MORNING NEWSLETTER

October 2018

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01

World economy – Loss of global economic momentum

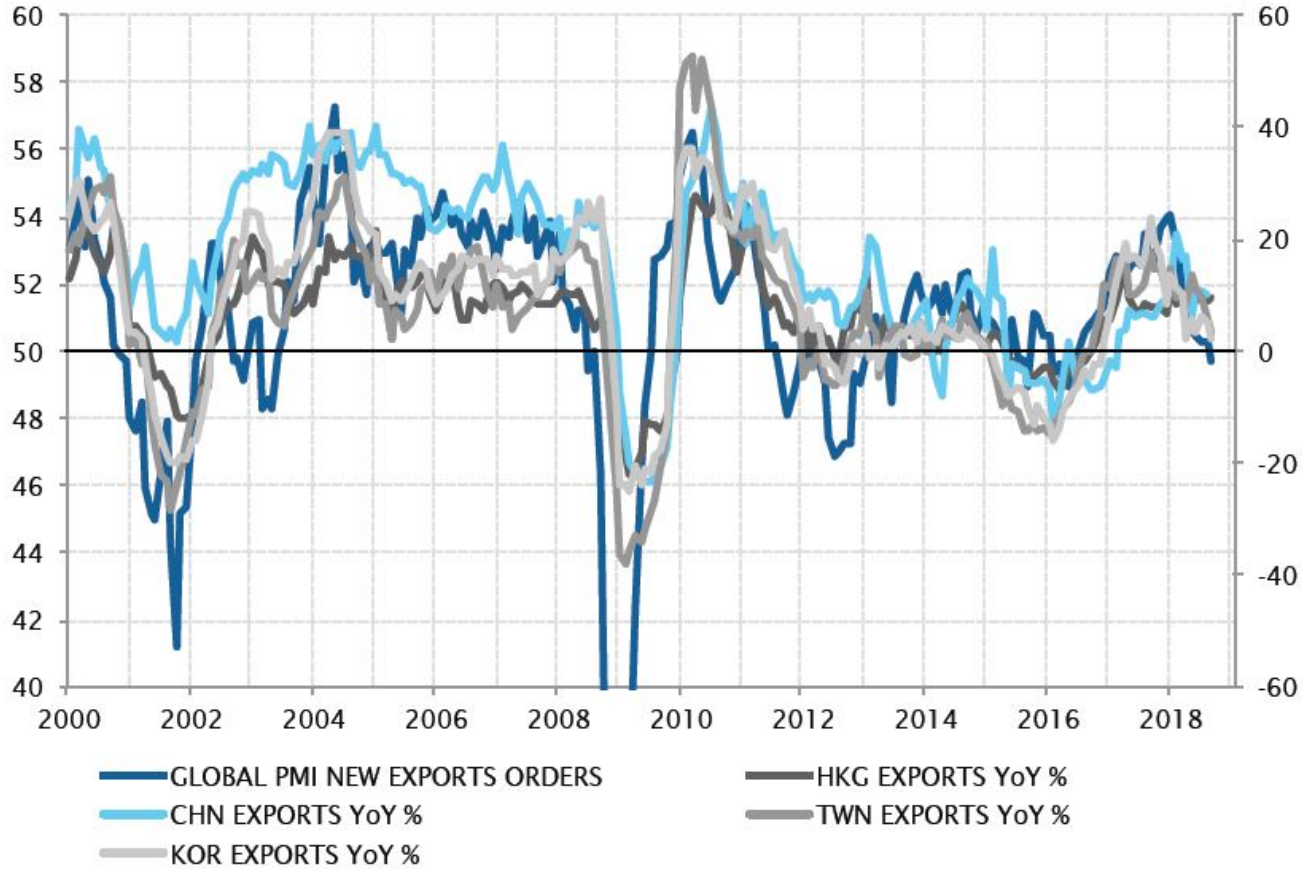
Was 2017 the peak of post-GFC global growth momentum? The synchronised growth acceleration witnessed last year gave way to a more heterogeneous and softer growth dynamic as protectionism, monetary policy divergences between the US and the rest of the world and higher oil prices combined to weigh on global macroeconomic momentum.

This dynamic has been especially visible in the most cyclical sectors of the economy. After hitting a seven-year high in January, new manufacturing orders consistently declined and fell into contraction territory in September. Growth in East-Asian country exports slowed in parallel amid softer Chinese demand and US tariffs.

