SYZ

ASSET ALLOCATION

INSIGHTS

SEPTEMBER 2020

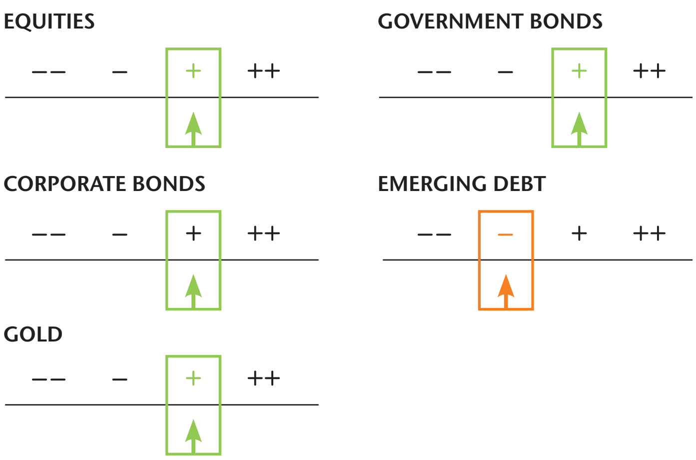
PROTECTING AGAINST DOWNSIDE RISK AS RECOVERY LOSES STEAM

The deepest trough of the coronavirus crisis is now far behind us. Following an impressive rebound from March and April lows, economic activity has gradually recovered, with positive GDP growth across all major economies in the second half of 2020.

While this comes as a relief, this was in all likelihood the ‘easy’ part of the recovery. We are now entering the second phase, where any new gains will be incrementally smaller – and governments will have to do more than reopen shuttered parts of the economy to stimulate growth. Already, manufacturing and service sector data for China and Europe – which are ahead in the coronavirus cycle – show activity is beginning to plateau.

It is time for investors to forget the heady rush of recovery and embrace the new reality – or, more accurately, the old reality. Prior to coronavirus, the world had already entered a new era of ‘Japanification’, characterised by low single digit growth and low inflation.

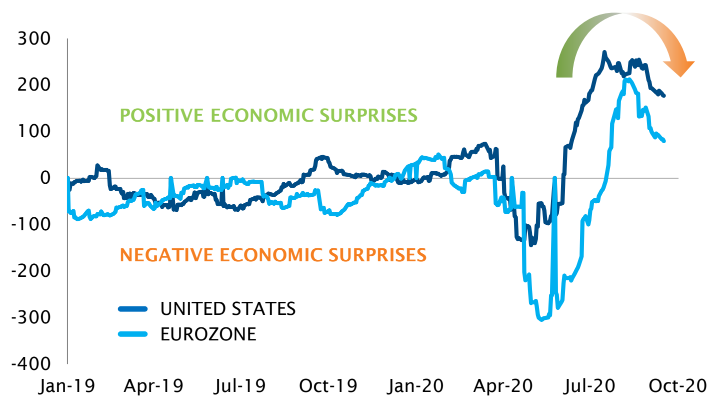
ASSET ALLOCATION VIEWS



TIME TO TAKE PROFITS

A few months ago, there was a clear asymmetry between the market’s overly pessimistic outlook and the high likelihood of an eventual recovery. This left a lot of room for surprise to the upside – which we capitalised on by increasing our exposure to risk assets. Now, markets have caught up to the good news and momentum is slowing. The possibility of more positive surprises – in the event a coronavirus vaccine being commercialised for instance– still remains, but so does that of negative ones now – if a second wave materialises, for example.

CITI ECONOMIC SURPRISE INDEX (VS MARKET EXPECTATIONS)



SOURCE: BANQUE SYZ, FACTSET

Overall, we remain constructive. We do not expect a second lockdown to shut large parts of the economy, as any such measures will likely be targeted and localised. Even if cases rise to alarming levels, societies have become much more efficient at dealing with the virus – including treating Covid-19 patients and organising social and economic activity around the virus.

However, we think the magnitude of the positive upside will be a lot less important. We have taken this opportunity to slightly reduce our preference for risk. Luckily, our exposure early on in the rally allowed us to trim areas which have already contributed to strong portfolio performance – such as a US equity ETF we added in June/July.

QUALITY MATTERS

As we enter a more challenging phase for the economy, it becomes even more important to maintain a bias towards quality. Both on the equity and the fixed income side, we look for reliable investments which can withstand milder growth.

We are still overweight tech, as we believe these stocks are poised to deliver even greater growth over the long term. However, we avoid the most hyped names and invest in proven powerhouses, such as Google, Mastercard and Amazon. While these companies have suffered recently, the sell-off was due to external factors coming out of Japan and to a normal rotation which saw investors take profits on the extraordinary performance of these behemoths.

Similarly, conditions remain attractive for government bonds and investment grade credit, even if valuations for the latter are less enticing than they were in April. While the absolute returns are low, we prefer this combination of low risk and low reward to riskier high yield bonds, which may suffer from milder growth.

Meanwhile, convertible bonds will be particularly useful as we move into this new phase of growth. Their asymmetric return profile – or convexity – allows us to limit downside risk, thanks to their bond-like characteristics, while capturing upside through their ability to participate in equity market rallies.

STAY ON YOUR GUARD

To contend with the possibility of a downside surprise, protection is crucial. We have remained invested throughout the year but maintained protections in order to safeguard our portfolio against a further downturn. We have also kept diversifiers such as gold, which remains useful despite the elevated valuations it soared to this summer.

By taking profits from our equity and gold allocations, we have more cash at our disposal, which we are not yet deploying. This environment is ripe for value traps, but investors must be careful not to overlook quality for price as economic conditions are about to change.

We resisted the temptation to invest in value stocks this summer, as several beginnings of a rotation from growth to value failed to materialise. High yield bonds also appear cheap, but the loss of economic momentum may prevent spreads from tightening as rapidly as they have over the past few months. We are therefore investing selectively into this asset class.

As the impact of the coronavirus recedes and growth is re-established, geopolitical noise is regaining its bearing on markets. Instead of reacting primarily to the overwhelmingly positive macroeconomic data, markets are once again swayed by events such as the upcoming US election, and investors will have to contend with renewed volatility over the next few months.

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