

Our monthly view on asset allocation (April 2018)

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There are plenty of reasons to be cautious, and that thus explains the current challenging market environment: the Facebook data scandal, trade disputes, monetary policy tightening and softer economic data, to name a few.



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- The global economic picture remains positive when looking at growth, inflation and monetary policy, but suddenly it feels much less predictable.
- Volatility has returned to financial markets since the start of the year driven by macroeconomic uncertainties.
- Bond markets have improved on the margin but we maintain a preference towards equities.



Fundamentals are stronger than sentiment

There are plenty of reasons to be cautious, and that thus explain the current challenging market environment: the Facebook data scandal, trade disputes, monetary policy tightening and softer economic data, to name a few. While rising interest rates and weaker growth momentum in developed markets aren't really a surprise, the conjunction of these two elements has created a more fragile market backdrop compared to last year's perfect Goldilocks scenario. In this context, an escalation in the retaliatory imposition of tariffs is certainly the biggest worry for markets. So far, the numbers aren't significant enough to derail global growth and we believe that the US (i.e. President Trump), as well as China and other major economic partners, have no real incentive for a trade war that will certainly lead to mutual destruction. In other words, rhetoric is cheap.

On a more positive note, US inflation concerns have receded, validating to some extent our tactical decision to upgrade duration to a mild disinclination last month. We are keeping this stance as there is perhaps a little bit more upside to emerge in the next few weeks, especially as government bonds valuations have improved since the end of last year. However, the medium-term picture remains challenging as inflation fears may resurface sooner or later and the central bank's tightening path is reassessed.

In the fixed income space, our mild preference for emerging market debt has been reinforced by an improvement in both absolute and relative valuations, especially versus credit. Furthermore, emerging economies are experiencing their Goldilocks moment with an improving economic backdrop, while some additional monetary policy easing should support a slow and gradual growth rebound. However, EM bonds, especially in local currency, might face some pressures with the coming Fed rate hike and/or a dollar rebound; hence, we remain tactical and selective within this asset class.

As far as the equity market is concerned, the potential regulatory headwinds for some big technology companies have translated into disillusionment with the market leaders. These uncertainties are weighing on our assessment of valuations, especially for high-flying names. But, we aren't in the dot-com bubble any more - most of today's technology companies exhibit strong earnings growth and cash flow generation. The same could be said for the rest of the equity markets; there has clearly been a change in the volatility regime since February, even if profit growth estimates have accelerated since the end of last year. Here is the intricate dilemma investors have to face: a currently very favourable economic backdrop, which is expected to deteriorate going forward. The million-dollar question is how much and how fast? We believe it's more a mid-cycle slowdown than a recession. And on the other side of the equation, stretched valuations leave little room for manoeuvre to absorb external or political uncertainties, such as a full-blown trade war that could pose a serious threat to the macro picture. While the status quo is the least likely outcome (i.e. volatility does have some delayed impact), we are keeping a mild preference on risk as we continue to believe we are experiencing a correction rather than the beginning of a bear market. Spring should bring some green shots of hope.

_Fabrizio Quirighetti

Economic backdrop in a nutshell and global economic review

It is hard not to link the return of volatility to financial markets with the recent rapid increase in macroeconomic uncertainties. In just a few months, a period of steady, harmonised, inflation-less and seemingly-predictable global expansion has evolved into something much more polymorphic.

In the US, upside risks for growth and inflation have emerged, buoyed by the tax cut package. However, this has also increased the expected pace of monetary policy tightening, with uncertain ripple effects in a context of record US T-Bill issuance. And Donald Trump has opened a Pandora's box by announcing the imposition of tariffs on US imports.

In the meantime, the Eurozone has run out of economic momentum after apparently hitting its own speed limit, especially as its export engine faces headwinds such as a stronger euro and global trade uncertainties. Japan is faced with unexpected political uncertainty as Shinzo Abe, the triumphant victor in last Autumn's elections, is mired in a scandal that could drive him out of power and bring a more fiscally conservative Prime Minister before year end.

Finally, emerging economies, which have been on an upward trajectory recently, now face the combined threat of US tariffs, their potential adverse impact on China and the prospect of tighter US monetary policy.

Interestingly enough, none of these factors is necessarily negative, nor guaranteed – and they certainly do not have clear consequences. The global economic picture overall remains positive, whether on the growth, inflation or monetary policy front. But, it does suddenly feel much less predictable.

Growth

All major developed and emerging economies are expanding. Recently, Europe experienced a reversal in economic data trends, pointing to slowing growth momentum.

Inflation

In parallel to the growth dynamic, inflation momentum in Europe has also been weaker of late, while it is still modestly positive in North America and Japan. The disinflationary dynamic at play in several large emerging economies remains in place.

