

Our monthly view on asset allocation (March 2017)

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Equity markets and risk assets in general continue to defy fundamental valuation gravity.



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- The vast majority of business surveys and confidence indicators point to an improving growth backdrop in the course of the first quarter of the year.
- We are concerned about bond valuations in general and have been for a while, yet during the last few months some value has resurfaced in western government bond markets.
- Even if we can't really speak about a complete irrational exuberance, markets are clearly pricing in a perfect world.

Trees don't grow to the sky

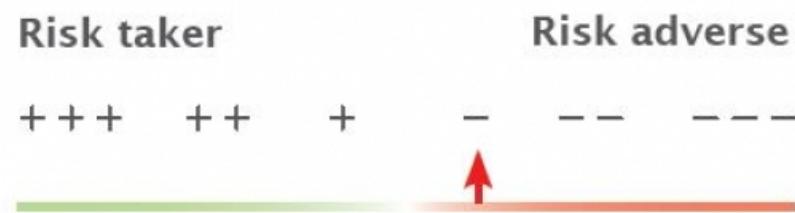
Equity markets and risk assets in general continue to defy fundamental valuation gravity. Even if we can't really speak about a complete irrational exuberance, markets are clearly pricing in a perfect world where economic and earnings growth may only surprise on the upside, inflation pressures do not exist, central banks will continue to sit on the accommodative side for ever and political risk will never materialise. The lofty valuation of US technology companies is an emblematic sign of virtual disconnection with the reality of our challenging world. This bears the question, are investors walking on egg shells? In the meantime, US treasuries walk for sure on their head! Indeed, there is something surprising about the lack of reaction of the latter given the increasingly hawkish tone in the Fed's recent comments to the inflation figures that came out above expectations. There has also been further acceleration in leading indicators, confidence surveys and economic activity in the US according to the latest data. Either the bond market has already anticipated a large part of the cyclical upturn and its consequences on the monetary policy of the Fed - quite possible given the already extremely speculative net short positioning on US treasury futures – or there is some form of complacency or blindness that now reigns in the bond markets? Where are the vigilantes?

At the same time, there are few financial assets that can act as a parachute in the portfolios in the event of a risk-off scenario, and whose valuations have become more attractive since the US election. Thus, the additional value of US treasury bonds, in terms of adjusted risk returns in a balanced portfolio has improved significantly allowing investors, including purely quantitative funds, to continue to add risk assets such as stocks, HY debt and emerging currencies by diluting their volatility and inherent risk with a large dose of these bonds. Magic isn't? Until then there will be a significant change in the volatility of one of these major asset classes and/or in the correlation among them. The more time that passes, the more the mixture becomes larger and less stable.

It may indeed be too early to worry because inflation does not seem ready to appear in the Western world and the economy shows no sign of shortness of breath as the first round of the French presidential elections approaches. Or maybe not. Anyway, we do not want to chase rising markets that are not backed by fundamentally good reasons, based on both economic background (which for now seems fine) and valuation purposes (where we get concerned). We prefer to be quite selective in the way we are allocating our risk budget, focusing on areas where we feel remunerated for the risks. For the more adventurous, I will let you meditate on the following adages, hoping that it will either be good advice to you or failing that it will also torment you. "The trees do not go up to the sky" and "No one ever died of having sold too early".

— Fabrizio Quirighetti

Global risk sentiment



Asset class preference

Equity



Government Bonds



Credit



Economic backdrop in a nutshell

Global economic activity continues to ride the firm cyclical momentum that appeared at the end of last summer. The vast majority of business surveys and confidence indicators point to an improving growth backdrop in the course of the first quarter of the year. The “reflation scenario” remains very much in place from an economic point of view. However, some elements warrant to temper somehow the optimism triggered by this run of positive economic surprises. Political risk is an obvious one, not only in Europe with the coming elections, but also in the US where the Trump administration now needs to deliver on the radical economic agenda developed during the campaign. Monetary policy is another important one, as firmer economic growth and higher inflation raises the pressure on the Fed (and possibly the ECB) to remove some of their very accommodative stance, with hard-to-quantify impacts on highly indebted developed economies. Equally hard to quantify is the net impact on emerging economies, of higher rates and a stronger US dollar vs firmer global demand. Bearing those elements in mind may prove to be useful to avoid being surprised when the current economic upswing loses steam later this year.

Growth

In developed economies, all lights are currently green on the business cycle side. Within emerging economies the landscape is more contrasting, with country-specific factors preventing the growth dynamic to be as broad-based. Still, most of them experience positive economic growth.