In such a context, the IMF's downward revision in growth forecasts came as no surprise. It now expects world GDP to plateau at 3.7% this year and next, around levels reached in 2017, instead of accelerating towards 4%. Softer growth projections for Europe and emerging markets warranted this adjustment.

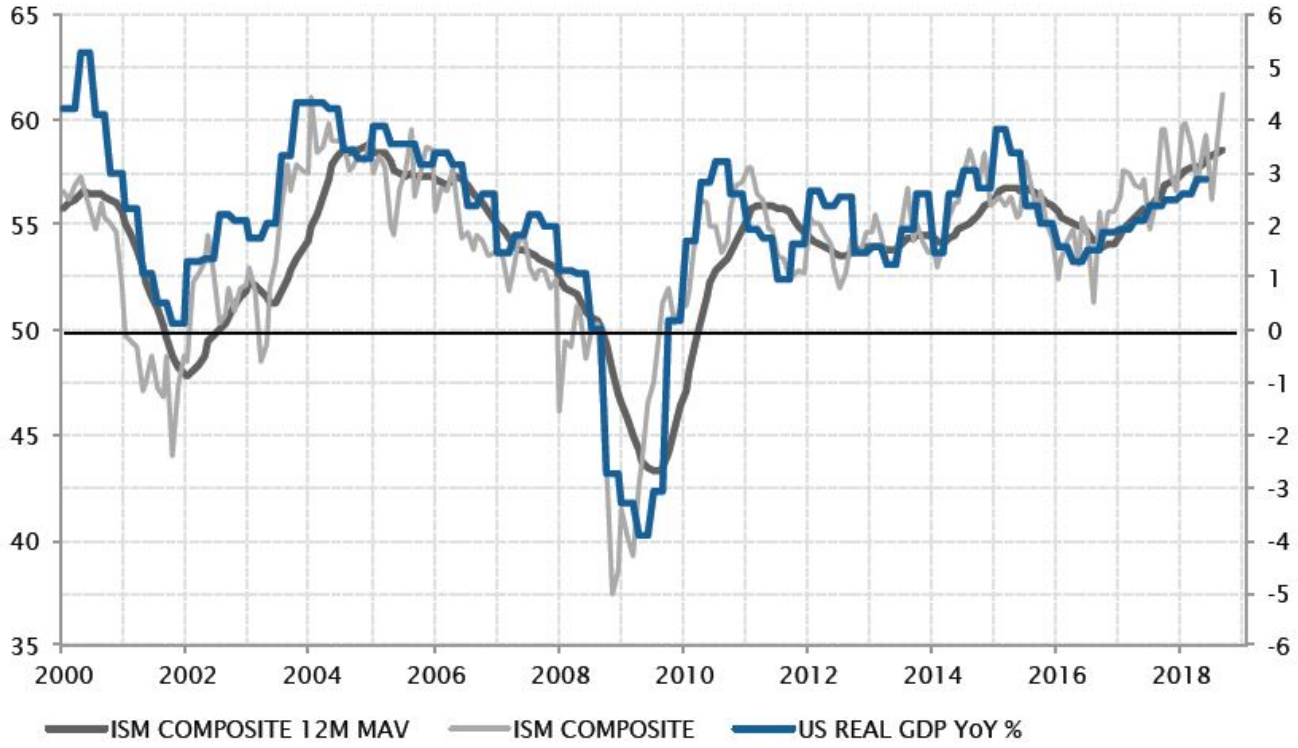
2018 witnessed a significant slowdown in global cyclical momentum

Sources: Factset, SYZ Asset Management. Data as at: 01 October 2018



Ever stronger growth in the US ahead of midterm elections

Sources: Factset, SYZ Asset Management. Data as at: 01 October 2018



02

US – The economy keeps accelerating ahead of midterm elections

Amid a softer global growth environment, the US economy continues to stand out and deliver strong and above-expectations economic data. The latest monthly indicators of activity in the manufacturing and service sectors indeed show an ongoing expansion at – or possibly above – the previous decade's peak, consistent with the 4% annualised GDP growth seen in Q3 and the 4.2% growth in Q2. This dynamic was particularly impressive in the domestically-oriented service sector, where employment growth jumped to unprecedented levels.

The US is therefore growing at roughly twice its long-term potential growth rate, with Trump's fiscal easing having turbocharged an economy which was already enjoying a low unemployment rate. The world's largest economy will post the strongest growth out of all major developed economies this year. It is expected to slow down into next year, as the fiscal sugar rush wanes and assuming no further tax cuts are enacted. The question now is whether Trump and the Republicans will get credit for this outperformance in the upcoming midterm elections.