Monetary policy stance

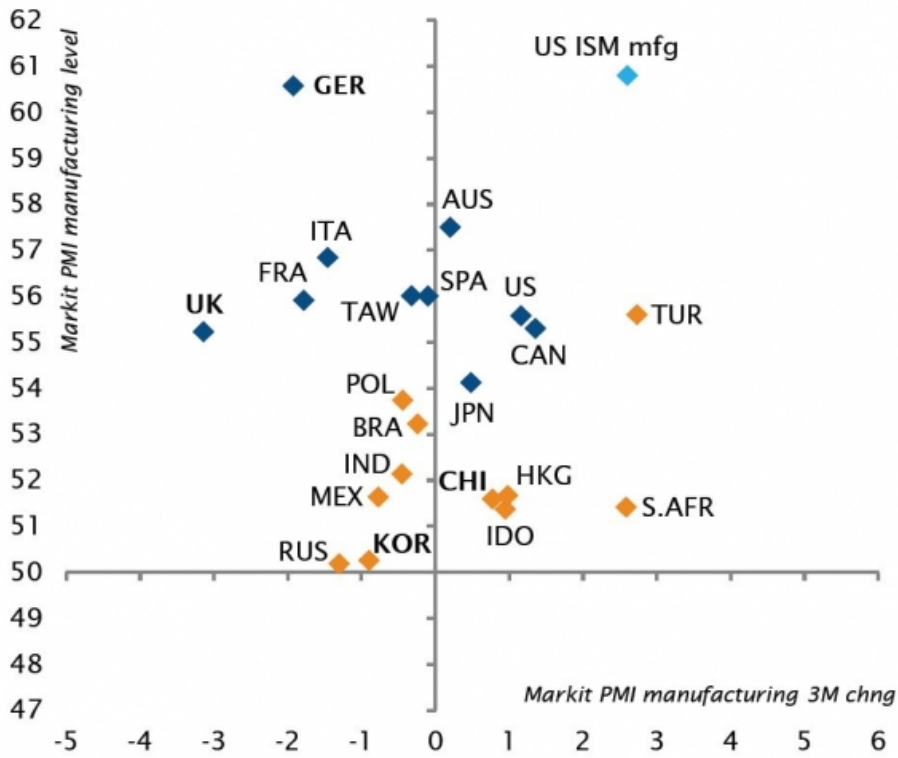
Monetary policy normalization is running its course in the US, while the ECB must proceed more cautiously given softer growth and inflation dynamics. Among emerging central banks, the gradual trend toward less restrictive policies is still at play.

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— *Adrien Pichoud*
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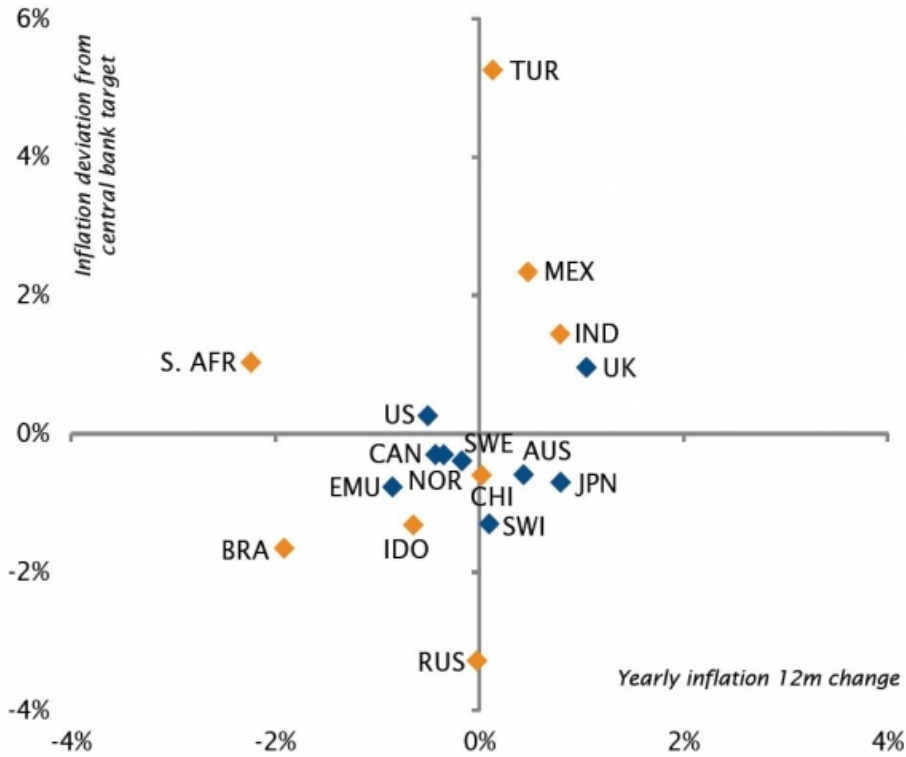


PMI Manufacturing trends and level



Source
Sources : Factset, Markit, SYZ Asset Management. Data as at : 21 March 2018

Inflation trend and deviation from Central Bank target



Source
Sources : Factset, Markit, SYZ Asset Management. Data as at : 21 March 2018

Developed economies

Oops!... Donald Trump did it again! We are not talking here of a specific tweet, White House sacking or sudden diplomatic U-turn. Instead, we refer to the burst of optimism triggered by the tax cut approved by Congress at the very end of 2017. In a similar fashion to the immediate post-election period, all confidence indices on both the household and business side have jumped markedly higher, reaching levels not seen for years if not decades.

