

Our monthly view on asset allocation (May 2018)

Monday, 05/14/2018

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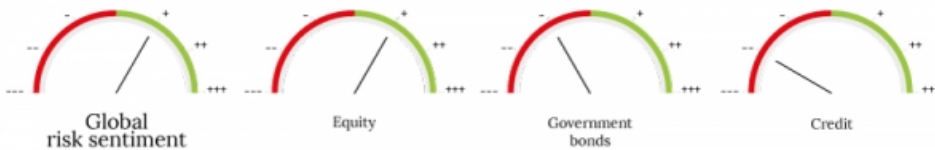


Hartwig Kos



Adrien Pichoud
Chief Economist & Senior Portfolio Manager

- There haven't been many changes and the global economic picture remains positive however the noise around tariffs, trade wars and geopolitical tensions have risen significantly.
- The preference for cyclical over defensive sectors remains intact for the time being even if the recent market volatility has created some changes to the equity markets' dynamics.
- We keep some preference for risk and haven't downgraded duration, as it has regained some decorrelation characteristics.



Uncertainties surrounding valuations... not earnings growth !

While there haven't been many changes in the economic backdrop, which overall remains supportive, noise levels have nonetheless risen significantly. Concerns about tariffs, trade wars and geopolitical tensions have completely overshadowed the positive impact of tax cuts, which should be felt on earnings growth over the next few quarters. Looking forward, investors are also wondering if the expected increase in the US budget deficit, to pay for this fiscal gift, will change the dialogue around monetary policy. Speaking of monetary policy, the flattening of the US yield curve is also raising concerns as it has usually signalled a more difficult period ahead.

It is too soon to have a clear-cut view, but we do not believe that these headlines will really drive earnings for the foreseeable future. We expect rhetoric around tariffs to have a limited impact on growth and inflation, although we acknowledge that uncertainties surrounding this issue may be a temporary drag on spending or hiring plans. The noise around tariffs has hurt sentiment in both financial markets and surrounding business investment, which has unfortunately affected the valuations investors are willing to pay. On this point, it's worth mentioning the change in the volatility regime since February, especially true of the US equity markets, which have seen significant day-to-day, as well as intra-day, index price variations. The risk contribution of the US market, generally deemed as the most defensive or the least risky among the different large equity markets, has increased above other markets. The fate of the technology sector may also be playing a role in this unusual rise in US equity risk. As far as the slope of the yield curve is concerned, flattening always happens when central banks tighten and there will certainly be a slowdown ahead (i.e. the steepest part of the recovery is behind us). However, it could be quite far away. Back in mid-2005, the difference between the 10Y and 2Y UST was close to the current level of about 50bps, and it even inverted temporarily in the first quarter of 2006. So, the yield curve cannot be used as a timely indicator.

In this context, we are keeping some preference for risk and a mild disinclination for duration. Valuations have become marginally more attractive on equities, and to a lesser extent credit, but not significantly enough to trigger additional buy opportunities. Conversely, the recent rate decrease, especially in continental Europe, has made nominal government bonds more expensive. We haven't yet downgraded duration, as it has regained some decorrelation characteristics and inflation has remained subdued. The only notable change is that we now prefer EM hard currency debt vs EM local debt (downgraded to a mild disinclination). This asset class should continue to benefit from an overall improving macroeconomic backdrop (growth catching-up, inflation decreasing and potentially less restrictive monetary policy ahead), sounder structural fundamentals (less reliance on external money to fund contained budget or current account deficits) and should thus be spared from Trump's gyrations and the gradual monetary policy normalisation in developed markets.

_Fabrizio Quirighetti

Economic backdrop in a nutshell and global economic review

A large question mark has appeared recently over the global economic outlook. The aggregation of economic, political and geopolitical developments has gradually led to the emergence of one key question: is the ongoing economic softening an early sign of a global growth slowdown to come or is it just a stabilisation after the spectacular progress witnessed in 2017?

Let's be clear: we favour the second hypothesis and continue to believe in a supportive economic backdrop for the remainder of the year. However, the convergence of softer growth data, hardened US/China trade rhetoric and heightened US/Russia tensions (economic sanctions and a Cold War-style confrontation in Syria), has instilled a growing sense of unease in investors' mind. Nothing really concrete has taken hold yet, but there is an unpleasant feeling that it wouldn't take much for the picture to turn bleak.

Coming on top of that are central bankers: very logically given their mandates, the Fed, the BoE and the ECB are now willing to normalise their policy. The Fed hiked interest rates again in March and will continue to do so in the quarters ahead. The Bank of England is looking at following up last year's first move. And the ECB is indicating that it will begin exiting its QE program by year end. However warranted, and even if monetary policies remain very accommodative in absolute terms, this synchronised trend toward tighter conditions at a time of less certain growth conditions revives concerns of central bank-induced growth extinction, as reflected by flatter yield curves. The coming months will therefore be key to assessing whether recent macroeconomic data softness is indeed a reflection of mere stabilisation or an early sign of something more profound.

