

Our monthly view on asset allocation (July 2017)

Wednesday, 08/02/2017

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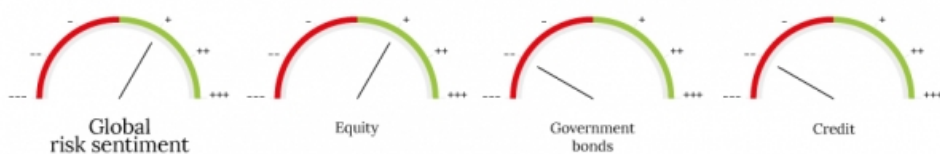


Adrien Pichoud

Chief Economist & Senior Portfolio Manager

- Economic growth is positive almost everywhere and the outlook remains positive for the second half of the year.
- Our main concern is an unordered re-pricing of some yield curves on the back of a tentative of normalisation from the ECB and a Fed's hike in September.
- In this environment, the overall risk stance in our multi-asset portfolios was kept slightly positive (+), while rate sensitivity is kept low (--).

Positive or negative stance on global risk sentiment and the main asset classes are rated using a six-rating scale that ranges from (+++) to (---).



How to remove excess liquidity without causing a volatility spike?

Imagine an economy which has experienced 2.8% real growth annually on average since 2009, with inflation only starting to creep higher this year to 1.7% in May, close to the central bank's 2% target. The unemployment rate has fallen from a peak of 9.3% at the beginning of 2010 to 6.7% in May. It is expected to have a balanced budget and a current account surplus in excess of 4% this year. With that in mind, what would be your best guess about its central bank's recent monetary policy decision? Some form of tightening or a hawkish stance? Dead wrong! It decided not only to maintain its target rate at -0.5%, but to expand quantitative easing (QE). This anecdotal example from Sweden says a lot about the current degree of accommodation provided by the major central banks, in a context that has improved markedly since the financial crisis. In other words, the majority of central banks input is far too large today.

The risks are either that economic and inflation expectations dive suddenly or central banks start realising that the side-effects of their ultra-loose policy are getting larger than the expected benefits. We strongly believe the likelihood of a recession should remain low in the foreseeable future, especially as monetary policies remain unchanged. However, our main concern is an unordered re-pricing of some yield curves, especially in Germany or the US, on the back of a tentative normalisation from the ECB, a rate hike from the Fed in September or, to a lesser extent, some fiscal measures from Trump.

In this environment, the duration and risk stances in our multi-asset portfolios were kept respectively to a disinclination (-) and mild preference (+). The equity allocation preferences have been tilted toward some geographical areas such as Europe (++) and Japan (from - to +). Note that financial and industrial sectors, value style and small-caps should also perform well in this more challenging context for fixed income. In this area, US nominal bonds, which were our "least bad choice for duration so far this year, were downgraded to mild disinclination (-) because we expect positive surprise as the consensus has probably become too pessimistic on the US economic outlook. In the currency space, while the euro (+) should continue to appreciate against the USD, we cannot exclude a short-lived and contained rebound of the dollar, consistent with our cautiously optimistic outlook for the US.

_Fabrizio Quirighetti

Economic backdrop in a nutshell

The global economy presents a growing puzzle for central banks. On the one hand, economic growth is positive almost everywhere and the outlook remains strong for the second half of the year, with the only marked changes being in momentum and cyclicity. On the other, inflation is already slowing and the blame cannot be put exclusively on oil. This makes for an uncomfortable situation for the Federal Reserve and the European Central Bank, stuck between growth that seems to warrant monetary policy normalisation and below-target-inflation that suggests keeping very accommodative monetary policies in place. Faced with such a dilemma, the Fed has so far chosen to continue the normalisation it initiated at the end of 2016, while the ECB is hesitant to start withdrawing its support despite the dissipation of political risks. Falling oil prices complicate the dilemma as they will dampen any inflationary pressure in the months to come. The way this disconnect is resolved will have important implications for FX, rates and equity markets. But it may persist for some time.

Growth

In an expanding global economy, the Eurozone and Japan continue to lead as their growth rates defy expectations, enjoying mid-cycle expansion supported by very accommodative central banks. The emerging world has weakened but is still growing, with the exception of the domestically-driven recessions in Brazil and South Africa.

