ASSET ALLOCATION INSIGHTS

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Downgrading credit from attractive to positive

Last week we decided downgrade equities from positive to cautious. Indeed, our view is that the aftershock of the Fed's policy tightening is starting to be felt in the financial system and the wider economy. We believe that we have entered yet another period of uncertainty which should lead to an Equity Risk Premium re-rating.

This week, we are further de-risking portfolios by downgrading credit from attractive to positive.

Charles-Henry Monchau *Chief Investment Officer*
Adrien Pichoud *Chief Economist & Senior Portfolio Manager*
Luc Filip *Head of Discretionary Portfolio Management*

PRIVATE BANKING

The recent developments in the US and European financial sectors have increased the risk of a faster-than-expected deterioration in macro dynamics, as well as the risk of financial stress. Those risks, if materialized, could fuel equity and bond volatility but also put upward pressures on credit spreads in the weeks and months ahead.

We however note that the swift central bank intervention on both sides of the Atlantic last week and the improvement in valuations due to the widening spreads imply that Investment Grade credit continues to offer value for the yield level it provides, especially for good quality issuers (A-rated and above) that would be less at risk of significant repricing in a risk-off scenario.

The combination of a less favourable macro environment but supportive valuations in the higher quality spectrum warrants an adjustment of our preferences on credit to reflect a more uncertain environment.

As such, we are further de-risking portfolios by downgrading our stance on credit from attractive to positive. We are downgrading Investment Grade Credit from Attractive to Positive, High Yield Credit from Cautious to Unattractive and Subordinated Debt from Positive to Cautious.

The big picture

The collapse of Silicon Valley Bank (SVB), the largest bank failure since the 2008 financial crisis, and the fallout of Credit Suisse have raised concerns about potential contagion and a broader banking crisis. But so far, the US government's quick response in guaranteeing that deposits will remain available and the quasi bailout of Credit Suisse have been able to stabilize markets and prevent a broader bank run. Central banks have been sticking to their plans as the ECB, The Fed, SNB and BoE raised rates in line with expectations while signalling they are ready to provide ample liquidity to the financial system if needed.

So what's next?

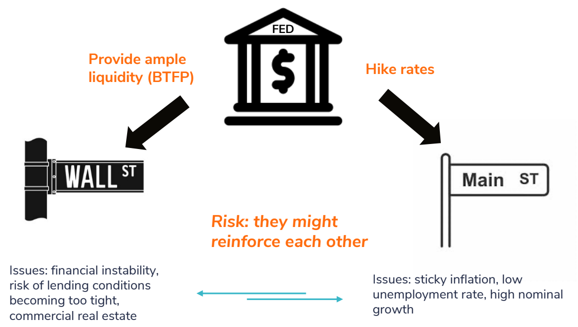
First, we do not believe that this is a systemic event similar to 2008. This financial event was serious enough for authorities to intervene but should not involve the largest banks. Generally speaking, the banking sector is well capitalised. The BTFP (Bank Term Funding Program) announced by the Fed and the Treasury will allow banks to fund deposit outflows without crystallising losses on depreciated assets by pledging them to the Fed instead. This should lower contagion risks. It can even be seen as a disguised Quantitative Easing.

Second, there is the risk that this is NOT the final "breakage" during this hiking cycle. Looking back at history, central banks hike rates until something breaks. The UK liability-driven-investments (LDI) crisis last Summer was the first episode. The SVB and Credit Suisse crises came next. But a bigger crisis (a larger bank, hedge funds, commercial real estate, etc.) could still be around the corner.

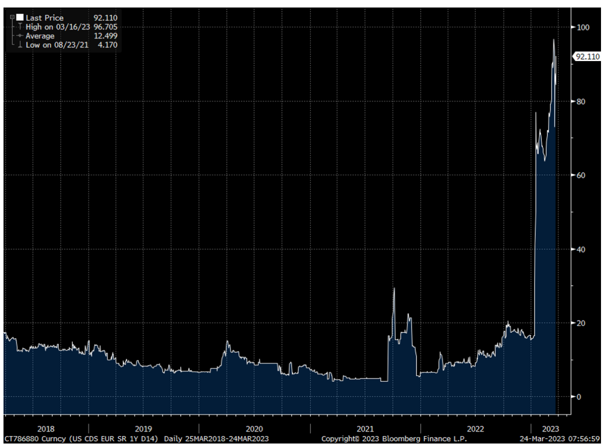
Third, SVB's failure will exacerbate headwinds facing the tech sector and make funding start-ups much more difficult. Higher rates and changing spending patterns post-pandemic were already problematic for the sector, and this knock to confidence won't help. The FDIC rescue plan which seeks to protect uninsured depositors should prevent a collapse though. But the cost of capital is expected to increase while some States (e.g California) reliant on innovation and new technologies are likely to suffer.

