best risk-adjusted investment in the equity space but some more value can be found in Japanese and eurozone equities. »

— Maurice Harari

Senior Portfolio Manager



Bond markets

In terms of the bond asset allocation, no changes were made in the last two months, following this summer's investment grade credit upgrade to a 'mild disinclination' – with high yield still at a 'disinclination'.

We still prefer nominal government bonds – at a 'mild preference' – versus inflation-linked bonds or 'linkers' – at a 'mild disinclination' – because of their valuation dynamics and of the supportive economic backdrop. Real rates should increase as developed central banks end their quantitative easing programmes and start normalising rates without much inflation acceleration.

Japan and Germany were both upgraded by one notch to a 'disinclination' and a 'mild disinclination' respectively, as they are now competing with US treasuries – hedged in base currencies.

In emerging markets, we are still overweight foreign currency debt – at a 'mild preference' – over local debt – at a 'mild disinclination'.

Forex, alternatives and cash

There was no change in assessment this month. We are keeping our 'mild preference' for the euro and the Japanese yen over the US dollar.

Maurice Harari

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