JANUARY 2022

Flash —

Answers to FAQs

Please find below answers to our Client's most FAQs (frequently asked questions) on current market turmoil, our portfolio positioning, upcoming Fed meeting and Russia / Ukraine risk.

Syz PRIVATE BANKING

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FAQ 1: Markets are off to one of the worst start of the year. Is the bull market over?

2022 is off to a rough start for risk assets. At the end of last week, the S&P 500 was down 8.3% from its high on January 4. This is the largest pullback since September 2020. The carnage is even worse when looking at the most speculative parts of the market. Some of the darling of 2021 (momentum stocks, unprofitable tech names, SPACs, cryptos, etc.) have been facing relentless selling over the past two months. But the sell-off accelerated in the past three weeks. Meanwhile, the US 10-year rates have risen from 1.5% to as high as 1.9%, a two-year high.

Main trigger of the pullback seems to be the latest December Fed minutes (published early January) which showed the intention of the FOMC to not only hike rates but to accelerate the unwind of its balance sheet. Given that the massive expansion of G3 central balance sheets has been seen by many investors as one the main drivers of last year bull market, is it time to call an end to it?

From our point of view, we believe that we are going through a period of transition rather than an end of the long-term trend. As we mentioned in our 2022 global outlook and latest Asset Allocation Insights, 2022 is expected to be more volatile than last year as risk assets need to acclimate to a period of normalization in which government and central bank support will be reduced. We think the recent market volatility is consistent with this transition, as risk assets need to price in an acceleration of the Fed agenda on the back of elevated inflation.

On the positive side, global growth should remain strong while the profit cycle is far from being exhausted, which means that earnings momentum should remain a tailwind for equity markets this year. Valuations are not cheap but remain favorable to equities versus bonds, especially in non-US markets such as Europe and Japan. Hence our positive outlook for risk assets.

For sure, the recent rise of US 10-year bond yields has been spectacular (+ 50 basis points since early December). But this is not the first time during the current bull cycle that equity markets need to deal with rising bond yields. We saw similar episodes last year, which included a 0.7% jump between January and March, and another 0.5% rise between August and October. The 1st quarter 2021 episode triggered two pullbacks in the S&P 500 (-3.5% and -4.2%) but the main US equity index ultimately rose more than 7% during that period. In the 3rd quarter, the spike in bond yields triggered a 5.2% decline in US stocks but here again, the S&P 500 rose over that period (+2.8%).

We believe that we are currently going through a similar experience, i.e equity markets are likely to go through a choppy period with some spectacular pullback and reversals. This will last the time it will take for the bond market to price in a tighter Fed policy. We think that there is still potential for long-term yields to rise further but the magnitude of the rise is not expected to be as spectacular as the one we observed over the last few weeks. We also think that the Fed is unlikely to tighten monetary policy to a level that will significantly undermine economic growth or financial markets.

In a nutshell, the liquidity context is less supportive than last year and volatility is expected to be higher. While monetary policy is denting sentiment and valuations, it is unlikely to put an end to the corporate profits cycle. We think that high single-digit earnings growth in developed markets is doable this year and this should be enough to extend the current bull market.

FAQ 2: Are you implementing any tactical changes in your discretionary portfolios?

Our discretionary portfolio management process relies on the conclusion of our asset allocation committee and but also on our proprietary risk-based portfolio construction process and on our market indicators.

As of the start of 2022, we had a positive allocation to equity markets but with some portfolio protection in place (lookback put-spread options) and exposure to broad-based commodities and gold. While the simultaneous decline in equity and bond markets have hurt performance in January, the equity protection and diversifiers have offset part of the decline.

Fast forward to the end of January, should we proceed to any changes to our tactical asset allocation? A review of our main indicators lead us to the following conclusions:

- Macro-economic cycle remains positive for risk assets
- Liquidity indicator is unchanged (neutral)
- Earnings growth remains positive
- Valuations are still neutral

The main change compared to mid-January (the date our last tactical asset allocation committee) is about our market factors indicators. Indeed, on an aggregated basis, market technical signals have been deteriorating.

The weight of evidence leads us to a positive view on equity markets but less than two weeks ago.

Our portfolio construction process also involved a proprietary risk-based model which takes into account asset class correlation and volatility. The recent rise of risk level is triggering a modest first-step of de-risking of the portfolios (between 3% and 4% equity reduction in balanced portfolios).

From a country and style perspective, we continue to favor a mix of secular plays (large-caps quality growth names mainly in the US) and some tactical value / cyclical exposure (hence a

preference for regions such as Europe and Japan). Indeed, the shifting-rate environment has been a catalyst for style rotation within equity markets. Value investments have outperformed growth investments during this phase, and this leadership is likely to continue as long as we stay in this period of adjustment.

