

Our monthly view on asset allocation (November 2018)

Thursday, 11/22/2018

The month of October introduced a sharp correction to financial markets on the back of concerns about a Chinese slowdown, peak earnings, trade war, the Italian budget and the tightening of US monetary policy. Our overall global risk sentiment remains positive, with an emphasis on US equities, and the real alternative offered in the form of US treasury bills, while our view of the credit markets remained unchanged at disinclination. As growth prospects remain supportive and inflation is not a threat, our positioning aims to benefit from the recent market correction.



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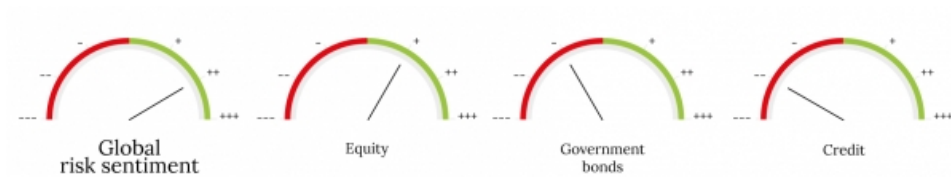
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Kiss goodbye to TINA

As far as fears are concerned, investors were spoiled this year for Halloween. They went through one of the most terrifying months, spooked by a set of characters including Donald Trump, Jerome Powell and Matteo Salvini.

Despite legitimate fears surrounding China or peak earnings, the real trigger of the October market correction is linked to the sudden reappearance of TIARA. No, not a hurricane, not serial killer doll Chucky's sister, but the acronym for 'there is a real alternative'. TIARA is the new substitute, after a decade of financial repression, for 'there is no alternative', or TINA. In other words, for the first time since the Great Financial Crisis, US treasury bills are yielding more than inflation. US investors no longer need to take additional – and perhaps unwanted – risks in order to preserve the purchasing power of their savings.

If the recent fall in stock markets had been mainly caused by recession fears, usual safe havens such as long-term US treasuries or the Swiss franc would have posted gains last month. However, this was not the case. The return of TIARA, signalled by the Fed and Jerome Powell in their September meeting, now acts as a powerful magnet, draining cash outside assets that do not offer sufficient compensation against the return of a simple deposit account.

This could be seen as the late stage of US monetary policy normalisation if, as we expect, there are no excessive inflationary pressures requiring the Fed to adopt an even tighter policy. This long, gradual and quite hectic process started more than five years ago with Ben Bernanke and the Taper Tantrum. Many assets valuations have already more or less adjusted since then: gold, EM assets – which moved in parallel with Fed hike expectations – and even some parts of the equity markets, such as US small caps or the technology sector. Until recently, these were defying the gravity law of cash yield.

The recent equity sell-off may thus be interpreted as a healthy rebalancing-correction. In this context, we still want to keep equity risk in our portfolios, as valuations have now improved, growth prospects remain supportive and inflation is not a real threat. However, we still dislike duration and above all credit, given the asymmetry between potential gains and losses. Quite bluntly, as the Fed is now trying to remove the 30-year old Greenspan put, asset allocators should reconsider whether duration will continue to act as a buffer in volatile market environments, or if credit will still exhibit higher risk-adjusted returns than equities going forward. A mix of gold and yielding US dollar cash may likely be helpful to counterbalance equity risk and thus stabilise overall portfolio volatility.

_Fabrizio Quirighetti



Economic backdrop in a nutshell and global economic review

As the IMF put it, "overall, world economic growth is still solid [...] but it appears to have plateaued". A look at absolute levels of economic indicators across large economies currently supports this assessment of ongoing expansion without improvement. Part of the world is still experiencing softening cyclical dynamics, as the strength of the US dollar and global trade tensions weigh on manufacturing activity in Asia and Europe. However, domestic demand in these areas is still holding firm, and – general debt levels aside – the lack of significant excess in business investment, residential real estate or consumption supports the scenario of a current 'plateauing', likely to extend for some time.

