ASSET ALLOCATION INSIGHTS

Our monthly view on asset allocation (September 2017)

Wednesday, 09/06/2017



Fabrizio Quirighetti
Macroeconomic Strategist



Hartwig Kos



Adrien Pichoud
Chief Economist & Senior Portfolio Manager



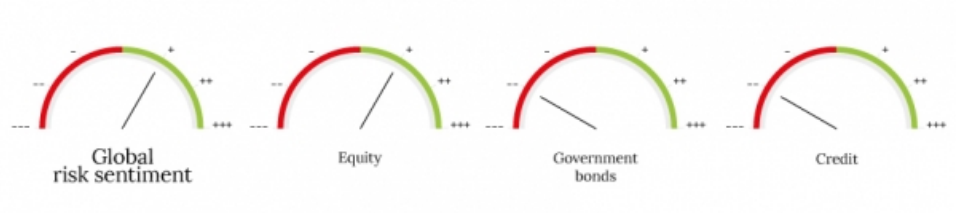
Luc Filip
Head of Discretionary Portfolio Management

— The macroeconomic backdrop could hardly be more positive than the current one and such environment seems likely to prevail for the coming months.

— Jackson Hole has been a non-event that could be sum up as: “looser for longer but please don’t remove banks regulations”.

— 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 (---).



More chances to hit the debt than the inflation ceiling

Let's get straight to the point: there haven't been any material changes in the economic environment, our asset valuation analysis or in our risk framework to recommend significant changes in our positioning. Not even Trump's tweets or some geopolitical challenges, such as tensions with North Korea, the Venezuela crisis or new terrorist attacks in Europe, seem able to alter the current = economic backdrop of global synchronised growth with low inflation and very loose monetary policies.

In the meantime, the earnings season has also been supportive, especially in the US with high positive earnings and a top-line sales beat ratio of around 70%. It was more mixed in Europe as expectations were probably too high. Nevertheless, sales and earnings growth of respectively about 7-8% and 15-16% year-on-year can't be seen as bad. The rapid appreciation of the euro over the summer (helped to some extent by the dollar's weakness) has weighed on the European equity market's performance in local currency. With a more stable euro-dollar relationship going forward and even a likely pullback towards 1.15 in the next few months, the potential for outperformance in European equity remains intact for valuation purposes. We have tactically downgraded the euro to a mild disinclination stance (against USD) and reiterated our preference for European equities.

Is inflation late or dead? It seems to be the $100m question for both central bankers and investors as there is now a clear consensus surrounding economic growth. While the current synchronised expansion is far from spectacular, it offers other advantages as it is a global and very steady phenomenon, meaning low volatility and contained uncertainties. So, the process of normalisation now essentially relies on the inflationary cycle. In this context, Jackson Hole has been a non-event that could be summed up as: "looser for longer but please don't remove banks' regulations". It reminds me of a swarm of fireflies asking firemen to remain cautious and close enough to prevent a disaster. Central bankers and some investors think inflation in goods and services is just late, but we believe it is dead. Current monetary policies are now much more effective at creating asset price inflation, distortions in the financial system and rising imbalances, which need still more regulations and firemen to control them.

Looking forward into September, we don't expect meaningful changes to central banks' exit strategies to arise from the next European Central Bank or Federal Reserve meetings. However, the US debt ceiling debates are looming and may lead to some volatility spikes by the end of September. US politics, and the Trump administration in particular, are much more volatile and unpredictable than economic growth, inflation or central banks decisions. We just hope their decisions won't have a lasting negative impact.

_Fabrizio Quirighetti

Economic backdrop in a nutshell

A decade after the financial crisis began to unfold, the global economy has finally experienced synchronised expansion. Witnessing the four largest economic areas see positive growth at the same time hasn't happened since the 2008/09 recession as the US, Japan, Europe and then China have alternately experienced idiosyncratic economic soft patches. And if the potential for further improvement appears limited, with a slight loss of momentum to come in the second half of the year, downside risks are also quite limited in the next six to 12 months, except for potential external shocks on the geopolitical or commodity front. Such stability in the outlook, in an environment where inflation remains positive but resolutely low, creates an almost perfect environment for central banks: no need to provide additional accommodation but no urgency to normalise their policies. They can afford to move gradually and carefully. This contributes to a very favorable macroeconomic picture made of stable positive economic growth, positive and low inflation, and accommodative and predictable monetary policies. The macroeconomic backdrop could hardly be more positive than the current one and, even better, such an environment seems likely to prevail for the coming months.

