ASSET ALLOCATION INSIGHTS

Monthly Update | Issue 97 | 14 October 2024

Key takeaways

- Overall, the overall macro and liquidity conditions are rather positive for risk assets. Still, equity market valuations are rich, especially in developed markets and some risks are under-priced. Consequently, while we keep our preference for equities over bonds, we refrain to increase exposure at this stage. We keep our neutral stance on equities.
- Our view on Eurozone equities is downgraded from neutral to negative, mainly due to weakening economic trend, while we upgrade our view on emerging markets from negative to neutral (China stimulus, improving earnings dynamic, room for easier monetary policy).
- Within rates, we continue to favour the 1-10 years segment over long-dated bonds.
- We keep our gold and hedge funds exposure for diversification purposes. Our stance on currency (neutral dollar against major pairs) is unchanged.

Syz PRIVATE BANKING

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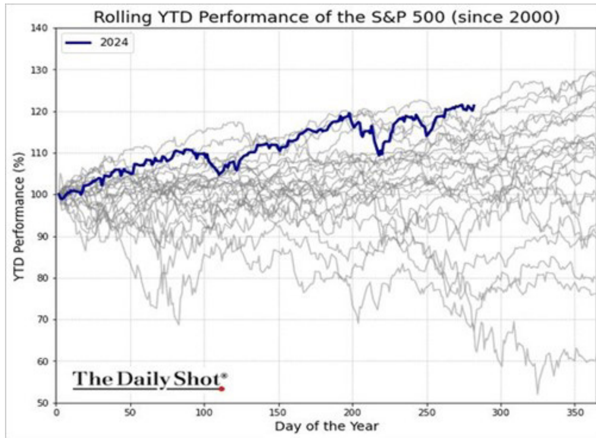
THE BIG PICTURE

At the time of our writing, the S&P 500 is about to hit $50 trillion in market cap for the first time in history. It's now up +40% since October 2023's low and +22% in 2024, making it the best year-to-date performance of the decade for this time of the year.



This euphoria is taking place despite the Russia-Ukraine war still going on, very high tensions in the Middle East and a very uncertain US elections outcome. Meanwhile, equity valuations remain highly demanding especially for the US large-caps, and bullish sentiment is through the roof: US equity futures positioning by investors excluding market-makers just hit a net long of ~$290 billion, the most on record.

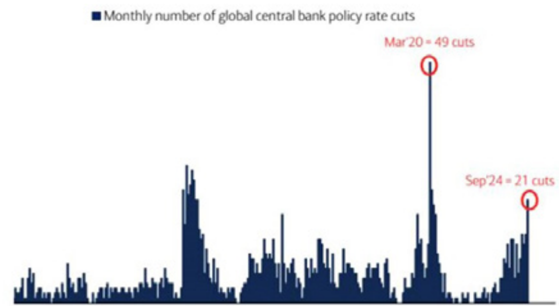
Since the beginning of the year, net long positioning has more than doubled. This is also twice as high as during the previous peaks seen in early 2018 and 2020. Meanwhile, US households' stock allocation as a percentage of financial assets hit a new record of 41.8% in Q2 2024. Investors are all-in on stocks.

Source: Goldman Sachs FICC & Equities Division Futures Strats Group as of 24-Sep-2024
Past performance is not indicative of future results

Are we in bubble territory for stocks?

Not necessarily. There are indeed some fundamental reasons to justify the current market advance.First, we are currently facing an almost synchronised global monetary cycle. The two largest economies in the world – the US and China – are injecting fiscal and monetary policy stimulus at the same time. September 2024 has been the biggest month of monetary easing since April 2020. Last month, central banks around the world cut interest rates 21 times, the most since the COVID crisis. This was also the 3rd highest number of cuts since the Great Financial Crisis.

Chart Sep'24 is biggest month of monetary easing since Apr'20
Monthly global central bank policy rate cuts



Source: BofA Global Investment Strategy, Bloomberg. Large sample of 100+ central banks

Secondly, recent economic data shows that the hard landing scenario seems less and less plausible. Some economies – e.g. Germany – might already be in recession. But in the US, Citigroup economic surprises index is at its highest since April, having flipped positive recently.

The recent stimulus package announced in China – while unlikely to trigger a major reacceleration of the Chinese economy - could be a boon for global economic growth especially in emerging markets. With oil prices way off the highs, a weaker dollar than at the start of the year and stable bond yields, non-US equity markets are currently enjoying some much welcome tailwinds.

