ASSET ALLOCATION INSIGHTS

Our monthly view on asset allocation (November 2017)

Saturday, 11/11/2017

While the economic backdrop, earnings-per-share growth and sentiment remain supportive, asset prices have now more or less priced in the current goldilocks scenario.

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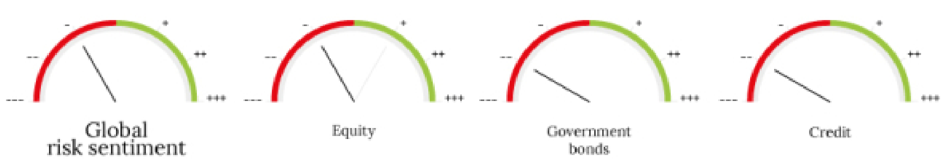
- Still a clear broad-based global growth environment, with no sign of any meaningful change to be expected in the near future.
- Several equity markets were downgraded from (++) to (+) due to less attractive valuations.
- The overall risk stance in our multi-asset portfolios is decreased to slightly negative (-) whereas the duration risk is kept low (- -).



Goldilocks tapering

Let's get straight to the point: we are adopting a more cautious stance towards our global risk assessment, which has been downgraded to mild disinclination in our portfolios. While the economic backdrop, earnings-per-share growth and sentiment remain supportive, asset prices have now more or less priced in the current goldilocks scenario. So, the questions we are asking ourselves are: how much upside remains on equities and credit markets? Not so much. Can economic growth continue to surprise the consensus on the upside? Not likely. Will inflation fall further in the next few months? It seems very unlikely. Will central banks' ultra-loose monetary policy continue to resist the rational exuberance in the financial markets? We doubt it.

In other words, the safety margin is expected to shrink going forward as the goldilocks scenario should at some point start to deteriorate. Volatility may then pick up as the massive "central banks' put" fades away with the odds of a (healthy) correction, or at least a consolidation, picking up. Don't misinterpret our view: we aren't calling a bear market but just keeping some of our chips selectively out of the markets as the expected risk-adjusted returns of some assets such as credit and US equities (specifically technology stocks) aren't appealing. As the continuation of the markets' rational exuberance cannot be totally excluded, it makes sense to focus our risk budget on the laggards of the current bull markets, namely European and Japan equities, which have the advantages of better valuations, more "cyclicality" and higher visibility on their economic and political situations. That's the best way to hedge ourselves against a powerful human emotion, i.e. the fear of missing out… because as usual, it ain't over till it's over!

On the other hand, the duration stance was kept in disinclination as the path of least resistance for rates remains currently on an uptrend. Inflation is bottoming out, some kind of central banks' monetary policy normalisation, led by the Federal Reserve, is expected down the road and Trump's fiscal plan is now back on the table. A spike in rates due to exaggerated concerns about inflation or clumsy central banks normalisation remains our biggest concern. If it happens, it will certainly provide a more interesting entry point to both reload some equity risks into our portfolio and adopt a more constructive view on governments bonds.

_ Fabrizio Quirighetti

Economic backdrop in a nutshell and global economic review

Let's start with a confession: the current economic environment feels odd to your faithful economist, scarred by a decade of crises, below-par growth and ever-looser monetary policies. This year's combination of global synchronised growth and monetary policy normalisation seems too good to be true, with recent years suggesting something nasty will eventually come out.

And yet, despite political turmoil in Spain, elections in Italy and stalled Brexit negotiations, strong economic growth keeps the risk of a negative surprise coming out of Europe low. In the US, Republicans are finally getting close to pass a long-due tax cut package and provide fiscal stimulus to the US economy. In Japan, political continuity shall extend the current strong growth dynamic. Oil producing countries are enjoying the highest crude prices in two years. Chinese growth has stabilised and anything will be done to avoid troubles during the Communist party congress. The Fed, the ECB, the BoE all hint towards monetary policy normalisation, but those intentions are so tempered by cautiousness and gradualism that financing conditions are set to remain loose for a while.

