ASSET ALLOCATION INSIGHTS

Our monthly view on asset allocation (October 2017)

Thursday, 10/12/2017

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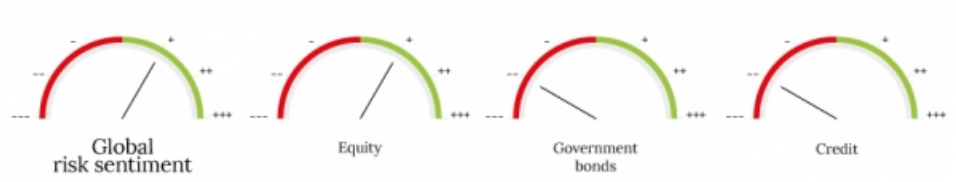
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- The favorable growth environment prevailing since the beginning of the year remains intact, with even some of the weak countries gradually recovering.
- Japan was upgraded from (+) to (++) this month. Europe and Japan are the most favoured equity markets at this point.
- 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 (---).



1, 2, 3...and then no more?

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...and their actions here are not crazy in the least! They are taking care not to frighten the markets, which have been among the great beneficiaries of the extremely loose policy. If, like Janet Yellen and most of the central bankers, you are bemused by the "mysterious" disappearance of inflation in prices for goods and services, you will at least agree that monetary policy has had the expected effects on inflation in prices for financial and real-estate assets. The Fed will therefore move slowly: it will simply stop reinvesting some coupons and bonds that will expire. It will also initially limit this automatic but highly controlled unwinding to $10 billion a month, and then gradually raise the limit to $50 billion. I'll spare you the calculations: less than $300 billion in 2018, and no more than $600 billion the following year. In short, Ms Yellen says it will be "like watching paint dry."

But markets and investors—us included—are anxious. Hence a certain apprehension regarding US long-term interest rates (if they rise too quickly) and the credit market (if liquidity evaporates). It's sort of like the wave of uneasiness you get as the airplane takes off and you briefly consider the possibility of an unlikely but potentially disastrous accident. But let's try a bit of positive autosuggestion, so that we don't give way to an unfounded panic. Although the Fed and the US are at the heart of finance and the global economy, other major central banks, such as the ECB and the BoJ, will continue to experience swelling balance sheets. The net sum of the major central banks' balance sheets will therefore increase further next year. Plus, with interest rates still near zero in most of these economies, it is unlikely that US long rates will soar on their own. Finally, the market's reaction to the Fed's reduction in its balance sheet—or its monetary tightening via rate hikes, the next of which may come as early as December—will also depend on the economic context in which they arise. I can't imagine US Treasuries selling off solely because of monetary tightening if nominal growth suddenly nosedived...

Economic expansions and bull-market phases have never died from old age, so it's still (much?) too early to worry. And I'm not just saying that for self-reassurance!

_ Fabrizio Quirighetti

Economic backdrop in a nutshell

A severe hurricane. A missile launch followed by Twitter jeering. Another severe hurricane. Another missile launch followed by more jeering. Yet, financial markets barely react. Cold cynicism? No, it's the economy, stupid! The vast majority of the global economy is expanding: 179 countries out of 192, for an aggregate 98.8% of world GDP, are expected to experience positive GDP growth this year according to the IMF and no recession is in sight for 2018. In the meantime, this expansion is not generating inflationary pressure, for reasons that are only partially understood but have the immediate implication that central banks don't need to tighten monetary policy rapidly and long-term interest rates remain low. This last part of the equation even strengthens the case for a continuation of the global expansion in the quarters ahead. While interest rates remain low, the one big macro imbalance of the global economy - high public and private debt - is unlikely to collapse. In such a context, natural disasters, as long as they affect localised areas, and saber-rattling, as long as it doesn't turn into actual nuclear war, are unlikely to impede the macroeconomic outlook.

Growth

The favourable growth environment that has prevailed since the beginning of the year remains intact at the end of the summer, with even the weak links of the global economy (Russia, Brazil, South Africa) gradually recovering. The only way to balance such a bright growth picture is to acknowledge that it can hardly improve further.

Inflation

Inflation is currently THE key indicator. Its lack of reaction to strong growth and low unemployment continues to puzzle central bankers in developed economies, with the notable exception of the UK. In emerging economies, inflation has also slowed to unusually low levels in many countries, but structural headwinds appear less pronounced than in DMs.

