ASSET ALLOCATION INSIGHTS

Monthly Update | Issue 84 — 12 May 2023

Peak inflation, Peak rates, Peak yields. What's next?

Key takeaways:

- While market dynamics remain supportive, the macro & fundamental context are still uncertain and could lead to an Equity Risk Premium re-rating
- We keep our cautious stance on equities and rates as well as our positive view on credit
- We are downgrading China & EM Asia equities to positive (from attractive). We are upgrading Government bonds to positive (from cautious)

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PRIVATE BANKING

The big picture

Rising inflation, rising interest rates, and rising bond yields were the main headwinds for financial markets last year. Fast forward to 2023 and it seems that they have all peaked, at least in the U.S.

Last week, the Fed raised rates by 25bps, its 10th consecutive rate hike since March 2022. The Fed language indicated that a pause in rate hikes may be likely: while Chair Powell did not say it explicitly, some of the language in the Fed's statement hinted that a pause may be coming.

This week, US Consumer Price Index (CPI) came out at +4.9% yoy, the smallest 12-month increase since the period ending April 2021. While inflation is still more than twice the Fed's target, the progress made since June 2022 peak (+9.1%) demonstrates that the tightening of monetary conditions is starting to produce its effect on inflation.

Meanwhile, US and global yields seem to have peaked as well as investors anticipate lower growth and less inflationary pressure ahead.

The cooling down of inflation and easing of yields have been supportive for equity markets, in particular for the long duration stocks such as the mega-cap tech.

So, what's next?

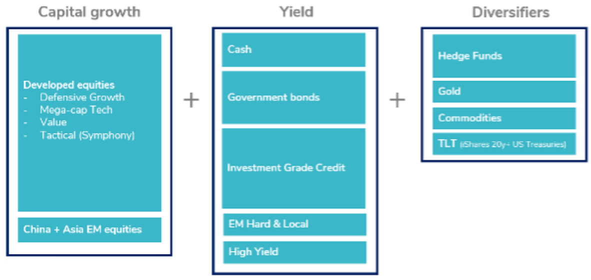
Overall, markets have moved higher this year, with the S&P 500 Index up over 8% and the Nasdaq up over 17%, but the rally thus far may be fragile. The equity leadership in the market is narrow, with quality growth and defensive sectors leading the way, while cyclical sectors (energy, financials) and small-cap stocks have been underperforming in a slowing economy. Treasury bond yields have also moved lower since their recent peaks in early March, perhaps as investors seek safe-haven assets and as growth concerns rise.

But after a nice start to the year, markets are now facing the impact of the Fed's 500 basis points tightening. Indeed, the fastest rate hike cycle since the 1980s may already be impacting the real economy. The regional bank crisis is so far the biggest casualty. Commercial real estate might be next. In the meantime, lending standards are tightening and this should impact macro-economic growth.

As such, we believe that we have entered a new period of uncertainty, which should lead to an Equity Risk Premium re-rating. Indeed, we believe that the "Goldilocks" scenario is at risk: while global inflation is softening, recession risk is increasing, and earnings/margins are likely to be under pressure. Liquidity conditions are still not supportive for risk assets. While the Fed is likely to pause, a "pivot" would be subject to macro deterioration, which will be in and of itself a negative for risk assets. We therefore expect market volatility to increase in the weeks ahead, especially if the economy heads into an economic downturn or the banking system requires more intervention. However, we believe that last year's 25% fall in the S&P 500 captured some of the mild recession that may lie ahead.

In this context, we maintain our total-return "all-weather" portfolio strategy. We keep our cautious stance on equities through a diversified exposure to developed equities and an allocation to China and Emerging Markets (EM) Asia stocks. Within Fixed Income, we keep our cautious stance on rate and a positive view on credit. Yield is generated through cash, investment grade credit, government bonds, EM bonds as well as a small allocation to High Yield. Diversifiers include hedge funds, gold, commodities and long duration US government bonds.

An illustrative view of a balanced portfolio (the size of the boxes roughly indicates the relative allocation of the various "buckets")



Indicators review summary

Our tactical asset allocation process is based on five indicators.

