ASSET ALLOCATION INSIGHTS

Monthly Update | Issue 90 14 February 2024

Key takeaways

- Global growth dynamics are picking up after a subdued 2023 across most regions. The US economy demonstrates resilience with job creation, steady wage growth, and a 3.7% unemployment rate. Meanwhile, markets are re-pricing downward the number of rate cuts in 2024. A decent earnings season seems to be offsetting the later.

- From a market perspective, risk assets are off to a very decent start of the year. The S&P 500 Index reached new highs and breached the 5,000 threshold for the first time. We note however that the equity market advance remains driven by a small number of US mega-cap tech stocks. Most international markets didn't manage to record gains (in dollar terms) since the start of the year, with the exception of Japan where the Nikkei 225 index just hit a 34-year high. The surge of the dollar is another notable development.

- Our well-diversified positioning since the start of the year has been playing out rather well with our two favourite equity markets (US and Japan) outperforming. Going forward, we want to keep our allocation to Equities, Credit and Rates close to our strategic asset allocation (SAA) neutral weights. However, in light of recent macro and market dynamic developments, we are implementing the following changes: 1. Within equities, we are downgrading Switzerland to NEUTRAL and we are downgrading Emerging Markets to UNDERWEIGHT; 2. Within Fixed Income, we are upgrading GBP Yield curve to OVERWEIGHT; 3. Within FOREX, we are downgrading EUR and CHF (vs. $) to NEUTRAL.

Syz PRIVATE BANKING

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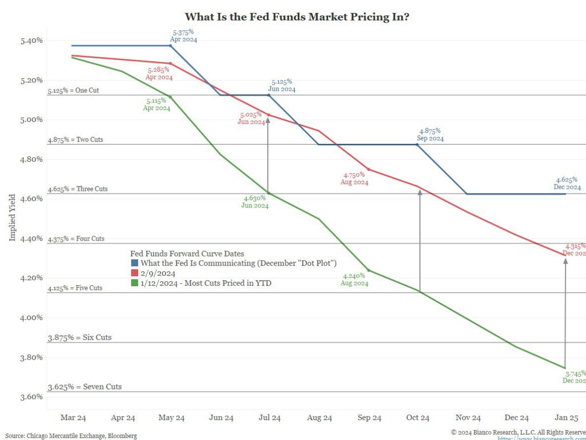
THE BIG PICTURE

US economic figures keep surprising on the upside, following a series of data releases last month highlighting the continued resilience of the US economy. Firstly, there was a solid employment report, with 216k jobs adding to the economy in December, as well as steadier wage growth and an unemployment rate holding firm at 3.7%. Further into the month, fourth-quarter GDP of 3.3% annualised was significantly ahead of consensus expectations. The GDPNow model estimates 4.2 percent of real GDP growth (seasonally adjusted annual rate) in the first quarter of 2024.

On the monetary policy front, the Fed (and other developed markets central banks) remain on hold. As expected, the Fed kept its policy rate unchanged in January, but the market's focus was mainly centred on future meetings, seeking any signals around when a rate cut may come (markets had been pricing in a cut as early as March). The Fed did NOT give the market what it was hoping for, instead emphasising that it plans to wait a while longer to build greater confidence that inflation will remain on its current, descending path. This was the right move, in our opinion. Cutting prematurely runs the risk of having to backtrack if inflation were to perk up again, an outcome that would be far more detrimental to the markets than staying on hold a little longer. Markets have been re-pricing downward the number of Fed rate cuts expected in 2024. Four rate cuts are now priced in for 2024 (red), the least number of cuts year-to-date. This is down from seven rate hikes on January 12 (green).



Source: Bianco Research

The US economic strength contrasts with recent developments in China. Indeed, the Chinese domestic economy continues to struggle, with disappointing retail sales and further deterioration in housing activity. Fourth-quarter GDP rose by 5.2% year-on-year, in line with predictions but remaining historically weak. Whilst the PBOC announced several stimulus measures, it was not the political "bazooka" the markets had hoped for to boost activity.

Another important story for the start of 2024 has been geopolitics, as the strikes from the Houthi rebels on commercial shipping in the Red Sea implied significant supply-chain disruption. Against that backdrop, freight costs have spiked again, Drewry's World Container Index is up to $3,824 per 40ft container as of 01 February. That's almost triple its levels from October 2023, when costs were at a post-pandemic low.