Inflation

Given current global growth levels, inflation rates are puzzling. Beside the fading base effect of oil prices (and before the impact of the latest crude price decline was felt), all price measures were slowing down, including wage growth in the US. In emerging markets, inflation is also mostly slowing, driven by their currencies regaining ground against the US dollar.

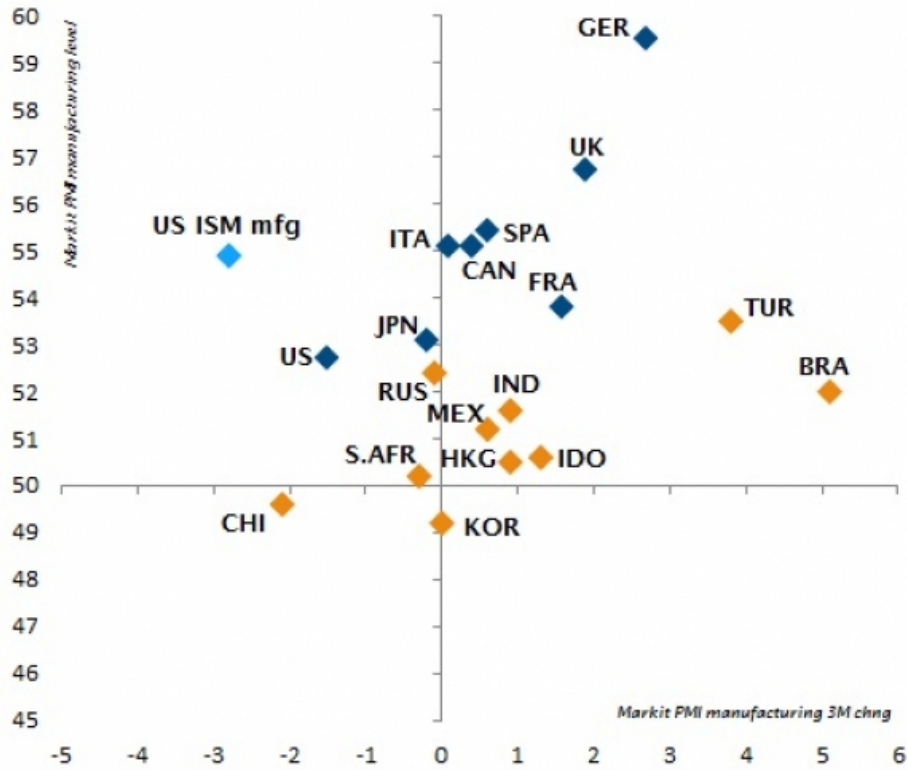
Monetary policy stance

Continuing economic expansion, declining unemployment rates and dissipated political risk in Europe suggest that monetary policy should become gradually less accommodative going forward. But developed market central banks face slowing inflation rates falling below target, except in the UK where the case for monetary policy normalisation is possibly more apparent.

« The way the disconnect between growth and inflation gets resolved will bear important implications for FX, rates and equity markets. »

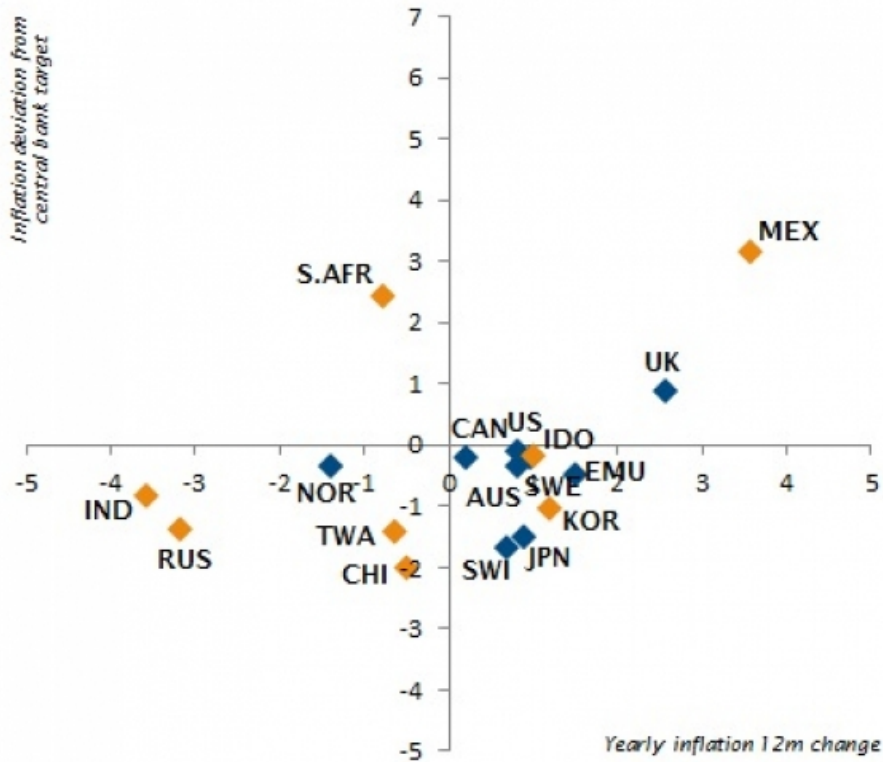
— Adrien Pichoud
Chief Economist & Senior Portfolio
Manager

