

Our monthly view on asset allocation (August 2019)

Friday, 08/23/2019

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Admittedly, the combination of lower rates and reassuring economic data, especially in the US, is a clear positive for equities, credit and EM assets. However, price action over the past few weeks has been quite fast and furious, especially in fixed income.



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TOO FAST, TOO FURIOUS

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Admittedly, the combination of lower rates and reassuring economic data, especially in the US, is a clear positive for equities, credit and EM assets. However, price action over the past few weeks has been quite fast and furious, especially in fixed income.

This has left little safety margin for unexpected developments – as if a sustained rate cut cycle by the Fed was 100% guaranteed, along with ECB rate cuts and a resumption of asset purchases. As if the Trump-Xi truce in trade tensions displayed at the G20 would last and eventually lead to a resolution. As if central bank intervention would prevent a recession. And as if an improvement in economic growth and inflation, likely to temper Fed and ECB dovishness, could be ruled out.

None of these are guaranteed in our opinion. This leaves us in a situation where we do not want to fight the incoming liquidity wave unleashed by central banks but where we also do not want to be in the front row during the ride. Valuations appear quite stretched across the board, and the potential for further upside seems limited within the current macroeconomic environment.

We have therefore taken some profits on our credit exposure raised in the previous month. On the other hand, we acknowledge the negative or declining yield of 'safe' investments de facto creates powerful support for risky assets – and positive economic developments cannot be ruled out. Therefore, we maintain our existing allocation to equities and EMs, along with some high-quality duration, gold and yen to balance potential negative risks to the macro outlook.

Until we can tell whether monetary policy easing will manage to propel economic momentum, or on the contrary whether it will come too late to reverse the downward macro trend, remaining 'cautiously neutral' in terms of asset allocation and sectors is the best way to navigate markets.

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ECONOMIC BACKDROP IN A NUTSHELL AND GLOBAL ECONOMIC REVIEW

The global growth and inflation picture has not dramatically changed from the previous month. Therefore, the response and outlook for central banks, especially the Fed and the ECB, remains front and centre of the macroeconomic assessment. Interestingly, the messages conveyed by the two main central banks are quite similar, despite different domestic economic situations and trends.

On the European side, the ECB confirmed what Mario Draghi said at Sintra in June, namely that the central bank was ready to use all available instruments – rate cuts, resumption of asset purchases, tiering of negative interest rates for banks. In the US, the Fed cut the federal funds rate by 25bps, as widely expected, and, while carefully avoiding formal commitment, left the door open for further rate cuts depending on economic developments.

Both central banks mentioned prevailing downside risks to the outlook of their respective economies, but the current situation is quite different on the two sides of the Atlantic. The eurozone is barely growing, supported only by the resilience of household consumption, while the manufacturing sector is contracting. This context is sufficient for the ECB to ease monetary policy, unless an unexpected improvement materialises in the coming months.

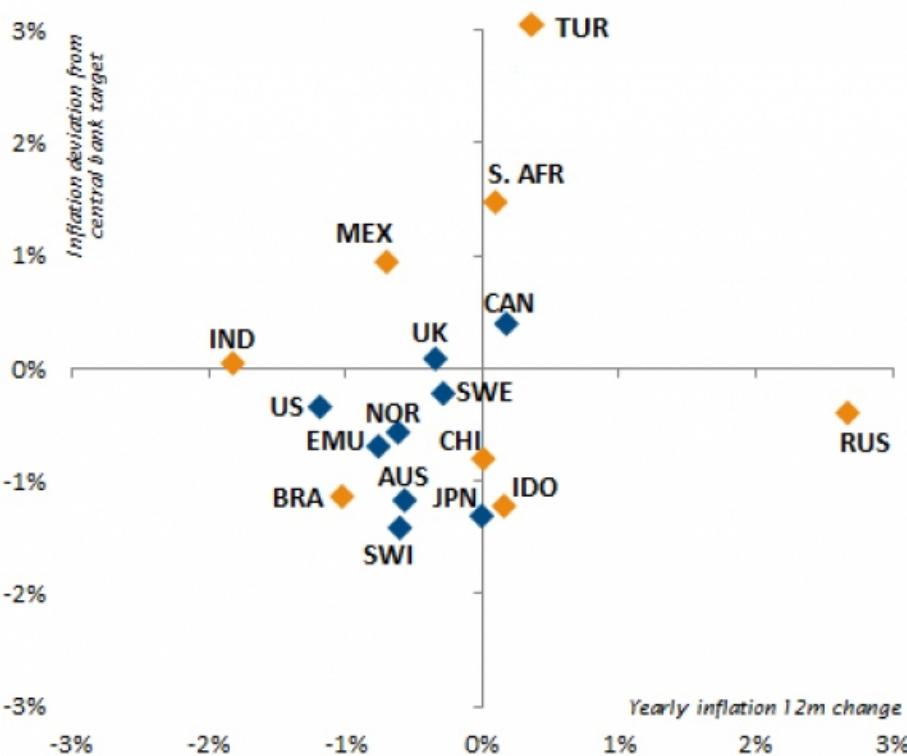
Conversely, the US economy is for the moment holding up reasonably well, even if it lacks cyclical momentum. The first rate cut is therefore more of an 'insurance easing' in the context of dampened inflationary pressures. It could be extended further if global developments weigh on business and household sentiment.