From a market perspective, the start of the year has been pretty decent for risk assets. Global equities have been moving higher. In the US, the S&P 500 index was driven to record levels in early January, as bullish expectations of a soft-landing scenario carried on the "Magnificent Seven" rally. The 7-stock basket reached new highs, but the 7 is now 6... as Tesla heads in the opposite direction.

European and Japan equities continue their bull run but remain cheap vs. US stocks. Japan was the best performing of the major stock markets in January; it is now up nearly 5% in dollar terms, building on last year's strong performance. Unexpected weakness in wages, coupled with uncertainty over the economic impact of the New Year's earthquake, prompted markets to re-evaluate the likely removal of the negative interest rate policy (NIRP) in the short term. The Euro Stoxx 50 index achieved its highest level in 20 years (in local currency). It is worth noting that European equities are currently trading at their lowest valuation in history, relative to US equities. Continued concerns about China's economic outlook probably contributed to the poor performance of the MSCI Asia ex-Japan Index and the MSCI Emerging Markets Index since the start of the year.

YTD performance (in USD) for selected equity markets

Country	Return in USD, YTD
Brazil	-7.8%
South Africa	-5.0%
China	-4.9%
Switzerland	-4.2%
UK	-4.0%
Indonesia	-2.5%
India	-1.7%
Germany	-1.3%
Mexico	-1.2%
Europe	-1.1%
France	-0.9%
Japan	4.5%
US	5.4%

Within fixed income, as investors grew less optimistic that central banks would cut rates in the first quarter, sovereign bonds lost ground. US Treasuries and European sovereign bonds are slightly down year-to-date. Still, despite the Fed being on hold and strong US economic data the trend seems to be for lower 10-year yield as the 50-day moving average is now below the 200-day. In credit, the European high-yield bond market stood out with positive returns (nearly +1% year-to-date), on the other hand, its US counterpart has been stagnating. Global investment grade credit, meanwhile, recorded negative returns in January, despite the tightening of spreads. The appreciation of the US dollar weighed on emerging market debt, which have been retreating since the start of the year.

Regarding commodities, the geopolitical backdrop is leading to a rise in oil prices after three consecutive monthly declines, with Brent Crude (+6.1%) and WTI (+5.9%) both recording gains in January 2024.

In FX, the US dollar has been strengthening against all other G10 currencies since the start of the year.

Our well-diversified positioning since the start of the year has been playing out rather well with our two favourite markets (US and Japan) outperforming. For sure, some of our equity positions outside the Magnificent 7 have been struggling as it remains a very narrow market driven. But our participation to the equity market upside has been satisfactory while our fixed income exposure hasn't been too penalising either.

As we move in the second part of the first quarter, there are reasons to be cheerful but also to be fearful on equity markets.

On the positive side, some strong fundamentals are supporting current economic advance: 1) a decent earning season (80% have reported actual EPS above estimates, which is above the 10-year average of 74%); 2) a resilient US economy which should support forward earnings growth and 3) excluding Mag-7, valuations in the US and abroad are not expensive.

We also note at least 3 strong technical and sentiment developments: 1) the S&P 500 uptrend remains strong; 2) the 1-year cycle is expected to turn more positive in a couple of weeks and 3) there's a lot of "dry powder" on the sideline: Money-Market Fund Assets reach $6 Trillion for the first Time

On the negative side, S&P 500 12month forward P/E is back to 20x, the equity risk premium remains elevated as bond yields have been on the rise, the dollar is strengthening (which is a negative for global liquidity) and interest rate cuts expectations have been revised downward.

And some market dynamics are a source of concern: 1) Market breadth has deteriorated; leadership remains narrow; 2) The speed of the recent rise has pushed technical indicators into "overbought" territory; 3) Asset managers long positioning is extreme and; 4) sentiment is becoming too optimistic despite elevated Middle-East tensions, presidential election uncertainty, etc.

