

Our monthly view on asset allocation (April 2017)

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Looking in the rear-view mirror, the main introspection from critics would be that investors have been slightly too cautious too early on risky assets.



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- While global growth is undeniably positive, the growing gap between the sharp acceleration pictured by “soft data” and the milder trend of “hard data” instills some uncertainty about the outlook.
- There is currently asymmetry between the potential gain in risky assets and their potential drawdown.
- The French election might well be the entry point back into equity markets, particularly Europe.

Waiting for Godot?

Looking in the rear-view mirror, the main introspection from critics would be that investors have been slightly too cautious too early on risky assets. While our economic backdrop analysis was and still remains globally upbeat, lofty valuation levels on equities, especially in the US, and in the credit space (more precisely in the High Yield segment) has impeded us to be braver so far. Thus, it sounds legitimate wondering if we are not waiting for Godot...

We don't think so. First of all, we haven't been too pessimistic, but rather cautiously exposed as our tactical risk stance has remained in "mild" disinclination since January. Indeed, we haven't been calling for a severe market correction but have kept some dry powder to jump in when valuations become more attractive and/or some uncertainties will be lifted. In the meantime, we continue to strongly believe that there is currently asymmetry between the potential gain in risky assets and their potential drawdown, and given these pricey valuations, risk has been allocated more selectively across and within each asset class. Markets reaction following the Fed's latest hike and the first disappointment of Trump's policy (immigration, Obamacare) confirmed our views and positioning. Without any significant shifts in the economic outlook and the asset valuation framework, we haven't found yet any reasons to modify our stance towards risk and duration.

Looking forward, we remain constructive on equities, especially non-US and European equities as they may clearly outperform in the second part of this year when the European political risk premium fades away. For the time being global investors are still distracted by the French elections and Trump's activity on Twitter, but they will certainly realise at some point that the euro zone's economic growth is as strong as US and with plenty of catch-up potential. The ECB will sooner rather than later taper and the euro is not (yet) dead. In parallel, the reality check of Trump's reflationary policy should come below the high expectations already priced in. In this context, our selective favourable stance to some hard and local currency debt should also offer better risk-adjusted returns than US credit for example. And US Treasuries are perhaps less at risk of a major upward repricing in rates than German Bunds or Japanese government bonds.

In this environment of higher Fed fund rates that doesn't lead to a stronger dollar and a jump in US long term rates, the surprises and thus big changes on markets may now come from other major economic areas or central banks. If we really observe a broad based and synchronised lift in nominal GDP –from last few years depressed levels- the best opportunities lie certainly outside the US equity and credit markets. Godot is really coming.

_Fabrizio Quirighetti

Economic backdrop in a nutshell

The global economic picture has not changed much over the past few weeks: developed economies continue to enjoy positive cyclical dynamic, with the caveat that it is more pronounced in business and household surveys than in actual activity data. Emerging economies exhibit less clear-cut trends, with idiosyncratic factors and inflationary pressures causing restrictive monetary policies to prevent them from benefitting from positive developed market dynamics as much as they have in the past. The sustainability of this positive global growth trend depends on three key questions. Will the Trump administration be able to deliver a fiscal stimulus matching the high expectations built up in the past few months? Will the Fed be able to conduct gradual rate normalization without impacting economic activity and market confidence? Will the European political agenda derail the firm ongoing growth? Those questions will have been answered (at least partially) before the beginning of the summer and they make the coming months a potential turning point.

Growth

While global growth is undeniably positive, the growing gap between the sharp acceleration pictured by "soft data" and the milder trend of "hard data" instills some uncertainty about the outlook. Such a gap is unlikely to last for long and the way it closes will shape global growth prospects for the second half of 2017. We suspect that the improvement will not be as spectacular as surveys suggest but we acknowledge that there are risks on both sides for the moment.

