

Our monthly view on asset allocation (May 2020)

Monday, 05/18/2020

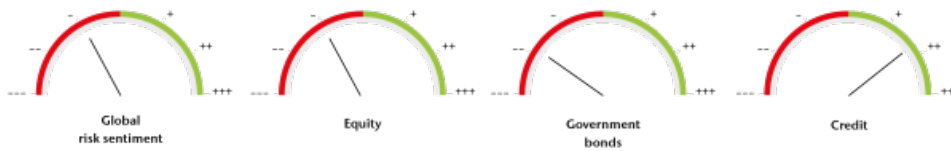
The past three months have been truly extraordinary and difficult for just about everyone in the world. From an investor's point of view, this period has upended many longstanding economic data series and challenged "conventional wisdom" regarding the link between equity performance and earning revisions, and correlations among asset classes. Who could have imagined 30 million new US jobless claims in just six weeks, PMI surveys below 30 or even 20 across major economies, a 30% equity rally amid sharp downward earning revisions and unprecedented uncertainty regarding the outlook, stable long-term rates despite this rebound in equity markets, or egative oil prices, just to mention a few?



Adrien Pichoud
Chief Economist & Senior Portfolio
Manager



Maurice Harari
Senior Portfolio Manager



Delicately balancing risk in phase II of the pandemic

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Regarding how long the "global economic pause" will last, all developed economies are gradually moving toward phased relaxing of the initial rigid social distancing measures in order to allow economic life to resume its course. The risk of the pandemic resurging is the Sword of Damocles hanging over the outlook, but it seems reasonable to expect GDP to start recovering ahead of the summer. Recovering the level of economic activity prevailing before the crisis will take time, probably several quarters, but at least the dreaded scenario of a long-lasting depression seems to have been avoided.

The pace of this economic recovery will likely be the best gauge of how effective recent government interventions have been. Beyond mandatory support to the health care system, the fundamental aim of the public spending and guarantees is indeed to contain the blow to productive capacities so that businesses and households won't be bankrupt when social distancing measures are finally eased. It is still too early to assess how much will be achieved on that front. Most companies have stopped providing earning guidance, and investors keep pace with the recovery to gain confidence on sales and earning prospects.

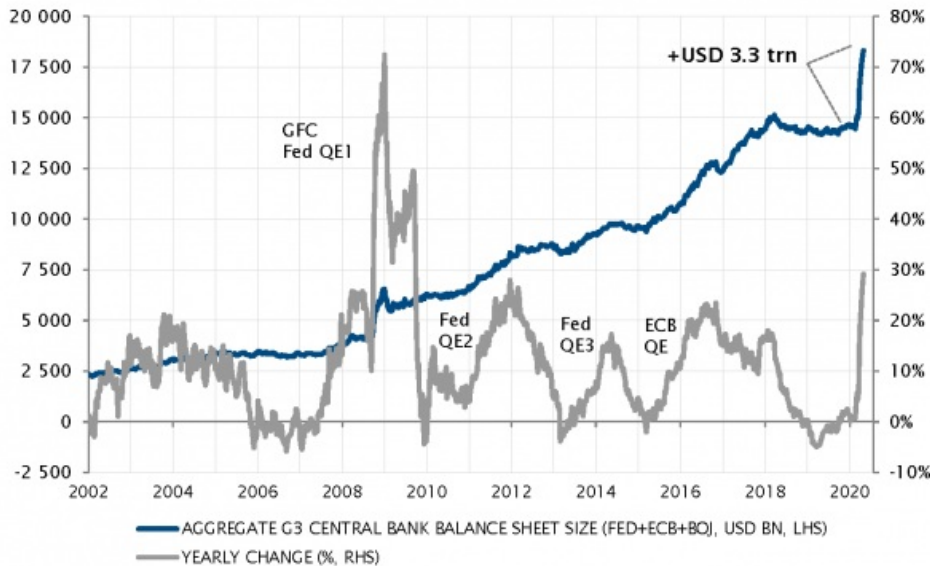
It is also still too difficult to gauge how much has already been priced in financial markets. The relief from probably avoiding a sustained depression thanks to government interventions may have fueled the April rally in equity markets. By the same token, however, we have a better sense of the pandemic's spread and risk, which also rules out the scenario of a rapid return to the pre-crisis levels. Between these two extremes, the span of outcomes is pretty wide. For investors, it requires finding a balance between being exposed to the expected gradual economic recovery and remaining wary of all the numerous risks and unknowns in the months ahead (including those not directly related to the pandemic, such as political or geopolitical ones).

