

Our monthly view on asset allocation (May 2019)

Thursday, 05/16/2019

Markets continued to be supported by the goldilocks markets environment, where central banks remain dovish, growth is decent and there are no signs of inflationary pressures. Despite this positive backdrop, our equity and bond preferences are unchanged at mild disinclination as valuations are becoming less attractive and subsequently the upside potential is limited. Our overall portfolio positioning is cautious, which is reflected at our mild disinclination towards global risk sentiment and we continue to focus on carry, diversification and identifying growth stories.



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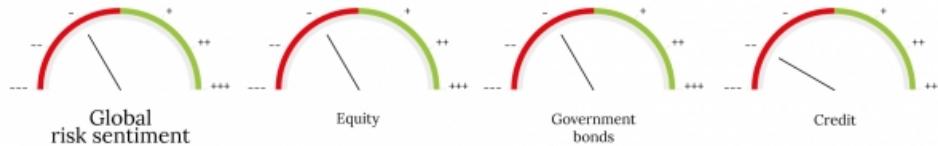
Maurice Harari

Senior Portfolio Manager



Luc Filip

Head of Discretionary Portfolio Management



May is here

The adage says, 'sell in May and go away'. But for most investors like us who weren't brave enough to add at the bottom, the fear of missing out (FOMO) has finally risen, like the White Walkers in Game of Thrones, from beneath the ice-cold bear market sentiment. Markets and asset prices are once again supported by a goldilocks context, which was reinforced by dovish central bank messages, decent growth prospects – evidenced by solid US job creation and signs of improvement in Chinese economic indicators – and still no signs of inflationary pressures following muted US wage growth and lower-than-expected CPI figures in Australia. While we acknowledge this scenario won't last forever, its end has likely been postponed by a few weeks or months.

It would seem legitimate to follow the crowd, raise our risk stance and add to equities, as the backdrop couldn't be more favourable. However, it could prove much wiser to resist this move. Overall valuations are no longer attractive enough and upside potential now appears quite limited. With US stocks having regained their losses from the end of last year and reached fresh highs, the exuberance of FOMO is shrinking confidence in the market's ability to keep climbing. In other words, the more White Walkers are on the ice because it seems rock-solid, the more cracks will start to appear. It also goes without saying, venturing out makes them an easier prey for the fire and fury of dragons – in this case, the bear market's revenge. As a result, we have preferred to tilt and tweak our equity allocation towards cyclical and away from defensives rather than significantly adding to it. The main risk of staying cautiously put is we could miss an important upward trend if equity markets enter a bubbling environment.

So, we humbly admit we should have been braver a few months ago, but it is not always easy or obvious to behave like a knight in shining armour. In any case, the bravest aren't always the ones who survive the longest – both in Game of Thrones and in financial markets.

—Fabrizio Quirighetti

Economic backdrop in a nutshell and global economic review

After several months of uncertainty, the prospects for global growth have finally started to improve. The Chinese economy is finally showing concrete signs of picking up, which is boosting emerging markets (EMs) as a whole. In a context where US growth is holding reasonably firm and the US dollar now has less upside potential, following the Federal Reserve's spectacular dovish U-turn, the macro environment for emerging economies has significantly improved, barring a few countries still plagued by the consequences of unorthodox economic policies, such as Turkey and Argentina.

This nascent favourable dynamic in the emerging world contrasts the ongoing cyclical softness displayed across developed economies. Industrial activity has been stalled in the eurozone since last year, with domestic consumption the only thing keeping GDP growth up and signs of a cyclical upturn yet to be seen. The US economy is also losing steam, partly due to the impact of softer global growth and trade tariff increases. But the main factor currently dampening US growth is the dissipation of fiscal stimulus, which should be seen as a logical development rather than a concerning sign of an imminent recession.

As a result, the combination of resilient domestic demand in developed markets (DMs), the end of Fed and ECB policy normalisation, pickup in China's growth dynamic, seemingly constructive US-China trade talks, a postponed Brexit and the tailwind of rising crude prices supports a constructive outlook for global growth over the coming months. Additionally, some of the downside risks which appeared in Q4 2018 have somewhat receded over the past few weeks.

