ASSET ALLOCATION INSIGHTS

Monthly Update | Issue 88 24 October 2023

Key takeaways:

- We expect the US & global economy to cool down in the months to come, leading to a Fed pause. This would be a positive for equity and bond markets over time.
- In the short run, however, equity markets are dampened by rising fears of "persisting inflation & sticky high rates", as rallying oil prices revive inflationary concerns and rising long-term rates challenge valuations.
- From a tactical asset allocation perspective, we continue to keep portfolio asset allocations (Equities, Credit, Rates) close to neutral weights. However, in light of deteriorating market technical indicators and due to the rise of real yields, we are implementing the following changes: 1. We've slightly reduced the global equities exposure. A balanced sector & style exposure is warranted. US, Switzerland and Japan remain our favourite markets; 2. We've slightly increased the allocation to government bonds. We continue to progressively increase the average portfolio duration. A bias towards quality credit remains warranted; 3. We've moved back to neutral on EUR & CHF (vs. dollar) and 4. We've added a small exposure to a global commodities ETF (tilted towards energy). We still consider Gold as a portfolio diversifier.

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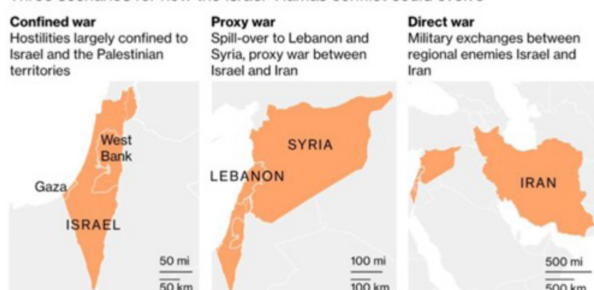
The big picture

Geopolitical concerns, tough talk from Fed officials, and a rise in long-term bond yields to 16-year highs appears to have weighed on investors' sentiment and stock valuations. The S&P 500 just recorded its fifth weekly negative decline out of the past seven weeks. The Nasdaq fared even worse and has nearly moved back into bear market territory, down 19.9% below its late 2021 peak. Europe, Japan and China equities have also been pulling back.

The Israel-Hamas conflict is the new "known unknown" investors now have to deal with at a time when rising oil prices were already pushing oil prices and bond yields upward. There are basically three possible developments for how the Israel-Hamas conflict could evolve: 1) Confined war; 2) Proxy war; 3) Direct War.

Confined Conflict or Regional War?

Three scenarios for how the Israel-Hamas conflict could evolve



Source: Bloomberg Economics

Global growth and inflation impact of three scenarios for how the Israel–Hamas conflict could evolve

Scenario	Details	Impact on oil prices and VIX*	Impact on global GDP and inflation**
Confined war	- Ground invasion of Gaza - Limited broader regional conflict - Lower Iranian crude output	Oil: +$4/barrel VIX: No impact	GDP: –0.1 ppts. Inflation: +0.1 ppts.
Proxy war	- Multifront war in Gaza, West Bank, Lebanon, Syria - Unrest in wider Middle East	Oil: +$8/barrel VIX: +8 points	GDP: –0.3 ppts. Inflation: +0.2 ppts.
Direct war	- Israel and Iran in direct conflict - Unrest in wider Middle East	Oil: +$64/barrel VIX: +16 points	GDP: –1.0 ppts. Inflation: +1.2 ppts.

Source: Bloomberg Economics
*Impact calibrated based on 2014 Gaza War, 2006 Israel–Lebanon War, and 1990–1991 Gulf War.
**Impact on year on year change in global GDP and inflation for 2024, estimated using Bayesian Global VAR

A direct war between Israel and Iran is the scenario which could have a strong impact on markets, with sharp increase in oil prices and the VIX and on the economy, with a drop in GDP and a rise in inflation.

Yet, history suggests that geopolitical risks and the associated shock in confidence tend to be short-lived, as markets gravitate toward the more sustainable drivers for returns.