On the earnings front, the usual negative revision is taking place ahead of the third quarter earnings season. However, earnings momentum remains positive and global equity indices should see their underlying companies grow earnings by high single to low double-digits in 2025. Profits have kept pace with nominal GDP and margins are at record high. Core companies are monsters with high share buy backs, sky high ROEs, and huge free-cash-flow generation.

Stocks are indeed expensive vs. bonds but given new risks with bonds (e.g. massive supply due to fiscal indiscipline in most G7 countries), a lower Equity Risk Premium might be warranted.

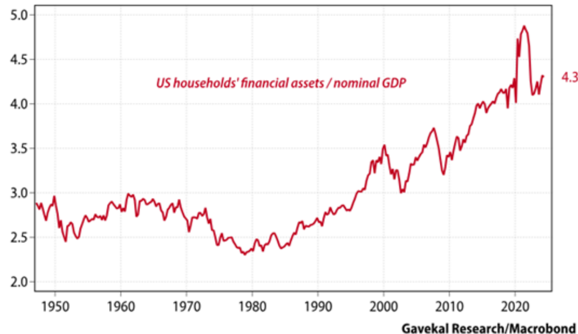
So, is this market unbreakable?

Not so fast.

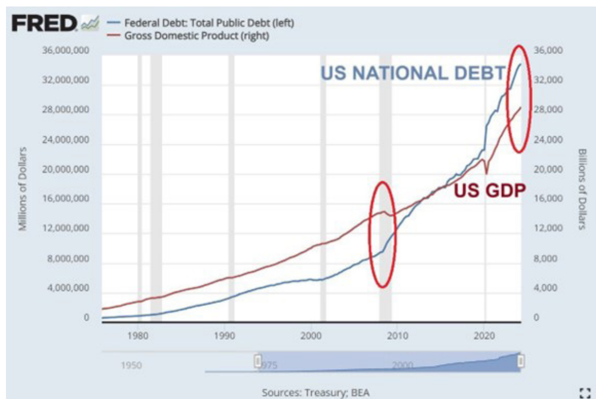
First, we need to consider the "tail risks" adjacent to our core scenario which is a soft landing of the global economy. While the odds of a hard landing of the global economy have been decreasing recently, we need to keep in mind that historically, most hard landing have started with a soft landing. For example, there is a "J-curve" effect once the economy starts to slow down, with an acceleration of the downside once the job market starts to get impacted.

Second, markets might have been getting ahead of themselves when it comes to the number of rate cuts that the Fed might be willing to implement. Another "tail scenario" is a no-landing, which could force the Federal Reserve to put on hold monetary easing. This could trigger another rise in bond yields, putting pressure on equity market valuations. In the case of a "no-landing" scenario, premature monetary easing could trigger a secondary wave of inflation with unpleasant consequences for equity markets.

Third, in 2000, US households were less exposed to financial assets than they are today. Back then, the value of US households' financial holdings was roughly 3.5 times US GDP. Today, that multiple is 4.3 times—almost 25% higher. As the US consumer contributes to roughly 80% of the US economy, any severe equity market pullback could have severe consequences on their morale and spending habits, hence affecting economic growth. In this context, it is not so much the US economy impacting the stock market but rather the other way round.



Fourth, the risk of a "fiscal blowout" in the US or in Europe remains. In the US, a budget deficit of 6% at full employment is unprecedented. We live an era of fiscal dominance which means that profits would be lower without the fiscal excesses. Debt stock over 100% of GDP is the largest in peace time. If interest rates stay high, debt sustainability is in question and could at some point incentivise investors to require much higher yields on government bonds issued by the most indebted G7 countries. Previous recessions like in 2008 or 2011 have come from the private sector borrowing too much.



Finally, geopolitical uncertainties remain elevated. The new US President and Congress might not necessarily please the financial markets. Meanwhile, any escalation in the Middle East could trigger a rise in oil prices and increase the odds of a stagflation scenario.

What does it mean in terms of asset allocation?

Going forward, we expect the Fed rate cut cycle to proceed gradually. Barring a financial crisis or a sharp and unexpected change in the path of inflation or unemployment, the current rate-cutting cycle is not going to be dramatic; we expect the Fed to make incremental, 25 bps cuts to its policy rate. Moreover, the Fed is going to stay highly data dependent and will calibrate accordingly.