Macro & Fundamental Factors
(Leading indicators)

→ Macro-economic cycle:
NEUTRAL

→ Liquidity:
NEGATIVE

→ Earnings growth:
NEGATIVE

→ Valuations:
NEUTRAL

Market Factors
(Coincident indicators)

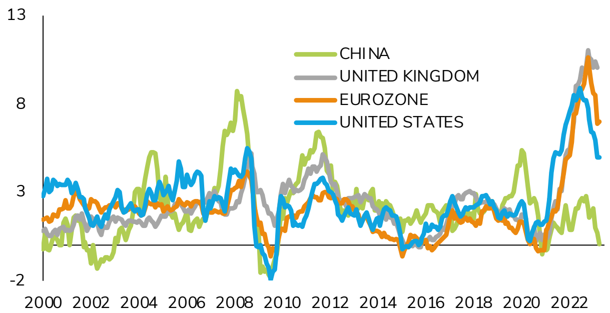
→ Market dynamics (Breadth, Sentiment, etc.):
POSITIVE

Indicator #1

Macro-economic cycle: **Neutral**

The current macro-economic dynamics remain positive, supported by tight job markets on both sides of the Atlantic fuelling strong domestic demand and solid service sector activity. The ongoing recovery in Europe after the energy-led slowdown of late 2022 also contributes to positive global momentum, as well as the reopening of China (even if less spectacular than expected and, here too, concentrated on domestic service activity). However, cyclical sectors (manufacturing, real estate, banks…) are under rising pressures from tighter financial conditions. The tightening in lending standards and financing conditions suggest that the tipping point where rising rates seriously bite into economic activity may be about to be reached. On top of that, additional headwinds such as the US debt ceiling deadline may also impact economic growth later this year. The combination of still ongoing positive growth momentum, on the one hand, and rising headwinds and risks on the other hand, makes for an overall neutral score for the macro-economic cycle. The risks are clearly tilted toward the downside, but the current benign growth environment might extend for some time, until the loss of cyclical momentum eventually drag economies in recession by undermining job market dynamics.

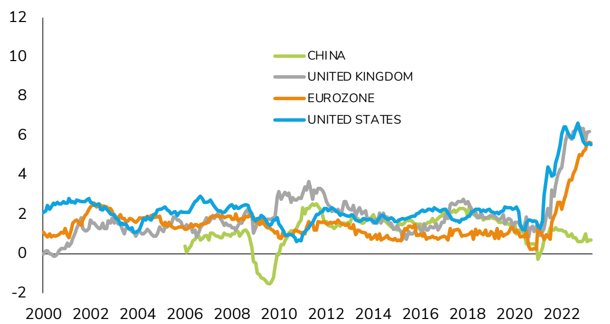
Headline CPI inflation YoY%



Source: Banque Syz, Factset

Inflation slowdown is underway, thanks to base effects, softer energy prices and declining good prices. But solid domestic demand keeps underlying inflationary pressures alive.