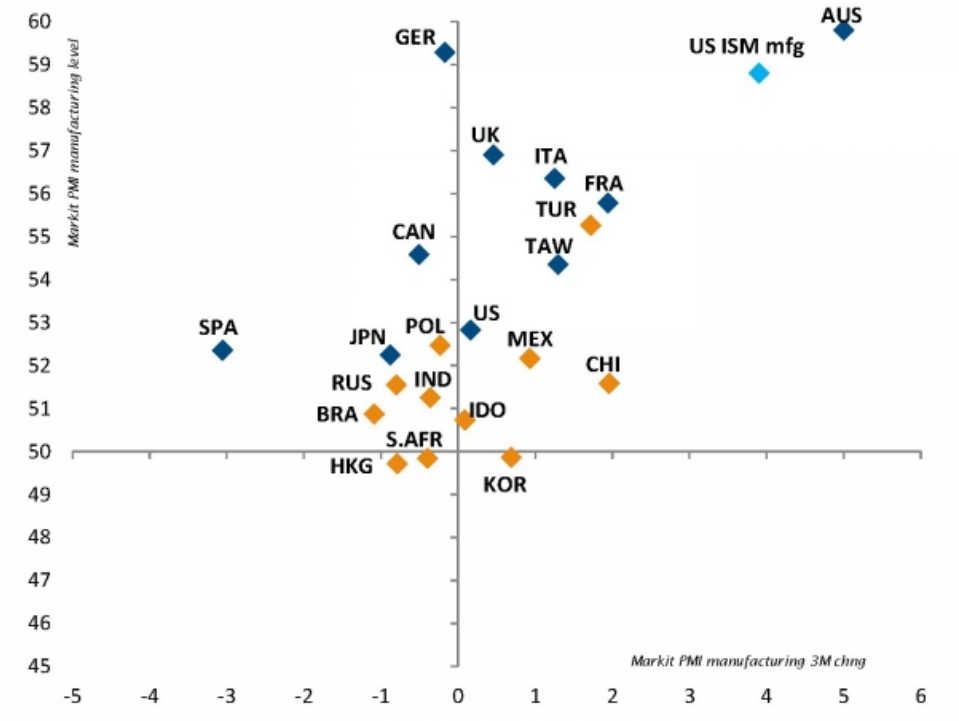
Monetary policy stance

It is "normalisation time" for central bankers across developed economies, with all the main central banks hinting more or less openly that they are looking to withdraw existing monetary policy support given the positive growth dynamic. But such normalisation can and will only happen at a fairly gradual pace, given the lack of acceleration in inflation. In EMs, central banks maintain their relatively restrictive bias.

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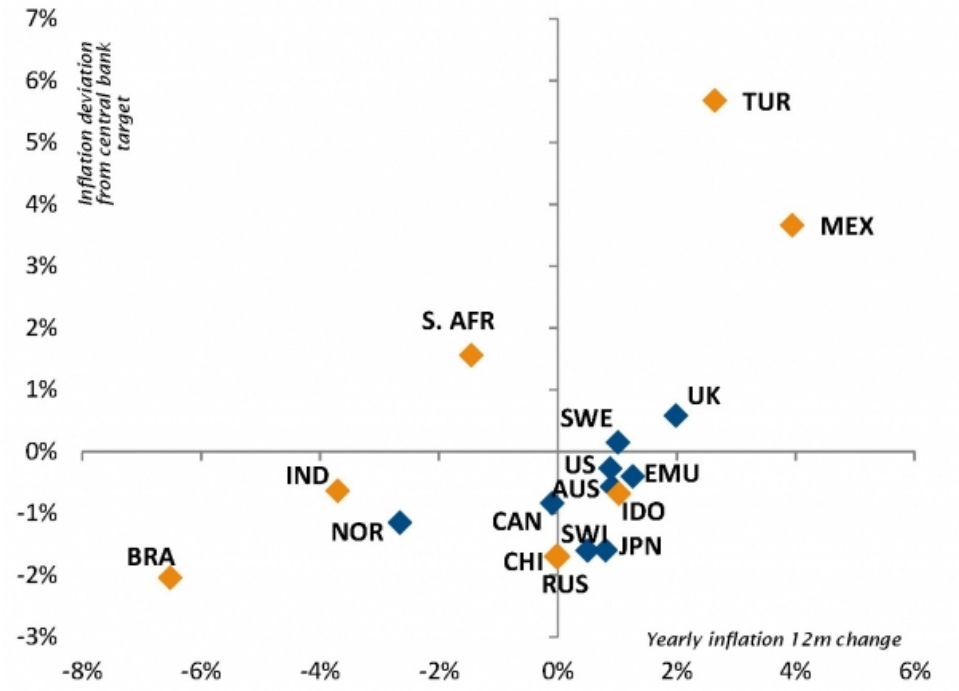
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PMI Manufacturing trends and level



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

Inflation trend and deviation from Central Bank target



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

Developed economies

In a US economy growing steadily around potential without negative surprises, future economy policy has become the main uncertainty. On the fiscal side, the dreaded deadline for the debt ceiling has been pushed to December in order to avoid badly-needed hurricane relief funds being stuck in the current Congressional quagmire. But the debate will come back and, with it, the recurring issues of promised tax cuts, infrastructure spending and health care reforms that have so far disappointed expectations. On the monetary policy side, the Federal Reserve has triggered the beginning of the well-telegraphed "QE-reversal" and still expects to extend the rate hike cycle in December and into next year. However, markets seem less convinced than the Fed that the current inflation weakness is just temporary.