Inflation

Inflation dynamics have been positive across the board recently, principally driven by oil price base effects in developed economies and by currency weakness in some emerging economies. Such trend might extend further, but will not alter fundamentally weak underlying inflationary pressures, especially in developed markets. Base effects are prone to dissipate over time, as in Europe where the peak in headline inflation rate might already have been reached.

Monetary policy stance

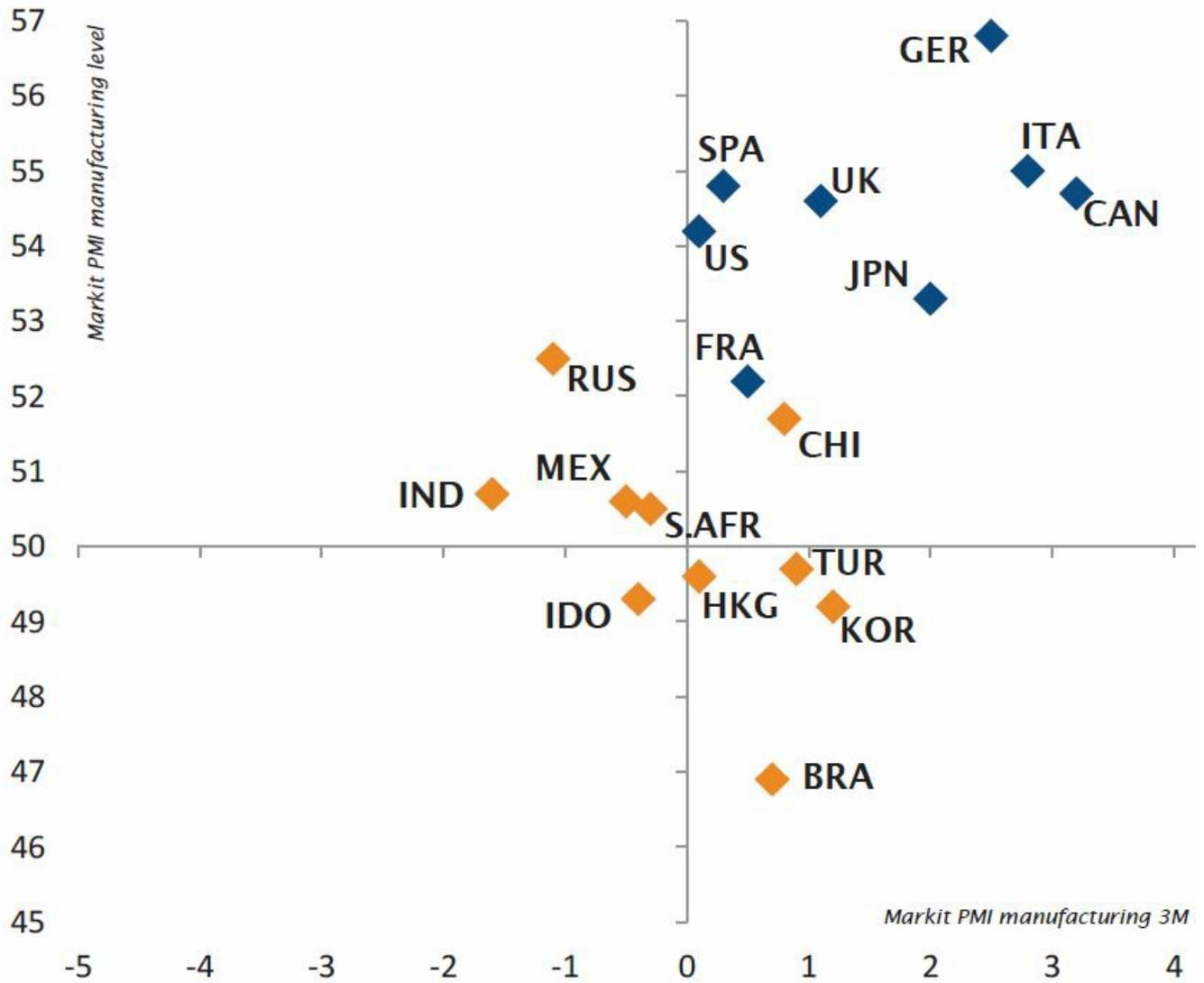
Overall, monetary policy is due to remain rather accommodative in developed markets and rather restrictive in emerging markets, where currency weakness and resulting inflationary pressures require higher rates. In the US, further rate hikes will depend on the continuation of the positive growth and inflation trends. The ECB might also consider gradual normalization with QE tapering, but only once immediate political risk is out of the way.

