

Our monthly view on asset allocation (March 2018)

Wednesday, 03/28/2018

The return of volatility at the beginning of February resulted from the unwinding of the great goldilocks consensus: inflation is now gradually converging towards major developed markets central banks' targets.



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- Economic indicators continue to point towards strong expansion across the global economy.
- The return of volatility introduces uncertainty in markets and at the same time opportunities.
- Our global risk sentiment remains slightly positive, with a preference towards equities.



The postman always rings twice

The return of volatility at the beginning of February resulted from the unwinding of the great goldilocks consensus: inflation is now gradually converging towards major developed markets central banks' targets. While we do not think it will get out of control, central banks will thus normalise gradually in sync with the nominal growth trend and so valuations will have to adjust somewhat lower. But, we do not think we are at the beginning of a major and lasting bear market as earnings growth will not nose dive in the foreseeable future.

It's all about finding a new equilibrium by applying a lower current multiple to higher expected earnings. This phase of adjustment should theoretically be very gradual. But, in practice, it will now be expected to move in violent jolts, triggered sometimes by exaggerated or unfounded fears. This greater uncertainty, compared to the overcrowded goldilocks consensus of last year, may offer sizeable opportunities for those who keep a cool head and tactically navigate through these sawtooth markets. As the postman always rings twice, it's a safe bet that the demon of inflation and the spectre of a bond bear market associated with it will come back to haunt investors in the next few months.

As part of this process, valuations in nominal bonds has already improved markedly as they have adjusted to more hawkish central bank communications and inflation trending higher. Thus, we should now be more at ease with duration compared to a few months ago, especially as economic growth momentum and surprise indices are not accelerating anymore (momentum is fading away and economic surprise indices are declining). Consequently, our duration stance was tactically upgraded to "mild disinclination". So, in simple English, long-term rates are expected to stabilise or remain quite range bound in the next few weeks. This may lead to a stabilisation and potentially even a rebound in prices for risky assets. With less evidence of overheating, rates and inflation should not creep up further and valuations should not experience another leg down, at least in the short term. Because of this, the portfolio's overall risk stance was kept in "mild preference".

While the bull market isn't over, neither perhaps is the correction. Markets may indeed be spooked again in between April and June by a second round of upward pressures on rates as the inflation base effect will be less favourable (i.e. the annual inflation rate may temporarily jump). Based on our economic cycle analysis, our asset valuation review and our risk balancing framework, we should be able to hedge tactically against the next volatility spike. Inflation's bark is unfortunately sometimes worse than its bite.

Fabrizio Quirighetti



Economic backdrop in a nutshell and global economic review

As global economic growth remains strong and even gains momentum, the inevitable is finally happening: inflation is picking up from the abnormally low level seen in 2017. It proves the Federal Reserve, who saw the weakness of inflationary pressures as a transitory factor which would dissipate eventually, right. And, while it certainly has the potential to continue spurring on volatility in financial markets, this development has to be seen as a confirmation of the ongoing global growth dynamic.

Rising wage growth and price inflation in the US are likely to make the job of the new Fed president simpler in the coming weeks. While Janet Yellen had to justify during much of 2017 why the Fed was rising rates despite slowing inflation, a combination of solid growth indicators and improving inflation indices now make the case for further rate hikes much easier for Powell.

The ECB's job may, however, remain more difficult: although the Fed's lead and a strong business-cycle dynamic plead for an acceleration in the pace of monetary policy normalisation, Draghi has to bear in mind the Eurozone is far less advanced in its growth cycle than the US, as unemployment rates are still high and inflation has not yet hinted at a "catch-up" dynamic similar to the US'. By jumping in the Fed's wake, there is a risk of moving too soon and weakening long-awaited ongoing economic growth. By not doing so, there is a risk of missing a potentially rare window of opportunity...

Growth

All economic indicators continue to point towards robust and strong expansion across the global economy, with developed markets still displaying the best dynamic. However, emerging economies appear to be finally joining the global growth "party" after spending most of 2017 somewhat behind in terms of momentum.

Inflation

In parallel and interestingly enough, while inflation starts to pick up in several developed economies, it rather tends to slow down in emerging ones. Currency stabilisation, often at the price of restrictive monetary policies, helps cool down inflation rates.