Growth

Hardly any (visible) cloud on global growth prospects was seen in the summer, as business cycle dynamics stabilise at a firm pace. Winter will inevitably come at some point but it seems that, as far as the economic outlook is concerned, the threat is far from imminent.

Inflation

The Phillips curve continues to be challenged by ever subdued inflation rates despite declining unemployment rates across the developed world. Structural disinflationary trends such as technological change, free trade, demographics and rising debt are keeping a lid on all measures of inflation, from wages to consumer prices.

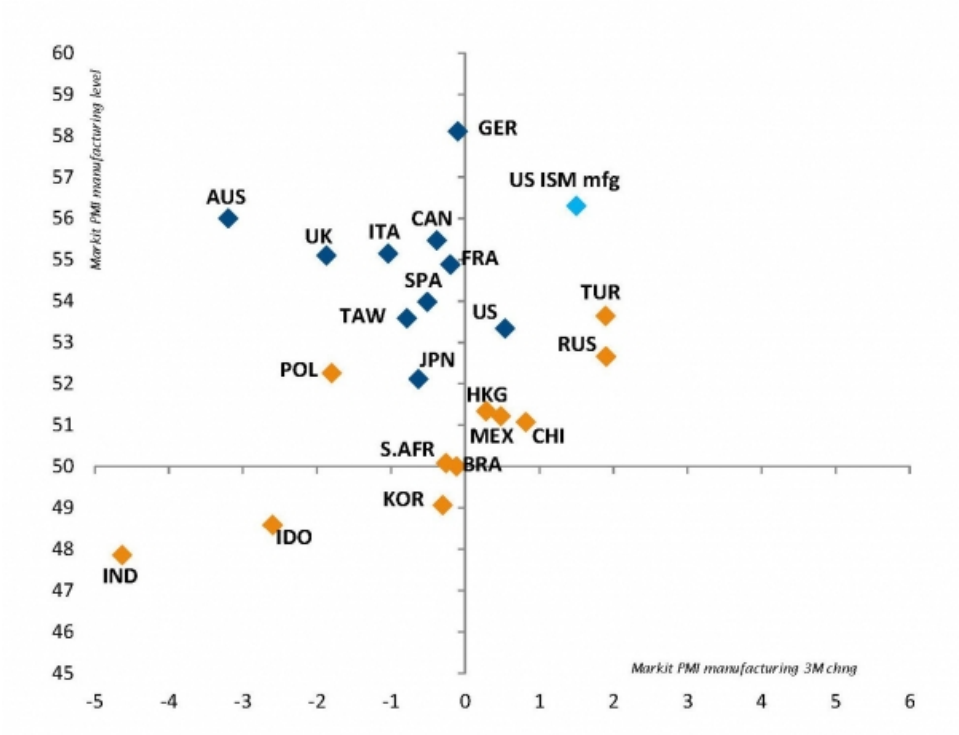
Monetary policy stance

Central bankers hold the key to a continuation of such a positive macro environment. In debt-laden economies, they have to tread carefully when looking for normalisation. So far, the Federal Reserve, the ECB and the Bank of Japan have emphasised their cautiousness but any haste on the path of policy normalisation might prove to be disruptive. Excessive monetary policy tightening is currently the main risk hanging above the bright global macroeconomic outlook.

