

Our monthly view on asset allocation (February 2017)

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As complacency is now king, we are in fact concerned by stretched valuations on both equity and credit markets.



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- Entering 2017, the vast majority of the global economy is experiencing positive and improving growth dynamic.
- We are concerned by stretched valuations on both equity and credit markets, especially high yield that has not seen any correction in the last few months.
- As complacency is now king, we are taking some chips off the table by reducing our overall risk stance.

What could go wrong ?

There is a sea of change on financial markets compared to one year ago, as we moved from excess pessimism to some form of irrational hope. Sentiment is clearly supported by a more favourable economic backdrop : activity indicators are globally picking up, inflation is moving higher and major developed central banks are either finally contemplating to hike or, at least, not hinting to cut rates further into negative territory. However, it's worth noting that firstly, rates are already at very low levels in terms of economic growth, inflation and key policy target rates, and secondly, we don't expect meaningful or sustainable overshooting in these three key variables in the future as the nasty trinity of poor productivity gains, muted labour force growth and high indebtedness remains in place. In other words, our medium-to-long term scenario hasn't changed, growth will continue to come through, core inflation will tend to undershoot central banks' targets and thus monetary policy will err on the accommodative side.

While last year there were plenty of reasons for investors to get concerned and scared enough to sell equity at their bottom levels, which we avoided, we are now struggling to find a consistent narrative to be overly cautious and drastically reduce our risk stance. We are sceptically optimistic. It's quite difficult to predict what could go wrong in the next few weeks in order to derail the current tailwinds : European political risk premium has shrunk, Chinese woes have been removed on the border line, rates aren't high enough to weigh on the overall equity markets, central banks won't deliver a nasty surprise and economic momentum should remain strong. As complacency is now king, we are in fact concerned by stretched valuations on both equity and credit markets. The margins to absorb any negative, unknown surprises are thin as they are already pricing the perfections described here above.

Consequently, we are taking some chips off the table by reducing our overall risk stance from mild preference to mild disinclination. We are keeping some reflation trades on the equity side where there is still some upside for valuation and economic backdrop reasons, even if the outperformance may not be as clear going forward as it has been over the last few months. Selected EM debt exposure - with Mexico and Turkey being our top picks - and some duration exposure through US treasuries are starting to offer some value both in terms of valuation and portfolio construction. After buying on the sound of cannons, we now opt to reduce on the sound of the Trumpets.



Global risk sentiment



Asset class preference



Government Bonds



Credit



Economic backdrop in a nutshell

The global economy has entered 2017 on a much stronger footing than the year before : no China worries, no fear of deflation, no fall in oil prices, hope of a significant improvement in the US growth outlook... This new year starts under the auspices of positive cyclical dynamics across most large economies, positive global inflation trends, stabilized growth in China and prospects of fiscal policy support, especially in the US. The key question is to know whether such "reflationary" environment can shape the entire year ahead or if some disenchantment is around the corner, leading the end of 2017 to finally look like early 2016 in some kind of mirror effect... Our view unfortunately leans toward the later option but, for now, recent positive macro trends are bound to extend into the first months of 2017 and the short-term investment framework is still one of (almost) synchronized positive global growth and inflation dynamics.

Growth

Entering 2017, the vast majority of the global economy is experiencing positive and improving growth dynamic. Firm consumption in developed economies, supported by rising employment, fuels final demand and helps industrial activity to recover after the 2015 soft patch. The only economies lagging behind this dynamic are affected by idiosyncratic issues.