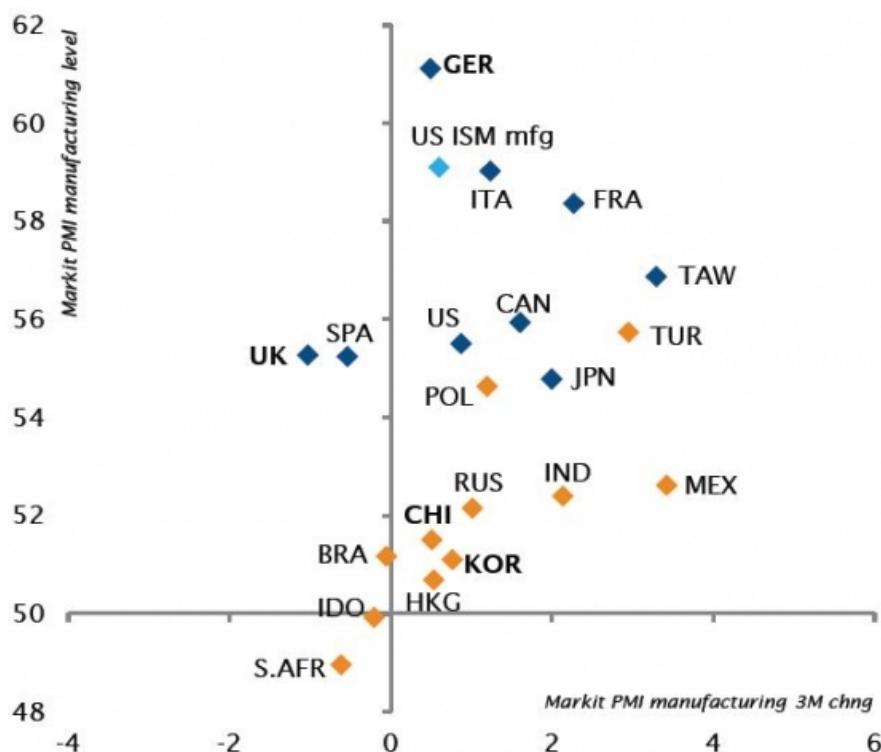
Monetary policy stance

The latest inflation data point to further removal of monetary policy accommodation by the Fed in months ahead, possibly followed with more or less haste by other large DM central banks. On the contrary, EM central banks might become less restrictive at the margin.

« Inflation is finally showing the tip of its nose in the United States! »

— **Adrien Pichoud**
Chief Economist & Senior Portfolio
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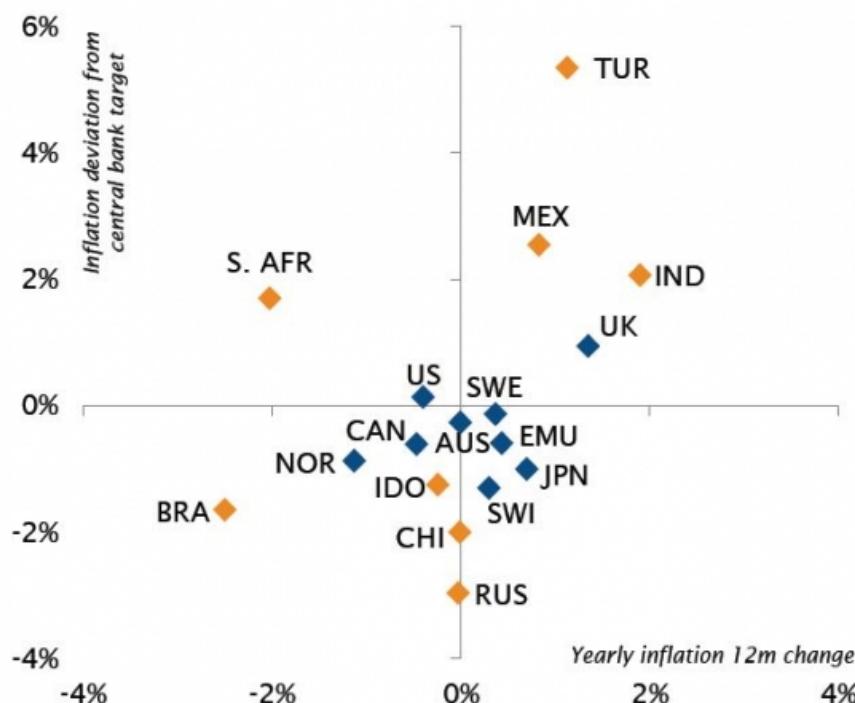
PMI Manufacturing trends and level