Overall, this is a rather positive scenario for risk assets. Still, equity market valuations are rich, especially in developed markets, while some risks seem to be underpriced due to Middle East tensions and US election uncertainties. Consequently, while we keep our preference for equities over bonds, we refrain to increase exposure at this stage. We keep our neutral stance on equities. Our view on Eurozone equities is downgraded from neutral to negative, mainly due to weakening economic trend, while we upgrade our view on emerging markets from negative to neutral (China stimulus, improving earnings dynamic, room for easier monetary policy).

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A MACRO & MONETARY POLICY UPDATE

GLOBAL GROWTH

Diverging dynamics are at play in the global economy. The United States remain surprisingly resilient and continues to grow strongly, while Europe extends its worrying downward trend, dragged down by Germany. In the meantime, after a summer slowdown, China's short-term prospects have suddenly improved thanks to the economic package recently announced. At a sectoral level, global manufacturing activity remains under pressure while services are holding up well in most regions.

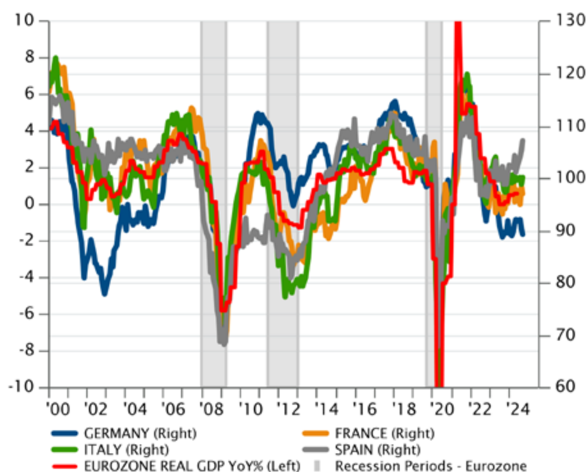
Economic surprises are positive again in the US, but still negative in Europe. In China, the dynamic should improve soon.

This desynchronisation of growth dynamics, coupled with the coming US elections, raises the level of uncertainty surrounding the outlook. However, this should not detract

from the fact that the world's two largest economies will benefit from an easing of monetary policy and from fiscal support over the coming months, which should be enough to keep global growth on a positive trend.

More specifically, in the United States, domestic consumption remains firm and supports the "soft landing" scenario, as low unemployment and softer inflation keep fuelling households' spending. While some indicators point to downside risks for the labour market, recent employment data has defied expectations, and the ongoing easing in financing conditions will likely prevent an unwarranted deterioration in economic conditions in the months ahead.

Europe faces a much less favourable economic backdrop as the prolonged slump in manufacturing activity weighs heavily on the German economy. Growth had already started to slowdown since the beginning of the summer, and the recent data has confirmed this negative trend. Activity in Germany is depressed and continues to decline, to the point where GDP is now expected to stagnate at best for the entire year 2024. In France, the "OlympicEffect" has quickly faded away. In the meantime, in stark contrast with last decade's dynamics, peripheral economies now exhibit better growth momentum, especially Spain that is led by tourism and strong service sector activity. However, overall growth momentum is weak for the monetary union and keeps undershooting expectations. This situation weighs on the Swiss economy as subdued demand in its main export market combined with the strength of the CHF are a drag for exporting sectors.



As for China, the economic measures announced at the end of September are unambiguously positive. During the summer, further signs of growth slowdown had raised the risk of the economy slowing below stall speed. Chinese authorities therefore decided to "go big" on providing support to their ailing economy, and the package appears sufficiently large and broad based to act as a positive shock. However, if this will likely reverse the negative trend and spur economic growth in the months ahead, medium and long-term challenges remain for China. Unfavourable demographic dynamics, depressed business and households' sentiment, and rising trade barriers in the US and in Europe will remain headwind for China's growth going forward.

GLOBAL INFLATION

Inflation is slowing down across the board and now tends to surprise to the downside in developed and emerging economies. Labour market normalisation and slower wage growth support the disinflationary dynamic. Inflation rates are now back around central banks' targets in the US and in the Eurozone, China is flirting with deflation and deflationary pressures are increasing in Switzerland. The recent rise in energy prices might exert short term upward pressures on inflation but, unlike in 2021/22, it appears unlikely to reignite a true inflationary dynamic given a more subdued global demand and normalised labour markets.

MONETARY POLICY

The global rate cut cycle is now started. There is room to cut as inflation normalises and growth slows down in some areas. As monetary policy has become restrictive with the slowdown in inflation, central banks will cut rates in developed and emerging economies. They will likely proceed gradually as long as economic growth remains positive, but they could cut significantly in 2025 if inflationary pressures truly dissipate or if economic growth disappoints. The potential for rate cuts might be even larger in some EM economies now that the Fed has started cutting rates.