Still, against this fundamentally reassuring backdrop, political developments are becoming growing headwinds to economic sentiment, with troubling similarities on both side of the Atlantic. In the US, Donald Trump may not be entirely wrong in pointing to higher Fed rates as a risk for the economy. But he conveniently forgets to mention the ongoing steady cycle of rate rises is warranted by the strength of the US expansion, which is fuelled by his very own fiscal policy. He may also bear in mind higher rates would probably have been less damaging to emerging market (EM) countries if US tariffs had not hit them at the same time.

In Europe, a similar negative feedback loop may be at play. The Italian government's fiscal activism is forcing the ECB to stick to its normalisation stance to avoid being accused of complacency – even if persistently disappointing data in Europe may warrant a softer tone.

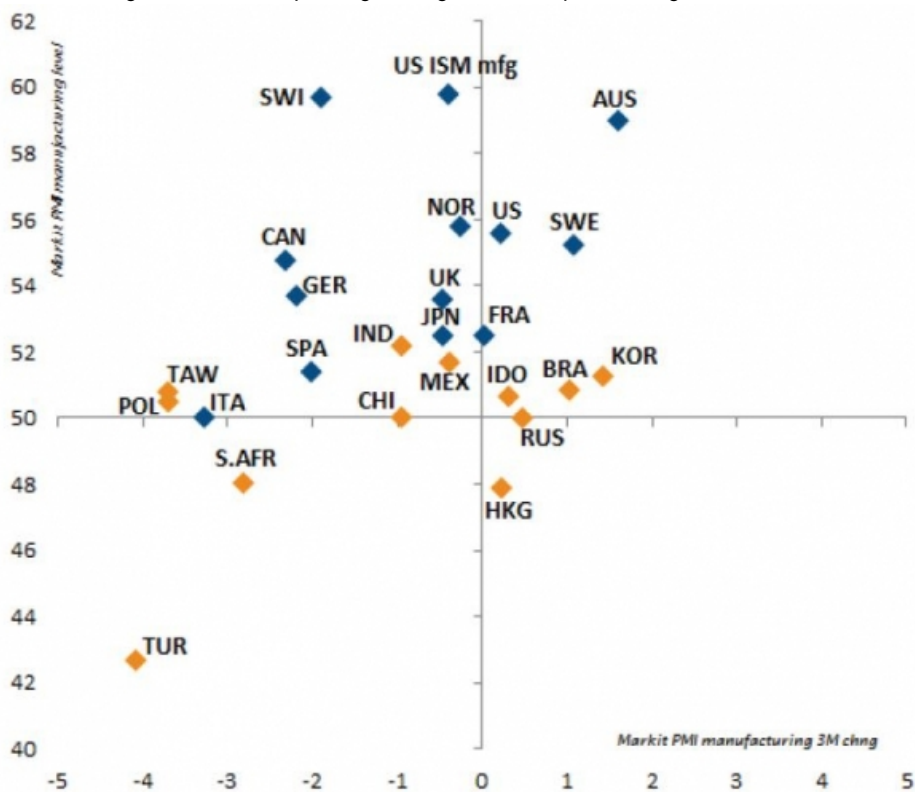
Therefore, political interferences in monetary policy are gradually raising the risk that loss of global economic momentum could affect robust final demand fundamentals. While this is still not the case, it is certainly something to keep in mind.

Growth

The global growth picture is becoming increasingly polarised between resilient growth in developed economies, thanks to firm domestic demand, and slowing growth dynamics in emerging economies, as slowing trade and a stronger dollar weigh on activity.



Country PMI Manufacturing – Level and 3-month change
Most of the global economy still growing but now ‘plateauing’



Source
SYZ Asset Management. Data as at: 25 October 2018

Inflation

Unlike on the growth front, inflation dynamics are remarkably synchronised across DMs and EMs, barring a few specific situations such as Turkey and Argentina. Most of the global economy is currently experiencing mild and relatively benign positive inflation.

