ASSET ALLOCATION INSIGHTS

Our monthly view on asset allocation (June 2018)

Wednesday, 06/06/2018

Markets continue to muddle through against an overall supportive economic backdrop, with assets fully or fairly priced.

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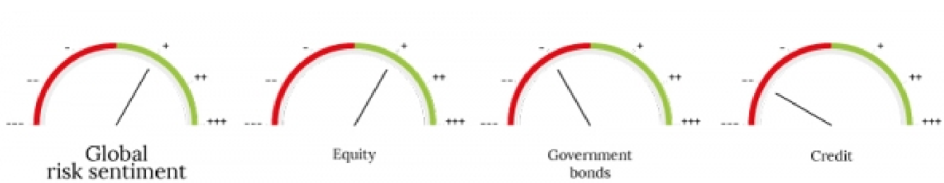
— US dollar has been strong, supported by good domestic numbers and rate hike talks, but the strength may be short-lived.

— Inflation remains in check, but has been trending higher.

— Trade wars are a cause for concern and compound an already complex geopolitical situation.



Diluting the cyclical bias

Markets continue to muddle through against an overall supportive economic backdrop, with assets fully or fairly priced. At the margin, there is currently a divergence between the US and the rest of developed markets in terms of growth, inflation and monetary policy dynamics. Consequently, the mix of a stronger greenback and higher US rates is making emerging market central bankers' lives less easy, as illustrated by recent monetary policy decisions, which either tightened severely or backtracked suddenly from further easing.

We believe that this divergence shouldn't last for long. Europe and Japan are probably experiencing a mid-cycle slowdown, or rather a temporary pull back after the surprisingly strong growth experienced in 2017, but inflation should start to creep higher in these economies too and the ECB's narrative may turn less dovish as soon as next month. To some extent, the divergence may even help the ECB to put some indirect pressure to the new Italian government to ensure it continues complying to fiscal discipline.

The stabilisation of asset correlations and asset volatility, as well as lower-than-expected inflation and wage data, is encouraging. Especially as this reduces the evidence that the market is overheating, which is taking pressure off the Federal Reserve to tighten aggressively. Oil at this level shouldn't be a trouble maker on either the inflation front or on US growth. The temporary uptick in headline inflation won't impact the Federal Reserve's outlook, while investment spending on energy-related sectors may compensate to some extent for the drag on consumption. Thus, we believe there is no need to change our preferences on risk and duration, kept respectively in a mild preference and a mild disinclination.

However, a more balanced equity allocation is now required as the global economy is more of an expansion than a recovery phase, inflation is grinding gradually higher and yield curves are flattening on the back of monetary policy normalisation. Furthermore, the relative valuation of defensive versus cyclical assets has generally improved over the last few months. As a result, we are diluting our cyclical bias by starting to build positions in defensive sectors, such as healthcare, and by downgrading both the Eurozone and Japan to a mild disinclination. Their valuations deteriorated recently and they could be penalised further either by their currencies rebounding or by more growth disappointment if we are proved wrong.

_Fabrizio Quirighetti

Economic backdrop in a nutshell and global economic review

It may look like a "return to normalcy". After an interlude when old Europe and ageing Japan took the global expansion driving seat in 2017, the United States is now back at the forefront of the world economy. While most developed economies are losing steam in 2018, the US economy continues to display a strong mix of consumption and business investment spending, supported by fiscal policy, and it is on track to post stronger GDP growth this year than last, unlike other major developed economies. The Federal Reserve is comfortably on auto-pilot with its rate hike cycle. Even on geopolitical issues, the US seems to have the upper hand for the moment, whether in Korea, in the Middle East or on trade negotiations. No wonder in such a context that the US dollar has regained ground from its post-Davos three-year low.

The US leading on growth, rate and FX terms is not without consequences for the rest of the world economy. Emerging economies with large external financing needs find little comfort in this kind of US dollar strengthening, especially when they are also oil importers at a time of rising crude prices. One can already hear the first cracks in fragile Argentina and Turkey, but the pressure is likely to rise even for economies enjoying better economic momentum recently, such as South Africa, India and Brazil. Global GDP growth might well be similar in 2018 than last year as forecasted by the IMF, but the global expansior is set to be much less harmonious than in 2017.

Growth

Underneath a still broad-based global expansion appear diverging trends: stronger US growth, resilient emerging economies with external surpluses, softening dynamics in Europe and Japan and wobbling emerging markets with external deficits.