« A decade after the financial crisis began to unfold, the global economy has finally renewed with synchronised expansion. »

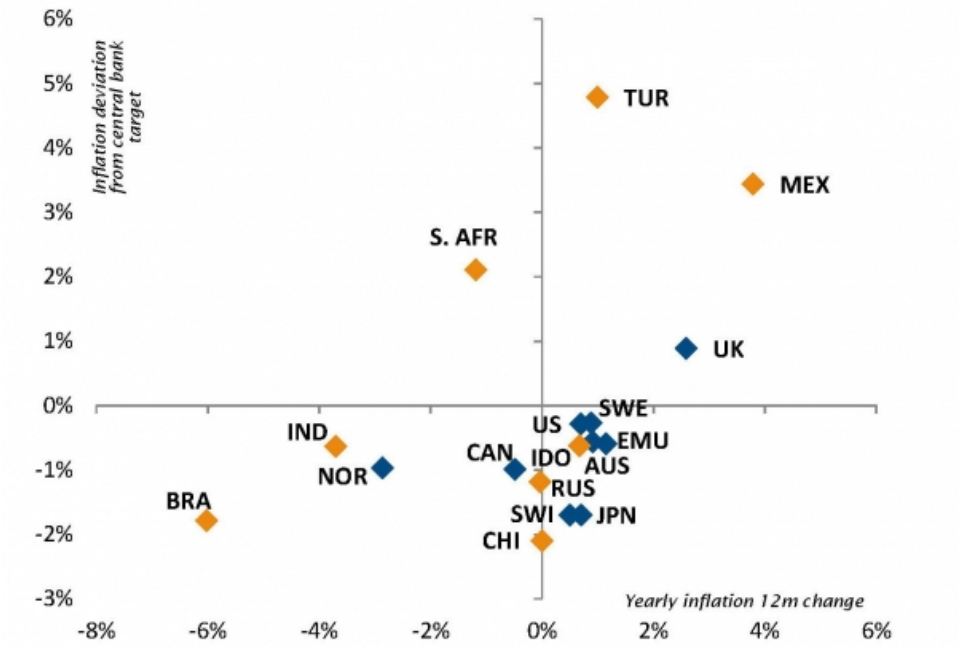
Adrien Pichoud
Chief Economist & Senior Portfolio Manager

PMI Manufacturing trends and level



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

Inflation trend and deviation from Central Bank target



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

Developed economies

In the United States, inflation data continues to stand out amid an otherwise quite harmonious economic backdrop of mild balanced growth. Indeed, price indices have again surprised to the downside and yearly inflation rates are slowing down. Yet, from retail sales to investment spending via all consumer and business surveys, the US economy is expanding at a robust pace. The Fed has hinted toward an announcement of the beginning of its balance sheet unwinding at its next FOMC meeting on September 20th and such an announcement would surely be made easier if inflation bounces up a little by then. In the meantime, the nearing debt ceiling deadline and possible government shutdown will bring additional pressure on the Trump administration and Congress to reach an agreement on promised fiscal reforms.

In the Eurozone, solid growth remains widespread as illustrated by Q2 GDP data, where even Italy posted an acceleration. However, and unsurprisingly, after the strong improvement of the first half of the year, indicators are generally stabilising at elevated levels, as growth cannot depart much further from its long-term potential. The latest euro appreciation triggered by Draghi's speech in June may become a headwind (for export-oriented industries) and also complicates the ECB's task as it dampens inflation expectations.