Examining 10 prominent historical episodes of military conflicts/attacks, a study by Edward Jones shows that the knee-jerk reaction is for stocks to decline the day of the event and performance to be mixed over the following month, as investors have a natural aversion to uncertainty. But the impact on returns usually proves temporary, as equities were higher in most cases six months and one year later.

Could geopolitical tensions force the Fed and other major central banks to turn dovish? So far, this does not seem to be the case. U.S. Federal Reserve chair Jay Powell signalled last week that the central bank could keep interest rates unchanged at its next policy meeting that ends on November 1. However, he also warned that inflation is still too high, and he said that more rate hikes are still a possibility if, economic data continues to come in stronger than expected.

A stubbornly hawkish Fed is one of the reasons behind the continuous rise of global bond yields. Despite geopolitical concerns, US 10-year Treasury bonds are now flirting with the 5% key level on the back of a resilient economy, supply/demand imbalances and global central banks raising rates. For the first time since 2000, both 6-month Treasury Bills and 10-year bonds are yielding higher than the S&P 500 earnings yield. Even during the 2008 Financial Crisis, cash never yielded higher than S&P 500 earnings. As this gap keeps widening, competition from cash and bond yields versus stocks keeps rising. With some negative consequences on stock valuations and one key question : with a 10-year real yield at 2.5%, which is 0.5% above the US economy's potential growth rates, isn't it time to consider turning positive on US long-duration government bonds?

In the next section, we respond to the frequently asked questions from clients. We present our latest asset allocation decisions based on the 5 pillars of our asset allocation process. To conclude, we share our tactical asset allocation grids with the main changes versus last month.

Frequently asked questions (FAQs)

FAQ #1

Where do we stand in our global growth scenario?

Recent months have delivered some surprises and some long-awaited confirmations on the global economic front.

The US economy has continued to surprise on the upside, extending its streak of positive economic data disclosures at play since the beginning of the year, thanks to unabated domestic demand for services.

The European economy has continued to surprise on the downside, with an unexpected sharp deterioration in economic indicators over the summer, as the impact of more restrictive financing conditions began to filter through economic data and added to existing headwinds already in place since 2022.

The Chinese economy has finally shown signs of stabilisation, after a long period of slowdown and disappointing data over the Spring, when the post-reopening recovery failed to match expectations. The long-awaited stabilisation in China's economic growth now appears to take shape.

Our take: The global economy is now exhibiting unusual desynchronisation, with very different growth dynamics between the main drivers of global growth. Such desynchronisation cannot last for very long. While China can remain in a cycle of its own, the US will likely lose momentum at some point and narrow the existing gap with Europe.

More positive surprises in the US, still negative surprises in Europe, and China finally delivering the expected stabilisation

FAQ #2

Where do we stand in our expected «disinflation scenario»?

Headline inflation peaked in the second half of 2022 across large, developed economies and has been slowing down since then as Good prices' inflation (coming from supply chains' tensions) and energy prices trended lower. The impact of those two drivers will gradually wane off from the 12-month rolling inflation rates going forward.

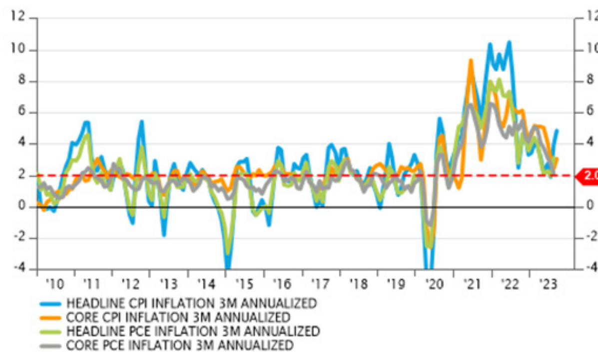
Last month, the recent rise in energy prices led short-term inflation dynamics to bounce higher.

"Core" inflation has followed with a lag and has only slightly slowed down in the US and Europe, as service price inflation remained fuelled by firm consumer demand (especially in the US) and rising wages and labour costs. "Core" inflation is still clearly above central banks' targets.

