

Our monthly view on asset allocation (September 2019)

Thursday, 09/12/2019

As is often the case, August has not been as quiet a month in financial markets as those taking summer holidays would expect. After two months where the sweet nectar of upcoming rate cuts propelled equity and bond markets, a tweet was enough to remind investors of the harsh reality: trade tensions and uncertainties surrounding global growth are here to stay, and with them potential downside risks to sentiment and economic activity.

In this context, it is important to distinguish between real and potential developments. Objectively, the current situation is that global economic growth continues to slow down due to weakening cyclical momentum, softer industrial activity and uncertainties about global trade and geopolitical conditions – US tariffs and Brexit, just to mention a few. However, so far, economic growth remains supported by resilient service activity and household consumption, with low or declining unemployment, accommodative financing conditions and increased house prices.



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RESIST TEMPTATION

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Looking forward, the risk is clearly that the downward trend in industrial activity and business sentiment might spill over to the service sector and impact consumer confidence. The longer this downward trend continues, the higher the chances that such a spillover could trigger the dreaded scenario of a global recession. However, there is no evidence this scenario is taking shape yet. Hence, it would be as imprudent to assume such a negative scenario will materialise as it would be to assume things will finally take a turn for the better.

Depending on the scenario, valuations of equities or bonds might be seen as either too expensive or still attractive given the significant monetary policy easing that is expected. In this situation, we believe the best approach is to maintain a balance between assets likely to benefit from a scenario of growth stabilisation, such as equities, credit and emerging market (EM) debt on the one hand, and assets expected to defend portfolios on the other, should a global recession materialise. These include government bonds, gold and the Japanese yen.

We feel the main danger at this stage is to yield to the temptation of acting without a factual basis, thus destabilising the allocation and taking an unwarranted bet. While acknowledging the rise in downside risks, we are sticking to our 'cautiously neutral' stance, favouring intra-asset class reallocation to enhance the robustness of our portfolios.

_Adrien Pichoud



ECONOMIC BACKDROP IN A NUTSHELL AND GLOBAL ECONOMIC REVIEW

The longer things stay the same, the more binary they become. This could sum up the global macroeconomic environment that has exhibited similar trends since the beginning of the year without significant changes in the past few weeks: enduring weakness in cyclical industrial activity and resilience in domestic-driven service activity. Since the latter weighs more on GDP than the former, it is so far sufficient to maintain GDP growth in positive territory across the developed world – with the exception of Germany, which shrank in Q2.

The longer this situation lasts, the more binary the outcome. The continuation of the downward trend in manufacturing activity, coupled with lingering trade tensions and uncertainties, undoubtedly raises the risk of spillover to services and household sentiment that would drive economies into recession. But the mere stabilisation of industrial activity in developed economies would be enough to dispel short-term fears of recession and support a scenario of late-cycle, soft-but-positive economic expansion, especially in the context of renewed monetary policy support. In other words, the divergence between industrial and service activity cannot widen forever, and, depending on which sector breaks the trend, the rising concerns about the global macro outlook might be proven wrong – or validated. In either scenario, it might be taken for granted that central banks will become more accommodative, at least due to the depressed level of inflation and inflationary pressures.