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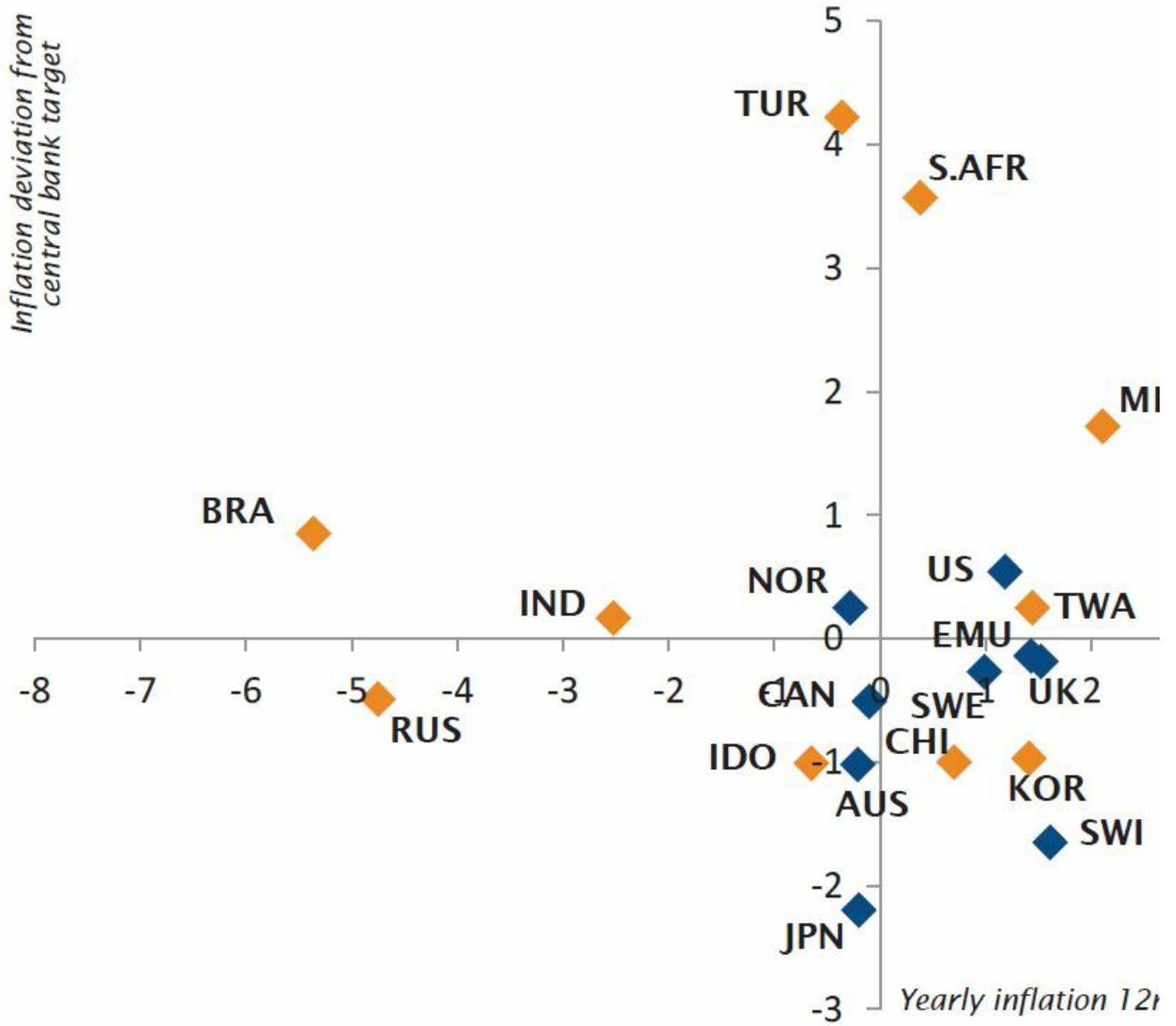
— *Adrien Pichoud*
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● PMI Manufacturing trends and level



