

## Our monthly view on asset allocation (January 2018)

Monday, 01/08/2018



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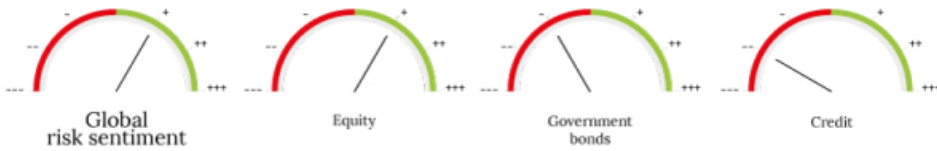


**Hartwig Kos**



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

- The US and Eurozone continue to deliver positive economic surprises.
- We maintain our preference towards the equity markets as bond markets continue to be expensive.



## Keep dancing

The economic and financial backdrop hasn't changed much over the last few weeks. And it won't just because we have entered a new year: a goldilocks environment, coupled with stretched valuations, still prevails. The only noticeable economic news has been the US tax reforms and related cash repatriation. This will lift growth temporarily and add about \$10 to S&P500 EPS or about 7% additional earnings growth this year to a rough consensus estimated average of \$150. How the repatriated cash will be split between M&A, exceptional dividends and productive investment, remains an open question depending on specific stocks and sectors but, again, this boost should not alter the economic outlook beyond 2018.

In the meantime, US inflation continues to surprise on the downside despite low unemployment, higher commodity prices and strong growth. It is the same story for the other major developed economies: inflation, or rather the lack of it, is allowing central bankers to err on the dovish side. On top of the usual structural factors such as ageing, low productivity and debt overhang, the Amazon effect seems to have also kept inflation at bay as, thanks to technology, supply now tends to adjust as fast as demand. Looking forward, we now see upside risks to growth in the first part of 2018, especially in the US, while inflation is also expected to show more clear-cut signs of bottoming out around the end of the first quarter.

We are keeping a constructive stance on risk in our portfolios, favouring equities (especially Japan, then Europe and finally US), over credit. The overall high yield segment offers little upside potential, except a meagre carry - that is even lower than the dividend yield on the European markets - while being at risk from fading economic momentum and/or higher inflation and so rates normalisation at some point next year. A greater scrutiny and selectivity is thus warranted. A few specific names, such as Mexico and Turkey, in EM hard currency and local debt continue to offer some relative yet unexciting value.

Even if we don't believe in a surge in inflation and a massive bond sell-off (we instead foresee a "timid" bond bear market), our duration stance was kept at a disinclination. In the current economic context and risk-on financial environment, the path of least resistance for rates remains on the upside. The least bad choice is US duration and preferably through inflation-linked instruments. As usual, our main concern remains a sharp repricing of the long end of the government bonds curves that could translate into downward adjustments for valuations across many asset classes. Inflation is the ultimate enemy of financial assets. However, equities should not adjust abruptly as long as inflationary pressures are benign and the final level, the speed of rates increases, and the underlying reasons remain reasonable (i.e. are in synch with the macro backdrop). To sum up: good times should keep rolling as we enter into the New Year.

*\_Fabrizio Quirighetti*

## Economic backdrop in a nutshell and global economic review

The economy managed to deliver another positive surprise before the end of the year 2017: the US Congress finally reached an agreement to pass the long-overdue tax reform that had fueled much market speculation after the election of Donald Trump. In a context where US economic data had already recovered momentum after a dull H1, this tax reform can only support and extend the ongoing positive dynamic, even if its direct quantifiable impact on GDP should be limited. Such a development is not negligible when it is related to the world's largest economy! Especially as the strong positive momentum is being echoed by other developed economies, with Europe still leading the pack, and as emerging economies benefit from strong external demand and recovering commodity prices. From a macro perspective, the Goldilocks environment continues to prevail in early 2018, with even possibly more short-term upside risks than downside risks to the business cycle. The big question mark around the 2018 outlook is inflation: the risk of some pickup in price indices, even mild, has increased and the speed and magnitude of any acceleration, if it were to happen, may raise pressure on central bankers to adopt a firmer approach to monetary policy normalisation.

### Growth

All large developed economies are recording positive and often strong GDP growth rates compared to their potential. Continental Europe is certainly the hot spot for this global momentum, with positive spillover of the eurozone's strength to neighboring economies, especially emerging economies in eastern Europe. Along with the positive US growth outlook, such trends are set to extend into the first half of 2018 in the absence of any exogenous shock.

### Inflation

Within developed economies, inflation rates remained insensitive to the strength of the business cycle in 2017. While there is still no visible trend yet, hints of some upward movement (even if limited) are building and make inflation the key macro factor to watch for 2018.

