

Our monthly view on asset allocation (October 2019)

Monday, 10/07/2019

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Adrien Pichoud

Chief Economist & Senior Portfolio Manager



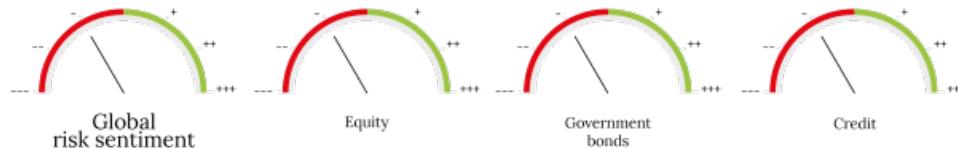
Maurice Harari

Senior Portfolio Manager



Luc Filip

Head of Discretionary Portfolio Management



WALKING A THIN LINE

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A few additional layers of uncertainties may even have appeared in the recent weeks. Firstly, investors have been reminded of the highly volatile situation in the Middle East and the sensitivity of energy prices to geopolitical developments in the region.

Secondly, while the Fed and the ECB both unsurprisingly announced additional steps to ease credit conditions, unusual dissensions appeared within the two institutions on the merits of these actions. A significant number of members from either institution were openly against the decisions taken in September, to the point of triggering the resignation of one member of the ECB Governing Council, and two official votes being cast against the rate cut among the 10 voting members of the Fed. The vagueness surrounding the economic outlook has led to cracks in the prevailing consensus on the need to use monetary policy to respond to low growth and inflation.

Another consensus of the past decade is being increasingly challenged: fiscal balancing. A growing chorus of voices is calling for a more active use of fiscal policy, especially in the context of (very) low rates for a (very) long time. From fiscally orthodox Germany to the Brexit-plagued UK, from early US presidential campaign debates to Japan, the debate over public spending is gaining more focus as a potential solution to address slowing economic growth, growing inequalities and environmental issues.

The outlook is by definition uncertain and the very essence of investment. Human nature (and good year-to-date performance) may currently render investors more sensitive to very real negative news and downside risks: continuing slump in industrial activity, tentative "hawkish" rebellions within central banks, geopolitical risks... But the resilience of final demand in developed economies, low rates, potential support of fiscal policy, and the fact that financial market prices already point to a significant economic weakness should not be discarded. For now, this situation still warrants maintaining a balanced positioning in portfolios. A thin line to walk, for sure, but possibly the only way to avoid being wrong-footed when the outlook eventually becomes less uncertain.

Adrien Pichoud

ECONOMIC BACKDROP IN A NUTSHELL AND GLOBAL ECONOMIC REVIEW

More of the same! For better or for worse, economic trends haven't really changed in the past month. The global economy is still slowing down, dampened by an industrial sector close to or possibly already in a recessionary state. Household consumption remains positive, buoyed by low unemployment, firm housing markets and affordable consumer credit. For now, the latter is still sufficient to balance the negative impact of the former and maintain economic growth in positive territory. However, the balance of risks clearly leans toward the downside as long as there is no sign of stabilization, let alone an uptick, in industrial activity. Geopolitical and political risks such as US/China trade, Brexit, Middle East instability, US domestic politics also weigh on the negative side of the balance.

Monetary policy is expansionary across the globe and becoming more so wherever possible, including a growing range of Emerging market economies. In that respect, the Fed's U-turn on the rate hike cycle last year with its rate cuts this year may have one long-lasting implication: the peaking of the US dollar after a 5-year appreciation cycle driven by the widening gap between US rates and rates in the rest of the developed world. Indeed, without calling for an extended rate cut cycle in the US—unnecessary as long as growth remains positive—the likelihood of another U-turn from the Fed and the resumption of rate hikes appears highly unlikely in the coming year. Therefore, interest rate differentials should not support a further strengthening of the greenback. Welcome news for emerging economies that are still very USD-sensitive, even if they still have to cope with slowing global growth for the moment.

