ASSET ALLOCATION INSIGHTS

Our monthly view on asset allocation (August 2017)

Monday, 08/28/2017

The economic backdrop remains favourable with positive global growth momentum, especially outside the US, and a lack of inflationary pressures allowing central banks to remain on the accommodative side.



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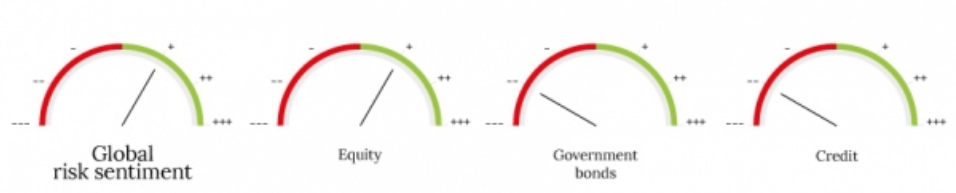
Hartwig Kos



Adrien Pichoud
Chief Economist & Senior Portfolio Manager

- The economic environment remains favourable with positive global growth and no inflationary pressure.
- Major concern: we are clearly struggling to find negative catalysts in the short-term on markets.
- The overall risk stance in our multi-asset portfolios is kept slightly positive (+) and the duration risk 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 (---).



Enjoy the summer lull

The economic backdrop remains favourable with positive global growth momentum, especially outside the US, and a lack of inflationary pressures allowing central banks to remain on the accommodative side. In other words, the Goldilocks environment continues to prevail. On the markets, everything continues to fly high or higher (except obviously for the dollar). Asset classes across the spectrum remain quite expensive, and exhibit historically low volatility. All of this is underpinned by extraordinary loose monetary policies. After a spike at the end of June / beginning of July, upward pressures on rates diminished rapidly with neither the Fed or the ECB in any rush take a more hawkish stance. As a result, EM assets continued to post strong performance as they benefit – even more than developed market – from a weak greenback, low rates and positive growth momentum: the perfect contextual trifecta. Moreover, they offer relatively attractive valuations compared to DM assets. So still more of the same. The question is, should asset allocators bother to intervene in the current climate?

But there is cause for concern: the more the market serenity lasts and the more fragile markets become. While our next significant move will certainly be a risk reduction, we are clearly struggling to find negative catalyst in the short term. Perhaps the Jackson Hole Economic Policy Symposium at the end of August as central banks monetary policies normalization tentative remains the major imminent threat. In fact, lofty overall assets valuations, especially in the fixed income, are due to their current overall exceptionally loose monetary policies themselves. While there were no changes in our geographical preferences in the equities space, some of our preferences in the bond universe were shifted marginally. EM hard currency debt was downgraded for valuation purposes from mild preference to mild disinclination. Inflation-linked bonds were upgraded to a mild disinclination as real yields improved somewhat. Furthermore, they should offer more resilience in a rising rates environment, especially if complacency around low inflation comes under pressure. As "you can observe a lot by just watching" (Yogi Berra), the overly accommodative stance from developed market central banks could also be challenged if inflation surprises, even temporarily, on the upside.

Indeed, by examining recent market development, it seems that economic figures related to prices and wages have now a much broader and larger impact on markets than the ones associated purely or uniquely to (real) growth. In other words, as there is now a broad consensus according in our opinion about steady but unspectacular growth, the inflation question and the consequences it may have on monetary policies has become pivotal for markets. In the meantime, we prefer to remain invested and to benefit from low volatility to buy some cheap protections on equities as well as on rates.

_ Fabrizio Quirighetti

Economic backdrop in a nutshell

The sustained and global growth momentum is spurring central bankers' confidence in this summer period. A growing number of them in the Western world are now pondering the idea of raising rates, something barely thinkable just a year ago. In the wake of the Federal Reserve's rate rises, even the lack of inflationary pressure is not enough to stop Mario Draghi hinting at the European Central Bank tapering quantitative easing, Mark Carney stating openly that a Bank of England rate hike could happen before the year end, or the Bank of Canada raising short term rates by 25bp. The apparent dissipation of deflationary risks justifies this willingness to consider normalising monetary policies. Central banks do not want to miss the window of opportunity offered by a favourable macro-economic backdrop. However, they will have to tread carefully as their economies, like the financial markets, have become accustomed to ultra-low rates and ample liquidity. The sensitivity of growth to financing conditions is higher than ever after increasing debt levels in the past few years, whether in the public or the private sector. In any case, with a positive, relatively balanced and stabilised growth environment, central banks are once again center stage in the financial landscape.