For the US Federal Reserve, the policy normalisation has finally started with a first big step, and the direction of travel is clear. The Fed must bring back its monetary policy stance to a neutral level, balancing recession risks and US election uncertainty. The timing and the pace of rate cuts will depend on incoming data: as long as the economy holds up well, rate cuts will likely be gradual, but the Fed has room to cut rate faster in case economic growth slows down. Fiscal policy will be a key factor in 2025 for the continuation of the rate cut cycle as it could influence medium-term inflation dynamics.

For the ECB, slowing inflation and deteriorating growth dynamics plead for an acceleration of the monetary policy easing from the quarterly 25bp cut followed so far. The German economy and its ailing industrial and real estate sectors desperately need easier financing conditions to resume better growth dynamics. As the job market deteriorates, wage growth will likely slowdown and clear the way for more ECB rate cuts going forward.

The SNB is also in a situation where it must continue to cut rates, as weaker-than-expected inflation and the strength of the Swiss franc raise the spectrum of deflationary risks again.

When it comes to global liquidity, conditions are rather neutral, and broad Financial Conditions remain quite accommodative. Quantitative tightening is still ongoing in the US and Europe, but "cleaner" measures of liquidity are still rather stable. Broad financial conditions remain accommodative as market credit spreads are tight and equity markets close to ATH.

THE WEIGHT OF THE EVIDENCE

Our asset allocation preferences are based on 5 indicators, including 4 macro and 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

The Macro Cycle remains positive for equity markets. China will benefit from economic stimulus and the US economy is holding up remarkably. Inflation is slowing down across the board and central banks have now embarked on their rate cutting cycle.

Liquidity remains neutral as the effects of ongoing quantitative tightening are balancing the impact of central banks' rate cuts.

We remain neutral on earnings growth. Bottom-up, the consensus is expecting an acceleration/broadening but a deceleration in China and Japan. However, revisions for 2025 are only positive in these two latter countries.

However, our equity valuations indicators remain in negative territory, as seen in the equity section. Valuations in China and in Europe are in line with historical averages, but prospects are now more attractive in China.

Market factors are still very positive. Despite the slight correction at the beginning of the month, the trend indicators remain positive. In parallel, technical indicators are neutral as markets have not reached yet the "overbought" territory. Market sentiment remains neutral, but one component (the put call ratio) is showing complacency. Finally, market breadth and volume are back to positive as the participation is strong in the USA but less so in Europe. Consequently, the overall signal is very positive.

Overall, the weight of the evidence is slightly positive for equities.

	(+)	(-)	WEIGHT OF THE EVIDENCE
MACRO CYCLE	The Macro Cycle remains positive for equity markets. The US economy is holding up remarkably and supports a "soft landing" (or even "no landing"?) scenario. China will benefit from the recent stimulus. Inflation is slowing down across the board and central banks have now embarked on their cutting cycle.	Uncertainty around the outcome of US elections makes the outlook uncertain, while Europe is clearly slowing down, with risks of stagnation or mild recession rising. China's structural challenges remain.	POSITIVE
LIQUIDITY	Financial conditions remain on the "easy side". Central banks will continue to cut rates in the coming months to avoid maintaining unnecessarily restrictive financing conditions as inflation gradually slows down. The pace of US Quantitative Tightening is slowing down, easing pressures on USD liquidity.	Central banks, especially the Fed as long as the US economiy remains strong, might be cautious in adjusting their policy stance toward neutral. Quantitative Tighening is still ongoing in the US and Europe.	NEUTRAL
EARNINGS GROWTH	The focus is now turning on 2025 earnings, and the bottom-up consensus calls for an acceleration in earnings growth: a broad-based acceleration in earnings growth in the US and a normalization of growth in Europe thanks to high employment and lower interest rates.	While not unusual, revisions remain negative across the board.	NEUTRAL
VALUATIONS	Valuations are reasonable in regions such as Europe and Asia.	We are cautious on valuation particularly for US equities. Uncertainties about the economic outlook in 2025 remain elevated (impact of US elections, weak economic momentum in Europe). The tensions in the middle east remain a potential black swan.	NEGATIVE
MARKET FACTORS	Despite the slight correction at the beginning of the month, the trend indicators remain positive (both are positive). In parallel, technical indicators are neutral as markets have not reached yet the "overbought" territory. Finally, market breadth and volume are back to positive as the participation is strong in the USA but less so in Europe.	Market sentiment remains neutral but one component (the put call ratio) is showing complacency.	POSITIVE