"core" (ex food & energy) CPI inflation YoY%

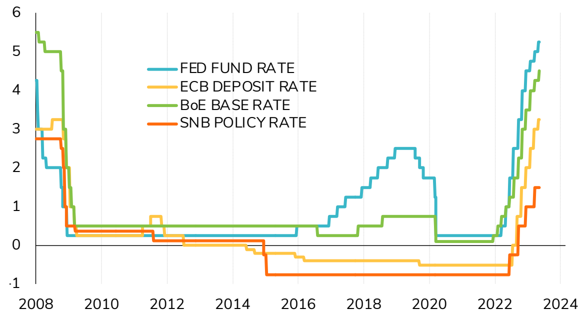


Source: Banque Syz, Factset

Indicator #2

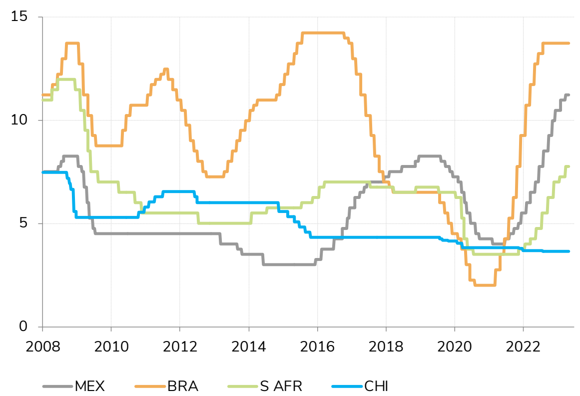
Liquidity: **Negative**

The rate hike cycle is not over yet, in May we saw rate hikes by the Fed, the European Central Bank (ECB) and the Bank of England (BoE), but it is probably coming to an end when it comes to the former. Central banks still face inflation rates significantly above their targets. Even more worrying, inflation is currently driven by rising service prices and higher wages and no longer by "exogeneous factors" such as energy & commodity prices or supply chain bottlenecks. The gradual unwinding of quantitative easing bond purchases (Quantitative Tightening) has not been halted, neither by the Fed nor the ECB. Higher rates and declining bond holdings by central banks continue to tighten financial conditions and reduce available liquidity in the economy and markets. Short-term liquidity facilities to prevent the banking system from seizing up are different by nature and are unlikely to balance or reverse the impact of higher rates and Quantitative Tightening. Liquidity conditions therefore remain negative for the time being and are likely to be so until tangible signs of imminent recession risk and/or significantly softer inflation appear.



Source: Banque Syz, Bloomberg

Central banks stayed the course in May with rate hikes for the Fed, the ECB and the BoE



Source: Banque Syz, Bloomberg

Indicator #3

Earnings growth: **Negative**

Current downtrend revision towards a plateau is confirmed with better-than-expected Q1 2023 earnings. The percentage of companies guiding higher EPS has increased while the percentage of companies guiding lower Earnings Per Share (EPS) has decreased. However, profit margins are at record highs and might be a headwind in the coming months (no more support). 2023 consensus EPS expectations shows some polarity among regions: flat for MSCI World and the S&P 500, negative for EM and the UK, positive for Euro zone, Japan and China (the highest level).

Indicator #4

Valuations: Neutral

Equity multiples are still too rich in the US. This is also why we believe that a risk premium re-rating might take place: there is not enough cushion on the valuation side for US equities. World ex-US valuations are rather expensive as well as current level is higher than the median. Europe and EM are fairly valued while UK and Japan are undervalued. Switzerland is expensive.

Equity valuations: 12m Forward P/E

	01-May-23	12m Fwd P/E		
	MSCI Index	Current	Median	Upside
World	2207	16.5	15.4	-6%
US	3949	18.8	15.0	-20%
Europe	1896	13.1	12.9	-1%
UK	2260	10.6	12.5	17%
Eurozone	265	12.6	12.8	1%
Germany	1036	11.5	12.8	11%
France	2658	13.5	12.8	-5%
Italy	860	8.2	12.8	57%
Spain	936	10.5	11.6	11%
Japan	1263	13.5	17.2	28%
Australia	1454	14.4	14.2	-1%
Hong Kong	14430	14.0	14.2	1%

Source: IBES, MSCI, Datastream. Long term median.

Indicator #5

Market dynamics: Positive

Market dynamics (breadth, sentiment, etc.) remain positive. In the US, a large majority of indicators are positive but several of them could easily get downgraded in case of a sudden lower move by the S&P 500. This is especially the case for market breadth (participation to the upside of the broad market), which has been deteriorating over the last few weeks. Indicators for Europe are positive as well albeit slightly less than in the US.

Despite the positive market dynamics, the macro and fundamental factors are still not supportive and this leads to keep a cautious stance on equities.

Asset Allocation Decisions

We keep a cautious stance on equities with a positive view on US, Eurozone, UK, Switzerland and Japan and a cautious stance on EM Latam and other EMs. We are downgrading China & Asia EM from attractive to positive. Indeed, the re-opening of the economy seems to be taking place more slowly than expected. Moreover, foreign inflows have been disappointing probably for geopolitical reasons.