### Monetary policy stance

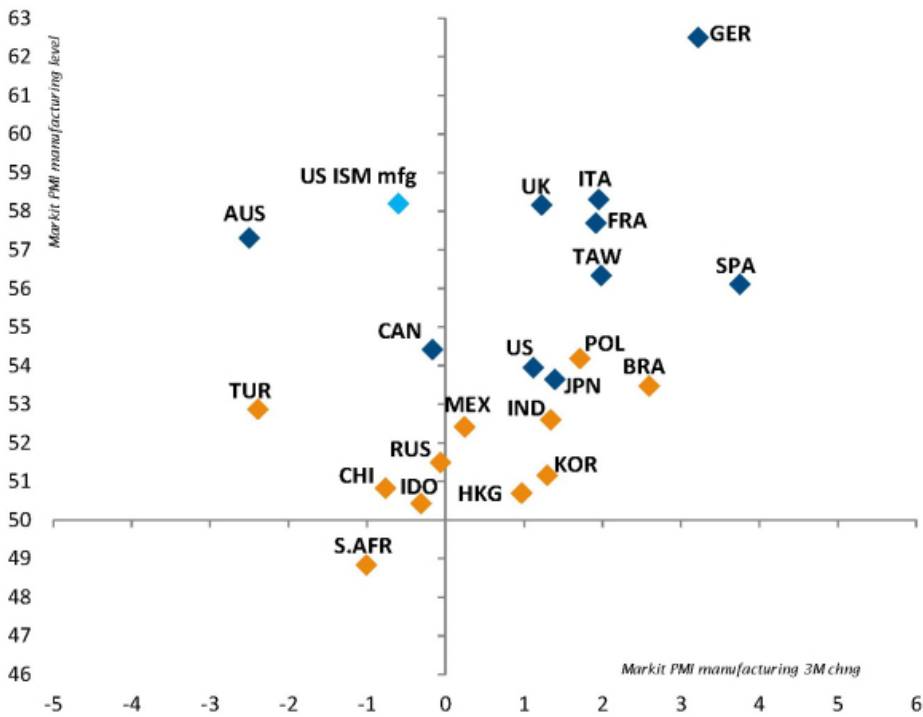
Indeed, the inflation dynamic will dictate the pace and extent of the ongoing (and so far very cautious) normalisation trend at play among major central banks. Should inflation prove to be firmer than expected in a context of strong economic growth, central bankers may feel the need to adjust their current accommodative stance faster than expected.

*« From a macro perspective, the Goldilocks environment continues to prevail in early 2018, with possible upside risks in the short-term. »*

— *Adrien Pichoud*  
Chief Economist & Senior Portfolio  
Manager

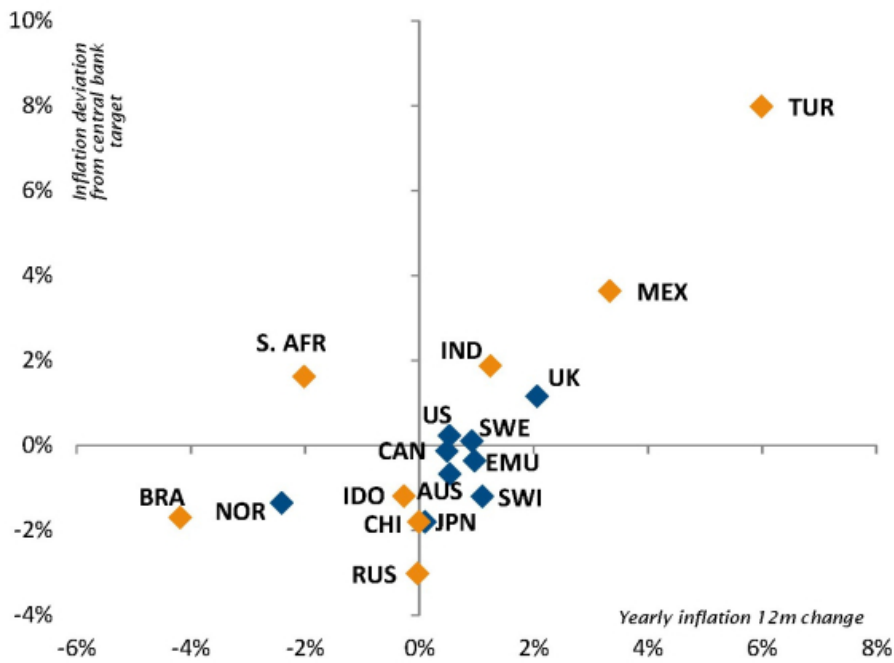


### PMI Manufacturing trends and level



Source  
Sources : Factset, Markit, SYZ Asset Management. Data as at : 22 December 2017

### Inflation trend and deviation from Central Bank target



Source  
Sources : Factset, Markit, SYZ Asset Management. Data as at : 22 December 2017

## Developed economies

The US growth dynamic extended unabated in the last weeks of 2017, with consumer sentiment, consumer spending, durable good orders, industrial production, real estate data and business confidence indices all pointing to firm expansion and another quarter of around-3% annualised GDP growth. As a result, the Federal Reserve was able to hike its key short-term rates for the third time in the year, displaying enough confidence in the fact that a tighter labor market will ultimately translate into an acceleration in wage growth and a pickup in price inflation. The vote for the long-overdue tax reform at the very end of the year can only support such a positive growth dynamic, even if the direct impact is likely to be modest. The "confidence impact" might be enough to fuel existing positive dynamic in investment, real estate, and even consumption, as consumer credit has recently rebounded despite rising short-term rates.

