ASSET ALLOCATION INSIGHTS

Monthly Update | Issue 86 30 August 2023

A healthy pause?

Key takeaways:

- After a strong first half of the year, the market's mood has shifted in August with both US and International equities taking what still looks like a healthy pause. China's growth issues and the rise of bond yields in the US have been the main triggers for profit taking.
- We remain neutral on equities, rates and credit. We are turning negative on EUR and CHF against USD. We are downgrading China & EM Asia equities to neutral and are upgrading US equities to positive.
- We continue to favour 3 main investment strategies: 1) Diversify into the lagging segments of the equity market that carry lower valuations; 2) Use volatility to our own advantage by buying on pullbacks; and 3) Use the bear steepening of the curve to extend duration within fixed-income portfolios.

Charles-Henry Monchau *Chief Investment Officer*
Adrien Pichoud *Chief Economist & Senior Portfolio Manager*
Luc Filip *Head of Discretionary Portfolio Management*
Fabrice Gorin *Deputy Head of Portfolio Management*
Gaël Fichan *Head Fixed Income & Senior Portfolio Manager*

Syz PRIVATE BANKING

The big picture

After a strong first half of the year, the market's mood has shifted in August with both US and International equities taking what still looks like a healthy pause. China's growth concerns and fears of higher rates for longer in the US have somewhat offset the enthusiasm around a resilient consumer, the moderation of inflation and the artificial intelligence boom.

Indeed, China is facing a severe property-sector decline which is slowing economic growth and generating stress in pockets of the financial system. As Chinese policymakers are unlikely to come with a monetary and fiscal "bazooka", growth is not expected to pick up any time soon. Markets now fear that with China's growth trending below par, this may have negative consequences on the rest of the world. Recent leading indicators in Europe seem to indicate that the old continent already feels the pain.

Meanwhile, US economic growth does not seem to slow down enough for the Fed to tweak its monetary policy. While there are clear signs of weakness in the manufacturing sector, services seem to be resilient. The third quarter could even bring some upside surprises as the Atlanta Fed Nowcast model is forecasting 5.9% annualized real growth.

In this context, the Fed is reluctant to declare victory on the inflation front. At the Jackson Hole Symposium, the overall tone of Chairman Powell was relatively hawkish. The main message was that the Fed is definitely on hold but leaning towards a more hawkish stance, should economic data not reflect progress on the inflation side / growth cooling down. The most likely scenario is for interest rates to stay at current levels for a long time. The long end of the US Treasury curve has been repricing the "Higher for longer" rhetoric, which has been weighing on equity valuations recently – and on "long duration" stocks. With the rise of bond yields and the compression of earning yields, US equities now look much more expensive than fixed income.

We also note that investor positioning is very different than at the start of the year. Systematic and risk parity funds have been gradually increasing their exposure to stocks. Should the market correction start to accelerate, they will become forced sellers and exacerbate the extent of the drawdown.

Another concern is the lag effects rising interest rates on the real economy. Renewed weakness by US banks stocks seems to indicate that the most aggressive rate hike cycle will not leave the economy and financial system unscathed.

On the positive side, the US earnings revision trend remains positive. If consensus estimates prove true, the second quarter will mark the end of the earnings downturn. S&P 500 earnings are expected to turn positive in the third quarter and rebound further in 2024. The combination of positive earnings growth simultaneously with the Fed finally pausing could very well help equity markets to resume their uptrend.

In the next section, we respond to the six most frequently asked questions from clients. We then present our latest asset allocation decisions based on the 5 pillars of our asset allocation process. To conclude, we suggest three investment strategies for the months to come.

Frequently asked questions (FAQs)

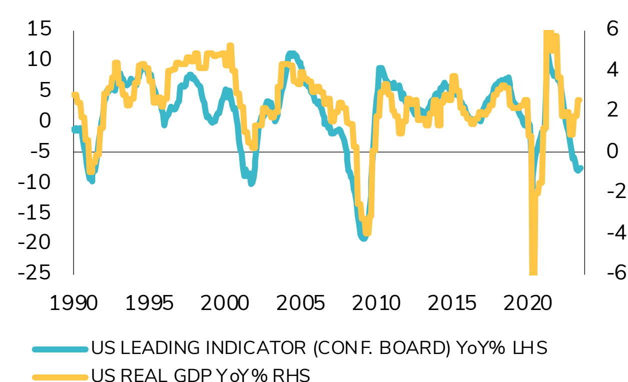
FAQ #1

When, if ever, will we see a recession?