We remain cautious on rates but are upgrading our preference for Government bonds to positive due to increasing signs of macro deterioration and the likelihood that the Federal Reserve has completed its rate hikes for this cycle. We stay positive on credit while we rate high yield investments as unattractive. We favour from 0 to 10 years segments due to the steepness of the credit spread curve which fully offset the inverted U.S. Treasury yield curve.

In Forex, we remain positive EUR. CHF and JPY versus USD, positive Gold and maintain our attractive view on Commodities and Hedge Funds.

Asset Classes Preferences

EQUITIES: Cautious

We keep our cautious stance on equities through a diversified exposure to developed equities and an allocation to China and EM Asia stocks. We're nevertheless downgrading the exposure to the later from attractive to positive as geopolitics weigh on the general sentiment of foreign investors. The reopening is underway, but certain pockets such as industrial production and the real estate market remain weak.

Our preferences on Europe and Japan are unchanged due to attractive valuation. Both are benefiting from China reopening. Overall, stock picking remains key in this environment.

When it comes to the US banking crisis, we believe that more turmoil could be ahead. Unlike Money Market Funds, most bank deposits do not pay interest. As such, the flows from banks into money markets funds are accelerating, up $100B in two weeks. Money market holdings hit a record $5.31T in the week that ended May 3 while deposits continue to contract at record levels. It is thus no surprise to see the crisis of confidence is spreading. A survey shows that close to 190 banks could collapse while roughly 50% of Americans are worried about their bank deposits.

When it comes to the broader US equity market, we note that the recent performance has been very concentrated. 97% of SPX YTD performance comes from 15 stocks – mainly coming from the Tech & Communications sectors. A chart of US Technology sector vs S&P500 index is back at February 2000 & January 1970 highs.

Chart 4: US tech vs S&P 500 back at Feb'00 / Jan'70 levels

Tech relative price performance vs S&P 500

Source: BofA Global Investment Strategy, Bloomberg, Global Financial Data

FIXED INCOME: Cautious on Rates, Positive on Credit

RATES: Cautious

We are upgrading our preference for government bonds to positive due to increasing signs of macro deterioration and the likelihood that the Federal Reserve has completed its rate hikes for this cycle. It is worth noting that historically, yields tend to decline after the tightening cycle ends. Furthermore, the negative correlation between stocks and bonds has re-emerged, providing additional support.

We recommend focusing on the front end and intermediate part of the yield curve, as they offer favourable carry and benefit from improving rate fundamentals. However, caution is advised when considering the long end, given the historical level of yield curve inversion.

Although liquidity has temporarily improved due to the Federal Reserve's easing of access to liquidity through overnight repurchase agreement operations, it is important to note that the Fed's balance sheet is shrinking again, and the Treasury General Account (TGA) is rapidly decreasing due to the debt ceiling.

Our preference for USD rates over EUR rates is justified by the fact that the European Central Bank (ECB) still needs to catch up, as reiterated by ECB President Lagarde, who expressed concerns about core inflation being "far too high" and the need to bring inflation back to 2%. We anticipate two rate hikes in June and July as the base scenario. However, we are upgrading our preference from unattractive to cautious on EUR core, CHF, and GBP yield curves, considering that the tightening of monetary policies is nearing its end.

We continue to avoid peripheral rates as the yield premium does not adequately compensate for weaker fundamentals and higher volatility, especially considering that the ECB will cease Asset Purchase Programmes (APP) reinvestments after June, preventing them from smoothing reinvestments any longer.

CREDIT: Positive

We stay positive on credit while we rate high yield investments as unattractive. We favour from 0 to 10 years segments due to the steepness of the credit spread curve which fully offset the inverted U.S. Treasury yield curve. Absolute yields are still offering attractive long term entry point. Focus on high quality corporate bonds that have proven their robustness even if money market funds compete the entire credit spectrum.

European high yield is more attractive than U.S. high yield due to heightened fears of a deeper recession in Europe and consequently higher default rates. The European premium has piled up again since the Credit Suisse affair. The current valuation of U.S. high yield spreads implies modest default rates and the absence of inflation slippage, or a near-term recession, but in absolute term, high yield bonds are not expensive.