In this context, we maintain the stance adopted since early April. Portfolios keep a defensive tilt, but we believe that High Grade corporate bonds offer very attractive opportunities supported by central bank policies that have addressed the acute liquidity issue of March. The same cannot be said of the High Yield bond market and Emerging Market debt, for which uncertainties regarding the economic outlook outweigh the impact of very accommodative monetary policies. We now see little potential for further decline in long term rates, and fewer diversification benefits of government bonds than in the past, with the exception of inflation-linked government bonds that still offer value, along with gold, given currently depressed inflation expectations and negative real rates. Finally, we maintain our equity allocation close to a neutral level, while tilting geographical and sectorial exposure toward quality and balance sheet strength and keeping protections against a still possible second downside movement.

_Adrien Pichoud



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Source
SYZ, Bloomberg Data as of 05.05.2020

Investment group strategy takeaways and asset valuation and summary

Risk and duration

The risk preference was increased to “mild disinclination.” From now on, given our central economic scenario (strong negative shock in Q2 with a gradual recovery in the second half of the year in developed economies), unprecedented monetary and fiscal policy support coupled with the improvement in valuations in March, we think that maintaining a very pessimistic stance no longer warranted.

Although we still want to remain defensive, we also want to be closer to a “neutral point” as we acknowledge that risks are now two-sided, with both possible scenarios: a second foot on the ground or an extension of the rebound in risk assets. Therefore, by coming closer to neutral we keep from being wrong-footed should there be more positive developments in equity markets.

The duration preference was decreased to “disinclination”. All major central banks have now delivered more rate cuts and liquidity injection programs that have sent interest rates at or back towards historical lows. Cash rates are now hovering around zero everywhere in the developed world. This has been reflected in the deterioration of safe-haven government bonds denominated in USD, EUR and GBP.

On top of that, governments are announcing historical fiscal spending plans to contain the impact of the economic lockdown. While we believe central banks will effectively do their best to prevent any long term rate increase, the medium-to-long term impact of such an increase on public debt is uncertain.

As a result, we consider that duration has less value in portfolios today and that risks are negatively asymmetric in holding long-term interest rate risk.

« The risk stance has been upgraded to mild disinclination moving closer to a neutral stance but still on the cautious side while the duration was downgraded to disinclination as risks are negatively asymmetric in holding long-term interest rate risk. »

Maurice Harari
Senior Portfolio Manager

Equity

The equity market sell-off has triggered a general improvement in valuations for developed markets. However, the significant uncertainty around earnings outlook makes it difficult to really assess the extent of this improvement in valuation.

Nevertheless, based on actual valuation levels, we raised our stance for Eurozone equity markets to “mild preference” while we reduced Swiss equities scoring to “mild disinclination” as the adjustment has been far less pronounced in March.

As India remains less attractive in terms of valuation than other EM equity markets, we reduced Indian equities to “mild disinclination”, while we upgraded Russia to “mild preference” on attractive valuation grounds.

We maintained our “preference” score for the US and Chinese equity markets.

Bond markets

The spectacular credit spread widening provides what we believe as one of those rare very attractive entry points for the investment grade credit space. We therefore upgraded this asset class to “strong preference”.

The valuation improvement has been strong across the board in the credit space, but it has been even more visible for USD investment grade and high yield. On top of that, the Fed has now joined the ECB in launching a corporate bond asset purchase program. For these reasons, we prefer USD credit over EUR credit in terms of relative preference within the investment grade and high yield spaces.

The valuation improvement in inflation-linked bonds (especially in the US and in Italy), with the attractiveness of potential decline for real rates coupled with undervalued inflation breakeven, warrants to raise this asset class to a “preference” ranking.

On the other hand, we downgraded nominal government bonds (expensive valuations and fiscal policy risk) to “mild disinclination”.

Moreover, the highly uncertain outlook for emerging market economies makes us stay away at the moment from emerging market local currency bonds (downgraded to “disinclination”).

Finally, we maintained the stance for high yield and emerging market debt in hard currency (at “mild disinclination”) as the large economic uncertainties and their potential impact on those asset classes offset for the time being the strong improvement in valuations.

Forex

With the uncertainty around the United Kingdom outlook, Brexit negotiations and the BoE monetary policy easing, we no longer see a strong case for GBP appreciation. Hence we downgraded the British pound to “mild disinclination” against the US dollar.

On the other hand, negative real cash rates and the potential for long term real rates to decline have created a favourable environment for gold that we upgraded to “preference”.

_Maurice Harari

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