Growth

Synchronised global economic growth continues to prevail, with Europe still catching up and experiencing rediscovered optimism. Positive business cycle dynamics have even resumed in North America after a more subdued phase. Global GDP growth is likely to accelerate toward 3.5% in 2017 after two years of (mild) slowdown.

Inflation

Inflation (or the lack of) is the conundrum of the moment as it fails to accelerate despite ongoing GDP growth and declining unemployment rates. However, deflation fears have disappeared and prices are generally rising across the globe, even if at a rather subdued pace in most developed economies.

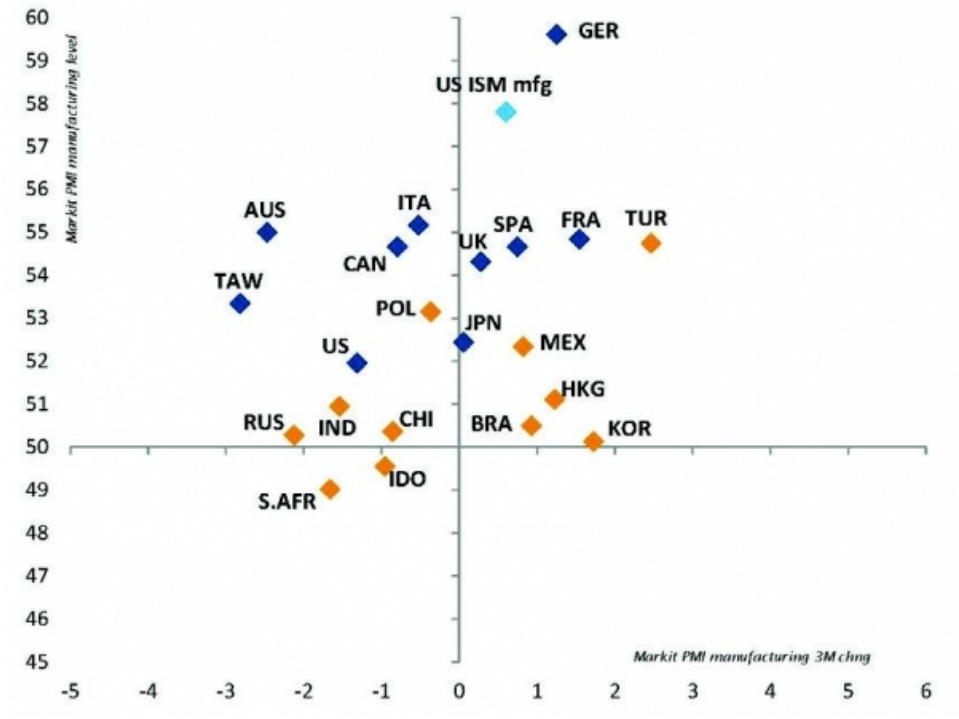
Monetary policy stance

Major developed central banks are now all hinting toward some monetary policy normalisation, willing to look through below-expectations inflation data that they deem to be the result of temporary factors. Central banks are forced in several emerging countries to maintain a more restrictive stance as they still face elevated inflation rates.