● Inflation trend and deviation from Central Bank target



Developed economies – As good as it gets?

In the US, continuous positive surveys meant the Fed pulled the trigger for a rate hike on March 15th. However, the gap between surveys, pointing to a sharp growth acceleration, and actual data, not showing significant improvement yet, still plead for cautiousness. High expectations around fiscal stimulus might be dampened by a complex context for legislative action, with the return of a ceiling on US public debt, longer than expected discussions around the Obamacare reform and diverging views, within the Republican party, on the shape of a tax reform.

In Europe, putting political risk aside, the macroeconomic backdrop is probably as good as it can get. With broad-based firm expansion within the Euro area, dissipated deflation risks but no increase in underlying inflation, and the ECB intending to maintain accommodative financing conditions. If French elections do not cause a negative confidence shock, the economic environment is expected to remain supportive going forward, eventually leading the ECB to consider more QE tapering.

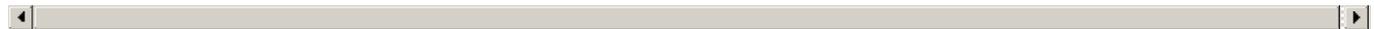
Japanese indicators do not exhibit the same cyclical momentum than Western economies, but they still underline ongoing expansion. The latest price data suggests a mild reversal of the previous slowing trend, possibly helped by Q4 Yen weakness, that keeps inflation just in positive territory and reduce pressure on the Bank of Japan.

Emerging economies – Inflation is center stage

Business cycle dynamics are generally positive among emerging economies, albeit less pronounced than in developed economies. Growth in China appears to have stabilized at a level consistent with GDP growth between 6.5% and 7%, the annoying part of it being that it has been largely supported by strong credit growth. The balancing act between growth and financial stability remains a challenge for Chinese authorities.

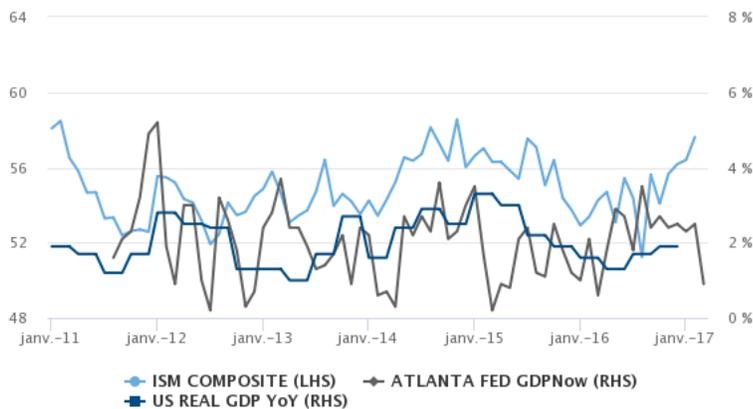
Inflation is a more prevalent issue in the emerging world, as the combination of factors such as weakening currencies, higher oil prices and credit growth keeps central banks in alert and forces them to maintain relatively restrictive monetary policies compared to their developed market counterparts. Such a stance also acts as a headwind for business cycle dynamic and may explain the relative lack of growth momentum compared to the western world.