In the euro area, economic indicators keep pointing to firm economic growth and even the latest euro strength doesn't seem to impact industrial activity so far. Paradoxically, such currency strength is likely to dampen future inflation somewhat, which has led to an odd situation at the latest ECB meting: the GDP growth estimate was revised up for 2017 (to 2.2%) and kept high for the next two years but inflation was revised lower, mostly due to the euro strength, meaning that the ECB's inflation target is not expected to be reached before 2020. The ECB chose to remain on the "normalisation track", hinting to a QE tapering announcement at the end of October.

Faced with a similarly strong economy but a lower absolute level of inflation (even if slightly rising), the Bank of Japan continues to pledge to keep ultra-accommodative monetary policy in place. On the contrary, the Bank of Canada has just doubled up on its surprise July rate hike, bringing back its target rate to the pre-oil price collapse level. The BoC isn't hindered by low inflation and rather considers that current strong GDP growth warrants monetary policy normalisation.

Emerging economies

Most emerging economies continue to benefit from a combination of positive domestic dynamics and strong external demand fueled by DM consumption. Even economies that have experienced difficulties in the recent past are gradually resuming growth (such as Brazil, Turkey, and India as the impact of the demonetisation reform gradually fades away). Among the larger EM countries, only South Africa remains plagued by business-negative political uncertainty.

_Adrien Pichoud

Europe continues to exhibit strong growth momentum despite euro strength



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

Investment Strategy Group: key takeaways

Risk and Duration

No change. The risk score remains at mild preference, and the duration stance is still at a disinclination.

« The USD is deeply oversold, the Fed is hinting at further interest-rate hikes and some progress appears to have been made regarding US tax reform, all of which indicates that there is potential for a medium-term trend reversal for the dollar, taking the lid off European and Japanese equities. »

Hartwig Kos

Equity Markets

The motto this month is “all in on the laggards”. With an upgrade to Japan, Europe and Japan are the most favoured equity markets at this point. Within Europe, Spain has been temporarily downgraded from preference to mild preference given the uncertainty surrounding the Catalan referendum. The UK, Australia and EM Latam were also downgraded from mild preference to mild dislike. While the overall risk stance suggests a mild level of investment conviction about equity markets in general, this very barbelled country allocation clearly conveys a great deal of conviction about our intra equity allocation. Where does this conviction come from?

We like Europe and Japan! The first and most obvious reason for this is the view on the US dollar. Since the beginning of 2017, the broad US Dollar index (DXY) has depreciated by more than 10%. This move has pushed the USD into fair-value territory on a real effective exchange-rate basis. This pronounced weakness has meant that areas such as emerging-market equities, which generally benefit from a weak dollar environment, have performed very strongly over the year. On the other hand, areas which traditionally benefit from a stronger USD, such as Japan and Europe, have been lagging behind the broader equity universe. At this point, however, the USD is deeply oversold, the Fed is hinting at further interest-rate hikes and some progress appears to have been made regarding US tax reform, all of which indicates that there is potential for a medium-term trend reversal for the dollar, taking the lid off European and Japanese equities.

This is also supported by the fact that political uncertainty, at least in Europe, is not a factor that could unhinge market sentiment.

Both Europe and Japan continue to look cheap relative to US equities. Our ERP has indicated this relative preference for quite a few months now, but as described in an earlier edition of this publication, the relative cheapness can be found in many mainstream valuation metrics as well. Europe and Japan currently trade on a 12m forward price earnings ratio of 14.7 and 13.7 respectively. This compares well to the US equity market, which is valued at 17.9. The leading price earnings ratio between the US and Europe is now at its lowest level since the end of 2012, and the differential of the leading PE ratio between Japan and the US equity market is close to its lowest level on record. Other measures, such as EV/EBITDA, also point to a pronounced valuation difference between the US and Europe and Japan.

Besides this, the economic reality is not properly reflected in either of the equity markets. Both have been laggards despite a macroeconomic backdrop that looks even more favourable than in the US. When it comes to Europe, economic indicators across the board are as strong as they have been in the last decade. Despite the prospect of ECB tapering, financial conditions remain very accommodative to say the least. The economic backdrop in Japan has been positive too, albeit slightly more muted. Nonetheless, it is evident that the general economic environment is clearly positive for both of these markets.

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Bond Markets

Bond markets continue to be expensive, as they have been for a while. Over the past few months, however, even the segments within the bond market that used to look appealing— particularly emerging markets—have somewhat lost their shine. They are still one of our top picks across the different fixed-income segments, but the weakness in the USD and the fact that global bond yields have drifted lower over the course of the year has meant that some valuations in this segment have started to deteriorate considerably. As a result, different markets within the EM block have been downgraded further. Mexican hard-currency bonds are now at a mild dislike, whereas they used to be at a mild preference. Despite this clear change in intrinsic attractiveness for emerging-market bonds, the decision to maintain the overall stance in assessment is based on a relative-value argument. Emerging-market bonds still don't look as bad as many other fixed-income segments.

Forex, Alternatives & Cash

No change.

_ Hartwig Kos

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