Inflation

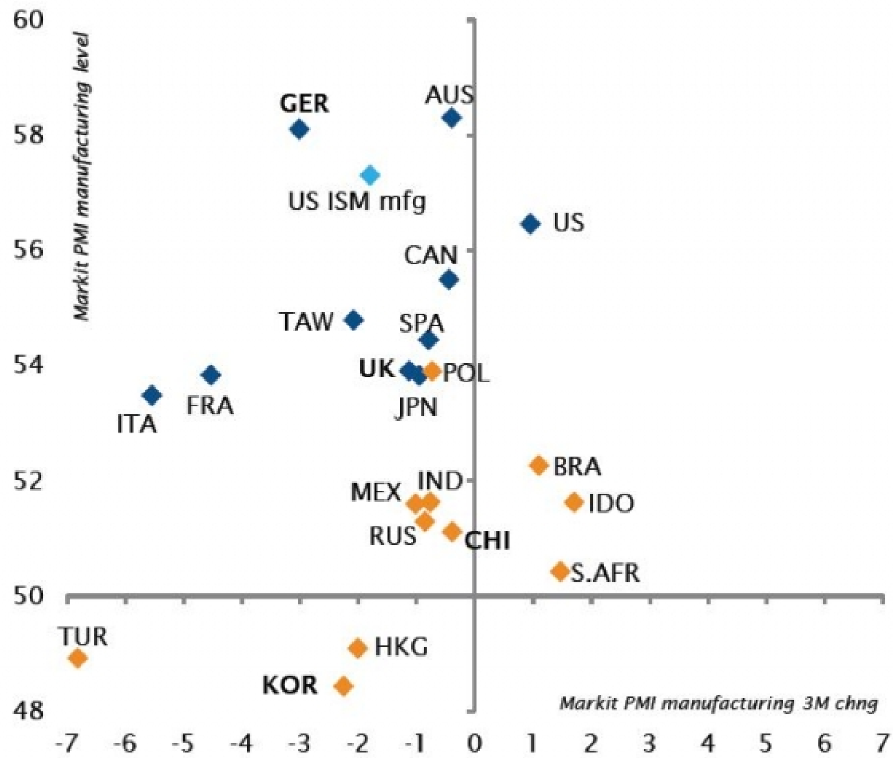
Inflation is still the puzzling missing piece of the developed market economic picture, even in the US where firm expansion and low unemployment have failed so far to trigger any acceleration in wages and prices. US dollar strength revives risks of FX-driven imported inflation in emerging economies.

Monetary policy stance

Only the Fed can stick to its rate normalisation plan, while other developed market central banks have to remain on the back foot due to the softer growth/soft inflation environment. The end of the large disinflationary trend in emerging economies also closes the monetary easing window of opportunities for their central banks.

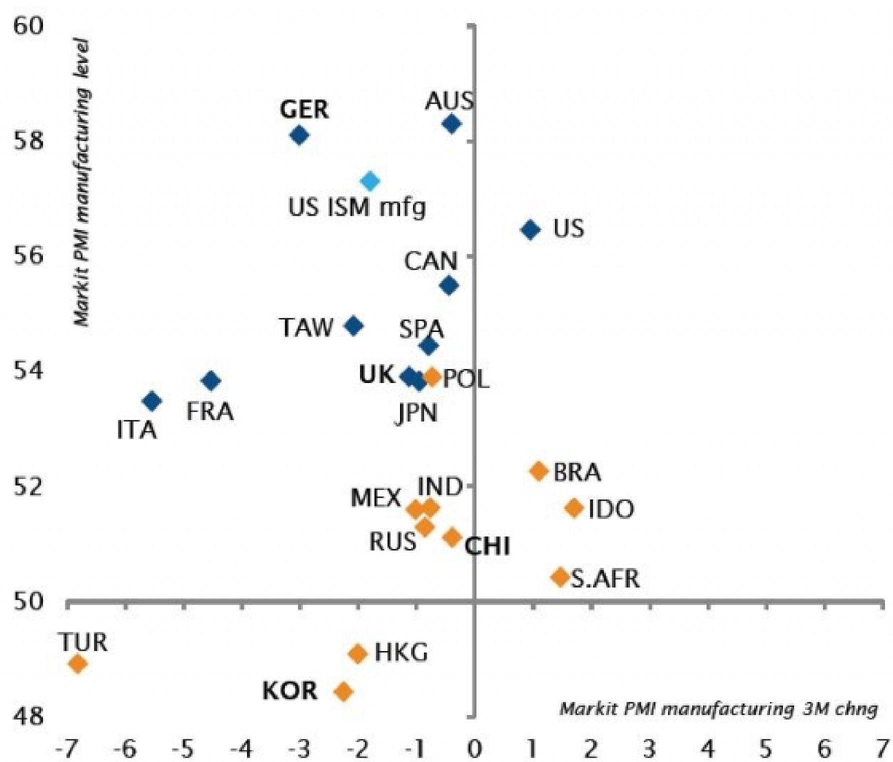
> *« An environment where the US leads on growth, rate and FX terms is not without consequences for the rest of the world economy. »*
>
> — *Adrien Pichoud*
> *Chief Economist & Senior Portfolio Manager*