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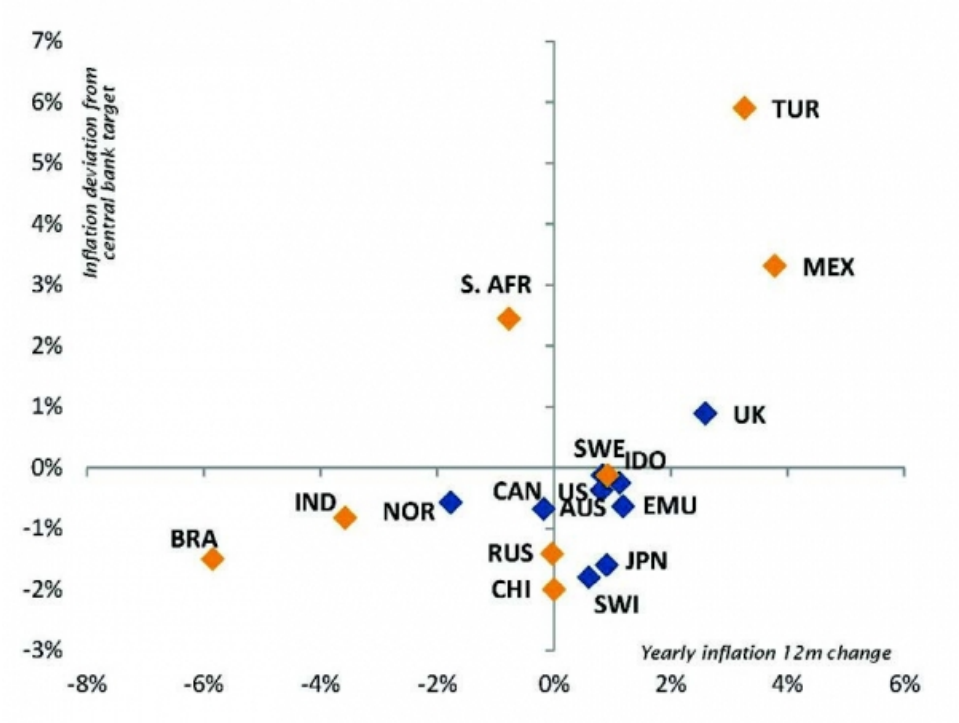
PMI Manufacturing trends and level



Source

Source: Factset, Markit, SYZ Asset Management. Data as at: June 2017

Inflation trend and deviation from Central Bank target



Source

Source : Factset, Markit, SYZ Asset Management. Data as at: June 2017

Developed economies

The apparent disconnect between activity and inflation is especially striking in the US, where economic data continue to show expansion, even if at a mild pace, without triggering any upward pressure on price indices. In fact, "soft data" confidence surveys have rebounded recently and give reassuring signals on the momentum of the economic cycle. But consumer price inflation and wage inflation continue to slow down and even instill doubt in the Fed's conviction that such weakness is transitory (cf. Janet Yellen's remarks before the Congress). So far, the Fed appears willing to stick to its scheduled plan of the gradual normalisation of monetary policy, with a mix of short-term rate hikes and balance sheet reduction, but the inflation puzzle casts some doubts around those prospects, especially in the absence of fiscal stimulus.

This situation characterises most developed economies, where economic growth is firmly positive and incites central banks to withdraw part of the extreme monetary policy support they have implemented in the past few years, despite inflation being clearly below their official target. The (likely uncoordinated) statements of the Bank of Canada, Mario Draghi and Mark Carney seem to fit such a scheme. Accelerating expansion in Canada and the Eurozone, and the so-far resilient activity in spite of rising inflation in the UK, make monetary policy normalisation easier to contemplate.

Japan and Australia differ from their western counterparts as their central banks so far continue to err on the side of caution and haven't signaled any willingness to abandon their current stance despite economic growth being positive.

Emerging economies

Although Brazil and South Africa remain stuck in recession, plagued by a mix of economic and political issues, the vast majority of the emerging world is also experiencing positive growth. The Russian economy has recovered from its oil-driven recession and has resumed expansion, with inflation now back at the central bank's target and stabilizing. The Chinese economy is growing steadily in line with the government's target, with the latest focus on financial stability suggesting that some of the support, to real estate in particular, might now be partially removed. Turkey benefits from the fiscal support implemented ahead of the referendum and inflation has likely peaked. Overall, the pattern in most emerging economies is one of positive growth, but unlike in developed economies, also of persistent inflationary pressure that will force central banks to keep a relatively restrictive stance.

