SYZ WEALTH MANAGEMENT

1 MONTH IN 10 SNAPSHOTS

April 2016

A REVIEW OF LAST MONTH'S ECONOMIC THEMES

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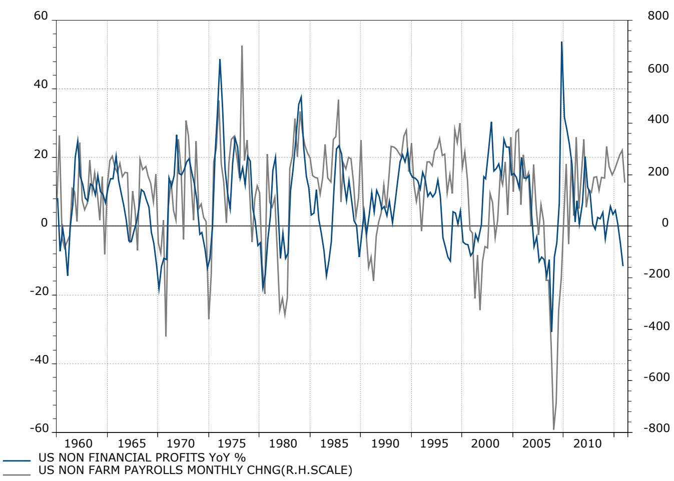
1. United States – Corporate profits declined in 2015

- Since 2013, the pace of growth of US companies has tended to slow down. The environment of soft growth, low inflation, and a gradual increase in wages has eroded margins little by little, which had reached a record level in early 2012. However, this trend recently picked up speed, and 2015 was thus the first year of contraction of aggregate profits of US companies since the 2009 recession.
- The oil sector was logically the most heavily affected due to the drop in oil prices, but in industry, the machinery, vehicle, and hardware sectors also saw a significant decline in their profits, while retail distribution also slowed down. Aggregate profits of US non-financial companies stalled in 2015, despite a real GDP growth that was admittedly weak but still positive.
- Putting aside the energy sector, the deterioration of the profitability of businesses can be seen as a logical evolution at this stage of the economic cycle: six years after emergence from recession, the increase in costs, particularly wage costs, has tended to reduce margins, and the rising dollar since 2014 has also been an unfavourable factor. However, in the current environment where growth remains moderate and is not speeding up and where companies have little leeway to increase their selling prices, this loss of earnings momentum could weigh on investment and employment in 2016. It could therefore end up having impacts on GDP growth and not just the evolution of equity markets.

Annual change in profits of non-financial companies and monthly change in number of employees