Source

Factset, Markit, SYZ Asset Management. Data as at: 23 February 2018

Inflation trend and deviation from Central Bank target



Source

Factset, Markit, SYZ Asset Management. Data as at: 23 February 2018

Developed economies

Inflation is finally showing the tip of its nose in the United States! Not to worry, this is far from the big inflationary scares of the late 1960s and 1970s. Rather, the recent uptick recorded in wages and prices merely shows inflation conditions catching up with the improved growth environment witnessed in 2017. Importantly, this dynamic had been expected by the Fed for the past year and was therefore already embedded into its economic projections. Still, the new Fed Chair and his peers will probably find comfort in the return of inflation, as it supports their progressive rate hike schedule – especially as business-cycle indicators continue to point towards firm economic expansion and fiscal stimulus will provide a tailwind to activity over the course of the coming months.

In Europe, the Eurozone continues to display strong economic growth across the board. Mid-cycle expansion is in full swing, with declining unemployment and easy financing conditions supporting consumption and investment. So positive is the situation, it is difficult to imagine additional improvement. Rather, the odds for the months ahead now point to a slowdown from the red-hot growth dynamic of the past quarters. Inflation remains very low and the Euro's appreciation by 15% against the US dollar over the past year is keeping a lid on imported inflationary pressures, especially taming the impact of rising oil prices. Positive business-cycle dynamics may also have reached their limit in the Eurozone's neighbours, such as Sweden or Switzerland. In the UK, Brexit uncertainties and higher inflation are weighing somewhat on the growth trend, but the resilience of the business cycle and above-target inflation are leading the Bank of England towards monetary policy tightening.

Emerging economies

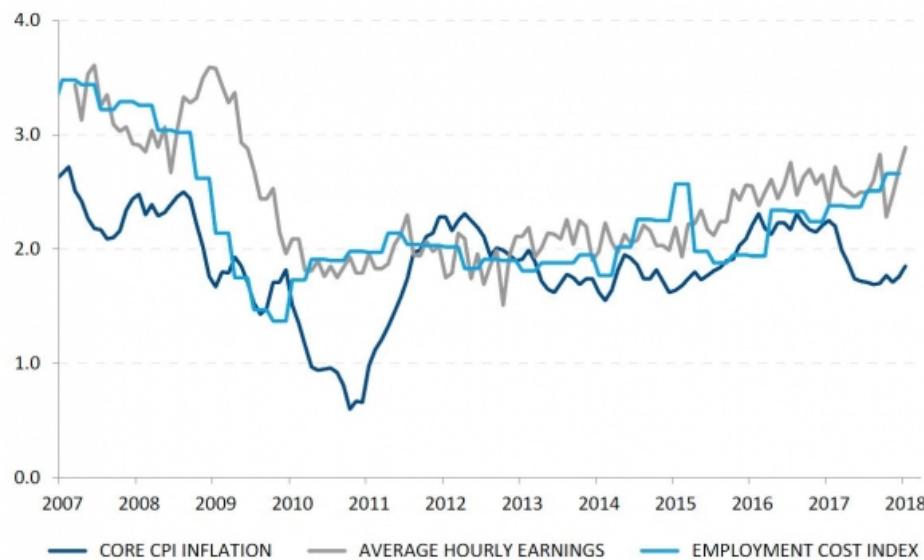
Emerging economies exhibited improving growth dynamics in the early weeks of 2018. While they had lagged the improvements recorded by their developed counterparts in 2017, they seem to be finally joining the global growth party. This may be linked to a combination of several positive factors, most of which are linked to the end of the US dollar appreciating. Firstly, it allows exporting economies to feel the benefits of strong final demand in the US and Europe without offsetting the FX impact. The relative stabilisation of FX markets also helps reduce inflationary pressures and therefore supports EM domestic demand. Finally, it also provides room for EM central banks to somewhat relax their restrictive monetary policy stance.

