

## Our monthly view on asset allocation (June 2017)

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Political uncertainty may remain the biggest unknown risk, if it's large enough to lead to policy uncertainties.



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- Political uncertainty may remain the biggest unknown risk, if it's large enough to lead to policy uncertainties.
- Analysts have started to revise their estimates on sales and corporate earnings upwards. This means that intrinsic, earnings driven, value appears to be coming back into equity markets.
- The equity mania is not in EMs, but in the technology sector, which has consistently outperformed since mid-2013.

## More of the same...

Sell in May and go away? It may be better to think twice. This is because nothing has really changed over the last month. While we remain concerned about expensive valuations across many asset classes, the current Goldilocks economic backdrop – acceptable growth without any inflationary pressures leading to gradual monetary policy normalisation – remains supportive of risk. Political uncertainty may remain the biggest unknown risk, if it's large enough to lead to policy uncertainties. A political flashpoint could indeed occur at any point but is now more likely in the US than in the Eurozone, with the increasingly maverick President Trump at the helm. But even so, it is extremely difficult to pinpoint a policy tipping point or a market damaging global stand-off – whether it is simmering tensions in the Korean peninsula, terrorist attacks or a Trump tweet. All this taken into account, we are keeping a mild preference for risk, which will benefit from low volatility levels, while keeping some protection in place, in case of a correction. We believe there is a high probability this will occur in the next few months and we will use this opportunity to reload some risk at a better entry point.

### Is it a case of history repeating?

The current low-volatility environment of rising equity markets is reminiscent of the 2005-2006 period: expensive asset valuations, a euro-zone recovery, the euro regaining ground against the greenback, and the ECB on the eve of normalising its monetary policy. Despite commentators considering the current context as either new or exceptional, we strongly believe it may be a case of history repeating with a few amendments. The key differences are, firstly, the equity mania is not in EMs, but in the technology sector, which has consistently outperformed since mid-2013. More importantly, the debt level in the global system has increased further, impeding any significant increase in the overall level of interest rates without causing a crash (that will lead to the final "japanification" step of developed economies).

### Volatility set to stay low

For the rest, it's more of the same - equities risk premium and credit spreads were even tighter than today. As long as there is not a sufficient shock to derail the global economy or change, drastically, the path of the Fed's monetary normalisation, volatility spikes won't last much longer and overall volatility levels will remain low. In this context, we upgraded EM LatAm equities to a mild preference on the back of the correction triggered by the new Brazilian politics scandal, as the fearful contagion outside the Brazilian equities market was undue. Highlighting the similarities with 2005-2006, US long-term interest rates should thus remain quite stable. The only (temporary) upward risks in the foreseeable future will certainly arise not because of US growth acceleration or a sudden change in the Fed's target rate path, but from a repricing of the German yield curve. It may now happen anytime soon, but the day of official reckoning from the ECB that their exceptional measures should be removed is coming. Thus we are keeping our tactical disinclination stance on duration, especially on German Bunds and JGBs. In the forex space, consistent with the views above, we believe the euro will continue to appreciate against the dollar and some carry trade positioning should get more crowded going forward. This is because some EM currencies, such as MXN or TRY, still offer rather cheap valuations with relative appealing absolute and relative yield, compared, for example, to the low expected returns of European HY which was downgraded to a disinclination last month. Similar to the upgrade in European equities last month, we continue to reshuffle our portfolio risks where we find some pockets of (relative) value.

*\_Fabrizio Quirghetti*



## Economic backdrop in a nutshell

Beneath the surface of a steadily expanding global economy, a surprising and somewhat unexpected development has quietly occurred in the past few quarters: Europe has outpaced the US in terms of GDP growth. It is now even exhibiting more cyclical momentum than most EM economies. What a reversal! Just a few years back, successive crises in peripheral economies, fears of euro disintegration and a Euro-wide recession had made the Eurozone the Ugly (and hopeless) Duckling of a global economy. If Europe's recovery has been quietly advancing, it is suddenly in the spotlight as 1/short-term political risk has vanished after the French elections 2/the US economy is losing steam, contrary to most Trumponomics-fueled expectations. Becoming the shining part of the global economy implies the focus is likely to turn toward monetary policy normalization and potential upside risk for the currency, two factors that may ultimately become headwinds to the current dynamic, as it has been the case in the US from 2014 onward. However, the ongoing strong economic dynamic appears likely to last, at least, till the end of the year in Europe, a welcome development for the global economy at a time when US growth disappoints and China struggles to rebalance its economic model.

### Growth

The vast majority of the global economy continues to experience positive GDP growth. Within the largest economies, the Eurozone now clearly stands out, both in terms of expansion rate and dynamic, while the United States and China experience a softening in their growth dynamic. Old Europe and Japan are currently the only large economic areas to grow above their long term potential.

### Inflation

From April data onward, inflation rates have no longer been significantly distorted by oil-related base effects. As such, inflation is back to a "boring" low-but-positive framework in Developed Economies. In EM economies, currency stabilization and restrictive monetary policies help to contain and even reverse inflation dynamics.

