ASSET ALLOCATION INSIGHTS

Our monthly view on asset allocation (December 2017)

Monday, 12/04/2017

Luc Filip
Head of Discretionary Portfolio Management

Fabrizio Quirighetti
Macroeconomic Strategist

Hartwig Kos

Adrien Pichoud
Chief Economist & Senior Portfolio Manager

- Overall risk appetite increased over the month for our strategy.
- Preference towards the equity markets continues to be our thesis due to valuations and the possibility of corporate earnings improvement in the US.
- Bond markets remain expensive despite mild improvements in valuations, but pockets of opportunities still exist.

Ready for a Santa Claus rally

Dear Santa Claus, there are only a few weeks to go before your long-awaited arrival and I would like to make sure that you have received my letter. Looking at the stock market performance that has accumulated at the foot of the Christmas tree this year, your elves have had to work a lot and your hood will be heavy to wear. I do not know how you did it, but I am the happiest of the investors. Everything was like in my dreams … For the first time in a very long time, there was economic growth everywhere, inflation has remained contained so far and the central bankers, who sometimes scolded us, did not even need to turn into bogey men. In short, you've spoiled us this year. Maybe you just missed a bitcoin at the bottom of our socks also !

Thank you Santa Claus for not having looked too much at our nonsense and those of the blond-haired politician who has heckled all year long in the back of the class. Hopefully, he decided to favour continuity by nominating Jerome Powell as the future new President of the Fed. More of the same could not have been a better choice to reassure markets. He also behaved nicely during his recent visit in Asia, avoiding triggering a geopolitical tsunami in its wake. In any case, I would be very grateful to you for not offering him anything to play war with his North Korean friend. Thank you also for the dovish ECB tapering announced last month as we were somewhat concerned about a potential nasty hawkish surprise. Super Mario has clearly remained our market's favourite toy central banker this year.

We perfectly know that this goldilocks environment won't last forever. At some point next year, inflation may start to rise (at least moderately), growth momentum will fade away and the big central banks will start gradually to withdraw the punch bowl. However, for the time being, we want to enjoy the end of the year season greetings. As a result we adopted again a more constructive views on our risk stance (upgraded one notch to mild preference), especially towards equities, in order to benefit from a very likely Santa Claus rally.

My colleagues and I obviously promise to behave well and try to be as wise as possible next year by limiting exposure to speculative debt (you warned us of the dangers with Toys 'R' Us) or to lend, eyes closed and without term premium compensation to the governments, to avoid financial repression on the cash that we would sometimes keep in deposit. Mom and Dad say you see everything we do from up there. So, we promise you to obey them, because we had all the gifts we wanted this year. Except perhaps bitcoins … But we do not hold it to you because like a lot of toys, it may soon be out of fashion. Now, I leave you because you must have a lot of work before Christmas night. Take good care of yourself and do not forget to say hello to Johnny Halliday : if he could continue to play all the music we love from up there, we should still be able to dance on the markets for the next few months.

_Fabrizio Quirighetti

Economic backdrop in a nutshell and global economic review

The end draws near for what will have been the best year for the global economy in the post-financial crisis era. It is this time of the year when economists submit their outlooks for the next year before enjoying a year-end break. In doing this exercise, all certainties are welcome and the past few weeks have brought a few interesting ones.

Firstly, we know now that Italy will gather more attention for its general elections and ongoing economic recovery than for its role in the World Cup. Possibly more importantly for financial markets, we know that the European Central Bank (ECB) will continue to purchase bonds until September and that it is therefore highly unlikely to hike rates before 2019. Finally, there will be no revolution at the helm of the Federal Reserve as the chosen successor of Ms Yellen, Mr Jerome Powell, appears likely to extend the current policy stance rather than bring a drastic change (at least in the short run).