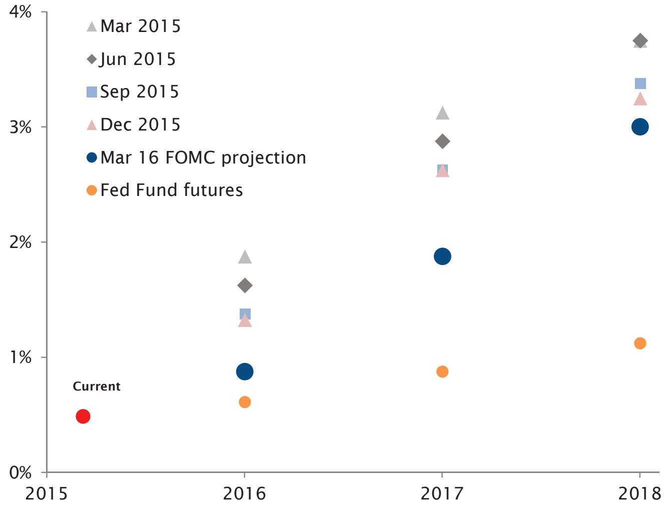


Source: Thomson Reuters Datastream

2. United States – The Fed becomes (even) more cautious on rate hikes

- On 16 March, the US Federal Reserve decided not to raise its key interest rate, keeping it at 0.50%. This decision, like the downward revision of projections of key interest rate changes, was widely expected after a bumpy beginning of the year both on markets and in economic news. The futures market anticipated (and still anticipates) barely an increase in rate by the end of this year.
- Last December, Fed members thought that they would be able to raise their rate four times in 2016. By cutting their expectations on 16 March to two increases for this year, they did not contradict their tendency for excessive optimism since 2014: the downward revision of their projections has indeed become a constant (see graph).
- However, Janet Yellen's recent statements suggest that the Fed has now assessed the negative impacts that increasing its rates, and therefore the dollar, could have in the world but also in the United States: pressure on commodity prices, emerging economies with debt in foreign currencies, emerging economies whose currency is pegged to the greenback (with China in the lead), but also on US exporting companies, inflation in the US, and therefore the pricing power of purely domestic companies. Now, according to Ms. Yellen, "*only gradual increases in the federal funds rate are likely to be warranted in coming years*", on the basis of the current economic scenario. Despite this caution and the downward revisions, a difference remains between the central bank's projections and the market's projections, which can be interpreted either as an excess of investor pessimism or the Fed's effort to maintain an optimistic (even cautious) bias.

Evolution of Fed Funds rate projections by FOMC members since March 2015 and implied forward rate anticipated by the market

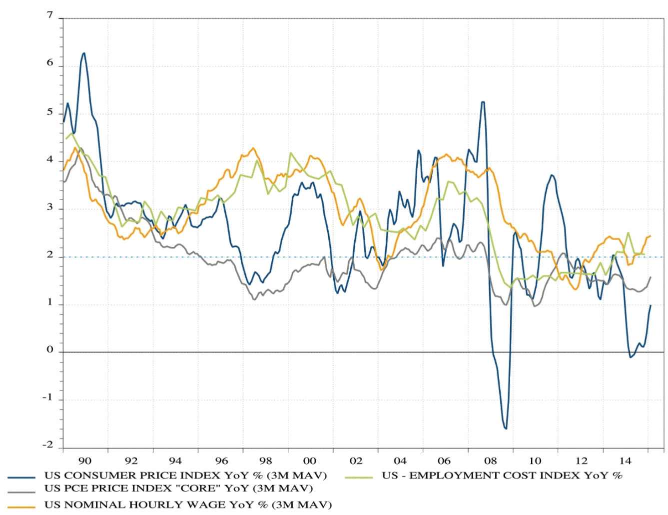


Source: Federal Reserve, Bloomberg

3. United States – No deflation...but so little inflation

- But why isn't inflation accelerating? This question is now at the heart of the Fed's queries, faced with an unprecedented situation of apparent full employment but a lack of significant acceleration of price increases. Whatever the measure chosen (consumer price, personal consumption expenditures index, hourly wages, employment cost, etc.), inflation remains low (see graph).
- There are multiple reasons for this weakness: falling energy and commodity prices and disinflationary effect of the dollar's rise through prices of the imported goods; downturn in industry and increase in the proportion of service jobs with low wage bargaining power; low participation rate, etc.
- The good news is that, unlike in the eurozone or Japan, the short-term risk of deflation is currently very low. The recent rebound in energy prices and the gradual dissipation of the base effects allowed inflation to rebound after flirting with 0% last year. However, the prospect of a return to the Fed's 2% target is still far off (2018 according to the Fed itself) and depends on a more sustained, durable increase in wages. That is why the change in hour wages has now (almost) stolen the limelight from job creation and the unemployment rate usually scrutinised when US monthly employment reports are released.

Annual change in the consumer price index (CPI), the personal consumption expenditures excluding food and energy prices index ("core" PCE), hourly wages, and the employment cost index (ECI)