Growth

Despite softer indicators and some disappointing data in Europe, all large economies keep on growing as they enter Q2. Growth is just not accelerating anymore.

Inflation

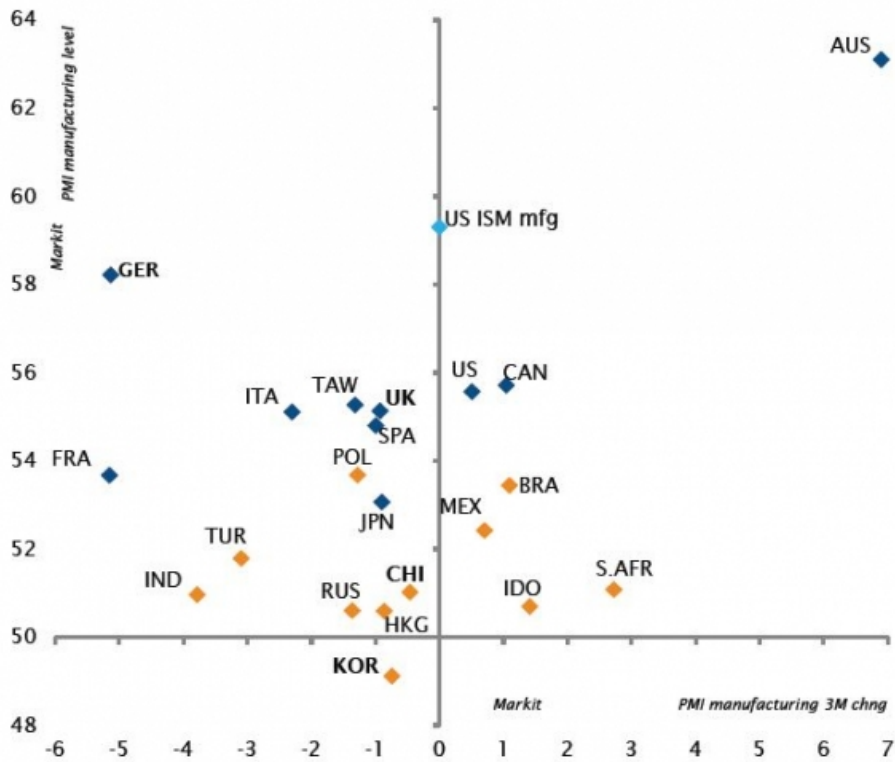
Inflation is slowly but surely moving upwards towards central banks' targets in developed markets, supported by oil prices at three-year highs. On the other hand, disinflation remains at play across most developed markets.

Monetary policy stance

Large developed market central banks are hinting at monetary policy normalisation to various degrees, on the back of positive growth and firming inflation rates, while emerging market central banks are benefitting from slower inflation allowing them to relax their restrictive stances.

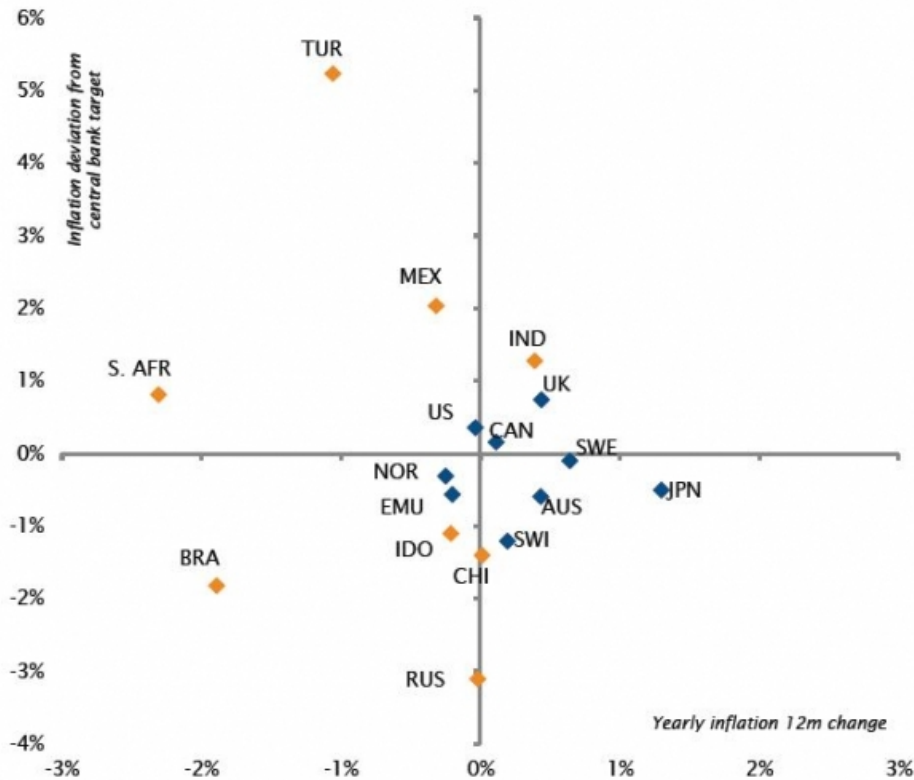
« The coming months will be key to assessing whether recent macroeconomic data softness is a reflection of mere stabilisation or an early sign of something more profound. »