All this is enough to be convinced that such a positive macroeconomic backdrop is likely to last for some time, as long as no exogenous shock occurs such as geopolitics or weather. It is, however, certainly not enough to forget about the underlying fault lines of the global economy: structural growth slowdown, high and rising debt levels, monetary policy hyper-sensitivity or political uncertainties fueled by rising inequalities. Those issues will inevitably resurface, even if probably later rather than sooner. In the meantime, let's enjoy the continuation of this supportive macro background but bear in mind that the upside from here is limited…

Growth

Still a clear broad-based global growth environment, with no sign of any meaningful change in the near future.

Inflation

Inflation remains mildly positive across developed economies but fails so far to accelerate, while it is slowing down in several large emerging economies.

Monetary policy stance

Large developed central banks look to normalise their accommodative monetary policies, but only very gradually. Several emerging market central banks can afford to relax their restrictive stance thanks to lower inflation, but also only gradually.

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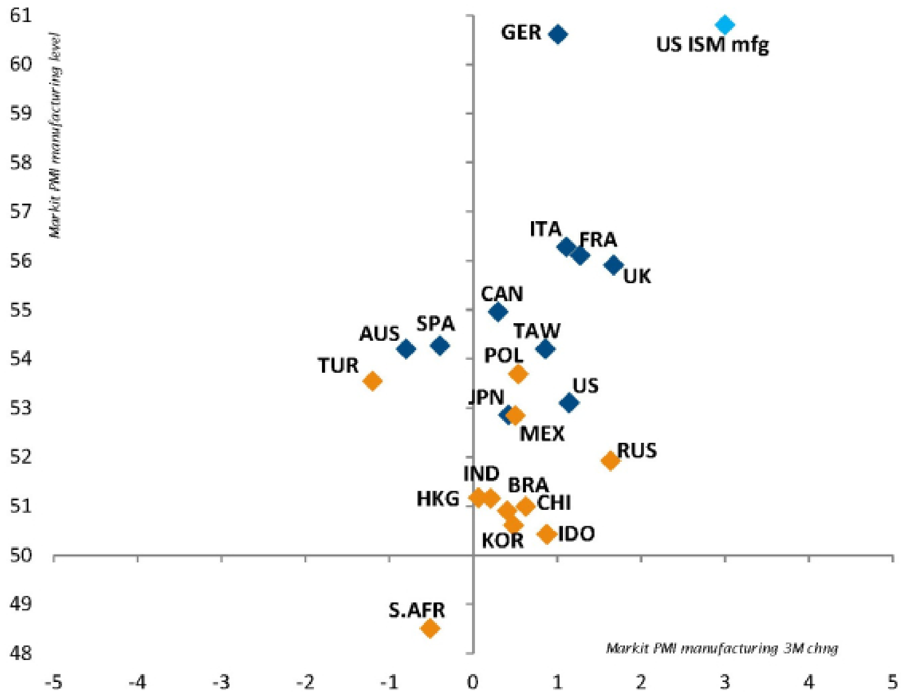
Adrien Pichoud
Chief Economist & Senior Portfolio Manager

PMI Manufacturing trends and level



Source
Factset, Markit, SYZ Asset Management. Data as at : September 2017

Inflation trend and deviation from Central Bank target

Source
Factset, Markit, SYZ Asset Management. Data as at : September 2017

Developed economies

US economic data have so far been only moderately affected by the passage of the two hurricanes in August, the most visible impact being on job creation anc wages. At the margin, those disasters may have a small "positive" impact on activity and inflation data in the months ahead, because of replacement and reconstruction needs. Along with the long-overdue tax cut package seemingly on track to be passed around year end, this creates an environment where the Fed is likely to get confident enough about growth and inflation prospects to hike by another 25bp in December, in what could possibly be the last rate movement presided over by Janet Yellen. In the meantime, the Bank of Canada is moving toward a "wait-and-see" approach after its unexpected rate hikes, as the very strong Canadian business cycle is decelerating slightly.

The Eurozone remains in "catch-up mode", with pent-up demand from consumers and businesses fueling a strong expansion (by European standards) that is lifting even the laggards such as France or Italy. Only Spain is expected to experience some slowdown, due to the impact of political uncertainty on the second-richest Spanish region. The pattern of solid and improving expansion also fits economies and Switzerland. Even the UK, plagued with huge uncertainties surrounding post-Brexit prospects, exhibits good economic resilience and continues to grow, even if at a slower pace than before the Brexit vote.