Growth

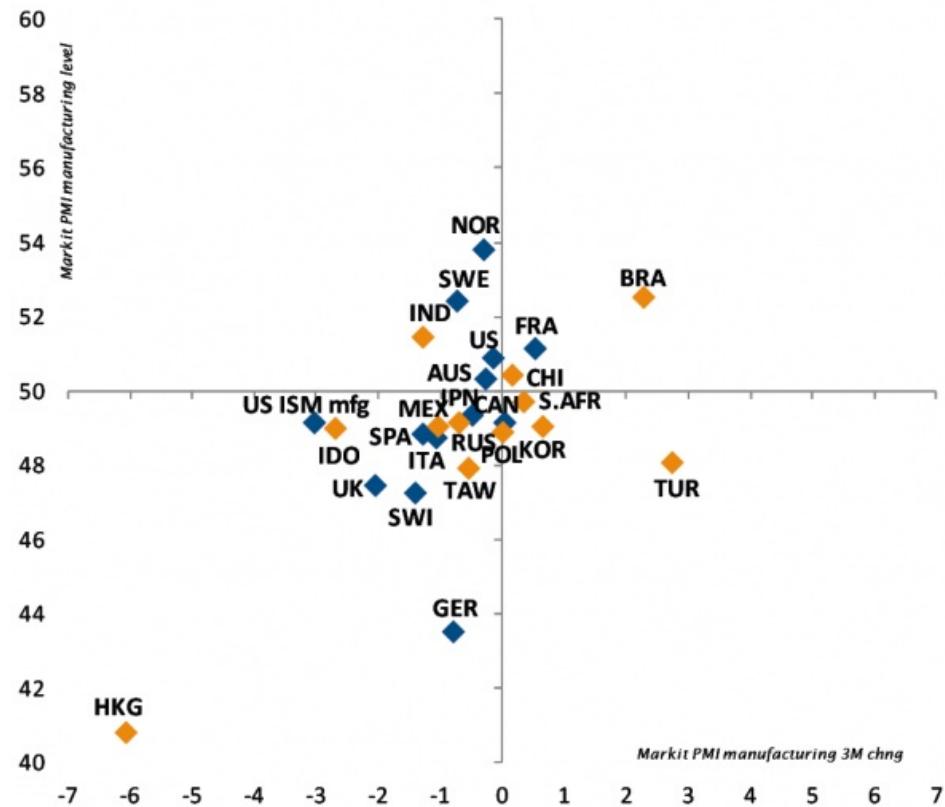
Despite a continuing slowing trend, growth remains positive across all major economies. Some tentative signs of stabilization seem to appear here and there but need to be confirmed.

Inflation

The downward trend at play in inflation data since the beginning of the year has found a bottom as base and technical effects fade away. Oil prices are the potential X factor for the inflation outlook in the absence of upward domestic demand pressures.



Still a global slowdown, tentatively less pronounced.



Source

SYZ AM, Factset. Data as of 31.08.2019

Monetary policy stance

The ECB monetary easing policy may have left a bitter aftertaste for its implicit "all in/ultimate move" nature. Nevertheless, it anchors Eurozone monetary policy at an extremely accommodative level for a long (long) time. The Fed, on one hand, and Emerging central banks, on the other, have more room to provide additional easing if necessary.

Developed economies

The US economy can still rely on robust consumer spending to expand at a rate close to 2%, despite the continuing industrial slowdown with the drop of the ISM manufacturing below the decisive level of 50 in August. Real disposable income for households is growing and the housing market remains firm. Uncertainties related to the US/China trade war and the possible impact of US tariffs on the price of imported goods remain a real risk but have not derailed expansion so far.

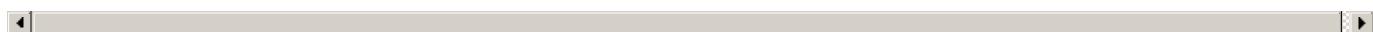
Germany remains the weak spot of European growth this year as the structure of its economy leaves it in the frontlines for experiencing the negative impact of a global trade slowdown and more European-specific Brexit uncertainties. However, the more domestic-oriented service sector in Germany and across the Eurozone continues to grow and keeps the economic expansion going, even if at a quite soft pace. Some indicators suggest that the worst of the industrial downturn might be behind us, but this remains highly dependent on global and political developments. The same can be said for neighboring European economies, such as Switzerland or Nordic countries, and a similar pattern, for similar reasons, is also at play in Japan.

Emerging economies

Not unlike the Eurozone and Japan, the growth of the Chinese economy is currently tied to its industrial sector and developments in the US standoff on tariffs and trade relations. Specifically, economic activity in Hong Kong has taken a hit from the protests there.