ASSET ALLOCATION VIEWS

EQUITIES

Regions, sectors, and styles

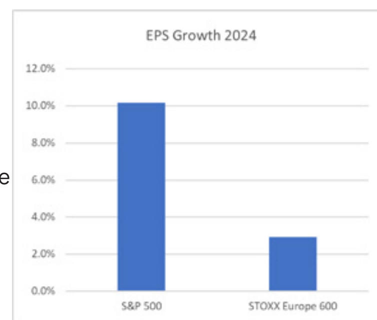
We continue to be neutral (slightly overweight due to market effects) on equities on the backdrop of a slowing global growth environment and elevated valuations partially offset by many central banks across the world that are cutting interest rates.

From a regional perspective, we are neutral on US equities as the soft-landing scenario continues to be well alive with resilient economic data and an ongoing easing cycle by the Fed, but valuations are stretched. Conversely, we are exercising caution regarding Europe due to a weakening economic trend. Germany, in particular, is facing challenges with sluggish manufacturing activity and a struggling automobile sector—one of Europe's largest employers—impacted by weak demand and fierce competition from Chinese brands.

Regarding emerging markets and China, we are now neutral as the measures announced by the Chinese government are limiting the risks of further slowdown in the economy and deflationary pressure. On the other hand, the central government is not yet willing to push for a large stimulus package while some underlying negative trends such as the demography remain negative.

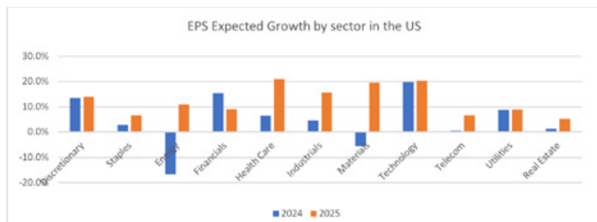
Earnings

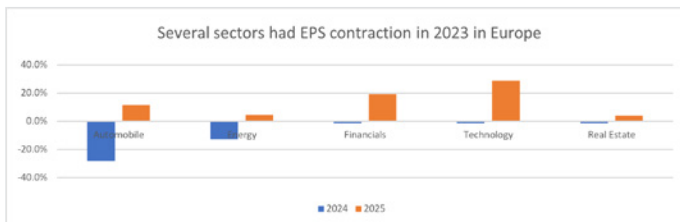
We are at the beginning of the third quarter earnings season and investors should expect a relatively positive message going into year-end in the US at least. Effectively, government spendings remain high in the US supporting consumption, and only a few companies have announced profit warnings in recent weeks. On the other hand, Europe is on the weak side as most large auto makers have issued profit warnings and the luxury sector won't be supportive yet as China will remain soft in the near-term. Therefore, revisions remain negative for Europe for this year earnings. The key topics investors will watch is the resilience of the consumer particularly in the US, the pace of investment in the AI field, and if manufacturing shows any sign of pick-up. We believe these trends will continue while employment remains high in the US, and large technology companies will continue to invest as their profits remain high.



However, attention will soon shift to 2025 earnings, where the debate intensifies. The bottom-up consensus calls for a broad-based acceleration in earnings growth, particularly in the US, where a wider range of sectors is expected to report higher earnings. Many investors anticipated this broadening to occur in 2024, but cyclical sectors such as industrials, materials and smaller market capitalisations have yet to experience the effects of a broader economic recovery.

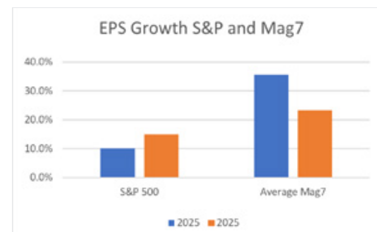
In Europe, as earnings growth is muted this year, the consensus expects a "normalisation" of the growth rate next year as five sectors had earnings contraction this year, and lower interest rates by the ECB are expected to be supportive.





Overall, for 2025, the consensus is clearly positive as bottom-up estimates are expecting a broad-based acceleration in earnings growth in the US and a normalisation of growth in Europe thanks to high employment and lower interest rates. However, while not unusual, revisions remain negative the board.

Let's look now at the "Magnificent 7": Microsoft, Apple, Nvidia, Alphabet, Tesla, Amazon, Meta. These were the major contributors of earnings growth both last year and this year in the US. Looking at the consensus, while decelerating, still exhibit resilient growth, and are expected as a group to outgrow the broad market in earnings growth next year. Thus, investors should not overlook them.