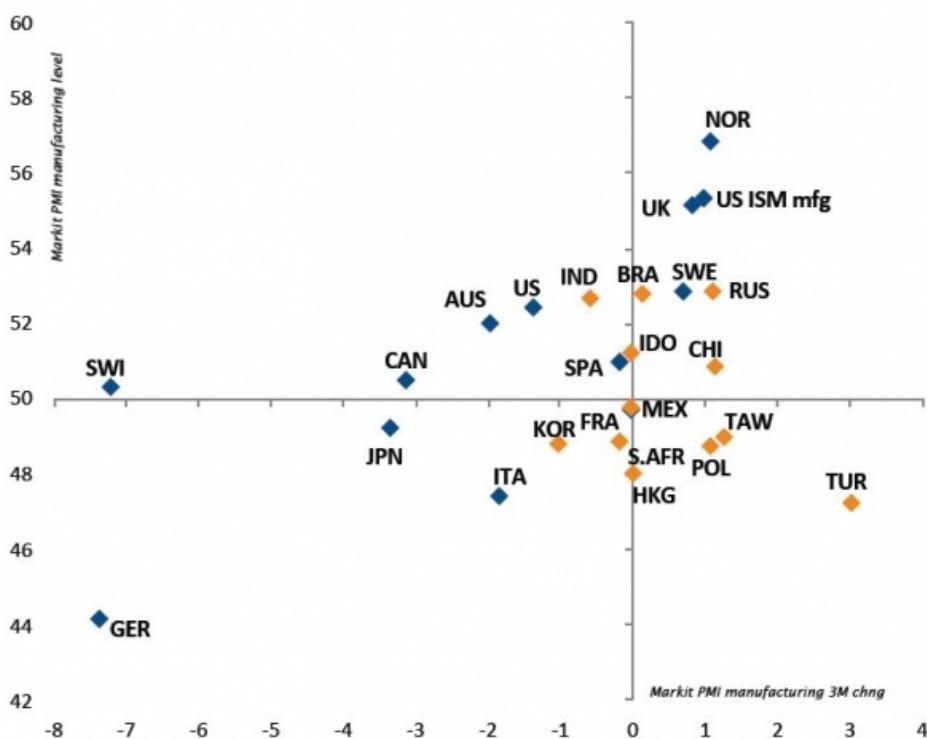
Growth

There are now clear divergences in terms of growth momentum between EM and DM economies. Within DMs, there are also stark differences between industrial export-related and domestic-related service sectors. Overall, the outlook remains constructive for global growth, with less perceived downside risks than a few months ago.

Inflation

Inflation remains subdued across the board and is even slowing down in DMs. The evolution of oil prices might bring some volatility to headline inflation indices in the months ahead.

EM growth dynamic improving in the wake of China



Source

SYZ Asset Management. Data as of: 11 April 2019

Monetary policy stance

All large DM central banks are now firmly following a neutral, generally accommodative stance, with no prospect for normalisation in the foreseeable future. Monetary policy should not be a headwind to global growth this year.

Global economic review

The US economy continues to experience a slowdown in growth momentum, bringing down its expansion rate towards its potential of about 2%. In a context of soft global dynamics and a flat USD yield curve, such a slowdown has raised concern around the risk of a more pronounced economic downturn. However, when taking into account the fading 2018 fiscal boost to investment and consumption, recent developments appear to be a logical 'soft landing' following a turbo-charged 2018. Drivers of domestic demand remain very supportive and, with the stability and visibility now provided on rates and financing conditions, the US economy should continue to expand at a very decent, albeit not spectacular, pace this year.

The industrial, cyclical part of the eurozone continues to exhibit weakness and a lack of momentum after a dismal 2018. However, consumption remains firm and so far it has barely been affected by this cyclical weakness. Unemployment is still declining, confidence in the service sector and among consumers stands elevated and domestic demand helped GDP growth rebound in Q1. In the context of constructive global growth expectations, despite persistent political uncertainties, the outlook for the eurozone remains positive. GDP growth is expected to settle at or slightly above potential in 2019. A similar divergence between external and domestic-related sectors can also be witnessed in Japan, with the same impact on the outlook for growth. There is limited potential for a spectacular acceleration, but also limited scope for a broader and deeper deterioration in economic activity. With inflation definitely on the soft side, central banks are right to stand still and maintain accommodative financing conditions as they are.