It is worth mentioning the accommodative bias of the Fed and the ECB is matched by a similar trend across emerging market central banks, leading to broad-based global monetary policy easing.

Growth

Global growth continues to decelerate due to negative cyclical momentum. However, domestic demand remains firm, keeping growth in positive territory in developed economies. The Taiwan business cycle is experiencing strong deterioration, which could indicate further slowdown in China.

Global growth still slowing – becoming weak



Source

Source: SYZ AM, Factset Data as of 02.08.2019

Inflation

The inflation backdrop remains mild in general, with signs of potential pickup from the low levels of H1 due to base and seasonal effects. There is still absolutely no sign of a resuming in underlying inflationary pressures.

Monetary policy stance

The Fed and the ECB have provided a clear signal of incoming monetary policy easing, that will in all likelihood start to be implemented during Q3. EM central banks are taking the low inflationary environment and the dovish Fed as an opportunity to cut interest rates.

Developed economies

The US economic backdrop has not changed much in the past few weeks. Activity in the industrial sector continues to gradually slow as the dissipation of the 2018 fiscal stimulus and the impact on business confidence of trade-related uncertainties weigh on investment spending.

On the other hand, a healthy job market and a tentative pickup in house prices support robust household consumption, keeping the US economy on track for growing at, or slightly above, its potential rate of 2%. In this context, the persistently low level of inflation provides grounds for the Fed to ease credit conditions pre-emptively to try to prevent further economic slowdown.

In Europe, especially in Germany, activity is seemingly stabilising at a low level. The industrial sector is contracting in all major eurozone economies, while household consumption is expanding, supported by declining unemployment rates. However, there is still no sign of the long-expected pickup in activity. The risk is if industrial weakness spreads to domestic-oriented sectors and consumer sentiment. The context of desperately low inflation is enough for the ECB to concretely look at further monetary policy easing by the end of the year.

In the United Kingdom, the Damocles sword of Brexit continues to cloud the outlook, and the risk of a no deal Brexit at the end of October has materially increased as the new prime minister, Boris Johnson, openly considers this option to be viable.

In Switzerland, the European industrial slowdown and the strengthening of the franc are taking their toll on the manufacturing sector, with activity sharply slowing since the beginning of the year.

Japan and Australia continue to exhibit positive GDP growth thanks to domestic demand, but they remain prone to any rise in trade tensions and China's economic slowdown.

Emerging economies

Chinese economic activity appears to have stabilised somewhat in the past weeks, at a quite subdued pace. GDP was up 6.2% YoY in Q2, as trade-related uncertainties weigh on business activity and household consumption. Contracting activity in Taiwan is a worrying sign that a further Chinese slowdown may be in the cards, as also reflected by the weak dynamic in South Korea.

In Latin America, the Mexican economy continues to slow under the combined effects of political and fiscal uncertainty – following the resignation of the finance minister – and the threat of US tariffs still clouding the outlook. On the contrary, activity appears to be picking up in Brazil, as the prospect of long-overdue pension reforms is taking shape and the central bank is on the verge of easing monetary policy.