Inflation

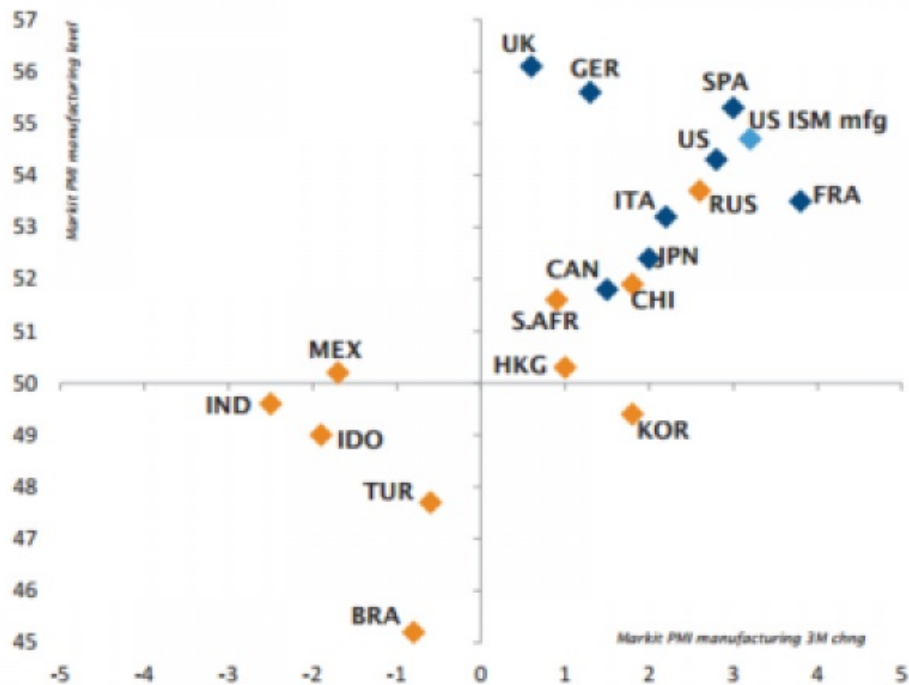
Actual inflation and inflation expectations have been trending up in the last few months of 2016. A combination of higher energy prices, positive base effects on yearly inflation rates, mild upward pressures on US wages and optimism around fiscal stimulus packages has managed to dissipate deflation concerns. However, actual and expected inflation rates remain low in absolute terms and the latest cyclical uplift will soon face structural headwinds.

Monetary policy stance

The positive growth and inflation dynamics remove pressure from central banks' shoulders in the developed world. The Fed has become more confident in its ability to "normalize" its monetary policy stance. The ECB has extended its QE program till the end of 2017 but seems to look for an "exit door" to its current ultra-accommodative policy stance. However, the high sensitivity of growth to credit conditions and subdued underlying inflationary pressures will continue to warrant very accommodative monetary policies going forward.



PMI Manufacturing trends and level



Source
SYZ Asset Management

« Recent positive macro trends are bound to extend into the first months of 2017. »

— **Adrien Pichoud**
Chief Economist & Senior Portfolio
Manager

Inflation trend and deviation from Central Bank target



Source
SYZ Asset Management

Developed economies

US economic indicators have continued to surprise on the upside. On top of the ongoing cyclical improvement at play since the summer, the election of Donald Trump has so far sent a positive confidence shock on the domestic side of the economy, pushing consumer confidence to a 15-year high and SME confidence to a 12-year high. Those high expectations are soon to be checked against reality once the Trump administration effectively takes the helm of the country. The Fed's optimism toward its ability to hike rates in 2017 will also much depend on the concrete policy measures of the Trump administration.

In the Euro area, the most pressing issue remains political risk, with elections in most large economies due in 2017. Beside this Damocles sword, the purely economic background is still encouraging, with broad-based positive growth dynamics, fading deflationary pressures and monetary policy to remain very accommodative till the end of the year at least. Brexit negotiations also fill into the "political risk" category but are more likely to influence mostly UK growth and inflation dynamics.

The Australian economy is enjoying a strong bout of growth, spurred by the rebound in commodity prices and strong domestic demand. Japan continues to benefit from the cyclical support of a weak yen, even if the FX impact should fade away in 2017.

Emerging economies

Economic performance are more heterogeneous among large emerging economies. Some of them enjoy tailwinds from strong export demand, rising oil and commodity prices and currency depreciation. As such, China, Russia, Poland, South Africa or Taiwan exhibit improving growth trends.

On the other hand, a handful of large emerging economies face idiosyncratic issues and lag behind the positive global cyclical dynamic : India and its demonetization reform, Mexico and Trump-related uncertainties, Turkey and political, geopolitical and monetary context, Brazil, still in early recovery phase.