PMI Manufacturing trends and level



Source
FactSet, SYZ Asset Management. Data as at: June 30, 2017

Inflation trend and deviation from Central Bank target



Source

FactSet, SYZ Asset Management. Data as at: June 30, 2017

Developed economies

The US economy remains in a period of steady but disappointing economic growth. The slowdown in credit aggregates has weighed on consumption, which was otherwise supported by continuing job creation. Capital expenditure is still recovering but not strongly enough to lift GDP growth. And some soft data, such as consumer confidence, are retreating from their post-election peak, highlighting a lack of momentum. In parallel, inflation is unexpectedly slowing down, a development the Fed decided to overlook in June as it hiked the Fed Fund rate and publicised its plan for the gradual disinvestment of its balance sheet. Given current trends, it is difficult to imagine a significant improvement in the second half of 2017, with the wild card being Donald Trump and Congress being able to introduce the long-awaited tax cuts.

The economic backdrop of the Eurozone remains quite positive, with strong expansion in Germany and Spain and solid growth across most of the monetary union. It is less surprising than in the US, because of the earlier stage in the cycle, higher unemployment rate and structural rigidities, to see inflation remaining low but this nevertheless induces heightened caution from the ECB. In the UK, the Bank of England faces the opposite scenario, with inflation rising (above the target) while growth is losing some steam as domestic demand suffers from diminished real purchasing power. A rising proportion of the Monetary Policy Committee now appears willing to raise rates from their post-referendum low sooner rather than later.

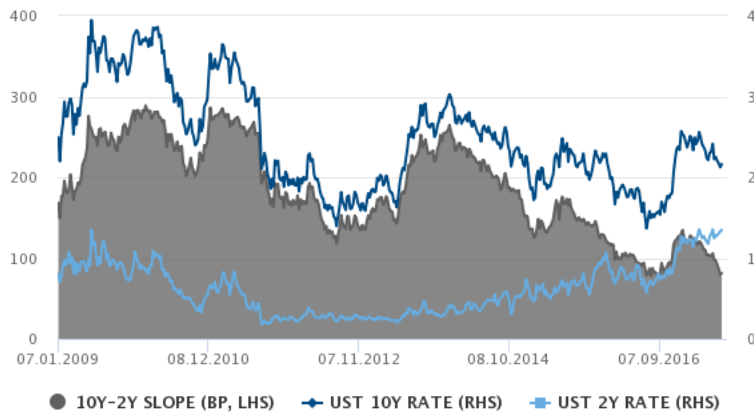
Emerging economies

The Chinese economy is marginally slowing as tighter credit conditions act as a headwind to real estate prices and investment. However, consumption remains steady and is keeping the GDP growth rate within the 6.5% trend it has followed for 18 months. Generally speaking, growth momentum is less strong in emerging economies than in their developed counterparts, in an environment of more restrictive monetary policies. The return of political turmoil in Brazil threatens the country's ongoing recovery and might postpone the end of the recession, as is the case in South Africa.