Inflation

The same can be said of inflation dynamics that are supported by favorable base effects and, in several emerging economies, by a weaker currency. However, it is worth mentioning that underlying inflation - excluding the temporary impact of commodity prices and FX movements - remains low in the developed world, suggesting that the ongoing acceleration of inflation is likely to be temporary.

Monetary policy stance

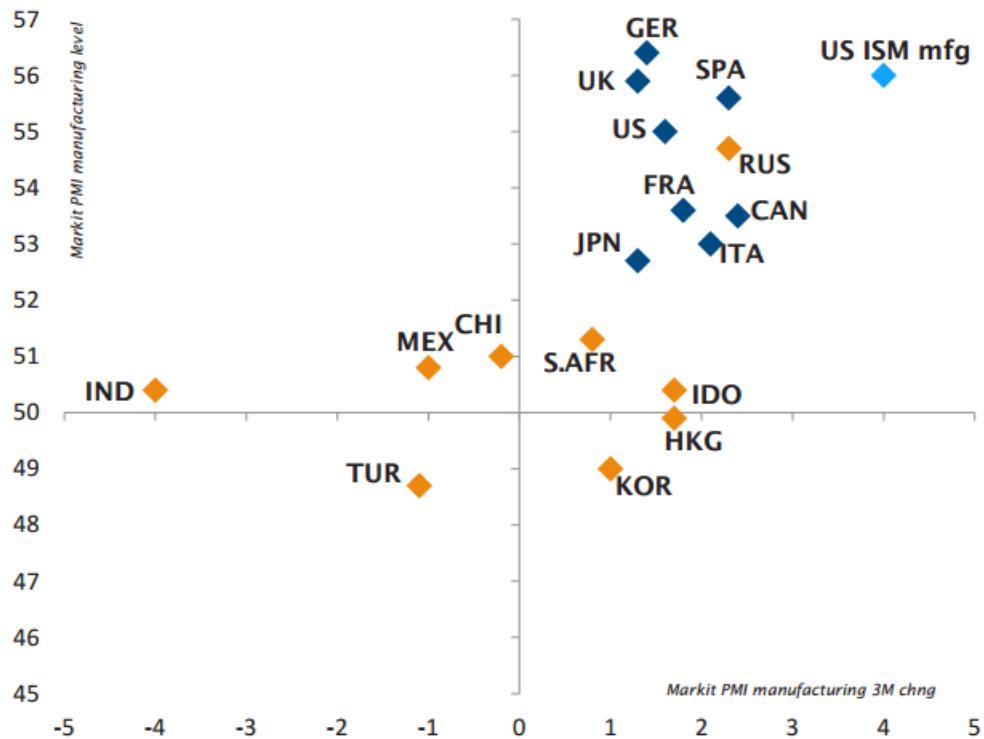
In the current growth and inflation context, monetary policy trends logically toward tightening rather than easing. However, a clear distinction has to be made between developed economies, where some central banks only begin to consider a gradual removal of the strong accommodative stance of the past years, and emerging economies where, in most countries, monetary policy is already restrictive to some degree.

« Global economic activity continues to ride the firm cyclical momentum that appeared at the end of last summer. »