In the meantime, the eurozone further extended the spectacular growth acceleration displayed since mid-2016. A powerful catch up in domestic consumption and investment is at play, supported by strong external demand and very accommodative credit conditions. All economies in the monetary union are enjoying this improvement, which also offers positive spillover for non-Euro neighbouring economies such as Switzerland, the Nordics and Eastern Europe. Even if inflation remains quite low in the eurozone, such a positive growth background is likely to ultimately fuel the debate around European Central Bank policy normalisation - but not before mid-year as the current reduced QE program is due to expire only in September.

Any debate around Bank of Japan monetary policy normalisation is also unlikely to be seriously held before the summer, given that the term of Mr Kuroda ends in April. The odds appear in favour of the reappointment of the incumbent but, whoever happens to lead the BoJ in the next five years, he may have to engineer a gradual normalisation of the monetary policy as well, in a context of still-strong economic growth in the Archipelago.

## Emerging economies

Growth dynamics continue to be positive across emerging economies as a combination of supportive global macro factors boost the overall level of activity: strong external demand stemming from developed economies, rising energy and commodity prices, a weaker US dollar, fading and sometimes even low inflation (with a few notable exceptions such as Turkey or Mexico) that allows central banks to relax their monetary policy stance. Eastern European countries such as Poland thrive in the wake of the eurozone dynamic. Eastern Asian economies enjoy the relative steadiness of China's growth rate and firm global demand, especially for tech products. Only South Africa among the major EM economies remains in a less rosy economic situation. If recent political changes can spur hopes of a direction change in the management of economic affairs, any potential impact is unlikely to be felt in the short run.

*\_Adrien Pichoud*

## Both the US and the Eurozone deliver strong positive economic surprises



Source

Sources: Factset, SYZ Asset Management. Data as at: 9 January 2018

## Investment Strategy Group Takeaways and asset valuation

### Risk and Duration

No change in assessment.

### Equity Markets

In terms of relative preferences across equity markets, the UK and Canada were upgraded by one notch to a mild preference this was done on the basis of comparatively attractive valuations. Japan was also upgraded by one notch to a preference from a mild preference, making Japan our most favoured equity market. What are the reasons for this?

Firstly, the market is cheap compared to other equity markets. This has been flagged by the multi asset team for a while and in great detail already. Another factor that provides a positive backdrop for Japanese equities is the strong economic backdrop paired with muted inflationary pressures, and a central bank that remains very accommodative. Moreover, Japanese equities are very under geared compared to most of the other western equity markets. What does this mean? Over the last ten years, corporates particularly in the US have issued debt in order to buy back shares. And indeed corporate buyback has been one of the biggest drivers of namely US equity performance. The negative knock on effect of this has been the fact that corporate balance sheets have become more and more geared. This means that an increasing part of corporate EBIT has to be used to cover interest expenses, leaving less and less net income available for other obligations. To illustrate this compare the current dividend yield of the TOPIX index is 1.74%, a bit less than the yield of the S&P500 which is 1.82%. Yet, the TOPIX has a dividend pay out ratio of below 30% while the S&P has a Pay out ratio of above 50%. This means that in Japan a much smaller part of overall net earnings needs to be payed out in order to maintain an equivalent dividend yield as in the us. A part of this difference is due to the difference in valuations between Japan and the US. But another part is due to the fact that in the US a bigger part of EBIT is absorbed by interest payment and the overall net income from which dividends are distributed is comparatively smaller. Moreover, we are currently in an environment where interest rates are gradually rising, means that the leverage in US Equities could eventually start to bite. Japan is much more shielded of that, and the BOJ is far behind the Federal Reserve in terms of their hiking cycle. Finally, even though investors are positive on Japan, the positioning in the market is still very light.

*« We are currently in an environment where interest rates are gradually rising, means that the leverage in US Equities could eventually start to bite. »*

— Hartwig Kos

### Bond Markets

After a solid performance of bond markets in the in November and Early December 2017, the assessment of Italian linkers, German bunds and Australian Government bonds was changed. This means that US treasuries are now the only developed government bond market that is scored at a preference, all other markets are scored at either a mild dislike or a dislike.

This shouldn't come at a surprise, US Treasuries do offer comparatively good carry relative to other bond markets. Moreover, the two year segment in the treasury market has seen a persistent rise in yields over the last six months. The yield on 2 year treasuries currently stands at 2%, which is higher than the dividend yield of the S&P 500. This means that US investors have now an income generating alternative to US equities. This is quite a profound shift in relative asset pricing, which might have knock on effects in the future.

### Forex & Cash

No change in assessment.

*\_Hartwig Kos*

*"The yield on 2 year treasuries currently stands at 2%, which is higher than the dividend yield of the S&P 500."*

— Hartwig Kos



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