Monetary policy stance

US-China antagonism on trade also translates into diverging monetary policy directions, with continuing normalisation in the former and policy easing in the latter. Monetary policy remains very accommodative across most of the non-Anglo-Saxon developed world.

Developed economies

In an environment of softer Chinese expansion and slowing global trade, household consumption remains a strong driver of economic growth across developed economies, with the support of low or declining unemployment rates, rising wages and in some cases, supportive fiscal policies. This is not only true in the US, where consumer confidence has reached levels not seen since 2000, but also – somewhat less impressively – in Europe and Japan. Accordingly, activity in the service sector remains a bedrock for extending the growth cycle, as manufacturing dynamics, especially in Europe, suffer from slowing global external demand. Admittedly, sentiment in Europe also faces renewed political uncertainty, with the Italian challenge to the EU fiscal framework, the announced end of the Merkel era and looming European elections, which populist parties intend to turn into a show of strength. But these headwinds have yet to affect household sentiment and thus have not yet threatened the ongoing economic expansion.

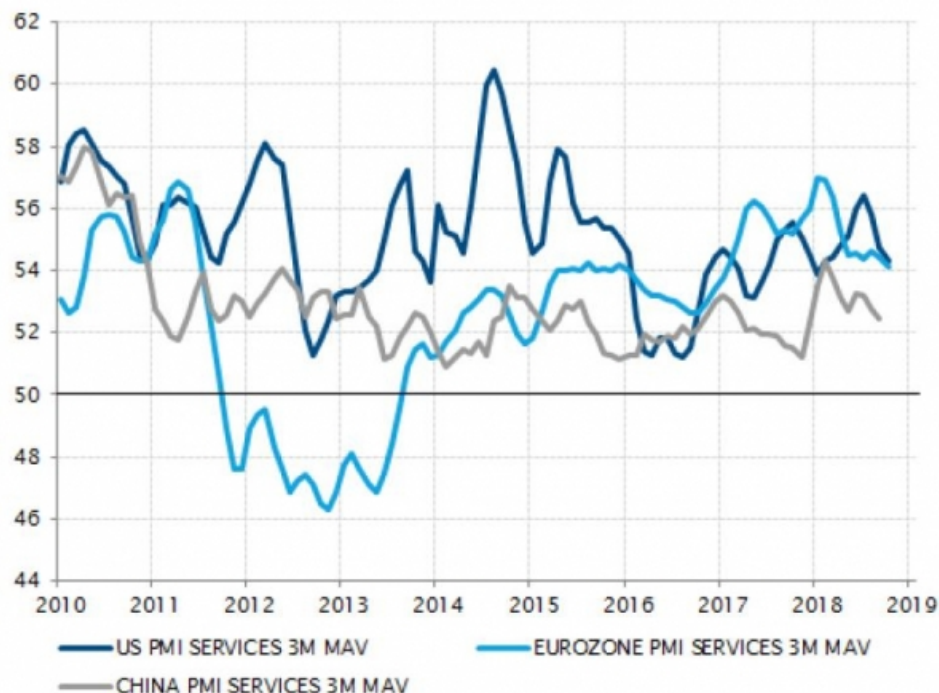
Emerging economies

The combination of soft China growth and trade restrictions is hampering growth dynamics across South East Asia. The full impact of US tariffs has probably not yet been felt, since it appears China significantly frontloaded exports of goods about to be taxed during the summer, leading to a temporary acceleration in trade-related activity. While this will inevitably fade, the extensive package of fiscal and monetary stimulus injected in China since the spring should counterbalance the impact of the slowdown in trade due in months ahead.

In any case, the combination of milder global growth and tighter dollar liquidity conditions is also weighing, to varying degrees, on most emerging countries. Although the worst of the summer crises is behind for Turkey and Argentina, both remain in fragile situations. After the election in Brazil, execution risk looms for the large reforms necessary to bringing the country's fiscal outlook on a sustainable path.