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

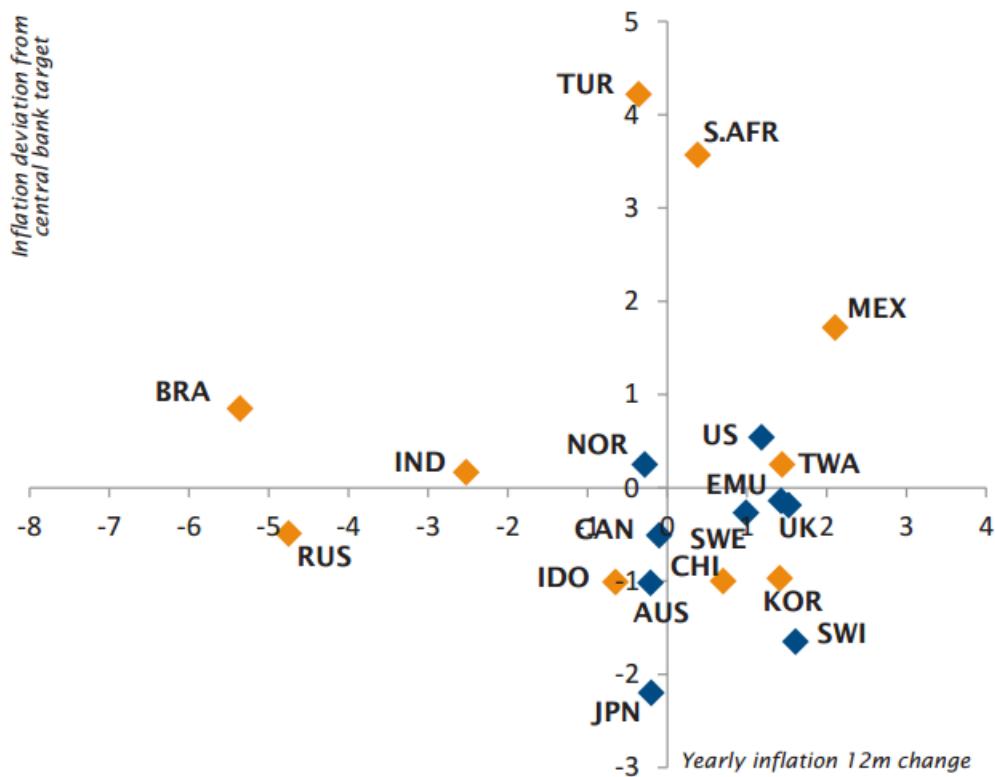


- PMI Manufacturing trends and level



Source: SYZ Asset Management

- Inflation trend and deviation from Central Bank target



Source: SYZ Asset Management, Datastream

Developed economies

US economic indicators continue to confirm the marked improvement in business and consumer sentiment, with several indicators reaching multi-year highs. However, it remains striking that "hard data" such as industrial production, business investment or even consumer spending have not, so far, reflected such an improvement yet. The jury is still out on whether the positive confidence shock will translate into a sustained acceleration in GDP growth, or if disappointment toward expected fiscal reforms, along with the impact of tighter financing conditions, will finally keep growth in its "low-but-positive" range of the past years. In Europe, while the political agenda maintains uncertainty around the outlook, economic indices continue to reflect a firm and broad-based positive dynamic, consistent with above -2% GDP growth at the Euro area level. The spectacular acceleration in inflation rates will most likely fade away once energy-related base effects dissipate, but it nonetheless raises calls, especially from Germany, for an ECB reaction and an unwinding of the QE program.

Among developed economies, Japan appears to lag somewhat in the ongoing growth and inflation dynamic, possibly due to the bout of strength of the yen last year that begins to materialise in economic data.

Emerging economies

The macroeconomic landscape is more contrasting in the emerging world. Some economies are benefiting from the positive growth dynamic of developed markets and exhibit positive momentum, especially where domestic economic policies manage to smoothen the impact of global FX and rates fluctuation. China currently falls into that category, along with South East Asia. Most of Eastern Europe also benefits from the dynamic of the Euro area.

Another group of emerging economies is still recovering from a difficult year in 2016 (Russia being the most advanced in the process while Brazil and South Africa are not out of the woods yet). The outlook is improving and gradually provides room for less restrictive monetary policies, making possible a "virtuous cycle" that will lead to a growth rebound this year.

Finally, a few large emerging economies (Turkey, Mexico, and to a lesser extent India) are under pressure from idiosyncratic factors. They find themselves in a "vicious cycle" where the central bank is forced to run a restrictive monetary policy because of rising inflation, at a time when growth is slowing down.

Adrien Pichoud



Investment Strategy Group: l'essentiel

Risk and Duration

No change in assessment. The extremely calm market environment at present is clearly concerning given the number of potential risk factors on the horizon. Random policies by Donald Trump, as well as uncertainties about the timing and trajectory of monetary policy changes by the Federal Reserve and the ECB, could quickly unhinge investor sentiment. Moreover, while this is not our best case scenario, the various national elections in Europe over the coming months could well throw the continent into a substantial identity crisis, that is potentially more dangerous than the European crisis witnessed in 2011. Therefore, we believe it would be unwise at this point to let oneself be lured into mentally extrapolating this calm market environment too far into the future and to add risk to the portfolio on the back of that.