On both sides of the Atlantic, leading indicators and gauges of consumer and business inflation expectations have been trending lower recently.

Our take: The scenario of a gradual slowdown in underlying inflation dynamics remains in place. The combination of labour market normalisation, higher rates and slowing economic growth (especially in Europe) will gradually cool down upward pressures on prices. However, risks are clearly tilted to the upside for inflation, as reflected by last month's data.

Annualised 3-month US inflation rates



FAQ #3

What's the impact of the geopolitical situation in the Middle East?

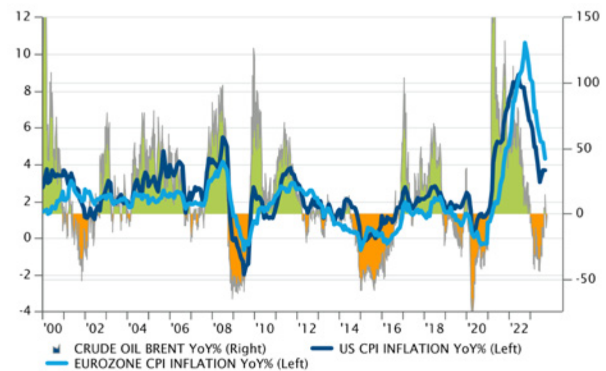
The dramatic situation in Israel and Gaza has unexpectedly raised tensions and risks in the region, threatening the encouraging dynamic triggered by the Abraham Accords.

From an economic point of view, the main impact of a deterioration in the balance of the region is likely to be on energy prices and supply. In particular, the looming risk of supply disruptions via the Strait of Hormuz, has the potential to trigger a surge in oil prices.

Natural gas prices, especially relevant to Europe ahead of the winter, could also be affected indirectly.

Our take: In the current situation of the global economy, a sharp rise in energy prices would be especially unwelcomed as it would impact negatively GDP growth (already under downward pressure) while fuelling inflationary dynamics at a time when central banks need to maintain restrictive conditions in order to cool it down. The risk of contagion to the entire Middle East is therefore a potential important downside risk to the global macroeconomic outlook.

The impact of oil prices on inflation rates was turning from "negative" to "neutral before the conflict erupted



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.

Indicators review summary - our five pillars

There is one main change versus last month: the "market dynamics" pillar has moved from POSITIVE to NEUTRAL. Market breadth (upside participation) continues to deteriorate while Volatility is also flashing red.

	(+)	(-)	WEIGHT OF THE EVIDENCE
MACRO CYCLE	The US economy remains supported by domestic consumption. Still no signs of recession in the US. China gowth seems to be stabilizing	Economic growth is slowing down globally. Europe is losing steam while China is unlikely to accelerate meaningfully. Tighter financing conditions will ultimately impact growth	NEUTRAL
LIQUIDITY	We are getting closer to the end of rate hike cycle	Financial conditions keep tightening. Central banks might maintain Quantitative Tightening and interest rates at elevated levels even during a recession	NEGATIVE
EARNINGS GROWTH	Top-line growth and margins remain resilient. 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. Excl. Technology, 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 positive (but S&P 500 is now below its 50 days and 100 days moving average and near its 200 days moving average). Seasonality is turning positive	Market breadth (upside participation) continues to deteriorate. Volatility is also flashing red	NEUTRAL (↓)

Asset Allocation

EQUITIES

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

Earnings revision has been a tailwind for equities during the first 9 months of the year and if consensus is right, earnings momentum will turn positive in 3Q and 4Q this year.

When it comes to 2024e and 2025e, earnings growth is expected to reaccelerate both in the US and Europe. However, we believe that expectations of double-digit growth for the next two years in the US might prove to be optimistic.

US and Europe EPS Growth consensus projections

EPS growth	2023e	2024e	2025e
S&P 500	1.1%	11.6%	12.4%
Stoxx 600	-0.6%	7.2%	8.5%

Source: IBES

From an absolute valuation perspective, some parts of the equity market are expensive, but there are pockets of value (see chart below). Even in the US, 12-month forward P/E excl.-Tech trades below median history.

