ASSET ALLOCATION INSIGHTS

Monthly Update | Issue 76 14 October 2022

The good, the bad and the ugly

Our main scenario is a rise in downside risks for the global economy, amplified by antagonist policies. This is due to a global growth slowdown that governments aim to mitigate through fiscal support, as well as a simultaneous inflationary environment that central banks are trying to contain. This combination spurs macroeconomic volatility which itself keeps asset price volatility elevated. Consequently, we maintain an "unattractive" stance on equities and a cautious view on both rates and spreads. We are positive on commodities and have a very attractive view on hedge funds. We remain positive on the dollar against all currencies as the greenback remains the only true inflation hedge at this stage.

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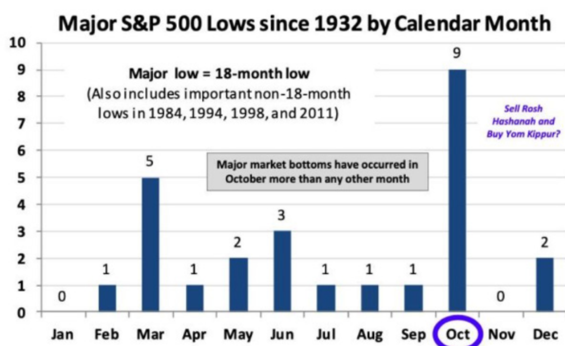
Syz PRIVATE BANKING

The big picture

The "everything down market" continues to weigh on multi-asset portfolios' performance. Looking at total return data going back to 1928 for the S&P 500 and US 10-year Treasuries, there were only 5 years in which both S&P 500 and 10-Year Treasury Notes went down (1931, 1941, 1969, 2018, 2022). This year is the only year in history in which both S&P 500 and the US 10-year Treasury bond are down more than 10% each. Will the "everything down market" continue or are we getting close to a turnaround point for global risk assets?

The good

- Despite the current gloomy picture, there are reasons to take a positive and contrarian view on markets.
- First, sentiment is too pessimistic, which is a positive from a contrarian perspective. For instance, hedge funds are running low on leverage. We are now at April 2009 levels according to Morgan Stanley. Meanwhile, the 5-day rolling average notional of index puts is $1 Trillion, per day, every day. That's a new record.
- Moreover, a mild recession is already priced in by the markets. Stocks are forward-looking and move ahead of the economy by about six months. The 25% decline in equities since January likely already reflects a mild recessionary outcome. If the downturn doesn't prove to be severe, equity markets could stabilize even as economic data underwhelms. Today, US investment grade yields to worst are the highest in more than a decade. In addition to the higher income potential, investment-grade bonds can potentially serve as a buffer against equity-market volatility.
- Seasonality is turning positive. Indeed, October is historically the month with the highest number of major lows ("The Bear-killer" and "Bargain month").



Source: Oppenheimer

- On the macroeconomic side, some downside surprises in economic reports are raising hopes that inflationary pressures could soon ease. The ISM manufacturing index fell to 50.9 in September, its lowest level since 2020. The ISM manufacturing prices paid fell to their lowest level since soon after the start of the pandemic. Global container freight rates hit a 21-month low early October, down 67% from their peak. It is still over 2x higher than pre-pandemic levels but continuing to move in the right direction. Meanwhile, used car prices are now down year-over-year, the first time we've seen that since May 2020.
- The number of job openings fell by 10.0% in August, the most since April 2020, and the fourth biggest decline in the past five months. The gap between the number of jobs and the number of unemployed remains high from a historical perspective, but it is starting to narrow. For now, companies are slowing the pace of hiring before cutting jobs, therefore keeping the unemployment rate low.

The bad

- The end of QE and the surge in bond yields continue to drive equity markets lower. As long as we don't get a Fed "pivot", markets will continue to adjust to the reality of tighter liquidity and higher bonds yields. Both are weighing on equity valuations.