Fourth, this financial event makes the life of the Fed even more difficult. The US "macro" issue is not an overleveraged sector or financial excess. It is a too tight labour market which keeps service inflation way above the Fed's target. The only way out is trough higher interest rates. Let's keep in mind that the Fed needs to address the current realities of economic data: US nominal GDP still running at 7.5%, a 3.6% unemployment-rate, headline CPI YoY running at 6.0% and core CPI less shelter MoM number at its highest level since September. As of now, it looks like the Fed is splitting the monetary policy (tightening) and financial stability (BTFP easing tool). On paper, this looks ideal. But there is a risk of one policy putting at risk the other and vice versa. If the BTFP works, the FOMC should be able to continue hiking rates; this could create more troubles for the weakest link of the economy and thus the smaller banks. If the program doesn't work, we might see more failures (leading to a recession) which will force the Fed to abandon monetary policy tightening at the cost of seeing inflation staying too high for too long (as the disinflationary impact will not take place immediately). There is thus a risk for the Fed to face a "heads I lose, tails you win" type of scenario...

A new roadmap: Central banks are likely to split the monetary policy (tightening) and financial stability (BTFP easing tool), i.e QE for markets but QT / tightening for anyone else...



Finally, the SVB "bailout" might pull the debt ceiling X date forward. A big $40b payment was made out of the Treasury for the FDIC. While the Treasury is denying that the expenditure will impact the debt ceiling X date, it didn't say why. Pulling forward the X date could create more volatility on equity markets. This stress is by the way reflected in the US CDS which keeps rising (see chart below).



Source: Bloomberg

Indicators review summary

Our tactical asset allocation process is based on five indicators.

Macro & Fundamental Factors
(Leading indicators)

→ Macro-economic cycle:
POSITIVE

→ Liquidity:
NEGATIVE

→ Earnings growth:
NEGATIVE

→ Valuations:
NEUTRAL

Market Factors
(Coincident indicators)

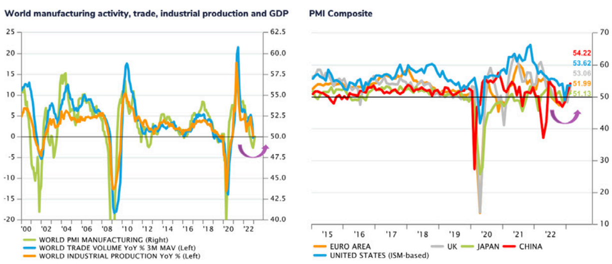
→ Market dynamics (Breadth, Sentiment, etc.):
NEUTRAL

Indicator #1

Macro-economic cycle: **Positive**

Our core scenario remains a soft-landing of the global economy, with positive short-term momentum (fuelled by a resilient US consumer, European rebound and China reopening), higher nominal growth prospects but rising downside risks on the back of the financial events which have been taking place since last week. The disinflationary process has started but it will likely take time, as parts of the economy still experience inflationary pressures (see yesterday's data in the US).

Global growth momentum is positive (at least temporarily) on the back of a mild European winter, US resilience and China reopening.



Source: Banque Syz, FactSet

Indicator #2

Liquidity: **Negative**

The global rate hike cycle is not over yet as central bankers have to ensure domestic inflationary pressures cool down. The failures of SVB and Signature have been sharply tightening financial conditions. Any contagion of these events to the rest of the financial sector might force the Fed to pivot much earlier than expected. As such, monetary policy could turn neutral or positive very quickly. But it would probably happen because macroeconomic growth prospects would be expected to deteriorate sharply (aka recession risk).

Indicator #3

Earnings growth: **Negative**

Earnings growth dynamics remain negative, with further downside risk in case of financial contagion.

Indicator #4

Valuations: **Neutral**

Attractive outside the US but 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.

Indicator #5

Market dynamics: **Neutral**

Our market dynamic indicators are still Neutral but with a clear deterioration over the last month. Market breadth (participation to the upside of the broad market) has been deteriorating over the last few weeks. We note that the trend could quickly turn negative again as the US market is close to breach some key levels (watch the 200 days moving average).

Overall, the deterioration of market dynamics and the downside risk to the macro pillar (not yet compensated by an improvement on the monetary policy pillar) leads us to downgrade our preference on equities.

Asset Allocation decisions

We believe that we have entered a new period of uncertainty, which should lead to an Equity Risk Premium re-rating. A week ago, we downgraded equities from positive to cautious. This week, we are further de-risking portfolios by downgrading our stance on credit from attractive to positive. We are downgrading Investment Grade Credit from Attractive to Positive, High Yield Credit from Cautious to Unattractive and Subordinated Debt from Positive to Cautious. We remain cautious on Government bonds but are adding a small position in high duration US Treasuries as a "tail hedge". We remain positive EUR and JPY versus USD, positive Gold and maintain our attractive view on Commodities and Hedge Funds.

Tactical positioning: our asset allocation matrix

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

Source: Investment strategy group - 20 March 2023

Change from last month

→ More attractive

← Less attractive

For further information

Banque Syz SA
Quai des Bergues 1
CH-1201 Geneva
Tel +41 58 799 10 00
Fax +41 58 799 20 00
syzgroup.com

Charles-Henry Monchau, Chief Investment Officer
charles-henry.monchau@syzgroup.com

Adrien Pichoud, Chief Economist & Senior Portfolio Manager
adrien.pichoud@syzgroup.com

Luc Filip, Head of Discretionary Portfolio Management
luc.filip@syzgroup.com