Europe is likely already in recession in Q3, amid persisting weakness on the manufacturing side (weak demand for exports, impact of high energy prices, excess inventories...) and recent softness in the service sector.

The US economy has been surprisingly resilient so far this year, buoyed by the strength of the labour market, excess savings from the post-Covid ara and supportive fiscal policies. Positive growth in real income and decent consumer confidence continue to fuel consumption. Leading indicators point to a possible recession in late 2023 or early 2024 caused by restrictive credit conditions. However, the possibility of a soft landing (or no landing at all) cannot be ruled out for the US.

United States – Leading Indicator and Real GDP YoY %



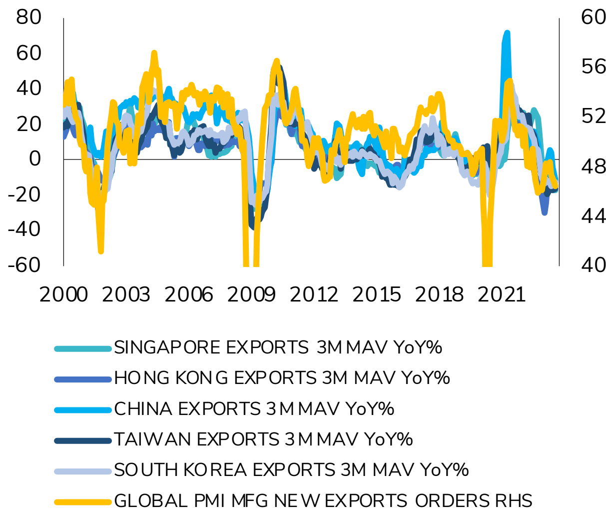
Source: Banque Syz, Factset

FAQ #2

What will be the global impact of China's growth crisis?

China's growth has failed to properly pick up in 2023 and is currently running below the stated objective of the authorities (5% GDP growth for 2023). This weakness in the second largest economy of the world is weighing significantly on neighbouring economies integrated in China's supply chains or exposed to Chinese consumers. It also impacts exporters of high-end manufactured goods (Europe) and commodities.

Global PMI Manufacturing index of New Exports Orders and exports from selected South-East Asia economies (YoY%)



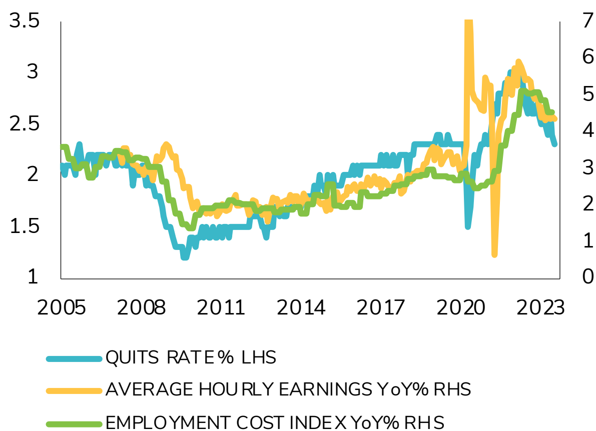
Source: Banque Syz, Factset

FAQ #3

Will inflation continue to slow down? Are there upside risks?

The encouraging downward trend in headline inflation will likely extend in the months ahead. Underlying inflation ("core") has yet to slow down significantly, but the expected softening in final demand should ease pressure on service prices in the months ahead. The evolution of the labour market is key: if wage growth doesn't slow as well, upward pressures on the price of goods and services might ultimately persist for longer-than-expected.

United States – Selected gauges of wages and labor market tightness



Source: Banque Syz, Factset

FAQ #4

Is the Fed done? A long pause or a cut anytime soon?

The Fed, and other developed markets' central banks, have probably almost completed their rate hike cycle, as growth momentum is slowing, and inflation is trending down. After the hikes will come a pause, for confirmation that the inflation genie is truly back in the lamp. Eventually, rates will be cut, either because a severe recession finally happens, or simply because inflation is back close to target.