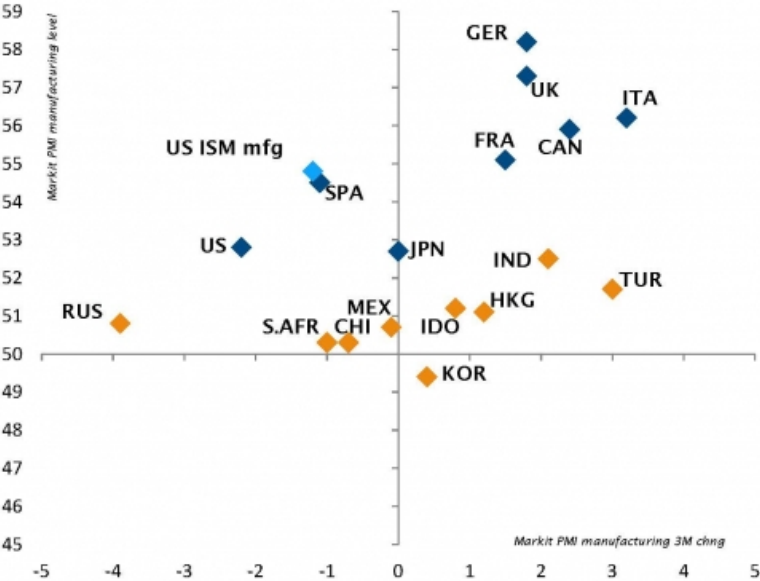
### Monetary policy stance

In the current context, the focus is likely to turn more toward the ECB than the Fed for monetary policy normalization in the second half of the year. However, the general stance of supportive monetary policies across the developed world, made necessary by the combination of subdued inflation and high indebtedness, will remain.

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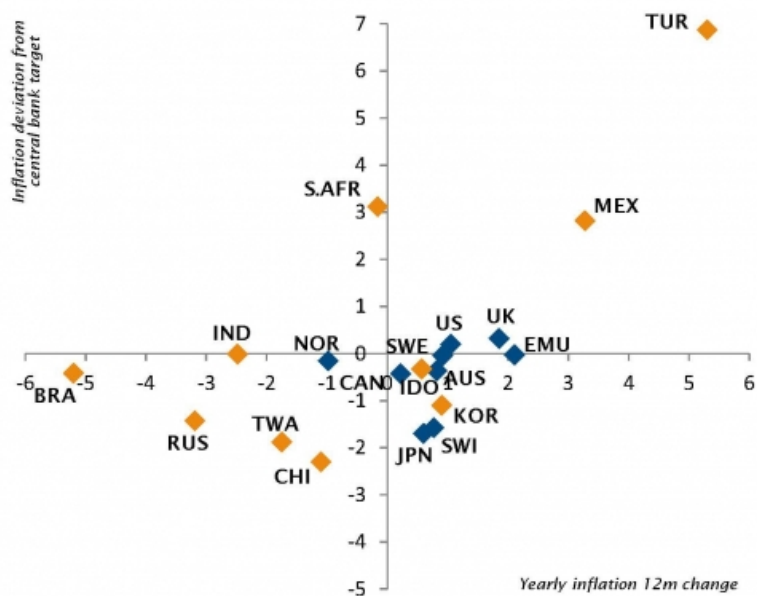
— **Adrien Pichoud**  
Chief Economist & Senior Portfolio  
Manager





Source  
 SYZ Asset Management

## Inflation trend and deviation from Central Bank target



Source  
SYZ Asset Management, Datastream

## Developed economies

The US economic situation hasn't really gotten any clearer in the recent weeks. On the one hand: consumption remains subdued and has significantly weighed on Q1 GDP growth; inflation shows no sign of acceleration, including at the wage level; the disconnect between confidence surveys and hard data remains; and, credit growth is slowing down. On the other hand: business investment has taken expansion up again, industrial activity is improving and the unemployment rate keeps falling - back at its pre-crisis low. In such contrasting environment, the Fed appears inclined to hike in June, and then reassess the outlook. The X-factor is Donald Trump: his ability or not to deliver on his extensive fiscal promises will be key to either spur the current sluggish growth toward a more dynamic trend or advance to its late-cycle slowdown...

In Europe, the spectacular run of strong-and-above=expectations data continues as mid-cycle dynamics are in full play. Germany and Spain lead the way but the Eurozone as a whole is enjoying very favorable economic conditions, as reflected by the 2.0% annualized GDP growth recorded in Q1, faster than the US as it was the case for 2016. All surveys point to Old Europe being the most dynamic spot of the global economy currently. The ECB will have to be very cautious when communicating around gradual monetary policy normalization if it doesn't want to undermine the European recovery.

Japan is another area where growth is positive and above potential, but the dynamic is less impressive than in Europe and inflation has dropped back into negative territory, suggesting that deflationary forces are not yet eradicated.