_Adrien Pichoud

PMI services in the US, eurozone and China (>50: expansion)
 Activity in services, reflective of domestic demand, holds firmly in expansion territory



Source
 Factset, SYZ Asset Management. Data as at: 25 October 2018

Asset valuation & investment strategy group review

Risk and duration

After a drop at the beginning of October, valuations have generally improved, especially for government bonds. The economic backdrop remains overall supportive but, on the margin, European growth is slowing.

The recent correction is seen as a healthy rebalancing, triggering a more severe adjustment for assets which so far proved resilient to the US monetary policy normalisation cycle. We do not expect a sharp bounce soon and believe equity markets should now stabilise. Nevertheless, volatility may remain relatively high – at above 15 levels for the VIX and VSTOXX – and sharp sector rotation, or churning, will continue to take place. This current period of higher volatility might persist in the short term, as political risks, such as the Italian saga, the trade war, US midterm elections and Brexit negotiations still weigh on general sentiment.

Hence, there was no change in our risk scoring, which we kept at a 'preference'.

In the current US normalisation cycle, inflation remains under control. This is even truer after the latest Fed comments, which indicated the central bank's commitment to normalising beyond 2018. It is too soon to increase duration, as we are not overly concerned about inflation overshooting or a strong acceleration in growth at this point. As a result, the duration score was kept at a 'mild disinclination'.

« The recent correction is seen as a healthy rebalancing with a more severe adjustment for assets that proved until recently more resilient to tighter monetary policy conditions. »

Equity markets

The key preference remains intact. In the spirit of running equity-heavy, yet well-balanced portfolios, the US equity market continues to be ranked as a 'preference' within the overall asset allocation – although in the last months we have been indirectly reducing this overweight by upgrading eurozone and Japanese equities.

In October, we brought one change to our equity allocation by downgrading Brazil to a 'mild disinclination'. We think the rally will not last forever and the new president will have to deliver on high expectations. The risk of disappointment is high in an economy with strong imbalances.

Regarding sectorial allocation, energy was globally downgraded to 'neutral', but we still like defensive sectors, such as pharmaceuticals and healthcare. In the United States, we maintained our preference for industrials and in Europe we still favour cyclical sectors like banks.

There is clearly value in the emerging market segment of equities; however, it is somewhat too early to meaningfully alter our preferences in favour of emerging markets just yet. We continue to monitor China, which now remains at a 'mild preference', for an eventual upgrade. We are waiting for a catalyst to lift headlines clouds on Chinese equities and for the result of increased domestic stimuli to potentially offset trade concerns, which are starting to be overdone. Chinese data continues to be released on the weak side but economic policies are becoming more supportive.

Bond markets

In terms of the bond asset allocation, real government bonds were upgraded to a 'mild preference' on the back of the increase in US real rates – US linkers were also upgraded to the same level. We are now indifferent between US linkers and nominal bonds, but for other developed markets we still prefer nominal bonds.

There were no changes concerning our relative preference for investment grade credit – at a 'mild disinclination' – over high yield – at a 'disinclination' – and emerging market hard currency debt – at a 'mild preference' – over local currency – at a 'mild disinclination'.

Forex, alternatives and cash

We upgraded gold by one notch to a 'mild preference'. As real rates have increased on the back of the Fed's message of normalisation – signalling the end financial repression – the downside to gold is quite limited. Gold may also now benefit from a stagflation scenario, as well as rising inflation expectations, if growth rebounds strongly. Furthermore, it acts as a hedge and diversifier, especially as the greenback is having difficulty rallying much further in a risk-off scenario – as are US treasuries.

There were no other changes in our currency scoring this month: we kept our 'mild preference' for the euro and the Japanese yen over the US dollar, while the Swiss franc remained at a 'disinclination'.

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