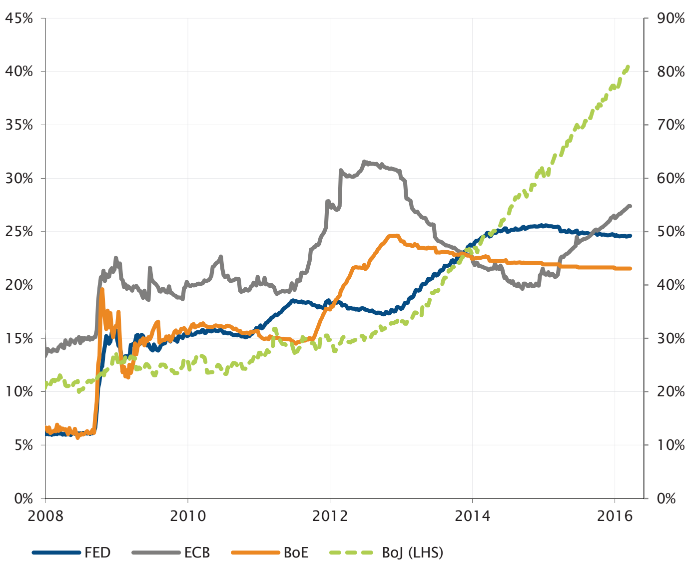


Source: Thomson Reuters Datastream

4. Eurozone – The ECB expands its arsenal and further relaxes its policy

- In a world where growth and inflation remain low and government debt is high, the central banks have become the last resort once economies show signs of weakness. Although the Fed and the BoE are now thinking about normalisation (without truly being able to establish it at the moment), this is still far from being the case for the BoJ and the ECB, always on the front line to attempt to tear their economy from the deflationary trap set by the ageing of the population, high public debt, and an unstimulating or restrictive fiscal policy.
- The most recent attempt came from the ECB, which, barely more than a year after the launch of its government bond purchasing programme (QE), had to decide in March to increase its size (from EUR 60 billion to EUR 80 billion per month), include corporate (non-bank) bonds, and offer new liquidity at a negative rate to banks willing to distribute loans to the private sector.
- These new measures will have the certain effect of boosting the growth of the central bank's balance sheet size, which will soon reach 30% of GDP (still far from Japan's levels). On the other hand, their effect on the economy's growth appears less certain, since it will essentially depend on the desire and especially the ability of banks to increase their loan offering, in a context of rather weak demand and interest rates so low that they are hampering their profitability.

Size of balance sheets of central banks (as % of national GDP)

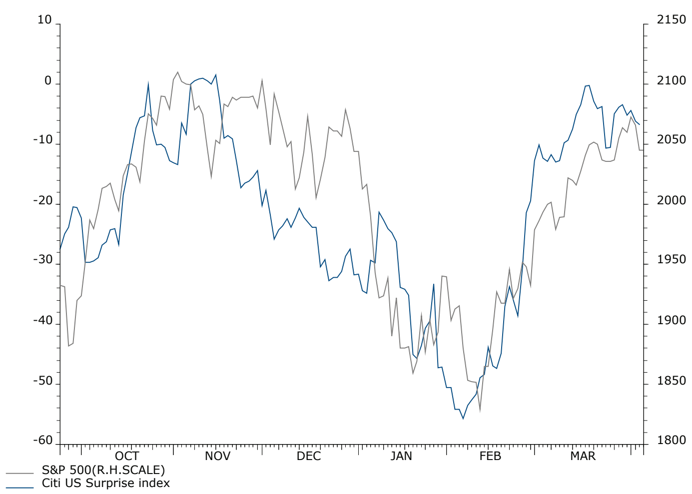


Source: SYZ AM

5. United States – The continued upturn in the US equity market

- In recent months, the US equity market has been correlated with the Citi macroeconomic surprise index, which has continued to sink into negative territory since the final quarter of last year.
- This loss of speed has resulted in recurring disappointments on the economic indicator front (slowdown in the services sector, a lower employment ratio, etc.) but also a US central bank that has started to become less accommodative by raising its key rate. In addition, the collapse in commodity prices has also heavily influenced global equity prices.
- The Citi macroeconomic index's drop ultimately reached a low point at the beginning of February, pulling down the S&P 500, which ultimately also rebounded more than +6% (since early February) to end the quarter in positive territory (+0.8%).
- Concerns about the US economy have calmed down with, for example, a non-manufacturing ISM that has stabilised and even a slight improvement in industry. In addition, job creation in February and March exceeded consensus expectations. These various factors therefore made it possible to avoid (or push back) a severe decline in growth in the United States. The most likely scenario still remains global growth that is positive but weak with inflation just above the threshold of 0%.

Evolution of the S&P 500 and Citi macroeconomic surprise index in the United States