Source: Bloomberg

- Other bad news: equity valuations are still not cheap. S&P 500 Enterprise Value to sales got cheaper but we have just arrived at the top of the 2000 dotcom bubble. The old trade -- TINA, or "There Is No Alternative" -- was about to buy everything (meme stocks, unprofitable tech, Miami condos, etc.) as bonds offered 0%. But now, 4.30% on 2-year Treasuries (so no duration risk) is a fundamental game changer for everything you associate with the QE era. This is a market which is more favorable for income types of investments and much less favorable to the old QE winners (tech, speculative stocks, etc.). Hence TARA (There Are Reasonable Alternatives).
- On the macro side, strong oil advance is not good news for inflation. Early October, WTI Crude oil recorded its biggest weekly gain since March on supply fears (OPEC+ cutting oil supply by 2 million barrels per day) and strong US jobs data. If sustained, this rebound will start pressuring the presumption that headline inflation will maintain its downward trajectory into the end of the year at a time when core inflation is still rising. The recent OPEC+ announcement makes Biden's release of

1mb per day look increasingly futile and unsustainable as the SPR (Strategic Petroleum Reserves) are getting depleted to dangerously low levels.

The ugly

- US government securities liquidity is worsening. Central banks around the world are swapping their stockpiles of US Treasuries for cash -- just in case they need to intervene in markets to bolster their currencies. Foreign monetary officials purged $29 billion in Treasury securities in the week ended Oct. 5, bringing the four-week decline in holdings to $81 billion, according to Federal Reserve data. It's the most-extreme outflow since the beginning of the pandemic in March 2020, leaving total holdings at $2.9 trillion.
- Risk gauges in Germany's government debt market rose last week to levels higher than recorded in the 2008 world financial crash. Meanwhile, the spread between the EUR swap and German 10-year yields closed above 1% for the first time ever. UK market borrowing costs continue to surge as quite a few "too big to fail" institutions are heavily exposed to UK Bonds and Gilts.
- Last but not least, the Russia-Ukraine war and the resulting tensions between US/Europe and Russia show no signs of abating. To the contrary, the risks of escalation have been increasing lately. One of the major turning point of 2022 is the growing East-West divide. The countries that have sanctioned Russia over its invasion of Ukraine represent only 16% of the world's population. Two-thirds of the world's population live in countries where the government has declined to condemn Russia's invasion of Ukraine. India, China and the Middle East are keen on cooperating with Moscow. As a consequence, the world has entered into the equivalent of a new "cold war" and this has consequences on structural inflation. Indeed, wars are about control. The control of technologies (chips), commodities (gas), production (zero-Covid) and straits (the Taiwan Strait, the Strait of Hormuz, the Bosporus Strait, etc.). Wars are also about alliances: After the BRICS, should we focus instead on Turkey, Russia, Iran, China, and North Korea playing "TRICKs" – an alliance of economies sanctioned by the U.S. getting ever closer economically (and militarily?). Overall, this new geopolitical paradigm is likely to create more macroeconomic and thus volatility on financial markets.
- So where do we go from here?

We keep an "unattractive" stance on Global equities

- The weight of the evidence (i.e. the aggregation of our fundamental and market indicators – see next section) forces us to keep an "unattractive" view on equity markets, i.e we remain underexposed on risk assets.
- From a regional standpoint, we keep a "positive" stance on US equities. We are upgrading UK equities from "unattractive" to "cautious". We are also cautious on China & EM Asia, Japan and EM Latam. We keep an "unattractive" stance on Eurozone equities. Our least favored market remains EM Eastern Europe equities (very unattractive).
- We keep a "cautious" stance on Fixed Income, credit spreads and rates. We keep a positive view on Commodities (with a "preference" stance on Gold) as well as a very attractive view on hedge funds.
- In Forex, we are positive on the dollar against all currencies. We keep an "unattractive" stance on the Euro as the Eurozone is facing a major energy crisis which is worsening the fundamentals of the common currency.

Indicators review summary

Our tactical asset allocation process is based on five indicators. The macro and fundamental factors are still tilted towards a negative stance on risk assets. The most dynamic factor of our process - market dynamics – remains neutral. On an aggregated basis, our indicators are pointing towards an "UNATTRACTIVE" view on risk assets.

Macro & Fundamental Factors
(Leading indicators)

→ Macro-economic cycle:
NEGATIVE

→ Liquidity:
NEGATIVE

→ Earnings growth:
NEUTRAL

→ Valuations:
NEUTRAL

Market Factors
(Coincident indicators)

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

Indicator #1
Macro-economic cycle: **Negative**

Economic growth continues to slow down across all large economic areas, except in the United States. Indeed, the US continues to expand firmly, led by domestic demand and services, even if some cyclical and rate-sensitive sectors (e.g Real Estate) are slowing down. Consumer spending keep growing (even in real terms), supported by rising jobs and wages (as well as accumulated savings). Investment keeps growing in overall, even if some sectors are already losing steam.