_Adrien Pichoud



Wide divergence between surveys and hard data keeps us gdp outlook uncertain

Source:SYZ Asset Management, Bloomberg



Investment Strategy Group: key takeaways

Risk and Duration

No change in assessment. The fact that Geert Wilder's anti EU party has not been able to secure sufficient votes to take control of the Netherlands is clearly a positive development. Nonetheless, one cannot draw a conclusion from this result for the outcome of the presidential election in France. While we believe that the French election might well be the entry point back into equity markets (particularly Europe), it is still too early to make that call. Moreover, the political impasse in the US over Obamacare, government funding and the potential tax reform have, in our view, the potential to disappoint equity markets even further. Hence, the equity risk score remains at a mild disinclination.

When it comes to duration, our view remains intact that bond markets are expensive and central banks are shifting into a less accommodative stance. The fact that bond investors reacted positively to the interest rate hike by the Federal Reserve in mid-March is a good sign, but it is as much testament to the expectation management by the Federal Reserve, as anything else. We are mindful that the ECB and the Bank of Japan might eventually be forced to change their dovish narrative. Hence no change in the assessment either.

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Equity Markets

Within equity markets, the only segment that has appeared to be attractively valued is volatility. Up until late March levels of implied equity volatility were as low as they have been in years. The VSTOXX, which is an index that gauges European equity volatility, tumbled post the Dutch elections to a level of 11.2%, the lowest level in the history of this index. One can argue that this measure of volatility is somewhat inaccurate, given the fact that options which have exercise levels that are far away from the prevailing equity index level are overrepresented in this volatility measure. Nonetheless, even when looking at implied volatility levels of options that are close to their exercise price it became clear that volatility is cheap. The generic measure of implied volatility of one month at the money options went also as low as 12%. Similar observations of cheap equity volatility can be found in the US with the VIX troughing at 10.6% in January, in Japan with the VXJ index bottoming at 14.5% and in emerging markets with the VXEEM index at 14% in early March. Since the defeat of Donald Trump over his plan to repeal and replace Obama care, which was one of his election promises, all of the aforementioned equity volatility measures have clearly started to edge higher. Yet they remain at very low levels, continuing to suggest a fair level of complacency around potential risks by market participants. When it comes to our scores, besides the downgrade of Canada and Norway to a mild dislike, there has been no change to the country preferences. The reason for the downgrade of these markets was due to their strong bias to resource stocks, paired with the fact that the oil price has fallen more than 13% since the beginning of the year.

Bond Markets

As mentioned in previous months we remain concerned about bond valuations. However, the fact that the interest rate hike by the Federal Reserve in mid-March was accompanied by a rally in the US government bond markets is evident that in the very near term Treasuries seem to have bottomed out. Moreover, the political showdown unfolding in the US, and the fact that US inflation pressures and growth momentum is likely to roll over given base effects, would suggest an at least stable environment for US bonds here onwards. Hence our relative preference for Treasuries over other bond markets. Yet, longer term there remains a significant question mark over the sustainability of current government bond yield levels. Political risks remain underestimated in Europe, and the fact that the ECB and the Bank of Japan will eventually have to become hawkish, is likely to present a headwind to bond markets. Namely Japanese government bonds are vulnerable to a repricing, given that they have barely moved since the US election. Hence our change in assessment.

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Cash remains king! Moreover, the USD trade finally seems to have turned. We have mentioned the fact that the strength in USD appears to be overdone for many months now, yet the US dollar continued to climb on expectations of interest rate hikes by the Fed and on hope of higher US growth induced by Donald Trump's reflationary policy agenda. With the Fed, having delivered a rate hike earlier than anticipated by markets and, with Donald Trump facing his first stumble on implementing his policy changes, the US dollar went into freefall. We expect this to continue and maybe even to accelerate as other western central banks will have to start to reassess their monetary stance.

_Hartwig Kos



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