03

US – The Fed gets closer to the end of the hiking cycle

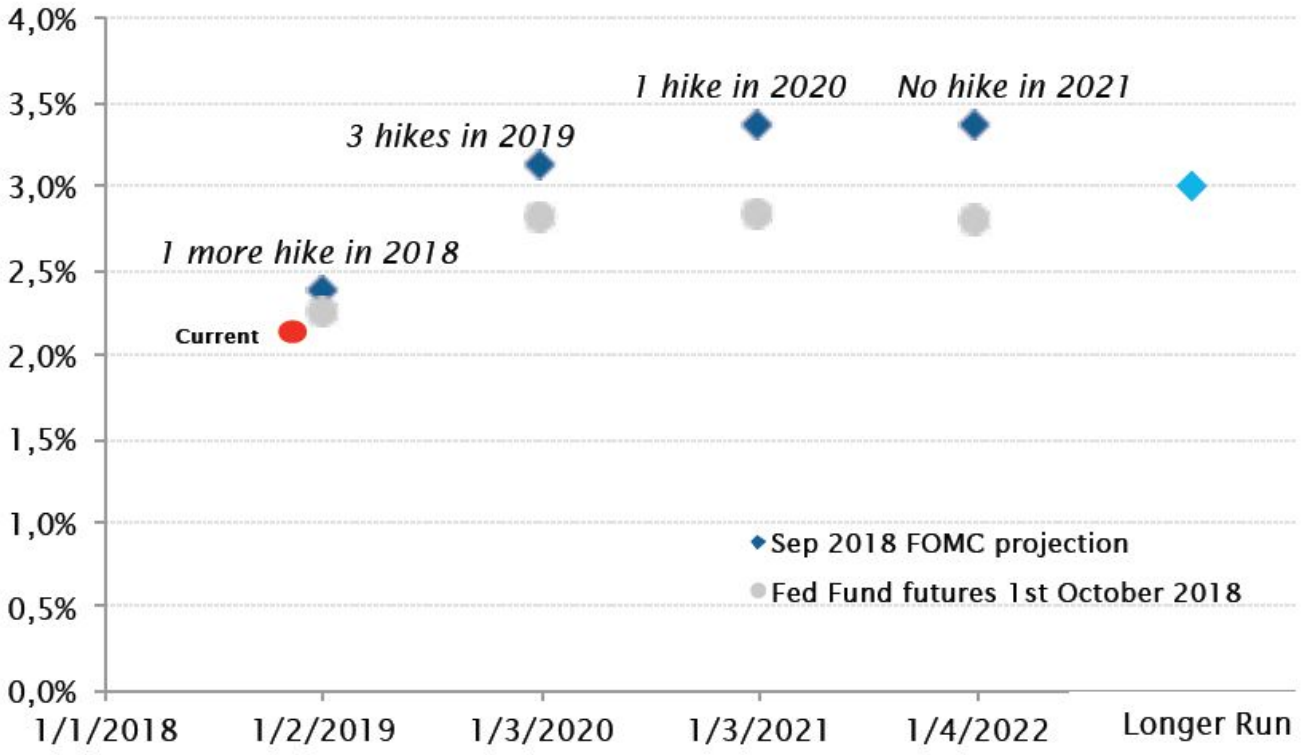
As widely expected, the Federal Reserve raised its key short-term rate by 25bps in September to 2.25% – the highest level seen in more than ten years. The central bank also reaffirmed plans for the future of its monetary policy path, implying one additional 25bps hike in December, three 25bps hikes in 2019 and then one 25bps hike in 2020.

The extension of the rate hike cycle appears fully warranted in the short run, given the current strong US growth dynamic. However, the Fed's rate projections beyond 2019 may contain the most important piece of information for investors. The fact the Fed essentially projects an end of the rate hike cycle at 3.25% in 2020 – only 25bps above its estimate of the neutral long-term rate – implies most of the rate normalisation has already been achieved.

Noticeably, future contracts already price in the December 2018 hike and most of the hikes expected in 2019. Unlike a few years ago, the Fed and the market agree on rate trajectory. It will keep going up for a bit, but we are not far from the end of the cycle.