PMI Manufacturing trends and level



Source
Factset, SYZ Asset Management. Data as at : 11 May 2018

Inflation trend and deviation from Central Bank target



Source
Factset, Markit, SYZ Asset Management. Data as at : 11 May 2018

Developed economies

In the general softening of momentum across developed economies, the United States clearly stands out as the only large economy to maintain a positive growth dynamic, reflected by continuously high business and consumer sentiment and solid activity data. The impact of the fiscal reform certainly helped to buoy confidence and is actually a concrete support to business investment spending, even if this impact should gradually fade away later this year. While this positive economic backdrop still hasn't translated into the expected acceleration in wages and price increases, there is enough ground for the Fed to remain on its policy normalisation path, with a 25bp rate hike per quarter. At this pace, monetary policy support will have been removed by early 2019.

The Eurozone is still experiencing some economic growth slowdown after the very strong levels reached in 2017. Euro strength has probably weighed on activity and sentiment in exporting economies, especially Germany. The uncertainty created by the US threat of import tariffs may also have further dampened sentiment for trade-sensitive industries. However, even after such a slowdown, economic expansion remains positive and even above the potential growth rate of the Eurozone. In this context, Spain has continued to stand out as the fastest growing economy among the largest monetary union members.

The UK has also been experiencing some growth softness amid GBP strengthening and soft domestic demand. Uncertainties surrounding the post-Brexit situation still cloud the outlook. Currency strength has also been a headwind for the Japanese economy, currently going through a softer growth patch. On the other hand, the depreciation of the CHF has helped the Swiss economy to withstand the slowdown of its main trading partner.

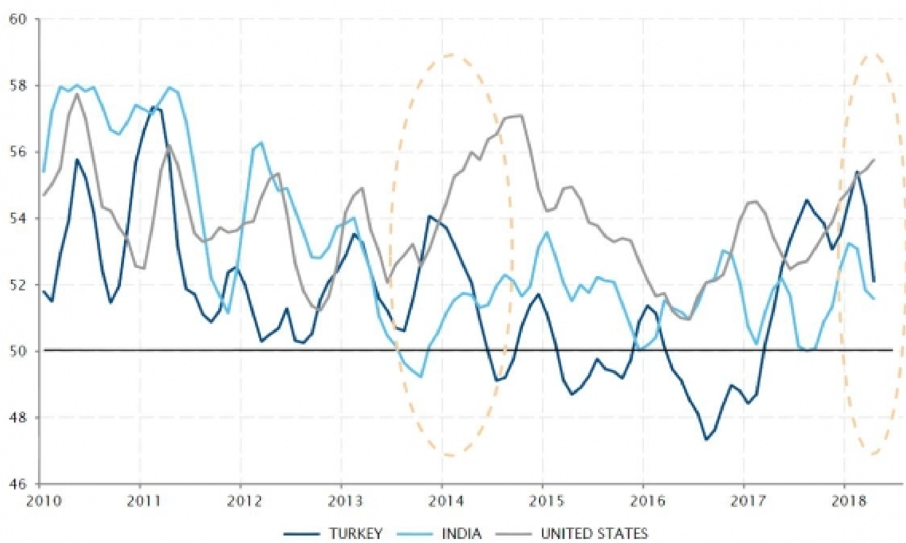
Emerging economies

As they do every so often, emerging economies currently appear to be split between two categories: the ones that don't rely on external financing, and the ones that do. For the former, including Eastern Asia in general and Russia, ongoing global economic growth provides a firm enough backdrop to enable them to sustain bouts of US dollar strength and uncertainty around trade tariffs, at least for a time. For the latter, the strengthening of the Greenback has immediate effects ranging from capital flows to currency depreciation, associated inflationary pressures and subsequent monetary policy tightening.