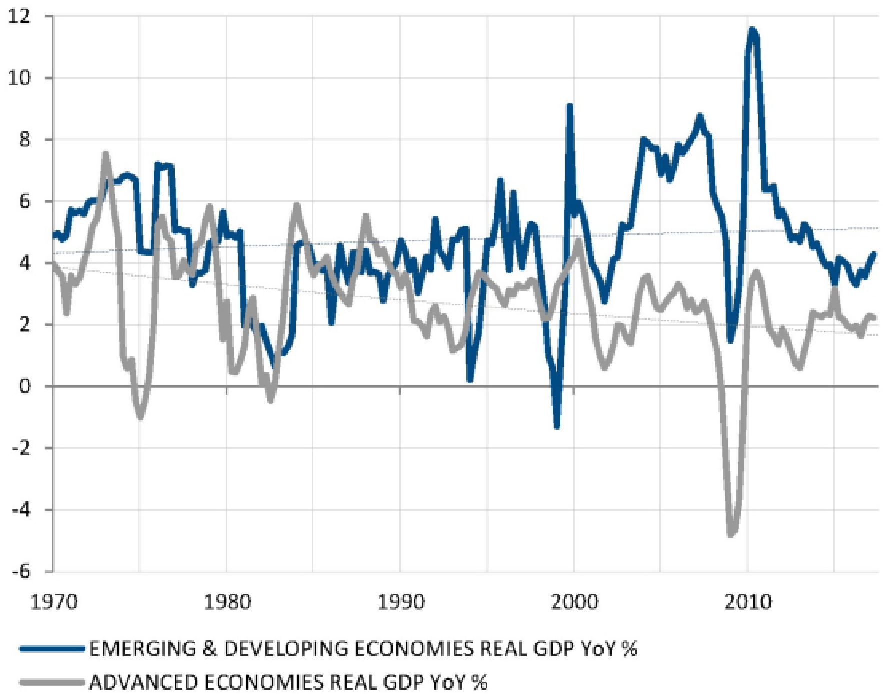
The Japanese economy continues to thrive, as reflected by the latest quarterly Tankan survey. With the BoJ committed to keeping supportive monetary policy despite growth and inflation improvement, and political continuity with the renewal of Abe’s mandate, all lights are green for the Archipelago, with the exceptior of the influence of North Korea.

Emerging economies

Economic growth is also positive across the developing world, with China’s GDP up 6.8% YoY in Q3, right within the government’s targeted expansion rate as the Chinese Communist party’s congress begins. EM Asia in general is supported by China’s stabilisation and a strong tech sector cycle fueling export growth, with only the Damocles sword of geopolitical concerns hanging over the short-term outlook. Brazil is slowly recovering and, with inflation at a 20-year low, the BCB has room to continue to cut the SELIC rate, a situation comparable to the one of Russia. In Mexico, inflation may have peaked but renewed uncertainties related to NAFTA negotiations, and the related downward pressure on the peso, keep the central bank on its toes. On the contrary, inflation remains quite high in Turkey and leaves the central bank between the rock of above-target inflation and the hard place of potentially slowing growth as fiscal stimulus benefits fade away.

_Adrien Pichoud

Above-trend growth in Developed Markets, rebounding growth in Emerging Markets



Source
IMF, Factset, SYZ Asset Management. Data as at : June 2017

Investment Strategy Group Takeaways and asset valuation

Risk and Duration

Having maintained a mild preference for equity risk for the better part of six months, the time has come to alter that stance slightly. The overall preference for risk has been downgraded to a mild dislike. This reduction in equity preference has, however, not come in tandem with an upgrade in the preference for duration. The stance on duration remains unchanged at a dislike. What are the reasons for this shift? Indeed, the economic backdrop remains favourable, and equity valuations albeit dull are far from stretched. Moreover, this goldilocks dream world of solid growth, low inflation and accommodative monetary policy is likely to persist somewhat longer. Yet, the gradient is most likely to change from here. Growth might be weaker on the margin, inflation might be stronger on the margin, and central banks will certainly be less accommodative on the margin, which means the "margin" is what is driving this modest change in assessment. Over the last eighteen months the favourable economic backdrop has provided powerful tailwinds for equity markets. But these winds are now shifting, which could well mean that a fair clearing price for equity markets is somewhat lower than current levels. Bond markets have started to look more appealing than before, but current levels are not attractive enough yet to warrant a change in assessment.