With that in hand, it seems that the risk of central banks suddenly turning less supportive has receded. For sure, central banks are all turning toward less accommodative policies, as illustrated by the Fed hiking rates and unwinding its balance sheet, the ECB tapering its quantitative easing program, and the Bank of England and Bank of China hiking rates. But, subdued inflation has so far allowed them to move with utmost cautiousness. And this is where the main visible uncertainty lies for us. Will inflation remain in the narrow sweet spot of 2017, i.e. not too low to avoid raising deflation concerns but not too high to avoid prompting a more decisive central bank reaction? To be clear, we remain firmly of the view that powerful structural factors prevent a genuine inflation acceleration. But this doesn't rule out some small deviation from current low levels, with potential triggers being tighter labour markets, higher oil prices, currency movements and fiscal policy changes.

In the absence of major imbalances on the investment, inventory or wage side, favourable global growth trends are likely to extend into next year. It is therefore inflation (even subtle) changes and, most importantly, central banks' reactions that are likely to be the X-factors of 2018. Not only for their impact on the one big imbalance that plagues the vast majority of the global economy, indebtedness often at record level, but also for the repricing that it could trigger in financial markets.

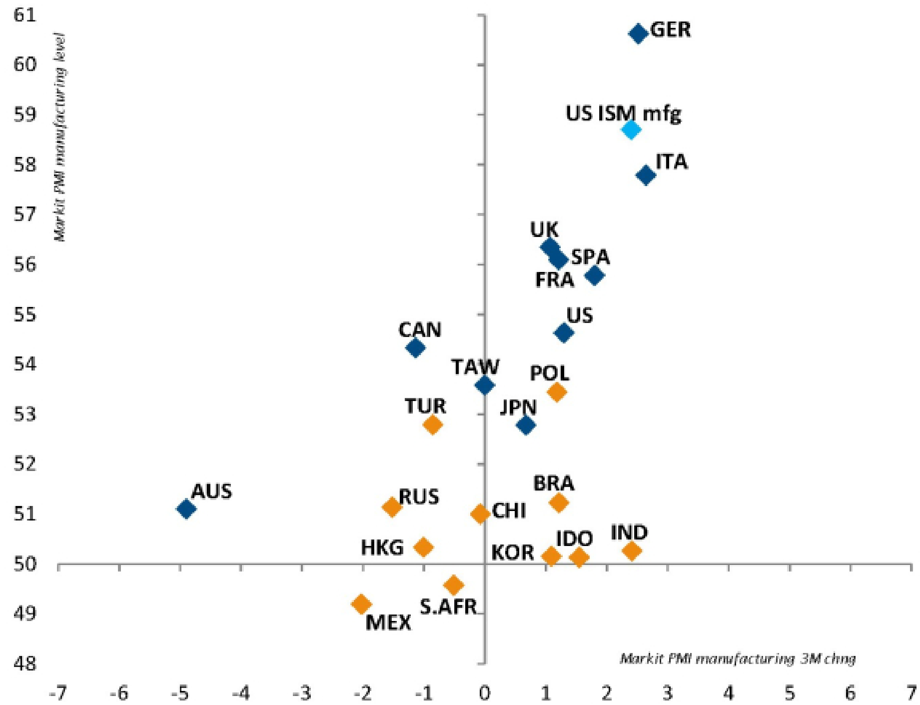
Of course, geopolitical uncertainties cannot be ignored when looking toward 2018. Instability on the Korean peninsula and Middle Eastern political tensions amid the Iran/Saudi Arabia rivalry certainly have the potential to disrupt global growth and financial markets, but they are hard to factor into economic forecasts.

Our view for 2018 could be summed up as such: we expect a similarly favourable global growth backdrop than in 2017. In this context, inflation is more likely to inch higher than to slow down. We think, should such a scenario materialise, that developed central banks may be tempted to take on the opportunity and attempt to withdraw some of the extraordinary support they have had to provide since 2008. Therefore, while the overall macroeconomic picture remains quite positive, it is likely to feel "less good" to financial markets than it did in 2017, when they were able to have their cake (ultra-easy monetary policies) and eat it too (synchronised global economic growth).