The Fed and Future markets agree on the direction of travel, but markets now expect a higher long-term "neutral" rate

Source: Bloomberg

FAQ #5

Are equities still too expensive?

Absolute global equity valuations: except for US tech, 12-months forward P/Es are not overly expensive. Indeed, with the exception of the US and Japan, 12-month forward P/Es are lower now compared to the start of the year (see upper chart). Valuations are more or less in-line with historical median ratio, including for the S&P 500 ex-technology sector. Indeed, absolute valuations have improved recently as stock prices have dipped and earnings have held up.

On the negative side, the rise in bond yields implies a lower Equity Risk Premium. For instance, the equity risk premium for the MSCI World (12 month forward P/E less 10 year real bond yield) has dropped by 150bps since October last year to 4.1%, the lowest level since 2007 (see lower chart).

12 months forward P/Es across key geographies

	Current	Jan'23	Current vs Jan'23
US	19.0	16.9	12%
Japan	14.1	12.9	9%
World	16.4	16.3	0%
EM	11.8	12.0	-2%
France	12.8	13.2	-3%
UK	10.1	10.6	-4%
Switzerland	16.4	17.6	-7%
Eurozone	11.7	12.7	-8%
Spain	9.8	10.8	-9%
Italy	7.8	8.6	-10%
Germany	10.5	11.7	-10%

Source: Datastream

	12m Fwd P/E		
	S&P500	Technology	S&P500 ex Tech
Current	18.9	25.8	17.2
Jan '23	16.9	20.1	16.0

Source: Datastream

Global equities risk premium

Source: BofA Global Research Datastream

FAQ #6

What is our view on the dollar?

The Bloomberg dollar index (DXY) recently crossed the 200 day moving average. The US dollar finds new support against the EUR, due to higher USD rates (in nominal and real terms), a faster decline in US inflation than in Europe and weaker growth dynamics in Europe vs the US.

EURUSD (in blue) vs. EUR/USD 10-year real rate differential

Source: Banque Syz, Bloomberg

The weight of the evidence

Our asset allocation preferences are based on 5 indicators including 4 macro & fundamental indicators (leading) and 1 market dynamics (coincident). The weight of the evidence suggests a neutral allocation to equities. Below we review the positive and negative factors for each of them.

	WEIGHT OF THE EVIDENCE (+)	WEIGHT OF THE EVIDENCE (-)	
MARCO CYCLE	The US economy remains supported by domestic consumption. Fiscal intervention continues to be a support to economic growth on both sides of the Atlantic.	Economic growth is slowing down globally. Europe is losing steam while China's weakness is a concern. Tighter financing conditions will ultimately impact growth.	NEUTRAL
LIQUIDITY	We are getting closer to the end of rate hike cycle.	Central banks might continue to keep QT and interest rates at elevated levels even during a recession.	NEGATIVE
EARNINGS GROWTH	Top-line growth and margins have been resilient in H1. Earnings revisions are positive and earnings momentum is expected to improve going forward.	AI-driven margins improvement are most likely overpriced. Positive earnings revisions are decoupling from PMI surveys.	NEUTRAL
VALUATIONS	Absolute valuations have improved recently. Excluding, P/Es are at or below historical average.	Equity risk premia are at or close to record lows. There is competition from cash and bonds	NEUTRAL
MARKET FACTORS	The trend remains a positive (but S&P 500 is now below 50 day moving average). High-Low is back to positive.	Breadth has been disappointing. Markets are not oversold yet	POSITIVE

Asset Allocation

We have a NEUTRAL stance on equities with a slightly positive view on Japan and the US (upgraded from neutral), a neutral view on the UK, Switzerland, EM Latam and China/EM Asia (downgraded from positive) and a slightly negative view on Eurozone and other EMs.

We maintain a neutral position on both rates and credit, with a slightly positive outlook on Investment Grade (IG) Credit and a slightly negative view on High Yield (HY) Credit.