Investment Strategy Group: Key Takeaways

Risk and Duration

Having witnessed a strong equity market rally in recent months one has to recognise that 2016 has been a year of extremes. It started with near apocalyptic fears about Chinese authorities having lost control of their economy, and falls in the oil price leading to a deflationary ice age for the global economy. It ended with "Trump-Phoria" and the accession of the "great reflation". In between, investors saw every globally meaningful, political tail risk materialise. Yet despite all this, financial markets kept roaring ahead. This was not only the case for western equity markets which delivered a total USD return of 7.5% as measured by the MSCI World, but also expensive and universally hated developed market bonds, as measured by the Bloomberg EFFAS G7 index, delivered a respectable total return of 1.3% in USD terms.

Whether investors apply the same reaction function to the tail risks that are on the horizon in 2017, such as the upcoming European elections and the implementation of Trump's policies, remains to be seen. But one thing is clear, the world will continue to be an uncertain place in the year ahead and the global political regime shift currently underway exacerbates this uncertainty. In the very near term, one has to be cognisant that some equity markets reflect a very positive view of the world in 2017 already, which is clearly concerning. As a consequence the risk stance was downgraded a notch from a mild preference to a mild dislike, the score for duration remains unchanged at a mild dislike.

Equity Markets

Given the rise in bond yields and stalling recovery in corporate earnings, equity risk premiums saw a persistent deterioration over recent months. Namely the US equity market has moved into expensive territory, Europe and Japan witnessed a move into the same direction albeit not as pronounced. Having downgraded the US last month and having become more cautious on the risk stance as a whole, it is appropriate for us to downgrade the core European markets from a preference to a mild preference as well. Recent developments in Europe, such as the potential for early general elections in Italy and the open inquiry for misuse of state funds against François Fillon the conservative front runner (and favourite candidate by market participants) in the French general elections, clearly promises further market volatility on the horizon. Yet, despite that we still remain cautiously optimistic about European equities given the remaining high political risk premium that investors continue to assign to the market.

Sectors and style preferences have become an increasing talking point in our macro analysis recently. In the first half of 2016 our view was to hold a fairly balanced portfolio with comparatively few sectorial and style preferences, and throughout the second half of 2016 our preferences shifted more towards value and cyclical sectors. This preference remains intact, however what has changed is the level of confidence that we have with regards to these preferences. Namely in the context of US equities it is fair to say that there is in our view a higher likelihood in generating positive returns from relative sector and style bets than from holding the overall market itself. The rationale for this view is less driven by our confidence of Donald Trump rapidly delivering reflationary fiscal stimulus packages, but more by the relative positioning of the investment community, which is still heavily positioned in the expensive bond-esque equity sectors that have underperformed considerably in recent months. Thus, opening the opportunity for a prolonged and gradual rotation into cyclical sectors as investors are forced to close their underweights.



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Hartwig Kos

Bond Markets

Western government bonds have become cheaper compared to a few months ago, but they are still expensive in our view. Moreover, the dislocations in the way risk models tread different bond segments, as described last month, continues to persist and leaves us concerned about bond markets overall. Within the different bond segments high yield stands out as the one market that has not seen any correction in the last few months, and risk models have become increasingly complacent about the actual risk that this bond segment carries. As a consequence high yield was downgraded to a dislike. Within developed bond markets the US and Canada look now somewhat more attractive, the same is the case for France and Italy. When it comes to emerging markets the relative preference for emerging hard currency bonds over local currency bonds remains intact. Our top picks in the hard currency bond universe are Turkey and Mexico. The Turkish 10Y dollar bond trades at yield levels of 5.75%, very close to its post taper tantrum peak in 2013 and very close to 2011 levels where Turkey suffered a severe funding crisis. A similar picture presents itself in Mexico, where the 10Y dollar bond is close to 4.2%. Within the emerging market local universe Russia and Brazil have clearly lost a lot of their appeal. The currencies still may be at very attractive levels and bond yields offer good carry, but these two markets have become very crowded consensus positions, while the risk premiums embedded in the yields reflect a fairly positive macroeconomic scenario for both countries.

Forex, Alternatives & Cash

Given our change to a less constructive stance for risk and duration, the assessment of cash was implicitly upgraded. In foreign exchange markets the Yen looks somewhat more attractive, due to its intrinsic valuation, but also due to our view that the recent strength in the USD appears to be overdone and the likelihood of near term US dollar weakness has increased considerably. Gold was also mildly upgraded from a strong dislike to a dislike, on considerations regarding the USD but also on the chance that US real yields might fall given increasing inflation expectations, paired with a potentially more hesitant Federal Reserve, than expected by market participants.

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