« While the overall macroeconomic picture remains quite positive, it is likely to feel "less good" to financial markets than it did in 2017. »

— *Adrien Pichoud*
Chief Economist & Senior Portfolio Manager

PMI Manufacturing trends and level



Source
Factset, Markit, SYZ Asset Management. Data as at : 17 November 2017

Inflation trend and deviation from Central Bank target

Source
Factset, Markit, SYZ Asset Management. Data as at : 17 November 2017

Developed economies

After two solid quarters of 3%+ GDP growth, the US economy appears set to extend its favourable dynamic into year-end. Confidence and business activity indices, but also so-called hard data such as retail sales and industrial production, suggest no loss of growth momentum during the beginning of Q4, a situation acknowledged by the Fed on November 1st. Only one category of economic data continues to disappoint: inflation and wage indices, all stubbornly below expectations and below the Fed's target. While the Fed displays enough confidence in a coming improvement on that front to communicate its readiness for a December hike, it will need to see some green shoots developing in order to carry on hiking rates throughout 2018.

The Bank of England has just joined the Fed and BoC in the "rate-raiser" club, with a 25bps hike offsetting the post-Brexit rate cut. Above-target inflation amid resilient economic activity led the BoE to adopt a slightly less accommodative stance and to keep the door open for more rate hikes in 2018. On the other hand, the ECB has managed to announce a slowdown of its asset purchase programme while containing expectations of monetary policy tightening. By committing to purchase (fewer) bonds until September 2018, it pushed away the possibility of a rate hike to 2019 at the earliest, ensuring that the still-strong economic growth in Euroland will not be deprived from very accommodative monetary policy support.

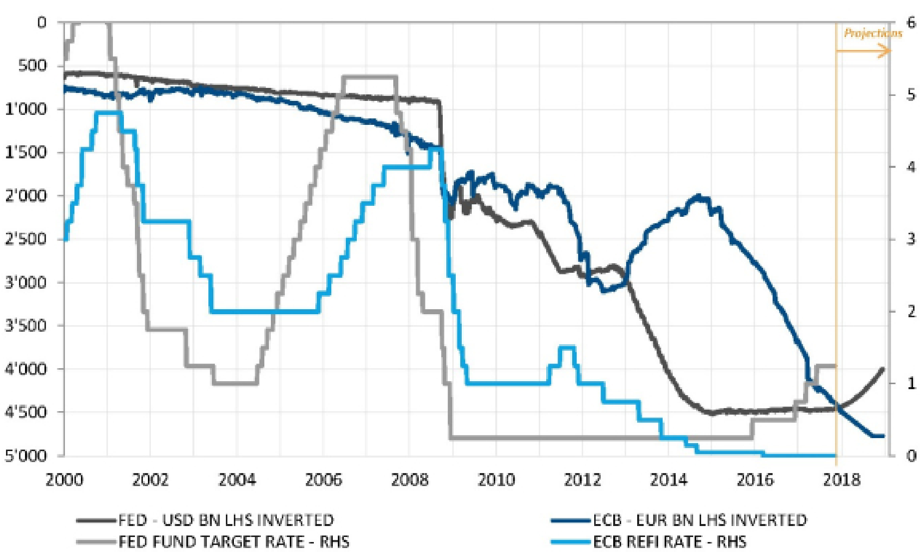
Japan has posted a seventh consecutive quarter of positive GDP growth, its longest streak in decades. The Bank of Japan still pledges to maintain ultra-loose monetary policy "until inflation reaches 2%" but the favorable macroeconomic backdrop may tempt the BoJ to abandon some of its most aggressive measures in 2018 - especially if all other major central banks move on to normalisation.

Emerging economies

As the sequence of the Communist Party Congress unfolds, Chinese officials are signaling their readiness to accept somewhat slower growth in order to meet its goals of curving credit expansion and greener development. Coincidentally, the latest economic data point to a mild loss of economic momentum for the Asian giant. Rising oil prices have continued to benefit producing countries such as Russia, but Middle East countries face growing political instability amid a rampant Iranian/Saudi Arabian struggle for influence. Mexico is suffering from earthquake-related disruption in activity but should resume expansion ahead of next year's general elections. Most of eastern Europe benefits from the strong growth dynamic of the Eurozone, with possibly the exception of Turkey, where inflation remains in double-digit territory and the support of pre-referendum fiscal stimulus gradually fades away.