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> —— *Hartwig Kos*

Equity Markets

Relative preferences have not changed, we remain "all in" on Europe and Japan, but the overall level for Europe, Japan and the United States has been downgraded each by one notch.

Bond Markets

It remains fact that bond markets aren't cheap and central banks are becoming less accommodative than in the past. These two arguments have broadly been the pillars of our negative stance towards duration, which was implemented in the summer of 2016., and indeed Western bond markets have seen a substantial rise in yields over that time. US Treasuries went from 1.4% to 2.3%, German bunds went from -0.2% to 0.4% and Gilts jumped from 0.7% to 1.3%. This tectonic upward shift in Western government yields, and unsynchronised monetary policy across the main central banks, has also created interesting micro opportunities within these bond markets. German bunds were once the most expensive bond market on earth and they now look more attractive than US Treasuries. When accounting for the interest rate differential between the US and Europe, i.e. the hedging cost between USD and EUR denominated assets, a lot of the yield advantage of Treasuries over bunds disappears. Currently the 10Y bund yields are at 0.36% and 10Y Treasuries are at 2.35%. The current six month hedging costs are at a level of 2.2% annualised. This means that in EUR terms Treasuries yield at 0.15% and vice versa bunds yield at 2.56% in dollar terms. Australian government bonds also look attractive, but this is as much a currency call as it is a call on yields.

Nonetheless, the bigger question remains, when is it time to become more constructive about developed government bond markets in general? Not yet, but soon, potentially sooner than one would expect. Taking US government bonds as an example, it is true that bond investors have systematically underestimated the monetary policy path orchestrated by the Federal Reserve for most of the year. During 2017 every single time the Fed rose rates, the market initially did not believe in a hike and Yellen or any of her Governors had to talk up expectations, despite the fact that financial conditions are as loose as they have been in the last few years. This suggests that there was clearly plenty of room for the Fed to tighten monetary policy even in spite muted inflationary pressures. However, since September the market has shifted somewhat with regards to expectations. The probability of a December hike by the Fed is already close to 90% and has been north of 50% since September. Moreover, quantitative tapering by the Fed has just started in October and the knock-on effects are unknown yet. In addition to that, the US tax reform also seems to be shaping up fast, in light of very low market expectations. All of which, has in our view the potential to push US yields higher in the near term - potentially, close to 3%. We would certainly be buyers of Treasuries at these levels, but also even before that.

It is true that the balance sheet unwind by the Fed changes the investment landscape in the US fixed income market, as the biggest buyer in town is not there anymore. The common argument that is put forward is the fact that by the laws of supply and demand (even if the pace of quantitative tapering is gradual), one would expect upward pressure on yields. But, when it comes to Treasuries, supply is also managed. The Treasury department might well choose to issue fewer bonds and bonds with shorter maturities, which could put marginal downward pressure on the long end of the US yield curve. When it comes to mortgage backed securities, there is much less scope to manage supply. However, in a rising yield environment mortgage holders are much less inclined to pay down their mortgages early. This means that the duration of these mortgage backed securities could well increase and fewer than anticipated mature in the near term. At this point the Fed is merely reducing their reinvestments, but it would not be unfeasible to see that there is not much reinvestments to make because these securities are simply not maturing that fast.

While the tax reform clearly sparks some excitement in the near term, it is still a long way for this legislation to pass, and the degree to which it contributes to rising yields remains to be seen. What is more important than this are the longer-term expectations that the Fed has set in terms of their dot plots. The FOMC's longer-run funds rate projections have persistently come down since 2012, from a level of 4.25% to currently 2.75%. The current market expectation for five year cash rates is close to 2%, so not very far off. In light of an increasingly flattening yield curve a level of 2.6% to 2.7% would not look bad at all.

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Forex, Alternatives & Cash

The Australian dollar was upgraded by one notch from a dislike to a mild dislike, valuations have improved somewhat and strong economic activity might force the RBA to eventually become more hawkish about their outlook for interest rates.

_Hartwig Kos

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