ALTERNATIVES: Gold & Hedge Funds attractive. Positive on commodities.

COMMODITIES: Positive overall. Keep a preference stance on Gold

Over the last few months, commodities have moved from being overbought to oversold as recession fears now dominate all markets. We remain positive on the asset class and see commodities as an attractive macro hedge. After years of capex underinvestment, many commodities are facing a supply shortage while demand is firm. The invasion of Ukraine by Russia and the sanctions are worsening the situation. Energy and commodities are needed for virtually everything, and Russia exports both massively. Furthermore, the supply shock might be a long lasting one. Indeed, despite ongoing negotiations between Russia and Ukraine, a stalemate with prolonged economic impacts looks likely.

Crude oil prices corrected on concerns about global growth and demand outlook, culminating in a 3-day crash (from 1 to 3 May). r Saudi Arabia cut the price of its oil delivered to Asia for the first time in four months following the weak China manufacturing demand data. We continue to expect higher prices for H2 due to:

1. supply constraints - overall supply remains down vs. 2022 and 2019 levels
2. the supply cuts decided by OPEC and Russia in early April will be implemented this month, withdrawing from the market more than 1.6 million barrels per day (mbd) from the market (1.1 mn from OPEC and 500K from Russia)
3. Energy Secretary J. Granholm announced that the US intend to refill the Strategic Petroleum Reserve before year-end to pre-Ukraine conflict levels
4. China oil demand recovery is expected to more than offset the slowdown in OECD demand in the near to medium-term
5. OPEC+ meeting in Vienna (3-4 June) will be a key catalyst for the oil market with prospects of further supply cuts increasingly probable.

Gold reached USD 2063 on 4 May thanks to increased safe haven buying due to continued concerns about the US banking system. Prices should remain stable now that the Fed raised rates as expected and Powell hinted at a pause in tightening. Gold ETFs continue to see inflows and central banks buying continue to show momentum.

We are thus positive on broad commodities. We keep our preference stance on Gold which remains a potential inflation hedge and a safe haven in a highly uncertain environment (including debt ceiling brinkmanship).

HEDGE FUNDS: Attractive

Alternative strategies grab their chance to deliver value. After the pandemic, economies are adapting to the changing cost of capital. Investors need a more selective and active approach to investing. As interest rates rise, hedge funds are providing positive returns. Alternative strategies are benefiting from lower liquidity and higher interest rates.

In terms of hedge funds strategies, we like well-established Global Macro funds that have a multi-PM 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 L/S and directional funds as their beta is too high. We do not like Event Driven funds as we believe the M&A landscape will be very challenging in 2023.

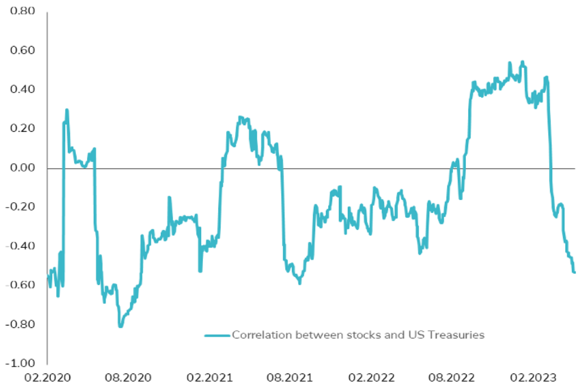
FOREX: Positive EUR, CHF and JPY against USD

We remain positive EUR, CHF and JPY versus USD. With the Fed likely to pause sooner than other developed markets' central banks and with the debt ceiling issue likely to hit headlines in the coming weeks, we expect the greenback to stay under pressure.

Cross-asset correlations and volatility

The bond/equity correlation is back to negative territory, implying there are diversification benefits to add government bonds in multi-asset portfolios. Volatility remains high on bond markets while staying muted in equity markets.

The correlation between US rates and stocks is turning negative again.



Source: Bloomberg

Tactical positioning: our asset allocation matrix

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

Source: Investment strategy group - 10 May 2023

Change from last month

→ More attractive

← Less attractive

For further information

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