

Our monthly view on asset allocation (March 2019)

Thursday, 03/14/2019

Markets and asset prices continued to trend positively, supported by monetary policies that shifted from a tentative normalization trend to neutral with a dovish bias. Our global risk sentiment remains that of mild disinclination as we believe that the market rally has gone too far too fast. Within this context our equity preference is at mild disinclination, while we downgraded bonds to the same level as valuations continued to deteriorate. In overall, our portfolios positioning is characterized by a cautious neutral stance.



Fabrizio Quirighetti

Macroeconomic
Strategist



Maurice Harari

Senior Portfolio Manager



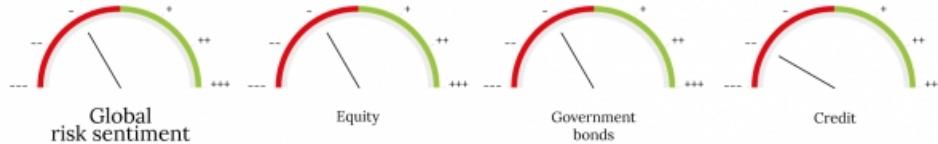
Adrien Pichoud

Chief Economist & Senior Portfolio
Manager



Luc Filip

Head of Discretionary Portfolio Management



Beware of avalanche hazard

In Switzerland, February is usually the time when families head off to the mountains for a week of skiing. This year, we were particularly lucky. There was a profusion of snow and near-perfect weather conditions over the children's holidays. The warm afternoons were nap-inducing, after a well-deserved meal on a scenic terrace. Who doesn't dream of a beautiful sunny day skiing in the crisp mountain air? With fresh powdery snow, this may come quite close to paradise. Unfortunately, however, every year, snow avalanches cause many accidents, ruining the lives of such blissful families.

The current market environment is reminiscent of both the good and bad memories associated with skiing. Valuations improved at the end of last year, finally giving investors some fresh powder to ski on. Weather conditions were cleared by the Federal Reserve's U-turn and reinforced by dovish stances in other developed markets. With no inflationary clouds on the horizon, we enjoyed a smooth ride through financial markets year-to-date. While we may regret not having benefitted more from the last two months of this smooth journey, now is not the time to try and extend the experience. This would only increase the risks and potential difficulties ahead. Avalanche hazards are mounting as the snow crust becomes less stable. In other words, valuations are less appealing because central bank reassurances have led, once again, to exaggerations and crowded trades. How can \$8-9trn of government debt with negative yield be justified, if not through financial repression by the central banks?

The current market rally has gone too far too fast. Being aware of the rising avalanche risk, we are keeping a cautiously neutral stance in our portfolios. We took some profits and implemented hedges through options strategies on the equity side, as well as on the fixed income side. Even gold's appeal now seems tactically less shiny. It's definitely time for a pause on a sunny terrace.

Fabrizio Quirighetti

Economic backdrop in a nutshell and global economic review

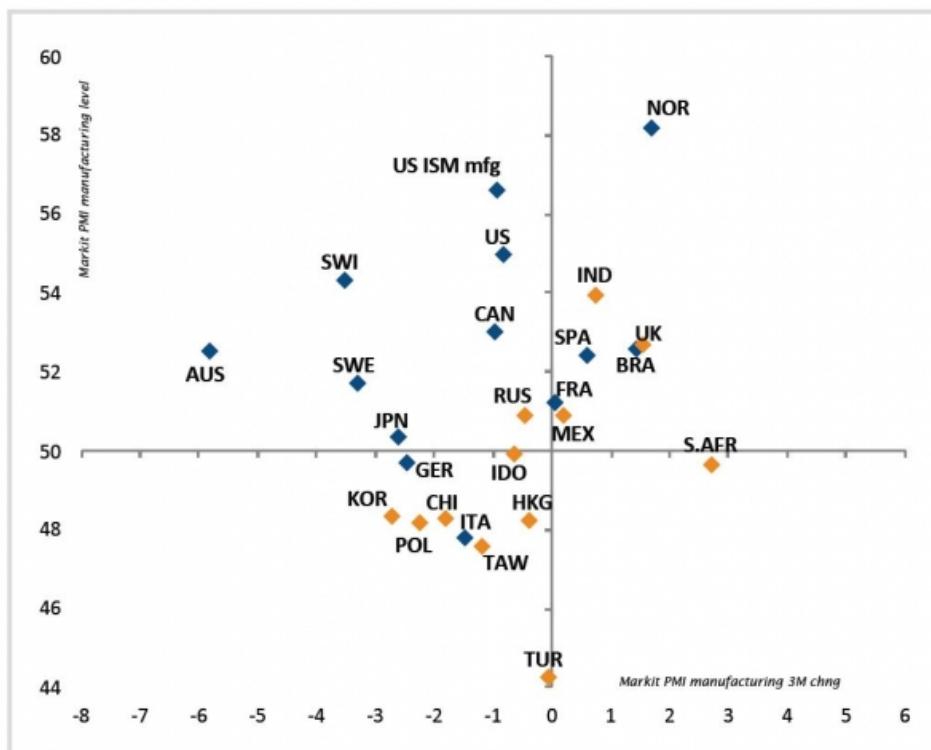
The upbeat investor sentiment witnessed so far in 2019 has essentially been fuelled by an unsustainable macroeconomic mix. The downward growth trend at play at the end of last year has continued, which is hardly good news per se. However, combined with the absence of inflationary pressures, this has led developed central banks to completely put aside considerations of monetary policy tightening, with the Federal Reserve, European Central Bank and Bank of Japan all signalling their readiness to ease monetary policy if necessary. This represents quite a remarkable U-turn from the Fed, which was still raising rate two months ago, and from the ECB and BoJ, which still have short-term rates in negative territory.