We recognize the possibility of "high for long" rates driven by US growth and inflation resilience, while also accounting for the integrated soft-landing scenario. Conversely, the potential for lower rates due to global growth slowdown is acknowledged. Thus, we recommend gradually extending duration in the present rate environment. This is driven by an appealing asymmetry in long-term rates, supported by anticipated growth and inflation moderation. High real rates and elevated long-term inflation expectations contribute to this favourable outlook. We also value long-term government bonds for equity allocation diversification during market uncertainty. However, caution is exercised amidst these opportunities. The ongoing reduction of the Fed's balance sheet affects liquidity and rate dynamics, while the anticipation of higher supply could trigger short-term shocks. An inverted yield curve doesn't favour the long end. A measured approach is crucial in light of these complexities. In view of the Eurozone's renewed challenges and the possibility of a pause in ECB policy, we are revising our position on EUR rates upwards. Our neutral credit stance emphasizes high-quality corporate bonds. We steer clear of chasing higher yields in the High Yield space due to overpricing relative to risk. In Emerging Market debt, a vigilant stance is maintained due to valuation and potential risk considerations.

On the forex side, we turned negative on EUR and CHF (versus USD) and neutral on JPY, GBP and EM currencies (versus USD).

Within commodities, we remain positive on gold, which continues to exhibit low volatility with other asset classes and should be a beneficiary of any tail risk event.

We also maintain our positive view on Hedge Funds. We like well-established Global Macro funds that have a multi-portfolio managers approach. We cautiously like Relative Value funds but are wary of liquidity conditions. We like having a core position in a diversified systematic strategy with a long-term commitment. We prefer staying away from Equity long/short and directional funds as their beta is too high. We do not like Event Driven funds as we believe the merger & arbitrage landscape will be very challenging in 2023.

Investment conclusions

After the strong rally which took place in the first half of the year, US large caps look expensive (in absolute and on a relative basis), market seasonality is not favourable and many investors (e.g systematic funds) are now fully invested in equities (i.e there are fewer potential buyers than before). A market pullback is thus not coming as a surprise.

We should however keep in mind that the context is far from being negative for equities:

1) inflation continues to trend in the right direction;
2) the Fed seems likely to remain on hold for now;
3) the economy is holding up better than expected;
4) earnings momentum is expected to improve in the coming quarters.

History tells us that strong rallies in the S&P 500 are typically followed by some form of pullback or correction, but these may not be long-lasting. Since 1950, there have been 35 instances of the S&P 500 rallying over 15%. On average, there has been at least one pullback that followed in the six months after the rally. The average correction that followed was -8.2%. In all instances, markets recovered from these pullbacks in about six months on average.

We thus keep a NEUTRAL stance on equities and believe that a market correction could provide opportunities to increase equity exposure.

We continue to favour 3 main investment strategies:

1) Diversify into the lagging segments of the equity market that carry lower valuations;
2) Use volatility at our own advantage by buying on pullbacks; and
3) Use the bear steepening of the curve to extend duration within fixed-income portfolios.

Tactical positioning: our asset allocation matrix

	--	-	NEUTRAL	+	++
Portfolio risk			Equities Credit Spreads Rates		
Equities		Euro zone Other EM	United Kingdom Switzerland China & EM Asia ← EM Latam	→ United States Japan	
Fixed Income		HY Credit	Government Bonds Subordinated debt EM Hard EM Local	IG Credit	
Yield curves			USD → EUR "peripheral" CHF GBP	→ EUR "core"	
Forex (vs USD)		EUR ← CHF ←	EM currencies GBP JPY ←		
Commodities		Commodities		Gold	
Alternative Investments				Hedge Funds	

Source: Investment strategy group - 24 August 2023

Change from last month

→ More attractive

← Less attractive

For further information

Banque Syz SA
Quai des Bergues 1
CH-1201 Geneva
Tel +41 58 799 10 00
Fax +41 58 799 20 00
syzgroup.com

Charles-Henry Monchau, Chief Investment Officer
charles-henry.monchau@syzgroup.com

Adrien Pichoud, Chief Economist & Senior Portfolio Manager
adrien.pichoud@syzgroup.com

Luc Filip, Head of Discretionary Portfolio Management
luc.filip@syzgroup.com

Fabrice Gorin, Deputy Head of Portfolio Management
fabrice.gorin@syzgroup.com

Gaël Fichan, Head Fixed Income & Senior Portfolio Manager
gael.fichan@syzgroup.com

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.