Valuations are more reasonable outside Technology US and Europe EPS Growth consensus projections

	Current	20Y Median	Current vs. Median
USA	18.5	15.8	17%
Switzerland	16.5	15.1	9%
World	16.3	15.0	9%
EM	11.7	11.3	3%
Japan	14.6	14.2	3%
France	12.6	12.8	-1%
Eurozone	11.5	12.8	-9%
UK	10.6	12.4	-15%
Spain	10.1	11.9	-15%
Germany	10.5	12.4	-16%
Italy	8.0	11.9	-33%

Source: IBES, MSCI indices

From a relative valuation perspective, US equities large caps remain expensive. Indeed, this is the first time since 2000 that Treasury Bills are yielding higher than the S&P 500 earnings yield. Even during the 2008 Financial Crisis, cash never yielded higher than S&P 500 earnings. And the gap between the S&P 500 earnings yield and cash is widening. Competition from cash and bond yields versus stocks keeps rising.

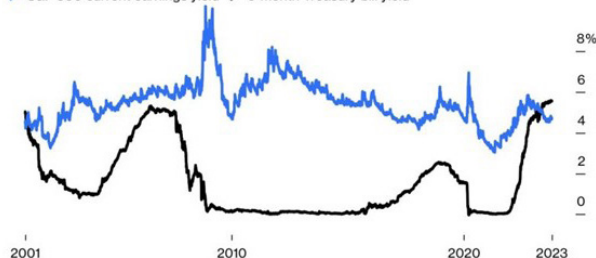
For a USD-reference account investor, here's the median Return by Asset Class:

1. Savings Accounts: 5.5%
2. 6-Month Treasury Bill Yield: 5.0%
3. iShares iBoxx $ Investment Grade Corporate Bond ETF: 6.5%
4. Investment Property Cap Rate: 4.5%
5. S&P 500 Earnings Yield: 4.2%

Bottom-line: Cash, Treasury Bills and high-quality corporate bonds are now paying a HIGHER yield than real estate and the S&P 500. In other words, taking a risk is compensated LESS than just holding cash or investing into low-risk bonds. This creates downside risk for equities.

Treasury Bills Versus S&P 500

Cash has yielded more than US stocks this year



Source: Bloomberg

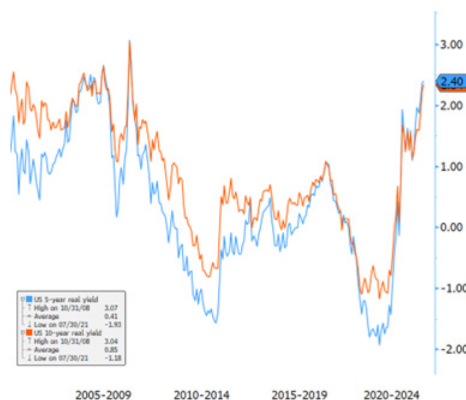
FIXED INCOME

Within Fixed Income, we are maintaining a neutral stance on both rates and credit, with a slightly positive outlook on investment grade and a slightly negative view on high yield. We are upgrading Government bonds from neutral to positive as the spike in yield is creating opportunities to lock attractive average yield-to-maturity. The slowdown in the global economy and cooling down of inflation limit downside risk.

While last year's rise in interest rates was primarily due to concerns about inflation, several factors contribute to this rise in long-term rates this year:

1. The announcement by the U.S. Treasury regarding a substantial increase in bond supply, beyond initial expectations, and with longer maturities to fund current fiscal policies, led to a "bear steepening" of the yield curve.
2. Furthermore, the gradual end of the negative interest rate policy in Japan reduced demand for government securities from developed countries, thus increasing the "term premium" in yield curves.
3. Similarly, the coordinated reduction in asset purchases by central banks in developed countries reduced demand and contributed to an increase in the "term premium. "
4. Finally, the unexpected resilience of economies, particularly the U.S., led to an increase in real interest rates.