## Emerging economies

The emerging world is expanding without any clear growth dynamic. The tightening in market financing conditions in China has caused a mild slowdown in growth indicators, without threatening the scenario of stable growth around 6.5% till year end. In Turkey, post-referendum monetary policy tightening may coincide with peaking inflation. In Brazil, it remains to be seen whether late political development have the potential to derail the gradual but positive recovering trend.

*\_Adrien Pichoud*



Positive economic surprises continue to single the eurozone out of the global picture



Source  
SYZ AM, Factset

## Investment Strategy Group: key takeaways

### Risk and Duration

Neither the Risk nor the Duration stance were altered. Risk remains at a mild preference and Duration at a mild dislike. Following the French elections significant political tail risks have been removed from financial markets. This has been reinforced by the result of the local elections in the German state of North Rhine Westphalia, which were widely seen as the bellwether for the federal elections in Germany, where Angela Merkel's CDU was victorious with significant gains compared to the Social Democrats. One has to remain conscious that there is the potential for disappointment when it comes to US politics, and some of the developments in Chinese money markets are worrying. Yet for the time being this does not appear to unhinge positive sentiment in financial markets.

*« The most recent strength of the Eurostoxx 50 has meant that this market is, in technical analysis terms, now testing a 17-year downtrend. While technical analysis always has to be taken with a pinch of salt, it is nonetheless interesting to see that market psychology towards European assets is shifting. »*

Hartwig Kos

### Equity Markets

In the equity space the valuation picture remains unchanged with equities being fair value by the virtue of bond markets being expensive. However, it is encouraging to see that analysts have started to revise their estimates on sales and corporate earnings upwards. This means that intrinsic, earnings driven, value appears to be coming back into equity markets. While in Europe upgrades have been made on the top as well as on the bottom line (upgrades in sales and earnings), US equities have only seen upgrades to the top line – upgrades to the bottom line are still lagging. In our view, the implications of this trend is that analysts are bullish on the macro picture in the US, but are probably in a 'wait and see' mode with regards to their expectations on corporate earnings, given uncertainties regarding the proposed tax reforms.

Apart from this rather positive development, another notable change has happened on market technicalities, namely in European equities. The most recent strength of the Eurostoxx 50 has meant that this market is, in technical analysis terms, now testing a 17-year downtrend. This picture is very pronounced in absolute terms, but it is relative to other equity markets as the dynamics are similarly encouraging. While technical analysis always has to be taken with a pinch of salt, given that it relies to a great extent of subjective interpretation, it is nonetheless interesting to see that the market psychology towards European assets is shifting. We maintain our positive stance on Europe.

When it comes to emerging markets, Latin America was upgraded by a notch to a mild preference. Mexican equities have undoubtedly been rattled by the election of Donald Trump, yet valuations are attractive, economic activity remains robust, and fears about Donald Trump building the wall are subsiding. Moreover, Brazil is one of the biggest recovery stories in the emerging market world this year. Since Michel Temer took office economic growth has started to stabilise and inflation has fallen 4% - a level not seen in a decade. Up until a few weeks ago the dark last days of Dilma Rousseff's reign when inflation was close to 11% and bond yields close to 17%, were distant memories in the minds of investors. Temer's reform agenda appeared to be on track, bond yields were well behaved and Brazilian corporates sent encouraging messages to their shareholders. Therefore, it is not surprising that the allegations against Michel Temer hit Brazilian assets like a hurricane. While we believe that there is more volatility to come, this upgrade will provide us with the flexibility to take advantage of selective investment opportunities in this region as and when they arise

*« It is truly scary to see that European equities, as represented by the Stoxx Europe 600 index, carry a trailing dividend yield (currently 3.43%) that is only marginally lower. »*

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## Bond Markets

Bond valuations remain a serious concern, while the apparent expensiveness of western government bonds have been highlighted by the multi asset team in the past. One must also highlight that within western government bonds there are some pockets of value. US Treasuries look ok and Italian bonds - nominal bonds as well as index linked bonds - look also somewhat more attractive. When it comes to credit we have long held the view that US investment grade credit with 150 basis points spread over treasuries (BBB segment), or European investment grade credit with option adjusted spreads of 135 basis points, simply does not provide sufficient cushion to insulate these bonds from rises in government bond yields. This, and the reasonably positive macroeconomic backdrop, were the main reasons for our positive stance on emerging market debt and high yield up until now. The case for emerging market debt remains widely intact, with a mild preference for foreign currency denominated bonds over local currency bonds. However, when it comes to high yield the picture has changed considerably. It is truly scary to see that European equities, as represented by the Stoxx Europe 600 index, carry a trailing dividend yield (currently 3.43%) that is only marginally lower than the yield on European high yield bonds. The broader Merrill Lynch Euro High Yield index currently carries a yield of 3.56%. In the US the difference is still healthy with the S&P 500 yielding 2.1% on trailing dividends and the broader US High Yield index is at a running yield of 5.9%. This pronounced expensiveness in European high yield bonds has triggered a further downgrade of the segment to a dislike.

## Forex, Alternatives & Cash

No change in assessment. Cash remains attractive, but less than before and we expect further weakening of the USD against the Euro and Sterling.

*\_Hartwig Kos*



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