For members of the latter category that happen to also be oil importers, the environment is becoming very challenging, as already seen with Argentina or Turkey. Indeed, Turkey now faces a delicate combination of slowing growth, persistently high inflation, deteriorating external imbalances and geopolitical and political uncertainties. Little wonder the Turkish lira reached a new low in April, which will ultimately force the central bank to raise rates aggressively at the expense of domestic demand. A very "classic" EM problem, but the risk is that more and more EM economies face comparable situations in the months ahead if the combination of a strong USD, rising US rates and higher oil prices persists.

_Adrien Pichoud

US growth and USD strength not good for economies like Turkey or India



Source
Factset, Markit, SYZ Asset Management. Data as at : 30 April 2018

Investment strategy group takeaways and asset valuation

Risk and Duration

While some factors, such as fears of a trade war, concerns over rising treasury yields and the threat of emerging market volatility have held investor sentiment hostage over the past few weeks, it is not yet time to change the stance on either risk or duration. The economic backdrop remains favourable and equity valuations are elevated, but far from stretched. Moreover, inflation dynamics are somewhat softer on the margin and investors have undoubtedly come to terms with the changing narrative of central banks more quickly than in the past. So, no change for the time being.

> *« While the positive stance on cyclical sectors such as energy and banks in the US and Europe remains intact, we are also increasingly finding opportunities in the more defensive part of the equity universe. Healthcare in Europe - in particular pharmaceuticals – is becoming an increasingly good value. »*
>
> —— *Hartwig Kos*

Equity Markets

When it comes to the stance on equities, our approach in the past was to hold beta in the portfolio tilted to the more cyclical parts of the equity universe, with relatively few differences between geographies. This is now changing. While the positive stance on cyclical sectors such as energy and banks in the US and Europe remains intact, we are increasingly finding opportunities in the more defensive part of the equity universe.

Healthcare in Europe - in particular pharmaceuticals – is becoming an increasingly good value. In the past, the industry was deemed defensive and very expensive. Indeed, in 2014 and 2015, the pharmaceutical segment was trading at an almost five-point premium relative to the broader market. However, over the past 24 months, as bond yields have started to rise, pharmaceutical stocks have seen a substantial de-rating relative to broader European equities. The industry is clearly not cheap by any stretch of the imagination, but it is closer to fair value than it has been for some time. Moreover, sentiment towards the industry and earnings revisions have picked up significantly over the past few months.

Having become more comfortable with bond yields and the outlook for interest rates from here, pharmaceutical stocks offer certain characteristics that are very favourable for a portfolio, such as low levels of debt to capital and high, sustainable growth rates. Finally, having pharmaceutical stocks can help to have a less cyclical / more defensive portfolio.

Another big shift is also occurring in our regional preferences. Eurozone and Japanese equities were both downgraded from mild preference to mild disinclination, while UK and US equities remain at a mild preference. The US versus Europe shift is particularly meaningful. Three considerations have led to this change in stance. Firstly, the relative resilience of the US economy compared to the European. Over the last few months, the US has continued to post solid economic data, while Europe saw much more patchiness in its data releases, bringing more potential for volatility in European equities. Moreover, equity valuations have improved in the US, while deteriorating in Europe. Finally, the EUR/USD exchange rate is back to 1.18, after reaching 1.25 in January of this year. This USD strength was somewhat expected, but we believe that it is temporary and the weakness in the USD is likely to resume in coming months, providing a modest tailwind for US equities, while representing a clear headwind for European equities.

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Bond Markets

There have been only small changes within this segment. Italian linkers and BTP's were downgraded on political concerns, as were Turkish local bonds.

Forex & Cash

After a period of significant USD strength it is only a matter of time until the dollar resumes its weakening path. The last few weeks saw somewhat softer activity in the European economy, causing investors to doubt the monetary policy agenda of the ECB. Inflation expectations in the US also continued to drift upwards, while inflation expectations in Europe have gone sideways. Moreover, market implied interest rate expectations in the US now exceed levels suggested by the Federal Reserve (at least in the near term). A fair number of dollar-positive dynamics have materialised and there is a good chance of these tailwinds fading over the months to come. As a result, the EUR was upgraded against the USD to a mild preference.

_Hartwig Kos

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