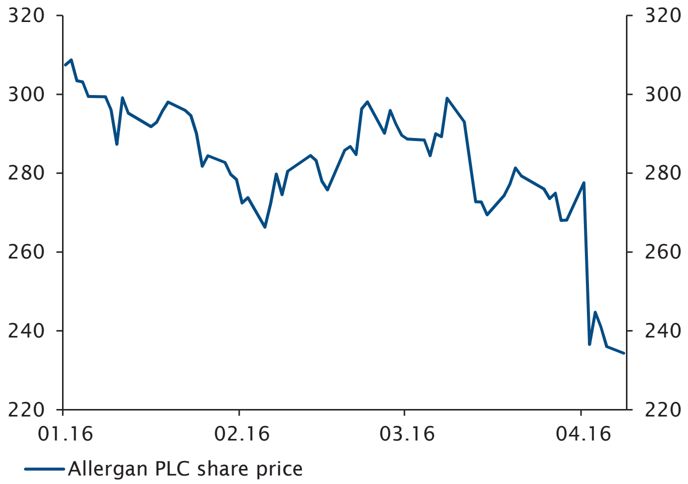


Source: Thomson Reuters Datastream

6. United States – A new factor in the fight against tax inversion

- The US Government surprised investors by announcing a series of measures aimed at making mergers motivated by tax savings more difficult. The pharmaceutical specialist Pfizer thus had to abandon its planned mega-merger with Irish company Allergan. Not only will Pfizer not be able to add Allergan's expertise in botox to its catalogue, but it will also not able to reduce its taxes by establishing its residence for tax purposes in Ireland.
- In an arrangement known as "tax inversion", a company acquires a competitor whose headquarters for tax purposes is in a jurisdiction where taxation rates are lower. Canada and Ireland, whose corporate tax rate is below 20% (compared with around 24% for the US), have seen many companies bought up by US companies in recent years.
- However, the tone is changing in the US Congress. Under pressure from President Obama, the Treasury Department issued new rules to eliminate this tax loophole that allows companies to avoid US taxes. Following this announcement, Pfizer put an end to its planned merger, causing Allergan's share to drop in the wake of the announcement and leaving its investors with a loss of more than 20%.

Evolution of the Allergan security

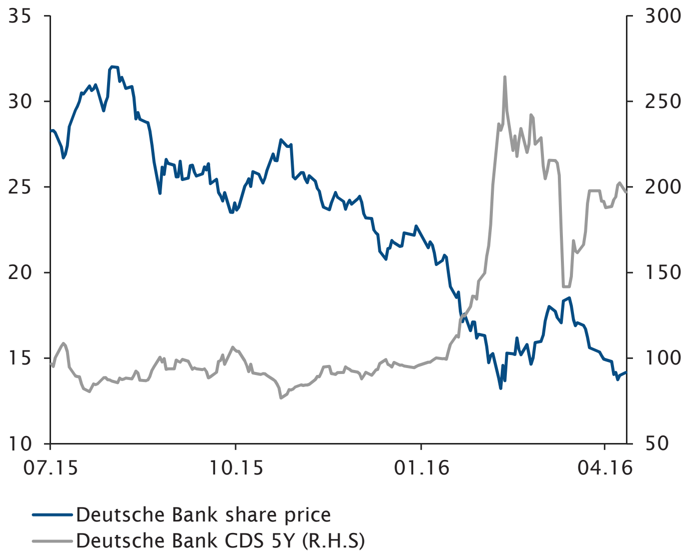


Source : Bloomberg

7. Europe – Bank securities under pressure

- 2016 is a particularly complicated year for investors who bet on European financials. However, there is no need to go to Spain or Italy to find banks whose performance over the year sends shivers down the spine. Just look at Deutsche Bank.
- Following a change in management in 2015, the German bank is continuing its drastic restructuring plan through a refocusing of its activities as well as thousands of job cuts. Despite significant efforts, the market still does not seem to trust John Cryan, and the security was severely punished over the first quarter, posting negative performance of 33%! More disturbing, rumours that the bank would not necessarily be able to pay the 6% coupon on its AT1 contributed to the recent volatility on the security as well as the widening of the CDS.
- However, many – including the ratings agency Moody's – agree that the bank is taking the necessary measures to get back on track. Even so, market conditions as well as investor confidence in the German giant still remain fragile.

Evolution of the Deutsche Bank security and the 5-year CDS



Source: Bloomberg

8. Bonds – High-Yield and emerging spreads tighten dramatically

- For the past year, the impact of the drop in oil prices on the US energy sector has resulted in a significant increase in the sector's risk premium and, by extension, all US High-Yield bond spreads, which, in February, reached their four-year high, a movement also observed on bonds of emerging issuers in dollars because of fears about the economic outlook amid a strong dollar.
- However, since mid-February, this trend has reversed with a generalised rebound in asset prices related to global growth (equities, commodities, loans). In March, this renewed risk appetite was maintained by the announcements by the ECB and the Fed, which, by reducing upward pressure on the dollar, gave a breath of fresh air to emerging economies. The rebound in emerging debt thus made it one of the top bond asset classes in 2016.
- It is true that, in a world where cash earns (almost) nothing, where "risk-free" rates are very low, but where overall growth remains positive, the attractiveness of the additional yield offered by emerging issuers or the most vulnerable companies cannot be disregarded, especially at the levels reached at the beginning of the year. However, we must then be prepared to withstand the volatility inherent in fluctuations in global growth outlooks and commodity prices.