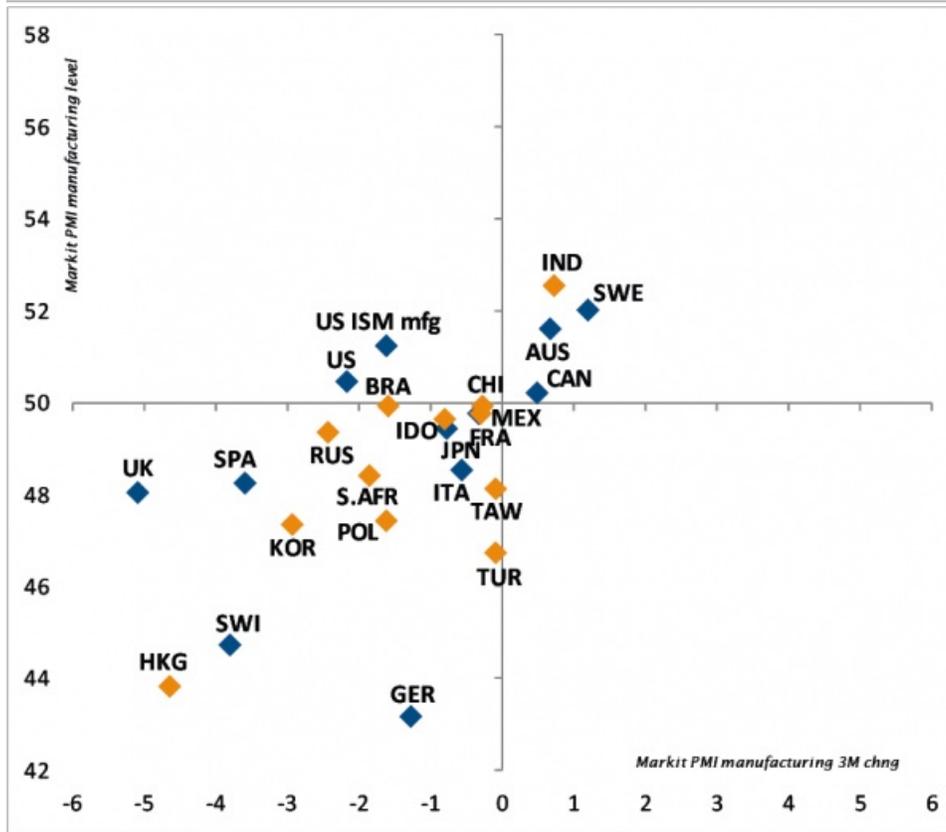
Growth

Most of the global economy continues to slow down due to the same combination of headwinds as in previous months: slowing global trade and investment due to US and China tariffs, global trade uncertainties and Brexit-related uncertainties in Europe. So far, there is no evidence the slowdown has let up or even inverted.

Inflation

Inflation remains low and mainly below central bank targets across developed and emerging economies. However, signs of reaching a bottom appear in the US and Europe, mainly due to technical factors. This means, however, that the deflationary trend in the first half of the year may be about to gently reverse.

Global industrial activity is now contracting due to trade uncertainties



Source
SYZ AM, Factset. Data as of 31.08.2019.

Monetary policy stance

After the large and well-publicised shift by central banks to announce imminent monetary easing, it is now time to deliver. The Federal Reserve has already cut its key interest rate in July but will likely continue to do so in September.

Developed economies

The US economy continues to display mixed economic indicators, with mild softness but no contraction in industrial activity and still quite solid service activity and household consumption, thanks to low unemployment and easy financing conditions. In this context, fears of recessions, or the expected Fed monetary easing, are based on concerns the global slowdown and trade tariffs might significantly affect activity in the future. While this is clearly a risk, it remains to be seen for the moment.

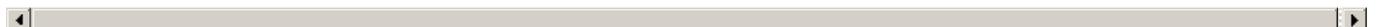
In Europe, the impact of slowing global demand for industrial exports has already severely hit economic growth and continues to affect manufacturing-heavy Germany. However, with some similarities to the US situation, the combination of declining unemployment, a buoyant housing market and easy credit sustains domestic-related activity and is helping most of the eurozone stabilise at a mild-but-positive growth level. Nevertheless, given depressed inflationary pressures and taking into account the downside risks to the growth outlook, the ECB still has very valid grounds for providing some easing in the months ahead. For Switzerland, this combination of slowing industrial activity in the eurozone and likely ECB rate cuts is a very negative macroeconomic cocktail. It weighs twice as heavily on an important part of the economy, through lower demand for Swiss exports and via the negative impact of a stronger franc versus the euro. The Swiss National Bank has limited opportunities for offsetting these dynamics. Likewise, the Bank of Japan has few options to tackle the decline in Japan's inflation dynamic prompted by the strengthening of the yen.

Emerging economies

The slowdown in global growth and the uncertainties related to trade and tariffs act as a gradual headwind on emerging economies despite relatively resilient domestic demand. Eastern Europe feels the impact of slowing German industrial activity, South East Asia is directly exposed to the repercussions of US-China trade tensions, and local situations, such as tensions between Japan and South Korea, only exacerbate trade instability.