PMI Manufacturing trends and level



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

Inflation trend and deviation from Central Bank target



Source
Sources : Factset, Markit, SYZ Asset Management. Data as at : 23 April 2018

Developed economies

If the US economy has lost some steam in Q1, it continues to grow at a healthy pace. Consumption is supported by a rock bottom unemployment rate, household income is slowly recovering and investment spending keeps growing amid strong business confidence. The comeback of "core" CPI inflation above 2% in March supports the Fed's view that monetary policy has to be normalised further, as it was at its March meeting. Short-term rates in the US are now nearing the important threshold of becoming positive in real terms (excluding inflation) for the first time in a decade. The Fed intends to extend this cycle further, in what will look from now an effective tightening cycle.

All European economic data have trended lower and below expectations in the past weeks. Is it a reason to worry? Is the long-awaited European growth recovery already over? The answer is no, at least not for the moment: if the recent slowdown was pronounced, the starting point was so high that economic data remain at levels still consistent with above-potential GDP growth. They just need to stabilise at some point... Declining unemployment rates across the board, pent-up investment spending and very supportive financing conditions look set to keep the growth cycle on track, but still low inflation gives the ECB no reason nor need to rush for the exit. The Bank of England is facing a slightly different situation as inflation has been above its target for the past year. If currency effects dissipate going forward, another 25bps rate hike will be mused. In Japan, recent softer growth reflects the still high sensitivity of the economy to yen fluctuations.

Emerging economies

The Chinese economy is currently in fairly good shape and therefore appears able to withstand a (limited) trade war. GDP growth has stabilised, gradually rebalancing towards domestic consumption. Capital outflows have been stemmed, credit growth is tentatively contained and the currency has stabilised or even rebounded against the US dollar. In such a context, the authorities have tools and room for manoeuvre to offset potential trade war headwinds up to a point.

Two large Latin American economies are due to hold elections later in the year: Brazil and Mexico. Both are displaying interesting economic backdrops – a positive growth dynamic combined with slowing inflation. However, on the political front, AMLO, the leftist candidate, largely leads the polls in Mexico, while Lula, who was aiming at representing the Brazilian left, has been sentenced to jail time on corruption charges.

Mr Erdogan has called early elections for June in Turkey. Time will tell if this decision was motivated by the anticipation of a forthcoming growth slowdown as fiscal stimulus tailwinds dissipate.

_Adrien Pichoud

Economic data have been soft recently, especially in Europe and Japan



Source

Sources : Factset, SYZ Asset Management. Data as at : 20 April 2018

Investment Strategy Group Takeaways and asset valuation

Risk and Duration

There has been no change in assessment on risk and duration. But, given the somewhat softer macroeconomic global picture paired with still-accelerating inflation, it is becoming increasingly evident that the next adjustment will most likely be a move downwards towards a mild dislike for risk and a dislike for duration.

Equity Markets

As mentioned previously, we have balanced the broad equity themes over recent months. This reflected our cautiously positive stance on equity risk as a whole, without taking too much geographical risk. With regards to equity sectors, the long-standing preference for cyclical over defensive sectors remains intact. For the time being this stance remains appropriate, however the recent market volatility has created some changes to the dynamics within equity markets. The most notable of these are the risk characteristics of US equities.

Despite being more expensive than Europe and Japan, the US equity market holds a relatively favourable score due to various factors. Firstly, USD risk is in our view skewed to the downside, which provides a mild tailwind to the broader US equity market. More importantly however, US equities have been one of the best ways to add defensive beta to investment portfolios because it is a structurally more defensive market than Europe and Japan. Yet, this relative benefit has been deteriorating considerably over the last few months. Comparing the daily intraday highs versus the daily intraday lows of the S&P 500, it becomes evident that the intraday volatility of the broad US market is as high as it was in 2008. Moreover, this intraday volatility is also considerably higher than it is in Europe and Japan.

It is clearly too early to change the assessment of US equities, but there seems to be somewhat of a regime shift happening in equity markets.

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Bond Markets

Having upgraded our view on duration and western nominal bonds over the last few months, there is little need to make further changes. Some mild adjustments to Canadian linkers and Australian nominal bonds were made this month. The only area where a more significant change in assessment was warranted was in emerging market local debt, which by now looks somewhat less attractive than emerging market foreign currency debt. Many of our preferred markets within the local bond universe have seen persistent downgrades over the last few months. The latest of these downgrades was Poland, which had seen an almost 30bps fall in 10 year yields over the last six months, a period when US 10 year yields rose almost 60bps. This leaves very few areas in the emerging market local debt space, although in Turkey there is still good value. Hence, this areas has seen a downgrade from a mild preference to a mild dislike. This leaves nominal developed market government bonds as well as emerging market hard currency bonds as our favoured bond markets.

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Forex & Cash

No change in assessment.

_Hartwig Kos

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