The global economy has now reached a crossroads. Either the combination of central bank support, domestic demand and the gradual dissipation of external risks will allow for growth to eventually stabilise; or the slowing trend will extend, and a recession will become a much more tangible threat. In the latter case, monetary policy easing might not be sufficient to maintain the 'feel good' market sentiment. In the former, central banks may drop their dovish stances as fast as they adopted them. We continue to believe the constructive growth scenario will prevail, but are bearing in mind such an outcome also implies less support – explicitly or implicitly – from central banks.

Growth

Global growth is still slowing, due to softer dynamics in developed economies. Some emerging economies are recovering and exhibit positive momentum. However, to be sustained, this trend requires positive growth in the main developed economies and a benign USD FX, as well as monetary policy developments.

Global growth momentum keeps slowing



Source

SYZ Asset Management. Data as of: 20 February 2019

Inflation

Inflation dynamics remain muted across the developed world, as slowing demand stifles the potential impact of tentative upward wage pressures. FX trends remain the main drivers of inflation dynamics in emerging countries.

Monetary policy stance

The general monetary policy outlook for developed economy central banks has swiftly drifted from a tentative normalisation trend – of varying time horizons – to a neutral stance with a dovish bias. By reducing upward pressures on the US dollar, this also provides relief to EM central banks, which had been forced into a restrictive stance by the Fed's monetary policy.

Developed economies

US economic indicators have been quite volatile and 'all over the place' recently, but generally point to a slowing growth rate. The combination of fading fiscal stimulus and the impact of the shutdown may explain this. More broadly, however, the balance of risks around the US growth outlook has tilted towards the downside – particularly in the current context of softening global growth. This explains the brisk inflection of the Fed's tone towards a clearly dovish stance.

In the eurozone, continuingly lower activity and confidence indices are also forcing the ECB towards an even more accommodative stance, especially as core inflation remains stubbornly stuck around 1%, despite rising wages. Germany narrowly avoided a technical recession in Q4, but failed to grow for a second consecutive quarter, and Italy effectively recorded its third recession in ten years. Fundamentals for domestic demand continue to suggest growth should pick up and remain positive for the monetary union as a whole. But the safety margin between stabilisation and a full-blown recession in Europe is now very thin. A hard Brexit scenario may have been the straw to break the camel's back, but recent developments suggest the UK Parliament, divided as it may be, is above all determined to avoid this outcome.

Ahead of the VAT rate hike due later this year, the Japanese economy is experiencing headwinds from softer global growth and uncertainties around the China trade outlook. This has led the BoJ, in the wake of the Fed and the ECB, to reassess its options and explicitly remind investors it stands ready to provide more accommodation if needed.

« We continue to believe that a constructive growth scenario will prevail, but bear in mind such an outcome will imply less support from central banks. »

— **Adrien Pichoud**
Chief Economist & Senior Portfolio Manager



Emerging economies

The stabilisation of Chinese macroeconomic data has long been expected and is key for global growth to regain its footing. In this respect, tentatively encouraging signs have appeared since the beginning of the year, with rising exports, a take-off in domestic lending and rebounding activity indices. On top of the prospect for a deal to emerge out of US/China trade negotiations, this data gives credit to the hypothesis that fiscal and monetary policy easing is finally putting a floor under the GDP growth slowdown. This would bring relief to the whole South East Asia area, which has clearly been affected by China's slowdown and uncertainties around trade.