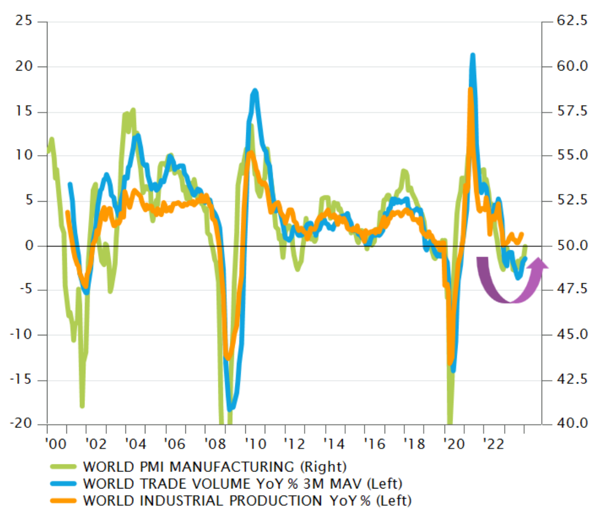
So where do we go next?

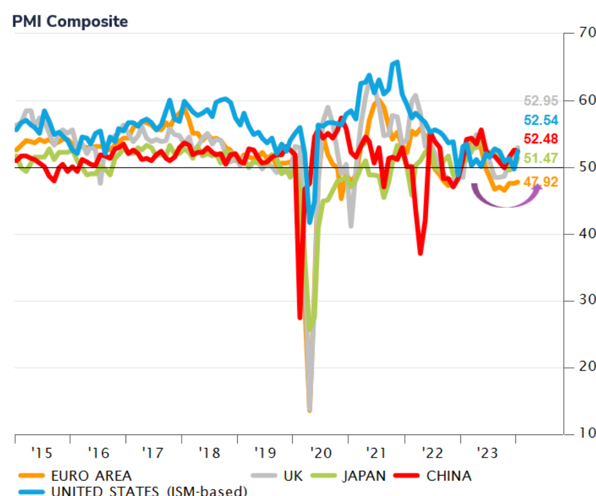
In the next section, we respond to the frequently asked questions from clients. We then present our latest asset allocation decisions based on the 5 pillars of our asset allocation process. To conclude, we share our tactical asset allocation grids with the main changes versus last month.

A MACRO & MONETARY POLICY UPDATE

Global growth dynamics are picking up after a subdued 2023 across most regions. We have been witnessing a broad-based improvement in manufacturing and services sectors' dynamics. Developed economies exceed expectations, with continuously positive economic surprises in the US, and now even in Europe. In Emerging markets, we observe strong growth momentum in India and Brazil while China appears to stabilise from a macro standpoint.

Global cyclical momentum appears to have troughed in Q3 2023 and has slowly been regaining some footing since then





United States – the unsinkable economy

US real GDP growth defies gravity and remains above potential despite soft global growth and restrictive financing conditions.

US consumers have a job and are pretty confident, so they keep spending. The main engine of the US economy, household consumption, continues to roar and US consumers seemingly have nothing to (really) worry about.

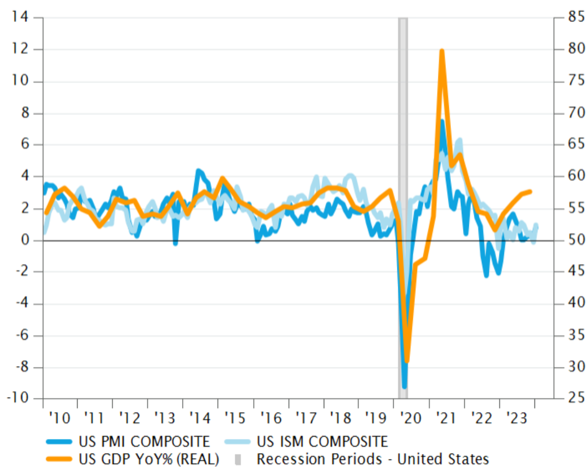
Is the worst of downside risk around growth already behind? The "red flashing" signals of the past few months remain potential downside risks, but they no longer deteriorate further and have even become less negative recently. Cyclical momentum appears to be recovering after a depressed 2023.

Fiscal policy might not be as supportive in 2024 as last year, but it will not be a headwind as Congress has agreed on necessary measures to avoid a painful shutdown. The fiscal deficit will remain large in 2024, at a level usually associated with recessions. It thus will not weigh on consumer-led GDP growth.