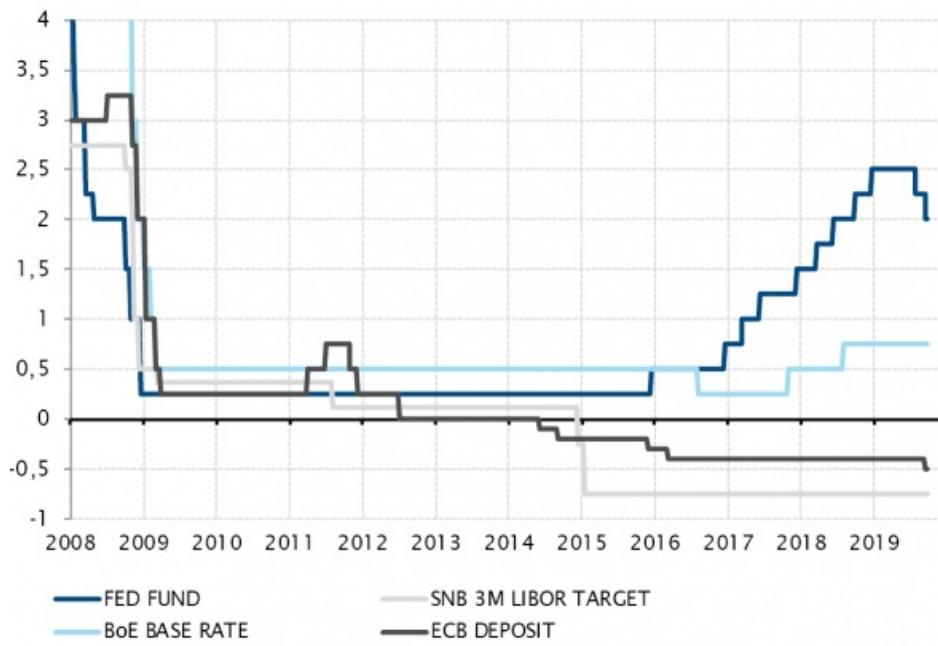
Growth is improving slightly across most large emerging economies, possibly bolstered by the combined domestic monetary easing policies and the relaxing of financing conditions in US dollars. However, growth remains very sensitive to global trade developments.

Adrien Pichoud



Key rates of selected central banks

The Fed and the BoE still have some room to cut rates. The ECB and the SNB, on the other hand, not so much...



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 "mild disinclination" even though the temptation of increasing it a notch was discussed in light of a tepid improvement in macroeconomic data coupled with still accommodative monetary policies. The conclusion was to wait for firmer evidence of stabilization in the global growth trend before effectively increasing portfolios' overall risk level.

The duration scoring was also kept at "mild disinclination" due to a lack of inflation and dovish central banks. In an environment with low inflation and accommodative central banks, duration can still provide a useful hedge for portfolios against a slightly less likely yet not negligible risk of a negative macro outcome, even at current expensive bond valuation levels.

The risk stance has been kept stable at "mild disinclination" but we are introducing a bit more cyclical and value bias to de-emphasize the defensiveness of the equity part.



Equity markets

We upgraded the scoring for Eurozone, Scandinavian and Chinese equity markets to “mild preference.” On the other hand, we downgraded South African equities to “mild disinclination” because of idiosyncratic risks.

By doing so, we aim to rebalance the equity allocation within portfolios towards less overweight in defensive markets or sectors and introduce a bit more cyclicity and value bias.

The tentative encouraging signals in cyclical dynamics in Europe and China led us to reduce this implicit defensive composition of the equity allocation.

Given the extreme levels of relative valuations between defensive and cyclical markets and sectors, we seek to reduce our defensive bias to avoid being caught wrong-footed were there a temporary reversal or a correction in relative performance triggered by a decline in global growth fears.

Bond markets

Similar to the equity allocation, we rebalanced the fixed income allocation towards a more neutral position by reducing our overweight position in terms of government bonds vs. credit.

Therefore our nominal government bonds are now a notch lower at “mild disinclination” (essentially because of valuations) and our investment grade and high yield credit were upgraded to “mild preference” and “mild disinclination,” respectively.

In the nominal government bonds bucket, Italian government bonds remain the preferred euro sovereign bond market considering ECB monetary policy easing and this market’s still-attractive relative value. US and Canadian government bonds are the other sovereign bonds of choice since in our opinion they offer the highest level of protection for portfolios in the event of a recession scenario that could lead to several Fed rate cuts.

Forex, alternatives and cash

The US dollar is still preferred over the euro, despite the US dollar’s higher valuation, since the greenback offers a better growth outlook and especially a still positive yield differential.

Finally, gold and the Japanese yen are ranked at “mild preference” as they are portfolio diversifiers in a risk-off environment.

Maurice Harari

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