Valuations

We are cautious on valuation particularly for US equities. We acknowledge lower interest rates are a positive for valuation as an acceleration in earnings growth into next year. However, there are uncertainties about the economic pick-up as the US economy may slow further and the situation in Europe is far from robust. Finally, the tensions in the Middle East remains unsettling for the markets. Given this context, we believe valuation is expensive in the US while more reasonable in some other regions such as Europe and Asia.

FIXED INCOME

Overview

We maintain a neutral position on fixed income within our portfolios, guided by a mix of encouraging inflation data, a cooling job market, and the onset of the Federal Reserve's rate cut cycle. While these positive indicators provide some optimism, several factors urge caution. Ongoing supply pressures driven by the need to finance the large fiscal deficit, a flat yield curve, and persistent interest rate volatility suggest it is premature to adopt a more bullish stance. Additionally, while our base case remains a soft landing, the potential for significant long-term interest rate declines is limited. In this context, we continue to favour the short and intermediate segments of the yield curve over long-duration bonds. We remain cautious on high yield and hold a neutral position on investment grade credit. Valuations in the high yield space are particularly stretched—especially compared to investment grade credit—given where we are in the economic cycle. Furthermore, with potential volatility expected in the second half of 2024, we are also cautious on USD-denominated emerging market debt. However, EM local debt could present opportunities if the US dollar continues to weaken.

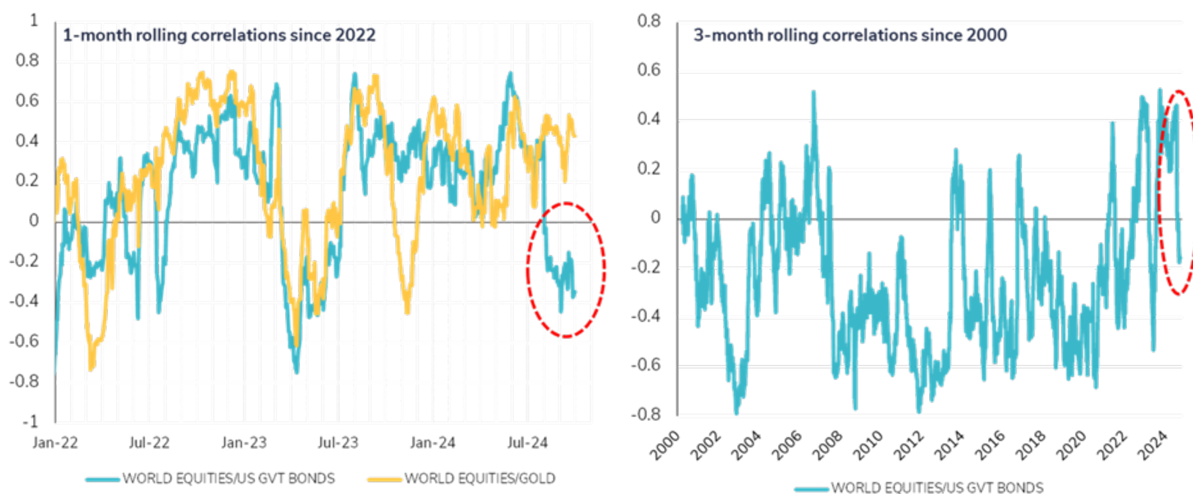
Government Bonds

Our outlook for government bonds with maturities under 10 years remains positive, as we anticipate favourable conditions for yield improvements by year-end. This view is supported by several key factors:

- Reassuring inflation data and economic stability: The US economy shows signs of normalisation, with a cooling job market and gradually declining inflation rates, despite occasional volatility.
- Monetary policies: Federal Reserve Chair Powell has initiated the rate cut cycle, which is expected to continue. In addition, easing quantitative tightening and improving liquidity in the Treasury bond market through a buyback program are expected to further stimulate demand.
- Bonds as a diversifier: Bonds are once again proving their worth as effective diversifiers in balanced portfolios, with their correlation to equities turning negative.

However, we remain cautious on longer-term bonds due to the flat yield curve, negative term premiums, ongoing rate volatility, and the pace of interest rate declines. Other concerns include the growing US fiscal deficit and increased Treasury issuance.

Bond-equity correlation turns negative in August for the first time in a year!