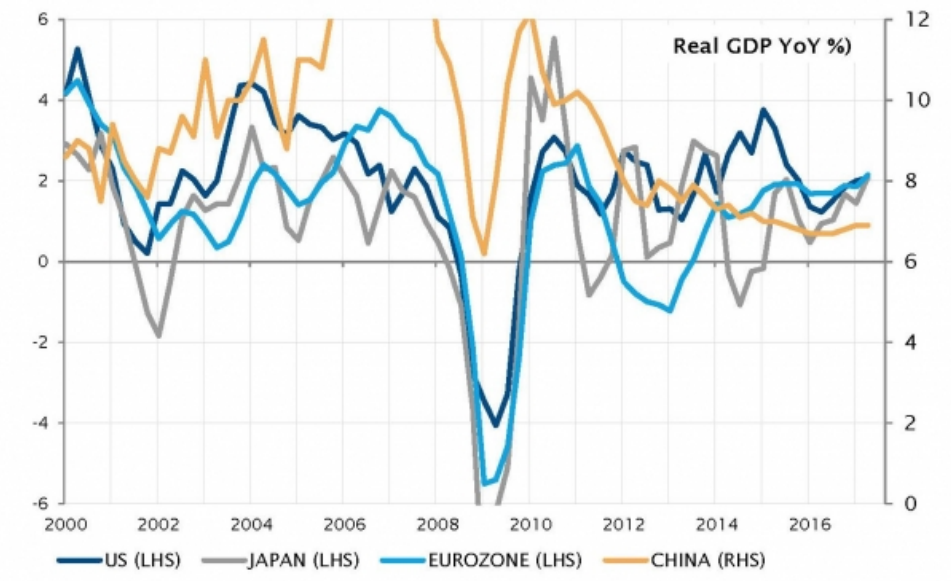
The Japanese economy is also running above its potential growth rate, supported by strong domestic demand. But as in the US or in Europe, such real GDP growth has failed to create inflationary pressures and has led to the BoJ maintain an accommodative bias. In the past two decades, the BoJ has already given way to the temptation of normalising at the first encouraging signs, only to be forced into a U-turn soon after. Mr Kuroda appears keen to avoid repeating the mistake.

Emerging economies

The emerging complex in the vast majority is also enjoying positive growth, with only politically-troubled Brazil and South Africa (not to mention Venezuela) failing to participate in the global expansion. The Chinese economy has stabilised, helped by fine-tuning in economic policies designed to bring stability ahead of the National Congress. External demand from developed economies, a somewhat weaker USD and low global rates create favourable growth conditions for most Asian, Eastern European and Latin American economies.

_Adrien Pichoud

Global synchronised positive growth for the first time in a decade



Source
Factset, SYZ Asset Management. Data as at: August 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.

« US valuations are clearly not very attractive but the “shocking” headline of a US CAPE level of 30 clearly overshoots the mark. »

Hartwig Kos

Equity Markets

There were no changes in our country preferences. Europe remains our preferred equity market followed by the United Kingdom, Japan and the United States. Our assessment of Emerging Markets is neutral to mildly negative. One of the charts that has created headlines recently is Robert J Shiller's CAPE Ratio of the S&P 500. The cyclically adjusted price-to-earnings (CAPE) ratio smooths the impact of economic cycles on price-to-earnings ratios by adjusting for inflationary pressures on earnings. The average CAPE ratio of the S&P between 1881 and 2017 was just below 17, while in July it hit 30, the third highest valuation in nearly 140 years. The second highest valuation level occurred during the 1920s, peaking in September 1929 at 32.6, while the highest occurred during the dot-com bubble when the CAPE ratio peaked at 44.2 in December 1999. Whenever the S&P has hit a CAPE ratio of 26 or higher, the average subsequent 36-month return was 4.2%. Should this ring alarm bells? The CAPE measure has a series of flaws. It assumes a ten-year business cycle, which is historically shorter, while the inflation adjustment is based on a CPI basket that has changed many times. Accounting and tax changes have also evolved the composition of corporate earnings over time. Nonetheless, the CAPE measure is a good way to cut the noise in valuations and to see the long-term picture. To compare across different markets we recreated the CAPE measure for the main equity markets based on MSCI indices. According to our data, the US CAPE ratio is 29, very close to the original Shiller dataset based on the S&P 500. Meanwhile, Japan's ratio is 26, Europe's is 20 and the UK's is 18. Based on this measure, the US is clearly more expensive than other markets. How does this compare to the proprietary equity risk premium framework used by SYZ? To review the similarities between the two valuation frameworks, we took the inverse of the CAPE measure, i.e. the CAPE earnings yield and deducted the cyclically adjusted bond yield (i.e. ten-year average) from it. This framework is akin to the well-known Federal Reserve model. This suggests that US equities remain 0.8% cheaper than bond markets, but that they are considerably more expensive than their western counterparts. US valuations are clearly not very attractive but the "shocking" headline US CAPE ratio of 30 clearly overshoots the mark.