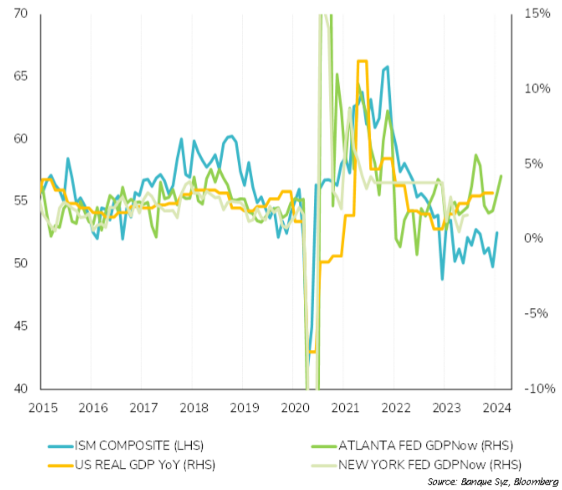
The "easy part" of the disinflationary process is behind. Buoyant final demand might sustain some upward pressures on rates. Nevertheless, rate cuts in 2024 remain the base case as inflation recedes. Still, the timing and extent is uncertain and now depends on economic growth momentum.

US real GDP growth defies gravity and remains above potential despite soft global growth and restrictive financing conditions

United States - ISM & PMI Composite and Real GDP YoY %



United States – Atlanta GDPNow, ISM Composite and Real GDP YoY%



If the economy keeps growing above trend at current rate levels, and upward pressures on prices remain, the Fed has no reason to rush into easing. The message from Mr Powell and Ms Lagarde is clear: rate cuts are the base case, but only if and when appropriate.

Central banks have sufficiently hiked rates for now, but they will remain cautious until they are confident that inflation dynamics have normalised. While monetary policy can be deemed restrictive (positive real rates & Quantitative Tightening), broad Financial Conditions are easy in the US, and at least not deteriorating in Europe.

Recent developments on global trade increase the risk of a looming supply shock. Indeed, geopolitical tensions in the Red Sea are raising the cost of shipping goods on the most used sea routes. This is one of the key risks we are currently monitoring.

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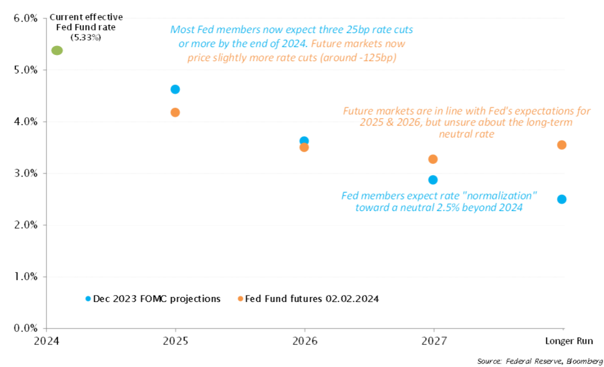


THE WEIGHT OF THE EVIDENCE

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) has been deteriorating recently while the speed of the recent equity advance has pushed technical indicators into “overbought” territory.

	(+)	(-)	WEIGHT OF THE EVIDENCE
MACRO CYCLE	Global economic surprises have been improving. The US economy remains supported by domestic consumption. Still no signs of recession in the US. China gowth seems to be stabilising.	China growth is unlikely to accelerate meaningfully. Tighter financing conditions will ultimately impact growth.	NEUTRAL
LIQUIDITY	Rate cuts in 2024 remain our base case not only in the US but also in Europe and the UK.	Central banks may continue to keep Quantitative Tightening and interest rates at elevated levels for few more months. Banks Term Funding Program (BTFP) expires in March.	NEUTRAL
EARNINGS GROWTH	A decent earning season (75% have reported actual EPS above estimates, which is above the 10-year average of 74%). A resilient US economy should support forward earnings growth. Earnings momentum is going to turn positive.	AI-driven margins improvement are most likely overpriced. Ex-Mag 7, the US is still going through an earnings recession.	NEUTRAL
VALUATIONS	Excl. Mag-7, valuations in the US and abroad are not expensive.	S&P 500 12-months forward P/E is back to 20x. Equity risk premium remains elevated as bond yields have been on the rise. There is competition from cash and bonds.	NEUTRAL
MARKET FACTORS	S&P 500 uptrend remains strong. The 1-year cycle is expected to turn more positive in a couple of weeks. There’s a lot of “dry powder” on the sidelines: Money-Market Fund Assets reached $6 Trillion for the first time.	Market breadth has deteriorated; leadership remains narrow. The speed of the recent rise has pushed technical indicators into “overbought” territory. Asset managers long positioning is extreme. Sentiment is becoming too optimistic.	NEUTRAL (↓)