Source: Syz CIO office, Bloomberg

In Europe, we maintain a neutral stance as the European Central Bank initiates monetary policy normalisation, beginning with its first rate cut in June and in September. We anticipate additional rate cuts in October and December, which could support a bull steepening of European rates. The market has largely priced in the French election outcomes as a contained, idiosyncratic risk, with the yield spread between 10-year Italian and German bonds returning to pre-election levels of 130bps. However, the bond market still perceives some risk, as the 10-year French real yield is near its highest level this cycle. While European wages remain a concern, the latest wage report shows promising progress, and ECB members are confident of further normalisation soon. Our outlook on UK government bonds is also neutral but close to turning positive. The political shift following Labour's victory has not significantly impacted the gilt market, with memories of the 2022 crisis under Liz Truss fostering caution towards expansive fiscal policies.

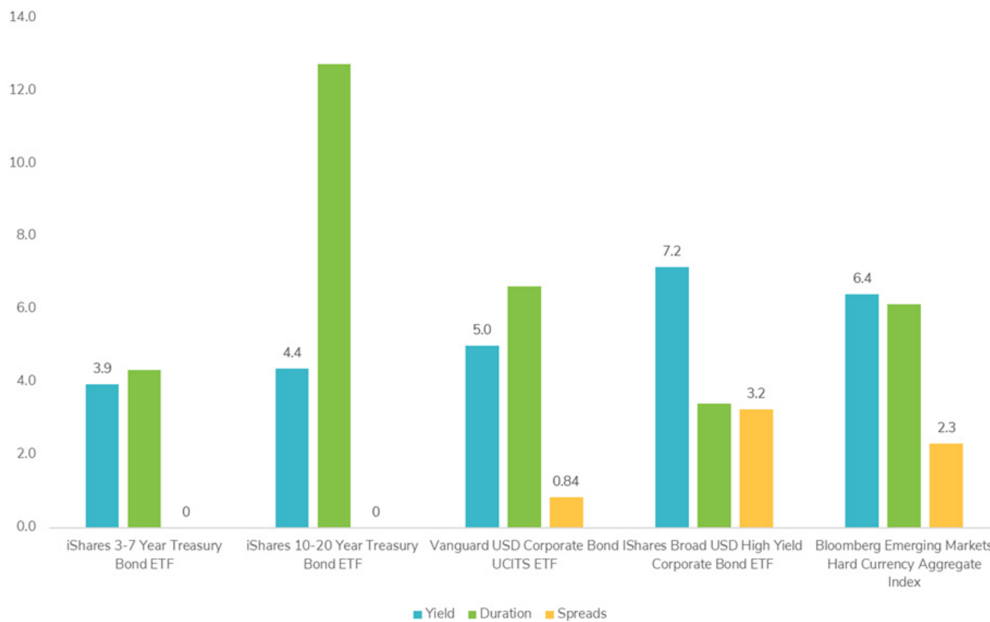
Market perception of French election risks

Source: Syz CIO Office, Bloomberg.

Corporate Bonds

Our stance on investment-grade bonds remains neutral. Credit spreads have tightened significantly to their lowest levels since 2021, reducing the safety margin to just 15% of the total yield. Current market conditions are “priced to perfection,” necessitating close monitoring. For the first time since 2022, there are more BBB-rated bonds with a negative outlook than those with a positive outlook. Despite these factors, the solid macroeconomic backdrop and concerns over US Treasury sustainability suggest that it might be premature to reduce credit exposure. In the high-yield sector, we see selective opportunities in short-term corporate high-yield bonds due to their favourable risk/reward profile, though we acknowledge that overall valuations in high yield are stretched, especially if volatility increases in the second half of 2024.

Yield composition across fixed income segments



Source: Syz CIO Office, Bloomberg.

Emerging Markets

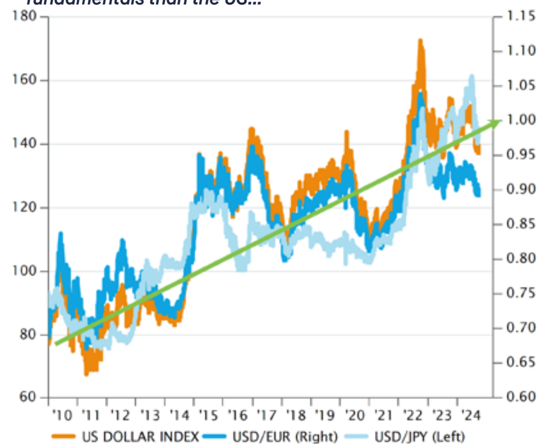
Our stance on hard-currency EM debt remains cautiously negative, though we identify some attractive opportunities in bonds with maturities up to four years. Market sentiment toward EM debt remains subdued, as evidenced by ongoing negative capital flows and rising short interest in USD-denominated EM debt. Valuations appear stretched, with EM corporate spreads at their narrowest since 2007. However, the recent weakening of the US dollar and declining US real interest rates have provided some relief to EM local debt, making it an attractive consideration if the trend continues.