_Adrien Pichoud

Unlike the Fed, the ECB is far from beginning normalisation



Source
Bloomberg, Fed, BCE, BoJ, SYZ Asset Management. Data as at : 17 November 2017

Investment Strategy Group Takeaways and asset valuation

Risk and Duration

Our assessment of overall portfolio risk was once again upgraded to a mild preference from a mild dislike. This was done after having seen a mild correction in equity markets over the past month, and recognising significant steps have been made in the US towards writing tax reforms into law.

If the tax reform, Donald Trump's 'flagship legislation', does indeed come through, which is becoming more certain by the day, then the stalling US business cycle might get another push upwards, and equity markets with it.

Undoubtedly, such a shift in policy would raise questions about inflation and future central bank reaction functions. Conscious of that, there has been no change in our assessment of duration. This despite the fact that bond markets have now started to look more appealing than earlier in the year.

> *« If the US tax reform does indeed come through, which is becoming more certain by the day, then the stalling US business cycle might get another push upwards, and equity markets with it. »*
>
> *—— Hartwig Kos*

Equity Markets

In terms of relative preferences across equity markets, there was only one adjustment. The US equity market was upgraded from a mild dislike to a mild preference. This upgrade has been made in light of two considerations.

Firstly, given the more defensive nature of the US equity market, this upgrade implies a defensive increase in risk preference.

Moreover, Europe and Japan remain more attractively valued than the US for the time being. Yet if the tax reform is to pass, which is in our view likely, corporate earnings in the US could be significantly revised upwards, providing support to US equity valuations.

Bond Markets

At the risk of stating the obvious, bond markets continue to be expensive. This remains true despite mild improvements in valuations since the summer.

In terms of relative regional preferences across developed government bond markets, our assessment of treasuries was upgraded by one notch to a mild preference, while Italian bonds were downgraded to a mild dislike. However, the overall bond asset allocation remains unchanged.

Emerging market bonds still stand out as the least bad – albeit some of the valuation advantages have eroded here as well. Nonetheless, there are still some asset price dislocations in emerging debt markets that provide significant investment opportunities. Turkish local bonds are a good example of that.

The recent selloff in the Turkish Lira has mostly gone unnoticed by market participants. Yet it feels like a déjà vu of last year's crisis, which erased one third of the lira's value against the US dollar and pushed 10-year local bond yields to 11.6%.

The predominant fears at the time were geopolitical and security risks as well as external vulnerabilities given a more hawkish Federal Reserve. Moreover, the selloff in the Turkish lira last year was accelerated by concerns surrounding the country's democratic foundations, given the constitutional referendum scheduled for March 2017, if passed, was going to grant president Erdogan significantly increased powers.

In January 2017, the Turkish Central bank (CBRT) broke its cycle and adopted a much more hawkish narrative as well as sharply raising the effective funding rate from around 8% to 12%. This was not the first time the CBRT made radical shifts to its monetary stance to support the Turkish currency. Both in 2011 and 2014, the lira came under severe pressure and both times the central bank tightened monetary policy by 500-600bps to defend it.

« There are still some asset price dislocations in emerging debt markets that provide significant investment opportunities. Turkish local bonds are a good example of that. »

—— Hartwig Kos

The generally positive macroeconomic backdrop has, for most of the year, allowed Turkish assets to recover some of their earlier losses. Yet since early September the lira has seen renewed pressure. It has sold off 16% and 10-year local bond yields have risen almost 250bps to 12.8%. Like in 2016, geopolitical concerns and security risks prevail. External vulnerabilities are flaring up again, given the pause in US dollar weakness and the Fed's more hawkish narrative, and Erdogan is taking a more aggressive stance against Murat Çetinkaya the governor of the CBRT, over his restrictive monetary policy.

Nonetheless, the CBRT has so far done the right things. It has started to raise the effective funding rate for banks i.e. tightened monetary policy to defend the lira, and it wouldn't be surprising to see a pronounced change in interest rates, like in 2011 or 2014. Moreover, at yields close to 12%, which is 1% carry a month, and with the currency as weak as ever, a fair amount of risk premium is clearly embedded in this bond market.

Forex & Cash

No change in assessment.

_Hartwig Kos

Disclaimer