Bond Markets

It is without a doubt that equity valuations remain supported by the expensiveness of bond markets. However, the yield sell off that occurred over the summer months has brought some value back to bond markets. Emerging Market debt and linkers remain the most favourable segments within the asset class. Canadian linkers have been upgraded to a mild preference from a mild dislike and our ultra-negative stance on German bunds was also softened somewhat.

« The three key trigger factors for this are in our view the collapse in the political risk premium in Europe and the deflation of the “Trump Trade”, alongside investors increasingly starting to expect a change in monetary stance by the ECB (which is now under question due to the strength of the currency). »

Hartwig Kos

Forex, Special opportunities & Cash

One of the key developments over the summer has been the rapid depreciation of the US dollar, particularly against the Euro. Within nine months the Euro has moved from close to parity to 1.20 against the US Dollar. Looking at this in technical terms, the Euro spot rate sits roughly 10% above its 200 day moving average, which is the most extreme technical move since the global financial crisis.

The three key trigger factors for this are the collapse in the political risk premium in Europe and the deflation of the "Trump Trade". In addition to that, markets are increasingly expecting a shift in the ECB's monetary policy, although this is now back in question due to the currency's strength.

The pace of appreciation can, in our view, be explained by the lack of a short-term valuation framework for currencies, which exacerbates trending characteristics and the volatility of foreign exchange markets. Taking equities for example the dividend yield of a stock goes down as stock prices go up and vice versa, giving investors at least some signal as to the expensiveness of a stock. Exchange rates don't have a similarly concise valuation framework. An appreciation of a currency is not automatically linked to an increase in the interest rate differential between countries. This is due to the fact that interest rates are set by central bank policy, which does not necessarily change as a result of changes in an exchange rate. The recent appreciation of the Euro versus the dollar is a good example. The interest rate differential between the three-month US T-bills in the versus three-month cash in Europe is currently 130 basis points in favour of the dollar. In December last year, when the Eurodollar was close to parity, this interest rate differential was 80 basis points. This means that in nine months of euro strength, the interest rate differential moved 50 basis points in favour of the US Dollar. The implication of this missing anchoring device in foreign exchange markets means that they are prone to trend much more than other financial assets and investors are relying to a much greater extent on technical signals and assumptions. While we believe that the Euro is likely to stay strong compared to the dollar, in the very near term we believe this trend will pause. This is due to the fast pace of the previous appreciation, which went against market assumptions, and because of muted expectations regarding further Federal Reserve interest rate hikes Donald Trump's tax reform.

_ Hartwig Kos

Disclaimer

This marketing document has been issued by Bank Syz Ltd. It is not intended for distribution to, publication, provision or use by individuals or legal entities that are citizens of or reside in a state, country or jurisdiction in which applicable laws and regulations prohibit its distribution, publication, provision or use. It is not directed to any person or entity to whom it would be illegal to send such marketing material. This document is intended for informational purposes only and should not be construed as an offer, solicitation or recommendation for the subscription, purchase, sale or safekeeping of any security or financial instrument or for the engagement in any other transaction, as the provision of any investment advice or service, or as a contractual document. Nothing in this document constitutes an investment, legal, tax or accounting advice or a representation that any investment or strategy is suitable or appropriate for an investor's particular and individual circumstances, nor does it constitute a personalized investment advice for any investor. This document reflects the information, opinions and comments of Bank Syz Ltd. as of the date of its publication, which are subject to change without notice. The opinions and comments of the authors in this document reflect their current views and may not coincide with those of other Syz Group entities or third parties, which may have reached different conclusions. The market valuations, terms and calculations contained herein are estimates only. The information provided comes from sources deemed reliable, but Bank Syz Ltd. does not guarantee its completeness, accuracy, reliability and actuality. Past performance gives no indication of nor guarantees current or future results. Bank Syz Ltd. accepts no liability for any loss arising from the use of this document. (6)