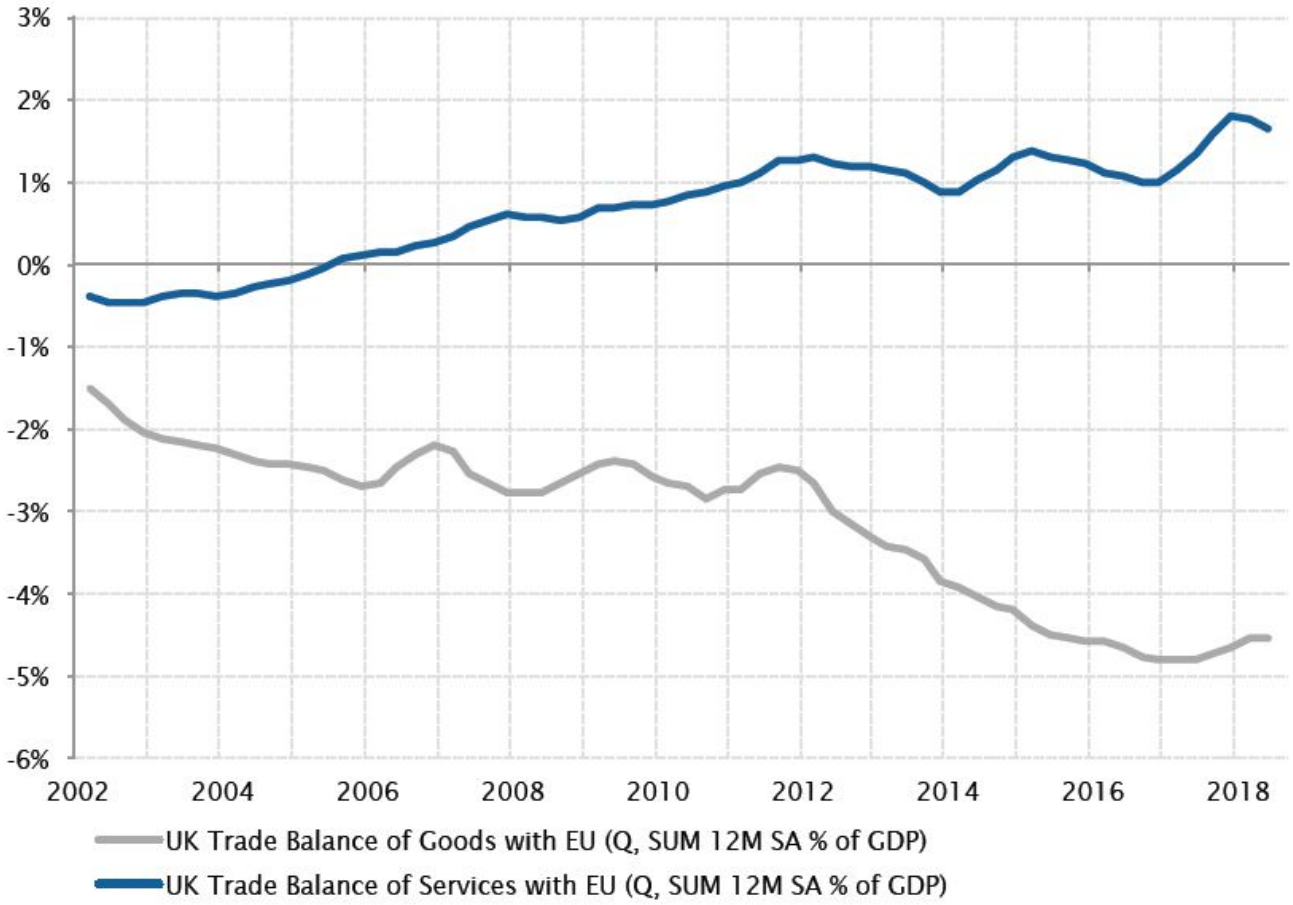
A few more hikes and then it's over?

Sources: Federal Reserve, Bloomberg, SYZ Asset Management. Data as at: 01 October 2018



Both the EU and the UK will suffer in a no-deal Brexit

Sources: Factset, SYZ Asset Management. Data as at: 01 October 2018



04

UK – Will economic reason overcome political antagonism in Brexit negotiations?

As the formal date set for Brexit nears, negotiations are entering the last stretch. In order to avoid a no-deal Brexit, an agreement must be found by mid-December in order to ensure approval by the British Parliament.

The Irish border issue appears to be the Gordian Knot of Brexit, as it epitomises the issues at stake. How can the UK preserve smooth trading of goods while formally exiting the EU and its founding principles of free movement of goods, capital, services and people?