European economies (UK included) already feel the impact of surging energy prices. And winter has not come yet. The energy-driven surge in inflation and the prospect of energy supply cuts or restrictions through the winter already heavily weigh on consumer and business sentiment, as well as on spending and investment. Switzerland stands out for the moment but will not be spared by Europe's woes.

China is struggling with Covid resurgences and turbulences on the real estate market. Monetary policy easing tries to soften the blow ahead of the Party Congress.

Slowing global growth and a rising US dollar weigh on most Emerging Market economies' growth prospects, even if some (Brazil, India, commodity exporters) show signs of resilience.

With regards to inflation, the increase in prices hits double-digit figures in Europe due to the energy crisis. Peak inflation is (probably) behind in the US, but not in Europe where energy could push inflation rates in double digit territory. Going forward, we expect inflation to be significantly above central bank's target in the US and Europe. Upward wage dynamics remain in the US and Europe and central banks need to see some inflexion here to be able to consider a "pivot". Asia is facing a milder inflation environment.

Overall, medium-term expectations are declining on global growth slowdown and determined central banks. Nevertheless, we still view the mix of declining growth and still elevated inflation as being negative for risk assets.

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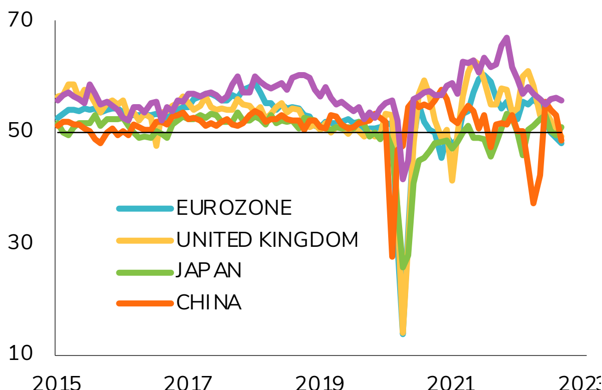


Source: Banque Syz, FactSet

Indicator #2
Liquidity: **Negative**

Central banks remain firmly on the path of rate hiking. To regain control on inflation dynamic, and preserve its credibility, the Fed has no choice but to tighten monetary policy until there are clear and tangible signs of a reversal in inflation dynamics.

If there is to be a pivot, it could rather be in Europe given the looming recession. Indeed, a recession (and corresponding fall in domestic demand) would dampen underlying inflationary trends. It seems imminent in Europe, not yet in the United States.

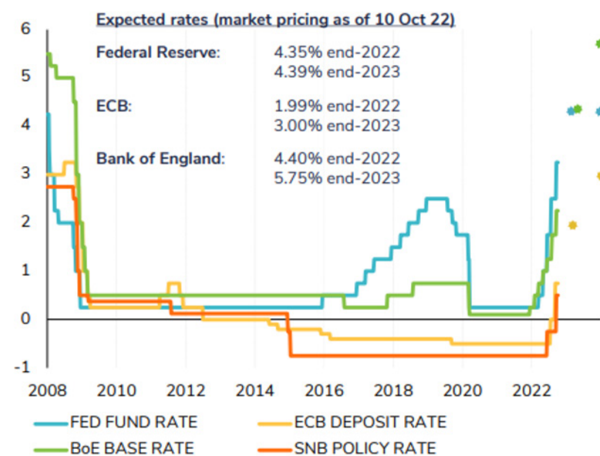
Still, despite the elevated recession risk in Europe, the ECB has to hike for the moment. Indeed, wage dynamics are also on the rise in Europe, indirectly supported by fiscal intervention. And monetary policy normalization has barely started yet as the ECB is behind the curve.

Central banks are, at the same time, fighting existing inflationary trends and trying to offset the impact of fiscal interventions. Monetary policy is getting tighter across all economies, with higher rates and withdrawn liquidity. As seen in the UK, the more the government support its economy with fiscal spending, the more the central bank has to hike rates.

Overall, the liquidity environment remains negative for risk assets as most developed markets are facing more rate hikes, quantitative tightening and global liquidity reduction.

Central banks are firmly on the path of hike

Key central bank rates and market-implied levels for end-2022 and end 2023



Source: Banque Syz, Bloomberg

Indicator #3
Earnings growth: **Neutral**

In the second quarter of 2022, 75% of S&P 500 companies reported a positive earnings per share surprise and 70% of S&P 500 companies surprised positively on the revenue front (source: Factset). However, growth momentum is weakening. For the quarter, the aggregate earnings growth rate for the S&P 500 is 6.3%. This is the lowest earnings growth rate since Q4 2020 (4.0%).