The two Latin American giants, Brazil and Mexico, are experiencing encouraging growth dynamics, fuelled by optimism around the impact of their new presidents' expected policies. Nevertheless, the two differ quite strongly in their focus and approach. The election of Mr Bolsonaro in Brazil triggered hopes of long overdue structural reforms, which support business investment, while AMLO's election in Mexico appealed to households through promises of higher minimum wages.

The drop in oil prices seen in Q4 2018 is now weighing on Russia's economic indicators, but the rise of inflation to a two-year high is keeping the central bank in a restrictive mode.

Adrien Pichoud



Inflation (CPI YoY) in the US, Eurozone, UK and China

Central banks have become dovish due to slowing growth and inflation



Source

Factset, SYZ Asset Management. Data as of: 20 February 2019

Asset valuation & investment strategy group review

Risk and duration

Markets and asset prices are once again supported by accommodative monetary policies. The central bank put is back in place, following the Federal Reserve's U-turn, but the current situation cannot last forever. Either global growth will bounce back, in which case we may start increasing our risk stance and lowering duration, or if the opposite happens, with growth decelerating further, we would look to increase duration and lower our risk exposure.

While we envisage a favourable scenario, with growth stabilising in the second half of 2019, we are not convinced radical change will come in the near term. Given rich valuations and ongoing political uncertainties, we have therefore kept risk at a 'mild disinclination'.

We believe the rally in equity markets will soon be capped – on one hand by Fed hikes, if activity improves, and on the other hand by worries over growth, even if the Fed resumes cutting rates.

Given the strong gains we have made so far, it is time to implement 'cheap' and asymmetric protections to start consolidating our year-to-date positive performance.

We still have no sectoral bias, but we continue to favour high quality dividend stocks that offer attractive carry. They should be less volatile than the rest of the equity market and we also prefer them to credit.

On the duration front, we kept our stance unchanged from last month at a 'mild disinclination'. Bonds now have limited upside, as rates have reached historically low levels again – especially in Europe, where valuations are expensive. However, it is worth having some duration in the portfolios, to balance risk.

In addition, the macro dynamic is still losing strength and the pause in monetary policy normalisation does not support a significant increase in rates. Tactically, rates could spike towards 3% for the US 10-year treasury and to 0.5% for the German 10-year bund if economic growth momentum rebounds rapidly, but this is not our base case at the moment.

« We will not run after the rally and are keeping our risk stance at a 'mild disinclination'. Equity performances could soon be capped by less accommodative monetary policy, especially in the United States. »

— Maurice Harari
Senior Portfolio Manager



Equity markets

We maintained our relative preference for US over eurozone equities, even though the equity risk premium for the US became less attractive and earnings revisions are slowing. In a fragile environment, we still favour their resilience and defensive characteristics compared to eurozone equities.

We also prefer the United Kingdom and Switzerland over the eurozone – despite 'very cheap' valuations in Germany – in the absence of sufficient 'buy' triggers and with ongoing trade tariff risk weighing on the European automobile industry. In the case of a general election in the United Kingdom, we would immediately consider downgrading UK equities.

In the emerging markets space, we prefer Asia – with the exception of India – and Russia over Latin America and South Africa, for valuation reasons.

There could also be a strong structural 'bullish call' for Brazilian assets – both bonds and equities – if reforms, especially those concerning pensions, are voted and applied by Congress. For the time being, we hold Brazilian equities at a 'mild disinclination', following the strong rally and taking into account stretched valuations.

Even if our stance has not changed, on the margin, we are leaning towards reducing our allocation to Europe and adding to emerging markets – especially if we foresee positive news on the trade war front, as well as better Chinese economic data and a stable US dollar.

Bond markets

Nominal government bonds were downgraded to a 'mild disinclination' because valuations have deteriorated over recent months. They now have limited upside, as rates have fallen back to historically low levels. However, it is worth maintaining some duration in the portfolios to balance the overall risk. In addition, the macro dynamic is still losing strength and the pause in monetary policy normalisation does not support a significant increase in rates.

Real government bonds may be more interesting, as they should suffer less if the growth outlook stabilises or improves, and if inflation expectations edge up.

In the emerging markets debt space, hard currency bonds – especially denominated in euros – are still favoured over local currency on a valuation basis.

Forex, alternatives and cash

In terms of currency preferences, we still hold a 'mild preference' for the British pound and the Japanese yen against the greenback, given valuations. Gold continues to be at a 'mild preference' for its diversification characteristics in the current risk-off environment. The Swiss franc remains at a 'disinclination', with a European Central Bank that will probably err further on the dovish side than expected, indirectly keeping a lid on the franc, which is now benefiting less from its safe haven status.

Maurice Harari

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