ASSET ALLOCATION

EQUITIES

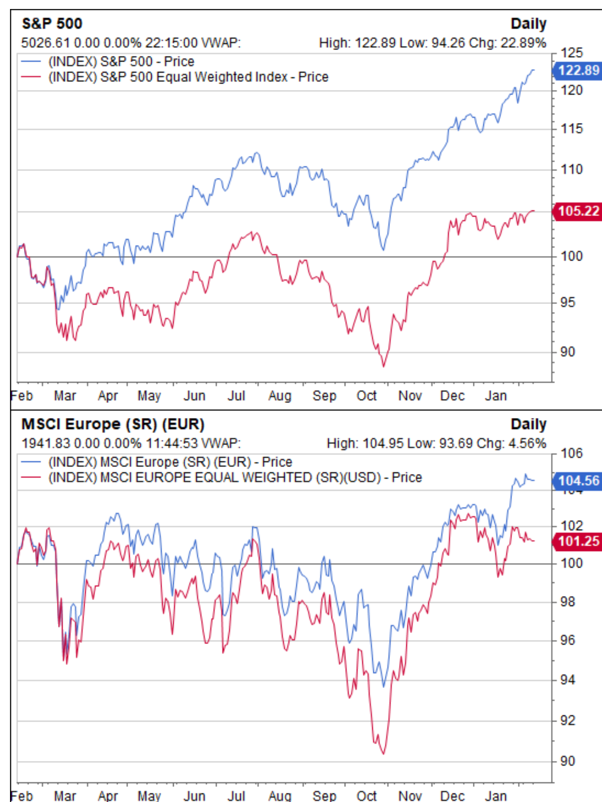
We remain NEUTRAL on equities as we think the strong performance of the past few months reflects the improving outlook as the market sentiment appears stretched on the positive side.

From a region/country standpoint, we keep our slight preference for the US and Japan as earning growth are expected to continue this year and next.

We are now neutral on Swiss equities as the strong Swiss franc is a headwind. We also keep our neutral stance on the Eurozone/UK as earning momentum remains muted.

We are under exposed emerging markets and Chinese equities as the dollar remains strong and, in the case of China, the lack of confidence of consumer and corporate as well as the weak market momentum keeps us at bay for the time being.

In the US, the concentration effect has continued lately but we are seeing a weakening in the market breath while the risk in commercial real estate and regional banks remains.

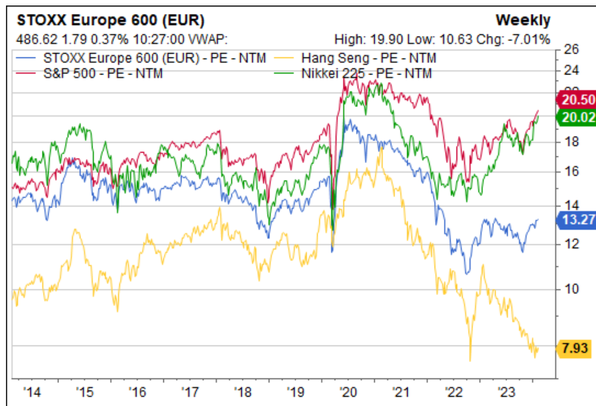


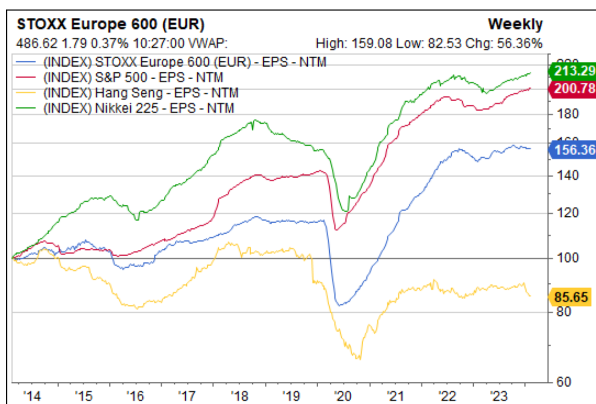
Looking at earnings expectations, the US will likely need to see more contribution outside the mega-caps to grow to deliver double-digit EPS growth next year. Earning revisions are negative across the board with Europe, Switzerland, and China the most negative for next year.