Bottom-line: we don't expect a more hawkish outlook on the rate cycle but the surprise could come from an earlier than expected end to QE. As the main trigger of the current market seems to be the intention of the FOMC to accelerate the unwind of its balance sheet, such a news would put more pressure on risk assets.

FAQ 3: What to expect from the FED meeting which ends tomorrow?

The Federal Reserve meets on Wednesday. Consensus expect the Fed to leave interest rates unchanged with an end of QE happening in March 2022. However, the probability of an immediate end to quantitative easing (QE) asset purchases has raised the last few weeks.

Speaking at his Senate confirmation hearing on 11 January, Fed Chairman Jerome Powell was rather clear on the agenda: "As we move through this year ... if things develop as expected, we'll be normalising policy, meaning we're going to end our asset purchases in March, meaning we'll be raising rates over the course of the year... At some point perhaps later this year we will start to allow the balance sheet to run off, and that's just the road to normalizing policy."

As we already mentioned at several occasions, the Fed has a window of opportunity to normalize monetary policy in the coming quarters. The economy is growing above potential, inflation stands at the highest rate since 1982 and the unemployment rate is now below 4%. Financial markets are now pricing in four rate hikes in 2022 with the first hike expected to happen in March.

From our point of view, the Fed is unlikely to guide on a more aggressive rate hike cycle than the four rate hikes currently priced in by the market. With the recent tightening of Financial conditions and IMF downgrading global economic outlook, we don't expect a major shift in the Fed dots.

But the rate hike cycle will not be the sole focus of financial markets. While the Fed is saying that it will keep buying Treasuries and agency mortgage-backed securities through to mid-March, some believe that the Fed could announce on Wednesday an immediate conclusion to their QE asset purchase program. Indeed, Chairman Powell acknowledged last week that "we're mindful the [Fed] balance sheet is $9trillion. It's far above where it needs to be".

On the back of recent inflation data and given the tight labor supply situation, an earlier than expected end to QE is plausible. Such corrective action on the balance sheet would help reduce talk of a potential 50 basis points March rate hike, while opening up the possibility of an earlier start to a shrinking of the balance sheet.

FAQ 4: What is your view on Russia-Ukraine risk?

The huge dichotomy between oil prices and Russia main equity index (RSX) seems to indicate that the Russia political risk is overpriced. Russian equities have actually lost more ground in the face of present sanctions threats than the closest comparable episode which took place in 2018. Profitable exporters and profitable banks have been hit massively (the MOEX financial index down 30% since last August) and this could indeed create opportunities. However, we note that he depreciation of the ruble has been well contained (it depreciated by 50% against dollar during the Crimea crisis in 2014). Likewise, the bond market seems to price in much less risk than during the Crimea crisis as Russia CDS currently hovers around 250 basis points versus 600 basis points in 2014. One explanation could be the strengthening of the fiscal position on the back of surging oil and gas prices.

Looking ahead, we do see the potential scenarios unfolding:

1. (Medium probability) De-escalation of tensions as an agreement between Russia and US on a new security accord is found => Ruble will strengthen against dollar and Russian assets will rebound aggressively
2. (High probability) Tensions to stay elevated. The two parts continue to talk but no agreement is reached (although everyone favor diplomatic channels). Risk premium on the ruble and Russian assets to stay elevated for some time
3. (Medium probability) Escalation of the conflict in Donbas. Russia gets involved in Eastern Ukraine either directly or indirectly. The West retaliate with sanctions
4. (Low probability): full-scale conflict with invasion of Ukraine by Russian troops. Massive sanctions by the West. Ruble collapses and risk premium on Russia assets go to the roof. Global markets hit as well.

In a nutshell, the most likely scenario is tensions to stay elevated until the end of March. Beyond this point in time, Mr Putin will have less bargaining power as Europeans will be less reliant on Natural gas as Winter season will be over.

From a global macroeconomic and market perspective, the Russia-Ukraine crisis keep geopolitical risk elevated and could thus lead to higher volatility. It also complicates the task of the ECB by pushing Natural gas prices upward. More than 50%

of European inflation in 2021 was due to higher energy prices. Should Natural Gas prices continue to creep upward, the ECB will struggle to keep rates unchanged in the face of inflation rates staying meaningfully above central bank targets. A less dovish ECB will bring new risks for equity markets and spreads.

We believe that the US and its allies will limit themselves to threatening rather than actually imposing the 'nuclear' sanctions options of disrupting Russian commodity exports (as opposed to relatively milder measures targeting sovereign debt). The reason for this would be that the resulting economic pain would outweigh the importance of Ukraine."

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