The impact of political developments is mixed, with clear relief coming from Zuma's resignation in South Africa, while looming elections in Brazil and Mexico maintain uncertainty around those economies' outlook. Also mixed is the impact of higher oil prices, which act as a tailwind for producing countries but threaten importing economies – especially the ones plagued with current account vulnerabilities. While FX-related impacts are positive for all large EM economies, political and oil price developments might well be the key differentiating factors among them in 2018.

Adrien Pichoud



US wage and price inflation is finally picking up



Source

Factset, SYZ Asset Management. Data as at: 23 February 2018

Investment Strategy Group Takeaways and asset valuation

Risk and Duration

February has seen a significant rise in bond yields, sharp falls in equity markets and a long-anticipated pick up in equity market volatility. Yet despite the rather dramatic market gyrations over the month, surprisingly little has changed. Equity valuations remain bleak, and bond markets have only barely begun to see an improvement in valuation levels. Given this, it is clearly too early to upgrade our risk stance, while the generally positive macro backdrop prevents us from becoming too negative on portfolio risk either. Hence, no change. Yet, when it comes to bond markets, investors have started to come to terms with the new reality of a more hawkish narrative from the main western central banks. This calls for a reassessment of the, up until now, rather negative stance on fixed income risk. As a consequence, the assessment for duration was improved by one notch from a dislike to a mild dislike.

« We are conscious that Japan's prolonged goldilocks scenario is entering its late stages, and that it is geared towards the global business cycle. Meanwhile, the negative correlation between equities and FX markets has not broken down completely. We are therefore fearful of a somewhat softer growth environment going forward, and a yen that keeps rising. »



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Equity Markets

For a few months now, Japan has been the market with the highest levels of investment conviction. This has been predicated on two factors; firstly, the strong link to the motoring global business cycle. The notion of Japan being the globe's cyclical market still holds with its high degree of operational leverage and high sensitivity to global PMIs. It has also been aided by the fading negative correlation between the Yen and Japanese equities.

We are conscious that Japan's prolonged goldilocks scenario is entering its late stages, and that it is geared towards the global business cycle. Meanwhile, the negative correlation between equities and FX markets has not broken down completely. We are therefore fearful of a somewhat softer growth environment going forward, and a yen that keeps rising. One has to bear in mind that Japan is a current account surplus country with a still very cheap currency. Besides that, the global trend towards higher protectionism is particularly painful for relatively mercantile economies with a high manufacturing basis such as Japan.

While we still believe in the investment case for Japanese equities given the intrinsic cheapness of the market and the fact that Japan tends to be a beneficiary of a rising yield environment, we have decided to downgrade Japan by one notch from a preference to a mild preference, bringing it in line with all the other developed equity markets.

Bond Markets

Having illustrated the case for western government bonds already at the end of last year and once again earlier this year, the selloff in February has finally pushed yields to levels where a change in assessment is warranted. While it is true that bond markets aren't cheap, central banks are becoming less accommodative than in the past.


« The market-implied cash rate for five years' time, a measure that can be used to gauge longer-term cash expectations, has risen by more than 40 basis points since the end of 2017. »



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Investors have now come to terms with the fact that the market environment has changed. Taking the US as an example, while bond investors broadly underestimated the monetary policy path orchestrated by the Fed for most of 2017, market expectations for interest rate hikes in 2018 are in our view more realistic, if still at the lower end of the spectrum. There has also been a profound change in the market's expectations for longer term cash rates. The market implied cash rate for five years' time, a measure that can be used to gauge longer-term cash expectations, has risen by more than 40 basis points since the end of 2017. The rate is currently at 3.14%, well above the FOMC's December median of longer-run funds rate projections, which is 2.75%. Not only that, it is also higher than any of the individual dots provided by the Fed governors. This clearly indicates that the Fed's governors may alter their plots at the March meeting, but it also signals the fact that market expectations have come a long way, making us much more comfortable in owning duration at this point. This view is expressed through nominal government bonds and through emerging market debt (local and foreign currency), all of which are scored at a mild preference.

Forex & Cash

Sterling was downgraded by one notch to a dislike - this move came in the light of a strong appreciation of the currency against the USD, neutralising a lot of the relative cheapness of the exchange rate. It also reflects the fact that politically the country remains in ruins, with very limited visibility regarding the progress of Brexit negotiations.

Hartwig Kos

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