In this context, the trend toward more rate cuts and an easing in credit conditions, already at play for several months, appears likely to continue, especially with the Fed and ECB embarking once again on the path to quantitative easing.

_Adrien Pichoud



Global activity index for the manufacturing and service sectors.
 Global manufacturing activity is now contracting, while service activity so far remains resilient and keeps global growth afloat



Source
 SYZ AM, Factset. Data as of 31.08.2019

ASSET VALUATION & INVESTMENT STRATEGY GROUP REVIEW

Risk and duration

We kept the risk stance at a 'mild disinclination', even though we were tempted to decrease portfolio risk exposure due to recent deterioration in market sentiment. Nevertheless, we took an indirect approach to reducing risk by acting within the structure of our equity and fixed income products to make them more defensive.

We preferred this tactic since we are already cautiously positioned in terms of equity exposure. Moreover, equity valuations were stable in the past quarter and did not worsen enough to trigger a significant change in the equity stance.

While downside risks on the macro side, namely the recession risk, increase as the slowing global growth trend extends, we continue to believe the most likely scenario is one where global growth will not turn outright negative. Rather, it should stabilise at a sluggish yet positive rate, thanks to broad-based monetary policy easing and its support to domestic consumption in developed economies. We do not have sufficient macroeconomic evidence to change our scenario or to position our portfolios for a recession.

Finally, a reduction in the total equity allocation may destabilise portfolios, thus making them more vulnerable to a correction should interest rates spike after economic indicators stabilise and market sentiment improve.

The duration scoring also remains at 'mild disinclination'. Although there is a risk of higher interest rates in the macroeconomic positive surprise scenario, we believe this risk remains low given structural headwinds to inflation dynamics, the 'low-for-longer' interest rate regime and a balance of risks to growth tilted to the downside.

The risk stance has been kept stable at "mild disinclination" but we are tilting the structure of portfolios towards more defensive markets and assets but without altering the overall portfolio balance.

— Maurice Haran



Equity markets

We upgraded Japanese and Swiss equity markets (with the currency exposure open) to a 'mild preference'. These two markets are rather defensive from a sectorial and balance-sheet-quality point of view. At the same time, they bring some diversification characteristics through the risk-off Japanese yen and Swiss franc currencies.

We kept eurozone equities generally unchanged at a 'mild disinclination' but we highlight a high level of cautiousness and a stronger disinclination bias for German equities. This is due to worrying German macro-dynamics and sectorial bias to the auto industry. We are also avoiding too much exposure to European cyclical and banks.

Regarding emerging markets, we downgraded Mexico to a 'mild disinclination' as the combination of geopolitical and domestic political risks led us to differentiate it from broader emerging markets, which still garner a 'mild preference'.

Bond markets

We moved our preference for emerging market hard currency and local currency bonds down a notch to a 'mild disinclination' and 'disinclination', respectively, in light of rising uncertainties in the global growth outlook, potential fault lines in Argentina and Hong Kong and some possible foreign exchange downside risks for local currency debt.

On the other hand, we upgraded nominal government bonds to a 'mild preference' as we are willing to maintain some high-quality rate exposure in portfolios for balancing purposes. Investment grade credit and high yield scorings were left unchanged, at a 'mild disinclination' and 'disinclination', respectively, after having already been downgraded one month ago.

Finally, we reduced the stance of Russia local debt to a 'mild disinclination'. After the strong year-to-date performance, we were able to see some foreign exchange weakness and less relative value in rates. Positive investor sentiment that supported the Russian rouble this year could on the margin deteriorate following the announcement of another round of US sanctions against Russia.

Forex, alternatives and cash

We upgraded our preference for the Swiss franc to a 'mild disinclination', although the franc looks quite expensive based on purchasing power parity and other valuation metrics. The fact that the Swiss National Bank limited opportunities for manoeuvring as a measure to counteract upward pressure on the currency and the franc's safe haven status make it a potentially useful defensive allocation.

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

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

_Maurice Harari

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