The surge in the 5 and 10-year real yields



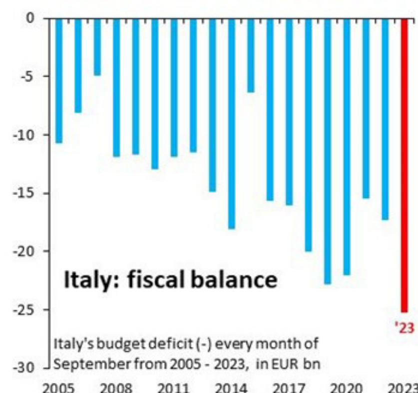
Ongoing risks continue to shape bear steepening. Firstly, the continuous reduction of the Fed's Balance Sheet is depleting liquidity, further accentuating rate movements. Secondly, the escalation in geopolitical tensions and the resurgence of oil prices might exert temporary upward pressure on rates in the short term. However, this also reinforces the argument for an impending long-term growth slowdown. Thirdly, an inverted yield curve is not conducive to favouring the long end of the spectrum. Lastly, inflation, as reflected in breakeven rates, is not cheap, while the real yield curve is still deeply inverted.

Despite these challenges, several positive factors are emerging.

1. There exists an attractive asymmetry in rates, bolstered by the anticipation of a slowdown in both economic growth and core inflation. Ex: US 20-year yield @5% yield to maturity.
2. Real rates presently stand at their highest levels in a decade.
3. The market's consensus still leans towards fewer than one rate hike, with no cuts expected before the latter half of 2024.

In this context, we recommend adding government bonds and to gradually extend duration, as there is an attractive asymmetry in long-term rates, supported by expected moderation in growth and inflation. The resurgence of oil prices could temporarily weigh on short-term rates but increases the case for a long-term growth slowdown.

In Europe, considering our concerns about the Eurozone's growth outlook and the potential conclusion of the ECB rate hike cycle, we are adopting a neutral stance on EUR rates. We are downgrading Euro Peripherals bonds mainly due to the concerns on Italy's fiscal situation. Indeed, Italy 10y risk spread over German bunds have spiked >200bps. Italy fiscal balance continues to worsen at a time when debt ratio is 140% of GDP while borrowing costs are rocketing.



Source: Robin Brooks

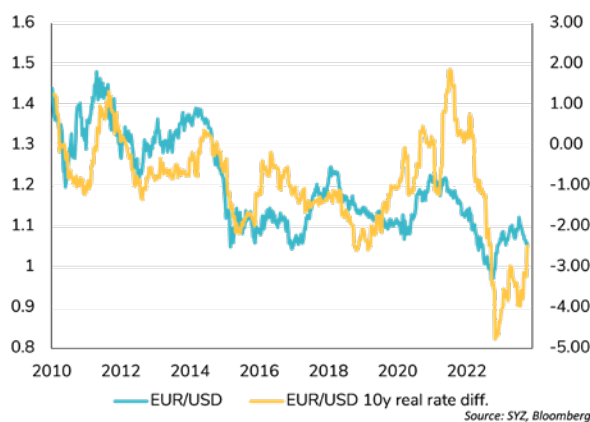
Within the credit space, our neutral stance emphasises high-quality corporate bonds. We are avoiding the pursuit of higher yields in the high yield sector due to overpricing relative to risk. In Emerging Market debt, we maintain a vigilant stance due to valuation and potential risk considerations. Higher oil prices and a strong US dollar pose challenges for oil-importing EM nations, especially Asian countries, while some Latin American countries may benefit

FOREX & ALTERNATIVES

On the forex side, we are upgrading EUR and CHF against dollar from negative to neutral. Weak growth dynamic and disappointing economic data in Europe still are a drag for the EUR. The real rate differential remains in favour of the USD, but the gap has recently narrowed somewhat.

We remain neutral on JPY, GBP and EM currencies (versus USD).

The real rate differential remains in favour of the USD, but the gap has recently narrowed somewhat.