However, again as in late 2016/early 2017, such optimism is failing to translate into concrete higher real economic growth. Household consumption even remains below par, despite the low unemployment rate. Whether this reflects pent-up demand to be unleashed once the tax rebate cheques hit mail boxes, or this is an early sign of the impact of less accommodative credit conditions on a credit-driven economy, remains to be seen. Despite this, upbeat sentiment and rising investment spending support a positive outlook for the US economy.

In Europe, the stars have moved out of the perfect alignment of H2 2017. Economic indicators are retreating somewhat from last year's highs - partly because such strong figures could not extend forever, but also due to shorter-term headwinds such as the delayed impact of a stronger euro on European exporters, especially in a context of rising global trade tensions. On top of that, Italian politics is again raising concerns around the EU projects after a few months of respite.

The positive side of this for markets is that it may dissipate any temptation for the ECB to hurry monetary policy normalization, especially when inflation is edging lower in the Eurozone. It also means that other European central banks will have to wait a little longer to exit their ultra-loose policies. The Bank of England may be the exception as it contemplates one rate hike in response to above-target inflation, especially as the Brexit transition deal nears completion.

Emerging economies

Until now a laggard among the large EM economies, South Africa is finally experiencing positive economic dynamics and a convincing recovery, helped by political changes - and the positive feedback loop initiated by a rebounding currency that reduces inflationary pressures and offers room for the central bank to possibly cut rates later in the year.

Slowing inflation dynamics continue to characterise most of the emerging world, as dollar softness and the resulting imported disinflation allows several central banks to relax their stance, with additional rate cuts in Brazil or Russia and a shift in outlook in Turkey or Mexico. For Mexico and Brazil, the looming presidential elections offer a degree of uncertainty to otherwise favourable growth scenarios.

The Chinese economy has displayed firm economic data of late, although likely distorted somewhat by the Chinese New Year calendar. The fine tuning of credit conditions to control the growth of the financial system is running relatively smoothly. Short-term uncertainty for China primarily lies in the potential impact of any US tariff and, even more importantly, the possible escalation of trade tensions between the two largest economies on the planet.

_Adrien Pichoud

US confidence is high but real growth lags so far



Source

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

Investment Strategy Group Takeaways and asset valuation

Risk and Duration

No change in assessment.

Equity Markets

There were few changes to our equity preferences last month; only Sweden was upgraded by one notch from a mild dislike to a preference.

However, looking at the broader picture, over the last few months the Investment Strategy Group has started to rebalance its broad investment views on the equity side. Most of the main geographical segments have received a similar assessment, with the notable exception of emerging markets, where we continue to prefer fixed income over equity risk.

We have held a long-standing preference for cyclical over defensive sectors. Our favourite sector over recent periods, besides energy, was financials, specifically banks. Cheap valuations, their general link to the global business cycle, as well as their natural hedging characteristics against rising interest rates, meant that banks have had a high allocation across many of our portfolios to date.

While we still like this segment as an investment theme, some of the initial investment rationale has softened somewhat. Banks are not as cheap as they were in the past, yields have risen to quite an extent over the last few years already and while the business cycle remains robust, the trajectory is more likely down than up from here. Although it is still too early to become constructive on defensive sectors, we are starting to see value in areas such as pharmaceuticals and telecommunications, which have suffered substantially during this period of rising yields.

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Bond Markets

Having upgraded our view on duration and western nominal bonds over the last few months, there are some natural follow-up adjustments that need to be made. Namely, upgrades for French and Italian government bonds. Both segments, especially Italy, look cheap versus Germany. Moreover, the continued dovishness of the ECB is likely to limit spreads widening from here. This means that all European bond markets are now scored at the same level, a mild dislike. The same argument holds for European investment grade credit, which has also been upgraded from a strong dislike to a dislike, bringing it in line with all other investment grade segments.

Within emerging markets there are some minor changes, but the overall picture remains the same. Both emerging market local and hard currency bonds remain, besides western nominal government bonds, our preferred bond segments. Yet, some of the areas of preference within this asset class have changed somewhat. Polish and Mexican local bonds were downgraded by one notch to a mild dislike, while Turkish hard currency bonds were upgraded to a preference. In the case of Poland this was due to a deterioration in valuations given a very strong performance; for Mexico, this was due to concerns about NAFTA negotiations and election risk, alongside the evident vulnerability of the Mexican peso in a more challenging risk environment. The upgrade on Turkish bonds was made on valuation grounds - a lot of the negative news flow regarding Turkey appears to be discounted in markets.

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— Hartwig Kos

Forex & Cash

Given the progress that has been made between the UK and the European Union in negotiating a transition period for Brexit, a fair amount of pressure has been lifted off Sterling; hence, the downgrade was reversed from a dislike to a mild dislike. Otherwise no changes to these areas were made.

_Hartwig Kos

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