Risk premium of USD "High-Yield" and "Emerging" bonds (bp)

Source: Thomson Reuters Datastream

9. Emerging countries – Return of emerging assets until when?

- Emerging assets often react together, as this graph shows (emerging equities and Asian currencies against the dollar). As Asian currencies appreciate against the US dollar, their respective equity markets are yielding positive absolute performance levels (and vice versa).
- In 2015, the Asian Dollar Index lost around 6%, the EUR lost 10% against the dollar, and the Dollar Index appreciated by +9%. At the same time, emerging equity markets also suffered by ending the year at -8%.
- After a difficult beginning of the year, a return of risk appetite has resulted in a sharp increase in emerging assets since February. At the end of March, the Asian Dollar Index had appreciated by +1.6% YTD, the MSCI EM +2.4%, and emerging debt +5.2%.
- It is also interesting to note that today, one of the countries posting top performance levels in 2016 is none other than Brazil, which, at the same time, is going through one of the worst political crises in its history. The equity index is up +15.5%, the BRL has gained +9.7% against the greenback, and its bonds in local currency and hard currency are also posting positive performance.
- This rally in emerging assets could quickly become precarious if the Fed becomes more aggressive in its cycle of rate hikes, the first consequence of which would be a stronger dollar (therefore emerging currencies under pressure, declining equity markets, etc.).

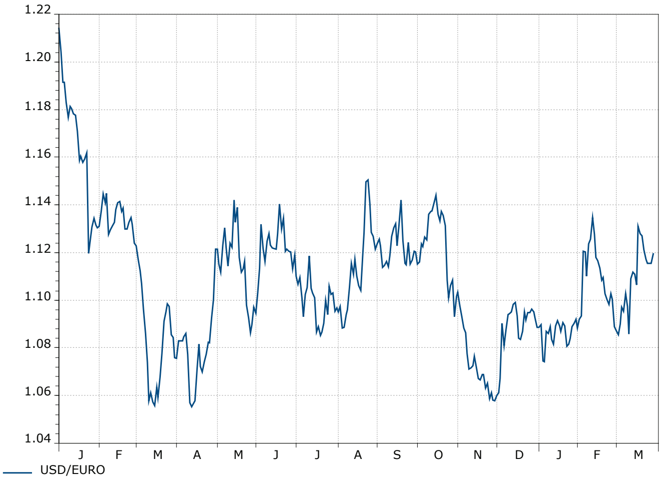
Evolution of the MSCI EM and the Asian Dollar Index

Source: Thomson Reuters Datastream

10.Foreign exchange – EUR/USD still caught between the ECB and the Fed

- At the end of March, the euro reached its highest point in more than five months against the dollar, at 1.14, an appreciation of +4.5% during the month. This movement was essentially fuelled by the expectations revised downwards about the Fed's monetary policy. At the same time, the ECB's announcements did not have the expected bearish effect on the euro, with the ECB announcing that it did not intend to cut its key interest rates even further.
- In reality, for more than a year, the evolution of the euro/dollar exchange rate has been determined by a pendulum between the world's two main central banks. The 1.10 level seems to be the equilibrium point, and moving away from it would, in one direction, call into question the Fed's objectives and, in the other direction, the ECB's objectives. A rising dollar negatively affects activity and passes deflationary (or disinflationary) pressure from the rest of the world to a US economy whose inflation remains too low to completely reassure the Fed. However, an overly sharp increase in the euro, symmetrically, threatens the fragile growth that has emerged over the past two years and removes any hope for the ECB of seeing, in the medium term, inflation move away from the threshold of zero with which it has been flirting dangerously for 12 months.
- The euro/dollar rate, around this level of 1.10, is thus a "prisoner" of the Fed and the ECB, and it seems very difficult to see it move away from this point significantly and sustainably. As long as the situation of weak growth and low inflation persist on both sides of the Atlantic, the members of each central bank will have no other choice, as in tennis, but to intervene (at least verbally) in order to keep the exchange rate around this equilibrium point, hoping that the opponent does not hit back too hard.

Euro against US dollar since early 2015



Source: Thomson Reuters Datastream