If most of the focus is on the British side of the negotiation table, the dilemma is no lighter for the EU, as compromising on its principles would open a dangerous Pandora's Box. A sudden stop in the trading of goods and services between the two blocks would likely hurt not only the UK, given its current trade surplus with the EU in financial services, but also the EU, given its large trade surplus in goods with the UK.

If the two positions appear irreconcilable at the political level, the convergence of interests at the economic level is what keeps negotiations going and suggests some form of agreement is ultimately more likely than not. However, this will probably come at the price of high-wire political contortions, orchestrated drama on both sides and not before the eleventh hour.

05

Italy – A politically-motivated breach of EU fiscal rules

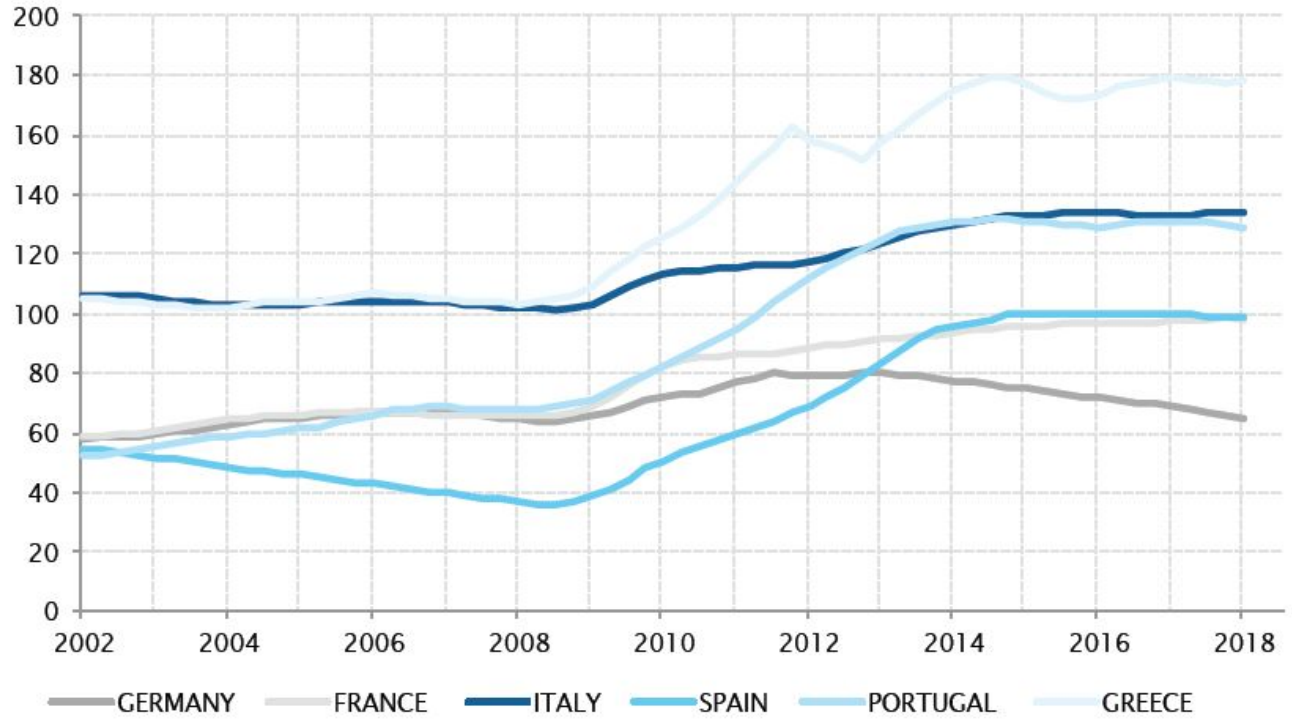
Plot twist or not? For weeks, the Italian finance minister Tria had repetedly signalled a 2019 budget deficit of 1.6% of GDP. This level, in line with the European Commission's recommendation, would have maintained an inversion of the public debt trajectory. All of a sudden, a draft budget was instead released with a deficit of 2.4% of GDP, ostensibly breaking the EU fiscal framework.

Two things are at stake here. The first is hardly debatable. Italy has the world's fourth largest absolute amount of public debt, behind the US, Japan and China. It also now runs the second-highest debt-to-GDP ratio in the eurozone – at above 130% – second only to Greece. This ratio keeps drifting higher, even though GDP growth has been mildly positive in the past five years. Fiscal restraint is therefore required for Italy to curve the trajectory of the debt-to-GDP ratio downwards, as Spain or Portugal have done.