FOREX (view against USD)

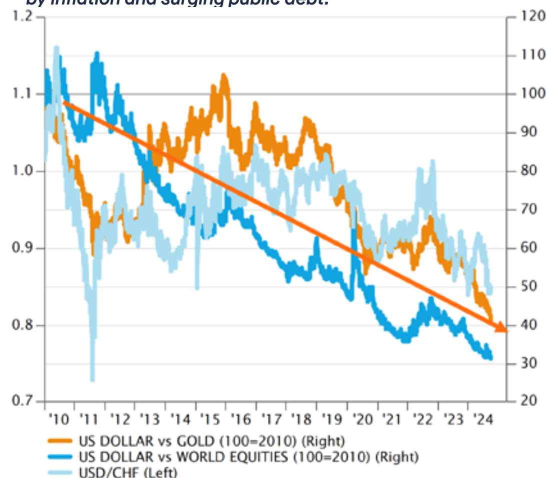
Following recent economic development and the continuation of the global rate cut cycle, we now expect the US dollar to remain broadly stable against most major currencies. With the Fed now having joined the global rate cut movement, interest rate differentials will no longer be as much of a support for the greenback, and the upside potential for the USD appears limited.

We bear in mind that the outlook for the US dollar is relative: one can only have a view on it against something else. Our current neutral view on the greenback is set against other major currencies, around the current strong level where it has been driven by higher rates and relatively favourable (or least unfavourable) economic fundamentals.

↓ The US dollar has been strengthening against currencies with worser fundamentals than the US...



↓ ... but its value vs real assets or sound currencies has been eroded by inflation and surging public debt.



ALTERNATIVES

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? Because: 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 insurance against adverse circumstances, such as inflation, recession, etc. 3) There is heavy demand stemming from central banks, especially in emerging markets.

We are keeping a positive stance on commodities as a portfolio diversifier and protection against inflation upside, which is not our core scenario. Commodity prices are moving higher, driven by resilient US growth, geopolitical uncertainty, segmentation of global trade and AI demand for energy.

We 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 and arbitrage landscape will be very challenging in 2024.

INVESTMENT CONCLUSIONS

- Overall, the overall macro and liquidity conditions are rather positive for risk assets. Still, equity market valuations are rich, especially in developed markets, while some risks seem to be underpriced due to Middle East tensions and US election uncertainties. Consequently, while we keep our preference for equities over bonds, we refrain to increase exposure at this stage. We keep our neutral stance on equities.
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TACTICAL ASSET ALLOCATION (TAA) DECISIONS

TAA Balanced moves

We started the year with an allocation to equities which was close to our Strategic Asset Allocation (SAA). Due to market effects, the allocation has been rising progressively to overweight throughout the first half of the year and we didn't sell into strength. However, during our July Tactical Asset Allocation Committee, we decided to rebalance portfolios towards a neutral allocation to equities, which means that we effectively reduced our exposure to equities to neutral. Since then, positive markets have been driving our exposure to a slight overweight.

As mentioned earlier, we favour equities over fixed income but refrain on adding more risks at this stage. The true exposure to equities within client portfolios is thus slightly overweight versus our Strategic Asset Allocation.

Within equities, we decided to downgrade European equities from neutral to negative and to upgrade Emerging markets from negative to neutral. See below matrix of preference moves.

ASSET ALLOCATION GRID

TACTICAL ASSET ALLOCATION (TAA) 4.10.2024

	--	-	NEUTRAL	+	++
Portfolio Risk		**Cash**	Fixed Income Equity Alternatives		
Fixed Income		**HY (local or global hdg)** **EM Debt**	Govies 10+ (local) Corporate IG (local)	**Govies 1 - 10 (local)**	
Equities		**Euro Zone** ←	United States United Kingdom Switzerland Japan → Emerging Markets		
Alternative Investments			Hedge Funds		
Commodities				**Gold** **Commodities**	
Forex (vs USD)			EUR CHF GBP JPY EM currencies		

Change from last month: More attractive → Less attractive ←

Source: Investment strategy group - 4 October 2024

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