After reaching a record high of 13.5% in Q2 2021, S&P 500 profit margins have fallen back to 10.9% in Q2 2022 as sales

growth has slowed and companies find it harder to pass on higher costs to their customers. On the positive side, we note that balance sheets remain solid as well and companies have room for more share buybacks. Earnings revisions in Europe are holding up much better than PMIs would suggest. But for how long?

While Q3 US earnings estimates have been revised downward quite aggressively over the last few weeks, 2023 expectations remain too optimistic. As such, we continue to see earnings growth as being a mild tailwind for equities but still believe that some downward earnings growth revisions should act as a headwind for equities in the months ahead.

US 12 month forward EPS during past recessions

MSCI US 12m Fwd. EPS

Recession year	Peak date	Trough date	Peak to trough move
1990	Jan-91	May-91	-14%
2001	Aug-00	Nov-01	-23%
2008	Oct-08	Apr-09	-40%
2020	Mar-20	Sep-20	-15%
Average			**-23%**
Median			**-19%**
Current	**At peak**		

Source: J.P. Morgan

Indicator #4

Valuations: **Neutral**

Global equity valuations have de-rated this year. The S&P500 multiple has de-rated by the same magnitude as seen in previous recessions. The 10Y real yield is critical, because for the S&P 500 P/E ratio to rise, the 10Y real TIPS yield must fall. On a relative basis, Equity Risk Premium is a headwind now, as it has probably reached a bottom. Overall, this indicator remains NEUTRAL. Equity markets are less expensive than last year but they are not cheap either.

The S&P500 multiple has de-rated by the same magnitude as seen in previous recessions

US 12m forward P/E during past recessions

Recession	Peak	Trough	MSCI US peak to trough move	12m Fwd P/E at MSCI US peak	12m Fwd P/E at MSCI US trough	Move in MSCI US 12m Fwd P/E from peak to trough
1990	Jul-90	Oct-90	-20%	12.8	10.4	-19%
2001	Mar-00	Oct-02	-51%	25.7	13.8	-46%
2008	Oct-07	Mar-09	-56%	15.4	10.4	-32%
2020	Feb-20	Mar-20	-34%	19.6	13.2	-33%
Average			**-40%**	**18.4**	**12.0**	**-33%**
Current	**Dec-21**	**Sep-22**	**-25%**	**22.4**	**15.8**	**-29%**

Source: JP Morgan

Indicator #5

MARKET DYNAMICS: **Neutral**

Our market dynamic indicators remain neutral. The S&P 500 trend remains negative with the 200-day moving average falling and while the price remains below the 200-day moving average. This signal continues to show that the long-term bull trend has been broken and that we remain in a bear market of lower lows and lower highs. The rate of change is very negative as well. Market breadth (e.g percentage of stocks trading above their 200 days moving average) hasn't improved recently. The US Bull-Bear ratio is negative as well. There is a high percentage of bears but we don't see any turnaround yet. The picture is roughly the same with MACD and Put-Call ratio: there are oversold but there is still no signs for these ratios to revert their trend. We note that volatility has been picking up lately but hasn't reached extreme levels. From a geographic point of view, indicators are more favorable for US equities than for European stocks.

Asset Class Preferences

Equity allocation

Unattractive

Risk assets are facing several headwinds; high inflation and rising rates which are weighing on global growth (with Europe already into an energy crisis), China reopening hampered by Covid and geopolitical tensions and high political uncertainty (US Mid-term elections, shockwaves in Europe from the war in Ukraine and sanctions on Russia). Meanwhile, fiscal intervention tries to cushion the blow from rising energy prices but given the high level of indebtedness of most developed countries, it seems that the market is less willing to finance fiscal deficits than in the past. As mentioned earlier, seasonality is becoming a positive for the rest of the year. But overall, the weight of the evidence leads us to keep our "unattractive" view on equities.

From a regional point of view, we are upgrading the UK to cautious (from Unattractive). We believe UK large cap Equities (FTSE 100) are attractive despite the recent turmoil caused by the new government's fiscal policy announcements. This segment is essentially composed of exporters, as 70% of FTSE 100 earnings are derived from outside the UK. Therefore, these exporters are not as impacted by the policy uncertainty and benefit from a weaker GBP. Besides, UK equities are trading at a record discount to other Developed Markets regions which we believe more than compensate current troubles. Our stance on the other regions remain unchanged.