The other important aspect of this budget proposal is the openly-stated willingness of Salvini and Di Maio to challenge the European Union, not only on its set of fiscal rules but also on its broader role, from social to immigration issues. In this respect, their decision not to respect fiscal constraints was much more of a political decision than an economic one.

Italy's debt trajectory has yet to be curved down

Sources: Factset, SYZ Asset Management. Data as at: 01 October 2018



French consumer confidence hits lowest point since April 2016

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



06

France – Consumer confidence continues to deteriorate

French consumer confidence disappointed in September, falling by two points to 94, below the long-term average of 100 and consensus expectations of 97. One driver of this fall was the future living standards component, which lost seven points in September, underlying household concerns about the economic situation in twelve months' time.

Consumer confidence surged in May 2017, following Emmanuel Macron's election. The gauge started to decline meaningfully this year, losing ten points and reaching its lowest point in more than two years. The decline in confidence was concomitant with the deterioration of President Macron's approval ratings, which are currently at record lows.

However, consumer confidence could recover in the following months, on the back of the €6bn tax cut for households recently announced by the government in the 2019 budget proposal.

07

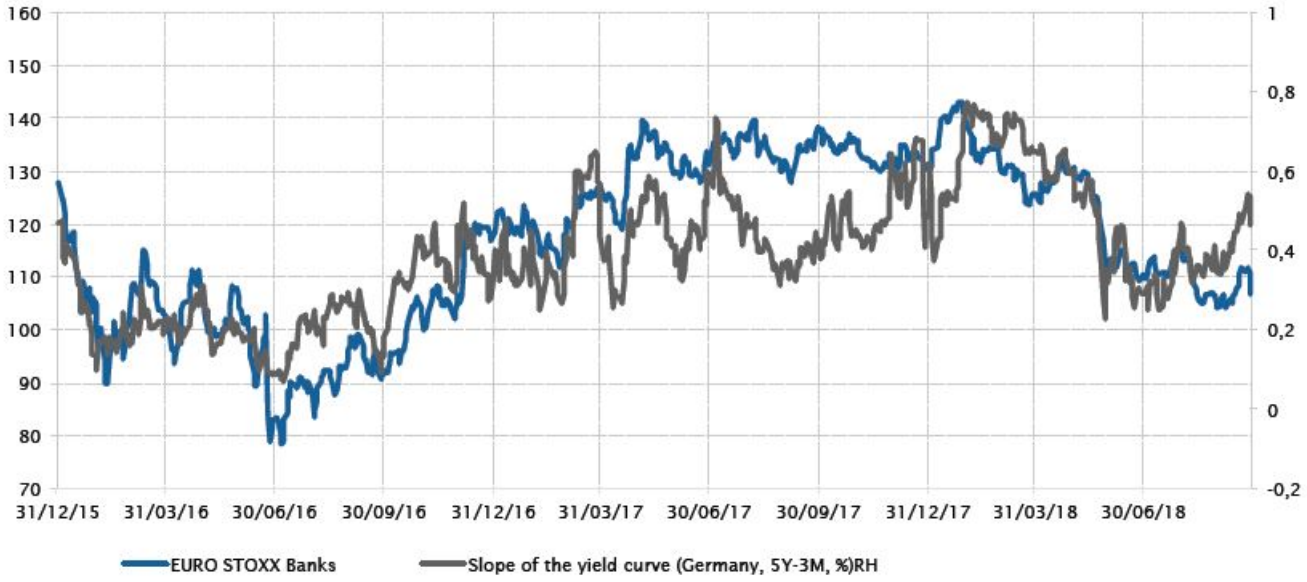
Equities – European banks and German yield curve correlation

In September, European banks outperformed the broad European equity index by 2.0%, but on a year-to-date basis, it is still the worst sector, underperforming by 15.5%. On the other hand, the German yield curve representing the difference between 5-year and 3-month maturity has steepened by 35bps in September.

Bank earnings in Europe are close to three times inferior to what they used to be before 2008. With a flat yield curve making it difficult for banks to grow their net interest margin, not to mention the quantity of non-performing loans sitting on their balance sheets, bank earnings have been under pressure. In such a context, loan growth is positive, but it is growing at a subdued pace compared to the past, even if recently, non-performing loans have started to peak. In terms of money flow, institutional investors seem to be underweight banks.