_Adrien Pichoud

The Fed is leading on the normalisation path, tempting others to follow



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

Investment Strategy Group : key takeaways

Risk and Duration

No change in assessment. The risk score remains at a mild preference, and the duration stance continues to be at a disinclination. While clouds are clearly gathering on the horizon, given the general unease about monetary policy, it is still to early to shift the needle on our risk preference. Moreover, shifting duration into a more negative stance from here would also be premature given the significant shifts in yields in the last few months. So for the time being we enjoy the summer lull. However, we are keeping an open eye on economic numbers inflation and policy developments that could potentially unnerve market participants.

« There is clearly a link between the strength of the Euro and the disappointing outcome of this earnings season in Europe. »

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Equity Markets

The valuation picture remains unchanged. Yet the earnings picture is clearly improving across developed equity markets. At the time of writing approximately half of US and European have reported their second quarter results. The results appear to be strong, particularly the US equity market has seen substantial upgrades to the top and bottom line. This is a very positive development, helping US equity valuations to break away from their heavy reliance on bond valuations. We have long argued, that the only reason why equities are cheap is because bonds are expensive and the latest rise in US bond yields has had a detrimental impact on US equity valuations in our ERP framework. Looking at the details of company reports across US sectors, the numbers have been universally strong, and it is interesting to see that whilst earnings and sales revisions have been patchy in the first quarter of the year, the second quarter sales revisions have been as high as they have been in the last 10 years, with earnings also in top percentile levels over the same time period. In Europe the results were considerably softer. After a very strong reporting season in the first quarter, earnings revisions have come in much less positive pointing to the weakest level since 2015. Sales on the other hand side have remained firm despite the strong appreciation of the Euro over the last few months. There are quite a few explanations for this divergence between sales and earnings revisions that can be put forward. When it comes to sales, one can highlight the strength of the domestic economy, and on the earnings side it might have to do with FX hedging losses or investments undertaken in light of stronger economic activity. Nonetheless, there is clearly a link between the strength of the Euro and the disappointing outcome of this earnings season in Europe. Going forward this relationship has to be monitored very closely, when making further assessments about our outlook for European equities. No changes to our country preferences for the moment.

Bond Markets

Not much has changed in Bondland either. Western government bonds remain expensive. Yet, after the recent selloff in bond markets, which has been very much driven by a correction in the real yield, index linkers do look somewhat more attractive. Therefore the entire block has been upgraded from a dislike to a mild dislike. Namely the US and Italy have seen a substantial rise in the real yield and are now scored at a mild preference. Canada also looks somewhat more attractive on the margin. We have long maintained the view that emerging market bonds are the most attractive segment in fixed income markets, within that we favoured the hard currency bond universe over local bonds, due to is favourable risk characteristics. Yet, given the strong performance of the hard currency bond universe in recent months, even some of our very favoured (and previously very attractively valued) markets such as Turkey have started to be come somewhat expensive. As a consequence the segment was downgraded and brought in line with our stance on local emerging market debt. Nonetheless, currently the EMBI Global spread over treasuries amounts to 322 basis points with a modified duration of 6.94 and an average rating between BBB and BB. Looking at US corporates, the BBB segment as measured by the Merrill Lynch index has a duration of 7.2 years with a spread of 139 basis points. Looking at the BB segment US corporates have a spread of 219 with a duration of 4.5 years. In Europe the BBB segment sits on an option adjusted spread of 113 basis points and a duration 5.3 and the BB segment is at 209 basis points with a duration of 3.89 years. This makes it evident that there is still a substantial yield pickup in emerging hard currency bonds relative to other credit markets. In an environment where harvesting spreads is one of the key sources of alpha the emerging market segment still remains the one of the least worst within the broader fixed income universe. Elsewhere, US high yield was downgraded by a notch to a dislike, given the very expensive valuations in this segments.

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Forex, Special opportunities & Cash

No change in assessment.

_ Hartwig Kos

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