EPS growth	2023 EPS	2024 EPS	YOY %	1M Change %	2025 EPS	YoY	1M Change %
S&P 500	214	219	2.0	-0.1	242	10.8	-0.3
STOXX Europe 600	35	35	-2.0	-0.8	36	4.7	-1.5
FTSE 100	756	681	-10.0	0.5	688	1.0	-0.9
Swit-zerland SMI	647	599	-7.3	-0.6	657	9.6	-1.4
Hang Seng Index	1 803	1 814	0.6	-2.2	1 967	8.4	-1.8
Japan Nikkei 225	1 595	1 517	-4.9	-0.5	1 818	19.9	0.1

Source: Factset

On the valuation side, Chinese equities are cheap, but the earning cycle is poor while we are again on the expensive side for US equities in aggregate at PE 20x, but adjusted for the concentration, the S&P500 equal weight PE stands at 16x which is more in-line with history.





FIXED INCOME

Within the realm of Fixed Income, we continue to hold a neutral outlook towards rates and credit, leaning slightly towards the positive for Investment Grade bonds and slightly negative for High Yield. Our analysis reveals nuanced positions across various segments.

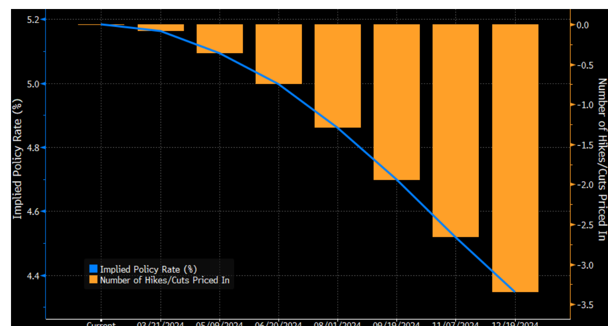
Our stance on government bonds is differentiated by maturity. We are favourable towards securities with maturities under 10 years, motivated by high real yields, a peak in central bank tightening, a trend towards disinflation, and their relative value against equities, alongside improving correlations. Conversely, we approach bonds with maturities over 10 years with caution due to an array of risks. The inverted yield curve and negative term premiums lessen the attractiveness of long-term bonds, especially as interest rate volatility remains pronounced. Despite initial concerns over the supply of long bonds in early 2024, recent successful auctions, notably the largest 10-year US Treasury to date, and Treasury Secretary Yellen's reassurances about supply stability offer some optimism. Although quantitative tightening currently influences the market, a slowdown is anticipated. The resilient economy's potential to delay central bank rate cuts contrasts with market expectations for cuts in the first half of the year.

Balancing the scales: positive vs. negative factors in bond investments

Source: Syz CIO office

In Europe, our concern for the Eurozone's growth prospects and the potential slowdown in the ECB's rate hike cycle prompts a neutral view on EUR rates. The tightening of spreads in Euro Peripherals, especially between Italian and German 10-year yields, calls for caution. Nonetheless, the UK bond market stands out as an attractive opportunity, thanks to expected CPI decreases signalling inflationary relief and supporting the potential for Bank of England rate cuts by mid-2024. This backdrop, combined with appealing yields following recent market pullbacks, underscores the UK bond market as an attractive investment avenue. Additionally, the market does not anticipate a rate cut until the first half of 2024.