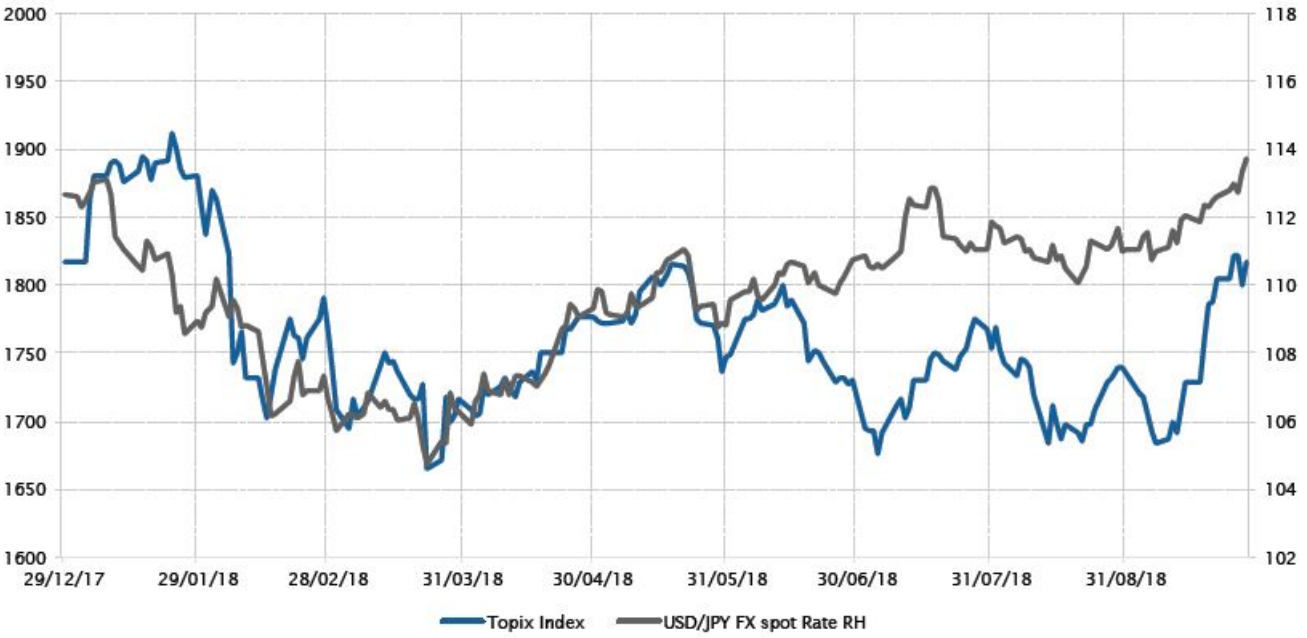
EURO STOXX Banks index evolution and German yield curve slope (5Y-3M in %)

Sources: Bloomberg, SYZ Asset Management. Data as at: 17 October 2018



Japanese equities (Topix) evolution vs. USD/JPX FX spot rate

Sources: Bloomberg, SYZ Asset Management. Data as at: 17 October 2018



08

Equities – Japanese equities strike new highs

The Japanese stock market has reached new highs since the month of May, following record closes on Wall Street.

In September, Japanese equities represented by the Topix bounced by 4.7% while their US and European counterparts were flattish. At the same time, the Japanese yen sold off by 2.3% last month against the US dollar, contributing to Topix outperformance. Historically, the Japanese market outperforms when the yen is weakening.

On the macroeconomic side, recent natural disasters may have temporarily affected economic activity in Japan but the underlying growth dynamic remains positive, supported by sustained domestic demand and yen depreciation benefitting exports.

Abenomics brought about by Prime Minister Shinzo Abe since 2012, mainly through monetary easing, fiscal stimulus and structural reforms, remain in place but the economy has yet to hit the 2% inflation target.

09

Equities – Choppy road for Tesla stock price

The Tesla saga kept investors on their toes as Elon Musk created a lot of noise around the company and its stock price. It all started when the CEO of the electric car company announced in a now infamous tweet he would take his company private at $420 per share and that ‘funding secured’ implied he had the backing of powerful investors.

As the story unfolded, it appeared funding was not secured and the $420 share price was a reference to marijuana made to please Musk’s girlfriend. The US Securities and Exchange Commission (SEC) sued Elon Musk for false and misleading statements and settled with him at the end of the month, closing the summer saga.

Under the current deal with the SEC, Musk must pay a $20m fine and will step down for three years as chairman of the board but will remain CEO.