The Turkish economy appears to be stabilising. The change at the helm of the central bank implies monetary policy easing is likely in the months ahead, which could fuel currency volatility and reignite inflationary pressures.

Adrien Pichoud



GDP growth and inflation in the US and the eurozone

Inflation is low on both sides of the Atlantic, but growth is still solid in the US. Still, both the Fed and the ECB will ease monetary policy.



Source

Source: SYZ AM, Factset Data as of 02.08.2019

ASSET VALUATION & INVESTMENT STRATEGY GROUP REVIEW

Risk and duration

We kept the risk stance at "mild disinclination" after last month's upgrade. After solid performances of most risky assets (equities, credit and emerging market debt) in the last few months, there was no further appetite to increase the level of risk. Moreover, the deterioration in asset valuations raised the question of tactically reducing the risk stance.

However, the economic environment and our outlook did not provide enough ground for moving into "disinclination" level. While global growth continues to decelerate due to the negative cyclical momentum, domestic demand remains firm and keeps growth in positive territory in most developed economies.

Instead, we decided to take some profits and trim the exposure on some segments of the portfolio that had benefited the most from Federal Reserve and European Central Bank support. This was undertaken in credit and emerging market debt allocations. However, the profit-taking has not fundamentally altered the overall balance of the portfolio.

The duration scoring remains also at "mild disinclination". There is still a risk of higher interest rates in the scenario of positive surprises on the macroeconomic front. However, we believe this risk remains low given structural headwinds on inflation dynamics, a "low for longer" interest rates regime and the potential downside risks to global growth.

« The risk stance has been kept stable at "mild disinclination" but we are taking some profits on some riskier segments of the fixed income world (credit especially) that kept rallying with valuations becoming more and more expensive. »



Equity markets

European, Chinese and Japanese equity markets are scored at "mild disinclination" while US and emerging markets broad exposure is one notch higher at "mild preference".

Within the UK equity market, as no-deal Brexit risk rises again, we express a clear preference for UK-listed multi-national exporters. They would be less affected by domestic developments and could benefit from a weaker British pound over domestic companies who could suffer from a hard Brexit scenario and/or sustained political uncertainty.

Moreover, we still prefer not to express too strong sectors bias, neither with defensives or cyclicals, as no sectors stand out in terms of both valuations and earnings momentum.

However, we are still keen on high dividend stocks, as they should be less at risk of a temporary interest rates repricing and also offer a real medium-to-long-term alternative to a low-rate environment.

Bond markets

Nominal government bonds remain at "mild disinclination". The risk for economic activity in general is still tilted to the downside.

France was downgraded in line with Germany to "disinclination" after last month's rally on the back of very expensive valuations and negative absolute yield levels. Italy remains at "mild preference", as there is still good relative value within the EUR sovereign bond space.

We still have index-linked government bonds (especially true for the US and Italy) and emerging markets hard currency bonds at "mild preference".

Investment grade and high-yield credit (still a preference for Europe versus the US) were downgraded to respectively "mild disinclination" and "disinclination".

This is a tactical move reflecting our willingness to take profits after the recent rally as a lot of good news is now incorporated into valuations.

In emerging markets, Turkey (hard currency bonds) was further downgraded to "disinclination" following the rising risk of a monetary policy mistake and the potential threat of US sanctions.

On the other hand, Brazil, Russia and Indonesia local bonds were all upgraded to "mild preference" and are now our top picks. The current environment of decelerating global growth, muted inflation pressures coupled with a dovish Fed is favourable for emerging markets central banks enabling them to cut interest rates (Russia already did it twice while Indonesia once and Brazil could follow). In addition, we particularly find appealing the duration in Indonesia and Brazil (steep yield curve), while the Russian rouble is attractive on valuation grounds.

Forex, alternatives and cash

The British pound has been downgraded one notch to "disinclination" as the probability of a hard-Brexit scenario has increased with Boris Johnson as the new UK Prime Minister.

The US dollar is preferred to the euro despite the greenback's higher valuation, but it offers a better growth outlook and, especially, a still positive yield differential.

We favour the Japanese yen, scored at "mild preference", over the Swiss franc – which has lost its safe-haven appeal on the back of the Swiss National Bank monetary policy easing bias.

Finally, gold is ranked at "mild preference" for its diversifying characteristics in a risk-off environment.

Maurice Harari

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