« After several months of uncertainty, the prospect for global growth has finally started to improve. »

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

Emerging economies

The encouraging green shoots of recovery visible in China since the beginning of the year have been confirmed by signs the monetary and fiscal stimulus implemented in 2018 is effectively feeding through to economic activity this year. This significant development removes one of the biggest concerns which weighed on markets late last year. It also provides a welcome positive impulse to most of the EM complex, especially neighbouring economies, in a context already made more favourable by the end of the Fed's monetary policy normalisation. The outlook for EM growth has therefore improved and should additionally benefit, in several countries, from political visibility and stability after the sequence of elections in several large EM economies.

The only outliers in this overall positive picture remain economies plagued with political uncertainty, a legacy of imbalanced economic policies and a lack of credible response to address the threat of external and domestic imbalances. Turkey, Argentina and Venezuela are perfect examples of how idiosyncratic issues can prevent an economy from benefiting from an improved global context.

Adrien Pichoud

China & World PMI Manufacturing and China Domestic Credit
 The credit-driven pickup in China activity supports an improving global growth outlook



Source

Factset, SYZ Asset Management. Data as of: 24.04.2019

Asset valuation & investment strategy group review

Risk and duration

During the month under review, we kept both risk and duration at a 'mild disinclination' in our asset allocation.

We believe markets and asset prices are still supported by accommodative monetary policies. The current goldilocks situation has been reinforced by the Federal Reserve's dovish message at the end of March, the US employment report showing solid job creation without upward wage pressure and we are seeing tangible signs of improvement for Chinese economic indicators. While this scenario will not last forever, for now its end seems to have been postponed. Nevertheless, we have preferred to tilt the equity allocation towards cyclicals and away from defensives, rather than increase its weighting.

On the duration front, we are keeping some duration through bonds – rather than indirect duration through equity sectors such as utilities or real estate. But the upside pressure on interest rates could materialise if a Chinese growth acceleration is confirmed – bringing European economies in its wake – and/or energy prices continue to edge higher, as the oil price base effect may become unfavourable later in the year.

« At the current stage, we are not willing to increase the portfolios' risk level too much by adding to equities. Instead, we have tilted them towards more cyclical and less defensiveness in terms of sectors and regional split. »

— Maurice Harari
 Senior Portfolio Manager

Equity markets

The eurozone and some emerging markets were upgraded to a 'mild preference', with the aim to tilt the equity allocation towards more cyclical in order to benefit from a likely improvement in the overall growth dynamic – even if it stays marginal. We now have an indiscriminate 'mild preference' for emerging markets, as we believe the favourable US goldilocks context could spread to emerging markets. On the other hand, we downgraded the United Kingdom, given another round of Brexit uncertainties and potential general elections in the near term, coupled with the more defensive profile of UK equities compared to their euro counterparts.

In terms of sectors, utilities and real estate were downgraded to underweight. In the current economic backdrop, we do not believe they will be supported by another decline in interest rates in the near term, and these defensive sectors may suffer from a rotation towards more beta, cyclicals and financials. We are still keen on high dividend stocks as they should be less at risk from a temporary interest rate repricing and also offer a real medium-to-long-term alternative in this low rate environment.

Bond markets

No changes in our relative preference for real over nominal government bonds and emerging market hard over local currency bonds, while our 'disinclination' for investment grade and high yield credit remains.

United Kingdom and Australia nominal bonds were downgraded to a 'disinclination' for valuation purposes.

South Africa and Indonesia hard currency bonds were upgraded to a 'mild preference', as both offer attractive valuation levels. The former avoided a downgrade from its investment grade status by Moody's while Indonesia may benefit from the presidential election, which would confirm and reinforce political stability, in addition to a less hawkish central bank.

Turkish local bonds were downgraded to a 'disinclination' as the outlook is darkening, and Russia and Brazil were upgraded to a 'mild disinclination' as there is some value in the short end of their respective curves.

Forex, alternatives and cash

The British pound was downgraded to a 'mild disinclination' against the US dollar because of less favourable and longer-than-expected developments in the Brexit saga, as well as the increasing risk of general elections in the near term.

At a 'mild preference', our assessment of the Japanese yen continues to be favourable compared to the Swiss franc, which lost on the margin its safe haven status on the back of the Swiss National Bank's monetary policy easing bias. Finally, gold is ranked at a 'mild preference' for its diversification characteristics in the current risk-off environment.

Maurice Harari

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