Market expectations for a UK rate cut:

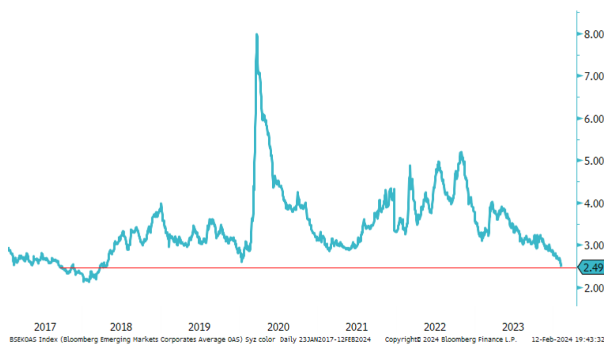


Source: Bloomberg

Within the corporate bond segment, we emphasise the desirability of high-quality corporate bonds with maturities of 5 to 10 years, targeting yields above 5%. This reflects our confidence in their ability to provide a balance between yield and risk. Our approach to High Yield is more circumspect, concentrating on issues with maturities or calls of up to 2 years, requiring yields over 7%. We maintain a positive outlook on subordinated debts, recognizing their favourable risk/reward profile within the fixed income landscape.

Our posture remains neutral towards Emerging Market (EM) debt, specifically targeting bonds with maturities of up to 4 years and yields exceeding 6.5%. This cautious optimism is moderated by the recognition that spreads in EM corporate bonds are at their narrowest since 2018, necessitating vigilant valuation and risk assessments.

Spread of Emerging Market corporate bonds:



Source: Bloomberg

FOREX

Given recent macro developments in the US, the timing and extent of Fed's rate cuts in 2024 is more uncertain and might be later than expected, and less than expected.

As a result, there is no reason at this stage to hold a positive view on the EUR and CHF, as the scenario of a stronger USD has gained probabilities.

EUR/USD: Rates and macro dynamics are less negative for the EUR, but macro developments importantly also support the USD → No more reason to hold a positive view on the EUR => DOWNGRADE TO NEUTRAL

CHF/USD: Fundamentals no longer warrant additional CHF appreciation, and the real rate differential pleads for a firmer USD vs Swiss franc at least in the short run → No more reason to hold a positive view on the CHF => DOWNGRADE TO NEUTRAL

The current account differential, a strong fundamental support for the CHF, has stabilised at an elevated level but is no longer growing. The real rate differential is clearly in favour of the USD and suggests some potential for a CHF pullback.

In the short-term, the USD might benefit from the real interest rate differential (nominal rate - inflation rate) that has recently become more supportive for the greenback: inflation in the US is slowing while short-term nominal rates remain high, which leads to rising real USD rates. As real CHF rates remain broadly stable, a higher real rate differential supports the US dollar.

However, when the Fed starts cutting its key rate, this real rate differential between USD & CHF should reverse lower and weigh on the US dollar vs CHF in the later part of 2024.

ALTERNATIVES

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 remains between gold and real yields. Why? 1) With debt sustainability 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.

We also maintain a neutral 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 remains very challenging.

INVESTMENT CONCLUSIONS

TACTICAL ASSET ALLOCATION (TAA) DECISIONS– 7.2.2024

We keep TAA allocation to equities, credit and rates close to SAA (Strategic Asset Allocation).

Global equities (NEUTRAL)

→ US and Japan remain our favorite markets (OVERWEIGHT)

→ We downgrade Switzerland to NEUTRAL (strength of CHF to penalize earnings)

→ We downgrade Emerging Markets to UNDERWEIGHT on the back of dollar strength

Fixed Income (NEUTRAL)

→ We remain OVERWEIGHT on Government bonds and Investment Grade Credit

→ We upgrade GBP Yield curve to OVERWEIGHT

FOREX

→ We downgrade EUR and CHF (vs. $) to NEUTRAL

Commodities and Alternatives

→ We remain OVERWEIGHT Gold and NEUTRAL on Hedge Funds and Commodities

ASSET ALLOCATION GRID

TACTICAL POSITIONING: OUR ASSET ALLOCATION MATRIX

	--	-	NEUTRAL	+	++
Portfolio risk			Equities Credit Spreads Rates		
Equities		Emerging Markets ←	Euro Zone United Kingdom Switzerland ←	United States Japan	
Fixed Income		HY Credit	EM Debt	Government Bonds IG Credit	
Yield curves		EUR “peripheral”	USD EUR "core" CHF	GBP →	
Forex (vs USD)			EUR ← CHF ← GBP EM currencies	JPY	
Commodities			Commodities	Gold	
Alternative Investments			Hedge funds		

Change from last month: More attractive → Less attractive ←

Source: Investment strategy group - 7 February 2024

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