« While we believe that the French election (despite the outcome) might well be the catalyst for a meaningful rally in European equities, we are aware of the potential volatility that could materialise in the run up to the election. »

Hartwig Kos

Equity Markets

Valuation wise there has not been much change, however corporate earnings have started to improve.. This is clearly an encouraging development, and going forward one can expect more improvements on that front. Unfortunately, market participants do currently pay very little attention to equity valuations and now more than ever the focus is on sentiment. A very good example of investors complete lack of regard for valuations is the Nasdaq. The index has obviously performed spectacularly well in recent years, and even year-to-date it has posted almost twice the performance of the S&P 500. Yet in terms of valuations there is nothing that would justify such euphoria. The trailing price-earnings ratio is close to 41, almost twice the price-earnings ratio of the S&P 500, and analysts expect the earnings of this index to more than double in the coming year. Despite this, the leading price-earnings ratio (this is the price-earnings ratio incorporating analysts earning's expectations) is still more than 20% higher than the leading price-earnings ratio of the S&P 500 (an index which we deem to be expensive in the first place). Such valuation levels can become far more stretched than this, especially when it comes to the Nasdaq. There is clearly policy support for US equity markets courtesy of Donald Trump, yet it is undoubtedly concerning to see such high levels of optimism in the market place. When it comes to US equities, our stance remains unchanged; we prefer the unloved and cyclical parts of the market, where valuations are still more acceptable. When it comes to European equities it is also about sentiment, however unfortunately it is mostly negative sentiment. The notion of political risk clouds any of the positives that equity markets actually have to offer. While we believe that the French election - despite the outcome - might well be the catalyst for a meaningful rally in European equities, we are aware of the potential volatility that could materialise in the run up to the election. As a consequence, France, Italy and Spain were all downgraded to reflect these concerns. At the same time we deem it appropriate to upgrade the stance on emerging markets. The rationale for this is partially due to the fact that valuations have improved somewhat and that the US dollar strength seems to be fading. Moreover, Donald Trump's softer tone towards China has eased fears of a global trade war. And then there is sentiment. When it comes to global equity markets investors are stuck between a rock and a hard place. Ignoring Japan for a moment, US equities are too expensive and European equities are too risky. So, emerging markets might well (in a bizarre way) become the "cheapish safe haven market" for investors for the months to come.



« We are fearful that the difference in French and German in yields could exceed the highs of 2011 where French government bonds traded at a premium of 190 basis points (1.9%) to German gov. bonds. »

— Hartwig Kos —

Bond Markets

We are concerned about bond valuations in general and have been for a while, yet during the last few months some value has resurfaced in western government bond markets. Namely the US bond market has considerably better value than the other core government bond markets such as Bunds, Gilts and JGB's. Within Europe peripheral bond markets have once again started to behave like credit instruments, which means that they are falling in periods of risk aversion and rising in positive markets. The two most vulnerable markets in Europe are in our view France and Italy. When looking at French bond yields they are currently trading at a 70 basis point (0.7%) premium to German bond yields. In the summer of 2016 this premium has been as little as 18 basis points (0.18%). This means that fears about French politics clearly dominate investors minds. We believe that this yield premium (risk premium) of France versus Germany can widen substantially from here. We are even fearful that this difference in yields could exceed the highs of 2011 where French bonds traded at a premium of 190 basis points (1.9%) to German bonds. In 2011 France was undoubtedly seen as a core country within the Eurozone. Now, given its current economic difficulties it is not so clear whether it can be regarded as a core country anymore (at least from an economic perspective). Moreover, the crisis of 2011 was a financial crisis, which could be resolved by the intervention of the ECB. However, this current crisis in Europe is an identity crisis, which is inherently more difficult to resolve. Hence previous reference points indicating extreme valuations, such as the 2011 peak in French yields over German yields may not be applicable at this point. We are conscious about the vulnerabilities in the European bond market, therefore France, Italy and the entire investment grade credit block has been downgraded to a strong dislike. There were no further changes in our assessment, except for an upgrade of Polish local currency bonds. This was done on the basis of an obviously more favorable backdrop for emerging market assets as a whole, paired with the fact the Zloty is cheap and that Polish bonds offer a substantial real yield. In addition, economic activity in Poland is improving markedly, while inflationary pressures remain subdued. But the wider consideration that was undertaken was again done in the context of market sentiment. Polish bonds are in our view European assets, but investors globally do not think that way. Poland is an emerging market in the view of the average investor. This makes this market weird and wonderful in the sense that polish bonds have characteristics of both Europe and emerging markets. Given our concerns about European peripheral bond markets, Poland might well prove to be an effective way to diversify portfolios. Polish 10Y local yields are currently at 3.8% which is in the range of where Portuguese government bonds trade. If one is uncomfortable with zloty risk, the yield of a polish local bond hedged back into EUR is approximately 1.6% which is close to where Spanish government bonds trade.

Forex, Alternatives & Cash

No change in assessment, cash is king.

Hartwig Kos

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