Adrien Pichoud

Fed hikes while inflation slows down lead to curve flattening

Source: Bloomberg, SYZ Asset Management. Data as at: June 30, 2017



Investment Strategy Group: key takeaways

Risk and Duration

There is no change to our risk assessment, The Risk score shows a mild preference for risk, while still being disinclined to take on additional duration. Although markets have remained largely constant since the French presidential election, consolidating some of the gains from earlier in the year, a number of potential future risk factors have dissipated. The fear of an early election in Italy, which sparked a severe market rout during late May, seems to have been unfounded. Moreover, Emmanuel Macron and his "En Marche" movement winning a clear majority in the French parliamentary elections suggests that long-awaited reforms are likely to be introduced in France. Angela Merkel has strengthened her power domestically by putting Donald Trump in his place during the NATO meeting in southern Italy, making the outcome of the German Federal election increasingly predictable. Finally, Theresa May's disappointing performance in the British general election in early June, has strengthened demands for a softer "Brexit". Yet, there are still potential risks looming; stretched valuations across major asset classes, the pronounced economic slowdown in China, and the sheer unpredictability of Donald Trump's policies remain areas of concern. For the time being, these concerns are not yet significant enough to merit a change in the risk score.

« Valuation-wise Japan is clearly one of the most attractive markets in the western equity universe. »

— Hartwig Kos

Equity Markets

Valuations-wise there has been little change in the equity markets. The United States continues to look somewhat more expensive compared to its western counterparts, with the United Kingdom being the most attractively valued market amongst the core markets, according to our equity risk premium framework. The pronounced attractiveness of the UK market, paired with the potential for further sterling weakness as "Brexit" negotiations begin, triggered an upgrade of the market from a mild dislike to a mild preference. Japanese equities have looked increasingly attractive in recent months. They screen well in terms of equity risk premia, economic activity has been improving since the beginning of the year, and monetary policy remains very favourable. At the same time, corporate earnings growth has been strong. Historically, investors used value measures such as price-to-book to assess the attractiveness of the Japanese equity market. This was because the deflationary environment in Japan made price earnings measures of Japanese equities look highly inflated. Although the overall inflationary environment has not changed much, both price-to-book and price-to-earnings suggest an attractive market in Japan. In terms of leading price-to-book ratio, the Topix trades at 1.26, less than half the level of the S&P 500 which trades at 2.96, while the Stoxx 600 trades at 1.84. The leading price-to-earnings ratio of the Topix is at 14.2 compared to 18.6 for the S&P 500 and 15.8 for the Stoxx 600. In comparison to the US, Japanese valuations are clearly increasing attractive. However, investors have been focusing on emerging markets, based on expected dollar weakness, and on a strengthening Europe. Japanese equities were seen as being hollowed out by the strength in the yen. Now with the Federal Reserve being more hawkish and with Mario Draghi finally talking about ending the accommodative monetary policy of the European Central Bank, the risk of the yen strengthening further is less pronounced than it has been before. This may prompt investors to start looking at Japanese equities again.

« Paired with a softer US Dollar, monetary conditions have become more accommodative in the United States despite three interest rate hikes in recent months. Investors have once again become highly complacent about the potential interest rate trajectory of the Federal Reserve. »

— Hartwig Kos

Bond Markets

At risk of repeating the same message over and over again, fixed income markets remain expensive and continue to be a substantial risk factor to equity valuations. Within the fixed income universe, emerging hard and local currency bonds remain the least worst segment. Yet even this area of the market has become increasingly expensive, which has triggered continuous downgrades of different country preferences within both segments over the last few months. The most recent downgrade is Poland, which was in the middle of our preferences on the hard currency bond side and one of our favoured markets on the local emerging market bond side. Valuations of high-quality duration remain very frothy. Taking US treasuries as an example, the current 5Y5Y forward rate, which measures 5 year yields in 5 years' time (a gauge for expected future interest rates) is at 2.8%. This is 40 basis points lower than in December 2016, which marks the most recent high point in yields. Over the same time period, the 5Y5Y forward measure of the treasury term premium, which is a risk premium that compensates investors for unexpected changes in short-term interest rates moved from close to 0.43% to -0.32%. This is a 75bps adjustment equivalent to the three interest rate hikes over the same time period. This means that, paired with a softer US dollar, monetary conditions have become more accommodative in the United States despite the three hikes and investors have once again become highly complacent about the potential interest rate trajectory of the Federal Reserve. Hence US Treasuries, which were our preferred part of the developed market bonds segment, were downgraded from a mild preference to a mild dislike. At the same time German linkers look somewhat more attractive at the margin, but remain at a disinclination score from a strong disinclination previously.

Forex, Special opportunities & Cash

No change in assessment.

— Hartwig Kos

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