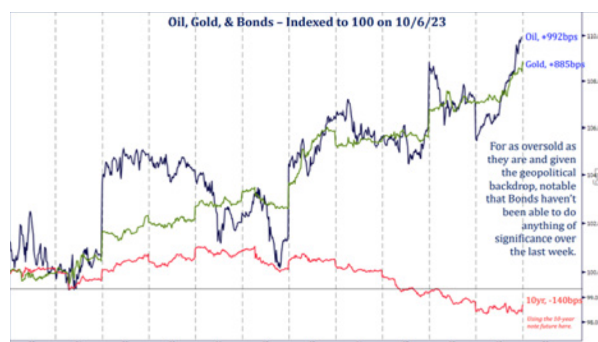


Source: SYZ, Bloomberg

We are upgrading commodities from negative to neutral. Indeed, oil and gold have been the best portfolio hedges so far, since the start of Israel/Gaza conflict.

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 note that a significant gap has opened between gold and real yields. Why? 1) With debt sustainability having become an ever-increasing issue, the market anticipates that real interest rates cannot stay at this level for too long; 2) Investors buy gold as an insurance against adverse circumstances (inflation, recession, etc.) But for gold to appreciate in dollar, a drop in real yields is probably required. In the meantime, gold remains a true diversification asset.

Oil and gold have been the best portfolio hedges since the start of Israel / Gaza conflict.



Source: Strategas

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.

Asset Allocation Grid

Tactical positioning: our asset allocation matrix

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

Change from last month: (→) More attractive (←) Less attractive

Source: Investment strategy group - 18 October 2023

- UPGRADE Government bonds from NEUTRAL to POSITIVE
  - Rationale: The spike in yield is creating opportunities to lock attractive average yield-to-maturity. The slowdown in the global economy and cooling down of inflation limit downside risk.
- DOWNGRADE Euro Peripherals from NEUTRAL to NEGATIVE
  - Rationale: Italy 10y risk spread over German bunds have spiked >200bps. Debt ratio of 140% of GDP. Italy must roll over old debt and finance new debt equal to 24pc of GDP over the next year (ECB data), and do so at rocketing borrowing costs. Fitch warned last week of a "significant loosening" in fiscal policy.
- UPGRADE Euro and Swiss Franc from NEGATIVE to NEUTRAL
  - Rationale: The real rate differential remains in favour of the USD, but the gap has recently narrowed somewhat.
- UPGRADE Commodities from NEGATIVE to NEUTRAL
  - Rationale: oil and gold have been the best portfolio hedges so far since the start of Israel/Hamas conflict.

Investment conclusions

Global economic growth is unusually desynchronised. The US economy is resilient, Europe is falling into a recession, while China is finally stabilising. Tighter financing conditions will ultimately weigh on the current positive US growth dynamic.

Central banks must remain focused on cooling down inflation for now. But the rate hike cycle has likely reached its end as restrictive financing conditions will impact future growth and inflation. Liquidity continues to be reduced by ongoing balance sheet reductions at the Fed & the ECB.

Fiscal intervention continues to be supportive but the risk of a US government shutdown looms. In the US, 2024 Presidential elections are already in sight The conflict in the Middle East has the potential to impact global economic growth if it disrupts energy supply.

Overall, our core scenario remains unchanged: we expect the US & global economy to cool down in the months to come, leading to a Fed pause. This would be a positive for equity and bond markets over time.

From an asset allocation perspective, we continue to keep portfolio asset allocations (Equities, Credit, Rates) close to neutral weights. A balanced allocation to the three main asset classes is justified by the fact that bonds currently offer attractive real yields while equity market remains our favourite asset class for the long run.

In the short run, however, equity markets are dampened by rising fears of "persisting inflation & sticky high rates", as rallying oil prices revive inflationary concerns and rising long-term rates challenge valuations. In light of deteriorating market technical indicators and due to the rise of real yields, we are thus implementing some slight changes within our asset allocation grid:

1. We've slightly reduced the global equities exposure. A balanced sector & style exposure is warranted. US, Switzerland and Japan remain our favourite markets.
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