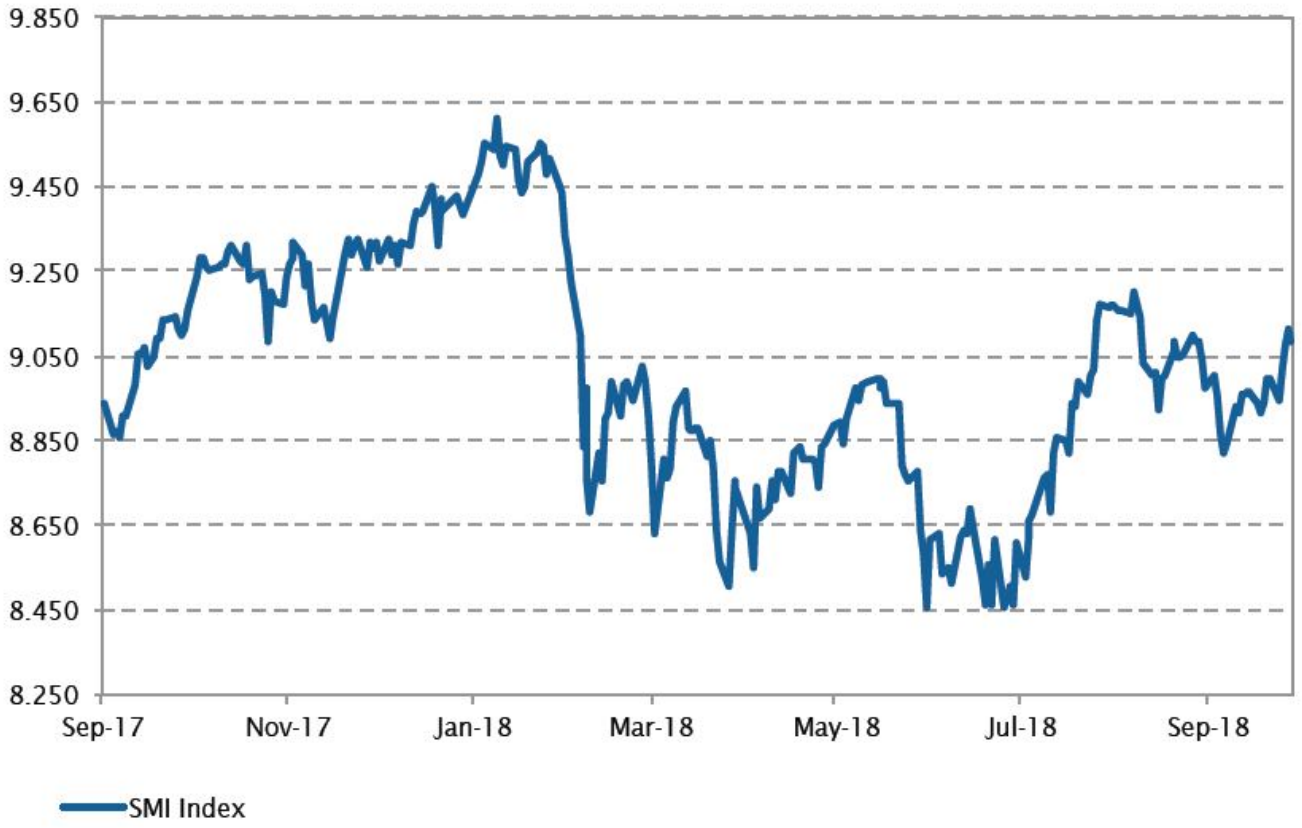
Roller coaster for electric car maker Tesla

Sources: BBG, SYZ Asset Management. Data as at: 28 September 2018



No impact on the Swiss market for now

Sources: BBG, SYZ Asset Management. Data as at: 28 September 2018



Equities – Switzerland in difficult talks with the EU

Brexit is not the only difficult negotiation currently being conducted with the EU. Less mainstream than Brexit but just as crucial for the country involved, Switzerland is holding tough talks with the EU over a ‘framework agreement’. At this stage, it appears the EU is highly determined to impose its will on Switzerland, probably as a way to show its strong hand to the UK.

Among the points discussed with the EU lies a crucial one for Switzerland, the functioning of its stock market or SIX Swiss Exchange located in Zürich. Switzerland is trying to obtain an extension of its equivalence status under the MiFID II regime, which would allow EU-based traders to continue buying and selling Swiss stocks on SIX without any problems. Without this equivalence, traders are in the dark on the future of trading Swiss names. The worst case scenario is trade volumes will strongly decrease, which will bring with it a host of negative implications.

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