In terms of sectors, we are reducing Information Technology to Neutral. We confirm our overweight stance on Energy and Health Care, and we are still underweight in Utilities and Real Estate.

Fixed income allocation

Cautious

We keep a cautious "cautious" stance on Fixed Income, including on rates. Indeed, sovereign bond yields are rising across the board, as markets price higher central bank rates (i.e higher real rates) amid continuing inflationary pressures. Inflation expectations edge lower as the Fed and the ECB appear credible in their anti-inflation stance, and downside risks on growth reduce concerns of a sustained inflationary dynamic. Absolute yield levels remain supported by inflation and hawkish central banks; the bright spot remains the short end as the U.S. yield curve is deeply inverted. Within Government bonds, we do have a preference for USD over EUR where ECB needs to catch-up and energy-driven inflation is surging.

As for credit, we keep our cautious stance. Investment Grade offers attractive absolute yields in USD and already prices a lot of bad news in EUR, but macroeconomic headwinds on growth and rates balance the improvement in valuations. The situation is similar for High Yield credit, that offers attractive yields but where spreads are not at extreme levels of cheapness.

Emerging Market Debt in USD are attractive in relative terms. Emerging Market Debt in local currency are not far from attractive levels. Nevertheless, we remain cautious on Emerging Markets bonds. Overall, valuations are attractive but flows remain negative. Emerging market companies are used to dealing with high inflation and a strong dollar (2013 experience). EM Local debt has become more attractive as EM central banks tighten their monetary policy. Their aggressive strategy is starting to pay off (see lower inflation in Brazil).

We remain positive on subordinated. This matured and resilient asset class offers premiums despite solid capital position. Valuations remain cheap due to growth concerns. Fundamentals benefit from rising interest rates.

Commodities

Positive overall. Keeping 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 sees 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. And unlike in 1973, it's not just the price of oil, but the price of everything that is surging. 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. We are thus positive on broad commodities. We keep our preference stance on Gold. Rising USD real rates continue to weigh on Gold prospects, but it can remain a potential inflation hedge and a safe haven in a highly uncertain environment.

Hedge Funds

Very 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 are positive on equity hedge with low net exposure and a trading approach. We are also positive on macro and CTA.

Forex

The US dollar remains supported by yield differentials

Euro remains in a downward trend due to the ongoing energy crisis in Europe and the Fed resolute hawkish stance. The surge in energy prices and concerns around winter supply weight on EUR prospects from several angles: macroeconomic growth prospects, inflation, interest rate differentials, external balance, flows of funds. The ECB is between a rock and a hard place, and fast rate hikes might not even be sufficient, especially as the Fed keeps hiking

The Swiss franc is temporarily overwhelmed by the dollar's strength, but the downside is nevertheless limited due to real rate differential and sound fundamentals. Fundamental drivers plead for a firm Swiss Franc over the medium term. Flight to safety from European assets is a powerful support. But faster Fed rate hikes than the SNB are supporting the USD in the short-run.

The sterling faces continuing downside risk as inflation surges and fiscal policy gets wild. The surge in energy prices and concerns around winter supply weighs on GBP prospects from several angles: macroeconomic growth prospects, inflation, interest rate differentials, external balance, flow of funds. The recent hawkish stance of the BoE is more than counterbalanced by the programme of new PM Liz Truss, a huge fiscal support to households and businesses

From a fundamental standpoint, the yen's additional downside risk is limited. However, the Japanese currency remains under pressure as long as the BoJ does not move. Growth momentum and monetary policy differentials continue to weigh on the yen vs the US dollar, the peak «rate differential» depends on the Fed as the BoJ is not inclined to move for the moment.

Cross-asset correlations and volatility

The bond/equity correlation is in positive territory, implying no diversification in multi-asset portfolios. Volatility creeps higher in equity markets, without large spikes. Volatility remains high on bonds markets.

Rolling 120d correlation between S&P 500 and 10 year Treasury yield has fallen to lowest (most negative) since 2006, i.e correlation between #bonds and equities is at the highest level since 2006

Source: Bloomberg

Tactical positioning: our asset allocation matrix

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

Source: Investment strategy group - 12 October 2022

Change from last month

→ More attractive

← Less attractive

For further information

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